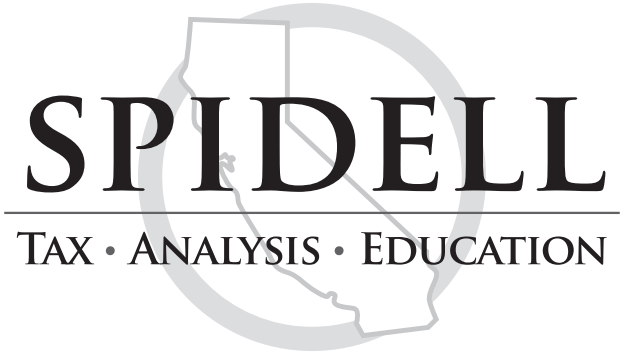
Taxation of Marijuana after Proposition 64



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TAXATION OF MARIJUANA AFTER PROPOSITION 64

Course objectives: With the passage of Proposition 64 in California and the legalization of the use of both medicinal and recreational marijuana in more and more states, tax practitioners must learn to navigate the legal and ethical implications of working with the cannabis industry. This course will provide an analysis and review of the issues confronting tax pros and will address the following topics: Adult Use of Marijuana Act (AUMA), Medical Cannabis Regulation and Safety Act (MCRSA), IRC §§280E and 471, CCA201504011, sales and use taxes, excise taxes, deductibility, forfeitures, COGS, Circular 230, the banking industry, payment methods, and much more.

This course will enable you to:

- Recall restrictions on the various types of licenses that businesses may hold
- Identify which cannabis products are subject to sales and use tax
- Recall how IRC §280E affects marijuana businesses and the deduction of expenses
- Determine how the regulations under IRC §§471 and 263A must be applied to a cannabis dispensary
- Identify how losses incurred in marijuana trafficking are treated
- Determine which costs may be included in COGS for marijuana producers

Category: Taxes

Recommended CPE Hours: CPAs — 2 Tax
EAs — 1 Federal Tax
CRTPs — 1 Federal Tax and 1 CA Tax

Level: Basic

Prerequisite: None

Advanced Preparation: No advanced preparation is required.

Expiration Date: January 2018

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PROPOSITION 64 — MARIJUANA

On November 8, 2016, California voters approved Proposition 64, the Adult Use of Marijuana Act (AUMA), which legalizes recreational marijuana for use by adults age 21 or older. The proposition will also allow nonmedical retail sales of marijuana and impose new taxes on marijuana sales, though those changes will not go into effect immediately.

Note the following:

- Effective immediately, if you are age 21 or older, you can possess an ounce of marijuana and grow up to six plants in your home legally;
- It is still illegal to smoke marijuana in public or to drive while impaired by marijuana;
- An excise tax of 15% will be imposed on retail sales of marijuana, and cultivation taxes of $9.25 per ounce of flower and $2.75 per ounce of leaves will be imposed on marijuana growers. These new taxes will be imposed beginning January 1, 2018. Medical marijuana will be exempt from some taxation;
- Nonmedical marijuana can only be sold by state-licensed businesses, and the state has until January 1, 2018, to begin issuing licenses for recreational retailers. So, for now, it is not legal to sell marijuana for recreational purposes; and
- Local authorities will have the authority to impose additional restrictions and taxes on marijuana sales.

Although the proposition legalizes the recreational use of marijuana for California purposes, it is important to note that marijuana is still an illegal substance for federal purposes. This means that supplying marijuana is considered drug trafficking for federal and state purposes. (***Californians Helping to Alleviate Medical Problems, Inc. v. Comm.*** (May 15, 2007) 128 TC 173)

It also means that your clients who choose to operate marijuana businesses are faced with interesting issues concerning taxation.

Leading up to Proposition 64

California was an early leader in the "war on drugs." In 1913 the state passed a bill that made possession of "extracts, tinctures, or other narcotic preparations of hemp, or loco-weed, their preparations and compounds" a misdemeanor. From 1913 through 1997, the state had over 1,850,000 arrests related to marijuana, 1,000,000 of them felonies. (Gieringer, Dale H., "The Origins of Cannabis Prohibition in California")

The (slow) path to legalization

While California led the way in the criminalization of marijuana, it was also one of the leaders on the path to legalization.

1973: Proposition 19, a ballot proposition to decriminalize marijuana, was defeated by a 66.5% majority.

However, decriminalization was established in 1973 when the legislature passed SB 95, the Moscone Act. SB 95 made possession of one ounce of marijuana a misdemeanor punishable by a $100 fine, with higher punishments for amounts greater than one ounce or for possession on school grounds or for cultivation.

1996: Proposition 215, the Compassionate Use Act of 1996, allowed the use of marijuana for medical purposes and passed with a 55% majority (see below).

2000: Proposition 36, known as the Substance Abuse and Crime Prevention Act of 2000, was approved by 61% of voters. It required that "first and second offense drug violators be sent to drug treatment programs instead of facing trial and possible incarceration."

2010: SB 1449 further reduced the charge for possession of one ounce or less of cannabis from a misdemeanor to an infraction, similar to a traffic violation. The maximum penalty was $100. There would be no mandatory court appearance or criminal record.

2010: California voters rejected Proposition 19 by a vote of 53.5% to 46.5%, an initiative that would have made possession and cultivation of cannabis for recreational usage legal for adults over the age of 21, and would have regulated it similarly to alcohol.

Medical marijuana

California's medical cannabis program was established when state voters approved Proposition 215 (also known as the Compassionate Use Act of 1996) on the November 5, 1996, ballot with a 55% majority. The proposition added Section 11362.5 to the California Health and Safety Code, modifying state law to allow people with cancer, anorexia, AIDS, spasticity, glaucoma, arthritis, migraines or other chronic illnesses the "legal right to obtain or grow, and use marijuana for medical purposes when recommended by a doctor." The law also mandated that doctors not be punished for recommending the drug, and required that federal and state governments work together "to implement a plan to provide for the safe and affordable distribution of marijuana to all patients in medical need."

Vague wording became a major criticism of Proposition 215, though the law has since been clarified through California Supreme Court rulings and the passage of subsequent laws. The first solution of this came by legislation that established statewide guidelines for Proposition 215 by Senate Bill 420 in January 2003. To differentiate patients from nonpatients, Governor Gray Davis signed California Senate Bill 420 (colloquially known as the Medical Marijuana Program Act) in 2003, establishing an identification card system for medical marijuana patients. SB 420 also allows for the formation of patient collectives, or nonprofit organizations, to provide the drug to patients. In 2010, the California Supreme Court ruled that SB 420 did not limit the quantity a patient can possess, and all possession limits on medical marijuana in California were lifted. (***The People v. Patrick Kelly*** (2010) Cal. Sup. Ct., Case No. S164830)

In October 2015, the governor signed the Medical Cannabis Regulation and Safety Act (MCRSA), creating a comprehensive state licensing system for the commercial cultivation, manufacture, retail sale, transport, distribution, delivery, and testing of medical cannabis.

Federal involvement

Though medical marijuana was legalized and accepted by the majority of California voters, Proposition 215 does not supersede federal law. Marijuana is still illegal under federal law, which causes a conflict between the state and the U.S. government. In ***City of Garden Grove v. Superior Court*** (68 Cal. Rptr. 3d 656 (2007), the California Court of Appeal (which in California is binding on all courts) upheld a decision of a trial court to "[order] the Garden Grove Police Department to give [Felix Kha] back his marijuana" stating "[b]ecause the act is strictly a federal offense, the state has 'no power to punish ... [it] ... as such.'"

Since the passage of Proposition 215, federal officials have tried various approaches — from criminal raids and prosecutions to civil injunctions to threatening to seize any property leased for medical cannabis uses — to thwart or slow the progress of medical cannabis in California. It was not until March 2009 that federal officials announced that they would no longer try to thwart medical marijuana distribution/use in California.

During his campaign, President Barack Obama signaled that as President he would cease the DEA's raids in California. On March 18, 2009, Attorney General Eric Holder announced "a shift in the enforcement of federal drug laws, saying the administration would effectively end the Bush administration's frequent raids on distributors of medical marijuana."

PROPOSITION 64 — NONTAX CONSIDERATIONS

The purpose of the Adult Use of Marijuana Act is to establish a comprehensive system to legalize, control and regulate the cultivation, processing, manufacture, distribution, testing, and sale of nonmedical marijuana, including marijuana products, for use by adults 21 years and older, and to tax the commercial growth and retail sale of marijuana. According to Section 3, Purpose and Intent, of the law, it is meant to accomplish the following (copied with editor comments in italics):

(a) Take nonmedical marijuana production and sales out of the hands of the illegal market and bring them under a regulatory structure that prevents access by minors and protects public safety, public health, and the environment.

The act is meant to incapacitate the illegal market, making it more difficult for minors to procure marijuana.

(b) Strictly control the cultivation, processing, manufacture, distribution, testing and sale of nonmedical marijuana through a system of state licensing, regulation, and enforcement.

There will be several license classifications "at a minimum":

- *Type 1: Cultivation; specialty outdoor; small;*
- *Type 1A: Cultivation; specialty indoor; small;*
- *Type 1B: Cultivation; specialty mixed-light; small;*
- *Type 2: Cultivation; outdoor; small;*
- *Type 2A: Cultivation; indoor; small;*
- *Type 2B: Cultivation; mixed-light; small;*
- *Type 3: Cultivation; outdoor; medium;*
- *Type 3A: Cultivation; indoor; medium;*
- *Type 3B: Cultivation; mixed-light; medium;*
- *Type 4: Cultivation; nursery;*
- *Type 5: Cultivation; outdoor; large;*
- *Type 5B: Cultivation; mixed-light; large;*
- *Type 6: Manufacturer 1;*
- *Type 7: Manufacturer 2;*
- *Type 8: Testing;*
- *Type 10: Retailer;*
- *Type 11: Distributor; and*
- *Type 12: Microbusiness.*
  (Business and Professions Code §26050)

Generally, a person or entity may hold more than one license except that a person or entity that holds a testing license may not hold any other license. (Business and Professions Code §26053)

A licensee cannot also be licensed as a retailer of alcoholic beverages or of tobacco products. (Business and Professions Code §26054)

No licensee may be located within a 600-foot radius of any K-12 school, day care center, or youth center.

A "microbusiness" is a small operator with cultivation space not exceeding 10,000 square feet. A microbusiness license would allow holders to cultivate marijuana and act as a licensed distributor, level 1 manufacturer, and retailer all under one license.

(c) Allow local governments to enforce state laws and regulations for nonmedical marijuana businesses and enact additional local requirements for nonmedical marijuana businesses, but not require that they do so for a nonmedical marijuana business to be issued a state license and be legal under state law.

Local jurisdictions may enforce local ordinances including local zoning and land use requirements, business license requirements, and requirements relating to reduction of exposure to second-hand smoke. (Business and Professions Code §26200)

(d) Allow local governments to ban nonmedical marijuana businesses as set forth in this act.

Cities and counties can regulate nonmedical businesses. They can require nonmedical marijuana businesses to obtain local licenses and restrict where they can be located. In fact, they can prohibit them. However, they cannot ban the transportation of marijuana through their jurisdictions. (Business and Professions Code §26200)

(e) Require track and trace management procedures to track nonmedical marijuana from cultivation to sale.

The track and trace procedures will include a seed-to-sale software tracking system with data points for the different stages of commercial activity including, but not limited to, harvest, processing, distribution, inventory and sale. (Business and Professions Code §26170)

(f) Require nonmedical marijuana to be comprehensively tested by independent testing services for the presence of contaminants, including mold and pesticides, before it can be sold by licensed businesses.

No marijuana may be legally sold unless a representative sample of such marijuana has been tested by a certified testing service to determine whether the chemical profile of such marijuana conforms to the labeled contents. Compounds subject to testing include tetrahydrocannabinol (THC) and others.

(g) Require nonmedical marijuana sold by licensed businesses to be packaged in child-resistant containers and be labeled so that consumers are fully informed about potency and the effects of ingesting nonmedical marijuana. *(Business and Professions Code §26120)*

(h) Require licensed nonmedical marijuana businesses to follow strict environmental and product safety standards as a condition of maintaining their license.

(i) Prohibit the sale of nonmedical marijuana by businesses that also sell alcohol or tobacco. *(Business and Professions Code §26054)*

(j) Prohibit the marketing and advertising of nonmedical marijuana to persons younger than 21 years old or near schools or other places where children are present.

It is prohibited to sell to any individual unless the individual to whom the marijuana is to be sold first presents documentation which reasonably appears to be a valid government-issued identification card showing that the individual is 21 years of age or older. (Business and Professions Code §26130)

Marijuana products may not be designed to be appealing to children. (Business and Professions Code §26130)

Any advertising or marketing shall only be displayed where at least 71.6% of the audience is reasonably expected to be 21 years of age or older, as determined by reliable, up-to-date, audience composition data. (Business and Professions Code §26151)

(k) Strengthen the state's existing medical marijuana system by requiring patients to obtain by January 1, 2018, a new recommendation from their physician that meets the strict standards signed into law by the Governor in 2015, and by providing new privacy protections for patients who obtain medical marijuana identification cards as set forth in this act.

