

Marijuana Training

Overview

Introduction	<p>Twenty three states and the District of Columbia currently allow some individuals to use medical marijuana. The states of Colorado, Washington, Alaska, and Oregon allow the use of marijuana for recreational purposes. In 2014, there were 11 additional states where pro-medical marijuana legislation passed but did not fully legalize its use. During the first quarter of 2015, proposed legislation to legalize medical marijuana failed in 7 states and there are 9 additional states where legislation is still pending. Pro-marijuana advocacy groups continue to propose legislation to allow the medical or recreational use of marijuana therefore the marijuana industry will likely continue to grow in the United States.</p> <p>In 1970, the Controlled Substances Act was passed establishing a single system of control for both narcotic and psychotropic drugs by creating five schedules to classify substances. Marijuana was placed in Schedule I, which contains drugs classified as having a high potential for abuse, no currently accepted medical use in treatment, and a lack of accepted safety for use of the drug or other substance under medical supervision.</p> <p>Current tax law regarding the marijuana industry is dependent on the classification of marijuana as a Schedule I drug. With the changing public opinion as states continue to legalize marijuana, and additional scientific research related to the medical benefits of marijuana, many marijuana industry operators believe it is likely marijuana will be reclassified from a Schedule I drug to a less restrictive drug. If the drug schedule changes, so will the tax laws related to marijuana. Marijuana industry supporters rarely agree with proposed IRC § 280E adjustments because they believe IRC § 280E will soon no longer apply to the marijuana industry, perhaps sooner than the time it takes their case to work its way through an examination, then to appeals, and finally to tax court.</p> <p>When conducting an examination, it is important to first obtain an understanding of how the industry operates; this includes knowledge of the products produced by the industry. It is also important to understand the unique tax laws related to the industry and prepare alternative positions if the current tax law changes. Examiners must fully develop their cases to include all issues related to gross receipts by marijuana growers and sellers. You must also develop all issues related to the deduction of expenses while considering the disallowance of retail related expenses under IRC § 280E.</p>
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(b)(3), 26 U.S.C. § 6103



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Introduction to the Marijuana Industry

Introduction	<p>The examination techniques used to audit a taxpayer operating a marijuana business are similar to those used to examine other cash intensive businesses. Some marijuana businesses have internal controls in place to ensure all transactions are recorded correctly, some marijuana businesses do not maintain or keep books and records, and many others do not maintain bank accounts. Some marijuana businesses strive to follow all applicable State laws and some operate without state licenses.</p> <p>Many marijuana related cases that are assigned to examiners do not clearly disclose their business activity on the return; rather it may list another industry such as horticulture, agriculture, care giving, or retail. You may not realize you are working a marijuana industry case until you have already conducted the initial phone call with the taxpayer or Power of Attorney.</p> <p>Prior to conducting the initial interview and the tour of the business, it is important that you have a good understanding of the products produced by the marijuana industry; this will assist you in identifying potential sources of income.</p>
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Varieties and Strains of Cannabis	<p>Cannabis strains can be either pure or hybrid varieties of Cannabis, typically of Sativa, Indica, and Ruderalis. Different varieties are developed by growers to intensify specific characteristics of the plant, to increase potency, or to differentiate a grower's strain to better market it in the industry.</p> <p>Variety names are typically chosen by individual growers, and often reflect properties of the plant such as taste, color, smell, or the origin of the variety. Some varieties are purposefully cultivated to contain a high percentage of cannabinoids.</p> <p>The main psychoactive constituent of Cannabis is tetrahydrocannabinol (THC). A typical Cannabis plant is known to contain roughly sixty additional trace amounts of additional cannabinoids. Another common cannabinoid that can be produced in high concentrations is cannabidiol (CBD). CBD is not psychoactive but recent studies indicate that it is shown to block the effect of THC in the nervous system. Different chemical composition of Cannabis varieties may produce different effects in different people.</p>
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Sativa Varieties	<p>Pure sativas are relatively tall plants that can reach as high as 14 feet. Sativas have long internodes (spaces between joints of a plant) and long branches, and are characteristic of large narrow-bladed leaves. Sativas bloom later than indicas, often taking a month or two longer to mature. Cannabis sativa contains a higher level of THC than CBD. Sativa is well known for its cerebral high effects.</p>
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Indica Varieties	Pure indica varieties are shorter and bushier than sativa and have wider leaflets. Indica is often favored by indoor growers due to its size. Cannabis indica has a higher level of CBD than THC. Indica is well known for its physical sedative effects, often preferred for night time use.
Ruderalis Varieties	Pure ruderalis varieties do not grow as tall as sativas or indicas and also flower earlier. Ruderalis can withstand harsher climates, and produces flowers based on plant age rather than light cycle changes. Pure ruderalis varieties have a lower THC level than sativas and indicas but are high in cannabidiol (CBD). Ruderalis are grown primarily for medical marijuana users not recreational users. This variety is reputed to be more resistant to insect and disease pressures. This is an attractive choice for plant breeders who create their own hybrid varieties, or those who graft plants from rootstock.
Controlled Environment	<p>In the wild, cannabis plants normally grow during the months of April to September. The optimal day temperature for maximum growth is between 75 to 86 degrees. In order to produce optimum quantities of THC, a cannabis plant needs fertile soil and a minimum of 12 hours of daylight. The cannabis plant also prefers an acidic soil with a soil pH between 5.9 and 6.5.</p> <p>Colorado's climate and alkaline soil is not optimal for commercial scale outdoor cultivation. This is primarily due to temperature fluctuations. The majority of Colorado grown marijuana is produced in controlled environments such as green houses and warehouses with additional lighting.</p> <p>Indoor growing has become increasingly common over the past decade because of the increased availability of equipment, clones and seeds, and the increased availability of cultivation instructions. Grow-operations or grow houses are a more inexpensive way to gain a steady, higher-quality supply of cannabis. On a large scale, grow houses have proven a viable commercial venture in Colorado.</p>



