

Taxes Considerations for Cannabis Businesses

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Agenda

- Background
 - Section 280E Background
 - Litigation of Tax Issues
 - Business Structuring Considerations
- Cost of Goods Sold
 - Legal Background
 - Accounting Issues
 - IRS Audits
- State Taxes
- 8300 Reporting




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BACKGROUND




Section 280E Background

- *Edmundson v. Comm’r*, T.C. Memo 1981-623
 - Illegal drug trafficker was permitted to deduct his ordinary and necessary business expenses incurred in his illegal drug business
- Legislative history of Section 280E
 - There is a sharply defined public policy against drug dealing to allow drug dealers the benefit of business expense deductions at the same time that U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal, enterprises. Such deductions must be disallowed on public policy grounds.
 - To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective cost of goods sold is not affected by this provision of the bill.
 - S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 309.



Section 280E

- Expenditures in connection with the illegal sale of drugs.
 - No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of Schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.
- Proposals to change Section 280E



CCA 20150411

- How is COGS determined when a taxpayer is subject to Section 280E
- IRS says inventory rules in force when Section 280E was passed must be applied
 - Section 471, no Section 263A
- Section 471 is broad and generally favors capitalization
- Farmer methods should be permissible
- *Patients Mutual Assistance Collective Corp. v. Comm'r*, 151 T.C. No. 11 (Nov. 29, 2018)
- Section 471
 - Resellers: Cost + transportation and acquisition costs
 - Manufacturers/producers: Full absorption – all costs incident to & necessary for production



1996 Memo

- In a 1996 memo to President Clinton discussing legalization and how to preserve National Drug Control Strategy
 - Federal strategy to "blunt the negative consequences of the recent 'medical marijuana' Propositions in California and Arizona"
 - "IRS will continue to enforce existing Federal tax law as it relates to the disallowance of expenditures in connection with the illegal sale of drugs. To the extent state laws result in efforts to conduct sales of controlled substances prohibited by Federal law, the IRS will disallow expenditures in connection with such sales to the fullest extent permissible under existing Federal tax law."



LITIGATION OF MARIJUANA COMPANY TAX ISSUES



Challenges to IRS Enforcement

- *Feinberg v. Comm’r*, 808 F.3d 813 (10th Cir. 2015)
 - Taxpayer asserted Fifth Amendment privilege in response to IRS discovery requests, IRS filed motion to compel
 - Taxpayer seeks writ of mandamus in response to Tax Court order compelling discovery
 - Tenth Circuit held it could not rule because Taxpayer was not faced with irreparable harm
 - Court points out that Taxpayer has burden of proof so refusing to provide information IRS requests makes it hard to meet that burden



Challenges to IRS Enforcement

- *Alpenglow Botanicals, LLC v. U.S.*, 2016 WL 7856477 (D. Colo. 2016)
 - Action for declaratory, injunctive and monetary relief in response to IRS denial of deductions
 - Taxpayer asserts that IRS does not have jurisdiction to determine if taxpayer is violating CSA, that Section 280E violates the 16th Amendment, that IRS violated taxpayer’s 5th Amendment privilege, and that Section 280E violates the 8th Amendment
 - IRS filed motion to dismiss, Taxpayer filed motion for summary judgement



Challenges to IRS Enforcement

- *Alpenglow Botanicals, LLC v. U.S.*, 2016 WL 7856477 (D. Colo. 2016)
 - IRS has discretion to determine whether taxpayer is violating CSA, does not require a criminal investigation
 - Because there was no allegation that costs (i.e., cost of goods sold) permitted under the 16th Amendment had been denied, there was no 16th Amendment claim
 - IRS was making a tax based determination, not performing a criminal investigation, so there was no basis for a claim that their 5th Amendment rights had been violated
 - Taxpayer failed to assert facts to establish an 8th Amendment claim



Challenges to IRS Enforcement

- *Alpenglow Botanicals, LLC v. U.S.*, 894 F.3d 1187 (10th Cir. July 3, 2018)
 - Section 280E is not being used to bring criminal investigations, only to enforce tax laws. IRS has authority to enforce tax laws and IRS investigations do not result in self-incrimination in criminal matters.
 - Taxpayers have burden to show they are NOT trafficking after IRS determines they are. Challenge is proving a negative with credible evidence.
 - Congress can deny deductions and that denial is not a penalty.