(l) Permit adults 21 years and older to use, possess, purchase, and grow nonmedical marijuana within defined limits for use by adults 21 years and older as set forth in this act.

Individuals 21 years of age and older are allowed to smoke, ingest, possess, transport, purchase, obtain, or give away to persons 21 years of age or older without any compensation whatsoever, not more than 28.5 grams of marijuana (approximately one ounce) not in the form of concentrated cannabis or eight grams of marijuana in the form of concentrated marijuana. (Health and Safety Code §11362.1)

Individuals 21 years of age or older are allowed to plant, cultivate, harvest, dry, or process not more than six living marijuana plants and possess the marijuana produced by the plants. The living plants must be in a locked space and must not be visible by normal unaided vision from a public place. (Health and Safety Code §11362.2)

(m) Allow local governments to reasonably regulate the cultivation of nonmedical marijuana for personal use by adults 21 years and older through zoning and other local laws, and only to ban outdoor cultivation as set forth in this act.

(n) Deny access to marijuana by persons younger than 21 years old who are not medical marijuana patients.

No licensee shall sell marijuana or marijuana products to persons under the age of 21 years, allow any such person on its premises, or employ any such person. (Business and Professions Code §26140)

(o) Prohibit the consumption of marijuana in a public place unlicensed for such use, including near K–12 schools and other areas where children are present.

Marijuana may not be smoked in any public place or in any location where smoking tobacco is prohibited. In addition, marijuana may not be smoked within 1,000 feet of a school, day care center, or youth center while children are present, except in a private residence and only if such smoking is not detectable by others on the grounds of such school, day care center, or youth center. (Health and Safety Code §11362.3)

(p) Maintain existing laws making it unlawful to operate a car or other vehicle used for transportation while impaired by marijuana.

An individual may not smoke or ingest marijuana or possess an open package of marijuana while driving, operating, or riding in the passenger seat of a motor vehicle, boat, vessel, aircraft, or other vehicle used for transportation. (Health and Safety Code §11362.3)

(q) Prohibit the cultivation of marijuana on public lands or while trespassing on private lands.

(r) Allow public and private employers to enact and enforce workplace policies pertaining to marijuana.

(s) Tax the growth and sale of marijuana in a way that drives out the illicit market for marijuana and discourages use by minors, and abuse by adults.

(t) Generate hundreds of millions of dollars in new state revenue annually for restoring and repairing the environment, youth treatment and prevention, community investment, and law enforcement.

(u) Prevent illegal production or distribution of marijuana.

(v) Prevent the illegal diversion of marijuana from California to other states or countries or to the illegal market.

(w) Preserve scarce law enforcement resources to prevent and prosecute violent crime.

(x) Reduce barriers to entry into the legal, regulated market.

(y) Require minors who commit marijuana-related offenses to complete drug prevention education or counseling and community service.

(z) Authorize courts to resentence persons who are currently serving a sentence for offenses for which the penalty is reduced by the act, so long as the person does not pose a risk to public safety, and to redesignate or dismiss such offenses from the criminal records of persons who have completed their sentences as set forth in this act.

(aa) Allow industrial hemp to be grown as an agricultural product, and for agricultural or academic research, and regulated separately from the strains of cannabis with higher delta-9 tetrahydrocannabinol concentrations. *(Health and Safety Code §11018.5)*

Complexity

The act consists of 62 pages. It adds to, amends, or repeals sections within six California codes.

Code Sections Added, Amended, or Repealed	
Code	**Number of changes**
Health and Safety Code	18
Business and Professions Code	82
Labor Code	1
Water Code	1
Revenue and Taxation Code	18
Food and Agriculture Code	5

In addition, the act references six other California codes:

- Vehicle Code;
- Penal Code;
- Civil Code;
- Government Code;
- Fish and Game Code; and
- Public Resources Code.

Comment

In addition to referencing other California codes, the act also references specific California acts and federal law. Moreover there is substantial cross-referencing among the codes that are amended (for example, there is a great deal of cross-referencing between the Bureau and Professions Code and the Health and Safety Code).

There are also several California government entities involved in administering the law as prescribed by the act.

California Government Entities Involved in Administering the Law	
Governor	Department of Pesticide Regulation
Legislature	Department of Fish and Wildlife
Attorney General	Department of Industrial Relations
State Controller	Department of Social Services
Director of Finance	Department of Education
Legislative Analyst's Office	Department of Finance
State Auditor	Department of Parks and Recreation
Department of Corrections	Department of Highway Patrol
Department of Public Health	Bureau of Marijuana Control
Department of Consumer Affairs	Marijuana Control Appeals Board
Department of Food and Agriculture	Board of Equalization
Department of Alcoholic Beverages Control	

Comparison of Proposition 64 rules and medical marijuana rules

The Adult Use of Marijuana Act (AUMA) and the Medical Cannabis Regulation and Safety Act (MCRSA) bear many similarities.

License categories and restrictions

Both MCRSA and AUMA set forth six general license categories.

General License Categories	
MCRSA	**AUMA**
Cultivation	Cultivation
Manufacturing	Manufacturing
Testing	Testing
Dispensary	Retailer
Distribution	Distribution
Transporting	Microbusiness

Under MCRSA, licensees are very restricted in their ability to hold multiple licenses. Subject to limited exceptions, MCRSA allows licensees to hold, at most, two different types of licenses. Also, subject to limited exceptions, MCRSA licensees are prohibited from holding an ownership interest in real property, personal property, or other assets associated with or used in any other MCRSA license category.

AUMA, on the other hand, would not impose the same restrictions. Under AUMA, only one type of license would be restricted: Those holding testing licenses may not hold any other type of license.

Taxes

All businesses operating under both AUMA and MCRSA are required to have a seller's permit with the State Board of Equalization.

AUMA imposes a 15% excise tax on gross receipts for both medical and recreational marijuana. The excise tax is imposed on purchasers of marijuana or marijuana products sold in California.

Pursuant to Proposition 64, California's sales and use tax does not apply to retail sales of medical marijuana when a qualified patient or primary caregiver provides his or her medical marijuana identification card.

Proposition 64 also imposes a cultivation tax on all harvested medical and recreational marijuana. The tax is as follows:

- **Marijuana flowers:** $9.25 per dry-weight ounce; and
- **Marijuana leaves:** $2.75 per dry-weight ounce.

Comment

This tax does not apply to marijuana cultivated for personal use.

Working together

Pursuant to the approval of Proposition 64, MCRSA licenses remain in force, and local governments that allow medical marijuana operators will have the ability to prohibit recreational marijuana businesses.

The Bureau of Medical Marijuana Regulation division of the Department of Consumer Affairs is renamed the Bureau of Marijuana Control and given chief authority to regulate the industry.

Subject to the discretion of the local government and the licensing authorities, a dispensary licensed to sell medical marijuana under MCRSA could also obtain a license to sell recreational marijuana from the same facility.

CALIFORNIA SALES AND EXCISE TAXES

SALES AND USE TAXES

Medical marijuana

Prior to Proposition 64, all medical marijuana sales were subject to sales and use tax. Effective November 9, 2016, certain sales of medical marijuana are exempt from sales and use tax.

The sales and use tax exemption only applies to the retail sales of medical cannabis, medical cannabis concentrate, edible medical cannabis products, or topical cannabis as those terms are defined in the Business and Professions Code §19300.5. To obtain the exemption, qualified patients or their primary caregiver must provide their valid Medical Marijuana Identification Card issued by the California Department of Public Health and a valid government-issued identification card at the time of purchase.

Retailers should not collect sales tax on the qualifying exempt sales of medical marijuana. Medical marijuana retailers will claim the exemption on their sales and use tax return and must retain supporting documentation to substantiate exempt transactions. Recreational marijuana sales will also be subject to sales and use tax.

Supporting documentation must include (either physical or electronic) for each transaction:

- The purchaser's nine-digit ID number and expiration date, as shown on the qualified patient's or primary caregiver's unexpired Medical Marijuana Identification Card (MMIC); and
- The related sales invoice or other original record of sale.

A valid MMIC is issued by the California Department of Public Health (CDPH).

The card includes the following:

- Issued by the "State of California" with the state seal;
- States either "Patient" or "Caregiver";
- Patient's or primary caregiver's photo;
- Nine-digit ID number;
- CDPH website to verify ID number;
- Expiration date; and
- County that issued card with phone number.

Retailers may verify the validity of the nine-digit ID number on the CDPH website.

Recreational marijuana

Sales and use tax will apply to sales of recreational marijuana. Sales tax will apply to the retail sales of related products including:

- Hash;
- Pre-rolls;
- Pipes;
- Rolling machines;
- Capsules;
- Tinctures;
- Tonics;
- Lotions;
- Teas;
- Edibles;
- Waxes;
- Buds and flowers;
- Vape pens;
- Rolling papers;
- Oils;
- Balms;
- Extracts;
- Gum;
- Topicals;
- Plants and clones; and
- Shirts, hats, books, magazines.

Delivery charges are generally taxable when dispensaries make deliveries with their own vehicles. However, delivery–related charges may be nontaxable, or partially taxable, when you ship using a common or contract carrier. For more information on shipping or delivery charges, see BOE Publication 100, Shipping and Delivery Charges.

Growers

Generally, most items purchased for use in a business are subject to sales or use tax. However, purchases of certain supplies may not be taxable, whereas purchases of other items may qualify for a partial exemption.

Supplies, equipment, and other business expenses

Purchases of items for use in a business (computers, fire extinguishers, advertising materials, pesticides, work gloves, among others) are subject to sales or use tax at the time of purchase. Certain purchases of specific types of equipment and machinery may be eligible for a partial exemption.

Farm and garden supplies

Seeds: Purchases of seeds are generally taxable. However, tax does not apply to purchases of seeds if the purchaser resells the seeds or resells the products grown from the seeds, as part of the purchaser's regular business activities.

Fertilizers: Tax does not apply to the sale of specified fertilizer to be applied to land or in foliar applications, provided the fertilizer is used to produce products for sale. All other sales of fertilizer are taxable.

Plants and clones: Tax does not apply to the sale of plants and clones if they will produce products that will be resold. The purchaser should give the supplier a timely valid resale certificate when purchasing the plant or clone. For more information on sales for resale see BOE Publication 103, Sales for Resale.

Partial exemption for farm equipment and machinery

In general, the sale of farm equipment and machinery is taxable. However, certain sales and purchases of farm equipment and machinery are partially exempt from sales and use tax. A grower may be able to take advantage of this partial exemption.

The partial exemption applies only to the state general fund portion of the sales tax, currently 5.25%.

To calculate the tax rate for qualifying transactions, subtract 5.25% from the sales tax rate that would normally apply at the location where the purchase is made. For example, if the current tax rate in that location is 9%, the tax rate for a qualifying transaction would be 3.75%.

Three requirements must be met for the partial exemption to apply. The item must be:

- Sold to a qualified person;
- Used exclusively or primarily (depending on the type of item) in producing and harvesting agricultural products. Primarily means 50% or more of the time; and
- Defined as farm equipment and machinery, which includes, but is not limited to, any tool, machine, equipment, appliance, device or apparatus used in the conduct of agricultural operations.

If *any* of these *three* requirements is not met, the partial exemption will not apply.

Examples of equipment and machinery that may qualify include:

- Planting equipment;
- Trimming tools;
- Drying racks and trays;
- Grow tents and lights;
- Environmental controls;

- Greenhouses;
- Hydroponic equipment;
- Solar equipment (see below for more information); and
- Irrigation equipment.

If the taxpayer leases farm equipment rather than purchases equipment, the taxpayer may still qualify for the partial tax exemption. For more information about leases, please see BOE Publication 46, Leasing Tangible Personal Property.

Buildings for raising plants

Certain buildings may qualify for the partial exemption for farm equipment. The building must be a single-purpose building to house plants, such as a greenhouse.

To qualify for the partial exemption, a horticulture building must be both of the following:

- Specifically designed for commercially raising plants or mushrooms; and
- Used exclusively for that purpose.

Diesel fuel

Most sales and/or purchases of diesel fuel are taxable. However, a partial sales and use tax exemption exists for certain sales and purchases of diesel fuel used in farming activities.

The partial exemption applies to the sale or purchase of diesel fuel only if the diesel meets the following two requirements:

- Be a type of diesel that qualifies for the exemption; and
- Be used in qualifying farming activities or related contract hauling.

A grower should provide a timely partial exemption certificate to the fuel supplier when purchasing diesel for a qualifying use. Purchases of diesel from fuel suppliers will qualify for the partial sales and use tax exemption when the fuel is used to:

- Prepare land for planting;
- Plant, protect, or grow crops;
- Harvest crops; and
- Transport the harvested unprocessed products from the field to the buyers.

The sale of diesel fuel to a grower may qualify for the partial exemption in the following situations:

1. A grower transports their newly harvested cannabis (unprocessed) to a dispensary in their diesel pickup truck. After delivering the product they return to the farm.
2. A grower uses diesel in their tractor to cultivate the land in preparation for planting the cannabis.

Diesel used to move the medical cannabis after processing is completed does not qualify for the exemption.