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Clones and Seeds	<p>Breeders devote a significant amount of time and resources to create hybrid strains containing specific medicinal effects. Replicating desired plant traits may prove difficult when breeders attempt to cultivate subsequent plants from seeds. This is due to genetic variability and the instability of determining gender in seeds. Cannabis has distinct separate male and female plants. Female plants do not pollinate themselves in the absence of males. Feminized seeds (predominately seeds for female plants) are becoming popular but the most common source of new plants in both commercial and individual (personal) marijuana grow operations are from clones.</p> <p>Breeders create clones in a similar process to standard houseplant cutting. They start with cutting from the mother plant, apply rooting hormone, place in growing medium, water, and provide the appropriate amount of light.</p>
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Products Produced by the Marijuana Industry	The marijuana industry produces a plethora of products in addition to smokable marijuana.
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Dried Flowers	<p>The flowers or Buds of the plant contain the highest concentrations of plant resin. Plant resin contains the highest concentration of active ingredients. The un-pollinated flowers of the female plants are the part of the plant that is used by medical and recreational users because they produce high amounts of potent plant resin. The natural resin production is to catch pollen. Cannabis has distinct separate male and female plants. Female plants do not pollinate themselves in the absence of males. Male plants and male flowers are not very potent and are not used in the industry.</p>
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Hashish	<p>Hashish or "Hash" is a solid or sticky cannabis product composed of compressed resin glands ("trichomes") from a cannabis plant. Hash has a high THC concentration as it is extracted from the heads of the marijuana plant's trichomes. The trichomes typically contain all of a plant's psychoactive THC. "Trim leaf" (small leaves surrounding the flowers) are usually coated in a large amount of trichomes; they can be collected to make hash. One simple method of collection is to separate the trichomes from the trim leaf using a basic screen; plant matter containing trichomes is run over or beat against the screen to separate the trichomes. Another method involves freezing the trim and then agitating it with ice to separate the trichomes, the mixture then is filtered through screen bags of decreasing screen sizes which capture the plant matter and allow the trichomes to pass to the bottom bag where they collect into a wet paste. The paste is pressed to extract most of the water and pressed into cakes and dried. In a dry-ice sifting process the trim leaf is placed in a filter bag with dry ice and shaken to allow a very pure concentration of trichomes to pass through which can be kept as powder or pressed into cakes.</p>
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Hash oil	Hash oil is an extract that is formed when a solvent is used to dissolve THC concentrations. The solvent used is commonly one of the following; butane, isopropyl alcohol, ethanol, hexane, or toluene. The plant particulates are filtered out and then the solvent carrying the soluble resins is evaporated or purged under a vacuum. The resultant oil may have a high THC content (depending on the parent material that it is extracted from). Hash oil is used in various cannabis-based products or can be smoked or vaporized as a concentrate.
Tinctures	Cannabinoids can be extracted from cannabis plant matter using high-proof spirits (often grain alcohol) to create a tincture. A common tincture is often referred to as "green dragon."
Infusions	There are many varieties of cannabis infusions distinguished by the variety of non-volatile solvents used in their production. The plant material is mixed with the solvent and then pressed and filtered to express the oils of the plant into the solvent. Examples of solvents used to create infusions are cocoa butter, dairy butter, cooking oil, glycerin, and skin moisturizers. Depending on the chosen solvent, the infusions may be used in cannabis foods or applied topically to one's skin.
Edibles	Cannabis foods, more informally known as edibles, are food products created or prepared with cannabis ingredients in herbal or resin form. Edibles are consumed as an alternate delivery means to experience the effects of cannabinoids without smoking or vaporizing cannabis or hashish. Instead, the cannabinoids are put into candy, cake, cookies, brownies, drinks, or other foods to be consumed for recreational or medicinal purposes.
Other Related Products	In addition to selling cannabis based products, dispensaries also sell paraphernalia used to smoke, vaporize, or consume the marijuana products. During the tour of the business it is important to gain an understanding of all products sold by each medicinal center.
Colorado Licensing Process - MED	See the attached exhibit explaining the State of Colorado medical marijuana licensing process.



Audit Techniques for Testing Gross Receipts

Introduction	<p>The Internal Revenue Manual (IRM) requires you to complete minimum income probes on all examinations. After all minimum income probes are completed, you must decide whether there is a reasonable indication of unreported income. If so, a more in-depth examination of income is necessary. This lesson will cover the audit techniques and tools for an in-depth examination of income. These techniques are to be used to directly address reducing the tax gap and also to ensure compliance.</p> <p>This lesson defines what constitutes a reasonable indication of unreported income and provides guidelines for an in-depth examination in general. It also provides an overview of the most commonly used formal indirect methods of estimating income.</p>
Initial Interview and Tour of the Business	<p>The most effective audit technique for obtaining income information is the interview with the taxpayer. You should interview the taxpayer concerning all possible sources of income in addition to the income that was reported on the return and accumulated funds from prior years. Before your initial interview, you should prepare a T-Account analysis.</p>
T-Accounts	<p>The initial interview offers your first opportunity to question the taxpayer about preliminary T-Account imbalances. The interview will allow you to gain useful information necessary to analyze the taxpayer's bank accounts and to reconcile their books and records to their filed return. In addition, as many taxpayers hire representation after the initial interview, it may be the only chance you have to talk directly with the taxpayer.</p>
Cash	<p>You should inquire about cash on hand and accumulated funds during the initial interview. It is important to establish these amounts since cash on hand and accumulated funds can provide an explanation for a Financial Status Analysis (preliminary T-Account) that appears to be out of balance. Taxpayers may not fully understand the difference between cash on hand and accumulated funds. It is important that the meaning of each is explained before the taxpayer answers the interview questions.</p>
Internal Controls	<p>Most of the knowledge needed to evaluate the control structure of a business is acquired through interviews of individuals with first-hand knowledge of the business. Thorough observations of the business operations should be performed during the tour of business.</p>



