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Basics of Marijuana Taxation

August 29th, 2017

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Basics of Marijuana

Taxation

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As of this writing, twenty-nine states have passed regulations permitting some level of marijuana sale and distribution. However, marijuana remains an illegal controlled substance under federal law. Federal law[1] prohibits the deduction of ordinary and necessary business expenses from income derived from drug trafficking. Practitioners need to navigate these conflicted laws, while being concerned if they are participating, under federal law, in a conspiracy to distribute narcotics.

Learning Objectives:

At the conclusion of this seminar, the participant can expect to:

1. Understand relevant laws allowing state-licensed medical marijuana programs
2. Understand the conflict of federal and state laws.
3. Understand the Ogden Memo and Cole Memo, along with their application and importance to the practitioner working with Cannabis clients.
4. IRC §280E, its history, and its application within the legal marijuana industry
5. Apply relevant Tax Court cases from the Cannabis industry to their current client situations.

Background of Federal Law

In 1970, Congress created a regime[2], the Comprehensive Drug Abuse Prevention and Control Act of 1970, or CSA, to curtail the unlawful manufacture, distribution, and abuse of dangerous drugs (referred to as "controlled substances"). Congress assigned each controlled substance to one of five lists, referred to in the law as Schedules. (Schedule I through Schedule V). These schedules are found in section 812 of the CSA.

Marijuana is included in Schedule I, which also includes: (a) opiates; (b) opium derivatives (e.g., heroin; morphine); and (c) hallucinogenic substances (e.g., LSD; marihuana (a/k/a *marijuana*); mescaline; peyote). The definition in schedule I states that drugs on this schedule have "…. a high potential for abuse….(have) no currently accepted medical use in treatment in the United States, (and) (t)here is a lack of accepted safety for use of the drug or other substance under medical supervision."[3]

While all practitioners already know this, it needs to be mentioned here that gross income for federal income tax purposes means "…all income from whatever source derived"[4]. The regulations specifically state that this includes gains from illegal income.[5]

[1] IRC §280E
[2] 21, U.S.C. §801-971 (1970),
[3] 21 U.S.C. §812
[4] IRC §61

Edmondson v. Commissioner [6]

Jeffrey Edmondson was "self-employed in the trade or business of selling amphetamines, cocaine, and marijuana"[7] during 1974, the year at issue. In response to a jeopardy assessment from the IRS, Edmondson filed a 1974 income tax return in June of 1975.

Edmonson did not keep contemporaneous books and records of his activities, presumably since the activity was illegal[8]. On his income tax return, Edmondson took an adjustment for cost of goods sold, and then deducted his ordinary and necessary business expenses under IRC 162(a): business use of the home, 19,433 miles driven on his personal car, travel and meals for a business trip, a percentage of his home telephone, and a small scale. In the end the Court found his oral testimony credible, and allowed the cost of goods sold adjustment and all the claimed expenses save for the business trip and meals, since he lacked 274(d) substantiation.

This decision was handed down in 1981, during the height of the Nancy Reagan "Just Say No!" media blitz and the era of Drug Awareness Resistance Education programs in elementary schools. The decision occurs fifteen years ahead of legalization of marijuana in California.

Public outrage over a 'drug dealer' taking tax deductions led to hearings in the U.S. Senate.

> "There is sharply defined public policy against drug dealing. To allow drug dealers the benefits of business expense deductions at the same time that the 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."[9]

Ultimately, The Tax Equity and Fiscal Responsibility Act, P.L. 97-248, added Sec. 280E to the Code in 1982:

> "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

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5 Reg. §1.61-14(a)
6 *Jeffrey Edmondson, a/k/a Jeff Edmondson v. Commissioner*. T.C. Memo. 1981-623
7 *Jeffrey Edmondson, a/k/a Jeff Edmondson v. Commissioner*. T.C. Memo. 1981-623
8 Like Artie Piscano in the movie Casino, it is a bad idea for criminals to create records.
9 1982 Senate Report No. 97-442 (Vol I), at 309 (1982)

> Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted."[10]

It is important to note that The Tax Equity and Fiscal Responsibility Act passed fourteen years ahead of the first medical marijuana law in California. Congress had not conceived of the potential for marijuana to be sold legally.

<u>Punitive Effects of IRC §280E</u>

Consider this example:

After 'winning' a recreational marijuana license in his state, Dooby Fields raises $100,000 through friends, family, and a Kickstarter campaign to open Dooby Fields, LLC, a marijuana dispensary in Recreational State. The LLC accepts default tax status as a partnership.

During the initial year of operation, the dispensary grosses $1,000,000 of sales. The accounting profit and loss appears below:

Dooby Fields, LLC		
Sales		$ 1,000,000
COGS		$ (300,000)
Gross Income		$ 700,000
Ordinary & Necessary		
expenses		$ (800,000)
Net Income		$ (100,000)

On December 31, no inventory remains on hand. While there was no malfeasance, Dooby was learning how the industry worked this year. He made some bad employee hires and spent too much on advertising and consultants After careful consideration, Dooby writes to his investors that he is closing the company doors as of December 31. Their $100,000 capital contributions funded the loss. No inventory or cash remain to distribute.