For more detailed information about diesel fuel used in farming, see 18 Cal. Code Regs. 1533.2, Diesel Fuel Used in Farming Activities or Food Processing.

Exemption for liquefied petroleum gas (LPG) used in farming activities

Sales of LPG for agricultural use are not taxable when purchased by a qualified buyer and used in commercial crop production or harvesting.

The buyer should provide a timely LPG exemption certificate to the vendor.

Nonagricultural use does not qualify for the exemption, even if used on a ranch or farm.

Partial exemption certificates

When a buyer makes a purchase that qualifies for a partial exemption, the buyer must provide an exemption certificate to the supplier.

In order for the certificate to be valid, the buyer must:

- Furnish the certificate timely to the seller;
- Provide all relevant information:
  - The buyer's name and address;
  - The type of property being purchased; and
  - The buyer's name or company name, title, telephone number, address, and the seller's permit number; and
- Sign and date the document.

An exemption certificate will be considered timely if it is given at any time before the seller bills the purchaser for the property, or any time within the seller's normal billing and payment cycle, or any time at or prior to delivery of the property to the purchaser.

Payment methods

Taxpayers can make their payments by one of several methods:

- For taxpayers filing over the Internet, payments are made online by debiting the taxpayer's bank account;
- By credit card using Discover, MasterCard, Visa or American Express. There is a 2.3% fee with a $1 minimum. See below for the web address and phone number to use to make payments; or
- By electronic funds transfer (EFT).

To make a credit card payment, call:

☎ Telephone
(855) 292-8931

Or, visit the BOE's website at:

Website
http://boe.ca.gov/onlineservices/#Make_Payment

Electronic funds transfer

A business that pays an average of $10,000 or more per month in sales and use taxes must make payment by EFT. (R&TC §6479.3) The BOE reviews payment histories and notifies businesses when they are required to pay by EFT.

Taxpayers not required to make payments through EFT may do so voluntarily. These participants are required to make EFT payments for at least one year, after which time they can request to be removed from the program.

Payments are made by Automated Clearing House (ACH) debit or credit.

To register for the program, taxpayers must file Form BOE-555-EFT, Authorization Agreement for Electronic Funds Transfer (EFT).

Cash payments

Marijuana business owners may pay their tax liability to the BOE in cash. By obtaining a seller's permit from the BOE and submitting a written request, BOE district offices will work with individual cannabis operators to establish a recurring schedule for payment, whether the taxpayers are legitimate distributors or underground sellers who want to legitimize their business.

Cannabis business must carefully substantiate their income

A marijuana cooperative, Just For You Caregivers, Inc., was liable for additional sales and use tax based on sales that auditors estimated by looking at a third-party website. (***Appeal of Just For You Caregivers, Inc.*** (September 28, 2016) Cal. St. Bd. of Equal., Case No. 854794)

Even though marijuana dispensaries are unable to maintain bank accounts, they still must be able to provide adequate books and records in the event of an audit.

Website reviews equal sales: During audit, Just For You did not produce books and records to the satisfaction of the BOE, who turned for more information to the Weedmaps.com website (www.weedmaps.com provides listings and reviews of cannabis cooperatives, storefronts, medical doctors, and delivery services based on geographic location) where Just For You was listed as a marijuana delivery service. The auditors looked at the types of services Just For You provided via the website and the reviews that customers left to make an estimate of how many sales Just For You averaged quarterly. The website showed hundreds of positive reviews, including 26 reviews during a quarter in which Just For You reported zero sales.

To back up their claim of unreported income, the BOE looked at another recent audit of a dispensary where quarterly sales averaged $72,053. Using that number, they determined that the taxpayer was reasonably bringing in $800 per day (or about 20 sales). Based on these findings, the BOE argued that Just For You failed to report $976,955 in taxable sales between January 1, 2011, and June 30, 2014.

Just For You argued that the business is a cooperative, not a delivery service, where rather than generating taxable "sales," members contribute money quarterly and based on how much they contribute, they receive a percentage of that quarter's crop. The deliveries Just For You made were ostensibly only for co-op members who were too sick to pick up their medicine. Just For You also argued against the reliance on the third-party website as evidence of sales because reviews were tantamount to "hearsay" and further could not be relied upon because the reviewers were likely under the influence of marijuana when they left the reviews.

No stone unturned: In reaching their unanimous conclusion that the auditor's methods produced a reasonable estimate of Just For You's income, the Board's main findings were:

- In the absence of proper books and records, they didn't have anything else to go on except for the information found on the third-party website to determine how many sales Just For You was making; and
- The income estimate was reasonable because it compared favorably to numbers found in a similar audit: That business was in the same industry (marijuana delivery service), in a nearby location to Just For You, and the sales were from the same time period.

It's important to note that if auditors suspect the taxpayer records at their disposal don't tell the full story, they will turn to any source they feel will substantiate their position. In this case, not only did the auditor turn up Just For You's listing on a dispensary rating website, which ultimately caused the

business to owe extra tax, but the auditor also discovered that a pit bull breeding business was listed at the home address of Just For You's owner. That business record was left over from a previous tenant, but during the appeal hearing, Board Member Harkey helpfully suggested that the owner resolve that issue to protect himself from future problems because the breeding business was not paying sales tax.

EXCISE TAXES

Proposition 64 imposes two new excise taxes on marijuana. Both excise taxes are imposed on both medical marijuana and recreational marijuana. Both excise taxes become effective on January 1, 2018.

15% excise tax on sales

Effective January 1, 2018, a marijuana excise tax is imposed upon purchasers of marijuana or marijuana products sold in California at the rate of 15% of the gross receipts of any retail sale of marijuana. (R&TC §34011) The excise tax is in addition to the sales and use tax imposed by state and local governments.

Gross receipts from the sale of marijuana or marijuana products for purposes of assessing the sales and use tax includes the 15% excise tax. (R&TC §34011(e))

Comment

This has the effect of imposing not only a 15% excise tax, but also a 15% surcharge on sales taxes.

Example of excise tax and sales taxes

Spicoli buys recreational marijuana at a retail outlet. He pays $100 for the marijuana. The excise tax is $15, so the total gross receipts for purposes of computing sales taxes is $115. The sales tax rate in his district is 9%. His sales tax is $10.35 (9% × $115). The total cost is $125.35.

Therefore, his effective sales tax rate is 10.35% (9% × 115%).

Note that if Spicoli had purchased medical marijuana and presented the proper ID card, he would not pay the sales tax, but he would pay the 15% excise tax. His total cost would have been $115.

Excise tax on harvested marijuana

Effective January 1, 2018, there is a cultivation tax on all harvested marijuana that enters the commercial market. (R&TC §34012) The tax is due after the marijuana is harvested.

Marijuana flowers

The tax for marijuana flowers is $9.25 per dry ounce. (R&TC §34012(a)(1))

Marijuana flowers are defined as the dried flowers of the marijuana plant as defined by the Board of Equalization. (R&TC §34010(f))

Comment

Marijuana flowers are commonly called the "bud." The flowers contain the most potent part of the plant. While leaves and other parts of the plant can be consumed, they are far less potent. (A 1960s song by Commander Cody was titled, "Down to Seeds and Stems Again Blues.")

Marijuana leaves

The tax on marijuana leaves is $2.75 per dry ounce. (R&TC §34012(a)(2))

Marijuana leaves are defined as all parts of the marijuana plant other than marijuana flowers. (R&TC §34010(a)(g))

Additional taxes and categories

The excise taxes are administered by the Board of Equalization ("the Board"). (R&TC §34013(a))

The tax rates will be adjusted for inflation beginning January 1, 2020. (R&TC §34012(k))

The Board may adjust the tax rate annually for marijuana leaves to reflect fluctuations in the relative market price of marijuana flowers to marijuana leaves. (R&TC §34012(b)) Additionally, the Board may from time to time establish other categories of harvested marijuana, categories for unprocessed or frozen marijuana, or immature plants. These categories will be taxed at their relative values relative to marijuana flowers.

Administration

The Board may prescribe by regulation a method and manner for the payment of the cultivation tax that utilizes tax stamps or state-issued product bags that indicate that all required tax has been paid. (R&TC §34012(d))

After establishing the tax stamp program, the Board may by regulation provide that no marijuana may be removed from a licensed cultivation facility or transported on a public highway unless in a state-issued product bag bearing a proper tax stamp. (R&TC §34012(f))

All marijuana removed from a cultivator's premises, except for plant waste, will be presumed to be sold and thereby subject to the cultivation tax. (R&TC §34012(i))

The tax does not apply to marijuana cultivated for personal use. (R&TC §34012(k))

Collection and payment

The excise taxes will be due and payable quarterly on or before the last day of the month following the quarter. (R&TC §34015(a))

On or before the due date, a return must be filed by each required to be licensed to sell or cultivate marijuana.

If the cultivation tax is paid by stamp, the Board will establish procedures for payment of the stamp tax.

In addition, the Board may require every person engaged in the cultivation, distribution, or retail sales of marijuana or marijuana products to file, on or before the 25th day of each month, a report using electronic media respecting the person's inventory, purchases, and sales during the preceding month and any other information the Board may require. (R&TC §34015(b))

In addition, the Board may perform unannounced inspections. (R&TC §34016) Inspections will be performed in a reasonable manner and at reasonable times taking into consideration the normal business hours of the place to be inspected. Inspections may be at any place at which marijuana or marijuana products are sold, cultivated, or stored.

Use of funds

All excise taxes, interest, and penalties will be deposited into the California Marijuana Tax Fund created in the State Treasury. (R&TC §34018) The funds are not to be treated as part of the General Fund. (R&TC §34018(c))

After initial spending, revenues will be allocated as follows:

- 60% for youth programs including substance abuse and prevention education and drug abuse treatment;
- 20% to clean up and prevent environment damage resulting from the illegal cultivation of marijuana; and
- 20% for:
  - Programs designed to reduce driving under the influence of marijuana, alcohol and other drugs; and
  - A grant program designed to reduce any negative impacts on public health or safety resulting from the AUMA.

County taxes

A county may imposed a tax on cultivation, manufacturing, producing, processing, preparing, storing, providing, donating, selling, or distributing marijuana or marijuana products. (R&TC §34021.5)

The board of supervisors for the county must specify in the ordinance proposing the tax the activities subject to the tax, the applicable rate or rates, the methods of apportionment, and the manner of collecting the tax.

Berkeley requires donations of medical marijuana

The city of Berkeley unanimously passed an ordinance that requires marijuana dispensaries to donate a minimum of 2% (by weight) of their product to low-income city residents. (Berkeley Municipal Code §12.27.080) Those qualified to receive this perk are residents who have income below $32,000 ($46,000 per family) and have a prescription for medical marijuana.

Because sales tax applies to medical marijuana, California will lose the tax on the 2% that is donated. Additionally, if the recipients of the donated product turn around and sell it, chances are they will not be collecting and remitting sales tax.

Advocates for this ordinance point out that some dispensaries already have such "compassionate distribution" programs in place, and that because medical marijuana is used as medicine, cost should not prohibit someone from accessing it. Opponents' arguments include resale issues and concern over passing out free pot to the low-income demographic.

Taxation of Marijuana Under Proposition 64

Type of tax	Type of marijuana taxed	Rate
Cultivation tax on flowers	Medical and nonmedical	$9.25 per ounce of dried marijuana flowers
Cultivation tax on leaves	Medical and nonmedical	$2.75 per ounce of dried marijuana leaves
Retail excise tax	Medical and nonmedical	15% of gross receipts
Sales and use tax	Nonmedical	Varies
Local tax	Varies	Varies

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. What is an accurate detail of the Adult Use of Marijuana Act, which was passed in November 2016 by California voters?

    a) Adults age 21 and over can have one ounce of marijuana in their possession and legally grow up to a dozen plants
    b) It is no longer illegal to smoke marijuana in public
    c) It is currently not legal to sell recreational marijuana
    d) There will be a 20% excise tax on the retail sales of marijuana beginning January 1, 2018

2. What is true about the interaction of federal law and Proposition 215, which legalized the use of medical cannabis in California?

    a) The law outlined under Proposition 215 required that federal and state governments work together in putting forth a plan for safely distributing medical marijuana
    b) Proposition 215 supersedes federal law
    c) Federal officials have generally acted in accordance with the directives of Proposition 215 since its passage
    d) The passage of Proposition 215 signaled that there was no conflict between the state and the U.S. government regarding the use of medical marijuana

3. When comparing Proposition 64, the Adult Use of Marijuana Act (AUMA), with the Medical Cannabis Regulation and Safety Act (MCRSA), which of the following is true?

    a) Both the AUMA and the MCRSA significantly limit licensees from holding multiple licenses
    b) Only under the AUMA are businesses required to have a BOE seller's permit
    c) A dispensary licensed to sell medical marijuana under the MCRSA may not sell recreational marijuana out of the same facility
    d) Under the AUMA, licensees holding testing licenses cannot hold any other type of license

4. For marijuana growers, which statement correctly reflects whether sales and use tax applies to purchases of specific business items?

    a) Sales of fertilizer is always taxable
    b) Leased farm equipment will not qualify for a partial tax exemption
    c) There is no tax on the sale of plants if the plants produce products for resale
    d) A building will qualify for a partial exemption only under the circumstance that it is used exclusively as a horticulture building

SOLUTIONS TO REVIEW QUESTIONS

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1. What is an accurate detail of the Adult Use of Marijuana Act, which was passed in November 2016 by California voters? (Page 1)

    a) Incorrect – Adults may have one ounce in their possession and grow up to six plants.
    b) Incorrect – It is illegal to smoke in public or while driving.
    c) Correct – California has until January 1, 2018, to begin to issue licenses to sell recreational marijuana.
    d) Incorrect – The excise tax is 15%.