Audit Techniques for Testing Gross Receipts

Tour of the Business	<p>A tour of business is extremely important on marijuana cases from both an income standpoint as well as an expense standpoint. An indirect method to prove unreported income will be discussed later and involves computing the amount of marijuana that could be produced from a grow facility based upon electricity usage. Actively touring a grow house and retail facility will also assist in providing knowledge of the square footage as used in the allocation of expenses between growing and retail using IRC 280E.</p> <p>Some taxpayers and representatives may not desire to have the IRS tour their place of business. Under section 7606, you are authorized to enter premises to tour a place of business. If the taxpayer or representative refuses to allow you to tour their business, contact Counsel so they can assist you. Counsel can pursue a Writ of Entry under section 7402. Section 7342 imposes a penalty of \$500 for refusal to permit entry or examination. Examiners should maintain written notes and records indicating the facts surrounding any taxpayer's refusal to allow a tour.</p>
HIPAA	<p>HIPPA is the federal Health Insurance Portability and Accountability Act of 1996. The Office for Civil Rights enforces the HIPPA Privacy Rule, which protects the privacy of individually identifiable health information held by covered entities and their business associates and gives patients an array of rights with respect to that information. At the same time, the Privacy Rule is balanced so that it permits the disclosure of health information needed for patient care and other important purposes. When examining a medical marijuana business, the taxpayer may claim HIPPA does not allow them to divulge information about their customers. The IRS is not interested in obtaining the customer health information, but is seeking information about marijuana sales made to customers.</p> <p>The HIPPA rules apply to covered entities and business associates with written contracts and arrangements with the covered entity. See definitions at 45 CFR 160.103. It is not completely clear that all medical marijuana dispensaries are "covered entities" for purposes of HIPPA. In any event, under the Law Enforcement exception to HIPPA, HIPPA cannot be used as a shield to withhold all information issued in an appropriate administrative summons. See Chief Counsel Notice CC-2004-034. If the taxpayer will not relent in their position that HIPPA bars disclosure of all requested information, please contact Counsel.</p>



Audit Techniques for Testing Gross Receipts

Fifth Amendment Defense	<p>In this industry, because the taxpayers are violating federal criminal statutes, they might have a legitimate Fifth Amendment claim. Nevertheless, this can normally be overcome because there are limitations to the Fifth Amendment defense.</p> <p>First, the taxpayer must show that the silence is “justified.” <u>Hoffman v. U.S.</u>, 341 U.S. 479, 486 (1951). In other words, the taxpayer must show that he has a legitimate fear/concern of prosecution. For many of these taxpayers, they cannot make this showing, since the U.S. Attorney has publicly stated that prosecuting state sanctioned entities is not a priority, and the taxpayer has no evidence that he or she is being investigated or charged with any criminal offenses. The Tax Court has recently held that where a taxpayer in this industry does not make a showing that it is under criminal investigation, or does not otherwise show a legitimate fear of prosecution, he or she does not assert a valid Fifth Amendment Claim.</p> <p>Second, most of the taxpayers in this industry operate through LLCs, partnerships, or incorporated entities. Collective entities such as these are not entitled to a Fifth Amendment privilege. <u>Braswell v. U.S.</u>, 487 U.S. 99, 104 (1988). Even though the collective entity acts through individuals, those individuals are not entitled to a Fifth Amendment privilege if the records and information sought are with respect to the entity.</p> <p>Third, many of the records we are requesting are required to be kept by the State of Colorado’s Marijuana Enforcement Division (MED), and a taxpayer cannot claim the Fifth Amendment with respect to records that are required to be kept by a government regulator. <u>In re Grand Jury Proceedings</u>, 601 F.2d 162 (5th Cir. 1979).</p> <p>You will need to present these arguments to the taxpayer or representative. We have had some success with last chance letters and/or Counsel contact directly with the representative. If those efforts are not successful, please follow the appropriate procedures to have a summons enforced.</p>
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Audit Techniques for Testing Gross Receipts

<p>Cash Intensive</p>	<p>Marijuana businesses are generally cash intensive businesses. Customers may pay in cash to protect their identity. In several states, banks have made it difficult to open accounts for known marijuana businesses. Accordingly, marijuana businesses claim that it is necessary that they deal in cash.</p> <p>The main concern about cash intensive business is funds are often used to make purchases and are not accounted for by being deposited into bank accounts. Unlike checks and credit card receipts, cash does not get recorded before the funds are used. Cash funds are easily withdrawn from the safe by the taxpayer, business partner, or shareholder for personal use. Most medicinal centers deposit enough funds into bank accounts to pay rental and other expenses. If funds are used to pay business expenses, these transactions will be easier to identify than the funds used for personal expenditures. The use of an indirect method to determine income may be necessary if it appears that a taxpayer failed to report all cash sales.</p>
<p>How is Cash Handled</p>	<p>A thorough understanding of how cash is handled is particularly important, so be sure to find out:</p> <ul style="list-style-type: none"> • Is cash accepted for sales? • Is there an ATM on the premises? • What other payments are accepted? • Who has access to cash during a shift? • Who collects the cash from customers? • Does the business use registers? • How many registers does the business have? • How much cash is stored in the registers? • Where is the cash kept at the end of the shift? • Who has access to the safe? • How much cash is kept in the safe at the end of each night? • Who deposits the cash into the bank? • Who decides how much cash to deposit? • Who counts the cash? • Are there records of how much cash is in the safe? and • Who reconciles the cash to the sales receipts at the end of the day or shift? <p>When cash is used to pay vendors or make purchases, you must find out:</p> <ul style="list-style-type: none"> • Who is authorized to make cash purchases? • What is the procedure for making cash purchases?, and • How are cash expenditures reported? • Who is responsible for reporting it? • How is it reported? • How often is it reported?

