UNITED STATES TAX COURT

WASHINGTON, DC 20217

LAUREL ALTERMAN & WILLIAM A. GIBSON, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent	Docket No. 13666-14.

ORDER

We admit Exhibit 1-R, Exhibit 2-R, Exhibit 14-J, Exhibit 39-J, and the testimony of Revenue Agent Tipton. We exclude the testimony of Henry C. Levy, including his expert report marked as Exhibit 55-P.

1. Exhibits 1-R and 2-R

Respondent offered Exhibits 1-R and 2-R. These are the 2008 and 2009 joint federal income-tax returns filed by petitioners. Petitioners object to the admission of these returns on relevancy grounds.

Evidence is relevant if it has any tendency to make a fact of consequence more or less probable than it would be without the evidence. Fed. R. Evid. 401. Petitioners argue that their 2008 and 2009 returns are irrelevant because these years precede the years at issue, which are 2010 and 2011. We think the 2008 and 2009 returns are relevant for at least two reasons.

First, the returns for 2008 and 2009 were prepared by Mark Pendleton, who also prepared the 2011 return. One of the issues in this case is whether petitioners should be penalized for improperly preparing their 2011 tax return. Petitioners argue that they had reasonable cause for any underpayment for 2011 because they relied on Pendleton to correctly prepare the 2011 return. The 2008 and 2009 returns shed light on Pendleton's role in preparing petitioners' tax returns and are therefore relevant to petitioners' liability for the penalty for 2011.

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Second, one of the issues before the Court is the cost of goods sold of Altermeds, LLC, a medical-marijuana business owned by petitioner Laurel Alterman. Petitioners argue that the cost of goods sold reported on their 2010 return is correct as to non-marijuana and marijuana merchandise purchased by Altermeds, LLC from third parties. Cost of goods sold for a particular tax year depends on calculations of cost of goods sold for prior years. Cost of goods sold is given by the following formula:

Cost of good sold	=	Cost of beginning inventory	+	Cost of acquisitions (both through production and purchases)	-	Cost of ending inventory

See Huffman v. Commissioner, 126 T.C. 322, 324 (2006), aff'd, 518 F. 3d 357 (6th Cir. 2008). Thus, the cost of goods sold for 2010 depends on the cost of inventory at the beginning of 2010. The cost of inventory at the beginning of 2010 is identical to the cost of inventory at the end of 2009. Because cost of goods sold for 2010 depends on the cost of ending inventory for 2009, and because petitioners urge the Court to adopt the cost of goods sold reported by them on their 2010 return, it is helpful for the Court to understand how they computed cost of goods sold on their 2010 return, which in turn depends on how they computed cost of goods sold on their 2009 return. The 2009 return is therefore relevant to the appropriate cost of goods sold for 2010.

Exhibits 1-R and 2-R are admissible.

2. Exhibit 14-J

Respondent offered Exhibit 14-J, petitioner Laurel Alterman's July 2010 application to the State of Colorado for a license to grow medical marijuana. Petitioners object on relevancy grounds.

The application contains information concerning Altermeds, LLC's marijuana-growing facility, known as the "grow site", where it grew some of the marijuana that it sold. The information on the application is relevant to the appropriate cost of goods sold allowances for self-grown marijuana for the two years at issue.

Exhibit 14-J is admissible.

3. Exhibit 39-J

Respondent offered Exhibit 39-J, Altermeds, LLC's application to the City of Boulder to approve the grow site. Petitioners object on relevancy grounds.

The grow-site application reflects the dates and types of inspections that were conducted by the City of Boulder at the grow site. The document sheds light on the timing of Altermeds, LLC's improvements to the grow site, and thus it is relevant to the appropriate cost of goods sold allowances for self-grown marijuana for the two years at issue.

Exhibit 39-J is admissible.

4. Testimony of Revenue Agent Tipton

IRS Revenue Agent Tipton audited petitioners. He later computed the amounts that respondent conceded as cost of goods sold. The conceded amounts include amounts for both marijuana grown by Altermeds, LLC at the grow site and marijuana merchandise purchased by Altermeds, LLC from third parties. Tipton testified as to how these conceded amounts were computed. Petitioners contend that Tipton's testimony is irrelevant because it goes behind the notice of deficiency.