Dooby has a problem He and his investors have an income tax liability. While the entity ended the year with an accounting loss of $100,000, the entity has significant taxable income, as illustrated below:

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[10] IRC §280E

Dooby Fields, LLC		
Sales		$ 1,000,000
COGS		$ (300,000)
Gross Income		$ 700,000
Ordinary & Necessary		$ (800,000)
IRC 280E adjustment		$ 800,000
Net Income		$ 700,000

Mr. Fields and his investors will split $700,000 of taxable income for the current year, despite there being no cash available . This is likely an unforeseen circumstance but illustrates the intentional punitive effect of IRC §280E. Probably, the investors are planning to deduct their proportionate share of the $100,000 accounting loss. Imagine the surprise when there is substantial income to report.

This is intentionally a simple example. While beyond the purpose of this text, the author wishes the reader to note that when structured and operated correctly, the use of a C-Corp to operate businesses with drug trafficking exposure mitigates the personal tax liability exposure.

Conflicts between state and federal laws

As we learned in High School Civics class, the Supremacy Clause of the US Constitution establishes the United States Constitution, federal statutes, and treaties as "the supreme law of the land" [11] . Pursuant to this clause, any state law which conflicts with a federal law is otherwise preempted. This was affirmed by the U.S. Supreme Court in *Gibbons v. Ogden*[12].

The Supreme Court has ruled that the federal government has a right to regulate and criminalize marijuana sales and use, even when a state's laws permit marijuana to be used for medical purposes. [13] [14]

At this juncture, we reach the conclusion that all of the State enabling marijuana legislation is otherwise voided by the Comprehensive Drug Abuse Prevention and Control Act of 1970, the federal law which classifies marijuana as a controlled substance.

[11] Article Six, Clause 2.
[12] 22 U.S. 1 (1824).
[13] *Gonzales v. Raich* 545 U.S. 1 (2005).
[14] *U.S. v. Oakland Buyers' Coop.*, 532 U.S. 483 (2001).

Enter the Obama Administration. On October 19, 2009, Deputy U.S. Attorney David W. Ogden issued a memorandum which we now refer to as the Ogden Memo. This document stated that the Justice Department would not make it an enforcement priority to pursue those in "clear and unambiguous compliance" with State medical marijuana laws.

Further to the Ogden Memo, on July 29, 2011, Deputy Attorney General James M. Cole confirmed the Ogden Memo. Cole further noted the "increase in the scope of commercial cultivation, sale, distribution and use of marijuana for PURPORTED medical purposes". Cole added that the Ogden Memo was never intended to shield such activities from federal enforcement action and prosecution, even where those activities purport to comply with state law. Cole concluded the memo by reminding persons who are in the business of cultivating, selling or distributing marijuana, and those who knowingly facilitate such activities, are in violation of the Controlled Substances Act, regardless of state law enforcement of the CSA.

In light of the continuing State ballot initiatives legalizing marijuana (under state law), Cole released an updated Department of Justice policy memo to all U.S. Attorneys on August 28, 2013.

The August 2013 guidance reminded U.S. Attorneys that traditionally the federal government has pursued marijuana cases which were large scale activities where control lied with gang, cartel or criminal enterprises. Further, the federal government has traditionally prosecuted marijuana cases involving sale and distribution to minors, interstate sales, and growth or use on federal lands. Finally, the Cole memo stated that those priorities would continue to guide the federal government's enforcement of the CSA. Federal enforcement would center on those priorities, regardless of federal law. Otherwise, outside of those priories, the federal government has traditionally relied on the States to enforce the narcotics laws of their states. Essentially, the federal government has defunded the ability of its agencies to prosecute the state licensed marijuana businesses which are in compliance with the law and the Cole Memo.

<u>Conclusion thus far</u>: A state licensed marijuana business, while violating the federal Controlled Substances Act, may operate its business without fear of federal prosecution provided the business, its owners and staff all follow the state law and comply with the Cole Memo. Said business must file a federal income tax return, but can not deduct any ordinary and necessary business expenses. The business is entitled to a cost of goods sold adjustment to gross income.

Background of State legalization

Twenty-six U.S. states, as well as the District of Columbia, provide for citizens to initiate legislation through ballot initiations[15]. Essentially, if enough signatures from state residents are collected, a targeted law can be put in front of the voters without action by the legislature.

In 1996, California residents passed proposition 215 making it legal for seriously ill patients, under doctor supervision, to use medical marijuana As of this writing, 29 states and the District of Columbia has some level of legal marijuana use. Washington, Oregon, California, Nevada, Colorado, Alaska, Maine and Massachusetts allow for 'recreational' possession and consumption of marijuana.

Taxation of federal illegal business

As mentioned earlier, businesses that are considered illegal at the Federal level are still required to file federal tax returns and pay income taxes. Typically, these businesses are allowed deductions for ordinary and necessary business expenses, thus reducing the gross profit and only paying taxes on income after expenses[16].

Any business is prohibited by IRC §162 (c) from deducting Illegal payments on their tax return. [17] [18] The Internal Revenue Service has made it perfectly clear through audits and litigation that the Service intends to enforce §280E upon legal state licensed marijuana businesses. This regime appears punitive and leaves the business with little tax saving strategy, other than to legally maximize the cost of goods sold adjustment to income.

