

# Understanding the Tax Implications of the Legal Marijuana Industry





# Learning Objectives

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Program Level: Basic

After completing this course, the learner should be able to:

- ✓ Recognize key aspects of the legal marijuana industry in the United States, including the federal and state legal dichotomy
- ✓ Identify relevant case law governing the legal marijuana industry
- ✓ Name key issues faced by CPAs in serving the legal marijuana industry
- ✓ Recognize guidance issued by various state boards of accountancy with respect to the legal marijuana industry

Field of Study:  
Taxes

Program Prerequisite:  
None

Advance Preparation:  
None



# Program Content

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This course will be an overview of:

- The state of the legal marijuana industry in the United States
- The dichotomy between federal and state law, including relevant case law as it relates to taxation of this industry
- Considerations a CPA must weigh in deciding whether or not to provide services to this industry
- Guidance issued from state boards of accountancy with respect to legal marijuana

# Major Topic / Concept Index

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# Overview of the Legal Marijuana Industry

# Overview of the Legal Marijuana Industry

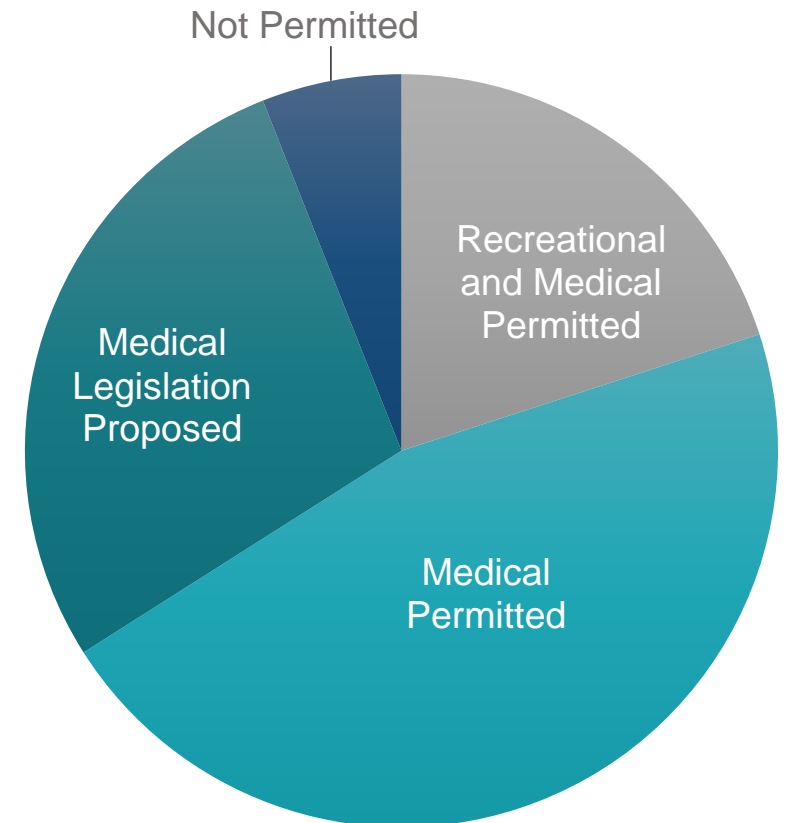
## The Legal Marijuana Industry<sup>3</sup>

It is no secret that the legal marijuana industry is growing. Marijuana is permitted for medicinal purposes in over half of U.S. states.<sup>3</sup>

At the start of 2019, the use of marijuana has been approved for medicinal purposes in 33 states, and in 10 of those states, recreational use of marijuana has been legalized.<sup>3,4,5</sup>

Furthermore, 14 additional states have introduced legislation or ballot initiatives to consider legalization for medicinal or recreational purposes, and two additional states have pending ballot initiatives.<sup>3</sup>

Spending on legal consumption of marijuana is projected to be \$57 billion worldwide by 2027, with 33 percent of the projection coming from medicinal sales and 67 percent coming from recreational sales.<sup>26</sup> For context, the size of the global alcoholic beverage industry is between \$1.3 and \$1.5 trillion.<sup>32</sup>



Source: Data from "Cannabis Industry State Tax Guide"<sup>3</sup>

# Overview of the Legal Marijuana Industry

## The Legal Marijuana Industry<sup>5</sup> (continued)

Recreational & Medical Marijuana Permitted	Only Medical Marijuana Permitted		Marijuana Use Prohibited	
Alaska California Colorado District of Columbia Maine Massachusetts Michigan Nevada Oregon Vermont Washington	Arizona Arkansas Connecticut Delaware Florida Hawaii Illinois Iowa Louisiana Maryland Minnesota	Montana New Hampshire New Jersey New Mexico New York North Dakota Ohio Oklahoma Pennsylvania Rhode Island West Virginia	Alabama Georgia Idaho Indiana Kansas Kentucky Mississippi Missouri Nebraska	North Carolina South Carolina South Dakota Tennessee Texas Utah Virginia Wisconsin Wyoming

# Overview of the Legal Marijuana Industry

## The Legal Marijuana Industry (continued)

The legalization process may take the form of ballot initiatives or legislative initiatives in a given state, and it may be for medical or recreational use.

With the growth of the legal marijuana industry in so many states, businesses in this industry are increasingly seeking support from CPAs and CPA firms.



**Key Point:** There are implications for all states, not just those where medical or recreational marijuana is legal. Oklahoma and Nebraska asked the Supreme Court to hear a challenge to Colorado’s framework, alleging it “was causing marijuana to flow across the borders into their own states, creating law enforcement headaches.” The Supreme Court declined in 2016 to hear the case.<sup>16</sup>



# Overview of the Legal Marijuana Industry

## The Legal Marijuana Industry (continued)

For federal purposes, however, marijuana is considered a Schedule I controlled substance under the Controlled Substances Act of 1970, regardless of state action. The possession, use, and distribution of marijuana are prohibited.

This creates a conflict between state and federal law, which has legal, ethical, and tax considerations for CPA practitioners.



**Key Point:** Contrast this classification with the fact that more than half of the states permit medical use of marijuana.<sup>3</sup>



**Note:** A Schedule I designation means the “federal government has taken the position that marijuana has a high potential for abuse, has no currently-accepted use for medical treatment in the U.S., and lacks applicable safety for use under medical supervision.”<sup>2</sup>

# Overview of the Legal Marijuana Industry

## The Legal Marijuana Industry (continued)

Furthermore, there are questions surrounding the *enforcement* of both federal and local laws that create additional uncertainty for the industry.