2. What is true about the interaction of federal law and Proposition 215, which legalized the use of medical cannabis in California? (Page 2)

    a) Correct – This was one of the intents of the law, which also required that doctors not be punished for recommending the use of medical marijuana.
    b) Incorrect – It does not supersede federal law, and marijuana is still a federal offense.
    c) Incorrect – Until 2009, the federal government pursued criminal raids and civil injunctions for property seizure when the property was used for medical cannabis production or distribution. Under President Obama, however, the raids on distributors ceased.
    d) Incorrect – Proposition 215 was passed in 1996, but marijuana to this day is still illegal under federal law so there remains a legal conflict even though the federal government has ceased to crack down on the distribution of medical marijuana.

3. When comparing Proposition 64, the Adult Use of Marijuana Act (AUMA), with the Medical Cannabis Regulation and Safety Act (MCRSA), which of the following is true? (Pages 7-8)

    a) Incorrect – The limitations are more restrictive under the MCRSA than under the AUMA. Under the MCRSA, licensees may only hold up to two different types of licenses. There are no such restrictions pertaining to the AUMA except as noted in (d) below for those holding testing licenses.
    b) Incorrect – A seller's permit is required under both the AUMA and MCRSA.
    c) Incorrect – The decision as to which dispensary may sell what is up to the local licensing authorities, but a dispensary selling medical marijuana may also be licensed to sell recreational marijuana.
    d) Correct – The testing license is the only license that is restricted in that those holding that type of license may not hold another type.

4. For marijuana growers, which statement correctly reflects whether sales and use tax applies to purchases of specific business items? (Pages 10-11)

    a) Incorrect – No sales tax applies to fertilizer used in land or foliar applications as long as the end products on which the fertilizer is used will be sold.
    b) Incorrect – The partial tax exemption may apply to leased equipment as well as to that which has been purchased.
    c) Correct – This is considered a sale for resale where the purchases should supply a resale certificate at the time of purchase.
    d) Incorrect – There are two qualifications that must be met for the partial exemption for a building: The building must be specifically designed for raising plants and mushrooms for commercial use, and the building must be used exclusively for that purpose.

FEDERAL INCOME TAXES

GENERALLY

In the Comprehensive Drug Abuse Prevention and Control Act of 1970, 21 U.S.C. §801–971 (Controlled Substances Act), Congress created a regime to curtail the unlawful manufacture, distribution, and abuse of dangerous drugs ("controlled substances"). Congress assigned each controlled substance to one of five lists (Schedule I through Schedule V).

Schedule I includes:

- Opiates;
- Opium derivatives (e.g., heroin and morphine); and
- Hallucinogenic substances (e.g., LSD, marijuana, mescaline, and peyote).

Though a medical marijuana business is illegal under federal law, it remains obligated to pay federal income tax on its taxable income because IRC §61(a) does not differentiate between income derived from legal sources and income derived from illegal sources.

IRC §61(a) defines "gross income" broadly, using 15 examples of items that are includible in gross income. IRC §61(a)(3) provides that gross income includes net gains derived from dealings in property, which includes controlled substances produced or acquired for resale.

"Gains derived from dealings in property" means gross receipts less COGS, which is the term given to the adjusted basis of merchandise sold during the taxable year. (Treas. Regs. §1.61-3(a))

As the Tax Court explained in ***Reading v. Comm.*** (1978) 70 TC 730, 733, "[t]he 'cost of goods sold' concept embraces expenditures necessary to acquire, construct or extract a physical product which is to be sold; the seller can have no gain until he recovers the economic investment that he has made directly in the actual item sold."

A taxpayer derives COGS using the following formula:

- Beginning inventories; plus
- Current-year production costs (in the case of a producer) or current-year purchases (in the case of a reseller); less
- Ending inventories.

In general, the taxpayer first determines gross income by subtracting COGS from gross receipts, and then determines taxable income by subtracting all ordinary and necessary business expenses.

Edmondson

In 1981, the Tax Court allowed an illegal business to recover the cost of the controlled substances (i.e., amphetamines, cocaine, and marijuana) obtained on consignment and also to claim certain business deductions (a portion of the rent he paid on his apartment which was his sole place of business, the cost of a small scale, packaging expenses, telephone expenses, and automobile expenses). (***Edmondson v. Comm.***, TCM 1981-263)

IRC §280E

In 1982, Congress enacted IRC §280E, which reverses the holding in ***Edmondson*** as it relates to deductions other than the cost of the controlled substances. IRC §280E reads as follows:

"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."

Under Explanation of Provision, the Senate Report reads as follows:

"All deductions and credits for amounts paid or incurred in the illegal trafficking in drugs listed in the Controlled Substances Act are disallowed. To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill."

As marijuana is a Schedule I substance, businesses dealing in marijuana are subject to IRC §280E. Accordingly, marijuana businesses are only allowed to deduct the cost of goods sold and not business expenses.

Note that the Senate Report expresses concern over a constitutional challenge. The cost of goods sold is essentially a return of capital and the Supreme Court has held that the 16th Amendment, which authorized the income tax, precludes taxing the return of capital. (***Doyle v. Mitchell Bros.*** (1918) 247 U.S. 179)

Results of IRC §280E

In essence, IRC §280E means that marijuana businesses cannot take deductions that are allowed to all other businesses and, with half the states having some form of legal marijuana, it's likely that IRC §280E is applied to more legal businesses than it is to the types of illegal drug dealers that the provision was intended to penalize.

Therefore, unless a cost is included in COGS, it is subject to IRC §280E. Most businesses want to minimize the amount of costs that go into COGS, preferring instead to treat those costs as current deductions. However, because IRC §280E prevents the deduction of expenses, taxpayers in the cannabis business are in the opposite position of wanting to capitalize to inventory as much of their costs as possible.

In effect, cannabis businesses pay taxes on gross income. This may mean that they pay taxes at much higher rates than other businesses with the same net income.

According to anecdotal evidence, marijuana businesses are experiencing actual tax rates similar to the following example:

	Non-cannabis business	**Cannabis business**
Sales	$1,000,000	$1,000,000
Cost of goods sold	700,000	700,000
Gross income	300,000	300,000
Deductible expenses	200,000	0
Taxable income	$ 100,000	$ 300,000
Tax at 30%	$ 30,000	$ 90,000
Effective tax rate	30%	90%

Expenses that are likely to be scrutinized by the IRS include:

- Salaries;
- Utilities;
- Employee benefits;
- Marketing and advertising;
- Repairs and maintenance;
- Rent;
- Payments to contractors;
- Office expenses; and
- General and administrative (legal expenses, bookkeeping, etc.).

Dumping IRC §280E

Is it possible the IRC §280E problem can be resolved? The National Cannabis Industry Association believes that the best fix is to remove marijuana from the Controlled Substances Act.

In the 114th Congress, Senator Ron Wyden (D-Oregon) introduced S. 987, The Small Business Tax Equity Act, that would have more narrowly addressed the negative impact of IRC §280E without overhauling U.S. drug policy. However, the legislation died in Congress.

The legislation would have exempted cannabis businesses operating in compliance with state law from the provisions of IRC §280E, thereby allowing them to take the same business deductions allowed to all other legal businesses.

Congress has several options:

- **De-schedule or legalize marijuana:** Congress could remove marijuana from the Controlled Substance Act.
- **Re-schedule marijuana:** Marijuana is currently on Schedule I under the Controlled Substances Act and IRC §280E applies to Schedule I and Schedule II substances. Schedule I means that it has a high potential for abuse and no medically accepted use. In 1972, the National Organization for the Reform of Marijuana Laws (NORML) petitioned the Drug Enforcement Agency to re-schedule marijuana to Schedule V, citing government reports that marijuana has a relatively low social cost and has defined medical uses. The DEA denied the petition in 1988. In 2002, the Americans for Safe Access petitioned the DEA, citing supportive evidence of valid medical uses from the American Medical Association and other medical sources. The DEA denied the petition in 2011.
- **Repeal IRC §280E:** This would solve the problem for legal marijuana but would allow deductions for those engaged in the illegal trafficking of drugs.
- **Change one word in IRC §280E:** Presently, IRC §280E applies to persons trafficking in any controlled substance "which is prohibited by federal law or the law of any state." By changing "or" to "and," IRC §280E would only apply when the trafficking violates both federal and state law. The provision would no longer apply to marijuana businesses operating in states where it is legal.

CCA 201504011

In 2015, the IRS Chief Counsel issued an internal memorandum that opined on how state-legal cannabis business should compute their federal income taxes. (CCA 201504011)

The CCA takes the position that a taxpayer who traffics in Schedule I or Schedule II controlled substances utilizes IRC §263A in determining inventory costs and must use the regulations under

IRC §471, *as those regulations existed when IRC §280E was enacted* (IRC §280E was enacted in 1982; IRC §263A was enacted in 1986).

The CCA reasons that IRC §263A "is a timing provision" that does not change the character of any expense from nondeductible to deductible. For a taxpayer to be permitted to treat an expense as in inventoriable cost, that expense must not run afoul of the flush language at the end of IRC §263A(a)(2): "Any cost which could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph." (Also see Treas. Regs. §1.263A-1(c)(2)(i).) Taken together, IRC §280E and the flush language at the end of IRC §263A(a)(2) prevent a taxpayer trafficking in a Schedule I or Schedule II controlled substance from obtaining a tax benefit by capitalizing disallowed deductions.

Results of the CCA

This CCA was harsh news for taxpayers in the marijuana business. Taxpayers in the marijuana business were using IRC §263A to increase inventory costs. In essence, IRC §263A begins with costs capitalized to inventory under IRC §471 and adds to those costs.

IRC §471 regulations before enactment of IRC §280E

Interestingly, the CCA says that a person in the marijuana business must use the IRC §471 regulations before the enactment of IRC §280E. However, the CCA does not quote or provide those regulations as they existed before 1986 (it's not exactly easy to find such regulations).

Resellers: The CCA states that resellers are subject to Treas. Regs. §1.471-3(b). The version of that regulation as it was at the time enactment of IRC §280E is:

"§1.471-3 Inventories at cost

Cost means:

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods."

Producers: The CCA states that producers are subject to Treas. Regs. §§1.471-3(c) and 1.471-11 ("full absorption"). The versions of those regulations as they were at the time enactment of IRC §280E are:

"§1.471-3 Inventories at cost

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 or return on capital, whether by way of interest or profit. See §1.471-11 for more specific rules regarding the treatment of indirect production costs.

…

§1.471-11 Inventories of manufacturers

(a) Use of full absorption method of inventory costing. In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income (as required by section 471 of the Code), both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with

the "full absorption" method of inventory costing. Under the full absorption method of inventory costing production costs must be allocated to goods produced during the taxable year, whether sold during the taxable year or in inventory at the close of the taxable year determined in accordance with the taxpayer's method of identifying goods in inventory. Thus, the taxpayer must include as inventoriable costs all direct production costs and, to the extent provided by paragraphs (c) and (d) of this section, all indirect production costs. For purposes of this section, the term "financial reports" means financial reports (including consolidated financial statements) to shareholders, partners, beneficiaries or other proprietors and for credit purposes."

Comment

The full text of Treas. Regs. §1.471-11 is 20 pages and therefore cannot be reproduced in full in these materials.

The flawed ruling

The CCA is arguably a very flawed ruling. Keep in mind the interplay between IRC §280E and the flush language of IRC §263A.

The Senate Report to IRC §280E emphasized that, "To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill."

The flush language of IRC §263A states, "Any cost which could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph."

Note, too, that the IRS concludes that IRC §263A is a timing provision, not a deduction provision, and IRC §263A cannot convert a nondeductible item into a deductible item. But note that *all* inventory provisions are timing provisions.

The legislative history to IRC §263A is clear that "a single, comprehensive set of rules should govern the capitalization of costs." (S. Rep. No. 99-313, 140 (1986)) Moreover, the legislative history provides that the UNICAP rules are necessary so that costs that are "in reality" part of COGS are treated as such. Thus, IRC §263A is necessary to accurately reflect COGS, which is constitutionally guaranteed to all taxpayers in calculating gross income, including those in the marijuana business whose deductions from gross income are limited under IRC §280E.

Accordingly, the only provision that could cause IRC §263A to not be applicable to those in the marijuana business is the flush language of IRC §263A. Yet that language specifically provides that it only applies if a different provision prohibits the inclusion of the item in figuring income. But there is no such provision. Clearly that provision cannot be IRC §280E, which not only doesn't prohibit adjustments for COGS, it *mandates* them.

In short, the IRS is making a circular argument.