Challenges to IRS Enforcement

- *The Green Solution Retail v. U.S.* (10th Cir. 2017)
 - Taxpayer filed injunction to prevent IRS from investigating its business records and declaratory judgment that IRS was acting outside its authority
 - IRS moved for dismissal based on lack of subject matter jurisdiction asserting the Anti-Injunction Act prevents the court from hearing the case and Declaratory Judgment Act prohibits declaratory judgments in certain federal tax matters
 - Courts agreed with IRS - AIA bars cases to restrain activities leading up to assessment of tax and DJA bars a ruling that the IRS is acting outside its authority
 - Cert. denied March 2018



Challenges to IRS Enforcement

- *High Desert Relief, Inc. v. U.S.* (D. N.M. 2016)
 - IRS issued summonses for bank records, department of health records, and utility company records
 - Taxpayer filed motion to quash summons
 - Application of Section 280E is not tantamount to criminal investigation
 - Applying *Powell* factors, court determined, based on affidavit of Revenue Agent, IRS had a legitimate purpose, the inquiry was relevant to the purpose, the information was not already in IRS possession, IRS followed proper administrative procedure, and that there was no DOJ referral
 - Affirmed, Tenth Circuit March 5, 2019



Cannabis Companies

- Other Challenges to IRS Summonses
 - *Futurevision v. U.S.*: District of Colorado
 - IRS issued summons to obtain documents from Colorado Marijuana Enforcement Division
 - No illegitimate purpose, *Powell* factors met
 - IRS awarded costs
 - *Rifle Remedies v. U.S.*: District of Colorado
 - IRS issued summons to obtain documents from Colorado Marijuana Enforcement Division
 - No illegitimate purpose, *Powell* factors met



Tax Court Litigation

- Application of Section 280E to state legal businesses
 - *Californians Helping to Alleviate Medical Problems, Inc. v. Comm’r*, 128 T.C. 173 (2007)
 - Taxpayer’s business involved extensive caregiving services other than providing marijuana; dispensary was 10% of facility; director testified secondary purpose was providing marijuana; more income was attributable to other services
 - *Olive v. Comm’r*, 139 T.C. 19 (2012), *aff’d* 792 F.3d 1146 (9th Cir. 2015)
 - Bad records; no income other than sales of marijuana; no separate trade or business
 - Treas. Reg. §1.183-1(d)(1); *Schlafer v. Comm’r*, T.C. Memo 1990-66



Tax Court Litigation

- *Feinberg v. Comm’r*, T.C. Memo 2017-211
 - IRS determination was upheld because taxpayer failed to provide proper substantiation for business expenses
 - Tenth Circuit affirmed (Feb. 26, 2019)
 - no Fifth Amendment privilege in IRS examination where no criminal investigation: taxpayers “must choose between providing evidence that they are not engaged in the trafficking of a controlled substance or forgoing the tax deductions available by the grace of Congress”
 - Cooperate during IRS examinations



Tax Court Litigation

- *Alterman v. Comm'r*, T.C. Memo 2018-83
 - Sales of non-marijuana products were 1.4% of gross receipts in 2010 and 3.5% of gross receipts in 2011
 - Taxpayer also deducted business expenses
 - Appears taxpayer did not disallow any expenses pursuant to Section 280E
 - Cost of goods sold claimed on the return was, for the most part, amounts paid for purchases of inventory and did not include production costs
 - At trial, the taxpayer asserted that it incurred over \$100,000 of production costs each year in addition to the amounts paid for purchases of inventory



Tax Court Litigation

- *Alterman v. Comm'r*, T.C. Memo 2018-83
 - Sales of non-marijuana products were complimentary to the sales of marijuana products and therefore, were not a separate trade or business
 - Section 471 applied and allows taxpayers to include direct and indirect production costs in cost of goods sold
 - Taxpayers failed to properly account for beginning and ending inventories and therefore, couldn't argue that cost of goods sold should be increased
 - Negligence penalty applied because taxpayer did not keep adequate records to compute beginning and ending inventories or adequate books and records
 - No reasonable cause because the taxpayers did not seek advice regarding inventory accounting or the application of Section 280E



