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Medical Cannabis Businesses Operations: How Can Business Owners Navigate the Tax and Banking Law Minefields?

By Adam L. Abrahams, Esq.[*]

The sale and distribution of cannabis to patients for medical purposes has become a powerful economic engine in the United States. The U.S. legal cannabis market reached almost $10 billion in retail sales in 2017.[1] The sale of cannabis in some form has been legalized in 33 states and the District of Columbia.[2] California was the first state to make it legal for patients to obtain and use cannabis for medical purposes.[3] Ten states and the District of Columbia permit adult use of cannabis.[4] In 2018, Vermont became the first state to legalize cannabis through its legislature rather than through a ballot initiative.[5] Mexico and Canada have also legalized the use of cannabis.[6]

Who are these cannabis entrepreneurs?[7] These individuals include producers; dispensaries and cultivation centers; pot shops; transportation companies; laboratories and other testing facilities; investors; and companies that produce related products such as lotions, brownies, edibles, grow lights, and fertilizer.

THE FEDERAL RESPONSE TO STATE LEGALIZATION OF CANNABIS

Controlled Substances Act

The Controlled Substances Act (CSA) established federal drug policy under which the manufacture, importation, possession, use, and distribution of certain substances is regulated. It was passed by the 91st U.S. Congress as Title II of the Comprehensive Drug Abuse Prevention and Control Act of 1970 and signed into law by President Richard Nixon.[8] The CSA classifies controlled substances into five schedules ranked

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[1] Anna Stolley Persky, *Risky Business: Clients, Cannabis & the Law*, Washington Lawyer (April/May 2018) *citing* a study by Arcview Market Research, in partnership with BDS Analytics. The same study predicts that the legal market will reach $24.5 billion by 2021.

[2] Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Illinois, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Utah, Vermont, Washington, West Virginia. Alabama, Mississippi and Virginia permit possession of cannabis oil to treat severe epilepsy. Louisiana prohibits the use of Cannabis in a form that can be smoked—only oils, topical applications and other types.

[3] California Proposition 215 (1996) or otherwise known as the California Compassionate Use Act.

[4] Alaska, California, Colorado, Maine, Massachusetts, Michigan, Nevada, Oregon, Vermont, and Washington.

[5] Vermont's governor signed a bill legalizing cannabis into law in 2018. States such as Arizona, California, Colorado, Massachusetts, New Mexico, and Washington legalized cannabis via voter referendum.

[6] In October 2018, Canada became the first G-7 country to legalize the use of cannabis. In November 2018, Mexico's Supreme Court ruled that the prohibition of the use of cannabis was illegal.

[7] For purposes of this article, marijuana, where possible, shall be referred to as cannabis. The term ''marihuana'' means all parts of the plant Cannabis sativa L., whether growing or not; the seeds thereof; the resin extracted from any part of such plant; and every compound, manufacture, salt, derivative, mixture, or preparation of such plant, its seeds or resin. Such term does not include the mature stalks of such plant, fiber produced from such stalks, oil or cake made from the seeds of such plant, any other compound, manufacture, salt, derivative, mixture, or preparation of such mature stalks (except the resin extracted therefrom), fiber, oil, or cake, or the sterilized seed of such plant which is incapable of germination. *See* 21 U.S.C. §802(16).

[8] Pub. L. No. 91-513, codified at 21 U.S.C. §801 et. seq. Note that 21 U.S.C. §863 makes it unlawful to sell drug paraphernalia, but CCA 201820018 states that Gas Chromatographer Mass Spectrometers (GCMS) and Liquid Chromatographer Mass Spectrometers (LCMS), used by taxpayers involved in the cannabis indus-

on the basis of factors such as accepted medical use, safety under medical supervisions, and potential for abuse.[9] The CSA not only combined existing federal drug laws[10] and expanded their scope, but it also changed the nature of federal drug law policies and expanded federal law enforcement pertaining to controlled substances.[11]

Marijuana, or cannabis, is listed as a Schedule I Substance, which has the highest potential for abuse and no accredited medical use.[12] The classification of cannabis as a Schedule I substance is contrary to recommendations from the National Commission on Marijuana and Drug Abuse.[13] In 2001, the DEA rejected a petition to reschedule cannabis as a non-Schedule I substance, citing the lack of general accepted medical use.[14] Multiple attempts by lawmakers and litigants to reschedule cannabis under the CSA have failed.[15]

Justice Department Guidance to Federal Prosecutors Regarding Cannabis Enforcement under the CSA