On the other hand, their argument provides no support for the position that COGS may be defined differently for different classes of taxpayers. It's clear that deductions from gross income are a matter of "legislative grace," and that, by enacting IRC §280E, Congress has denied its legislative grace to deductions *from* gross income. However, it's equally clear that Congress feared a constitutional challenge if COGS could not be deducted when determining gross income. The CCA takes the position that IRC §263A applies in determining COGS for every seller of inventory goods except businesses trafficking in controlled substances. Different definitions of COGS for different kinds of businesses open the door to constitutional challenge that Congress sought to avoid when it enacted IRC §280E.

Moreover, the IRS provides no support for their odd assertion that marijuana businesses must use the definition of COGS found in the IRC §471 regulations as it existed when IRC §280E was enacted.

Can it be challenged? A CCA is only the IRS's statement of how they interpret the law and has no precedential value. Nonetheless, it leaves open the question of what taxpayers in the marijuana industry should do in the face of this CCA.

WORKING WITH IRC §280E

Marijuana businesses have taken two approaches to minimizing the impact of IRC §280E:

- Separate their trade or business activities into two sets of businesses (businesses that engage in drug trafficking and businesses that do not); and
- Characterize as many costs as possible as costs of goods sold rather than nondeductible operating expenses.

SEPARATE BUSINESSES

Taxpayers have tried separating their trade or business activities into two sets of businesses: businesses that consist of "trafficking" in marijuana and businesses that do not (i.e., businesses for which operating expenses are deductible).

Medical marijuana dispensers' business expenses can be deductible when these expenses are associated with activities not related to marijuana dispensing. To achieve this, the dispenser must be considered as involved in multiple trades or businesses. The trade or business other than the trade or business of medical marijuana dispensing must be separate from and cannot be merely incidental to the medical marijuana dispensing activities. Although how to distinguish a trade or business from another may depend on all the facts and circumstances, ***CHAMP*** and ***Olive*** are the Tax Court cases that are generally cited in making the distinction.

CHAMP

Californians Helping to Alleviate Medical Problems, Inc. (CHAMP) is a California organization dedicated to charitable purposes. It provided its members with caregiving services as well as medical marijuana under the California Compassionate Use Act of 1996. Members paid membership fees to receive extensive caregiving services and medical marijuana. They were required to have an authenticated doctor's letter recommending marijuana as part of the therapy. Members received a set amount of medical marijuana, not unlimited supplies. The taxpayer furnished its services at its main facility and at an office in a community church. The medical marijuana was dispensed at a counter of the main room which took up about 10% of the main facility. Members were not allowed to bring any marijuana into the church.

The IRS disallowed all of the taxpayer's deductions and cost of goods sold under IRC §280E. However, the Tax Court referred to the legislative history and noted that a taxpayer is not denied all of the business expense deductions simply because he or she is involved in trafficking a controlled substance. (***Californians Helping to Alleviate Medical Problems, Inc. v. Comm.*** (2007) 128 TC 173) As a result, the Tax Court had to determine whether the taxpayer's caregiving service was a trade or business separate from its medical marijuana dispensing. The IRS contended that the taxpayer's principal activity was providing access to marijuana and the caregiving services were merely incidental to the marijuana trafficking activities. The taxpayer argued that its primary function was to be a community center for seriously ill patients, not to provide marijuana to its members.

The Tax Court found that the taxpayer conducted discussion groups, regularly distributed food and hygiene supplies, retained personal counselors' services, coordinated social events and field trips, hosted educational classes, and provided other social services. Consequently, the Tax Court

concluded that the taxpayer operated two separate business provisions and, hence, the expenses were allocated between the two trades or businesses on the basis of the number of employees and the portion of its facilities devoted to each business.

Olive

The taxpayer in ***Olive*** rented a room and established a medical marijuana dispensary named the Vapor Room. (***Olive v. Comm.*** (2012) 139 TC 19) The Vapor Room had a comfortable community center atmosphere that allowed patrons to freely use vaporizers, games, books, and art supplies. Regular activities such as yoga classes, chess and other board games, and movies with complementary popcorn and drink, etc., were also provided. The only thing sold by the Vapor Room was medical marijuana, and its patrons primarily went there to consume marijuana. The sale of medical marijuana was the sole source of the Vapor Room's revenue. Later, the IRS in audit asserted that the taxpayer's costs of goods sold are deductible to the amounts the taxpayer was able to substantiate. Moreover, the taxpayer's business expense deductions were disallowed under IRC §280E.

As for the deductibility of the business expenses, the taxpayer argued that the portion of the Vapor Room's expenses attributable to the caregiving services should be deductible as it was allowed in ***CHAMP***. However, the Tax Court found that the Vapor Room was not in the same operation as the medical marijuana dispensary in ***CHAMP***. The court noted that the taxpayer in ***CHAMP*** had two businesses (caregiving services and medical marijuana), but the Vapor Room was engaged in only a single business (the dispensing of medical marijuana) with caregiving services and social activities as part of that business. As a result, none of the Vapor Room's business expenses were deductible.

Comparing the cases

Although the cost of goods sold in both ***CHAMP*** and ***Olive*** is deductible, the deductibility of business expenses in connection with caregiving services differs in the two cases. This difference is based on whether caregiving services can be considered a trade or business other than the trade or business of dispensing medical marijuana. Treas. Regs. 1.183-1(d)(1) stipulates that all facts and circumstances must be taken into account to ascertain business activities.

At the very least, the following three factors are important in ascertaining business activities:

- The degree of organizational and economic interrelationship;
- The business purpose, and
- The similarity of undertakings.

The Tax Court in ***Tobin*** listed various factors in deciding whether characterizing two or more undertakings as one activity is unreasonable:

- Whether the undertakings share a close organizational and economic relationship;
- Whether the undertakings are conducted at the same place;
- Whether the undertakings are part of a taxpayer's efforts to produce revenues;
- Whether the undertakings are formed as separate businesses;
- Whether one undertaking benefits from the other;
- Whether the taxpayer uses one undertaking to advertise the other;
- Whether the undertakings share management;
- Whether one person oversees the assets of both undertakings;
- Whether the taxpayer uses the same accountant for the undertakings; and
- Whether the undertakings share books and records.
  (***Tobin v. Comm.***, TCM 1999-328)

The Tax Court in ***Olive*** applied these factors to the facts and concluded that the Vapor Room's medical marijuana dispensing and caregiving services share a close and inseparable organizational and economic relationship.

Alternatively, the Tax Court distinguished ***Olive*** from ***CHAMP*** on the basis of different parameters, such as organizational mission, name of the organization, place to consume marijuana, experience of the director, task of the employees, members' qualifications, and membership fees, etc. To be treated as a separate trade or business, the caregiving services should be independent of the medical marijuana dispensing activities and cannot be merely incidental to the medical marijuana dispensing activities.

Comparison of *CHAMP* and *Olive* Cases		
Factor	***CHAMP***	***Olive***
Organizational mission	Charitable, educational	Profit
Name	Stresses the caregiving mission	Stresses sale and consumption of marijuana (Vapor Room)
Place	Consumption of marijuana restricted to designated areas	Consumption of marijuana could take place anywhere on premises
Employees	72% worked exclusively in caregiving services	All worked in caregiving and marijuana dispensing
Leadership	Experience in health services	No experience in health services
Payments	Members pay a single fee for caregiving and medical marijuana	Pay for marijuana; social services and other activities were complimentary for paying customers

ALLOCATING COSTS TO COGS

All is not lost. Even under the strict guidelines of CCA 201504011, COGS includes more than just the direct costs of the product. The CCA states that COGS include items that must be inventoried under the IRC §471 regulations (Treas. Regs. §1.471-3(b) in the case of resellers and Treas. Regs. §§1.471-3(c) and 1.471-11 in the case of producers).

A full discussion of inventory methods is beyond the scope of this course. We will approach inventories from a broad overview.

Resellers

Inventories for resellers (dispensaries in the case of medical marijuana establishments) are controlled under Treas. Regs. §1.471-3(b). That regulation provides that cost includes:

"(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods."

Thus, in the case of a reseller, inventory costs would generally only include the cost of the product plus freight in and any other costs involved in acquiring the product.

IRC §263A

As discussed, above, CCA 201504011, the IRS says that IRC §263A cannot be used for marijuana businesses. Again, however, a CCA is only the IRS's opinion, and a marijuana business may consider using IRC §263A. If using IRC §263A, a reseller is also likely to capitalize purchasing, handling, and storage expenses.

Producers

For producers, the analysis of what goes into COGS is far more extensive and far more costs can be allocated to COGS. Inventories for producers (growers) are controlled under Treas. Regs. §1.471-3(c) and Treas. Regs. §1.471-11.

Treas. Regs. §1.471-3(c) states that, in the case of merchandise produced by the taxpayer, COGS includes:

- The cost of raw materials and supplies entering into or consumed in connection with production;
- Expenditures for direct labor; and
- Indirect production costs incident to and necessary for production including an appropriate portion of management costs.

Treas. Regs. §1.471-3(c) then directs the reader to Treas. Regs. §1.471-11 for more specific rules regarding the treatment of indirect production costs.

Treas. Regs. §1.471-11 begins by stating that the taxpayer must use the full absorption method of inventory costing. (Treas. Regs. §1.471-11(a)) Further, the full absorption method must include both direct and indirect production costs.

Costs are considered to be production costs to the extent that they are "incident to and necessary for production."

Direct production costs

Direct production costs are generally those costs are both incident to and necessary for production and are components of the cost of either direct material or direct labor. (Treas. Regs. §1.471-11(b))

Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are considered in the ordinary course of the product and can be identified with that product.

Direct labor costs include the cost of labor which can be identified or associated with particular products. Direct labor costs include such items as:

- Basic compensation;
- Overtime pay;
- Vacation, holiday, and sick leave pay;
- Payroll taxes and unemployment.

Indirect production costs

Indirect production costs include all costs which are incident to and necessary to production other than direct production costs. Which costs must be indirect costs may or may not depend on how the taxpayer treats such costs on its financial statements. Some costs must be included in inventory regardless of the treatment on the taxpayer's financial statements, some need not be included in inventory even if included in inventory for financial statement purposes, and some must be included or excluded to match what's done on the financial statements. (Treas. Regs. §1.471-11(c))

GAAP

With reference to "financial statements," the regulation specifically mentions generally accepted accounting standards (GAAP). Therefore, to maximize the amount of indirect costs that can be included in COGS, the taxpayer (or tax professional) needs to have a thorough understanding of GAAP inventories in addition to a thorough understanding of tax inventory methods.

The following are indirect production costs that must be included regardless of financial statement treatment:

- Repairs expenses;
- Maintenance;
- Utilities;
- Rent;
- Indirect labor, including supervisory wages;
- Indirect materials and supplies;
- Tools and equipment not capitalized; and
- Quality control and inspection.
  (Treas. Regs. §1.471-11(c)(2)(i))

These costs are included to the extent, and only to the extent, that they are incident to and necessary for production or manufacturing operations or processes.

The following are indirect production costs that must *not* be included regardless of financial statement treatment:

- Marketing;
- Advertising;
- Selling expenses;
- Other distribution expenses;
- Interest;
- Research and product development;
- Losses under IRC §165;
- Percentage depletion in excess of cost depletion;
- Depreciation and amortization reported for federal tax purposes in excess of the amount reported in the financial statements;
- Income taxes attributable to income received on the sale of inventory;
- Pension contributions to the extent they represent past service costs;
- General and administrative expenses to the extent they are expenses incurred for the taxpayer's activities as a whole rather than to production processes; and
- Salaries paid to officers attributable to the performance of services which are incident to business activities as a whole rather than to production processes.
  (Treas. Regs. §1.471-11(c)(2)(ii))

The following are indirect production costs includable depending on the treatment of such costs in the taxpayer's financial statements:

- Taxes otherwise allowable as a deduction other than federal, state, and local taxes, attributable to assets incident to and necessary for production processes. For example, property taxes imposed on the taxpayer's business property or inventory are included in inventory if they are included in inventory for financial statement purposes;
- Depreciation and depletion;
- Employee benefits representing current service costs;
- Costs attributable to strikes, rework labor, scrap, and spoilage;
- Administrative costs of production (not including any cost of selling);
- Officer salaries attributable to production; and
- Insurance costs incident to and necessary for production.
  (Treas. Regs. §1.471-11(c)(2)(iii)

Allocation methods

Indirect production costs required to be included in inventory must be allocated to goods in inventory by the use of an allocation method which fairly apportions such costs among the items produced. (Treas. Regs. §1.471-(d)) Acceptable methods include the manufacturing burden rate method and the standard cost method.

Documentation is king

Whether the taxpayer is a reseller hoping to allocate expenses to separate activities or a producer hoping to allocate as much as possible to COGS, documenting activities is crucial.

This might be especially true with regard to labor. For example, in a retail store, employees might perform duties in both care giving and retail. In a producer's business, a supervisor might perform purely administrative duties and supervise production employees.

In either case, it would be prudent to acquire payroll software that is sophisticated enough to track employee time by job category (and it will take the cooperation of the employees to clock in and out when switching job duties).