Cost of Goods Sold

Cost of Goods Sold is not a deduction but actually an adjustment taken into account in arriving at gross income. Regulation §1.61-3(a) provides, "gross income" means "...the total sales, less the cost of goods sold." Although IRC §280E disallows any deduction for a marijuana seller's ordinary and necessary business expenses, the legislative history fails to include cost of goods sold in this rule. The literature suggests that Constitutional concerns of the Sixteenth amendment, which taxes 'incomes', are the reason for this exclusion.[19]

In the Senate hearings[20] prior to passing IRC §280E, discussion suggested including cost of goods sold in the 'disallowed' expenses for drug traffickers. However, the feeling that this could

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[15] https://ballotpedia.org/States_with_initiative_or_referendum. Accessed June 1, 2017.

[16] *Commissioner v. Tellier,* 383 US 687, 691 (1966).

[17] *Tank Truck Rentals, Inc. v. Comm.*,356 U.S. 30,31,24 (1958)

[18] *Hoover Motor Express Co. v. US*, 356 US 38,39 (1958)

[19] *Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner,* 128 T.C. 173, at 182. 16

[20] S. Rept. 97-494 (Vol. 1), at 309 (1982)

create a constitutional issue leading to court challenges (and delays) prevailed, and cost of goods sold remained an available adjustment to drug traffickers.

Although the Service has not issued regulations related to IRC §280E, the Service allows the adjustment for Cost of Goods Sold (COGS) on the tax returns of businesses engaged in drug trafficking.

On November 24, 2010, U.S. Representatives Fortney Pete Stark, Barney Frank, Jared Polis, Linda Sanchez, Raul Grijalva, and Sam Farr wrote to the office of the Chief Counsel of the IRS, asking the service to create guidance for regulations related to deductions for state licensed marijuana businesses.

The Chief Counsel's Office replied to the Congressman on December 16, 2010, stating that the IRS is unable to issue regulations for IRC §280E since neither the Controlled Substances Act nor IRC §280E make exception for medical marijuana. Further, the Chief Counsel places blame on Congress to change either IRC §280E or the Controlled Substances Act

Cost Method for Cost of Goods Sold

A business must use an inventory method of accounting whenever "the production, purchase or sale of goods is an income producing factor." [21]

Under an inventory method, costs related to producing, acquiring, storing, and handling goods are not currently deductible. These costs must be included in the costs of inventory and deducted when inventory is sold.[22]

In the typical business, tax professionals look to minimize current income by taking deductions during the current period. IRC §263A does not magically transform otherwise disallowed costs under IRC §280E into allowed capitalized costs, although the tax professional should look to maximize the amount of deductions which can be justifiably capitalized. Much billable work exists for tax and accounting professionals who possess the skills to wade through client inventory records and classify expenses to maximize the cost of goods sold deduction and support the conclusions at examination.

Generally, the current year inventory costs are added to the beginning of the year inventory amount and reduced by the costs of inventory on hand at the end of the year to calculate costs of goods sold for the year. [23]

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[21] Reg. §1.471-1
[22] Sec. §263A ; Reg. §1.471-3(b)
[23] § 263A; Reg. § 1.471-3(b)

Section 471 and methods required by Section 263A provide that marketing, advertising and selling expenses are “not required” to be treated as inventory costs.

Under Reg. §1.471–11, 6(a), taxpayers must include as inventoriable costs all direct (*e.g.,* the cost of inventory and delivery, and the cost of materials and labor for manufactured inventory) and indirect production costs (*e.g.,* rent and utilities related to inventory).

Example of Calculation of COGS:

Beginning Inventory	$ 100.00
Plus, Inventory Costs for year	$ 100.00
Less Ending Inventory	(50.00)
TOTAL COGS	$ 150.00

Uniform Capitalization Rules (UNICAP)[24]

UNICAP rules require more indirect costs to be allocated to inventory than the full absorption rules under IRC §471. The UNICAP rules require a producer of inventory to include in the cost of its inventory the direct costs of such property and such property’s proper share of those indirect costs, part or all of which is allocable to such property.[25] Under UNICAP, direct costs include direct material costs and direct labor costs.[26] UNICAP is required for most manufacturers and resellers with the exception of businesses with less than $10 million in gross receipts on a three year rolling average basis.[27].

Most cannabis businesses that do not produce products will not be required to comply with UNICAP. A reseller which is not subject to the UNICAP rules is *usually* required to include only direct costs in the cost of its inventory.[28] A marijuana business would be well advised to comply with the UNICAP rules, whether or not it is required to do so. First, this would allow it to maximize the costs allocated to cost of goods sold. Potentially, it could minimize the amount of disallowed business expenses. Nothing in the code or regulations states taxpayers cannot voluntarily follow the UNICAP rules.

For growers of marijuana, not all expenses will be allowed as cost of goods sold, but many will. Examples include: rent, electricity, water, nutrients, security, insurance, scales, grinders,

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[24] Section 263A
[25] IRC §263A(a)(2); Reg §1.263A-1,3.
[26] Reg. §1.263A-a(e)(2)(i)
[27] IRC §263A(b)(2)(B).
[28] Reg. §1.471–1, –3(b)

packaging materials, delivery vans, labor, excise taxes, accounting software, and traceability software.

Generally speaking, a state licensed marijuana retailer is 'trafficking' in the sale of marijuana in violation of the federal CSA and will NOT be allowed a deduction for ordinary and necessary business expenses.