- The U.S. Department of Justice has indicated it will focus on drug trafficking and use by minors and will “rely on state and local authorities to address marijuana activity through enforcement of their own narcotics laws.”<sup>2</sup>
- A memo from the Department of Justice in 2013 indicated federal funds would not be used to enforce federal marijuana laws in states where use of marijuana was legalized.<sup>11</sup>
- This memo was rescinded in 2018.<sup>31</sup>

# Overview of the Legal Marijuana Industry

## The Legal Marijuana Industry (continued)

- The U.S. Congress passed a spending bill for the Commerce-Justice-Science budgets in 2014 with the Rohrabacher-Farr or CJS amendment. This amendment prevents federal law enforcement officers from enforcing federal marijuana laws against users of *medical* marijuana in states where it is legal.<sup>11</sup>
- Such spending bills must be renewed periodically in order to be effective, and this particular amendment is still in effect. There is no guarantee future bills will include this amendment.<sup>11</sup>
- The U.S. Senate introduced plans in 2018 to legalize hemp as an agricultural commodity, but it is not clear what the impact on the cannabis industry overall will be.

# Overview of the Legal Marijuana Industry

## The Legal Marijuana Industry (continued)

- Increasingly, prosecutors at the state and local levels are declining to prosecute marijuana cases as well. Marilyn Mosby, the State's Attorney for Baltimore, said her office would focus instead on prosecuting violent crimes.<sup>10</sup>
- Prosecutors from Chicago, Philadelphia, Manhattan, and Brooklyn have made similar pronouncements.<sup>10</sup>



**Key Point:** There is uncertainty regarding both the legal conflict between federal and state law and the enforcement priorities of law enforcement and prosecutors. Regardless, the Department of the Treasury (and the IRS) is separate from the Department of Justice, so tax laws apply.

# Overview of the Legal Marijuana Industry

## The Legal Marijuana Industry<sup>2</sup> (continued)

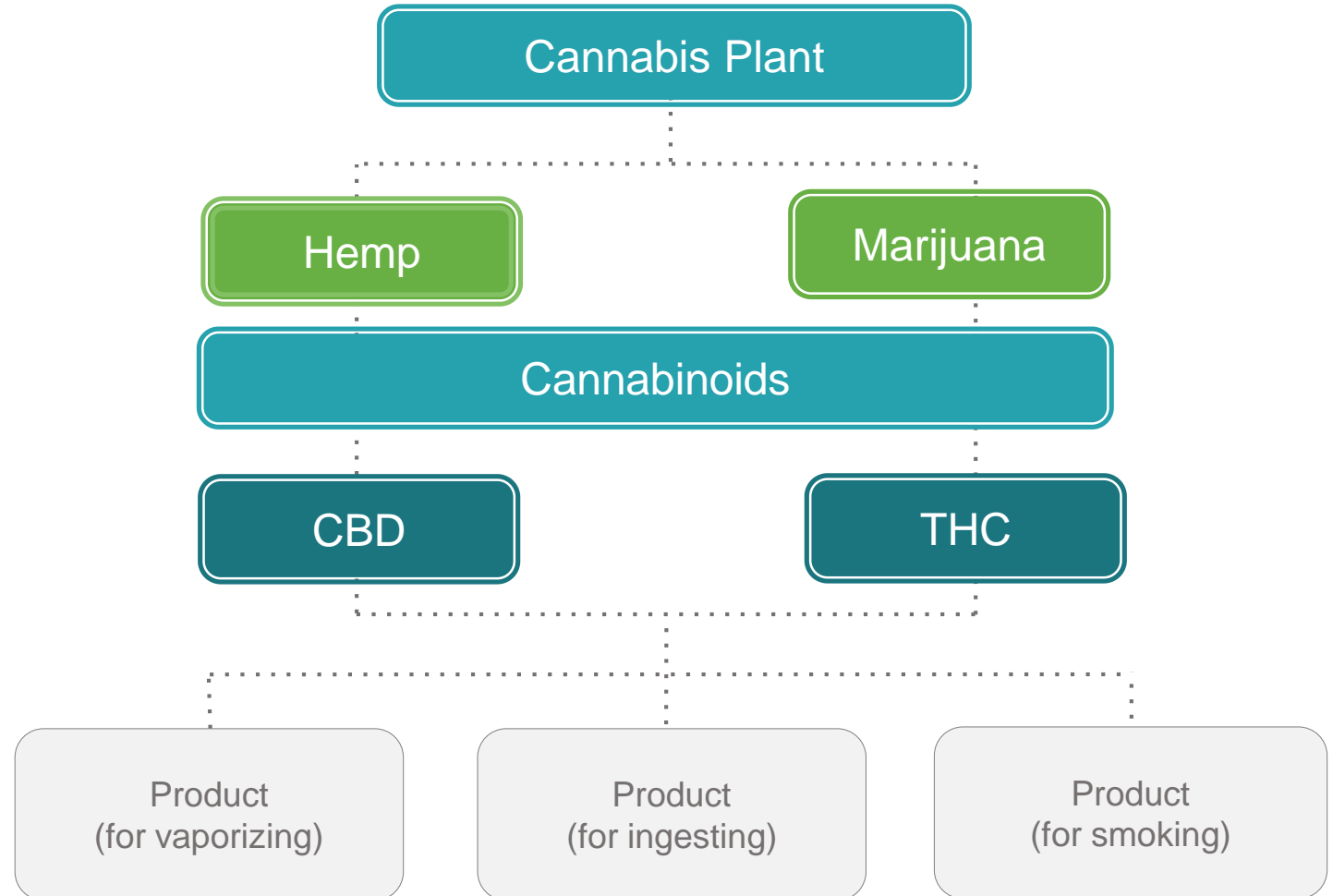
The uncertainty isn't limited to CPAs. The banking system has been required to file a Marijuana Limited Suspicious Activity Report (SAR) for legal marijuana activity, and the guidance from the Department of Justice notes that "banks could still face prosecution if they provide financial services to marijuana businesses that conduct activities in violation of state or federal laws."<sup>2</sup>

CPAs rightfully worry that such standards could be applied to CPAs and CPA firms as well. The AICPA recommends a full review of the Department of Justice guidance by CPAs engaged in this industry.

# Overview of the Legal Marijuana Industry

## Overview of Terms

1. There are multiple strains of the cannabis plant.
2. Each strain includes varying levels of cannabinoids.
3. CBD is the cannabinoid most associated with health benefits, while THC is the cannabinoid most associated with the psychoactive “high.”
4. Cannabinoids may be added to products for vaporizing, ingesting, or smoking.