FORFEITURES

The Tax Court has ruled that a medical marijuana dispensary whose marijuana was confiscated in a Federal Drug Enforcement Agency raid was not entitled to claim the cost of the confiscated marijuana as a COGS expense nor as an IRC §165 casualty loss. (***Beck v. Comm.***, TCM 2015-149) The business owner was also disallowed other Schedule C expenses.

Facts of the case

Jason Beck operated two medical marijuana dispensaries as a sole proprietorship and conducted the business under the name Alternative Herbal Health Services (AHHS). One of the dispensaries was located on Haight Street in San Francisco (it has since closed), and the other is located in West Hollywood.

The taxpayer claimed a variety of business expenses on his Schedule C in which he classified the operations as a "health care" business.

The dispensaries only sold marijuana, marijuana seeds, and edibles, but did not sell any related products such as pipes, papers, or vaporizers. However, Beck and other employees offered "educational" services, including but not limited to the following:

- Education on the effects of various strains of marijuana on the body;
- Education on the use and benefits of vaporizers;
- Discussions on the various strains of marijuana that were for sale (40 strains in the San Francisco dispensary and 70 strains in the West Hollywood dispensary);
- How to grow marijuana; and
- Counseling as to how to load a bong, pipe, joint, or other smoking device.

Although the dispensaries tracked their inventory and sales using a variety of techniques (e.g., tub sheets that tracked how much marijuana was placed in and removed from each tub, guest checks that described what was purchased and how much was charged, and z-tapes from the cash register), Beck routinely destroyed these records.

In January 2007, the DEA raided the West Hollywood dispensary and confiscated all the marijuana, edibles, and marijuana plants as well as all the cash that was on hand. None of these items were returned.

On his 2007 return, Beck listed the following on his Schedule C:

- $1.7 million in gross receipts;
- $1,429,614 in COGS ($600,000 of which was attributable to the items confiscated by the DEA); and
- $194,094 in expenses, which included lease payments, employee expenses, advertising, etc.

The IRS disallowed the business expenses and the COGS deduction.

Business expenses disallowed

Under IRC §280E, Beck is precluded from claiming any business expense deductions or credits related to trafficking in controlled substances. The evidence indicated that all of AHHS's activities centered around selling and/or dispensing marijuana.

Although the Tax Court has allowed a medical marijuana dispensary to deduct expenses related to a separate and distinct business that provided caregiving services within the dispensary, there was no separate business operated within AHHS's dispensaries. Rather, all of the "educational" services provided related to instructing customers how to use the marijuana that was sold. Furthermore, Beck failed to maintain any records that differentiated between the expenses incurred in selling the marijuana and the "educational" services that were offered.

The court rejected Beck's characterization of the seized marijuana as COGS because the marijuana was confiscated and not sold. Nor could Beck claim an IRC §165(a) loss for the seized marijuana because IRC §280E prohibits taxpayers from claiming any business expenses incurred in connection with the trafficking in a controlled substance.

Treatment consistent with prior rulings

The Controlled Substances Act lists the properties (for example, raw materials, money, vehicles, etc.) that are subject to forfeiture in drug trafficking cases. The forfeiture statute was designed to help fight against illegal drug trafficking. Confiscated marijuana is not cost of goods sold because the marijuana is confiscated instead of sold. (***Holt v. Comm.*** (1977) 69 TC 75)For the same reason, cash seized from marijuana businesses is not treated as part of the cost of goods sold. (***Mack v. Comm.***, TCM 1989-490) Also, permitting forfeited money to be included as a trade or business expense is expressly barred by IRC §§162(f) and 280E. (***Wood v. U.S.*** (1989) U.S. Court of Appeals,

Fifth Circuit, Case No. 88-3088) Moreover, losses incurred incident for forfeitures are not allowed under IRC §165 because the allowance is against public policy. (***Styron v. Comm.***, TCM 1987-25)

IRC §1341 allows a deduction in the current year for an income item that was incorrectly included in gross income in a prior year. The taxpayer in ***Wood*** argued that because the illegal drug income was taxed in a previous year, he should be allowed a deduction under IRC §1341 when the cash from the drug sales was forfeited in the current year. The Fifth Circuit noted that §1341 only applies when the taxpayer is entitled to a deduction under another provision of the Code. As drug trafficking is illegal, no deduction or credit is allowed under IRC §162(f) or IRC §280E . Therefore, because no Code section supported the taxpayer's position, he was not entitled to a deduction under IRC §1341.

MEDICAL EXPENSE DEDUCTION

Taxpayers cannot include in Schedule A medical expense amounts paid for controlled substances (such as marijuana), even if such substances are legalized by state law. (Rev. Rul. 97-9; IRS Publication 502, Medical and Dental Expenses) Such substances are not legal under federal law and therefore cannot be included in medical expenses.

IRC §213(a) allows taxpayers to deduct medical expenses to the extent that the expenses exceed 10% of the taxpayer's adjusted gross income (generally). IRC §219(b) says that deductible medicine or drug expenses will be taken into account only if the payments are for prescribed drugs or insulin. Treas. Regs. 1.213-1(e)(2) provides that "medicine and drugs" includes only items that are "legally procured." Treas. Regs. 1.213-1(e)(1)(ii) explicitly states that amounts expended for illegal operations or treatments are not deductible. Because marijuana is a controlled substance under the Controlled Substances Act, obtaining medical marijuana violates federal law and is not within the meaning of "legally procured." Therefore, payments for medical marijuana are not deductible medical expenses under IRC §213.

California conformity

California generally conforms to IRC §213. (R&TC §17201) Therefore, even though medical marijuana is legal in California, it is not deductible on California returns.

CALIFORNIA INCOME TAXES

Under IRC §280E, marijuana businesses are prohibited from claiming any deductions other than cost of goods sold (COGS). IRC §280E prohibits taxpayers from deducting expenses incurred in trafficking of controlled substances, even where marijuana is sold through a legal marijuana dispensary.

Personal income tax law

California personal income tax law conforms to the IRC §280E prohibition, so individuals, sole proprietors, partnerships, and LLCs taxed as partnerships may only deduct COGS. (R&TC §17201(c))

R&TC §17282 states that no deductions (including deductions for cost of goods sold) shall be allowed to any taxpayer on any of his or her gross income directly derived from illegal activities but only if the taxpayer was determined to be engaged in criminal profiteering, as defined in Penal Code §186.2 or in an act of criminal activity enumerated in R&TC §17282(a). Those activities include drug trafficking. For this limitation to apply, the current law expressly states that a taxpayer must be

found to be engaged in these activities through a final determination in a criminal proceeding, or a proceeding in which the state, county, city, or other political subdivision was a party.

Example of sole proprietor dispensary

Mary Juana operated a medical marijuana dispensary in Marytown. She had gross receipts of $100,000, COGS of $25,000, and business expenses of $70,000.

For federal and California purposes, she must report gross income of $100,000 and a deduction of $25,000 for COGS on her Schedule C. She may not deduct business expenses, so her net income subject to federal and California tax is $75,000.

Assume, however, it is determined that Mary was not selling medical marijuana legally under California law but was using her establishment to sell to individuals without prescriptions. She was convicted in a California state court of drug trafficking.

In this case, she may still deduct the COGS on the federal return, but for California purposes, she is not allowed any deductions for COGS, or other expenses, and the full $100,000 gross sales is subject to California tax.

Corporate income tax law

California's corporation tax law does not conform to IRC §280E. This means that a corporate taxpayer (including an LLC taxed as a corporation) may be allowed full deductions for COGS and business expenses. As with personal income tax law, no deduction is allowed for COGS or business expenses if the taxpayer is determined to be engaged in criminal profiteering, including drug trafficking. (R&TC §24436.1(a))

Example of corporate dispensary

The Joint, Inc. is a licensed medicinal marijuana dispensary. Joint's gross sales are $200,000. Joint's COGS is $75,000, and expenses are $115,000.

For federal purposes, Joint reports $200,000 in sales, COGS of $75,000, and $125,000 of taxable income.

For California purposes, because Joint is a corporation, COGS and all expenses are allowed, and Joint's taxable income is $10,000.

Assume, however, it is determined that Joint was not selling medicinal marijuana legally under California law. Joint was convicted of drug trafficking in a California state court.

In this case, Joint may still deduct the COGS on the federal return, but for California purposes, Joint is not allowed any deductions for COGS or other expenses, and the $200,000 gross sales is subject to California tax.

Incentives

Marijuana businesses may qualify for the New Employment Credit, and cultivators may also qualify for the Research Credit, the manufacturer's partial exemption of sales and use tax, and agricultural exemptions and credits.

OTHER ISSUES

PRACTITIONER CONCERNS

While marijuana is legal to some degree now in more than half the states, it remains illegal at the federal level. Under federal law, any entity that supports illegal activity or knowingly accepts fees derived from illegal sources arguably engages in federal racketeering. This presents an obvious risk for banks, financial institutions, insurance companies, and accounting firms.

Practitioners are also concerned that preparing returns for marijuana growers and retailers could lead to legal trouble and will be considered unethical or in violation of Circular 230. Practitioners are pushing the IRS to issue guidance clarifying that a tax professional will not be considered unethical, targeted for audit, or considered in violation of Circular 230 solely for preparing a return for a legal dispensary.

The 2014 Office of Professional Responsibility Report contains the following Internal Revenue Service Advisory Council (IRSAC) recommendation:

"IRSAC members believe that as a matter of substantive tax law either section 280E or the controlled substance schedules incorporated by reference into section 280E (or both) need clarification in light of these state law developments. Regardless of any such substantive changes, however, tax professionals need reassurance regarding their own roles in giving tax advice to and preparing tax returns for such businesses.

Recommendation from IRSAC

Published guidance should promptly clarify that a tax professional will not be considered unethical, will not be targeted for audit, and will not be in violation of Treasury Circular 230 solely for representing or preparing a return for a business that is illegal under federal law but legal at the state level under state law."

Although it was anticipated that the OPR would have guidance in early 2015, that has not yet happened.

Board of accountancy

Only eight state boards of accountancy have issued official guidance thus far: Arizona, Colorado, Connecticut, Florida, Maryland, Nevada, Oregon and Washington. Each of those state boards has said that providing accounting services to state-legal marijuana businesses is not itself a discreditable act, and those boards will not pursue independent disciplinary action against a licensee for providing such services.

At this time, the California board has no specific position regarding the marijuana industry. According to Arturo Ramudo, CPA, CISA, who presents ethics, regulatory review, and accounting and auditing courses for Spidell, as long as the tax return is prepared accurately, the board generally should not have a problem. Even if a CPA were to prepare a tax return for a drug dealer (illegal trade), the board's only concern would be that the return was prepared accurately based on the information provided or based on the information the CPA should have known (i.e., recognize 100% of the illegal income and none of the nondeductible related expenses).

As far as the American Institute of Certified Public Accountant's (AICPA's) Code of Professional Conduct is concerned, there is no specific standard regarding the marijuana industry. As long as the business is legitimate, the AICPA would not have an ethical problem. If it involves illegal sales, the Code does not prohibit the CPA from preparing the return, but it does require that the CPA consider the moral character of the individual and consider possible disengagement.

AICPA

On July 24, 2015, the AICPA issued "An Issue Brief on State Marijuana Laws and the CPA Profession" (updated January 8, 2016). In it, they advise practitioners to consider the following questions:

- What, if any, is the position of my state board of accountancy on CPAs providing services to marijuana growers/distributors?
- What are the legal risks of providing services to these businesses in my state?
- Is there a risk of prosecution to a CPA firm that provides services to marijuana-related businesses?
- What is the likelihood that the Drug Enforcement Administration (DEA) or the Department of Justice is going to prosecute this marijuana-related business?
- How are other CPAs in my state currently offering services to state-recognized medical marijuana dispensaries?
- How will providing the contemplated services affect my malpractice insurance?
- How will it affect my professional liability insurance?
- What is the likelihood that I may be disciplined, sanctioned, or lose my license by providing services to these businesses?
- What procedures/policies should I consider in order to assess whether the prospective client understands the laws of his or her state concerning marijuana-related businesses and if the client is following those rules?

Providing attest services

Businesses operating in the marijuana industry are seeking both assurance and nonassurance attest services, including audits, reviews, and agreed upon procedures engagements. Marijuana businesses in New Mexico and Minnesota are required to have an audit performed annually, for example. As such, the need for accounting and auditing services in these two states is great.

Practitioners wishing to provide accounting services must first address several issues:

- **Competency:** Does the practitioner have enough knowledge of the industry to plan an engagement properly?
- **Understanding the entity:** Does the practitioner understand the legal and regulatory environment of the industry? This is especially important given that the environment is ever-changing and unclear.
- **Determine the risks of material misstatements:** All businesses have risks, but there are several risks that are unique to the marijuana industry. For example, marijuana businesses often work on a cash-only basis. Cash businesses are more susceptible to theft and fraud.
- **Inventory:** How can the practitioner determine the quality and value of the product being produced?
- **Internal control environment:** IC may be especially difficult to navigate in a cash-only business.
- **Going concern:** The practitioner will need to assess the business's ability to continue operating. This may be especially hard to evaluate given the uncertainty of federal laws, banking issues and financing concerns.