Tax Court Litigation

- *Loughman v. Comm'r*, T.C. Memo 2018-85
 - Medical marijuana dispensary operated as S corporation
 - Taxpayer challenged disallowance of wages paid to shareholders which were not includible in COGS on the basis that because the income was double taxed on the shareholder's return Section 280E discriminated against S corporations
 - Taxpayers are "responsible for the tax consequences" of their decision to operate a marijuana business as an S corporation
 - Tax Court not sympathetic to inequities under Section 280E



Tax Court Litigation

- *Patients Mutual Assistance Collective Corp. v. Comm’r*, 151 T.C. No. 11 (Nov. 29, 2018)
 - California’s largest dispensary known as Harborside
 - In compliance with California regulations, patient members grew marijuana and sold it to the dispensary
 - Under California law, could not pay dividends or sell equity, so provided other services, such as natural therapies, yoga, etc. to patients for no additional cost
 - In 2012, was subject of civil forfeiture action for CSA violations, which was dismissed in 2016



Tax Court Litigation

- *Patients Mutual Assistance Collective Corp. v. Comm’r*, 151 T.C. No. 11 (Nov. 29, 2018)
 - Previous arguments re: separate trade or business, inapplicability of Section 280E to state licensed businesses, and inapplicability of Section 280E to cannabis business that had not been criminally prosecuted for violating CSA were unavailing
 - New holding: Section 263A does not apply to cannabis companies. Company was a reseller and must apply reseller regulations under Section 471
 - No penalties due to state of the law and good recordkeeping (T.C. Memo 2018-208)



Tax Court Litigation

- *Alternative Healthcare Advocates v. Comm’r*, 151 T.C. No. 13 (Dec. 20, 2018)
 - Alternative was C corporation, sold marijuana and non-marijuana products, claimed deductions other than COGS
 - Wellness Management Group, Inc. was in business of providing employees to dispensaries
 - S corporation, deductions for compensation, salaries and wages, rent, taxes and licenses, advertising, etc.; only customer was Alternative



Tax Court Litigation

- *Alternative Healthcare Advocates v. Comm’r*, 151 T.C. No. 13 (Dec. 20, 2018)
 - Alternative was trafficking, and so was Wellness who acted as agent for Alternative
 - Double disallowance of expenses was result of taxpayer’s structuring choices
 - Penalties applied: Taxpayer improperly relied on CHAMP even though facts were distinguishable, no evidence of reliance on accountant or tax professional



Eighth Amendment Considerations

- Is Section 280E an excessive fine or penalty?
- *U.S. v. Sanchez*, 340 U.S. 42 (1950)
 - Challenge to the Marijuana Tax Act on the basis that placed on the penal nature of the tax
 - “a tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activities taxed”
- *The Green Solution Retail v. U.S.*, 10th Cir, May 2, 2017: “Section 280E is not a penalty.”
 - See also *Alpenglow Botanicals, LLC v. U.S.*, 894 F.3d 1187 (10th Cir. July 3, 2018)



OTHER CONSIDERATIONS



Unbanked Taxpayers

- Taxpayers who do not have bank accounts and therefore cannot make electronic deposits will be relieved of Section 6656 penalties if:
 - Documentation showing ability to obtain bank accounts is submitted to the IRS on a periodic basis
 - Arrangements for cash deposits can be made
 - I.R.M. 20.1.4.26.1.1 (7-17-2015)



Structuring Analysis

- Flow through entities
 - Higher tax rate on Section 280E expense
 - Limited deduction for state taxes
 - Uncertainty on Section 199A
- C corporations
 - Reasonable comp
 - Accumulated earnings tax
 - For conversions, need to think about distribution of previously taxed earnings



Cannabis Companies

- Impact of Tax Reform
 - Flow through structures need to consider how Section 199A applies, consider whether restructuring makes sense
 - Changes to inventory rules for businesses with less than \$25,000,000 of gross receipts (Sections 448(c) and 471(c))
 - Exemption from Section 263A also applies to businesses with less than \$25,000,000 of gross receipts for prior three years




COST OF GOODS SOLD



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The Legal Problem


- Gross receipts vs. gross income
- Section 61(a)(3)
 - Section 280E
 - CCA 201504011
- What is cost of goods sold?
 - Section 471
 - Section 263A



