

Medical Marijuana Returns: Unique Issues

Luke Ortner and Matt Houtsma
Office of Chief Counsel
IRS

Overview

- Medical marijuana is a new and expanding industry, and commercial marijuana is on the horizon in Colorado. As with any new industry, the IRS is continuing to expend resources to ensure there is tax compliance within the industry.

Overview (cont.)

- Unique issues related to taxation of medical marijuana:
 - I.R.C. section 280E disallows deductions
 - MMJ businesses are usually cash business

I.R.C. section 280E

- “No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.”

I.R.C. section 280E (cont.)

- Although marijuana is legal under state law, it is still illegal under federal law and its sale is drug trafficking. United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483 (2001).
- So 280E applies.
- But . . .

I.R.C. section 280E – COGS

- Marijuana sellers can still claim costs of goods sold (“COGS”) as adjustments to income. Peyton v. Commissioner, T.C. Memo. 2003-146, at *5.

I.R.C. section 280E – COGS

- Relevant COGS definition under Treas. Reg. section 1.471-3
 - “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 cost of selling”

I.R.C. section 280E – COGS

- Because MMJ dispensaries are required under state law to produce 75 percent of their sold product, dispensaries must generally grow and produce their own merchandise. Otherwise, the purchase price of the marijuana is included in COGS.

I.R.C. section 280E – COGS

- COGS does include items such as labor expenses for producing the product, materials and supplies, and overhead expenses for the growing facility.
- COGS does not include expenses for the sale of marijuana, such as wages for a budtender or overhead expenses for the retail space.

I.R.C. section 280E - COGS

- Although taxpayers do have some flexibility in determining their accounting methods and whether an item is immediately expensable or includable in COGS, there are baseline principles in place.
 - Under Treas. Reg. section 1.471-3(c), COGS does not include costs of selling.
 - In Marcor v. Commissioner, 89 T.C. 181 (1987), nonacq., 1990-C.B.1, the Tax Court addressed the 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"

I.R.C. section 280E - Allocation

- Some dispensaries have attempted to allocate expenses to another, separate but related, trade or business.
- Results have been mixed. See Californians Helping to Alleviate Medical Problems v. Commissioner, 128 T.C. 173 (2007) (allowing allocation); Olive v. Commissioner, 139 T.C. No. 2 (2012) (no allocation allowed).

I.R.C. section 280E - Allocation

- Whether an activity is a trade or business is a question of fact. It depends on:
 - 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.

Treas. Reg. section 1.183-1(d)(1); Schlafer v. Commissioner, T.C. Memo. 1990-66.

I.R.C. section 280E - Allocation

- CHAMP (2007): Tax Court held that if the dispensary demonstrates it conducts activities that constitute separate trades or businesses, the expenses allocable to those activities will be allowable.

I.R.C. section 280E - CHAMP

● Findings in CHAMP:

- caregiving was the primary feature of the organization;
- dispensary provided caregiving services regularly, extensively, and substantially independent of providing medical marijuana;
- director of the dispensary had significant experience in health services;
- seventy-two percent of the taxpayer's employees worked exclusively in its caregiving business;

I.R.C. section 280E - CHAMP

● Facts in CHAMP (cont.):

- taxpayer segregated the space in which it provided yoga and other meetings from the space in which it provided marijuana;
- taxpayer provided regular, healthy meals;
- taxpayer organized field trips;
- 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.

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- CHAMP summarized: The organization was professionally run as a health and rehabilitation center and significant resources were devoted to health care. Accordingly, the organization was entitled to allocate expenses to the caregiving enterprise. The organization probably would have operated even in the absence of marijuana trafficking.

I.R.C. section 280E - Olive

- Olive (2012) – Tax Court does not allow dispensary to allocate expenses to a separate caregiving business.
- Facts:
 - TP did not incur additional expense to provide counseling and other services
 - TP used same space for both counseling and dispensing
 - Used single bookkeeper and accountant for the business.

I.R.C. section 280E - Olive

- Olive's most important fact:
 - Taxpayer “would not have had any revenues at all (and could not have operated) if none of the patrons purchased marijuana.”

I.R.C. section 280E - Olive

• Olive take home:

- Merely recommending specific strains of marijuana to address particular health issues, along with providing minimal additional counseling or caregiving, does not establish an independent trade or business.
- The Tax Court also rejected the argument that the taxpayer “trafficked marijuana only during the short time it took for the staff members to pass the medical marijuana to the patrons in exchange for payment and that the rest of the Vapor Room’s business was providing caregiving services.” Olive, 139 T.C. no. 2, slip. op. at 34.

MMJ-Cash Intensive Businesses

- Because marijuana trafficking is illegal:
 - Dispensaries may not be able to get a bank account
 - Customers prefer to pay in cash
 - Suppliers may want to be paid in cash
- This does not absolve a dispensary of the duty to keep adequate books and records. Failure to keep books and records can lead to a more difficult audit and penalties.

Questions and Answers?

Marijuana Businesses: Unique Exam and Collection Issues

Melinda Fisher and Matthew Houtsma
Office of Chief Counsel
IRS

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Collection Issues

- Can Collection Seize and Sell Marijuana?
 - Short answer: no.
- IRM 5.10.3.17 and 5.10.2.9 do potentially contemplate seizing and selling controlled substances. Final authority is with the Area Director, but you have to get Counsel opinion.
- Even if it were legal for the IRS to sell marijuana, our opinion will almost certainly be that it not be seized or sold.

Collection Alternatives for Marijuana Businesses

- When contemplating a financial analysis, should Collection disallow any expenses because it is an illegal business?
 - No, there is no analog to section 280E in the Collection context.
- Under IRM 5.15.1.7 Collection should allow expenses that are necessary for production of income because if you don't consider expenses you won't get an accurate picture of what you can collect while not driving the taxpayer out of business.

Collection Possibilities

- If Collection can't seize the marijuana or related product, and the taxpayer deals largely in cash, what can be done?
- Seizure of assets (cash register, safes, equipment, etc.) is a possibility, as is:
- Alter ego, fraudulent transfer, transferee liability, successor in interest theories if warranted by the facts.

Cash Payments to the IRS

- Because it is difficult for them to obtain bank accounts, some taxpayers will want to pay in cash.
- Procedures for making cash payments at a taxpayer assistance center are found at IRM 21.3.4.7.2.
- Easiest way is to have the TP go to the nearest Taxpayer Assistance Center. If they just drop in, this can be a long process, so it is best to call a TAC manager in advance and set up an appointment.

Questions?

SEPARATE TRADE OR BUSINESS ISSUES FOR TAXPAYERS AFFECTED BY SECTION 280E

July 21, 2016
Patsy Clarke
and Alicia Eyler



Deductions for Businesses

Section 162 – Trade or Business Expenses.

