

Tax and Legal Issues Facing Colorado's Marijuana Industry

BY NATALIE ROONEY

Colorado's marijuana industry is big and getting bigger. The tax and legal issues surrounding the industry are getting bigger as well.

77 WORDS

The cornerstone of the tax issues is Internal Revenue Code (IRC) Section 280E. The provision contains just 77 words, but "280E is a big economic hammer," says Ron Seigneur, MBA, CPA/ABV, ASA, CVA, Managing Partner, Seigneur Gustafson LLP, Lakewood.

Section 280E prohibits businesses from deducting otherwise ordinary business expenses from gross income associated with the "trafficking" of Schedule I or II substances, as defined by the Controlled Substances Act of 1970. The IRS has routinely applied Section 280E to state-legal marijuana businesses, since marijuana is still classified as a Schedule I substance.

The provision originated from a 1981 court case in which a convicted drug trafficker asserted his right under federal tax law to deduct ordinary business expenses. In 1982, Congress enacted 280E to prevent drug dealers and others involved in illegal activities under the federal code from realizing

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economic income tax benefits beyond their direct cost of goods sold (COGS) expenses.

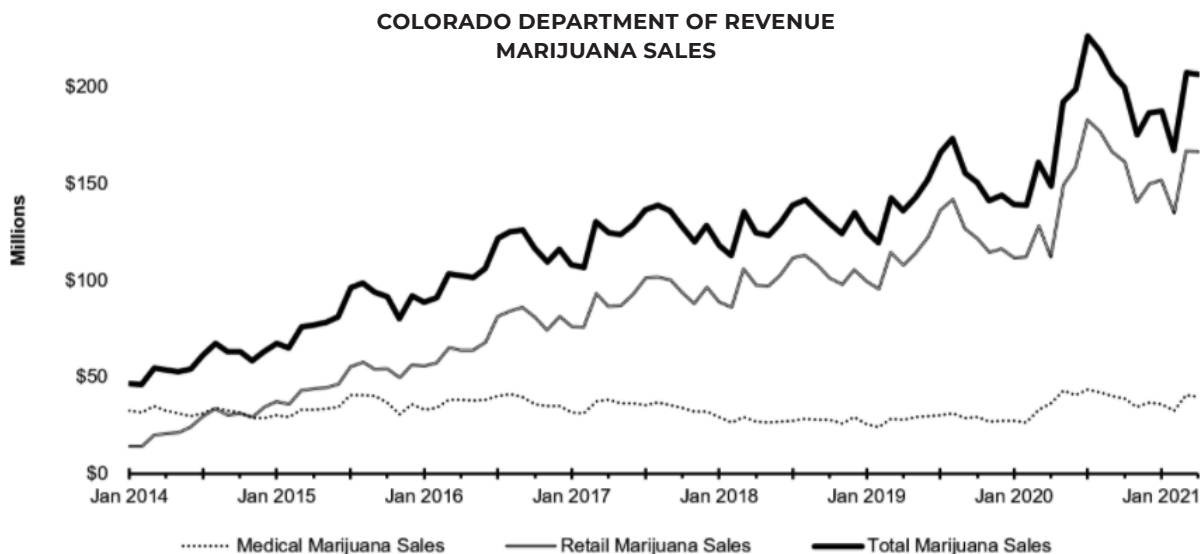
Jennifer Benda, Esq., a former Big Four CPA and current shareholder with Hall Estill, Denver, has developed a niche advising and defending businesses in the marijuana industry on tax-related matters. Most of her clients come to her because they've encountered an issue and are under IRS examination. "They've done their best to get their tax returns prepared, but there's a lot of uncertainty," she says. "I want to be sure they're aware and doing what they can to protect themselves and file the best tax returns possible."

COST OF GOODS SOLD = EVERYTHING?

While marijuana businesses can't deduct business expenses because of 280E, they can deduct COGS. Benda says because COGS isn't a narrow definition, a lot of legal battles take place as to how the rules can be applied. "Are you a reseller or a producer?" she asks. "How you're classified will give you different results. These companies are trying to maximize their cost of goods sold because they can't deduct anything else."

