**Tax Savings Strategies for the Marijuana Industry**

**I. Introduction**

Currently, the legality of the marijuana industry is confusing at best; marijuana is illegal federally, but simultaneously 33 states, including Oklahoma and Arkansas, and the District of Columbia, have passed statutes permitting the medical use of marijuana,and 10 states, including Colorado and the District of Columbia now permit, in regulated settings, the sale of marijuana for recreational use. However, the cultivation and sale of marijuana remains illegal under the federal Controlled Substances Act (“CSA”).State statutes that have legalized one or more aspects of marijuana-related activities remove the threat of state-level prosecution. However, federal laws criminalizing these activities remain.  Federal civil and criminal punishments can be assessed against anyone who grows, sells, imports, or holds controlled substances. Schedule I of the CSACSA lists drugs, including marijuana, that the federal government has determined to have (1) a high potential for abuse; (2) no currently accepted medical use in the United States; and (3) lack of safety for use even under medical supervision.

To date, federal policies and statutes regarding legalized use in states allowing medical or recreational consumption of marijuana have not been updated, and enforcement policies from the 1980s are still in effect. Thus, while marijuana distributors and growers may not face state sanctions, they do face federal sanctions and often find it quite difficult to do business. Some of the biggest limitations hindering the growth of a marijuana business are an inability to write checks, access a bank account, and obtain credit. For example, many federally insured banks are hesitant to open accounts or loan funds to marijuana-related businesses. Drug trafficking laws are designed to ensure that banks do not provide accounts or capital to any drug-related enterprise and make no distinction between state-level legal businesses (marijuana dispensaries) trafficking in Schedule I drugs and typical illegal drug trafficking. Even though the federal government has somewhat relaxed restrictions on banks serving state-sanctioned dispensaries, the regulations still require banks to heavily police these accounts. Due to the added costs and oversight required, many banks are simply unwilling to do business with dispensaries.

Another big hurdle for a marijuana business is the current tax framework, which treats marijuana businesses more adversely than both legal and illegal businesses alike. Under Internal Revenue Code ("IRC") Section 61, unless specifically excluded, all sources of income are taxable, regardless of their origin. Under the recovery of capital doctrine, taxpayers are allowed to recover their cost of goods sold. In addition, IRC Section 162 provides a current deduction for all ordinary and necessary business expenses. Generally, these rules apply regardless of a business’ legal status; thus, expenses such as rent, utilities, and advertising are generally allowable as deductions.

There are notable limitations to the deductions specified under IRC Section 162. For example, deductions for transactions that violate public policy (e.g., bribes, kickbacks and fines, or penalties paid to the government for violations of law) are disallowed. Therefore, expenses such as speeding tickets, parking fines, and illegal bribes are specifically denied as deductions for all taxpayers.

There is, however, an additional limitation for taxpayers engaged in the trafficking of controlled substances. IRC Section 280E denies all ordinary and necessary business expenses paid or incurred in connection with the sale or trafficking of controlled substances listed on Schedule I or II of the CSA. Currently, 21 USC 812(c)(10) lists marijuana as a Schedule I drug. Furthermore, federal courts have held that the sale of marijuana constitutes trafficking, regardless of legality at the state level. Thus, the ordinary and necessary deductions available to most businesses (both legal and illegal) are denied to the marijuana industry.

Section 280E currently states: “No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of Schedule I and II of the CSA) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.” The application of Section 280E rests of the presence of three key elements: 1) trade or business; 2) trafficking; and 3) a controlled substance.

Section 280E was enacted by Congress in 1982 to overturn the result in the Tax Court case *Jeffrey Edmondson v. Commissioner*, that held the taxpayer, who was engaged in an illegal drug dealing business selling marijuana, amphetamines and cocaine, was entitled to deductions for “telephone, auto, and rental expenses” that he incurred in his business. The Tax Court allowed these deductions, holding they were ordinary and necessary in his business, despite the criminality of the business.

Section 280E denies all deductions to illegal drug dealing businesses. However, for Constitutional reasons, Congress did not attempt to prevent taxpayers from using cost of goods sold ("COGS") to compute gross income. Thus, IRC Section 280E denies all deductions from gross income in computing taxable income, but illegal drug dealing businesses are permitted to take COGS into account in computing gross income.

IRC Section 471, gives broad authority to the IRS to force taxpayers to account for inventory in a way that most clearly reflects income. This regulation provides that a producer of property generally is required to treat indirect costs as COGS if they are “incident to and necessary for production” or manufacturing operations. A Taxpayer trafficking in a Schedule I or Schedule II controlled substance determines COGS using the applicable inventory-costing regulations under Section 471 as they existed when Section 280E was enacted. Specifically, resellers were subject to Section 1.471-3(b), and producers were subject to Sections 1.471-3(c) and 1.471-11 ("full-absorption regulations").