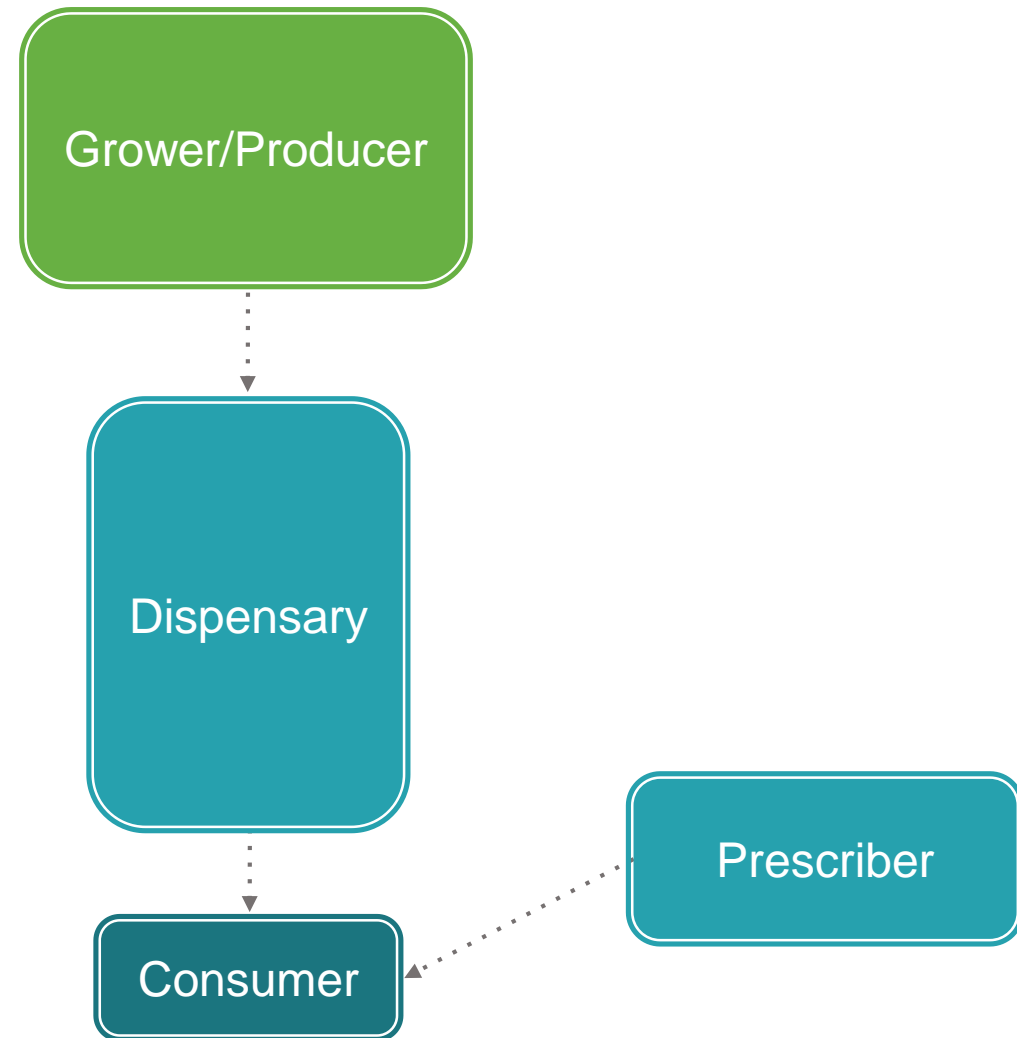


# Overview of the Legal Marijuana Industry

## Overview of Terms *(continued)*

The legal marijuana industry includes:

1. Growers or producers, licensed in states where growing or producing is legal.
2. Retailers, or dispensaries, which purchase products from growers and sell products to the consumer.
3. Consumers, who purchase the products.
4. Prescribers, who provide a prescription for consumption to consumers in states where a medicinal purpose is required for consumption.



# Overview of the Legal Marijuana Industry

## Issues to Consider<sup>2</sup>

With the projected growth in the legal marijuana industry comes a need for trusted business and tax advice. This raises a number of questions for the CPA to consider.

1. Might a CPA or a CPA firm be prosecuted criminally for performing these services?
2. Is providing these services permitted by the state board of accountancy such that performing these services will not be considered an “act discreditable” or affect the “good moral character” of the practitioner?
3. Will providing these services in a state where they are permitted affect a CPA’s license in another state where marijuana is not legal for either recreational or medicinal purposes?



# Overview of the Legal Marijuana Industry

## Issues to Consider<sup>2</sup> (continued)

4. Does the CPA or the CPA firm have the industry-specific expertise to serve the clients in a professionally competent way?
  - For audit or attestation services in particular, are there additional procedures that must be performed?
  - For tax services, did the CPA or the CPA firm apply guidance appropriately? (This may be a challenge given the uncertainty in the industry.)
  - Is the CPA or the firm regularly involved in education and conversations with peers providing these services to stay informed of best practices?

# Overview of the Legal Marijuana Industry

## Issues to Consider<sup>2</sup> (continued)

### 5. What is the impact on professional liability insurance?

- Confirm if the exclusion for criminal acts will apply to services to the legal marijuana industry.

#### Example: Serving Clients Across State Lines

Kimberly operates a small CPA firm in Cheyenne, Wyoming, which is just north of the Colorado state line. Kimberly provides tax services as well as compilations and reviews for several small businesses in northern Colorado. In Colorado, marijuana has been legalized for both medicinal and recreational purposes. However, in Wyoming, marijuana has not been legalized for either medicinal or recreational purposes.

Recently, Kimberly was contacted by Craig, who owns a chain of marijuana dispensaries in central and northern Colorado. He is interested in becoming a client and indicated that she came highly recommended from close friends and business associates.

Should she accept the work?

# Overview of the Legal Marijuana Industry

## Issues to Consider<sup>2</sup> (continued)

### Example: Serving Clients Across State Lines (continued)

It depends. Kimberly must consider many factors before agreeing to do business with Craig, including (but not limited to) the following:

- Given that marijuana is illegal in Wyoming, how will the Wyoming state board feel about Kimberly performing these services? Is it an ethical violation?
- How will Kimberly's clients in both Wyoming and Colorado feel knowing that she is working with a marijuana dispensary? Could she lose clients?
- Craig has indicated that he knows some of her existing clients. Could turning down the business opportunity negatively impact her existing business? Would those clients be insulted that she rejected a friend or business associate of theirs?
- Does Kimberly feel professionally competent to provide accounting services to this industry? Does she know enough about the industry, operations, regulatory requirements, and tax implications?
- Has Kimberly consulted with legal counsel to determine her potential risk? Has she reviewed her professional insurance policy to determine if these services are covered?

# Overview of the Legal Marijuana Industry

## Issues to Consider<sup>2</sup> (continued)

To mitigate some risk to the CPA firm, the AICPA suggests:

- A clear engagement letter detailing the exact services to be provided
- A signed representation letter from management, updated regularly, that states management understands the requirements of state law related to the cannabis business and that they intend to fully comply with those requirements at all times.
- Full documentation of all communications and services provided.