The Tax Cuts and Jobs Act of 2017 (TCJA) greatly expanded the gross receipts

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Source: State Sales Tax Returns (DR 100) and Retail Marijuana Sales Tax Returns
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threshold criteria for a small business. Under the TCJA, businesses with average annual gross receipts for the prior three years of \$25 million or less meet the small business criteria. As an industry in its early stages, many marijuana businesses meet the gross receipts requirement. These qualified small business clients who want to be more aggressive are turning to IRC 471(c), which was finalized by the IRS early in 2021. It allows small businesses to elect an internal method of accounting to report the cost of inventory as opposed to using the inventory rules established in IRC 471(a). Under the new regulations, marijuana owners may elect to treat inventory as non-incidental materials and supplies, which appears to open the door to allow them to determine their company's COGS. Even though it's early days for the regulations, Benda says some businesses are willing to be the guinea pigs. "Clients are very curious about the impact of this new provision," she says. "You have to look at the intent of the law. It's a potential loophole that may eventually close, but it's the hot new thing."

AN ONGOING LACK OF GUIDANCE

Typically, when a controversial IRC provision is released, it is accompanied by pages of interpretations explaining how to apply it. "The IRS has never done that for 280E," Seigneur says. "There have been a lot of court cases over those 77 words."

Even when guidance is released, the IRS often ignores it, taking positions contrary to its other positions. "That's hard to deal with when you're trying to prepare a tax return and pay tax liabilities," Benda says. "These aren't back-room enterprises. They're registered with the state. They're advertising. They can't take the risk of not filing a tax return."

A 2020 FAQ document is a perfect example of the ambiguity facing the marijuana industry. Brenda Clarke, CPA/ABV, CVA, CFF, a Seigneur Gustafson partner specializing in tax compliance for the marijuana industry, points out that in true IRS form the document is "very vague, borderline threatening, and includes language about penalties. The IRS could come in and say you didn't apply 280E correctly. You could suddenly find your tax liability up 40 or 50 percent. You don't have any cash in the bank, but now you have to cut a check to the IRS for hundreds of thousands of dollars. The perception from the outside is that you're making a lot of money, but revenue doesn't equal profits, especially after taxes. It can be a really tough industry."

HARBORSIDE RULING: NO RELIEF IN SIGHT

In April, a U.S. appeals court rejected California-based cannabis retailer Harborside's effort to stamp out Section 280E. In this case, the IRS allowed the cost to acquire the cannabis, but it was the processing, curing, trimming, and packaging that was disallowed and that Harborside pointed to as a Constitutional violation.

Harborside's attorney argued that by banning deductions for costs such as acquiring raw cannabis, dispensaries were being unconstitutionally taxed on gross instead of net income.

The ruling was a major blow to the marijuana industry's hopes of eliminating the federal tax provision that has cost companies countless millions of dollars over the years.

The outcome means that marijuana companies will continue to be taxed by the federal government at a far higher rate than mainstream businesses – unless Congress and the Biden administration approve legislation legalizing marijuana and taxing the businesses as any other industry.

Benda says while the IRS is starting to concede more cases to avoid litigation, it currently comes down to determining what inventory costs are, what rules a marijuana business is subject to, and whether a business is a producer, a reseller, or a vertically integrated company.

She notes a lot of other issues addressed in these legal cases aren't getting any traction either, like arguing that 280E doesn't apply to a state legal business, or not cooperating during IRS examinations because of Constitutional rights under the Fifth Amendment.

SMART VS. OVERLY AGGRESSIVE

Seigneur explains that there are essentially four segments to the marijuana business:

- **Cultivators** who grow the plants. Eighty to 90 percent of what they do is cost of goods sold.
- **Processors** who take the grown marijuana plants and process them into edibles and concentrates. Most of what they do is also cost of goods sold.
- **Dispensaries** which are the retail side. This is the group that really gets hammered because of the inability to deduct front of the house expenses.
- **Ancillary businesses** are everything that has sprung up to support the marijuana industry, including point of sale software,

consulting, accountants, attorneys, and advisors.

In the wake of Harborside, Seigneur and Clarke observe that the marijuana industry is trying to figure out how to reallocate costs above the line to get them into COGS in a way that would be permitted by the IRS. "It's an ongoing battle between tax preparers and clients who want to be aggressive. Sometimes we're not sure we can put our name on a return."

Another way clients have tried to aggressively reduce their tax exposure is by setting up a management company that avoids 280E by charging a management fee. "The IRS says that doesn't work," Seigneur cautions.

"We have clients who want to get super aggressive with their cost of goods sold and others who want to fly under the radar," Clarke says. "We advise all of our clients to have their books and records reflect their tax return."



WHAT'S THE DIFFERENCE BETWEEN CANNABIS AND MARIJUANA?