Risk mitigation

The AICPA memo (noted above) reminds the practitioner to always have an engagement letter with the client that explains what services are to be provided, what services will not be provided, and how much those services will cost.

The engagement letter should be signed by all principals in the business and should state that they understand the requirements of state law related to the marijuana business and that they intend to fully comply with those laws.

Practitioners should also consider the potential impact a client in the marijuana business could have on their malpractice insurance. Every professional liability policy has an exclusion for criminal acts. If a practitioner is found to have aided and abetted a client that is charged with illegally producing or selling marijuana, the practitioner's insurance will likely not cover those acts. Practitioners need to know what is specifically included and excluded in their policies.

Other suggestions

Because tax professionals, with the exception of attorneys, do not have privilege, a tax professional should be aware that the attorney–client privilege is not available. In the case of an audit, you should work under an attorney's shield.

Tax professionals should consult with their malpractice carrier for additional guidance.

For a discussion of risk management and suggestions for dealing with clients in the marijuana industry, go to the CAMICO insurance website:

Website
www.camico.com/blog/Marijuana_Business_Clients_Smokin_Hot_Issues_for_CPAs

BANKING

Federal law labels marijuana a controlled substance. For businesses operating in the cannabis industry, this fact is incredibly important, as it means any money earned stemming from the production or sale of marijuana is federally illegal.

Banks open themselves up to government seizure by the Federal Deposit Insurance Corporation (FDIC) if they choose to do business with anyone in the cannabis industry. Under federal law, banks must disclose marijuana-related transactions as suspicious activity. For banks, this could mean bringing unwanted federal attention and regulatory scrutiny if they choose to service the cannabis industry. As a result, large banking institutions are refusing to touch cannabis. JP Morgan Chase & Company and Bank of America have made it company policy to not work with the marijuana industry. Chase says that, "as a federally regulated institution, we don't process payments for businesses participating in federally prohibited activities."

In 2014, FinCEN issued guidelines essentially saying that banks could handle accounts from state-licensed marijuana businesses as long as those banks could ensure the marijuana businesses would comply with certain parameters, such as keeping product off the black market and not selling to youngsters.

But because the 2014 FinCEN memo was a policy change, not a change in law, most banks remain too scared to accept the business of state-licensed marijuana companies.

Senators write plea to FinCEN

A group of 10 U.S. senators is urging the Treasury Department to take steps to prevent the shutdown of plant-touching and ancillary businesses bank accounts.

The senators — seven Democrats, one Republican and two independents —placed special emphasis on ancillary businesses that have lost bank accounts because they worked with marijuana businesses. The senators cited lawyers, chemists, and security personnel as examples.

Senators' letter to FinCEN

December 14, 2016

Jamal El-Hindi
Acting Director
Financial Crimes Enforcement Network
P.O. Box 39
Vienna, Virginia 22183

Dear Acting Director El-Hindi,

As you know, this past election saw eight states vote to allow or expand some form of legal marijuana use, bringing the grand total to 29 states and jurisdictions in the United States. Yet, in these states, the majority of legal marijuana businesses, and businesses that provide services to them, are all but barred from participating in the financial system. As a result, many legal businesses are forced to operate in cash, which jeopardizes community safety, limits economic growth, and greatly expands the opportunity for tax fraud. We urge you to issue further guidance to financial institutions on their ability to provide services, specifically to indirect businesses that do nothing more than provide services to the state-sanctioned marijuana industry.

We want to thank FinCEN and the Department of Justice for issuing guidance clarifying reporting requirements, enforcement priorities and providing clarity to state-legalized marijuana businesses and the financial services industry. However, the 2014 FinCEN guidance did not distinguish between state-sanctioned marijuana businesses and the indirect businesses that service the marijuana industry, leaving it up to individual financial institutions to determine how to classify and treat indirect businesses. Limitations on access to financial services have become increasingly problematic for legal businesses and will only present a larger problem as more states legalize marijuana, either for recreational or medical uses. Indeed, since FinCEN's 2014 guidance was released, less than 3% of the nation's 11,954 federally regulated banks and credit unions have chosen to serve the cannabis industry.

Most banks and credit unions have either closed accounts or simply refused to offer services to indirect and ancillary businesses that service the marijuana industry. A large number of professionals have been unable to access the financial system because they are doing business with marijuana growers and dispensaries. This long list of professionals includes chemists who have had their checking accounts closed due to their role in testing marijuana for the presence of harmful materials like arsenic; the security industry, which marijuana businesses heavily rely on due to the massive amounts of cash they handle; and lawyers offering legal services to marijuana businesses, who have reported banks denying applications for bank accounts and credit cards.

To be clear, these legitimate, indirect businesses have been unable to open checking accounts and accept credit cards or checks. In some cases they have also lost access to existing accounts, such as retirement accounts, and have been forced to pay their employees, taxes, and bills in cash. Locking lawyers, landlords, plumbers, electricians, security companies, and the like out of the nation's banking and finance systems serves no one's interest.

Forcing all these direct and indirect businesses to operate in cash not only creates a huge target for criminals, but also complicates the collection of state and federal taxes. The fledgling legal market for marijuana is around $7 billion, a figure that's dwarfed by the overall $50 billion US market, most of which remains illegal. This business environment is an invitation to tax fraud, robberies, money laundering, and organized crime.

With tens of millions of Americans soon gaining legal access to marijuana under state laws, new guidance is necessary in order to allow banks to enhance the availability of financial services for indirect businesses that service the marijuana industry. This will not only bolster the safety of our communities, but it will also help to spur economic growth across the country. We urge FinCEN to issue such guidance without delay.

Marijuana businesses finding banking

Even though, according to the Senators' letter, above, only 3% of America's banks will service the cannabis industry, that means there are 266 banks in the U.S. that will, according to an FinCen report. According to a survey by the Marijuana Business Daily, approximately 40% of companies operating in the cannabis industry have bank accounts. (http://mjbizdaily.com/chart-week-60-cannabis-companies-dont-bank-accounts)

According to an article in Leafly, marijuana businesses are finding cooperative banks, generally smaller banks or credit unions. (www.leafly.com/news/politics/legalization-roundup-12-27-2015) According to Leafly:

"Credit unions like Salal must file quarterly Suspicious Activity Reports (SARs) on their cannabis clients with FinCEN. That sounds bad, but it's actually good. An SAR filed under the category "marijuana limited" means the client is operating a cannabis-related business that adheres to federal enforcement priorities as outlined in the Justice Department's 2013 Cole memo. If the credit union discovers activity that may violate those priorities, it's reported as a "marijuana priority" case. If the credit union closes out an account, it's reported as a "marijuana termination."

In a way, the FinCEN guidance turns banks into another set of eyes watching to make sure cannabis businesses follow the Cole memo priorities."

Paying taxes

In November of 2014, we reported that marijuana dispensaries are being dinged with a 10% penalty for paying federal payroll tax deposits in cash because, due to the nature of their business, most dispensaries are unable to get bank accounts. Allgreens, LLC, a dispensary in Denver, filed a petition in Tax Court against the IRS after being assessed the 10% penalty each quarter for timely paying their tax in cash.

As a result of the petition, the IRS has backed off of this particular dispensary, and negotiated a settlement in which the IRS will refund $25,000 in penalties and will abate future penalties. (Miyoga, D. "IRS deal will refund fines to Denver pot shop that pays taxes in cash" The Denver Post. Available at: www.denverpost.com/business/ci_27746718/irs-deal-will-refund-fines-denver-pot-shop) It is unclear whether this concession will be applied industry-wide.

Before conceding, the IRS had initially recommended that Allgreens funnel cash through a third-party, who would make the tax payments on their behalf. According to Allgreens' attorney, this is "the very definition of money laundering."

Board of Equalization

As noted above, the BOE will accept cash payments at their offices.

POLITICS

Marijuana remains illegal for federal purposes. The Obama administration officially adopted a policy of noninterference with state marijuana laws, as outlined in a 2013 memo by then-Deputy Attorney General James Cole.

In the Cole memo, the Justice Department acknowledged the reality that most drug enforcement is carried out by state and local — not federal — authorities. The department's position has been that as long as state legalization efforts didn't threaten certain federal priorities — like keeping marijuana out of the hands of minors, preventing driving while under the influence of drugs, and keeping marijuana

grow operations out of federal lands — it would exercise "prosecutorial discretion" and direct its limited law enforcement resources to other drug priorities, such as dealing with the opiate epidemic.

This wasn't always the case under previous administrations. Under the George W. Bush administration, the federal government conducted frequent raids arresting over 700,000 people.

Trump administration

According to a poll by the Marijuana Business Daily, over half of executives in the cannabis industry are worried about their business prospects under a Trump administration, with 30% saying they are "very concerned." Nineteen percent of those surveyed said they might curb their growth plans because of worries over how Trump will treat the marijuana industry, and another 34% are holding off on major decisions until they know the new administration's policies.

Trump's selection of several anti-marijuana politicians to his cabinet has created uncertainty in the industry. However, the President-elect has not issued an official policy on marijuana.

He said, during his campaign, that he is "100% in favor of" medical marijuana, but he has said on several occasions that marijuana "is bad" and is "causing a lot of problems in Colorado."

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

5. What is true of IRC §280E, and how does it currently apply to marijuana businesses?

    a) IRC §280E upheld the decision in ***Edmondson v. Comm.***, which allowed an illegal business dealing with controlled substances to claim specific business deductions
    b) Marijuana businesses are subject to IRC §280E and may not deduct cost of goods sold or business expenses
    c) IRC §280E specifically deals with illegal businesses, so in states where medicinal and/or recreational marijuana has been legalized, cannabis businesses are exempt from its provisions
    d) For marijuana businesses, if a cost is not included in COGS, it is subject to IRC §280E and cannot be deducted

6. The IRS has issued CCA 201504011 to address how legalized cannabis businesses in different states should compute their federal income taxes. Which choice below is true as it pertains to this advice?

    a) The CCA states that marijuana businesses must use IRC §471 regulations before the enactment of IRC §280E
    b) IRC §263A applies to marijuana business and works in a dispensary's favor because the character of expenses may change from nondeductible to deductible
    c) IRC §280E prohibits adjustments for COGS
    d) The CCA has precedential value and is not likely to be challenged

7. What are the significant details of two recent Tax Court cases, ***Californians Helping to Alleviate Medical Problems* (*CHAMP*)** and ***Olive***, both of which dealt with medical marijuana dispensaries?

    a) In ***CHAMP***, the court denied the business expense deduction because the organization was trafficking in controlled substances
    b) *CHAMP* dealt in two different business, one in caregiving, for which the court allowed business expense deductions, and one in dispensing medical marijuana, for which the expenses were disallowed
    c) In ***Olive***, the taxpayer's caregiving services bore no relation to their marijuana dispensary, so their business expenses were deductible
    d) The Tax Court ruled in both cases that no business expense deductions were allowed because their basic business was to dispense marijuana

8. For marijuana producers who must determine what goes into COGS, which of the following is true?

    a) Treas. Regs. §1.471-3(c) states that management costs cannot be included in COGS
    b) Treas. Regs. §1.471-11(a) directs taxpayers to use the full absorption method for direct production costs only
    c) COGS includes raw materials, supplies, and direct labor expenses
    d) Direct labor costs do not include vacation and holiday pay

9. Which statement below best reflects the issues and/or potential consequences for tax practitioners who make the decision to represent marijuana businesses?

    a) The IRS has issued guidance for tax professionals, stating that they will not be targeted for audits or be considered unethical or in violation of Circular 230 for working with legal marijuana dispensaries
    b) There are eight state boards of accountancy that have put forth guidance for tax professionals representing marijuana growers and/or retailers, including California
    c) Certain states require that marijuana businesses be audited annually, which means that there are increased opportunities for accounting services
    d) At this time, taking on marijuana clients is not recommended by the American Institute of Certified Public Accountants

10. Which choice is true regarding marijuana businesses and the banking industry?

    a) Most established large banks will work with marijuana businesses
    b) Banks are required to disclose transactions pertaining to marijuana as "suspicious activity"
    c) In states where marijuana has been legalized, it is no longer labeled as a federally controlled substance, so more and more banks are willing to associate with marijuana businesses
    d) A 2014 FinCEN memo reported on the legal changes of how the enforcement network would allow financial institutions to work with marijuana businesses as long as those businesses observed certain rules such as keeping marijuana off the black market and not selling to children

SOLUTIONS TO REVIEW QUESTIONS

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To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

5. What is true of IRC §280E, and how does it currently apply to marijuana businesses? (Page 18)

    a) Incorrect – IRC §280E reversed the decision in ***Edmondson*** by disallowing all business deductions for trafficking in a controlled substance.
    b) Incorrect – COGS is allowed because it is considered a return of capital, and the Supreme Court prevents its taxation.
    c) Incorrect – IRC §280E applies to all marijuana businesses irrespective of whether or not marijuana has been legalized in their respective states; business deductions are still disallowed.
    d) Correct – IRC §280 precludes the deduction of expenses for the illegal trafficking in drugs, which means that taxpayers with marijuana businesses essentially pay tax on gross income.