# Overview of the Legal Marijuana Industry

## Issues to Consider *(continued)*

The next two sections will review the federal and state tax considerations, plus guidance shared by state boards of accountancy.



**Reference:** The AICPA provides guidance, resources, and updates to CPAs working in this industry through its State Regulatory and Legislative Affairs division. Additionally, the National Association of State Boards of Accountancy shares resources.<sup>18,29</sup>



2

## Industry-Specific Tax Issues

# Industry-Specific Tax Issues

## Federal Tax Issues

There are a number of industry-specific tax issues to consider at both the federal and state levels. For federal tax purposes, the first question is: What expenses are deductible at the federal level?

In general, Section 162 of the Internal Revenue Code (IRC) permits the deduction of ordinary and necessary business expenses. This would include general and administrative expenses, overhead expenses, advertising expenses, etc.



Section 162 states, “There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”

# Industry-Specific Tax Issues

## Federal Tax Issues *(continued)*

However, IRC Section 280E prohibits the deduction of expenses associated with trafficking in controlled substances. Ordinary and necessary business expenses are not deductible for marijuana businesses because marijuana is considered a controlled substance at the federal level.



Section 280E states, “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... which is prohibited by Federal law or the law of any State in which such trade or business is conducted.”



**Key Point:** Section 280E essentially nullifies Section 162 for purposes of the legal marijuana industry.



# Industry-Specific Tax Issues

## Federal Tax Issues *(continued)*

Cost of goods sold is not a deduction, but rather a reduction of gross income, codified in the regulations of the tax code under Regulation Section 1.61-3(a). Thus, income in the legal marijuana industry may be reduced by the cost of goods sold, even if those goods are a controlled substance under federal law.



Regulation Section 1.61-3(a) states, “In a manufacturing, merchandising, or mining business ‘gross income’ means the total sales, less the cost of goods sold...”

It continues to state, “The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer.”

# Industry-Specific Tax Issues

## Federal Tax Issues (continued)



**Key Point:** The substantial difference in deductibility at the federal income tax level between cost of goods sold and ordinary and necessary business expenses creates additional risk for CPAs working in this area.

Business owners in the legal marijuana industry may be tempted to inappropriately shift operating expenses into cost of goods sold. As such, CPAs may need to apply special scrutiny when evaluating these areas for tax and audit purposes.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>6</sup> (continued)

There are several court cases of interest in this industry that address these tax issues. The first is *Californians Helping to Alleviate Medical Problems Inc. v. Commissioner of Internal Revenue*, which was decided by the Tax Court in 2007.

1. In this case, Californians Helping to Alleviate Medical Problems (CHAMP) was a C Corporation whose primary purpose was to provide caregiving services to its members who had terminal illnesses including AIDS, cancer, and multiple sclerosis.
2. Its secondary purpose was to provide medical marijuana to members and advise them on using it for health benefits. Members were required to have valid paperwork from a physician supporting the use of medical marijuana.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>6</sup> (continued)

3. Members paid membership fees for counseling and wellness services, which were extensive, and a fixed amount for marijuana.
4. CHAMP reduced its income for cost of goods sold and ordinary and necessary business expenses under Section 162. Originally, the IRS disallowed both cost of goods sold and the ordinary and necessary business deductions.
5. However, the IRS “conceded this determination” with respect to cost of goods sold.
6. The IRS also noted that CHAMP had substantiated its ordinary and necessary business expenses.



**Key Point:** Reducing income for cost of goods sold *is permitted* in a marijuana business.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>6</sup> (continued)

7. CHAMP deducted all ordinary and necessary business expenses under Section 162. The IRS argued that Section 280E applied, disallowing all deductions.
8. The court found that only expenses associated with the sale of marijuana were disallowed under Section 280E. “Section 280E does not preclude petitioner from deducting expenses attributable to a trade or business other than that of illegal trafficking in controlled substances simply because petitioner also is involved in the trafficking of a controlled substance.”
9. Thus, the fact that CHAMP had two separate businesses meant that ordinary and necessary expenses associated with the health care business were deductible, while expenses associated with the marijuana business were not.



**Key Point:** Simply engaging in a legal marijuana business does not make all expenses nondeductible if there are separate business activities.

However, it is vital to maintain excellent records to demonstrate the separate businesses and the extent to which they are economically interrelated (or not).<sup>21</sup>

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>6</sup> (continued)

10. CHAMP also argued that it was not engaged in “trafficking” marijuana, but the court disagreed, finding that CHAMP’s activities were within the definition of trafficking, which it cited as “to engage in commercial activity; buy and sell regularly.”

- The Tax Court upheld this finding in 2015 as well in *Canna Care, Inc. v. Commissioner*, stating that the sale of marijuana is trafficking, even if it is permitted by state law.



**Key Point:** Even if the business is legal in the state in which it operates, it is still considered “trafficking” for purposes of the Controlled Substances Act at the federal level.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>19,20</sup> (continued)

*Martin Olive v. Commissioner of Internal Revenue*, commonly known as the “Vapor Room Case,” was decided by the Tax Court in 2012 and the 9<sup>th</sup> Circuit Court of Appeals in 2015.

1. The Vapor Room was an unlicensed medical marijuana dispensary that sold three types of marijuana. It was organized as a sole proprietorship in California, so income and expenses were reported on the owner’s individual tax return.
2. It was designed to be “comfortable and lounge-like,” with couches, tables, games, and art supplies throughout the space. Yoga classes and chair massages were also offered.



**Key Point:** The court found that “dispensing...medical marijuana pursuant to [California law] was ‘trafficking’ within the meaning of Section 280E.”<sup>19</sup>

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>19,20</sup> (continued)

3. Anyone could go to the space for free, but Olive required purchasers of medical marijuana to possess valid documentation. The court held that the Vapor Room only operated one business, that of a retail medical marijuana dispensary.
4. Both the Tax Court and the 9<sup>th</sup> Circuit Court of Appeals held that ordinary and necessary expenses were not deductible to the taxpayer, Martin Olive, because of Section 280E.
5. These expenses included office supplies, advertising expenses, security, rent, phone and Internet, bottled water, utilities, and postage.
6. The court also held that Olive was permitted to deduct cost of goods sold. Estimates of cost of goods sold were permitted in this case based on expert testimony.



**Key Point:** Section 280E prevents the deduction of ordinary and necessary business expenses associated with trafficking in a controlled substance.



**Key Point:** Cost of goods sold is deductible in the marijuana industry. These expenses are not subject to the restrictions of Section 280E.