**II. Cases on strategies to minimize impact of IRC Section 280E**

To minimize the impact of Section 280E, taxpayers have tried various strategies. One such strategy is to separate their trade or business activities into two sets of businesses: businesses that consist of "drug trafficking" and businesses that do not.

A. The first strategy came about in a 2007 case, *Californians Helping to Alleviate Medical Problems* *v. Commissioner of Internal Revenue*, 128 T.C. 173 (2007) ("CHAMP"). The Tax Court allowed business deductions for the "patient care" portion of a medical marijuana dispensary in addition to the firm's costs of goods sold. CHAMP was a not-for-profit entity under California law with a mission to provide caregiving services to members of the community with debilitating diseases. The organization charged a fee to its members for caregiving services that included providing limited amounts of medical marijuana. The caregiving services also included support groups, lunches for low-income members, hygiene supplies, counseling, massages, social events, field trips, and online computer access. The Tax Court agreed with the taxpayer's assertion that its primary business was the provision of caregiving services. As such, business deductions under Section 162(a) for the caregiving portion of the business were permitted, and Section 280E would not prohibit these deductions, "simply because the taxpayer was also involved in trafficking in a controlled substance."

The Tax Court further stated that the IRS regularly permits a taxpayer to engage in more than one business unless the separate characterization is artificial or unreasonable.The court relied on the 1943 Supreme Court case, *Commissioner of Internal Revenue v.* *Heininger*, 320 U.S. 467, 474 (1943)quoting the following language: "It has never been thought . . . that the mere fact that an expenditure bears a remote relation to an illegal act makes it non-deductible." Because of the taxpayer's ability to substantiate the business expenses, despite the fact that they were not specifically allocated to one aspect of the business or the other, the court took it upon itself to apportion the expenses, allowing those pertaining to legal activities and disallowing those for illegal activities.

The *CHAMP* case is precedent for marijuana businesses to argue that, by engaging in one line of legal business that does not involve the sale of marijuana, the taxpayer may deduct business expenses that are properly allocable to the legal business. However, the taxpayer must still adequately substantiate the expenses, which would normally not be that difficult. Unfortunately, many marijuana businesses are being operated on a cash basis because many banks will not do business with them.  This makes substantiating expenses much more challenging.

However, the courts have not been kind to taxpayers who attempt to avail themselves of the CHAMPS "second line of business argument."

B. In *Olive v. Commissioner*, 139 T.C. 2, (2012), Olive ("Taxpayer"), was a California dispensary, called the Vapor Room Herbal Center, whose sole source of revenue was its sale of medical marijuana. Taxpayer deducted expenses related to this business on its return under the CHAMP "second line of business argument," which the IRS disallowed under Section 280E. Olive claimed patrons went to the Vapor Room in equal parts to relax and smoke marijuana. To encourage relaxation the Vapor Room was set up like a lounge; with couches, chairs, and tables located throughout. In addition, games, books and art supplies were available for use, along with tea, water, and snacks - all of which was provided free of charge*.* Olive argued his business was similar to the business in CHAMP, equal parts the sale of goods and relaxation services. The Tax Court disagreed, stating:

Petitioner asserts that the Vapor Room’s overwhelming purpose was to provide caregiving services, that the Vapor Room’s expenses are almost entirely related to the caregiving business and that the Vapor Room would continue to operate even if petitioner did not sell medical marijuana. We disagree. We find instead that petitioner had a single business, the dispensing of medical marijuana, and that he provided all of the Vapor Room’s services and activities as part of that business. The record establishes that the Vapor Room is not the same type of operation as the medical marijuana dispensary in CHAMP that we found to have two businesses.

In reaching this decision the Court in *Olive* applied the nine factors from *Rupp v. Commissioner*, 103 T.C.M. (CCH 1594, 1598, 2012 TCM (RIA) 2012-108), to determine if there in fact two businesses operating. These nine factors are:

1. Whether the undertakings are conducted at the same place.
2. Whether the undertakings were part of a taxpayer’s efforts to find sources of revenue from his or her land.
3. Whether the undertakings were formed as separate activities.
4. Whether one undertaking benefited from the other.
5. Whether the taxpayer used one undertaking to advertise the other.
6. The degree to which the undertakings shared management.
7. The degree to which one caretaker oversaw the assets of both undertakings.
8. Whether the taxpayers used the same accountant for the undertakings.
9. The degree to which the undertakings shared books and records.