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The Legal Problem

- Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.
- Gross receipts v. gross income
 - Difference is costs
 - What is a cost v. a deduction



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The Legal Problem

- Section 61(a)(3)
 - Gross income includes: “gains from dealings in property”
 - If you cannot sell a product for more than it cost you to create the product, you do not have gross income
 - Section 280E eliminates deductions other than cost of goods sold for marijuana business
 - Therefore, marijuana businesses are encouraged to maximize cost of goods sold and the IRS is constitutionally limited to taxing gross income (after the deduction for cost of goods sold)



The Legal Problem

- What is cost of goods sold?
 - The inclusion of only direct material and direct labor in cost of goods sold is “unacceptable for accounting and tax purposes” and therefore, indirect manufacturing expenses are required to be included in cost of goods sold. See Treas. Reg. § 1.471-2(f)(7); *All-Steel Equipment Inc. v. Comm’r*, 54 T.C. 1749 (1970) (where taxpayer’s method of accounting for cost of goods sold for financial reporting included only direct labor and materials, taxpayer was required to include an allocable portion of all manufacturing expenses in ending inventory).



The Legal Problem

- What is cost of goods sold?
 - Case law notes that “in a manufacturing operation ‘cost of goods sold’ is more difficult to determine since the items necessary to produce the salable article as distinguished from the other ordinary and necessary expenses of operating the business may not be easily ascertainable.” *Johnson v. Comm’r*, 42 T.C. 441, 444 (1964).
- What is the fight about?
 - Allocations of costs which are partially retail and partially production costs and how to allocate overhead costs such as accounting, legal, etc.



The Accounting Problem

- Cost accounting
 - Direct v. indirect costs
 - Variable v. fixed costs
 - Overhead costs
- Section 471 Regulations
- Financial Reporting and GAAP
- Section 263A



The Accounting Problem: Direct v. Indirect Costs

Direct Costs

- Growing medium
- Seeds
- Water
- Grow equipment
- Direct labor
- Plant tags

Indirect Costs

- Utilities
- Rent
- Licenses for production/cultivation
- Testing
- Compliance costs
- Repairs
- Quality control
- Indirect labor



IRS AUDITS



The IRS Audit

- Cash Based Businesses
- Determining Direct v. Indirect Costs
- Tax Return Confusion



Cash-Based Businesses

- Internal Controls – any cash-based business is closely scrutinized by the IRS and other taxing authorities. Having robust internal control procedures, in writing, which are strictly enforced, will go a long way in establishing credibility with taxing authorities. Use of cash logs and regular cash reconciliation processes are critical.
- Form 8300 requirements – educate yourself or hire an accountant who can work with you to comply with this filing requirement.



IRS Audits of Cash-Based Businesses

- Due to lack of banking, auditors have a hard time verifying receipts and expenditures
- Cash logs should be used to substantiate deposits and cash expenditures documented with receipts
- POS/Seed to Sale systems generally verify gross receipts on the return
- Cash expenditures are the real issue for marijuana businesses



Typical Section 280E Expenses Disallowed

- Dispensary rent
- Dispensary employees
- Dispensary FF&E
- Advertising and marketing



Reporting Issues

- Tax Return Confusion
 - Management company structure and implication of related entities in Section 280E activities
 - Direct and indirect costs not reported on cost of goods sold line
 - Disclosures on M-1s
- Expenses scrutinized by IRS
 - Packaging – generally, if done at dispensary
 - Security and regulatory compliance costs
 - Licenses



STATE TAXES



State Taxes

- Sales Taxes
 - Often lower or no sales tax on medical, sometimes depends on how state taxes prescription drugs
 - Often higher sales tax for recreational
- Excise Taxes
 - Some states apply to medical, some not to medical, most apply to recreational
- Income Taxes
 - Section 280E application at state level, can vary based on individual v. corporate structure (AK, NH, NJ, PA)



Fox Rothschild Cannabis Industry State Tax Guide



This Guide is designed to assist in tax compliance by providing quick access to the relevant tax provisions in the 50 states and the District of Columbia.