Audit Techniques for Testing Gross Receipts

How is Cash Handled (continued)	<p>Even with weak internal controls, a taxpayer may be properly reporting income, but the only way to know this is to gather detailed information about how the business is conducted, documenting cash inflows and outflows and thoroughly interviewing the owner regarding cash receipts and expenditures.</p> <p>It is important to find out who takes cash to the bank and what accounts it may be deposited into. If the same employee (or owner) who records the income and prepares the bank deposit slip also takes the cash to the bank, they could change the amount on the deposit ticket and skim some or all of the cash.</p>
Cash Registers	<p>Ask if cash registers are used by the business, and determine how many registers are on the premises. Ask follow up questions to determine how many sales persons are on the floor at one time during each shift. Keep in mind that even if a taxpayer has a cash register, they may not use it properly. During the initial interview, ask what percentage of the business' sales is attributed to cash versus the percentage of credit cards or check payments.</p> <p>At the end of a shift an owner or manager often uses a special key to print "end of day" sales reports (An X report is a detailed tape, and a Z report is a sales summary tape). Typically the cash in each register will be compared to the sales on the Z tape at the end of each shift.</p> <p>If the taxpayer has a computerized cash register system and claims that they cannot provide the requested financial records, contact the cash register manufacturer for instructions on how to obtain the reports needed. Most programs made within the last decade can produce the essential reports.</p>
Summons	<p>If the taxpayer does not respond to your Information Document Requests or is unable or unwilling to furnish necessary testimony or documents, which are not otherwise available, you may need to issue a summons. A summons is an administrative demand to a person to appear at a specified time and place and/or to provide information and testimony. If the summoned person fails to provide the information, the U.S. District Court may compel the person to provide the summoned information.</p> <p>Before issuing a summons, analyze each situation in the light of its particular facts and circumstances. Weigh the importance of the requested information with the amount of time and resources it will require if you issue a summons. You should attempt to obtain information voluntarily from the taxpayer or third parties prior to issuing a summons.</p>

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Summons Enforcement	<p>If a summons is issued and the taxpayer still refuses to comply, court enforcement action may become necessary. It is imperative you obtain permission from your group manager before issuing the initial summons. It is also advisable to either discuss the summons request with local counsel before issuing, or send it to counsel for review. You must ensure the summons was properly executed, served, and counsel is able and willing to enforce the summons if necessary. Be certain you personally serve the summons on the taxpayers to ensure that it is later enforceable.</p> <p>What if they say they have no records? Why is this important to get a written statement saying as much? 5th amendment issues, get counsel involved early.</p>
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Audit Techniques for Testing Gross Receipts

Indirect Methods

The minimum income probes, including the reconciliation of the IDRS documents, Cash-T analysis, and comparisons to industry averages are not the primary reason for your adjustments to an income item, rather are the starting point intended to help you establish the scope of your examination and to determine the type of detailed testing you will perform.

Neither the Code nor the Regulations define or specifically authorize the use of formal indirect methods. However, IRC § 446(b), Exceptions, General Rule for Methods of Accounting, provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

IRM 4.10.4.6.2.1(2) states the following list, which is not intended to be all inclusive, identifies circumstances that, individually or in combination, would support the use of a formal indirect method.

- A financial status analysis that cannot be balanced; i.e., the taxpayer's known business and personal expenses exceed the reported income per the return and nontaxable sources of funds have not been identified to explain the difference.
- Irregularities in the taxpayer's books and weak internal controls.
- Gross profit percentages change significantly from one year to another, or are unusually high or low for that market segment or industry.
- The taxpayer's bank accounts have unexplained items of deposit.
- The taxpayer does not make regular deposits of income, but uses cash instead.
- A review of the taxpayer's prior and subsequent year returns show a significant increase in net worth not supported by reported income.
- There are no books and records. Examiners should determine whether books and/or records ever existed, and whether books and records exist for the prior or subsequent years. If books and records have been destroyed, determine who destroyed them, why, and when.
- No method of accounting has been regularly used by the taxpayer or the method used does not clearly reflect income. See IRC 446(b).

Audit Techniques for Testing Gross Receipts

Bank Deposits and Cash Expenditures Method	<p>The classic bank deposits case is <u>Gleckman v. United States</u>, 80 F.2d 394 (8th Cir. 1935). The court held that standing alone bank deposits and large items of receipts do not prove additional tax due. On the other hand, if it is shown that these amounts can be associated with a business or income-producing activity, then the income is taxable. Since the Gleckman case, the Bank Deposits Method has received consistent judicial approval.</p> <p>The Gleckman case, and the cases that followed, taught that in order to use the Bank Deposits and Cash Expenditures Method in determining income, it must be shown that:</p> <ul style="list-style-type: none">• The taxpayer was engaged in a business or income-producing activity,• The taxpayer made periodic deposits of funds into a bank account or accounts,• An adequate investigation of deposits was made by the examiner in order to negate or eliminate the likelihood that the deposits arose from nontaxable sources of income, and• Unidentified bank deposits have the inherent appearance of income; i.e., the size of the deposits, odd or even amounts, source of checks deposited, dates of deposits, etc. <p>The Bank Deposits and Cash Expenditures Method should not be the automatic choice when selecting a formal indirect method. For example, cash intensive businesses, where significant amounts of gross receipts are not deposited and numerous cash outlays occur, do not lend themselves to this method.</p> <p>If the Bank Deposits and Cash Expenditures Method is the method of choice, the entire analysis must be completed; shortened versions that do not account for business and personal cash expenditures are insufficient.</p> <p>The Bank Deposits and Cash Expenditures Method is recommended when:</p> <ul style="list-style-type: none">• The taxpayer's books and records are unreliable, unavailable, withheld, or incomplete.• The taxpayer makes periodic deposits of funds into bank account(s) which appear to be generated from an income-producing activity.• The taxpayer pays most business expenses by check.• The taxpayer previously used bank account deposits to determine and report taxable income. <p>The obvious challenge with using this indirect method when examining a marijuana industry case is the taxpayer may not even have a bank account. If the taxpayer does have a bank account, they may not be depositing all their cash receipts and they may be using undeposited cash to pay for both business and personal living expenses.</p>
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Audit Techniques for Testing Gross Receipts