- ▣ Section 162(a) provides a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any **trade or business**.”
 - Examples: employee salaries, rent, utilities, and advertising.
- ▣ To be engaged in a trade or business for purposes of § 162, a taxpayer must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit.

Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987); *Portland Golf Club v. Commissioner*, 497 U.S. 154, 164 (1990).

Separate Trade or Business

- ▣ Section 280E does not preclude a taxpayer from deducting expenses attributable to a separate business **other than** that of illegal trafficking in a controlled substance simply because it also is involved in the trafficking of a controlled substance.
- ▣ Therefore, a taxpayer may argue that it has another business separate from its marijuana business.
 - Another business might involve the sale of items other than marijuana, such as tee shirts, hats, pipes, vaporizers, cookbooks, etc.
 - It might also involve providing services, such as caregiving services.

Separate Trade or Business

Two cases provide a detailed analysis of whether a taxpayer has another business separate from its marijuana business:

1. *Californians Helping To Alleviate Med. Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007) (hereinafter *CHAMP*).
2. *Olive v. Commissioner*, 139 T.C. 19 (2012), *aff'd*, 792 F.3d 1146 (9th Cir. 2015).

Other cases provide a brief mention of this issue:

Beck v. Commissioner, T.C. Memo. 2015-149.

Canna Care, Inc. v. Commissioner, T.C. Memo. 2015-206.

CHAMP

- ❑ In *CHAMP*, the taxpayer was a community center for members with debilitating diseases, and it operated with a dual purpose.
- ❑ Its primary purpose was to provide caregiving services to its members; its secondary purpose was to provide its members with medical marijuana.
- ❑ The taxpayer's members paid a single membership fee for the right to receive caregiving services and a specific amount of medical marijuana.
- ❑ The caregiving services were extensive, and the marijuana distribution took up approximately 10% of the space at the taxpayer's main facility.
- ❑ The director and staff had significant experience in health services, and 72% of the employees worked exclusively in the caregiving business.

CHAMP

- ▣ The Tax Court found that the caregiving services generated income because the members paid their membership fees as consideration for both caregiving services and medical marijuana.
- ▣ After considering all of the facts and circumstances of the case, the Tax Court held that the taxpayer's provision of caregiving services was a business separate and apart from its provision of medical marijuana.

Olive

- ▣ In *Olive*, the taxpayer operated a sole proprietorship.
- ▣ Its principal business was the retail sale of medical marijuana; it provided minimal activities and services, including yoga classes and massages.
- ▣ There was no membership fee and no charge for the activities and services — the sole proprietorship's *only* source of revenue was its sale of medical marijuana.
- ▣ After considering all of the facts and circumstances of the case, the Tax Court held that the taxpayer had a single business, the dispensing of medical marijuana, and that he provided all of the sole proprietorship's services and activities as part of that business.
- ▣ TP appealed to the Ninth Circuit, which affirmed.

Separate Trade or Business Overview

- ▣ First, it is necessary to determine whether a taxpayer's primary purpose for engaging in the purported other business activity was for income or profit. *Groetzing*, 480 U.S. at 35; *Portland Golf Club*, 497 U.S. at 164.
- ▣ In many situations involving a purported separate caregiving business, the taxpayer does not charge (or imposes a very minimal charge) for the services or goods, which shows that the taxpayer did not intend to make a profit solely by the provision of the services.
- ▣ As a matter of law, a taxpayer cannot have another business if the taxpayer does not intend to profit from the purported other activity.

Separate Trade or Business Overview

- ▣ Assuming the taxpayer had the intent to make a profit, the next step would then be a facts-and-circumstances analysis to determine whether that purported other business activity was a separate trade or business.

Separate Trade or Business

- ▣ In *Olive*, the Tax Court provides the relevant factors:
 - The degree of organizational and economic interrelationship of the different undertakings.
 - The business purpose for carrying on the activities separately or together.
 - The similarity of the various undertakings.

Organizational Interrelationship

The Court will consider:

- (a) Whether the undertakings share a close organizational and economic relationship,
- (b) whether the undertakings are conducted at the same place,
- (c) whether the undertakings were part of a taxpayer's efforts to find sources of revenue from his or her land,
- (d) whether the undertakings were formed as separate businesses,
- (e) whether one undertaking benefited from the other,
- (f) whether the taxpayer used one undertaking to advertise the other,
- (g) the degree to which the undertakings shared management,
- (h) the degree to which one caretaker oversaw the assets of both undertakings,
- (i) whether the taxpayers used the same accountant for the undertakings, and
- (j) the degree to which the undertakings shared books and records.

See *Keanini v. Commissioner*, 94 T.C. 41, 46 (1990); *Estate of Brockenbrough v. Commissioner*, T.C. Memo. 1998-454; *Hoyle v. Commissioner*, T.C. Memo. 1994-592; *De Mendoza v. Commissioner*, T.C. Memo. 1994-314; *Scheidt v. Commissioner*, T.C. Memo. 1992-9.

Some Questions about Organizational Interrelationship

- ❑ Were both activities conducted in the same location?
- ❑ Did both activities have the same manager? Or the same employees?
- ❑ Did both activities use the same bookkeeper? Same return preparer?
- ❑ Were both activities reported on one return? Did the taxpayer maintain one set of books, or two separate sets of books?
- ❑ Was there one legal entity for both lines? Or two separate legal entities?

Purported Trades or Businesses that Involve Services

If the purported other business activity involves services, the following questions should be answered:

1. What services were provided?
2. Where were the services provided?
3. On what days and times were the services available?
4. What was the fee schedule for the services?
5. Were the services available only to customers who purchased marijuana or were they available to the general public?
6. How did an individual sign up for the services?
7. Which employees or contractors provided the services?

Purported Trades or Businesses that Involve Services

Additionally, if the purported other business activity involves services, the following documents should also be requested:

- ▣ Service contracts or agreements from providers.
- ▣ Training and certifications for all caregiving employees and contractors.
- ▣ Copies of all flyers and advertising for the services.

Purported Trades or Businesses that Involve Goods

If the purported non-marijuana business involves selling products, make the following inquiries:

1. Determine what products were sold.
2. Determine whether they were related to marijuana sales (e.g., pipes, vaporizers, etc.).
3. Determine the amount of gross receipts that was received or accrued from the sale of these products.
4. Determine the cost that was paid or incurred to acquire these products (COGS).
5. Review the allocation of labor, rent, advertising, and other expenses between the marijuana business and the purported non-marijuana business.
6. Determine whether the taxpayer's records or returns show that the purported non-marijuana business earned a profit or sustained a loss.