The sole written guidance from the IRS comes in the form of a Chief Counsel's Advice (CCA)[29] This CCA addresses two questions:

First, how is cost of goods sold determined for a taxpayer subject to IRC §280E?

Taxpayers should calculate Cost of goods sold "using the applicable inventory-costing regulations under §471 as they existed when §280E was enacted.[30]

Therefore, Reg. §1.471-3(b) for resellers, and Regs. §1.471-3(c) and 1.471-11 for producers are applicable for computing COGS.

Second, may the IRS require the taxpayer to use an inventory method for the controlled substance?

"Yes, unless the taxpayer is properly using a non-inventory method to account for the…controlled substance pursuant to the Code, Regulations, or other published guidance."

It is interesting to note that the author is aware of no other circumstances where interpretation of a law is restricted to other laws in effect at that time of passage. Michael Kosnitzky and Matt Kaden of Boies, Schiller & Flexner LLP have gone so far as to state that the IRS CCA will fail on constitutional grounds, once challenged.[31]

<u>IRC §280E</u>

IRC §280E denies a taxpayer any deduction for any amount paid or incurred in the year in carrying on any trade or business if such trade or business consists of trafficking in controlled substances. The Supreme Court has consistently ruled that deductions are a matter of "legislative grace" rather than constitutional requirements. [32] [33] [34] [35]

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[29] Office of Chief Counsel IRS Memorandum Number: 201504011 Release Date: 1/23/2015
[30] Ibid.
[31] Kosnitzky and Kaden, "IRS Interpretation Causes Reefer Madness", *Taxes, The Tax Magainze,* May 2015
[32] *Interstate Transit Lines v. Commissioner*

Application of CHAMPS to attain some IRC 61 deductions (The 'Two Business" rule)

The use of IRC 263A alone to increase Cost Of Goods Sold may still leave the legal marijuana business with a punitive effective tax rate after application or IRC §280E. Absent any regulations to guide the practitioner, we look to relevant U.S. Tax Court cases for guidance.

It is well established that a taxpayer can have more than one trade or business[36]. In *Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner* (CHAMPS)[37]. the Tax Court expanded IRC §280E to permit the deduction of ordinary and necessary expenses to the extent two businesses are conducted at the same business location.

Some states, including California, operate using a caregiver model. It is important to understand the differences in this business model. Some dispensaries in this model offer palliative care, which is specialized medical care for people with serious illnesses. It focuses on providing patients with relief from the systems and stress of a serious illness. The goal is improving the quality of life for both the patient and the family.

CHAMPS was in the business of providing counseling and other caregiving services to its members, who were individuals with debilitating diseases. Under the California Compassionate Use Act of 1996[38], the taxpayer provided marijuana to members who requested it. The business charged its members a membership fee that generally reimbursed the business for its costs of the caregiving services and its costs of the medical marijuana. This left the business substantially in compliance with California law, since in the caregiver model the caregiver is reimbursed for costs, but should not generate a profit on an ongoing basis. At audit, the Service disallowed the expenses as non-deductible under IRC §280E because they were incurred in connection with the trafficking of a controlled substance under the federal CSA.

47% of the of the CHAMPS members suffered from AIDS, while the remainder suffered from cancer, multiple sclerosis or other terminal or chronic diseases. The primary purpose the entity was to provide caregiving services to its members. The secondary purpose was to provide members with medical marijuana pursuant to the provisions of California law and instruction in the use of the marijuana to benefit their health.

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[33] *Deputy v. Du Pont*

[34] Knight v. Commisioner

[35] *New Colonial Ice Co., Inc v. Helvering*

[36] *Alverson v. Commissioner*, 25 B.T.A. 482, 488 (1937

[37] 128 T.C. 173, 182 (2007)

[38] California. Health & Safety Code sec. 11362.5

The most important aspect of this case is that the palliative care services provided by CHAMPS were extensive. Support group sessions were held for members including those with AIDS, addiction, and emotional development problems. Low income members were provided with hearty daily lunches and hygiene supplies were also available. Counseling benefits related to life-coping issues were available. In short, CHAMPS was a palliative care entity that happened to dispense marijuana, rather than simply a marijuana dispenser.

On its tax return, CHAMPS did not make any allocation subject to IRC §280E. All ordinary and necessary business expenses were deducted.

At trial, CHAMPS argued they had two businesses: a primary trade or business of palliative care (caregiving) and a secondary trade or business as a marijuana dispenser. CHAMPS argued and the Court agreed, that the deductions for the non-trafficking business should not be subject to IRC §280E. The Service accepts the characterization that two or more undertakings are separate activities, unless the characterization is 'artificial or unreasonable".[39]

> Section 280E and its legislative history express a congressional intent to disallow deductions attributable to a trade or business of trafficking in controlled substances. They do not express intent to deny the deduction of all of a taxpayer's business expenses simply because the taxpayer was involved in trafficking in a controlled substance. We hold that section 280E does not preclude petitioner from deducting expenses attributable to a trade or business other than that of illegal trafficking in controlled substances simply because petitioner also is involved in the trafficking in a controlled substance.

It is important to note that CHAMPS had contemporaneously created records which clearly showed the costs spent on each activity, including detailed time records of employees' time spent in each of the two businesses.