In reaching its decision, the Tax Court established a precedent that it will hold a medicinal marijuana facility to a strict standard in establishing that it offers multiple lines of business. Olive argues the Court in CHAMP held a medical marijuana dispensary that allows its customers to consume medical marijuana on its premises with similarly situated individuals is a caregiver if the dispensary also provides the customers with incidental activities, consultation or advice. The Court ruled such a reading is wrong. Olive also did not establish the Vapor Room’s activities or services independent of the dispensing of medical marijuana involved caregiving or were extensive. The Court perceived Olive's claim that the Vapor Room actually consisted of two businesses as simply an after-the-fact attempt to artificially equate the Vapor Room with the medical marijuana dispensary in CHAMP so as to avoid the disallowance of all of the Vapor Room’s expenses under Section 280E. The Court did not buy it and held Section 280E applies and precludes Olive from deducting any of the Vapor Room’s claimed business expenses.

As you can see, if a facility is to have any hope of wielding the CHAMPS argument, it must be prepared to:

1. Show that the alternate business line is extensive enough to "stand on its own;" in other words, it would be a viable business for the taxpayer even in the absence of the sale of marijuana, and
2. If the taxpayer asserts it has a second line of business, it should treat itlike a second line of business, accounting separately for its income and expenses so that if the IRS or courts are kind enough to agree with the taxpayer, the amount of deductible expenses are readily available.

C. Chief Counsel Advice 201504011

As a result of the CHAMPS case, the IRS determined that marijuana businesses could reduce their taxable income to allocate indirect costs to inventory and, upon sale, to deductible costs of sales. On January 23, 2015, the IRS Office of Chief Counsel issued Chief Counsel Advice ("CCA") 201504011 to clarify marijuana businesses are allowed a cost-of-sales deduction for indirect production-related business expenses, including: production-related wages, rents, and repair expenses that are allocated to cost of sales. However, other expenses are still nondeductible.

The CCA clarifies Section 280E was enacted in 1982, and therefore taxpayers should apply the inventory accounting methods that applied at that time under Section 1.471. The 1982 version of Section 1.471-11(c)(2)(i) lists the following "indirect production costs which must enter into the computation of the amount of inventoriable costs" (emphasis added):

(a) Repair expenses;

(b) Maintenance;

(c) Utilities, such as heat, power and light;

(d) Rent;

(e) Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan;

(f) Indirect materials and supplies;

(g) Tools and equipment not capitalized; and

(h) Costs of quality control and inspection,

to the extent, and only to the extent, such costs are incident to and necessary for production or manufacturing operations or processes.

Further, if a marijuana-production business produces financial statements in accordance with generally accepted accounting principles (“GAAP”), under the 1982 version of Section 1.471-11(c)(2)(iii), inventory can also include the following costs to the extent that they are properly allocated to inventory for GAAP purposes:

1. Taxes deductible under Section 164, other than state, local, and foreign income taxes;
2. Depreciation and depletion;
3. Deductible employee benefits, including pension and certain profit sharing contributions, workers' compensation expenses, stock bonus plans, premiums on life and health insurance, and miscellaneous employee benefits such as safety, medical treatment, cafeteria, recreational facilities, and membership dues;
4. Costs pertaining to strikes, rework labor, scrap, and spoilage;
5. Administrative expenses related to production;
6. Officers' salaries related to production; and
7. Insurance costs related to production.

Given this list of additional costs that could be deductible, the tax savings of producing GAAP financial statements may well justify the cost of preparing them.

The CCA also discusses the IRS's view on the effect of the Section 263A uniform capitalization rules on the determination of costs of goods sold for marijuana producers and resellers. Congress enacted Section 263A in 1986, four years after Section 280E. The IRS explained that while Section 263A requires taxpayers to capitalize some expenses that were deductible under the previous rules, Section 263A is a timing provision, and its enactment only affects when a taxpayer can deduct certain expenses, not whether those expenses are deductible or nondeductible. In particular, Section 263A(a)(2) states that "[a]ny cost which (but for this subsection) 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."

Accordingly, the IRS found that, reading Section 280E in conjunction with Section 263A, a taxpayer cannot obtain a tax benefit by capitalizing under Section 263A expenses that are nondeductible under Section 280E. Because the enactment of Section 263A did not change which costs could be deducted under Section 280E, the IRS concluded that a marijuana trafficker's inventoriable costs (i.e., the costs it can deduct as cost of goods sold) should be determined under the pre-Section 263A inventory-costing regulations under Section 471 that were in effect when Section 280E was enacted in 1982.