Purported Trades or Businesses that Involve Goods

Additionally, if the purported other business activity involves a purported non-marijuana product, the following documents should also be requested:

- All records related to the sales, purchases, and production of the purported non-marijuana product.
- Photographs showing where in the store the product was displayed.
- Records of any advertisements for the non-marijuana products.

QUESTIONS?



17

(b)(3).26 U.S.C.
§ 6103



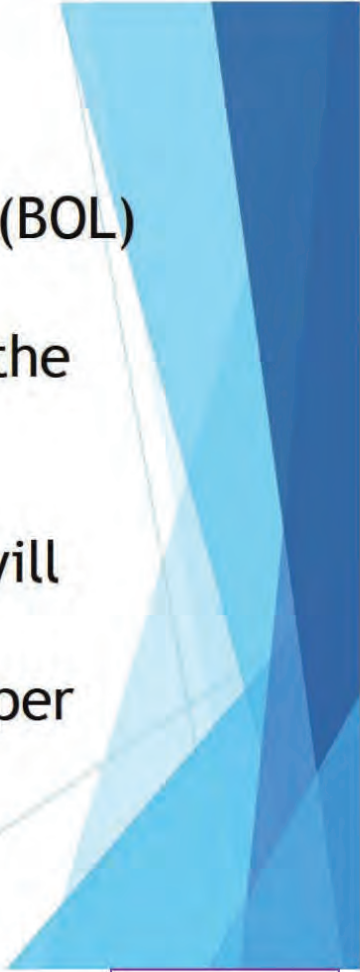
Medical Marijuana

Pasha Subhani
Territory Manager, Michigan Territory
Midwest Area
SBSE, Exam

(b)(3):26 U.S.C. §
6103

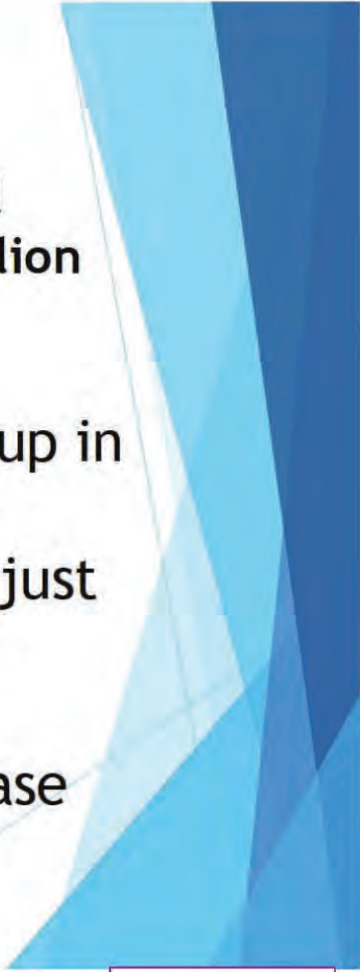


(b)(3) 26 U.S.C. §
6103



Israel's Breath of Life Pharma (BOL) has set up the world's largest medical marijuana facility in the world.

According to estimates, BOL will produce 80 tons - more than 175,000 pounds - of cannabis per year.



EAZE is moving into recreational marijuana delivery with \$27 million in new funding.

The cannabis industry has lit up in the last year, including weed delivery startup EAZE, which just raised \$27 million in Series B financing and claims a 300 percent year-over-year increase in gross sales.

Chicago Tribune reported Last Week;

In 2016, rates of marijuana use among the nation's 12- to 17-year-olds dropped to their lowest level (6.5 percent) in more than two decades.

On the other hand, last year 20.8 percent of Americans between the ages of 18 and 25 used marijuana at least monthly, the highest number since 1985. Among adults ages 26 to 34, 14.5 percent used marijuana monthly in 2016, also the most since 1985.

The background features abstract geometric shapes in various shades of blue. On the right side, there is a large, complex shape composed of several overlapping triangles and polygons. On the left side, there is a smaller, simpler triangular shape.

Advertisements; Cutting Through Cannabis Confusion What Employers Should Know About Marijuana Law

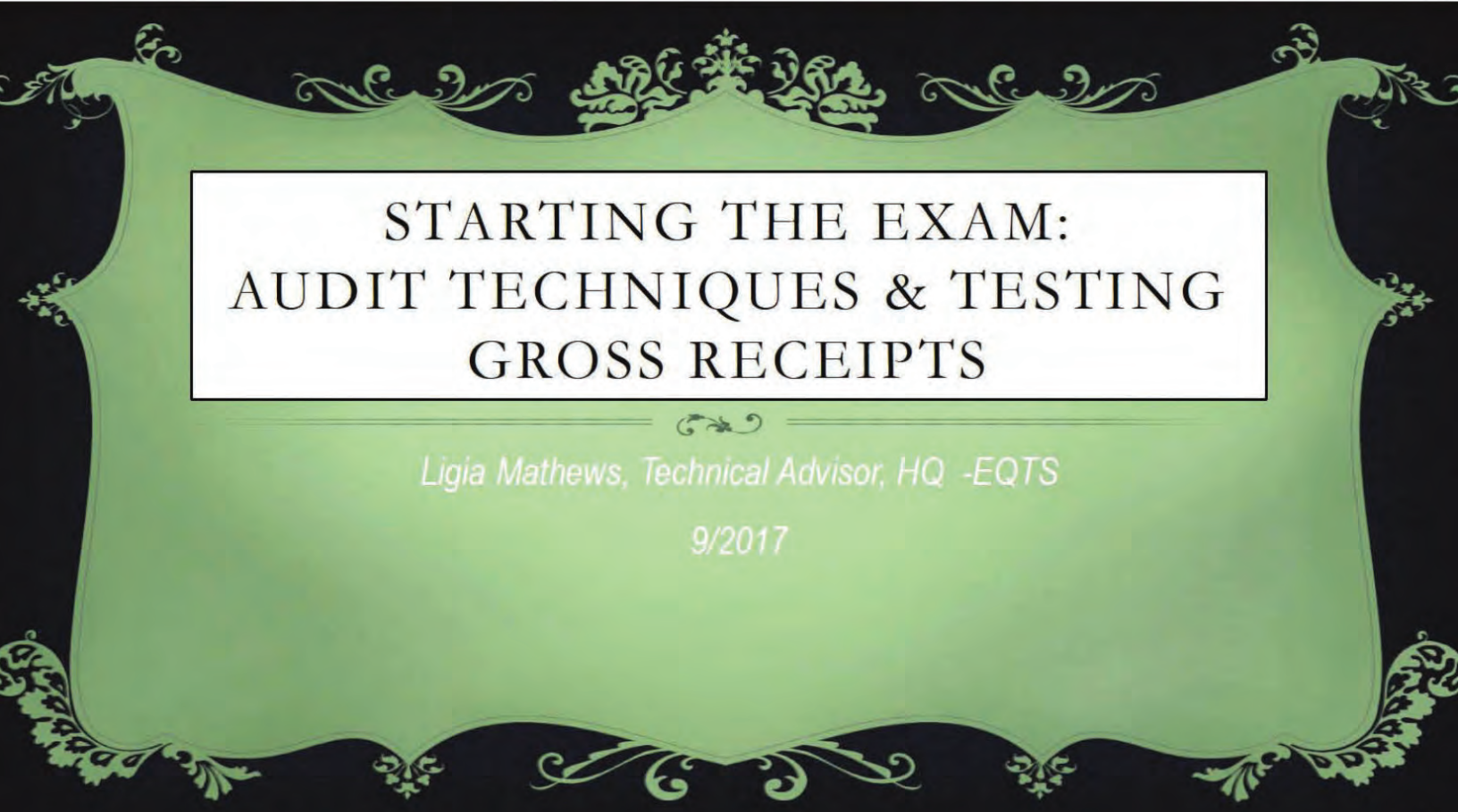
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§ 6103