Source and Application of Funds Method	<p>The use of the Source and Application of Funds Method in establishing unreported income received the Supreme Court's approval in <u>United States v. Johnson</u>, 319 U.S. 503 (1943). In addition to proving the taxpayer owned gambling establishments whose winnings were unreported, it was proven that in three of the years involved, the taxpayer's personal expenditures exceeded his current income plus his declared accumulated funds.</p> <p>The Source and Application of Funds Method is best used when the taxpayer's return indicates that the taxpayer's deductions and other expenditures appear out of proportion to the income reported, cash does not all flow from a bank account which can be analyzed, or the taxpayer makes it a common business practice to use cash receipts to pay business expenses. The basic theory of this formal indirect method is that any excess expenses (applications) over income items (sources) represents an understatement of taxable income.</p> <p>Sources of funds are the various ways the taxpayer acquires money during the year. Decreases in assets and increases in liabilities generate funds. Funds also come from taxable and nontaxable sources of income.</p> <p>Applications of funds are ways the taxpayer used money during the year. When you are conducting an examination, determining business related expenses is usually easy because the taxpayer reported a deduction for the business expense on the tax return. With some additional work, you can identify purchases of traceable assets such as real estate and vehicles.</p> <p>The most challenging part of using any indirect method is determining the taxpayer's personal living expenses and the amount of cash the taxpayer has accumulated. The use of statistical data might be a basic starting point for you when you are trying to determine the personal living expenses but it usually conservative. You may be determining the amount of accumulated cash based on the taxpayer's oral testimony. Taxpayers operating a business in the marijuana industry are unlikely to willingly show you their accumulation of cash. The taxpayer may state they have a small accumulation of cash at the beginning of the year and claim they used it all up during the year.</p> <p>The Source and Application of Funds Method may not be the best indirect method for you to use when you are conducting an examination on a marijuana industry case simply because determining personal living expenses and the accumulation of cash is one of the most significant parts of the equation.</p>
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Audit Techniques for Testing Gross Receipts

Net Worth Method	<p>Group manager approval is not required when initiating the use of a formal indirect method, except for the Net Worth Method (see IRM 4.10.4.6.7.2 (2)).</p> <p>The use of the Net Worth Method of proof has been approved by the Supreme Court in: <u>Holland v. United States</u>, 348 U.S. 121 (1954). <u>Holland</u> set forth the following requirements the government must meet when using the Net Worth Method:</p> <ul style="list-style-type: none">• Establish an opening net worth, also known as the base year, with reasonable certainty.• Negate reasonable explanations by the taxpayer inconsistent with guilt; i.e., reasons for the increased net worth other than the receipt of taxable funds. Failure to address the taxpayer's explanations might result in serious injustice.• Establish that the net worth increases are attributable to currently taxable income.• Where there are no books and records, willfulness may be inferred from that fact coupled with proof of an understatement of taxable income. But where the books and records appear correct on their face, an inference of willfulness from net worth increases alone might not be justified.• The government must prove every element beyond a reasonable doubt, though not to a mathematical certainty. <p>The Net Worth Method of reconstructing income is based upon the theory that increases in a taxpayer's net worth during a taxable year, adjusted for nondeductible expenditures and nontaxable income, must result from taxable income.</p> <p>While the Net Worth Method was originally used against taxpayers whose principal source of income was from an illegal activity, it is now regularly recommended in fraud cases, especially where significant changes in net worth have occurred and other methods of proof are insufficient. The Net Worth Method is relied upon to corroborate other methods of proof and test the accuracy of reported taxable income.</p> <p>The use of the Net Worth Method has the same challenges as the other indirect methods; proving personal expenses and the accumulation of cash.</p>
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Audit Techniques for Testing Gross Receipts

<p>General Considerations for Testing Gross Receipts</p>	<p>As a general matter, developing an unreported gross receipts case for a medical marijuana business is challenging, since so many transactions are cash transactions. Although each case will have differing facts, you should consider pursuing the following information when attempting to ascertain whether gross receipts are underreported.</p> <p>The following information is in addition to standard information examiners use when developing gross receipts cases, such as bank account information and witness interviews</p> <ul style="list-style-type: none"> • Utilities records through the current date • Plant counts and lighting module counts, including an identification of the type of lighting used¹ • Information regarding the experience of the individual primarily responsible for the grow facility, usually obtained through interview or a resume • An inventory of equipment used in the grow facility² • Square footage of the grow facility, including square footage of the area devoted to marijuana cultivation³ • The taxpayer’s marijuana production records, including full records regarding the dried, saleable, product produced during the year, and the number of harvests per year • Complete Records from Marijuana Inventory Tracking Solution (MITS) Accounts⁴ • Retail and/or wholesale pricing information for all periods at issue • Sales tax information • Investor prospectuses • The name of any armored cash transporters used by the taxpayer, e.g., Brinks, Loomis, or MJ specific businesses such as MPS or BlueLine, along with associated records • Complete records of all packaging, including child resistant packaging and vials, purchased by the business • Information from any ATM/Cash machines in the selling establishment • Information from marijuana POS record keepers such as MJFreeway.
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¹ This may be obtained through a tour of the grow facility, or from files held by the MED.

² See http://evan-mills.com/energy-associates/Indoor_files/cannabis-carbon-footprint.pdf for a general discussion of a simulated house grow operation, including discussion of the equipment used.

³ This can often be obtained from a tour of the business, a review of a rental lease, or from files held by the MED.