Thus, marijuana retailers can allocate to inventory and the cost of sales the invoice price of purchased cannabis, net of trade or other discounts, as well as the transportation and other costs necessary to gain possession of the inventory. The costs allocable to inventory are considerably greater for marijuana-producing activities and are potentially even greater for a marijuana producer for whom GAAP-basis financial statements are prepared. Finally, all fully substantiated caregiving costs appear likely to be deductible when the facts and circumstances reflect those in CHAMP.

D. In *Alterman v. Commissioner. of Internal Revenue,* T.C. Memo. 2018-83,Laurel Alterman and William Gibson (collectively referred to as "Taxpayers") operated a Colorado medical marijuana dispensary, called Altermeds, LLC ("Altermeds"). At Altermeds, they also sold cannabis paraphernalia, hats and shirts which they claimed constituted a second business, separate and distinct from the sale of marijuana. The IRS audited Taxpayers, who reported all of their income and expenses related to the marijuana dispensary on a Schedule C. Following the audit, the IRS issued a notice of deficiency allowing Taxpayers’ costs of goods sold, but disallowed all business expense deductions (under Section 280E) except depreciation and section 179 expenses. The Tax Court upheld the IRS' disallowance of all business expense deductions, even those related to that portion of taxpayers business that sold non-marijuana products such as marijuana paraphernalia. The Court held that the sale of paraphernalia, hats and shirts was not a separate trade or business due to only 4% of Altermeds sales were of non-marijuana merchandise. Due to such a small percent of Altermeds sales consisting of non-marijuana merchandise, the Court held such sales was merely complementary to Altermeds efforts to sell marijuana.

With its "second line of business" argument denied, Altermeds turned to the last option of the targeted marijuana facility: arguing that the business had overstated its non-deductible General & Administrative ("G&A") expenses and understated its deductible COGS.

This is the second approach to minimizing the impact of Section 280E. You characterize as many costs as possible as COGS rather than operating expenses. As the Tax Court has observed, “[the concept of COGS] 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." In general, a taxpayer first determines gross income by subtracting COGS from gross receipts, and then determines taxable income by subtracting expenses from gross income. Section 471 gives broad authority to the IRS to force taxpayers to account for inventory in a way that most clearly reflects income. IRS regulations under Section 471, provide that a producer of property generally is required to treat indirect costs as COGS if they are “incident to and necessary for production” or manufacturing operations.

In 1986, Congress enacted Section 263A, which requires purchasing, handling, and storage expenses, as well as a portion of third party service costs such as accounting or legal fees, to be included in COGS in addition to the costs covered by Section 471 regulations. Absent an inclusion in COGS, indirect costs for cannabis businesses are subject to Section 280E. Section 280E denies deductions from gross income. It does not impact costs for determining gross income. Increasing COGS decreases gross income and decreases the amount of denied deductions from gross income as a result of Section 280E. This creates an incentive for cannabis businesses to maximize their costs included in COGS. Normally, taxpayers with inventories prefer to treat costs as deductible expenses rather than including them in COGS, because expenses are currently deductible, while COGS does not reduce income until the taxpayer sells the inventory items to which the COGS relates. However, because Section 280E prevents the deduction of many cannabis-related costs as current expenses, taxpayers in the cannabis industry have reversed the normal tax planning objective and prefer to maximize the costs treated as COGS.

There were several problems with this characterization of as many costs as possible as COGS rather than operating expenses in Altermeds.  First, Altermeds' bookkeeping was less than reliable and they did not keep a detailed inventory count. And the Court concluded, Altermeds was improperly deducting every dollar of purchased and produced marijuana as COGS.

In a last ditch effort, Altermeds argued that the court should simply take a percentage of its total revenue, as determined based on the testimony of industry experts, as its supportable COGS, as the court did in *Olive*. However, the court declined to do so, because for unstated reasons, it found the Altermeds expert's testimony inadmissible and thus the application of such a ratio was impossible.

**III. Conclusion**

It cannot be stressed enough the importance of meticulous recordkeeping if you own or operate a marijuana dispensary and work in an industry in which the IRS has a tool like Section 280E at its disposal to deny all of your non-COG deductions. If you are going to argue you have a substantial second line of business, treat it like one, separately recording revenue and expenses. But even if you don't try a second line of business argument, you have to maintain consistent, thorough, and defensible allocations of costs between general and administrative expenses of your business, that are subject to Section 280E, and COGS, which are not.