As part of this case, we must evaluate petitioners' claim that they are entitled to cost of goods sold greater than the cost of goods sold conceded by respondent. Tipton's testimony allows us to determine how respondent calculated cost of goods sold conceded by respondent after trial. In particular, Tipton explained how the amounts of the concession relate to certain depreciation and section 179 deductions claimed by petitioners on their tax returns and allowed by the notice of deficiency. We will rely on Tipton's testimony only for the purpose of determining the effect of respondent's concession.

Under these circumstances, Revenue Agent Tipton's testimony is admissible.

5. Testimony of Henry C. Levy

Petitioners offered a report by Henry C. Levy as his expert testimony under Rule 143(g) of the Tax Court Rules of Practice & Procedure (hereafter referred to as the Tax Court Rules). Tax Court Rule 143(g) permits the Court to admit the report of an expert witness as his or her direct testimony. Before trial, respondent filed a motion in limine objecting to the admissibility of Levy's report. The Court deferred ruling on the motion in limine. At trial, the Court permitted Levy to give additional testimony solely as an offer to proof. Respondent objected to his oral testimony. The Court deferred ruling on the admissibility of Levy's oral testimony. Thus, the Court has not yet resolved the admissibility of (1) Levy's report or (2) Levy's oral testimony.

Whether either of these forms of Levy's testimony (his report and his oral testimony) are admissible depends on the application of Fed. R. Evid. 702. This rule provides:

> A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:
>
> (a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;
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> (b) the testimony is based on sufficient facts or data;
>
> (c) the testimony is the product of reliable principles and methods; and
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> (d) the expert has reliably applied the principles and methods to the facts of the case.

The admissibility of Levy's testimony also depends on Tax Court Rule 143(g). This rule provides in part:

> (1) [A]ny party who calls an expert witness shall cause that witness to prepare a written report for submission to the Court and to the opposing party * * *. The report, prepared and signed by the witness, shall contain:

(A) a complete statement of all opinions the witness expresses and the basis and reasons for them;

(B) the facts or data considered by the witness in forming them;

* * *

(2) * * * An expert witness's testimony will be excluded altogether for failure to comply with the provisions of this paragraph, unless the failure is shown to be due to good cause and unless the failure does not unduly prejudice the opposing party, such as by significantly impairing the opposing party's ability to cross-examine the expert witness or by denying the opposing party the reasonable opportunity to obtain evidence in rebuttal to the expert witness's testimony.

Petitioners contend Levy is an expert in accounting and in tax return preparation for marijuana dispensaries. We need not determine whether Levy is qualified as an expert in these fields. Even if he is so qualified, his testimony does not satisfy Fed. R. Evid. 702(a), (b), and (c), and Tax Court Rule 143(g).

For purposes of analyzing its admissibility, Levy's testimony can be divided into three parts:

- First, Levy opined that Altermeds, LLC's cost of goods sold reported on the returns for 2010 and 2011 should be increased by its costs of growing marijuana paid in each respective year. Levy estimated these increased amounts. With these increases, the costs of goods sold were, in Levy's view, $691,663 in 2010 and $462,736 in 2011.

- Second, Levy opined that the ratios between his cost of goods sold calculations to Altermeds, LLC's gross receipts for each year, 77% in 2010 and 70% in 2011, were "completely consistent with the hundreds of tax returns we [i.e., he and his accounting firm] have prepared over the past 17 years."

- Third, Levy opined that Altermeds, LLC paid $51,727 of expenses in 2010 and $62,377 of expenses in 2011 in categories of business-expense deductions that are outside the scope of section 280E (which disallows deductions for expenses of a business consisting of illegal

trafficking in controlled substances).[1] The expenses that Levy included in his estimates were the costs of selling non-marijuana merchandise, the cost of complying with the law, and the costs of counseling patients on what type of marijuana to buy.