# Industry-Specific Tax Issues

## Federal Tax Issues<sup>19,20</sup> (continued)

7. Some inventory was given away or sampled free of charge, and employees and volunteers of the Vapor Room often consumed inventory without paying for it. In general, such giveaways are not deductible as part of cost of goods sold.
8. Olive produced “ledgers” for the IRS agent as part of the audit, but these were insufficient books and records for the business. Additionally, the amounts in the ledgers did not match what the taxpayer claimed on his tax return.
9. The court found Olive failed to maintain sufficient records to substantiate income and expenses, and it imposed accuracy-related penalties on him because of “substantial understatement of income tax or, alternatively, negligence or disregard of rules and regulations.”



**Key Point:** Maintaining excellent records is of paramount importance in all businesses—but especially in the legal marijuana industry.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>1</sup> (continued)

*Alternative Health Care Advocates, et al. v. Commissioner of Internal Revenue* was decided by the Tax Court in December of 2018.

1. Alternative Health Care Advocates was a C corporation that operated a medical marijuana dispensary in California.
2. Alternative Health Care Advocates had a related S corporation, Wellness Management Group, that handled payroll for the C corporation, plus other expenses, such as advertising and rent.
3. The S corporation did not provide management services for any other clients, but the owners said it could conceivably do so in the future.
4. Both the C corporation and the S corporation deducted ordinary and necessary business expenses under Section 162.



**Key Point:** A separate case, *U.S. v. Oakland Cannabis Buying Group*, found that marijuana is a controlled substance within the meaning of the Controlled Substances Act even when it is medical marijuana prescribed or recommended by a physician.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>1</sup> (continued)

5. Alternative also sold other items, including “books, T-shirts, hats, rolling papers, grinders, incense, lighters, ashtrays, and cleaning supplies for pipes and bongs.”
- Alternative estimated that 10 to 15 percent of its personnel’s time was spent on the sale of these nonmarijuana items.
  - Alternative argued that its “varied commercial activities place it squarely outside the reach of Section 280E,” but the court disagreed, finding that Section 280E did apply and Alternative could not deduct its ordinary and necessary business expenses.
  - Alternative also argued that the sale of goods was separate from the sale of marijuana, but the court disagreed, finding “a close and inseparable organizational and economic relationship” between the two.



**Key Point:** Recall that in the CHAMP case, the court recognized separate business activities, but in this case, there was insufficient separation between the activities.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>1</sup> (continued)

6. The C corporation (Alternative) and the S corporation (Wellness) used QuickBooks to manage income and expenses, and they maintained separate bank accounts. Recall that they were related corporations, with common ownership.
7. Wellness argued that it was not in the marijuana business but rather in the management business, so it should be entitled to deductions under Section 162.
8. The court found that although Alternative and Wellness were legally separate entities, “Wellness employees were engaged in the purchase and sale of marijuana (albeit on behalf of Alternative); that was Wellness’ primary business.” Thus, Section 280E applied to Wellness as well, disallowing its Section 162 deductions.



**Key Point:** One key question to consider here relates to the S corporation. If it were not related to the C corporation and provided payroll services to a variety of companies, would it be allowed to deduct ordinary and necessary business expenses? Or would it have to separate—and not deduct—expenses associated with its dispensary clients?

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>1</sup> (continued)

9. The last issue in this case related to the cost of inventory deducted by Alternative. Alternative argued it should be permitted to deduct additional costs as inventory because Section 263A permits the capitalization and inclusion in inventory of certain indirect costs. The court disagreed since such indirect costs would not be normally deductible to Alternative because of Section 280E.
  
10. More interestingly, Alternative also argued that it was a “producer” and thus its production costs should be included in inventory.
  - If these costs were included in inventory, presumably they would be deductible as cost of goods sold, rather than disallowed as ordinary and necessary business expenses.
  
  - The court found that Alternative was not a producer of marijuana, but rather a reseller.



**Key Point:** Presumably, a grower that is a legitimate producer of cannabis would be entitled to include production costs in inventory.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>23,25</sup> (continued)

*Patients Mutual Assistance Collective Corporation d.b.a. Harborside Health Center v. Commissioner of Internal Revenue* was decided by the Tax Court in November of 2018, and it addresses a similar cost of goods sold / inventory question to that raised in *Alternative*.

1. The court found that Harborside was a reseller, not a producer, and as such it was not permitted to capitalize indirect costs as inventory.
2. The court further noted that only costs that would be otherwise deductible—that is, not excluded by Section 280E—could be part of the UNICAP (uniform capitalization) rules of Section 263A.



**Note:** The judge's opinion in the *Harborside* case includes extensive history of the legal actions in this industry, and it is an excellent read.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>23,25</sup> (continued)

### CPA Practice Alert

CPAs should be especially vigilant in reviewing and gaining comfort with operating costs and cost classification. Due to the differences in federal tax treatment for certain costs, business owners in the legal marijuana industry may be motivated to take especially aggressive tax positions in the following areas:

- Classifying their business as a producer rather than retailer in an attempt to capitalize indirect costs into inventory
- Shifting costs from operating costs (i.e., ordinary and necessary business expenses) into cost of goods sold
- Incorporating other financially inconsequential elements or business lines (i.e., also selling clothing, accessories, wellness classes, etc.) into their primary business model in order to justify shifting overall operating and overhead costs into those business lines, claiming they are deductions under Section 162

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>23,25</sup> (continued)

### CPA Practice Alert (continued)

In addressing these issues, CPAs should consider:

- The primary structure, function, and operation of the business; are they really producing the product or just acting as an intermediary between the producer and end consumer?
- How do the margins of the business compare to industry averages? For example, if a marijuana dispensary is reporting gross margins 40 percent below the industry average, then there is a higher risk that this business owner has inappropriately shifted operating costs into cost of goods sold.
- When evaluating business lines, CPAs should focus on substance over form. What is the real primary purpose of the business? Where are the majority of revenues derived?



# Industry-Specific Tax Issues

## Federal Tax Issues<sup>17</sup> (continued)

*Jesse M. Loughman and Desa C. Loughman v. Commissioner of Internal Revenue* was decided by the Tax Court in June of 2018.

1. The Loughmans were joint owners of Palisades Health Care IN, also known as Colorado Alternative Health Care Ltd. Palisades is an S corporation organized in Colorado.
2. At issue in this case is whether or not the Loughmans were subject to “double taxation” or “discriminatory tax treatment” because of Section 280E.
3. As in other cases, ordinary and necessary business deductions were not allowed under Section 280E. For Palisades, this disallowance included a disallowance for wages paid to the Loughmans, the owners of the S corporation.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>17</sup> (continued)

4. The Loughmans claimed that because they were required to pay themselves a reasonable wage as owners of the S corporation, and then were prevented from deducting that wage under Section 280E, they were subject to double taxation.
5. The court found this was not discriminatory, because it would also be true if the Loughmans paid a third party for the services rendered. Plus, the economic and tax consequences of wage income and pass-through income is different.
6. Further, the court noted that the Loughmans were able to choose any business entity to operate Palisades, and were thus responsible for the tax consequences of that choice.