Advertisements;

We are a full-service CPA/Consulting firm specializing in the Cannabis Industry. We are experts at minimizing the tax impact of IRS 280E in conjunction with the effective use of the IRS Code 263A Uniform Capitalization Act. We can perform Cost Segregation Analysis, initiate expense allocation strategies, 8300 reporting, compliance setup, certified financial audits/statements, entity formation, QuickBooks setup, Research and Development tax strategies, corporate and individual income tax returns.

Other thoughts....

(b)(3)26 U.S.C.
§ 6103



STARTING THE EXAM: AUDIT TECHNIQUES & TESTING GROSS RECEIPTS

Ligia Mathews, Technical Advisor, HQ -EQTS

9/2017

OBJECTIVE

- ❖ Identify audit techniques for the initial stages of the examination of a marijuana business

UNDERSTANDING THE INDUSTRY

- ❖ Products
- ❖ Pricing
- ❖ Security
- ❖ Vendors and customers



UNDERSTAND THE INDUSTRY

Exercise:

❖ List what you think might be five days of the year with the largest sales of marijuana nationwide

❖ Survey said...

CASH INTENSIVE INDUSTRY

Varying levels of sophistication of marijuana businesses

- Some will have internal controls in place to ensure all transactions are recorded correctly
- Some do not maintain or keep books and records

DISCLOSURE OF BUSINESS ACTIVITY

Marijuana businesses generally do not clearly disclose their business activity on their returns.

The business may list industries such as:

- Horticulture
- Agriculture
- Care Giving
- Retail

AUDIT STEPS FOR TESTING GROSS RECEIPTS

As with any cash intensive business...

- ❖ The IRM requires you complete minimum income probes on all examinations.
- ❖ After all minimum income probes are completed, decide whether there is a reasonable indication of unreported income.
- ❖ Pre-Plan is especially important

INITIAL INTERVIEW

- ❖ Very important!
- ❖ Be prepared
- ❖ Use the interview (and tour of the business) to narrow the scope of the examination

WHAT TYPE OF MARIJUANA BUSINESS IS THIS?

- ❖ Is this a grow operation?
- ❖ Is this a retail operation?
- ❖ Is this a combination of grow and retail or another type of MJ business?
 - Vertically integrated operation with grow and sales?
 - Distributor of products?
 - Testing of products?
 - Value added business – such as a cooking business making edibles?

UNDERSTAND THE BUSINESS

- ❖ Generally Cash Intensive
- ❖ May have unusual/non-traditional methods of banking or storing proceeds from sales.
- ❖ Cash is not necessarily recorded before the funds are used.
- ❖ May only deposit enough cash into accounts to cover operating expenses

TOUR OF THE BUSINESS

- ❖ A tour is very important on MJ cases from both an income standpoint as well as an expense standpoint.
- ❖ Key information may be obtained from the tour to provide information necessary to establish the need to use an indirect method.

HOW IS CASH HANDLED?

- ❖ WHO?
- ❖ WHAT?
- ❖ WHERE?
- ❖ WHEN?
- ❖ HOW?

IS CASH USED TO MAKE BUSINESS PURCHASES?

- ❖ WHO?
- ❖ WHAT?
- ❖ WHERE?
- ❖ WHEN?
- ❖ HOW?



SAMPLE PRELIMINARY QUESTIONS FOR GROW:

- ❖ *Identify location of grow operation*
- ❖ *Identify people*
- ❖ *Identify process*

BASIC QUESTIONS FOR RETAIL:

- ❖ How were gross receipts calculated?
 - Walk through the sales cycle.
- ❖ What about the Merchant Accounts? ATM machine?
 - How is the business being banked? Process for deposits?
- ❖ *Was there inventory?*
 - *And if so, what anything Capitalized into Inventory?*
 - *How was inventory accounted for?*
 - *Who was in charge of the inventory?*

MJ BUSINESS WITH EMPLOYEES

- ❖ NEED TO ESTABLISH WHAT THEY DO FOR THE BUSINESS
- ❖ TP MAY TRY TO CLAIM THAT THEY ARE NOT INVOLVED IN THE MJ PART OF THE BUSINESS

COGS QUESTIONS:

❖ *COGS –*

- *Rental cost?*
- *Utilities cost?*
- *Equipment?*
- *Supplies?*
- *Materials?*
- *Where registered? State? County? City?*
- *Applications for license to resell?*
- *Is there a lease? Who's name is on the lease?*
- *Who is the landlord?*

VERIFY KEY ALLOCATIONS/ GROUPINGS

- ❖ Labor expense related to production activities vs. selling activities.
- ❖ Rent for production facilities vs. rent for sales facilities.
- ❖ Depreciation for production assets vs. depreciation for non-production assets.
- ❖ Expense allocations between multiple business if the taxpayer claims to have another business separate from its marijuana business

SUMMARY

- ❖ Cash intensive business
- ❖ Specialized industry with unique issues

OBJECTIVE

- ❖ Identify audit techniques for the initial stages of the examination of a marijuana business

SEPARATE TRADE OR BUSINESS ISSUES FOR TAXPAYERS AFFECTED BY SECTION 280E

September 19, 2017

Alicia Mazurek
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(b)(3) 26 U.S.C.
§ 6103

Business Deductions

Ordinary & Necessary:

Section 162(a) provides a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any **trade or business**.”

Examples: employee salaries, rent, utilities, and advertising.

Continuity & Regularity:

To be engaged in a trade or business for purposes of § 162, a taxpayer must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit.

- Comm’r v. Groetzinger, 480 U.S. 23, 35 (1987);
- Portland Golf Club v. Comm’r, 497 U.S. 154, 164 (1990).