We analyze each of these three parts of Levy's testimony in turn.

a. Levy's cost of goods sold computations for 2010 and 2011

Levy determined the cost of goods sold for each year by aggregating (1) the cost of growing marijuana paid in the year, and (2) the cost of purchasing merchandise (both marijuana and non-marijuana merchandise) paid in the year.

i. Cost of growing marijuana

(1) The facts and data underlying Levy's estimate of wage costs of growing marijuana

Levy's report does not discuss the facts and documents he used in forming his opinion as to the wage costs of growing marijuana. Levy opined that some of the wages paid to Altermeds, LLC's employees in 2010 and 2011 were costs allocable to the cost of producing self-grown marijuana merchandise. These amounts were calculated by Levy as $72,899 for 2010 and $151,947 for 2011. These amounts were intended to include amounts paid for labor at the grow site to grow marijuana. These amounts were also intended to include amounts paid to Altermeds, LLC employees to trim marijuana that was bought from third-party sellers into final, saleable form. The report did not provide an explanation of how much of each particular employee's wages made up Levy's allocable wage cost totals.

In preparing the report, Levy reviewed Revenue Agent Tipton's calculations of gross receipts, the gross receipts and other items reported on the tax returns, and Altermeds, LLC's general ledger for each year in issue. Levy did not independently verify the amounts of Altermeds, LLC's gross receipts. He did not review the check register for each year in issue. He did not speak directly to any

[1]All section references are to the Internal Revenue Code of 1986, as amended.

of Altermeds, LLC's employees or petitioner Laurel Alterman. What Levy knew of Altermeds, LLC's business activities he learned through petitioners' counsel. Petitioners' counsel directed Levy's questions to petitioner Laurel Alterman and reported her answers back to Levy. Levy compiled the information he learned in this manner with other information into a worksheet and used the worksheet to arrive at the allocable wage costs. He did not attach the worksheet to his report. We hold the report does not comply with Tax Court Rule 143(g)(1)(B), as it failed to include the facts Alterman provided to Levy through counsel and which Levy used in forming his opinion regarding wage costs. For example, the report failed to include the worksheet Levy used. Levy's failure to include the facts regarding wage costs also causes us to conclude that his testimony regarding wage costs is based on insufficient facts and data under Fed. R. Evid. 702(b) and his method of calculating wage costs is unreliable under Fed. R. Evid. 702(c).

(2) Cost of self-grown marijuana for category of expenses other than wages

Levy's report does not specifically explain why he considered a particular non-wage expense to be allocable to the cost of self-grown marijuana paid during each respective year (a cost he considers to be cost of goods sold for that particular year). For example, his report stated that, of $119,639 claimed on the 2010 return for depreciation and section 179 expenses, $99,398 of that $119,639 amount is allocable to the cost of self-grown marijuana. The report did not itemize the specific expenses that constituted the $99,398. Levy's oral testimony did not explain the point either. Indeed, his oral testimony showed that his allocation of depreciation was fundamentally flawed because he did not amortize depreciation over multiple years. His oral testimony also confirmed that his calculation of depreciation and section 179 expenses was not based on reviewing any receipts for the expenses.

Levy's report similarly lacks an explanation for all other categories of expenses, not just depreciation and section 179 expenses discussed in the paragraph above, that make up his calculation of the cost of self-grown marijuana.

We conclude that in these respects Levy's method of calculating cost of goods sold is not based on sufficient facts and data and is unreliable. See Fed. R. Evid. 702(b), (c).

ii. Cost of merchandise: Levy's total cost of goods sold calculations assumed that the tax returns correctly reported the cost of the merchandise purchased from third parties

Levy used cost of goods sold amounts reported on petitioners' Schedules C for both years as the cost of merchandise purchased from third parties. He added these amounts to his computations of costs of growing marijuana to arrive at total cost of goods sold for each year. Thus, in this respect, Levy's report assumes that the amounts reported on a tax return are correct. Such an assumption is an unreliable method of calculating costs and is based on insufficient facts. Levy's reliance on the amounts reported on the tax returns is especially problematic in this case because, even though Levy examined the general ledger, he did not account for the discrepancy between the amounts recorded in the general ledger for merchandise purchased from third parties and the corresponding amounts reported on the returns. Levy's opinion of this component of cost of goods sold with respect to purchased merchandise is not based on sufficient facts and data and is not the product of reliable principles and methods. See Fed. R. Evid. 702(b), (c).