Absent §280E regulations pertaining to two distinct businesses operating from the same location, we look to the guidance under IRC §183 and the supporting regulations. Reg. §1.183–1(d)(1) provides that "(t)he taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case."

Most significant facts and circumstances in making this determination are:

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[39] Treasury Reg. 1.183-1(d)(1) *Alverson v. Commissioner*, 25 B.T.A. 482, 488 (1937

[39] 128 T.C. 173, 182 (2007)

[39] California. Health & Safety Code sec. 11362.5

[39] Treasury Reg. 1.183-1(d)(1)

1. Degree of organizational and economic interrelationship of various undertakings.

2. Business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting.

3. Similarity of various undertakings.

The Tax Court later expanded facts and circumstances test in Rupp v. Commissioner[40], which provides nine factors for use in determining whether the two undertakings share a close relationship to one another:

1. Whether the undertakings are conducted at the same place;

2. Whether the undertakings were part of a taxpayer's efforts to find sources of revenue from his or her land;

3. Whether the undertakings were formed as separate activities;

4. Whether one undertaking benefited from the other;

5. Whether the taxpayer used one undertaking to advertise the other;

6. The degree to which the undertakings shared management;

7. The degree to which one caretaker oversaw the assets of both undertakings;

8. Whether the taxpayers used the same accountant for the undertakings

9. The degree to which the undertakings shared books and records.

The Tax Court subsequently applied the nine factors of *Rupp* in *Olive v. Commissioner 139 T.C. No 2.* While not cannabis industry friendly, *Olive* helped further frame the outer limitations of the ‘two business rule’.

Olive operated “The Vapor Room”, purportedly a medical marijuana dispensary and a caregiving activity. The Court found that the taxpayer was not operating two businesses and was therefore not entitled to portion of its IRC 61 ordinary and necessary business expenses.

[40] *Rupp v. Commissioner*, 103 T.C.M. (CCH) 1594, 1598, 2012 T.C.M. (RIA) 2012-108

Some of Olive's patrons suffered from AIDS, HIV, cancer and other terminal diseases. Taxpayer felt *CHAMP* applied here. The court applied the nine factors from Rupp and found that the taxpayer operated only one business.

Contrary to *CHAMPS,* where the Court found two businesses existed, in *Olive* the Court determined that there was one activity, trafficking in a controlled substance.

Conclusion

Assisting clients in the legal marijuana industry is challenging. In addition to the hazards of practicing in this niche, the practitioner must be skilled in cost accounting and stay current in developing tax court cases to ensure client application of IRC §280E is both the most beneficial to the client while staying compliant in the evolving legal landscape.

Circular 230 Professionals and the Cannabis Industry

We have discussed that the sale, possession and use of marijuana is illegal pursuant to federal law. While the laws of twenty-nine states allow their citizens to violate ONE specific federal law, they do not create carte blanche to violate ALL federal laws.

Risk of Criminal Prosecution of the Practitioner

> "Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal". [41]

Could this law be applied to professionals assisting or advising cannabis businesses in connection with:

a. Preparing a lease.
b. Preparing financial statements.
c. Tax advice or preparing tax returns.
d. Lecturing on the tax treatment of medical marijuana businesses.

Consider these scenarios**:**

1. Bill, a new client, is referred by Frank, his criminal attorney. Bill was convicted last month of embezzling $100,000 from his employer. He is being sentenced next month, and prior to that, Frank wants the tax return for the year of the embezzlement amended to reflect the embezzlement income.

[41] 18 U.S.C. §2(a) (2006)

2. Jennifer is a long time client. During this year's tax interview, she mentions how she has 'figured out' how to embezzle $1,000 per month from her employer. She would like to report the income for last year, and pay you to help plan how to 'best handle' future years' reporting.

3. Dooby, a recent entrepreneur in the legal marijuana industry, was awarded a license by Recreational State to dispense marijuana. He can't seem to get a bank account open, and needs your help with 'all these licensing forms'.

In the case of Bill, his criminal activity occurred in the past. The assistance he seeks is related to correctly reporting that past activity for income tax purposes, not a potentially on-going crime or conspiracy. A tax practitioner can assist him, confident they are not at risk of committing a crime.

Jennifer is actively engaged in an ongoing crime, and has requested assistance in hiding the crime. Although a practitioner can always assist a taxpayer with their reporting obligations regardless of the source of the income, in this instance it might be wise to disengage from Jennifer, since a practitioner does want to appear to be conspiring with her.

In Dooby's case, the practitioner wants to complete their due diligence. The practitioner needs to confirm that Dooby is licensed, that he understands the laws of Recreational State as they apply to legal marijuana businesses, and that he is complying with the Cole Memo. Provided that Dooby continues to remain compliant, the practitioner can safely assist Dooby with his accounting and tax needs.

Risk to Professional Licenses

While we can feel assured that our arrest is not imminent when assisting the licensed, compliant marijuana business, the Circular 230 practitioner[42] needs to consider the risk to their professional licenses.

Most state CPA boards have not issued any guidance with respect to their licensees advising state licensed marijuana businesses. Of concern to practitioners is that most states have "morals" or "good moral character" clauses in their licensing laws. Could a licensee be deemed to be of poor character for working with marijuana businesses? As of June 2017, only eight state accountancy boards have issued guidance.