6. The IRS has issued CCA 201504011 to address how legalized cannabis businesses in different states should compute their federal income taxes. Which choice below is true as it pertains to this advice? (Pages 20-21)

    a) Correct – The regulations under IRC §471 were enacted prior to IRC §280E, and the CCA takes the position that taxpayers trafficking in controlled substances must apply those regulations.
    b) Incorrect – IRC §263A cannot change items that are nondeductible into deductible; marijuana dispensaries must apply the rules under IRC §471.
    c) Incorrect – IRC §280E, in fact, mandates such adjustments.
    d) Incorrect – It is only guidance based on the IRS's interpretation of the law, which leaves it open to taxpayer challenge.

7. What are the significant details of two recent Tax Court cases, ***Californians Helping to Alleviate Medical Problems* (*CHAMP*)** and ***Olive***, both of which dealt with medical marijuana dispensaries? (Pages 22-23)

    a) Incorrect – The Tax Court allowed for business expense deductions related to the organization's significant caregiving services, which could be separated from their dispensing of marijuana. In general, no deduction is allowed under IRC §280E for the dispensing of marijuana because drug trafficking is illegal.
    b) Correct – The court viewed the organization's caregiving services as separate from their marijuana dispensary, so they allowed CHAMP to deduct expenses related to caregiving.
    c) Incorrect – In ***Olive***, the court found that the multiple aspects of their business were inseparable, and their only revenue was from marijuana sales, which resulted in a ruling that none of the taxpayer's business expenses were deductible.
    d) Incorrect – In ***CHAMP***, the taxpayers were allowed business deductions for their caregiving services only. In **Olive**, on the other hand, any caregiving services were incidental to the sale of marijuana.

8. For marijuana producers who must determine what goes into COGS, which of the following is true? (Page 25)

    a) Incorrect – The regulations specifically state that an appropriate part of management costs may be included in COGS.
    b) Incorrect – The full absorption method must be applied for both direct and indirect production costs.
    c) Correct – Also included are indirect production costs that are necessary to the production of the merchandise, as well as an applicable share of management costs.
    d) Direct labor costs do not include vacation and holiday pay (Incorrect – Direct labor costs are those associated with the production of a specific product and include basic compensation, overtime, vacation and sick pay, and payroll taxes.

9. Which statement below best reflects the issues and/or potential consequences for tax practitioners who make the decision to represent marijuana businesses? (Page 32)

    a) Incorrect – The IRS has not provided any guidance at this time.
    b) Incorrect – California is not included among those state that have provided guidance: Arizona, Colorado, Connecticut, Florida, Maryland, Nevada, Oregon, and Washington.
    c) Correct – These states are currently New Mexico and Minnesota. As more states legalize marijuana use, the need for accounting services will increase so practitioners must understand the industry, understand the legalities, and determine the risks.
    d) Incorrect – The AICPA has made a list of questions that practitioners should consider when working with the cannabis industry, but the organization has not put forth any standards, and the Code of Professional Conduct does not prohibit professionals from preparing returns for marijuana businesses.

10. Which choice is true regarding marijuana businesses and the banking industry? (Page 33)

    a) Incorrect – Large banks such as Bank of America and Chase currently do not work with marijuana businesses because those businesses are engaged in what is still considered a federal crime.
    b) Correct – This is true under federal law. The FDIC may seize funds from financial institutions that do business with the marijuana industry.
    c) Incorrect – Marijuana remains a federally controlled substance, and as a consequence, money earned from marijuana-related businesses is still considered illegal.
    d) Incorrect – The memo represented a policy change, not a legal change, so most banks still won't work with marijuana businesses, even if those businesses hold a state license.

GLOSSARY

Absorption costing: also called full costing or full absorption method, where all costs pertaining to the production process are accumulated and apportioned to individual products. This creates an inventory valuation required for external financial reporting. The costs are not recognized as expenses in the month that they are paid for but remain as inventory assets until sold, at which time that are charged to COGS

Adult Use of Marijuana Act (AUMA): also known as Proposition 64, which was approved by voters in November 2016 and legalized recreational marijuana for use by adults age 21 or older. Nonmedical retail sales of marijuana will also be allowed, and there will be new taxes imposed on its sale as of January 1, 2018

Attest services: an independent review of data or an assertion about subject matter for which another party is responsible. These services may encompass audits, reviews, compilations, agreed upon procedural engagements, etc.

Buds: marijuana flowers, which contain the most potent part of the plant

Circular 230: contains rules governing the recognition of attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, registered tax return preparers, and other individuals who represent taxpayers before the IRS. The rules apply to federal tax practice standards overseen by the Office of Professional Responsibility

Controlled Substances Act: a 1970 federal statute that puts forth U.S. policy as it pertains to the manufacture, importation, possession, use, and distribution of drugs. All substances are put into one of five schedules based on their medical use, potential for abuse, and safety

Cost of goods sold (COGS): direct costs that can be attributed to the production of goods, including materials and labor. Indirect costs such as distribution and sales force expenses are not included

Direct cost: expense that can easily be connected to a particular "cost object," whether a product, department, or project and that are components of the costs of either direct material or direct labor

Excise tax: a tax paid when a purchase is made on a specific product or service. The tax may be hidden in the price of the goods or activities sold

FinCEN: a bureau of the Department of Treasury – Financial Crimes Enforcement Network – whose mission it is to safeguard the U.S. financial system from "illicit use" and to promote national security through the collection and analysis of financial intelligence

Indirect cost: a cost other than a direct production cost and that pertains to running an entire company rather than just a "cost object." These costs include advertising, depreciation, supplies, administration, personnel, etc., and can be referred to as overhead

Leaves: all parts of the marijuana plant other than the flowers

Medical Cannabis Regulation and Safety Act (MCRSA): signed by the governor in October 2015 to create a comprehensive state licensing system for the commercial cultivation, manufacture, retail sale, transport, distribution, delivery, and testing of medical cannabis

Medical Marijuana Identification Card (MMIC): issued by the California Department of Public Health with a nine-digit ID number and expiration date that allows for the qualified exemption from sales and use tax

Microbusiness: as pertains to marijuana, a small operator with cultivation space not exceeding 10,000 square feet. A microbusiness license would allow the holder to cultivate marijuana and act as a licensed distributor, level 1 manufacturer, and retailer all under one license

Office of Professional Responsibility (OPR): impartially interprets and applies the standards of practice for tax professionals. Their objective is to support tax administration by ensuring all tax practitioners, preparers, and other third parties abide by professional standards and follow the law

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TAXATION OF MARIJUANA AFTER PROPOSITION 64

Course description and study guide

Course objectives: With the passage of Proposition 64 in California and the legalization of the use of both medicinal and recreational marijuana in more and more states, tax practitioners must learn to navigate the legal and ethical implications of working with the cannabis industry. This course will provide an analysis and review of the issues confronting tax pros and will address the following topics: Adult Use of Marijuana Act (AUMA), Medical Cannabis Regulation and Safety Act (MCRSA), IRC §§280E and 471, CCA201504011, sales and use taxes, excise taxes, deductibility, forfeitures, COGS, Circular 230, the banking industry, payment methods, and much more.

Completion deadline and exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Category: Taxes

Recommended CPE Hours: CPAs — 2 Tax
EAs – 1 Federal Tax
CRTPs — 1 Federal Tax and 1 CA Tax

Level: Basic

Prerequisite: None

Advanced Preparation: No advanced preparation is required.

Course qualification: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement

CPE sponsor information: Spidell Publishing, Inc. (Registry ID: 104931)

Expiration Date: January 2018*

*Exam must be completed within one year of the date of purchase

Learning assignment and objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

Assignment:

At the start of the materials, participants should identify the following topics for study:

- Proposition 64
- California sales and excise taxes related to medical and recreational marijuana
- Federal income taxes
- California income taxes

Learning Objectives:

This course will enable you to:

- Recall restrictions on the various types of licenses that businesses may hold
- Identify which cannabis products are subject to sales and use tax
- Recall how IRC §280E affects marijuana businesses and the deduction of expenses
- Determine how the regulations under IRC §§471 and 263A must be applied to a cannabis dispensary
- Identify how losses incurred in marijuana trafficking are treated
- Determine which costs may be included in COGS for marijuana producers

After studying the materials, please answer exam questions 1-10.

Course Evaluation for Spidell Publishing, Inc.

Program title: **Taxation of Marijuana after Proposition 64**

If applicable, program instructor: _____

Program date: _____ Participant name (optional): _____

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest rating.

1. Were the stated learning objectives met? _____
2. If applicable, were prerequisite requirements appropriate and sufficient? _____
3. Were the program materials accurate? _____
4. Were program materials relevant, and did they contribute to the achievement of the learning objectives? _____
5. Was the time allotted to the learning activity appropriate? _____
6. If applicable, were the individual instructors knowledgeable and effective? _____
7. Were the facilities and/or technological equipment appropriate? _____
8. Were the handout and/or advanced preparation materials satisfactory? _____
9. Were the audio and visual materials effective? _____

IRS Course Number (if applicable): CRA7E-T-00259-16-S

TTP (CTEC) Course Number (if applicable): 1019-CE-0715

Date course completed: _____

Number of hours it took to complete the course: _____

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Examination for Spidell's Taxation of Marijuana after Proposition 64

PLEASE: Place the correct response for each question on the attached answer sheet and retain this examination for your records. If you purchased the online version, or would like to complete your exam online, please log-in to your SpidellCPE online account to submit your answers to the exam. 70% or more (7 of 10) correct responses are necessary to receive credit for this course. This course must be completed within one year of the date of purchase.

Final Exam Questions

1. Which California act created a broad state licensing system for the manufacture, sale, and testing of medical cannabis?
   - **a)** Medical Marijuana Program Act
   - **b)** Medical Cannabis Regulation and Safety Act
   - **c)** Compassionate Use Act
   - **d)** Substance Abuse and Crime Prevention Act
2. Which statement correctly describes details that are outlined in the Adult Use of Marijuana Act (AUMA)?
   - **a)** A microbusiness, which is a license classification under AUMA, is a small operator with less than 5,000 square feet of cultivation space
   - **b)** Local governments can ban nonmedical marijuana businesses
   - **c)** Businesses that sell alcohol and/or tobacco may sell nonmedical marijuana
   - **d)** No licensee is allowed to be located within a 1000-foot radius of any K-12 school, day care center, or youth center
3. Which of the following retail sales of marijuana products would be subject to sales and use tax?
   - **a)** Edible medical cannabis
   - **b)** Topical medical cannabis
   - **c)** Recreational cannabis lotion
   - **d)** All of the above are subject to sales and use tax
4. What is true of excise taxes on marijuana under Proposition 64?
   - **a)** There is a cultivation tax on flowers for nonmedical use only
   - **b)** There is a cultivation tax on flowers and leaves of $9.25 per ounce of product
   - **c)** Retail excise taxes do not apply to medical marijuana
   - **d)** There is a retail excise tax on both medical and nonmedical marijuana of 15% of gross receipts
5. Which statement is correct as it applies to the federal taxation of income from a medical marijuana business?
   - **a)** IRC §61(a), which defines "gross income," does not pertain to income from the production or resale of controlled substances
   - **b)** Marijuana is a Schedule I controlled substance that is illegal to manufacture or sell, although it is still subject to federal income tax
   - **c)** IRC §61(a) distinguishes between income that has been derived legally from that derived illegally
   - **d)** COGS does not apply to income derived from trafficking in controlled substances

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6. The Tax Court's rulings in ***CHAMP*** and ***Olive*** were based on each organization's mission, facility, experience, employee tasks, etc. When comparing the two cases, which of the following is true?

   a) Marijuana was the sole source of revenue in both cases
   b) Neither organization required a doctor's recommendation for marijuana use
   c) Olive's mission was both charitable and educational
   d) With CHAMP, members didn't pay for marijuana separately but paid a single fee for both marijuana and caregiving services

7. For marijuana businesses, in order to maximize the amount of indirect costs to include in COGS, a tax professional must understand tax inventory methods and GAAP inventories. Indirect production costs that are required to be included in inventory irrespective of their treatment on a financial statement include all but which of the following?

   a) Maintenance
   b) Utilities
   c) Product development
   d) Quality control

8. Under the Internal Revenue Code, how are forfeitures handled?

   a) Losses incurred in marijuana trafficking are not allowed under IRC §165
   b) Confiscated marijuana may be included in COGS
   c) Seized cash from marijuana sales is deductible as COGS
   d) Forfeited money and/or confiscation of marijuana income may result in an allowable deductible expense under IRC §1341 for an income item that was not correctly included in gross income in a previous year

9. In the following scenario, what is Ringo's net income subject to federal tax? *Ringo operates a medical marijuana dispensary in Cooltown. His annual gross receipts amounted to $120,000, COGS of $35,000, and business expenses of $75,000.*

   a) $120,000
   b) $85,000
   c) $10,000
   d) $45,000

10. Inhale, Inc. is a licensed medical marijuana dispensary in San Francisco. Its gross sales are $250,000, with COGS of $85,000 and expenses of $105,000. For California, what is Inhale's taxable income?

    a) $250,000
    b) $165,000
    c) $145,000
    d) $60,000