Primary Purpose

Primary Purpose:

To be engaged in a trade or business for purposes of § 162, a taxpayer must be involved in the activity with continuity & regularity and the taxpayer's primary purpose for engaging in the activity must be for **income or profit**.

Profit Intent:

Whether activity constitutes a “trade or business” is whether it was entered into with the “*dominant hope & intent of realizing a profit.*”

- United States v. Am. Bar Endowment, 477 U.S. 105, 110 (1986);
- Brannen v. Comm’r, 722 F.2d 695, 704 (11th Cir. 1984);
- Vorsheck v. Comm’r, 933 F.2d 757, 758 (9th Cir. 1991).

I.R.C. Section 280E

No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

I.R.C. Section 280E

IRC Section 280E does not preclude a taxpayer from deducting business expenses attributable to a separate trade or business. A taxpayer is not precluded simply because it is also involved in the trafficking of a controlled substance.

Taxpayer's Separate Business Arguments:

- Sale of retail items other than marijuana.
- Providing services, such as caregiving services.
- Testing marijuana potency
- Caregiving
- Compliance
- ATM Machines

MEDICINAL MARIJUANA CASES

Separate Trade or Business



(b)(3).26 U.S.C.
§ 6103

Tax Court Cases

1. (CHAMP) Californians Helping To Alleviate Med. Problems, Inc. v. Comm'r, 128 T.C. 173 (2007).
2. Olive v. Comm'r, 139 T.C. 19 (2012), *aff'd*, 792 F.3d 1146 (9th Cir. 2015).
3. Beck v. Comm'r, T.C. Memo. 2015-149.
4. Canna Care, Inc. v. Comm'r, T.C. Memo. 2015-206.



CHAMP

In *CHAMP*, the taxpayer was a community center for members with debilitating diseases, and it operated with a dual purpose.

- ▣ **Primary purpose:** Provide caregiving services to members;
- ▣ **Secondary purpose:** Provide members with medical marijuana.
- ▣ **Membership Fee:** The taxpayer's members paid a single membership fee for the right to receive caregiving services; this included a specific amount of medical marijuana.
- ▣ **Caregiving Services:** Extensive services, and the marijuana distribution took up only 10% of the main facility.
- ▣ **Health Care Experience:** The director and staff had significant experience in health services, and 72% of the employees worked exclusively in the caregiving business.



CHAMP

- ▣ The Tax Court found that the caregiving services generated income, because the members paid one membership fee for both caregiving services and medical marijuana.
- ▣ After considering all of the facts and circumstances of the case, the Tax Court held that the taxpayer's provision of caregiving services was a business separate and apart from its provision of medical marijuana.



OLIVE

In *Olive*, the taxpayer operated the Vapor Room, a sole proprietorship.

- ▣ **Primary Purpose:** *Olive's* principal business was the retail sale of medical marijuana; it provided only minimal other activities and services, including yoga classes and massages.
- ▣ **Membership Fee:** There was no membership fee or charge for any activities or services – the sole proprietorship's *only* source of revenue was the sale of medical marijuana.
- ▣ **Single Business:** After considering all of the facts and circumstances of the case, the Tax Court held that the taxpayer had a single business, the dispensing of medical marijuana, and all of the taxpayer's services and activities were part of that retail business.

OLIVE

Held: Section 280E precluded Olive from deducting any of his claimed business expenses.

- ▣ *Determinations:*
 - All revenue came from the sale of marijuana.
 - A second business did not exist simply because patrons were also provided with snacks, a massage, or a movie.
 - TPs are not excused from providing records.

- ▣ TP appealed to the Ninth Circuit, which affirmed the Tax Court decision.

CANNA CARE

Canna Care v. Commissioner, T.C. Memo. 2015-206

- ▣ *Facts:* TP opened center to make money and argued that the sale of non-marijuana products was a separate business.
- ▣ *Held:* Section 280E precluded Canna Care from deducting any of its claimed business expenses. The Court could not differentiate between costs for marijuana sales and non-marijuana sales.
- ▣ *Determination:* Petitioner was involved in the trade or business of trafficking in a controlled substance within the meaning of the Federal Controlled Substances Act.

BECK

Beck v. Commissioner; T.C. Memo 2015-149

- ▣ *Facts*: TP operated two retail locations, only conducted marijuana related sales and activities, there was no separate business. DEA raided the location and seized \$600,000 in marijuana. TP tried to deduct seized drugs as COGS.
- ▣ *Held*: Section 280E precluded Beck from deducting any of his claimed business expenses, and also precluded TP from deducting seized marijuana as COGS. Penalty was upheld as TP intentionally destroyed records and inventory. TP failed to keep adequate records.
- ▣ *Determination*: Petitioner was involved in the trade or business of trafficking in a controlled substance within the meaning of the Federal Controlled Substances Act.

GOLDEN STATE CO-OP

Golden State Cooperative, Inc. v. Commissioner; Dkt. No. 2502-15 (Bench Opinion 2016)

- ▣ *Facts:* TP operated a retail marijuana store, only conducted marijuana related sales and activities, there was no separate business.
- ▣ *Held:* Section 280E TP precluded from deducting claimed business expenses, but was allowed additional COGS.
- ▣ Penalty was NOT upheld.

SEPARATE TRADE OR BUSINESS

What Factors Should Be Considered?

What Interview Questions Should be Asked?

What Documents Should Be Requested?

What are the Resources?

Separate Trade or Business Overview



STEP 1: Income & Profit Motive

1) Was the Primary purpose for engaging in the activity for income or profit?

- *Groetzinger*, 480 U.S. at 35; *Portland Golf Club*, 497 U.S. at 164.

2) Was Any Income Charged or Generated?

In many situations involving a purported separate caregiving business, the taxpayer does not charge (or imposes a very minimal charge) for caregiving, which shows that the taxpayer did not intend to make a profit solely by offering the services.

- As a matter of law, a taxpayer cannot have another business if the taxpayer does not intend to profit from the purported other activity.

Separate Trade or Business Overview



STEP 2: Facts & Circumstances Test

Assuming the taxpayer had the intent to make a profit, the next step would be a facts-and-circumstances analysis to determine whether that purported other business activity was a separate trade or business.



Separate Trade or Business Factors

In *Olive*, the Tax Court provided the following relevant factors:

1. The degree of organizational and economic interrelationship of the different undertakings.
2. The business purpose for carrying on the activities separately or together.
3. The similarity of the various undertakings.