The Arizona State Board of Accountancy has stated that

> "Merely accepting an engagement to provide accounting services to a medical marijuana dispensary does not, on its face, constitute an act discreditable to the

[42] For purposes of this discussion, the author has omitted risks to state licensed attorneys

> procession and it will not pursue independent disciplinary action against an Arizona CPA based sole on such acceptance". [43]

The Colorado Board of Accountancy has promulgated that :

> "It is the Board's position that offering to perform or performing professional services for clients in the marijuana industry who are in compliance with Colorado Medical Marijuana Code and the Colorado Retail Marijuana Code is not in itself specifically prohibited by the Accountancy Act….".[44]

The position of the Oregon Board of Accountancy is:

> "CPAs should consider the potential risks and uncertainties involved, including but not limited to the continued uncertainty surrounding enforcement of applicable federal drug laws and related provisions of the Internal Revenue Code. The board will not take action for simply providing services to a legal state licensed business".[45]

The Washington State Board of Accountancy's Executive Director issued a statement in 2014[46], stating that:

> "Members should "diligently evaluate and address the potential risks and uncertainties associated with providing such services" to clients…(o)ffering or performing professional services to those commercial business enterprises licensed by the Washington State Liquor Control Board (WSLCB) is not specifically prohibited by the Public Accountancy Act or Board Rules."

The Connecticut State Board of Accountancy stated it "will not pursue independent disciplinary action against Connecticut CPAs or CPA firms who are operating within the bounds of state law"[47]

The Nevada State Board of Accountancy issued guidance stating that:

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[43] "Provision of Professional Services to Medical Marijuana Dispensaries by Arizona CPA's (sic)", March 28 2016 https://www.azaccountancy.gov/General/News_And_Updates.aspx#Q24 accessed December 30, 2016
[44] Colorado Board of Accountancy. Colorado Board of Accountancy's Position Statement Regarding Certified Public Accountant Certificate Holder's Providing Services to the Marijuana Industry. December 2015
[45] Oregon Board of Accountancy. "Guidance for Licensees Providing Services to the Marijuana Industry". March 19, 2015
[46] Washington State Board of Accountancy. Position Statement of the Executive Director of the Washington State Board of Accountancy. 2014
[47] Connecticut State Board of Accountancy. Position Statement of the Connecticut State Board of Accountancy on Recent Developments Regarding State Marijuana Laws. 2015

> "Nevada licensees and firms that elect to provide services to the marijuana industry legalized in any state in which the licensee practices will not face action by the Board based solely on the fact that the licensee or firm is providing such services. However, licensees are reminded that the federal government views such activity as a federal criminal offense. The Board's position does not negate the possibility that disciplinary action may be taken by the Board should a licensee be found guilty of a federal criminal act." [48]

Maryland's regulator of CPAs stated that "upon advice of counsel, in light of the current state of Maryland and Federal law, the Boards will take no regularity action against a CPA of firm…. provided that the business is operating legally under applicable state law." [49]

The Florida Board of Accountancy stated in 2015 that:

> "the provision of public accounting services, … to marijuana-related businesses in states where marijuana-related businesses have been legalized, in the absence of a criminal conviction of the certified public accountant for the provision of those services, in and of itself does not constitute a lack of good moral character."[50]

The common thread across these eight states' guidance to CPAs is that simply assisting a state licensed business, by itself, will not get the practitioner disbarred. It is the author's opinion that the CPA licensing board of each of the remaining twenty-one states with legal marijuana needs to issue similar guidance. Further, as other states adopt legal marijuana laws, these protections should be part of that enabling legislation.

While the other forty-two states' Boards of Accountancy have not provided guidance, here are some interesting developments to watch:

Neither the California State Board of Accountancy nor CalCPA have issued any guidance to licensees. It has taken the state twenty-one years to issue statewide regulations for dispensaries.

Michigan has 240,000 registered medical marijuana patients, which means at least 40,000 people are legally growing marijuana as that state's caregiver model allows the caregiver to grow marijuana for themselves and up to five other patients. There is no guidance from the State

[48] Nevada State Board of Accountancy. Guidance for Licensees Providing Services to the Marijuana Industry. 2015
[49] Gring, Dennis L. Email from Maryland Board of Public Accountancy Executive Director. 2015
[50] Florida Board of Accountancy. Response to Petition for Declaratory Statement by Howard, Howard and Hodges, Certified Public Accountancy and Consultants. 2015

Board of Accountancy. Currently, the State CPA Society refers members to the AICPA Issue Brief on State Marijuana Laws and the CPA Profession. Strangely, growers are required to obtain a Review report from a CPA and file it within 30 days of years' end.

Since 2010, New Mexico's Board of Health requires annual Audits of licensees (all are non-profits, under the law). The New Mexico Board of Accountancy refuses to issue guidance to its licensed CPAs, claiming it is "beyond (their) scope". The Accountancy Board recommended CPAs seek legal counsel before accepting marijuana engagements. Finally, the Accountancy Board requested that the New Mexico Department of Health remove the Audit requirement, which is still in the most recent Department of Health rules (February 2015).

Illinois has no published guidance for CPAs, but the Illinois Marijuana regulations require some marijuana reports to be completed by CPAs.

Minnesota offers no published guidance, but growers are required to have an audit conducted annually by an independent CPA.

