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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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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 tegisiative initiony 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.

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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

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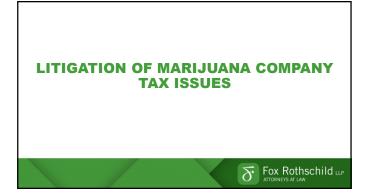
CCA 20150411

- 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)

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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."



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

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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

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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 invastingtion.

- 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.

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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

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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

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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

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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) on o Fith Amendment privilege in IRS examination where no criminal investigation: taxpayers "must choose between providing evidence that they are not engaged in the trafficting of a controlled substance or forgoing the tax deductions available by the grace of Congress" Cooperate during IRS examinations

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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

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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

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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

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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

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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 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 negative due to state of the law and good record/sepaing (TC)

 - No penalties due to state of the law and good recordkeeping (T.C. Memo 2018-208)

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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

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Tax Court Litigation

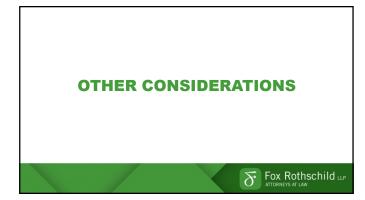
- Alternative Healthcare Advocates v. Comm'r, 151 T.C. No. 13 (Dec. 20, 2018)
 - Alternative was trafficking, and so was Wellness who acted as agent for Alternative $% \left({{{\left[{{{\rm{A}}} \right]}_{{\rm{A}}}}_{{\rm{A}}}} \right)$
 - Double disallowance of expenses was result of taxpayer's structuring choices
 - Penalties applied: Taxpayer improperly relied on CHAMP even though facts were distinguishable, no evidence of reliance on accountant or tax professional

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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)





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 $\ensuremath{\mathsf{IRS}}$ on a periodic basis
 - -Arrangements for cash deposits can be made
 - I.R.M. 20.1.4.26.1.1 (7-17-2015)

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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

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Impact of Tax Reform

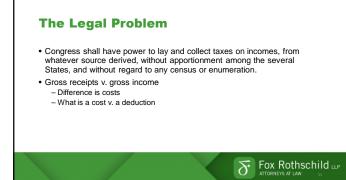
- Flow through structures need to consider how Section 199A applies, consider whether restructuring makes sense
 Changes to inventory rules for businesses with less than \$25,000,000
- of gross receipts (Sections 448(c) and 471(c))
- Exemption from Section 263A also applies to businesses with less than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

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The Legal Problem

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



The Legal Problem

• Section 61(a)(3)

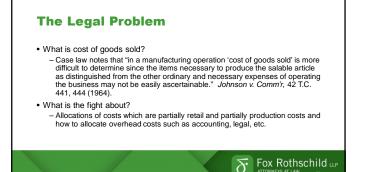
- Gross income includes: "gains from dealings in property"
- If you cannot sell a product for more than it cost you to create the product, you do not have gross income
- Section 280E eliminates deductions other than cost of goods sold for marijuana business
- Therefore, marijuana businesses are encouraged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

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The Legal Problem

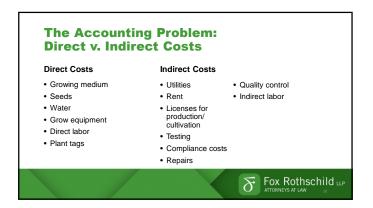
• What is cost of goods sold?

- 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. Commr*, 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 Accounting Problem

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





The IRS Audit

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

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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.
- \bullet Form 8300 requirements educate yourself or hire an accountant who can work with you to comply with this filing requirement.

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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

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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

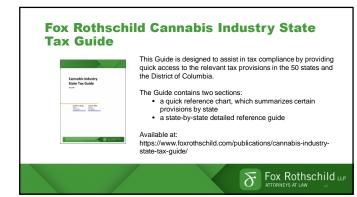
 - Packaging generally, if done at dispensary
 Security and regulatory compliance costs
 - Licenses



State Taxes

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)





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

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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://bsaefiling.fincen.treas.gov/ main.html
- Can be mailed to:
 - IRS Detroit Computing Center P.O. Box 32621 Detroit, MI 48232 (Certified, Return Receipt recommended)

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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

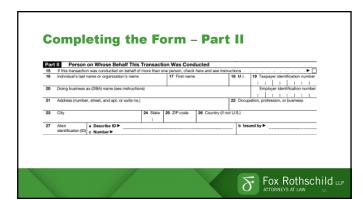
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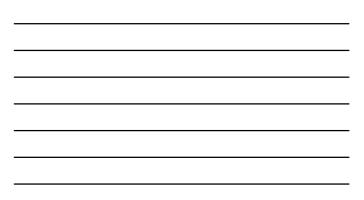
Criminal Penalties

• Willful failures

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

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