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Separate Trade or Business Factors

1. Close Organizational & Economic Relationship
2. Business Purpose
3. Employees Shared
4. Membership Fees
5. Location of Both Businesses
6. Names of the Businesses
7. Activities Performed
8. Revenue Generated
9. Business Advertising
10. Degree of Shared Management
11. Degree of Oversight for Both Businesses
12. Accounting and Separate Books & Records
13. Allocation of Expenses to Businesses

BUSINESS

BUSINESS

Organizational Interrelationship

The Court will consider whether the:

- a) undertakings share a close organizational & economic relationship,
- b) undertakings are conducted at the same place,
- c) undertakings were formed as separate businesses,
- d) undertakings benefited from each other,
- e) taxpayer used one undertaking to advertise the other,
- f) degree to which the undertakings shared management,
- g) degree to which one caretaker oversaw the assets of both undertakings,
- h) taxpayer used the same accountant for the undertakings, and
- i) degree to which the undertakings shared books and records.

Organizational Interrelationship Cases

- ▣ Keanini v. Comm'r, 94 T.C. 41, 46 (1990);
- ▣ Estate of Brockenbrough v. Comm'r, T.C. Memo. 1998-454;
- ▣ Hoyle v. Comm'r, T.C. Memo.1994-592;
- ▣ De Mendoza v. Comm'r, T.C. Memo.1994-314;
- ▣ Scheidt v. Comm'r, T.C. Memo.1992-9.

Interview Questions

Organizational Interrelationships

- ▣ Were the activities conducted in same location?
- ▣ Did both activities share the same manager?
- ▣ Did they share the same employees?
- ▣ Did both activities use the same bookkeeper?
- ▣ Did they share the same return preparer?
- ▣ Were both activities reported on one return?
- ▣ Were there two separate sets of books?
- ▣ Were there separate legal entities for both?

SEPARATE ACTIVITY PROVIDING SERVICES

- ▣ Caregiving
- ▣ Advising
- ▣ Instructing on Use
- ▣ Informing Patients of Different Strains
- ▣ Massage
- ▣ Counseling

INTERVIEW QUESTIONS

Activities Involving Services

1. What services were provided?
2. Where were the services provided?
3. When were the services available?
4. How much was charged for the services?
5. Who were the services available to? (*Only customers or the general public*)
6. How did an individual sign up for services?
7. Which employees provided the services?
8. Were the employees trained to provide services?

DOCUMENT REQUESTS

Activities Involving Services

- ▣ Employee handbooks;
- ▣ Service contracts;
- ▣ Employment and Contracting agreements from all service providers;
- ▣ Training manuals and programs for services;
- ▣ Certifications for all service providers, including employees and contractors;
- ▣ Web pages, flyers, and advertising for services.

SEPARATE ACTIVITY NON-MARIJUANA SALES

- ▣ T-Shirts
- ▣ Pipes
- ▣ Hats & Bags
- ▣ Tubes
- ▣ Vaporizers
- ▣ Snacks & Food



INTERVIEW QUESTIONS NON-MARIJUANA SALES

1. What products were sold?
2. How were inventories kept, who kept them?
3. How was the mark-up determined?
4. Were the products related to marijuana (pipes, vaporizers)?
5. How much of gross receipts were received or accrued from the sale of these products?
6. What was the cost to acquire these products (COGS)?
7. Review the TP's allocation of labor, rent, advertising, and other expenses between the marijuana business and the purported non-marijuana business.
8. Was there a profit or loss for the sale of non-marijuana goods? (Do the records and returns show it?)

DOCUMENT REQUESTS NON-MARIJUANA SALES

- All sales records;
- All purchase records;
- All product pricing lists;
- All records showing the production of the non-marijuana product;
- Maps, photographs, & diagrams showing the location of product storage and displays;
- All advertisements for the non-marijuana products.



QUESTIONS?

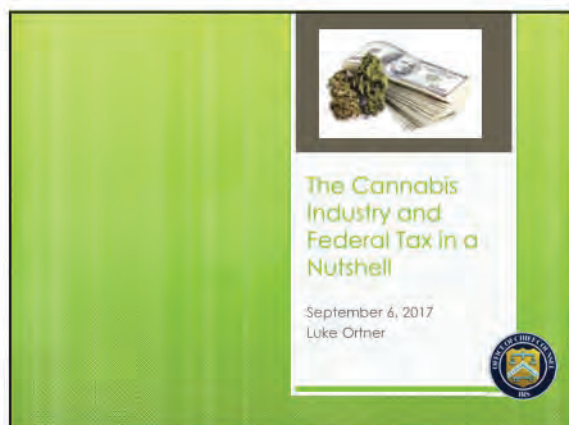
ALICIA.A.MAZUREK@IRSCOUNSEL.TREAS.GOV

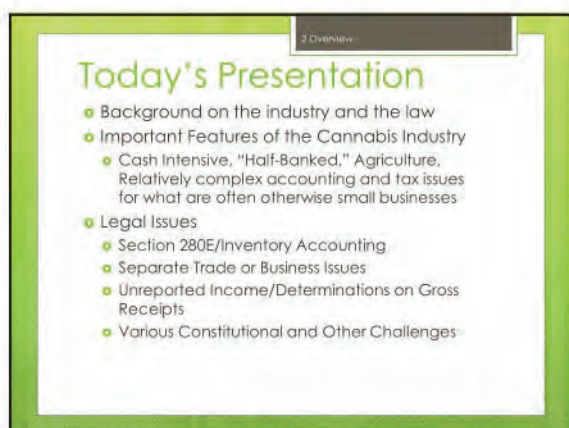
(313) 628-3118



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(b)(3).26 U.S.C.
§ 6103





[illegible]

4 Background

Cannabis in the U.S.A.

- Twenty-nine states and Washington D.C. have passed laws legalizing marijuana in some form, whether that be for recreational or medical use.
- Seven states, plus D.C., have legalized recreational use.
- States vary widely on the extent to which they have allowed a commercial industry to grow.

5 Background

Federal Law Prohibits Marijuana Trafficking

- 21 U.S.C. §§ 801-971 (1970), Controlled Substances Act
- State-legal marijuana laws do not change the fact that using marijuana continues to be an offense under federal law. See, e.g., *U.S. v. Oakland Cannabis Buyers' Co-op.*, 532 U.S. 483 (2001).

6 Background

Department of Justice restraint


- DOJ Memo on "Guidance Regarding Marijuana Enforcement," Aug. 29, 2013. Update to internal policy (initiated in 2009) of imposing restraint where states have legalized marijuana and imposed appropriate regulatory oversight. <http://www.justice.gov/opa/pr/justice-department-announces-update-marijuana-enforcement-policy>

7 background

Congress steps in; he Rohrabacher Amendment

- The "Rohrabacher Amendment," a rider to the 2015 and subsequent appropriations acts, barred DOJ from spending funds to enforce the CSA against state-legal medical marijuana businesses. *United States v. McIntosh*, 833 F.3d 1163 (9th Cir. 2016).
- No similar prohibition regarding recreational marijuana.