Office of Professional Responsibility Oversight

Since the Loving decision[51], the Internal Revenue Service needs to obtain an injunction to prevent an individual from preparing a tax return. OPR disbarment removes the right to represent taxpayers before the Service, but not the right to be an unlicensed preparer of income tax returns. While IRS injunctions and return preparer penalties are always a risk, the enrolled agent working with cannabis returns also needs to be concerned about Office of Professional Responsibility (OPR) referrals by IRS Agents.

> "Within those parameters what we would essentially be saying to the preparers in those states is that you've got some hard conversations to have with your clients about what goes on to the tax return, but as long as you are adhering to what the tax law says about treatment, you're going to be within the confines of what Circular 230 expects of your due diligence." [52]

Although Karen Hawkins has left the Service, this remains the closest to an official pronouncement from the IRS regarding the preparation of tax returns for those in the legal cannabis industry.

On July 19th, 2017, current OPR director Stephen Whitlock

IRC 6694 assesses penalties for understatement of tax liability for not applying law properly and for reckless or intentional disregard of rules or regulations. There are many unclear and

[51] Loving v. IRS, 742 F.3d 1013 (D.C. Cir. 2014
[52] OPR Director Karen Hawkins Nov. 19, 2014

unsettled areas of the law with respect to taxation of legal marijuana businesses. With respect to penalties, the IRS will consider both what preparers knew and what the Service feels they should have known at the point of alleged intentional disregard. Practitioners should be concerned about the correct application of IRC §280E and consider whether filing form 8275 is appropriate in cases where the basis for a claimed tax deduction is a Tax Court case.

Circular 230 professionals should take these consideration into account when preparing and advising Cannabis related businesses:

Circular 230 Section 10.22, Diligence as to Accuracy, discusses the due diligence requirements of practitioners with regard to tax returns and other documents filed with the Internal Revenue Service. 70% of cannabis businesses which 'touch the plant' lack access to banking, and therefore transact business entirely in cash. Further, improper application of IRC §280E or client information can distort results of a tax return sufficiently to have the Service consider accuracy related penalties. [53]

Circular 230 Section 10.34, Standards with Respect to Tax Returns and Documents, discusses unreasonable basis and unreasonable positions being taken by practitioners on a tax return. Further, the section reminds practitioners they cannot counsel their clients to take unreasonable positions on tax returns. Finally, section 10.34 reminds the practitioner that they must advise clients of the potential ability to avoid penalties by making disclosures when available, and how those disclosures can be made.

Circular 230 Section 10.35 mentions that lack of training is now disreputable conduct. Who is truly trained on issues of cannabis taxation? Documentation is the key to defending preparer penalties.

A chief concern of Circular 230 practitioners is "at what point does a conflict of interest arise when representing a taxpayer whose return was prepared by the practitioner". This is even more urgent when considering the delicate line between legal and illegal drug trafficking. Consider if the taxpayer being represented has crossed the line and might be involved in the sale of black market marijuana. Sometimes, a client and the practitioner are best served by referring out potential conflicts-of-interest.

IRC §7525 extends the attorney-client privilege of confidentiality to persons authorized to "Practice before the IRS" (under Circular 230), if the communications were (a) made in confidence; (b) in the course of soliciting advice from an authorized practitioner acting as such; (c) the communication was relevant to the advice sought; and (d) the information is sought in a civil tax matter.[54] [55]

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[53] IRC 6662(a)
[54] *Fischer v. U.S.*, 425 U.S. 391 (1976)
[55] *U.S. v. Rockwell Int'l.*, 897 F.2d 1255 (3d Cir., 1990)

Just when it's needed, the privilege is gone. It is extremely important to note that the privilege of IRC §7525 is not applicable in a criminal tax matter before the IRS[56] or a criminal tax proceeding in Federal Court brought by or against the U.S.[57]

In a criminal tax case the defendant's accountant is often the government's star witness. A court may order that the accountant testify against her client and fully disclose the previously privileged/confidential information.

Further, the privilege does not apply to advice regarding accounting, business, or other non-tax advice and it only applies to the IRS (not to other agencies or a state). The privilege does not apply to communications between a practitioner and a corporation (through an owner, officer, etc.) regarding participation in a tax shelter.[58]

The attorney-client privilege covers an accountant hired by an attorney to provide assistance rendering legal service to the attorney's client, the so-called **"**Kovel Accountant." [59] In these situations, the attorney hires the accountant and treats them as they would an employee. Privilege is extended to the CPA/Accountant/EA/Tax Professional. This mechanism cannot be used to cloak prior communications. The IRS does not look favorably upon these arrangements.

A few states, including Colorado[60], provide a statutory privilege for tax communications. It is more likely a practitioner will encounter State examinations of cannabis businesses than federal examinations, so it's important to understand the law of your state and the state where the client is located with respect to practitioner/client privilege.

Risk Mitigation

Assured that our licenses are safe and criminal prosecution is not a threat when working with cannabis clients, the practitioner must now consider the other risks to their professional practice and what mitigation is available.

It goes without saying that today's tax professional should be using engagement letters for all services provided to clients. A properly constructed engagement letter protects the professional from unrealistic expectations and outcomes of the client, while correctly representing to the client the duties and responsibilities of each party. A best practice is the use of a separate engagement letter for each individual service provided (representation, tax preparation, etc.).