# Industry-Specific Tax Issues

## Federal Tax Issues<sup>22</sup> (continued)

In *Alterman v. Commissioner of Internal Revenue*, the taxpayers advanced the second line of business argument, unsuccessfully. Altermeds LLC did sell additional nonrelated marijuana products, but it only accounted for 4 percent of sales, so the court did not see this as a separate line of business.

1. Altermeds also argued that its expenses were cost of sales, rather than general and administrative expenses. However, the records maintained by the LLC were unreliable.



**Key Point:** Excellent recordkeeping is imperative in documenting separate business activities, inventory, and business expenses, especially in the legal marijuana industry.<sup>22</sup>

# Industry-Specific Tax Issues

## State Income Tax Issues

In states where medicinal or recreational use of marijuana is permitted, there are state-specific income tax questions as well.

Recall that at the federal level, Section 280E prevents the deduction of ordinary and necessary business expenses associated with trafficking in a controlled substance. At issue is whether or not each state where marijuana use is legal limits the deduction of these expenses as well.

The question comes up on state corporate returns and state individual returns, when the marijuana business is organized as a pass-through entity.



**Reference:** States with permitted marijuana use may impose specific licensing, registration, or other compliance requirements. CPAs practicing in this area should ensure familiarity with each state's laws and regulations. The National Association of State Boards of Accountancy is a good starting point.<sup>18</sup>

# Industry-Specific Tax Issues

## State Income Tax Issues<sup>4</sup> (continued)

So does Section 280E apply at the state level? In some states, this is a moot point since neither medical nor recreational marijuana is legal.

But in other states, the starting point for calculating state income tax return is the federal tax return. Then adjustments are made for state-specific items that may be added back or further deducted.

There is no provision that Section 280E does *not* apply (meaning it does) in 24 states (listed on the next slide).

# Industry-Specific Tax Issues

## State Income Tax Issues<sup>4</sup> (continued)

### States Where Section 280E Applies at the State Level<sup>4</sup>

- Alaska
- Arizona
- Connecticut
- Delaware
- District of Columbia
- Florida
- Illinois
- Iowa
- Louisiana
- Maine
- Maryland
- Massachusetts
- Michigan
- Minnesota
- Montana
- New Hampshire
- New Jersey
- New Mexico
- New York
- North Dakota
- Pennsylvania
- Rhode Island
- Vermont
- West Virginia



**Note:** Legislators in both Maine and North Dakota have considered measures that would permit deductions disallowed by Section 280E, but neither state has enacted them.

# Industry-Specific Tax Issues

## State Income Tax Issues<sup>4</sup> (continued)

Four states have specifically permitted deductions disallowed under Section 280E, and a fifth (Arkansas) does not disallow 280E deductions.

- California's corporation tax code "does not conform to the Internal Revenue Code, meaning automatic denial of deductions under IRC Section 280E does not apply."
- Colorado "specifically allows corporations to deduct expenses disallowed by Section 280E."
- Hawaii allows taxpayers engaged in "medical marijuana businesses to deduct business expenses and claim credits on their income taxes."

### States Where Section 280E Does Not Apply<sup>4</sup>

- Arkansas
- California
- Colorado
- Hawaii
- Oregon

# Industry-Specific Tax Issues

## State Income Tax Issues<sup>4</sup> (continued)

Most states have the same treatment for Section 280E for individuals as corporations, but there are some exceptions.

- California's personal income tax system conforms to the federal system, and unlike for corporations, there is no provision that Section 280E does not apply for individuals.
- New Hampshire's personal income tax does not apply to earned income; the state income tax is only applied to interest and dividend income.
- In New Jersey and Pennsylvania, an individual is permitted to deduct ordinary and necessary business expenses, without a limitation for Section 280E.



**Key Point:** CPAs must pay close attention to state tax laws. In some states, the entity type (corporate or pass through) may determine whether or not deductions are disallowed by Section 280E.



# Industry-Specific Tax Issues

## State Sales or Excise Tax Issues<sup>4</sup>

Beyond income tax considerations, sales and excise tax considerations apply at the state level as well, specifically related to sales tax and excise tax.

A **sales tax** is a tax imposed on a transaction at the point of sale. Sales taxes are imposed at the state or local level. Some goods may be exempt from sales tax (for example, milk and some healthcare products). This varies by state.

An **excise tax** is a tax paid on a specific product or business. It is usually reported and remitted separate from sales tax, even if it is collected at the point of sale.



**Reference:** States with permitted marijuana use have generally published state-specific tax guidance for practitioners to use. CPAs must review such guidance regularly to ensure compliance with state-specific laws.

# Industry-Specific Tax Issues

## State Sales or Excise Tax Issues<sup>4</sup> (continued)

So do sales tax provisions apply to recreational or medicinal marijuana products? In some states, this question is moot because both recreational and medicinal marijuana sales are prohibited.

But in other states, it depends. In 13 states where medicinal marijuana is permitted, it is not subject to sales tax.

### Medicinal – Not Subject to Sales Tax<sup>4</sup>

#### No State Sales Tax

- Delaware
- Hawaii
- Montana
- New Hampshire
- Oregon

#### Exempt from Sales Tax

- Florida
- Maryland
- Massachusetts
- Minnesota
- New York
- Pennsylvania
- Vermont
- West Virginia



**Note:** It is not yet clear if medical marijuana will be subject to sales tax in North Dakota or Iowa.

# Industry-Specific Tax Issues

## State Sales or Excise Tax Issues<sup>4</sup> (continued)

In 17 states, the sale of medical marijuana is subject to sales tax.

### Medicinal – Subject to Sales Tax<sup>4</sup>

- Arizona
- Arkansas
- California
- Colorado
- Connecticut
- District of Columbia
- Illinois
- Louisiana
- Maine
- Michigan
- Nevada
- New Jersey
- New Mexico
- Ohio
- Oklahoma
- Rhode Island
- Washington



**Note:** In California, there are some medical marijuana products that are exempt from sales tax, but not all are.

Special sales tax rates are imposed on medical marijuana in the District of Columbia and Illinois.

# Industry-Specific Tax Issues

## State Sales or Excise Tax Issues<sup>4</sup> (continued)

The sale of marijuana for recreational use (in states where that is permitted) is generally subject to sales tax, with the exception of Oregon, which has no state sales tax.