iii. Levy's cost of goods sold calculations ignore beginning and ending inventories

Levy's calculations of cost of goods sold were aimed at calculating the costs paid to purchase and produce merchandise during each respective year (2010 and 2011). At most, such a calculation is relevant to the acquisition costs of merchandise during a particular year. Take, for example, the year 2010. The cost of goods sold for 2010 depends on three variables: (a) beginning inventory plus (b) acquisition cost minus (c) ending inventory. These are three separate variables. Levy's calculations are aimed at establishing only one variable, acquisition cost. Levy did not establish the other two variables: beginning inventory and ending inventory. Thus, Levy calculated the cost of goods acquired during 2010, not the cost of goods sold during 2010.[2] Levy's method of

[2]There are certain assumptions under which acquisition cost is indeed equal to cost of goods sold. This equality would occur, for example, if business operations remain stable from year to year. Levy did not show that Altermeds, LLC's business operations were stable. Indeed, the record suggests that its

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calculating cost of good sold is unreliable. His opinion on all components of cost of goods sold is inadmissible. See Fed. R. Evid. 702(c) (requiring expert testimony to be a product of reliable principles and methods).

b. Levy's comparison of his cost of goods sold calculations to the tax returns of other marijuana dispensaries

Using his calculation of costs of goods sold, Levy determined the ratio of cost of goods sold to gross receipts for Altermeds, LLC for each respective year at issue. He opined that these ratios were consistent with tax returns his accounting firm had prepared for medical-marijuana businesses. This analysis involving ratios is inadmissible for the reasons given below.

i. Levy failed to reliably determine gross receipts of Altermeds, LLC.

The accuracy of Levy's ratios of cost of goods sold to Altermeds, LLC's gross receipts depends on the accuracy of the amounts of Altermeds, LLC's gross receipts he used. Levy simply used the gross receipts amounts reported on petitioners' tax returns. He did not check to see if the gross receipts reported on the tax returns were consistent with the gross receipts stated in the general ledger. He also failed to ascertain whether the amounts stated in the general ledger for gross receipts were consistent with the amounts reported on the daily sales records that tracked Altermeds, LLC's daily gross receipts. Levy's failure to verify gross receipts means that his analysis of the consistency of the ratios is not based on sufficient facts and data. Fed. R. Evid. 702(b). Furthermore, it is not the product of reliable principles and methods. Fed. R. Evid. 702(c).

ii. Levy's use of data from other taxpayers' returns

Levy's report failed to include the information from other taxpayers' returns upon which he relied. This violates Tax Court Rule 143(g)(1)(B).

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[2](...continued)
business operations changed dramatically. Altermeds, LLC only began retail operations in 2009. It started growing its own marijuana in 2010 or 2011 (the exact year is disputed by the parties). Levy does not explain any other reason why acquisition cost should be the equivalent of cost of goods sold.

Furthermore, Levy did not indicate whether the tax returns on which he relied were Colorado medical-marijuana businesses like Altermeds, LLC. Levy's accounting firm is in California. Its clients are presumably California medical-marijuana businesses. Furthermore, Levy did not indicate whether the tax returns upon which he relied were from marijuana businesses that grew their own marijuana merchandise. Altermeds, LLC grew part of its own marijuana merchandise, as required by Colorado law. Thus, we conclude that Levy's opinion as to the consistency of the ratios is not based on sufficient facts and data. See Fed. R. Evid. 702(b).

It is true, as petitioners point out, that we admitted an expert report of Levy in Olive v. Commissioner, 139 T.C. 19 (2012), aff'd, 792 F .3d 1146 (2015). Olive explained that Levy had determined three specific ratios of cost of goods sold to gross receipts from three specific tax returns of his accounting firm's clients. The opinion stated the exact amounts of the three ratios used by Levy. Id. at 35. This suggests that more was known about the returns from other marijuana businesses in Olive than we know about the returns of other marijuana businesses relied on by Levy in this case. Further, the medical-marijuana business in Olive bought all of its marijuana merchandise from third-party sellers. 139 T.C. at 22-23. Altermeds, LLC grew some of its own marijuana merchandise. Further, in Olive another expert report regarding cost of goods sold ratios was available to us to test Levy's conclusions. Id. at 35. Because of these differences, we need not admit Levy's testimony merely because we admitted his expert report in Olive.