One must be specific on services provided and not provided (exclusions). The author currently excludes these services from coverage on all engagement letters, unless hired under a specific, separate engagement letter for the excluded service:

[56] IRC §7525(a)(2)(A)
[57] IRC §7525(a)(2)(B)
[58] IRC §6662(d)(2)(c)(ii)
[59] *U.S. v. Kovel*, 296 F.2d 918 (2nd Cir. 1961)
[60] C.R.S. §13-90-107(f)(I)

i. State excise, sales, use tax
ii. Form 8300/BSA/AML Compliance
iii. Reasonable Compensation
iv. Employee/Independent contractor
v. IRC §280E apportionment
vi. State tax returns to file

As we have stated, the tax professional can rely on not being prosecuted under federal law for assisting state licensed cannabis businesses, provided that the client is both following state licensing law AND in full compliance with the Cole Memo. Therefore, a professional might demand an annual Representation letter from the owners and managers of a cannabis business. In this context, we mean a representation letter as in the management representation letter solicited from clients in an attest engagement. This letter would represent to the practitioner that the managers and owners of the business (1) understand requirements of State law related to cannabis businesses (2) are in full compliance with these laws and (3) represent they understand the Cole Memo and are in compliance.

These clauses might help in a cannabis-business engagement letter:

1. Client agrees to notify you if they become non-compliant with Cole memo or state law.

2. Your engagement letter should already discuss grey areas of the law and how you will address them.

3. The practitioner may want to put in the engagement letter that if client becomes non-compliant with the Cole Memo or State law practitioner can withdraw without penalty.

4. The practitioner might consider an expanded hold-harmless agreement, since there are no regs for IRC §280E. Clients agree that it is an evolving area of law, and client holds practitioner harmless for any interpretation of law that the IRS subsequently changes (or tax court cases alter).

Errors and Omissions insurance generally covers preparation and consulting of cannabis returns. The author asks every carrier he encounters at tax related trade shows and education events. Insurance WON'T cover you if you are deemed to aid and abet a client in the commission of a crime. It is important to ensure your client knows they need to follow all applicable laws and use a bank account (if possible) for all transactions. The author recommends you call your insurance carrier and inquire about coverage for cannabis clients. Get the answer in an e-mail or other writing, if you can.

Tax professionals should be alert to anything the client may say or do that indicates they are in possible violation of the Cole memo or in violation of state law. A client not following either is open to federal prosecution, which could open the tax professional to that exposure, too. Actions such as selling excess marijuana to non-licensed dispensers are of particular concern.

Threat of RICO Suits

Racketeer Influenced and Corrupt Organizations Act[61], or RICO, specifies certain acts, associated with a "pattern of racketeering activity," as criminal. These acts could include using income from the RICO enterprise, gaining control of a RICO enterprise, or participating in a RICO enterprise, or conspiring to do any of these things. Surprisingly, a RICO case can be brought as a civil case, as discussed further along in this text.

Racketeering activity encompasses dozens of federal crimes, including dealing in a controlled substance, money laundering, and currency reporting violations under the Bank Secrecy Act.

Vicarious Liability Provisions state that any person who is part of the RICO enterprise who intentionally performs acts that foster the operation or management of the enterprise may be liable. "RICO liability is not limited to those with primary responsibility for the enterprise's affairs".[62]

Violations (criminal) can impose stiff criminal (or civil) penalties of up to 20 years' imprisonment. The RICO statute also creates a private right of action for anyone "injured in his business or property" because of a RICO violation[63], entitling a successful plaintiff to treble damages and attorneys' fees.

Of particular interest to tax professionals was a Safe Streets Alliance suit[64] in Colorado under civil RICO during 2014. The suit was brought on behalf of Holiday Inn franchisee. The suit alleged that a licensed marijuana retailer opening across the parking lot from the hotel would damage the value of the hotel.

The defendants in the Safe Streets RICO case were: Bank of the West, allegedly the dispensary's bank; Merchant's Bonding Company, the dispensary's bonding company[65]; and Accounting Specialists Inc., the ACCOUNTING FIRM for the dispensary. The suit maintained that all three were working together to permit retailer to operate.

The case was settled out of court, as follows: Bank of the West closed the dispenser's bank accounts and was released from the lawsuit. Merchant's Bonding Company paid $50,000 to settle its liability. Accounting Specialists paid $20,000 to settle the suit. AND THE DISPENSARY WAS NOT YET OPEN.

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61 18 U.S.C. §1962)
62 First Capital Asset Mgmt. v. Satinwood, Inc., 385 F.3d 159, 176 (2d Cir. 2004)
63 18 U.S.C. §1964(c)
64 Safe Streets Alliance v. Alternative Holistic Healing, LLC , Civil Action No. 1:15-cv-00349-REB-CBS.

65 During 2014, Colorado require marijuana dispensers to be bonded. This requirement was subsequently repealed.

The Bottom Line

Working with marijuana dispensers and growers is a highly specialized and potentially lucrative niche for federally authorized tax practitioners. This is not without risk. The practitioner is advised to:

1. Know its clients and their business practices.
2. Help the client create contemporaneous records.
3. Remind clients marijuana is illegal under federal law.
4. Alert the clients to safeguards related to:
    a. Theft
    b. Blackmarket sales
    c. Licensing compliance
5. Use engagement letters
6. Have insurance
7. Know when not accept a new client and when to disengage from a current client.