⁴ After December 31, 2013, Colorado required business to track inventory using the MITS RIFD system. See generally <http://www.metrc.com/>



Audit Techniques for Testing Gross Receipts

(b)(5)
Deliberative
Process

Utilities	<p>Nevertheless, utilities usage along with other cultivation observations can be a strong indicator of the amount of marijuana produced and sold. For example, if you perform a light count during a tour, you can perform a rough estimate of the expected yield from that harvest. Generally, a 1KW light and ballast module will produce 1.5 to 2 pounds of dried saleable product within a cycle, and there are usually 5-6 harvest cycles per year.</p> <p>If after comparing current utilities records with a prior year's records there are consistent utilities usages but inconsistent production records or gross receipts reported, you have a strong indicator that gross receipts are being underreported in one of the years. Similarly, you may find that both the current year and the prior year at issue indicate underreporting. In general, these comparisons will require you to compare current year utilities usage and records with prior years' usage and records, so your requests for information should include the year at issue up until the current date that lights are counted. Moreover, because the growth cycle creates a lag between utilities usage and harvest and sale, you should generally requests records from at least three months before the first period at issue.</p> <p>In situations such as these, the utilities records combined with a tour may be a good and relatively inexpensive indicator that additional investigation into gross receipts is warranted. They may also form the basis for developing an indirect method of income estimation.</p>
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Audit Techniques for Testing Expenses

IRC § 280E	<p>Per IRC section 280E, tax returns of marijuana involved businesses should not reflect “deductions” or below the line items unless those expenses are (1) incurred by a cash-method taxpayer not required to use an inventory method (and are expenses that would be properly includible in COGS for a marijuana business if that business were accounting for inventories), or (2) incurred in a separate and distinct business, see <u>Californians Helping to Alleviate Medical Problems v. Commissioner</u>, 128 T.C. 173, 183 (2007).</p> <p>It is extremely important that you inquire as to the allocation and categories of COGS reported on each return. More and more taxpayers are combining their disallowed business expenses and wages with the reported COGS.</p> <p>COGS for a retailer: COGS for a retailer includes only inventoriable costs capitalized under §1.471-3(b) as it existed before the enactment of §263A:</p> <ul style="list-style-type: none">• The purchase price of the marijuana (net of any trade discounts), and• The transportation or other necessary charges incurred in acquiring possession of the marijuana. <p>COGS for a grower: COGS for a grower includes inventoriable costs capitalized under §1.471-3(c) and §1.471-11 as they existed before the enactment of §263A:</p> <ul style="list-style-type: none">• Direct material costs;• Direct labor costs;• Category 1 indirect costs (§1.471-11(c)(2)(i)), such as repairs, maintenance, rent; and• Possibly, category 3 indirect costs (§1.471-11(c)(2)(iii)), such as taxes, depreciation, officers’ salaries attributable to services incident to and necessary for production operations. <p>COGS for a grower DOES NOT include Category 2 indirect costs (§1.471-11(c)(2)(ii), such as marketing expenses, advertising expenses, selling expenses, and general and administrative expenses incident to and necessary for the taxpayer’s activities taken as a whole.</p>
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Allocation of COGS

Per Treasury Regulation 1.471-3 which discusses COGS “cost means: ...(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any costs of selling...”

Treasury Regulation 1.471-11 provides great detail as to the items includible in inventory production costs of manufacturers. Regulation 1.471-3 discusses inventory rules for resellers. In these cases both may be applicable.

Starting in July of 2011, marijuana dispensaries (MMC) were required by the state of Colorado to be vertically integrated with a commonly owned growing operation (OPC – optional premises cultivation or CF - cultivation facility). The marijuana dispensaries are now required to produce 70% of the product sold in the related MMC. The 70% rule is based on a rolling 12 month production cycle. As of October 1, 2014, the Colorado laws changed now allowing for “wholesale” grow operations. As of October 1, 2014 a new category of marijuana business was introduced – a retail marijuana cultivation facility (RMCF) with its own separate license. The medical marijuana sellers (MMJ) will still be held to the 70/30 vertical integration model, but this too may change as the laws are reviewed.

IRC § 263A will generally not apply to these businesses. Chief Counsel’s Income Tax and Accounting division recently issued guidance on this issue in CCA 201504011.

In auditing these returns you may find that the taxpayer and their accountant included all “deductions” into COGS. There may be an amount shown as beginning and ending inventory or nothing at all reflected for inventory. An amount may be shown as “280E” adjustment or no adjustment amount reflected. The lack of a “280E adjustment” does not necessarily mean none was made in the preparation of the return. Returns are filed using both the cash and accrual method of accounting.

The initial interview is crucial to the understanding of how the return was prepared; the taxpayer’s understanding of the law; and the determination of potential income and expense adjustments.



Allocation of COGS (continued)	<p>The Office of Chief Counsel memorandum dated December 11, 2012 titled “Questions to be Asked at the Start of a Dispensary Audit and Other Revenue Estimation Issues” offers a good starting point for structuring your interview questions. Because business expenses associated with the trafficking will be unallowable per the rules of Code section 280E it is necessary to determine at which point “production” ceases and finished goods are readily available for transfer to the MMC (medical marijuana center) or RMS (retail marijuana store) for resale.</p> <p>For example:</p> <p>A marijuana dispensary sells clones. The clones are produced in the optional premises cultivation (grow facility) and transported to the marijuana dispensary for resale. While at the marijuana dispensary they are stored both in the purchasing area and in a basement area under grow lights. The taxpayer may argue the storage area should not be 280E limited.</p> <p>You should take the position once the plants have left production facility they become inventory of the marijuana dispensary In <u>Marcor v. Commissioner</u>, 89 T.C. 181 (1987), nonacq., 1990-C.B.1. the Tax Court addressed the section 471 regulations and case law on the distinction between COGS and expenses and held that "costs incurred after a taxpayer has acquired full dominion and control over the merchandise, e.g., selling expenses or subsequent transportation costs, are not included in inventory cost" Similarly, in <u>Van Pickerill Son, Inc. v. U.S.</u>, 445 F.2d 918, the court determined that once liquor is in saleable state (even if not fully aged), the expenses for selling it are sales expenses, not inventory costs.</p> <p>This type of distinction is necessary for such items as the refrigeration of edibles, storage of product after hours, or some other off premise storage area at which goods to which title has passed (read have been manifested to the dispensary) are stored; per Code sections 280E and 471 these costs are not includible in inventory and therefore non-deductible.</p> <p>The purchase of edibles (MIPs – marijuana infused products), cannabinoid derivatives, and bud product purchased from others will be included in the “purchases” computation of COGS at cost. Note, however, that the storage space for raw materials such as food products that will be used to produce edibles may be included in COGS.</p>
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Separate Trade or Business