Recreational – Subject to Sales Tax <sup>4</sup>	Recreational – Not Subject to Sales Tax <sup>4</sup>
<ul style="list-style-type: none"><li>• California</li><li>• Colorado</li><li>• Maine</li><li>• Massachusetts</li><li>• Nevada</li><li>• Washington</li></ul>	<ul style="list-style-type: none"><li>• Oregon (no state sales tax)</li></ul>



**Note:** Colorado and Maine impose sales tax on recreational marijuana sales at a higher rate than other products.

Vermont is still in the process of determining how recreational marijuana sales will be taxed.

# Industry-Specific Tax Issues

## State Sales or Excise Tax Issues<sup>4</sup> (continued)

Separate from sales tax, some states impose an excise tax on marijuana. The rates range from 3 percent to 37 percent. Key questions for a CPA to investigate include:

- Which products does the excise tax apply to? All marijuana products, or only those with high THC levels? Retail products not related to marijuana (like T-shirts)?
- Is there an excise tax exemption for medical marijuana?

The answers to these questions vary by state.

# Industry-Specific Tax Issues

## State Sales or Excise Tax Issues<sup>4</sup> (continued)

### States with an Excise Tax on Marijuana<sup>4</sup>

- Alaska
- Arkansas
- California
- Colorado
- Connecticut
- Hawaii
- Illinois
- Maine
- Massachusetts
- Michigan
- Montana
- Nevada (tax imposed at both wholesale and retail level)
- New York
- Oklahoma
- Oregon
- Pennsylvania
- Rhode Island
- Washington
- West Virginia



**Note:** Vermont is still in the process of determining how recreational marijuana sales will be taxed, which may include an excise tax.

Similarly, North Dakota's guidance is still pending.

# Industry-Specific Tax Issues

## State Sales or Excise Tax Issues<sup>4</sup> (continued)

Additionally, some states impose a specific excise tax on controlled substances, which may or may not include marijuana.

The CPA practitioner should understand whether these controlled substances taxes apply to legal businesses. For example, Rhode Island has a similar tax, but it does not apply to medical marijuana, which is legal in Rhode Island; the tax only applies to recreational marijuana, which is not.

### States with a Controlled Substances Tax<sup>5</sup>

- Alabama
- Connecticut
- Georgia
- Idaho
- Illinois
- Iowa
- Kansas
- Kentucky
- Louisiana
- Massachusetts
- Minnesota
- Nebraska
- Tennessee
- South Carolina
- Oklahoma
- North Carolina

# Industry-Specific Tax Issues

## Industry-Specific Tax Issues

The CPA faces a number of federal and state-level issues, specific to the legal marijuana industry.

- 1 Ordinary and necessary business expenses are not deductible at the federal level because of Section 280E.
- 2 Cost of goods sold is a valid reduction of income at the federal level.
- 3 Watch for inventory valuation rules to determine what expenses can (and cannot) be capitalized and included in inventory.
- 4 Identify separate business activities (if any) and track income and deductions accordingly.
- 5 Determine whether sales are subject to a state or local sales tax, and if so, to which products.
- 6 Determine if a separate excise or controlled substances tax applies, and if so, to which products or business operations.





3

## State Boards Weigh In

# State Boards Weigh In

## Licensure Issues

Beyond the industry-specific tax issues, a CPA providing services to the legal marijuana industry may have concerns, given that the businesses are illegal at the federal level (even if they are permitted in the state where operated).

Specifically, CPAs worry about “acts discreditable,” which are prohibited by the AICPA Code of Conduct, and the requirement that CPAs be of “good moral character.”

Under this guise, would providing services to the legal marijuana industry—which is still illegal at the federal level—be grounds for disciplinary action by state CPA boards?

# State Boards Weigh In

## Licensure Issues (continued)

A number of state boards of accountancy have issued guidance specifically related to this question.

Actions by the state boards do not give any legal advice as to whether or not providing services to an industry that is illegal at the federal level would constitute a crime. Instead, they focus on the licensure issues such services raise.

# State Boards Weigh In

## Licensure Issues<sup>8</sup> (continued)

- 1. Washington.** In 2018, Washington’s legislature passed, and its governor signed, a bill stating that a CPA “does not commit a crime solely for providing professional accounting services” to the legal marijuana industry.
  - Washington’s Board of Accountancy further clarified that “it will not initiate disciplinary action against CPAs that are compliant with our state’s self-imposed regulatory framework and remain free of other financially related violations of federal or state law.”
  - It also noted, “The Board cannot provide an assessment of the spectrum of risks that CPAs potentially face if they choose to engage with clients who are involved in the cannabis industry. Licensees are advised to seek their own legal counsel.”



**Key Point:** Note Washington’s legislature’s confirmation that CPAs *do not commit a crime* by performing accounting services for the legal marijuana industry, which goes beyond guidance issued by state boards.

But of course, this is legislation in the state, which does not preclude federal charges of criminal activity.

# State Boards Weigh In

## Licensure Issues<sup>24</sup> (continued)

**2. Oregon.** Oregon's Board of Accountancy issued guidance in 2015 clarifying that CPAs and firms licensed in Oregon "that elect to provide services to the marijuana industry legalized in any state in which the license practices" will not face disciplinary action solely for this reason. Oregon notes:

- CPAs must still adhere to professional standards, laws, and rules.
- The decision to provide services to this industry is a business decision by firms and individuals.
- CPAs should diligently address risk and uncertainties in this area.

# State Boards Weigh In

## Licensure Issues<sup>21</sup> (continued)

- 3. Nevada.** Nevada’s guidance begins similarly to Oregon’s: “Nevada licensees and firms that elect to provide services to the marijuana industry legalized in any state in which the licensee practices will not face action by the Board based solely on the fact that the licensee or firm is providing such services.”
- The board continues, “The Board's position does not negate the possibility that disciplinary action may be taken by the Board should a licensee be found guilty of a federal criminal act.”
  - CPAs must still adhere to professional standards, laws, and rules.
  - The decision to provide services to this industry is a business decision by firms and individuals.
  - CPAs should diligently address risk and uncertainties in this area.

# State Boards Weigh In

## Licensure Issues<sup>30</sup> (continued)

4. **Arizona.** Marijuana dispensaries in Arizona must be authorized and not-for-profit. Plus, they are required by law to receive an audit each year.
  - Arizona’s board confirmed, “merely accepting an engagement to provide accounting services to a medical marijuana dispensary does not, on its face, constitute an act discreditable to the profession and it will not pursue independent disciplinary action against an Arizona CPA registrant based solely on such acceptance.”
  - The board further notes, “during the contemplation of acceptance of any accounting services engagement for a medical marijuana dispensary, an Arizona registrant should diligently evaluate and address the potential risks and uncertainties associated with providing such services.”