The portion of Levy's opinion evaluating the consistency of his cost of goods sold estimates with other returns is inadmissible because he did not reveal the information about the other returns under Rule 143(g)(1)(B). Also, the information about the other returns in the record is insufficient under Fed. R. Evid. 702(b) (testimony must be based on sufficient facts and data).

c. Levy's opinion as to the amounts of deductible business expenses

Levy gave his opinion on the amounts of deductible business expenses that were paid by Altermeds, LLC and that are outside the scope of section 280E. To various categories of expenses, Levy allocated amounts that he thought were deductible as business expenses and not related to marijuana trafficking. The report did not explain how Levy determined the allocable expense amounts in each category. His report classified some types of expenses as deductible in 2010, but not in 2011, without explaining why. We conclude that Levy's testimony

regarding deductible business expenses is not based on sufficient facts and data under Fed. R. Evid. 702(b) and is not the product of reliable principles and methods under Fed. R. Evid. 702(c).

On this issue, much of Levy's report consists of his opinion about what types of expenses are outside the scope of section 280E. Expert witnesses may testify about facts, not law. Fed. R. Evid. 702(a); Hosp. Corp. of Am. v. Commissioner, 109 T.C. 21, 59 (1997); Alumax, Inc. v. Commissioner, 109 T.C. 133, 171 (1997), aff'd, 165 F.3d 822 (11th Cir. 1999); Stobie Creek Invs., LLC v. United States, 81 Fed. Cl. 358, 364 (2008).

d. Conclusion

The expert report by Levy and his proffered oral testimony are not admissible under Fed. R. Evid. 702 and Tax Court Rule 143(g). As the table below shows, all parts of the Levy's testimony are inadmissible, usually for multiple reasons:

Part of Levy's testimony	Subparts of Levy's testimony		Rule relied on by the Court in excluding testimony
a. Costs of goods sold is equal to amounts reported on returns plus Levy's estimate of costs of growing marijuana	i. Levy's estimate of costs of growing marijuana	(1) Wage costs--missing facts and missing explanation	--Tax Court Rule 143(g)(1)(B) --Fed. R. Evid. 702(b) --Fed. R. Evid. 702(c)
		(2) Non-wage costs--missing explanation	--Fed. R. Evid. 702(b) --Fed. R. Evid. 702(c)
	ii. Tax returns correctly reported cost of merchandise purchases other than cost of growing marijuana--Levy did not verify these amounts		--Fed. R. Evid. 702(b) --Fed. R. Evid. 702(c)
	iii. Total cost of goods sold computations--Levy ignored beginning and ending inventories		--Fed. R. Evid. 702(c)
b. The ratio of cost of goods sold and gross receipts is consistent with other returns	i. Gross receipts for Altermeds, LLC are assumed to be the same as the amounts reported on tax returns--without verification		--Fed. R. Evid. 702(b) --Fed. R. Evid. 702(c)
	ii. Information from other tax returns--not included in report		--Tax Court Rule 143(g)(1)(B) --Fed. R. Evid. 702(b)
c. Amounts of deductible business expenses	Computations and allocations of these amounts--unexplained by Levy		--Fed. R. Evid. 702(b) --Fed. R. Evid. 702(c)
	Legal conclusions pervade this part of Levy's opinion		--Fed. R. Evid. 702(a).

6. Actions

It is

ORDERED that Exhibit 1-R, Exhibit 2-R, Exhibit 14-J, Exhibit 39-J, and the testimony of Revenue Agent Tipton, are admitted. It is further

ORDERED that respondent's motion in limine, filed November 24, 2015, is granted in that the testimony of Henry C. Levy, including his expert report marked as Exhibit 55-P, is excluded.

(Signed) Richard T. Morrison
Judge

Dated: Washington, D.C.
February 15, 2018