The taxpayer may argue that the business sells other non-drug items such as tee shirts; pipes; cookbooks; and miscellaneous other marijuana related paraphernalia, they may also likely argue that the business provides other caregiving services to their clients. Your tour of the business will allow you to determine if this is true or false. Revenue Agents should ask specific probative questions about all other services the business claims to have offered:

- 1) Ask which employees or contractors provide services,
- 2) Ask for the fee schedule for the services
- 3) Find out how a patrol would sign up for services
- 4) Get contact information for any service providers
- 5) Ask for copies of all flyers and advertising for services
- 6) Ask for service contracts or agreements from providers
- 7) Ask for training and certifications for all caregiving employees

The Office of Chief Counsel Memorandum dated September 7, 2012 discusses the separate trade or business arguments. Review the memo prior to your initial interview; it is a good source of potential questions that can be used to address the claim of separate businesses during your initial interview and tour.

MEDICINAL CENTER CASE LAW

As of 2015, there is one statute, no regulations, and only two case decisions on the subject.

The two most relevant medicinal center case decisions to date are Californians Helping to Alleviate Medical Problems v. Commissioner, “CHAMP” 128 T.C. 173 (2007), and Olive v. Commissioner, 138 T.C. No. 2 (2012). In CHAMP, the Court allowed the clinic to deduct COGS for purchases of marijuana, and also allowed the allocation of business expenses to the separate but related caretaking business. It is important to note that CHAMP was an AIDS clinic originally set up by a professional health care worker to feed and care for terminally ill patients. When Mike Aldrich, the owner of the clinic, realized that marijuana was helpful in raising the appetites in sick patients he included marijuana to what was offered to the clinic’s members. The patient members paid a monthly membership fee that included access to all caretaking services, counseling, religious services, legal services, and a monthly allowance of marijuana.



Separate Trade or Business (continued)

In Olive, the Court did not find that the medicinal center’s claim of providing counseling to patients on the effects of marijuana, regular pizza and movie parties, a massage chair, and yoga class offerings rose to the level of regular, substantial, and extensive to be considered a separate business outside the trafficking of a controlled substance. Subsequently, the business expenses were not allowed under IRC § 280E. Neither Olive nor his staff had any healthcare or caregiving training. Olive argued that his staff provided counseling on the types of strains and effects of marijuana to patients and that this counseling should qualify as a separate business. Olive also argued that he “trafficked marijuana” only during the short time it took his staff to physically pass the marijuana to the patrons in exchange for payment at the cash register. He argued that all other expenses of the Vapor Room’s business were related to providing caregiving services and should be deductible.” This is sometimes referred to as the “stop watch allocation method.” The Court rejected this argument.

The key issue in both cases involved identifying what constitutes a bona fide separate trade or business. This is a question of fact not conjecture. The analysis depends on the degree of economic interrelationship between the two undertakings; the business purpose served by carrying on the undertakings separately or together; and the similarity of the undertakings – see Treasury Regulation 1.183-1(d)(1) and Schlafer v. Commissioner, T.C. Memo. 1990-66.

In CHAMPS, the Court found that the clinic demonstrated that it conducted separate and substantial religious and community outreach activities that qualified as a separate trade or business; therefore, the expenses could be allocated to those non drug related activities. In CHAMPS, the Court found that **caregiving** was the primary purpose of the organization. The dispensary provided caregiving services which were regular, extensive, and substantially independent of the provision of medical marijuana. The dispensary director and staff had significant experience in health services and 72% of the employees worked exclusively in the caregiving business. The taxpayer maintained a separate and distinct space in which it provided yoga and other meetings. They provided regular, healthy meals. They organized field trips and nearly half of the taxpayer’s members suffered from AIDS and paid a single membership fee for the right to receive caregiving services and medical marijuana. A good initial interview and tour of the property will generally resolve whether the taxpayer, analogous to CHAMP, has a credible argument that it operated a separate trade or business.

In Olive the Court determined the Vapor Room would not have any revenues, and therefore could not have operated, if none of the patrons purchased marijuana. In Olive the dispensary did not incur additional expense to provide counseling or other services to clients. Any counseling that was done was done in the same spaces as trafficking.