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10 Cannabis Industry Basics

Be aware of your state's rules

- Structure and operations are highly dependent on state regulations.
 - E.g., Colorado historically required vertical integration of grow and sales operations; Washington prohibited this.
 - California traditionally required entities to be cooperatives/non-profits, so the entities are C corps for tax purposes. Elsewhere we see LLCs and partnerships.
- States often require Cannabis businesses to keep extensive records. Often there is real time 24/7 video-recording, and real time "seed to sale" inventory tracking with RFID tags.

11 Cannabis Industry Basics

Cash Intensive Industry

- Traditionally, limited banking access, though this seems to be improving.
- "Half Banked": many run some expenses through a bank account, including a personal bank account
- But, credit cards, in-store ATMs often available.
- Consumers often wish to pay in cash; wary or leaving a paper trail for this illegal activity

12 Legal Issues Impacting Cannabis Businesses

Primary Tax Issue is I.R.C. section 280E

"No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of **trafficking in controlled substances** (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted."

13 Legal Issues Impacting Charitable Businesses – 280E

Section 280E cont.

It prohibits all deductions and credits, including, *inter alia*, those under sections:

- 162 – General business expenses;
- 163 – Interest;
- 164 – Taxes;
- 165 – Losses;
- 167 – Depreciation;
- 170 – Charitable Contributions.

But **Cost of Goods Sold (COGS)** are still allowable.
Congress was concerned that the 16th Amendment would only allow a tax on gross income, not gross receipts.

14 Legal Issues Impacting Charitable Businesses – 280E

Cost of Goods Sold


- Key in determining gross income for sellers.
- Section 61 (a) provides that gross income means all income from whatever source derived, including "gains derived from dealings in property."


Gross Receipts (typically sales revenue)
 - Cost of Goods Sold ("COGS")
 Gross Income

15 Legal Issues Impacting Charitable Businesses – 280E

Cost of Goods Sold

Inverse relationship between COGS and Gross Income.


 COGS


 Gross Income

16 Legal issues impacting Cannabis Business - 2017

Cost of Goods Sold

- Calculation to determine COGS:

$$\begin{aligned} &\text{Beginning Inventory} \\ &+ \text{Purchases/Production} \\ &- \text{Ending Inventory} \\ &= \text{Cost of Goods Sold} \end{aligned}$$

Cost of goods available for sale
- The more costs that go into **Purchases/Production**, the larger COGS is.
- In an attempt to increase COGS, TP's could capitalize more costs into **Purchases/Production**.

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Basics of Inventory Accounting

1125-A **Cost of Goods Sold**

Form 1125-A (2017)
 Department of the Treasury
 Internal Revenue Service

▶ Attach to Form 1120, 1120-C, 1120-E, 1120-S, 1120-SS, or 1120-B.
 ▶ Information about Form 1125-A and its instructions is at www.irs.gov/form1125-a.

Employer identification number

1	Inventory at beginning of year	1
2	Purchases	2
3	Cost of sales	3
4	Additional costs (20% cost of sales schedule)	4
5	Other costs (attach schedule)	5
6	Total. Add lines 1 through 5	6
7	Inventory at end of year	7
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on Form 1120 (page 1, line 8) the appropriate line of your tax return. See instructions.	8

18 Legal issues impacting Cannabis Business

Basics of Inventory Accounting

- §§ 471 and 263A determine which costs go into COGS.
 - § 471 requires **resellers** to capitalize to inventories invoice price and freight charges (less any discounts).
 - § 471 requires **producers** to capitalize to inventories direct materials, direct labor, and specifically identified indirect costs.

19 Legal issues impacting Cannabis
Businesses – 2015

Basics of Inventory Accounting

- § 263A (UNICAP) enacted 4 years after § 280E.
- § 263A provides uniformity over what costs must be capitalized for resellers and producers.
- § 263A also requires **additional** costs to be capitalized to inventories that weren't previously required to be capitalized under the pre-existing inventory rules (§ 471).

17 Legal issues impacting Cannabis
Businesses – 2015

Basics of Inventory Accounting

- § 263A is a timing provision – not a recharacterization of costs.
 - § 263A doesn't change costs from being deductible to nondeductible, or vice-versa.
 - § 263A simply postpones the deduction of certain expenses by associating them with inventory.
 - The expenses are then recovered through cost of goods sold when the taxpayer sells the inventory.
 - No cost can be capitalized to inventory under § 263A unless that cost would otherwise be deductible.

21 Legal issues impacting Cannabis
Businesses – 2015

What controls COGS for the Cannabis Industry – 471 or 263A?

- CCA 201504011 released January 2015.
- Considered what is included in COGS for producers and resellers in the business of trafficking controlled substances.
- CCA 201504011 concludes that TPs must determine COGS **using the applicable inventory regulations under § 471** as they existed when § 280E was enacted, and **may not include the additional costs covered by § 263A.**
- Generally, look at Treas. Reg. § 1.471-3 for resellers and § 1.471-11 for producers/growers.

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Section 471 Basics

- Resellers generally include the price of the purchased goods, plus transportation and acquisition costs. Treas. Reg. § 1.471-3.
- Producers/Growers generally include direct and indirect costs associated with growing the product itself. Treas. Reg. § 1.471-11.

23 Legal issues impacting Cannabis Businesses - 250E


Ending Inventory and Work in Process Calculations

Cost of Goods Sold Calculation	
Current year production costs OR purchases	\$ 1,000,000
Ending inventory	<\$ 375,000>
Cost of goods sold	\$ 625,000

Ending Inventory	
Ending work in process (WIP) inventory	\$ 300,000
Ending finished goods inventory	\$ 75,000
Total ending inventory	\$ 375,000

Generally, the producer/grower must value the unfinished WIP inventory. Otherwise, inventory costs reduce income before the associated product is sold.

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25 Legal issues impacting Cannabis Businesses - 280E

TPs failing to include WIP in ending inventory

- Farmers are generally not required to include WIP in ending inventory, or use an inventory method at all. See § 352 of the Revenue Act of 1978; Rev. Rul. 79-102; Treas. Reg. §§ 1.471-6 and 1.61-4(a). We cannot force them into a method of accounting whereby they include WIP in inventory.

26 Legal issues impacting Cannabis Businesses - 280E

TPs attempting to avoid inclusion of WIP in ending inventory

- To the extent that the taxpayer is reducing its income by inventory costs equal to WIP (by failing to include WIP in its inventory calculations), the taxpayer is effectively deducting those costs as current year expenses rather than COGS. Accordingly, the ending WIP amount represents an impermissible current year deduction for any section 280E taxpayer that is not using an inventory method.
- A CCA is forthcoming. Until then, contact IT&A or me if you run into this.