Although the terms "cannabis" and "marijuana" are often used interchangeably, they're not actually interchangeable. Cannabis is the genus while marijuana is the species. Both hemp and marijuana plants belong to the cannabis genus. **In other words, all marijuana is cannabis, but not all cannabis is marijuana.**

Clarke says it's important for marijuana businesses to consider their structure. When marijuana was first legalized, Colorado retailers had to grow 70 percent of what they sold, which is why grow and retail operations are often found together in one facility. In 2014, that provision was eliminated. Many companies figured out it's hard to both grow and sell well unless it's a really big operation that can vertically integrate, referred to as "seed to sale." Bigger players are adopting this Costco-type model, taking advantage of economies of scale to offer a quality product at a lower price.

THE BLACK MARKET FACTOR

As big as the legalized marijuana market

is, the black market is even bigger. A 2017 survey by the Cannabis Consumers Coalition in Colorado asked 17,000 Coalition members where they buy their marijuana. A majority of respondents still purchase illicitly from dealers or friends.

Legal marijuana is almost always more expensive than illegal marijuana. “The legal people are paying high taxes because of the penalties from 280E and the inability to deduct costs, together with the added costs of compliance with testing and regulators,” Seigneur says. “Then there’s someone down the street growing their own. It’s good stuff, and it’s cheaper, so people continue to buy from them. It’s putting excessive burdens on those who are legally competing with the black market. It’s a conundrum.”

The economic burdens of state and local excise taxes, testing fees, and regulatory requirements continue to give the illicit market a huge competitive price advantage, to say nothing of the dangers of contaminated product and lack of consistent purity and potency, Seigneur adds.

MAKING BANKING SAFE

As cash-only businesses, marijuana retailers have been prime targets for robberies and burglaries. As long as federal law still classifies marijuana as a Schedule 1 drug, banking remains problematic. Federally insured banks risk charges of aiding and abetting a federal crime or money laundering if they choose to do business with marijuana-related ventures.

Help may be on the way, however. In September 2019, in a bipartisan vote, the U.S. House of Representatives approved reform of federal banking rules that would allow legal marijuana businesses to access banks. The House bill has been stuck in the Senate Banking Committee since then, but there are signs that the U.S. Senate is now more favorably inclined to send this legislation to the Senate floor where it is anticipated to pass.

It’s a paperwork nightmare for banks to deal with marijuana businesses. FINCEN requires banks to file suspicious activity reports every time a marijuana business deposits money, essentially making banks a monitor for the business which in turn means lots of fees charged. “It’s not for the faint of heart,” Benda says.

The Secure and Fair Enforcement (SAFE) Banking Act would allow U.S. banks to service marijuana companies in states that have legalized marijuana. It appears to be gaining steam in Congress, even among Republicans.

The bill recently passed in the House of Representatives for the third time.

Colorado has actually been in a better situation than many states in terms of banking for the marijuana industry. State credit unions and smaller banks stepped in to fill the void left by FDIC-insured banks. Should the SAFE Act pass – some predict that could happen as soon as the end of 2021 – it would allow big, nationally chartered banks to serve the industry, including the ability to provide conventional lending and better access to capital.

CPAS & MARIJUANA

For CPAs who already have marijuana clients, or may be thinking about taking on marijuana clients, Benda advises carefully watching the excise tax numbers and where that money is going. “It’s huge for Colorado, and it’s an area of compliance where there’s a lot of confusion. There are so many weird issues that come up in excise tax audits.”

During the pandemic, marijuana dispensaries were deemed essential, which Benda says was important for the industry. “There has always been this sense that someone could flip a switch and shut it all down. But

once the industry was deemed essential, it became apparent how critical the industry is to economies.” She points to the sales tax remittance deferrals given to many companies during the pandemic. “That didn’t apply to marijuana companies,” she says. “The state was relying on that revenue for cash flow purposes. It was really critical, and it was eye-opening to see it all play out.”

Benda has been talking to her clients about the future and what federal legislation might look like. The MORE Act (Marijuana Opportunity Reinvestment and Expungement Act of 2020), which the U.S. House passed in Dec. 2020, is a proposal to deschedule cannabis and create a national excise tax to replace the current 280E tax burdens. “From a policy perspective, that’s what the industry is trying to get ahead of and make sure whatever this excise tax is works and doesn’t depress the industry.”

“From a national perspective, the excise tax has to replace that money in the federal budget,” Benda adds. “Everyone is expecting the excise tax, but they want one that isn’t cumbersome and reflects a good perspective of the industry.” ▲



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