<p>Champ vs. Olive</p>	<p>DIFFERENCES BETWEEN OLIVE & CHAMP</p> <ol style="list-style-type: none"> 1) CHAMP had two separate businesses. 2) CHAMP operated exclusively for charitable, educational, and scientific purposes with income slightly less than expenses. 3) CHAMP's director was well experienced in health services, and caregiving was the primary purpose of the dispensary. 4) 72 percent of CHAMP's employees worked exclusively in caregiving services. 5) CHAMP's Caregiving services were provided regularly, extensively, and substantially independent of providing marijuana. 6) CHAMP rented separate space from a church for counseling, yoga, meetings, that did not allow marijuana. 7) CHAMP provided hygiene supplies and healthy meals to low income patrons. 8) CHAMP Members paid a single membership fee that included caregiving and marijuana. 9) CHAMP began as an Aids clinic with its primary purpose to serve terminally ill patients.
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<p>Change in Accounting Method</p>	<p>Medicinal center cases can often involve the need for a Code section 446 change in accounting method. If the taxpayer reflected all costs as deductions and some would qualify, per Code section 471, as inventory production costs or they do not reflect any ending finished goods inventory in the COGS computation a change in accounting method is the result.</p> <p>The question that often arises is whether a Revenue Agent can change a taxpayer's accounting method to a more favorable method pursuant to Code 446 which would allow the Revenue Agent to recharacterize certain expenses as COGS which were previously mischaracterized as business expenses and disallowed under section 280E.</p> <p>Generally, an agent has the authority to change an accounting method. Rev. Proc. 2002-18. Accordingly, agents may recharacterize claimed section 162 expenses into section 471 inventory costs only if the claimed section 162 expenses actually meet all of the applicable rules to be characterized as a section 471 inventory costs. Chief Counsel's Income Tax and Accounting Branch recently issued detailed guidance on this issue in CCA 201504011.</p>
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Substantiation of Expenses	<p>Because trafficking in marijuana is illegal under federal law, many marijuana businesses do not have bank accounts or may run only limited activity through any established bank account. The industry claims that customers and suppliers prefer to be paid in cash; this creates additional audit work with respect to income and expenses.</p> <p>Taxpayers are required to maintain permanent records to substantiate all claimed expenses and COGS. There is nothing in the Internal Revenue Code or the Colorado statues which absolves or otherwise excuses marijuana businesses from keeping adequate books and records. In fact, both the states of Colorado and California require that marijuana businesses keep accurate books and records.</p> <p>The state statues can be found at the Marijuana Enforcement Division’s website www.colorado.gov/revenue/medicalmarijuana. Review of the website is suggested as preparation for any examination of a marijuana related business. The statues are very specific with respect to the types of recordkeeping required, who can be an owner, the application and licensing process and costs, security needs, etc. These taxpayers are involved in a business which is constantly under scrutiny as such any responsible business owner knows the rules and regulations much better than you will and understand the need to keep detailed business records. Detailed recordkeeping is just good business and helps the taxpayer to avoid suspicion and second guessing later on.</p> <p>As a business involved in cash intensive transactions, a reasonably prudent businessperson would go out of their way to document cash expenditures. When no documentation of expenses can be provided, ignorance and recordkeeping burdens are not acceptable excuses; the taxpayer knowingly entered this business and in fact, paid a great deal of money to get involved in the industry understanding all the related benefits and burdens.</p> <p>The examiner might be tempted to disallow deductions based on IRC section 6001 - no substantiation no deduction/COGS expense. Perhaps a better alternative is the use of Code section 280E if the expenditure is reflected as a deduction. Thus the expenditure is still considered a use of funds but deduction limited by 280E.</p> <ol style="list-style-type: none"> 1) Consider a single member LLC that reports as a disregarded entity, self-employment tax and (additional?) income tax are the result. 2) In a partnership, the managing/general partners will be subject to Self-employment tax on their share of net ordinary income and will also be subject to a basis adjustment for any non-deductible items. Filing a form 1120 would have increased the taxable income and an M-1 adjustment for non-deductible items. 3) Finally, an S-Corporation would have increased flow-thru income but a basis adjustment for items deemed subject to 280E.
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Substantiation of Expenses (continued)	<p>If the income analysis results in a proposed adjustment for unreported gross receipts the examiner needs to consider the argument which is most commonly raised – the cash was spent on business expenses which should be allowed as deductions.</p> <p>In a well-developed case the examiner always considers expenditures which are reasonable, ordinary and necessary trade or business expenditures. In non-filer or other lack of records cases often the examiner considers the use of biz stats in an effort to allow reasonable business expenditures. Unfortunately, there are no biz stats for marijuana business at this time.</p>
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Penalty Considerations

Introduction	We now need to determine whether a taxpayer should be subject to an accuracy-related penalty under section 6662(a). A taxpayer may be liable for a 20% penalty on any underpayment of tax attributable to negligence or disregard of rules of regulations or any substantial understatement of income tax. See IRC section 6662(a) and (b)(1) and (2). “Negligence” includes any failure to make a reasonable attempt to comply with the provisions of the Code and includes “any failure by the taxpayer to keep adequate books and records or to substantiate items properly.” IRC Section 6662(c). Negligence has also been defined as a lack of due care or failure to do what a reasonable person would do under the circumstances.
IRC § 6662 Accuracy Related	<p>The Service bears the burden of production to impose the accuracy-related penalty. See IRC section 7491(c); <i>Higbee v. Commissioner</i>, 116 T.C. 438 (2001).</p> <p>In <i>Olive</i>, the Service was successful in applying accuracy related penalties as attributable to negligence to the taxpayer for the underpayment of tax. *The Court did not assert penalties on the taxpayer for expenses that were substantiated and were disallowed due to IRC section 280E because the law was not certain on this issue when the taxpayer originally filed his 2005 and 2006 tax returns. Where a case is one “of first impression with no clear authority to guide the decision makers as to the major and complex issues,” a negligence penalty is inappropriate. <i>Foster v. Commissioner</i>, 756 F.2d 1430 (9th Cir. 1985). The decision in <i>CHAMP</i> was not decided until 2007.</p>
Reasonable Cause Exceptions	An accuracy-related penalty does not apply, however, to any portion of an underpayment for which there was reasonable cause and where the taxpayer acted in good faith. See IRC section 6664(c)(1).
SharePoint Site	https://adminnondisclosure2.prod.irs.counsel.treas.gov/Businesses_Dealing_in_Cannabis/SitePages/Home.aspx

Round Table Notes	
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(b)(3) 26 U.S.C.
§ 6103

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Withheld pursuant to exemption

(b)(5) Attorney/Client Privilege

of the Freedom of Information and Privacy Act