27 Separate Trade or Business

Separate Trade or Business

- Section 280E does not preclude a taxpayer from deducting expenses attributable to a separate business **other than** that of illegal trafficking in a controlled substance simply because it also is involved in the trafficking of a controlled substance.
- Therefore, a taxpayer may argue that it has another business separate from its marijuana business.

28 Separate Trade or Business

Separate Trade or Business

Two cases provide a detailed analysis of whether a taxpayer has another business separate from its marijuana business:

- *Californians Helping To Alleviate Med. Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007) (hereinafter CHAMP).
- *Olive v. Commissioner*, 139 T.C. 19 (2012), aff'd, 792 F.3d 1146 (9th Cir. 2015).

Other cases provide a brief mention of this issue:

- *Beck v. Commissioner*, T.C. Memo. 2015-149.
- *Canna Care, Inc. v. Commissioner*, T.C. Memo. 2015-206.

29 Separate Trade or Business

Separate Trade or Business

- First, it is necessary to determine whether a taxpayer's primary purpose for engaging in the purported other business activity was for income or profit. *Groetzinger*, 480 U.S. at 35; *Portland Golf Club*, 497 U.S. at 164.
- In many situations involving a purported separate caregiving business, the taxpayer does not charge (or imposes a very minimal charge) for the services, which shows that the taxpayer did not intend to make a profit solely by the provision of the services.
- Assuming the taxpayer had the intent to make a profit, the next step would then be a facts and circumstances analysis of the degree of organizational and economic interrelationship, the business purpose served by carrying on the undertakings separately or together, and the similarity of the undertakings. *Olive*, 139 T.C. at 41.

30 Cash Intensive Gross Receipts

Cash intensive business = gross receipts concerns

- Because businesses have lots of cash, and are often "half banked," there is real concern that gross receipts may be underreported.
- But, heavy state regulation, as well as investor/owner/management desire for control over cash transactions may lead to good cash controls.

31 Cash Interviews / Cash Receipts

Indirect Method Refresher

- Governed by I.R.C. section 7602(e).
 - Prohibits use of indirect method unless "reasonable indication that there is a likelihood of such unreported income."
- In the absence of adequate records, respondent may use a method of reconstruction which clearly reflects income. Method must be reasonable in light of the surrounding facts and circumstances. Holland v. United States, 348 U.S. 121 (1945); IRC § 446(b).

32 Cash Interviews / Cash Receipts

Types of Indirect Methods

- Bank Deposit and Cash Expenditures Method (a.k.a. Bank Deposit Analysis or "BDA")
- Source and Application of Funds Method
- Net Worth Method
- Markup Method
- Unit and Volume Method

33 Cash Interviews / Cash Receipts

Sources of Data and Info for Markup and Unit and Volume Method

- For Markup Method, pricing information is often available through
 - Local Law Enforcement
 - DEA Agents
 - State Data -- often available online or through public records requests.
 - Weedmaps.com and other Cannabis pricing info
- For Unit and Volume methods, DEA, local law enforcement, local growers, and marijuana publications can provide estimates of marijuana produced based on lighting, utilities, and square footage.
- Also consider packaging, other (sales) tax returns, and investor prospectuses.

34 Additional Issues

Challenges to Constitutionality or Applicability of section 280E

- Alpenglow v. U.S., 118 A.F.T.R.2d (RIA) 6968, No. 16-CV-00256-RM-CBS, 2016 WL 7856477 (D. Colo. Dec. 1, 2016), appeal filed June 28, 2017.
 - Pls claimed: (1) the IRS went beyond its jurisdiction in administratively determining that plaintiffs were not entitled to certain deductions pursuant to 280E because the IRS does not have authority to investigate violations of criminal statutes;
 - (2) Congress exceeded its power under the Sixteenth Amendment in passing § 280E because the Sixteenth Amendment requires that plaintiffs' ordinary and necessary business expenses be removed from their income;
 - (3) the IRS violated the Fifth Amendment in taking evidence from plaintiffs without informing them that they were under investigation for violating the Controlled Substances Act; and
 - (4) § 280E violates the Eighth Amendment's prohibition on excessive fines and penalties.
- All arguments were rejected by the U.S. District Court.

35 Additional Issues

Summons and Injunction cases

- In *The Green Solution v. U.S.*, 855 F.3d 1111 (10th Cir. 2017), TPs filed suits to enjoin the IRS from conducting an examination during which it would make a section 280E determination. TP advanced arguments similar to those in *Alpenglow*, generally claiming the IRS had no authority to administer section 280E. All arguments were rejected by the 10th Circuit.
- Similarly, summons quash cases asserting similar arguments have been rejected. See *High Desert Relief v. United States*, No. 16-CV-469 MCA/SCY, 16-CV-816 MCA/SCY, at *18-21 (filed March 31, 2017).

36 Additional Issues

Fifth Amendment issues in summonses and discovery

- Feinberg v. Commissioner*, 808 F.3d 813, 814 (10th Cir. 2015). In discovery dispute, Tax Court determined that petitioners did not have a legitimate Fifth Amendment privilege claim. The 10th Circuit, in a mandamus proceeding reviewing the discovery order, upheld the Court's ruling on procedural grounds, but signaled in dicta that it believed that **individuals operating medical marijuana businesses likely had a legitimate Fifth Amendment claim**.
- Consider subpoenas, discovery and summonses **directly to the businesses**, which, as collective entities, do not generally enjoy a Fifth Amendment privilege. *Braswell v. United States*, 487 U.S. 99, 104 (1988). Testimony may still be privileged, but documents should be produced.

37 Additional Issues

Collection Issues

- Generally, we cannot collect the most valuable asset of these businesses – marijuana. We will not sell it, so no reason to collect.
- Collection is currently putting together a desk book on the industry.
- Counsel contacts for MJ collection industry: Melinda Fisher and Michael Lloyd

38 Additional Issues

Failure to Deposit Penalty

- Section 6656 imposes a penalty for failure to make a required deposit of taxes.
- Since Jan. 1, 2011, almost all businesses have been required to make their deposits by electronic funds transfer.
- Relief guidance issued June 9, 2015, for unbanked taxpayers who are timely meeting their tax deposit obligations.
- <https://www.irs.gov/pub/foia/ga/spder/58SE-04-0615-0045111.pdf>

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Additional Resources

- Cannabis Sharepoint (contains client trainings as well as additional resources)
https://adminnondisclosure2.prod.irscountstres.gov/Businesses_Dealing_in_Cannabis/SitePages/Home.aspx
- DOJ Summons Enforcement Manual
https://www.justice.gov/sites/default/files/tax/legacy/2007/02/02/SumEntMan_May2006.pdf

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