- The Guide contains two sections:
- a quick reference chart, which summarizes certain provisions by state
 - a state-by-state detailed reference guide

Available at:
<https://www.foxrothschild.com/publications/cannabis-industry-state-tax-guide/>



FINCEN FORM 8300 REPORT OF CASH PAYMENTS OVER \$10,000 RECEIVED IN A TRADE OR BUSINESS



Type of Payments Requiring Form 8300

1. The amount of cash is more than \$10,000, and
2. The business receives the cash as
 - One lump sum of more than \$10,000, or
 - Two or more related transactions that total more than \$10,000, and
3. The establishment receives the cash in the ordinary course of business, and
4. The same agent or buyer provides the cash



When and Where to File Form 8300

- Due Date: 15th day after the cash was received, next business day if Saturday, Sunday or holiday
- Can be filed online at: <http://bsaeiling.fincen.treas.gov/main.html>
- Can be mailed to:
 - IRS Detroit Computing Center
 - P.O. Box 32621
 - Detroit, MI 48232
 - (Certified, Return Receipt recommended)



Penalties for Failure to File

- Non-Willful Failures: \$270 penalty per Form 8300 not filed (2019 rate – adjusted annually)
 - \$3,339,000 maximum per year if business gross receipts are greater than \$5 million (reduced to \$1,113,000 for gross receipts less than \$5 million)
 - \$50 if failure is corrected within 30 days of due date
 - \$110 if corrected after 30 days but on or before August 1
- Intentional Failures
 - Includes intentional failure to timely file or an intentional failure to include correct information
 - Penalty is equal to the greater of \$27,820 or the amount of cash received up to \$111,000
 - Criminal penalties may also apply



Criminal Penalties

- Willful failures
 - \$250,000 for individuals
 - \$500,000 for corporations
 - 5 years in prison
 - Combinations of penalties and prison



Completing the Form – Part I

Part I Identity of Individual From Whom the Cash Was Received									
2 If more than one individual is involved, check here and see instructions <input type="checkbox"/>									
3 Last name			4 First name		5 M.I.		6 Taxpayer identification number		
7 Address (number, street, and apt. or suite no.)				8 Date of birth (see instructions)		9 M M D D Y Y Y Y			
9 City		10 State	11 ZIP code	12 Country (if not U.S.)		13 Occupation, profession, or business			
14 Identifying document (ID)	a Describe ID			b Issued by			c Number		



Completing the Form – Part II

Part II Person on Whose Behalf This Transaction Was Conducted									
15 If this transaction was conducted on behalf of more than one person, check here and see instructions <input type="checkbox"/>									
16 Individual's last name or organization's name			17 First name		18 M.I.		19 Taxpayer identification number		
20 Doing business as (DBA) name (see instructions)				Employer identification number					
21 Address (number, street, and apt. or suite no.)				22 Occupation, profession, or business					
23 City		24 State	25 ZIP code	26 Country (if not U.S.)					
27 Alien identification (ID)	a Describe ID			b Issued by			c Number		



Completing the Form – Part III

Part III Description of Transaction and Method of Payment

29 Date cash received: M M D D Y Y Y Y Y Y Y Y 29 Total cash received \$.00 30 If cash was received in more than one payment, check here 31 Total price if different from item 29 \$.00

32 Amount of cash received (in U.S. dollar equivalent) (must equal item 29) (see instructions): (Amount in \$100 bills or higher \$.00)

a U.S. currency \$.00 (Country ▶)
 b Foreign currency \$.00
 c Cashier's check(s) \$.00 Issuer's name(s) and serial number(s) of the monetary instrument(s) ▶
 d Money order(s) \$.00
 e Bank draft(s) \$.00
 f Traveler's check(s) \$.00

33 Type of transaction:
 a Personal property purchased f Debt obligations paid
 b Real property purchased g Exchange of cash
 c Personal services provided h Escrow or trust funds
 d Business services provided i Bail received by court clerks
 e Intangible property purchased j Other (specify in item 34) ▶

34 Specific description of property or service shown in 33. Give serial or registration number, address, docket number, etc. ▶



Completing the Form – Part IV

Part IV Business That Received Cash

35 Name of business that received cash 36 Employer identification number
 37 Address (number, street, and apt. or suite no.) Social security number
 38 City 39 State 40 ZIP code 41 Nature of your business

42 Under penalties of perjury, I declare that to the best of my knowledge the information I have furnished above is true, correct, and complete.

Signature ▶ _____ Authorized official Title ▶ _____



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