# State Boards Weigh In

## Licensure Issues<sup>30</sup> (continued)

- Arizona emphasizes the need for CPAs to stay informed of the changing landscape for this industry, particularly with respect to professional standards, tax guidance from the IRS, and legal guidance from the Department of Justice and the SEC.



# State Boards Weigh In

## Licensure Issues<sup>7</sup> (continued)

- 5. Colorado.** Colorado’s board clearly states that providing services (or offering to provide services) to the legal marijuana industry is not specifically prohibited. But of course, CPAs will be held to the same “professional standards, laws, and rules applicable to all certificate holders.”
- The board notes its position is not an endorsement of such services, nor is it a statement of feasibility of meeting professional standards in this industry.
  - It is also not a “statement about marijuana enforcement in any other jurisdiction or by any other local, state, or federal authority.”

# State Boards Weigh In

## Licensure Issues<sup>9</sup> (continued)

6. **Arkansas.** After medical marijuana was legalized by ballot vote in 2016, a CPA petitioned the state board for guidance before providing services to the industry.
  - The board confirmed, “In and of itself, the provision of professional services...within states where the possession and distribution of medical marijuana has been legalized, and the client has been duly licensed or is in the process of licensure application does not constitute a lack of good moral character... nor would the provision of such services be considered an act discreditable to the profession.”
  - However, the board’s statement only applies to professional services provided to the industry.

# State Boards Weigh In

## Licensure Issues<sup>9</sup> (continued)

- If the CPA has a criminal conviction or plea, that must still be reported to the board, and the board may take disciplinary action accordingly “even if such conviction relates to the licensee’s provision of services to clients in the medical marijuana industry.”

# State Boards Weigh In

## Licensure Issues<sup>12</sup> (continued)

- 7. Florida.** Florida’s board issued a declaratory order in response to a specific question from a practitioner as well. The practitioner asked, “Does the provision of public accounting services...to marijuana-related businesses in states where marijuana-related businesses have been legalized, in the absence of the criminal conviction of the certified public accountant for the provision of those services, in and of itself constitute a lack of good moral character?”
- The practitioner was inquiring about providing services to a company based in Oregon, where both recreational and medicinal marijuana is legal, while the CPA was based in Florida, where medicinal marijuana is permitted but recreational use is not.
  - The question also emphasized the absence of a criminal conviction for providing such services.

# State Boards Weigh In

## Licensure Issues<sup>12</sup> (continued)

- The board confirmed that providing such services, without a criminal conviction, in “states where marijuana-related businesses have been legalized” (not only Florida and not only for medicinal purposes) “does not constitute a lack of good moral character.”

# State Boards Weigh In

## Licensure Issues<sup>27</sup> (continued)

8. **Massachusetts.** The policy statement in Massachusetts is very similar to Nevada's (and Oregon's). "Massachusetts licensees and firms that elect to provide services to the marijuana industry legalized in any state in which the licensee practices will not face action by the Board based solely on the fact that the licensee or firm is providing such services."
  - The board continues, "licensees are reminded that the federal government views such activity as a federal criminal offense. The Board's position does not negate the possibility that disciplinary action may be taken by the Board should a licensee be found guilty of a federal criminal act."

# State Boards Weigh In

## Licensure Issues<sup>14</sup> (continued)

9. **Michigan.** Michigan's board issued guidance in 2018, following the passage of medical marijuana legislation in 2017. As long as the business is in compliance with Michigan law, "a licensee will not face any action by the Department or the Board based solely on the fact that the individual licensee or licensed firm provides professional services to a client engaged in the medical marijuana industry."
  - The board notes that its position is not an endorsement of providing services in this area, and it emphasizes that professional standards must be maintained.

# State Boards Weigh In

## Licensure Issues<sup>28</sup> (continued)

**10. Connecticut.** In Connecticut, the sale and production of medical marijuana is legal, while possession of recreational marijuana is an “infraction” rather than a felony or misdemeanor. However, nonmedical possession and distribution is still illegal.

- The Board states, “It is exclusively the jurisdiction of state and federal courts to determine if and when drug laws are violated; in the absence of such a determination by the courts, the Connecticut Board of Accountancy will not pursue independent disciplinary action against Connecticut CPAs or CPA firms who are operating within the bounds of state law.”
- It notes that the board’s position is not professional, legal, or business advice to CPAs and that CPAs should consult with legal counsel.



**Key Point:** CPAs have the responsibility to stay current with laws in this area.



# State Boards Weigh In

## Next Steps

CPAs face a wealth of new business opportunities as more states legalize the use of marijuana for medicinal and/or recreational purposes. However, these new business opportunities are accompanied by substantial risks.

As such, practitioners should thoroughly evaluate the potential benefits and consequences of providing accounting services in this industry. They should consider:

1. Whether their firm is competent to provide such services and committed to remaining current with industry trends and regulatory requirements in a rapidly changing environment.
2. If their state board has issued an opinion on providing such services and whether there could be potential disciplinary or licensure ramifications.

# State Boards Weigh In

## Next Steps *(continued)*

3. Whether the firm could face potential criminal liabilities associated with existing federal regulations.
4. How the owners, partners, managers, and other key employees feel about any ethical obligations or implications of offering services to the legal marijuana industry.
5. How any major clients or other business associates may perceive their association with the industry.
  - For example, if a major client would be disappointed to learn that the firm is now serving the legal marijuana industry, would that client take its business elsewhere? Is that something the firm is willing to risk?

# State Boards Weigh In

## Next Steps *(continued)*

6. The extent of services that may be offered in the industry including bookkeeping, reviews, compilations, tax preparation, tax planning and advice, audit or attestation services, and management consulting services.
  - Further, what is the amount and significance of such potential revenue streams?
7. What special steps must the firm take to work with clients in this industry?
  - Recall that the AICPA suggests engagement letters for all client work, clear documentation of communications, and a representation letter from the client stating that management understands and intends to comply with state laws.<sup>2</sup>

# State Boards Weigh In

## Next Steps *(continued)*

- Has the firm confirmed the impact of this work on its professional liability insurance?
- Has it conferred with legal counsel with expertise in this industry to examine potential legal issues?

There is no one-size-fits-all approach. Some firms will prosper and grow by providing services to businesses in the legal marijuana industry. Other firms will decide that it's currently not worth the risk and take a "wait-and-see" approach by watching how other firms handle the new territory or waiting until the discrepancies between federal and state laws are resolved.

If a firm does decide to proceed in this industry, it must budget for adequate training, preparation, and documentation.

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A teal-colored horizontal banner featuring a blurred background of office supplies including a calculator, a pen, and papers. On the right side, there are several overlapping, semi-transparent geometric shapes in shades of yellow, green, and blue. The text "Thank you!" is written in white, sans-serif font, preceded by a vertical white line.

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