In 2009, the Department of Justice (DOJ) issued a Memorandum (Ogden Memo) providing guidance and clarification to federal prosecutors in states that enacted laws authorizing medical cannabis.[16] The Ogden Memo provided uniform guidance to focus federal investigations and prosecutions in the United States on ''core federal enforcement priorities.'' The Ogden Memo expressed concern regarding the distribution and sale of cannabis by large-scale criminal enterprises, gangs, and cartels. Although stating that the prosecution of ''illegal drug manufacturing and trafficking networks continues to be a core priority,'' the Ogden Memo directed federal prosecutors to not focus federal resources on individuals who clearly comply with existing state laws providing for the medical use of cannabis, explaining that this would unlikely be an efficient use of limited federal resources. However, the Ogden Memo noted that claims of compliance with state or local law could also disguise operations that are inconsistent with the ''terms, conditions, or purposes'' of those laws.

The Ogden Memo provided a non-exhaustive list of conduct that federal prosecutors should not consider to be in clear and unambiguous compliance with applicable state law, thus implicating possible illegal drug trafficking activity: Unlawful possession or unlawful use of firearms; violence; sale to minors; financial and marketing activities inconsistent with the terms, conditions or purposes of state law, including money laundering activity; financial gains or excessive amounts of cash inconsistent with purported compliance with state or local law; amount of cannabis inconsistent with purported compliance with state or local law; illegal possession or sale of other controlled substances; or ties to other criminal enterprises. The Ogden Memo did not change any authority to enforce federal law, and intended to only serve as guidance in the exercise of investigative and prosecutorial discretion.

In 2011, DOJ backpedaled and issued a new memorandum, clarifying the Ogden Memo.[17] The Cole Memo stated that DOJ should not use federal resources to prosecute cancer patients and other seriously ill people who use cannabis in compliance with state law. The clarification also specified that DOJ never intended to provide a shield for those who supplied medical cannabis to those in full compliance with state law.

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try to measure cannabinoids in marijuana does not constitute drug paraphernalia.

[9] The Drug Enforcement Administration (DEA) and the Food and Drug Administration (FDA) determine which substances are added to or removed from the various schedules, although the statute passed by Congress created the initial listing.

[10] In addition to the CSA, other statutes prohibit certain actions pertaining to drugs: Conspiracy to distribute drugs to third parties under 21 U.S.C. §846; maintaining a drug premises under 21 U.S.C. §856; selling drug paraphernalia under 21 U.S.C. §863 (there are asset forfeiture issues).

[11] Title II, Part F of the CSA also established the National Commission on Marijuana and Drug Abuse, known as the Shafer Commission after its chairman, Raymond P. Shafer, to study cannabis abuse in the United States. *See also* the report from the National Commission on Marihuana and Drug Abuse, *Drug Use in America: Problem in Perspective, Second Report* (March, 1973).

[12] 21 U.S.C. §812(b)(1). There is a lack of accepted safety for use of the drug or other substance under medical supervision.

[13] Raymond Shafer, during his presentation of the commission's First Report to Congress, recommended the decriminalization of marijuana in small amounts. He also stated that ''the actual and potential harm of use of the drug is not great enough to justify intrusion by the criminal law into private behavior, a step which our society takes only with the greatest reluctance.''

[14] *See* 66 Fed. Reg. 20037 (April 18, 2001). In such circumstances, placement of the drug in schedules II through V would conflict with the CSA because such drug would not meet the criterion of ''a currently accepted medical use in treatment in the United States. [*citing* 21 §U.S.C. §812(b)].

[15] *See United States v. Oakland Cannabis Buyers' Coop.*, 532 U.S. 483 (2001) (rejecting the common-law medical necessity defense); *Gonzales v. Raich,* 545 U.S. 1 (2005) (federal government has a right to regulate and criminalize cannabis, even for medical purposes).

[16] Memorandum issued by David W. Ogden, ''Investigations and Prosecutions in States Authorizing the Medical Use of Marijuana'' (Oct. 19, 2009).

[17] *See* Memorandum issued by James M. Cole, Guidance Regarding the Ogden Memo in Jurisdictions Seeking to Authorize Marijuana for Medical Use (Cole Memo) (June 29, 2011), clarifying the Ogden memo and reiterating the position of DOJ.

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On August 29, 2013, DOJ issued a second Cole Memo[18] that set forth enforcement priorities that focused on activities that were illegal under both state and federal laws, including: Distribution of cannabis to minors (or cannabis marketing that appealed to minors, diversion of cannabis products to minors, or trafficking near an area associated with minors); revenues going to criminal enterprises; diversion of cannabis from legal states to other states; state-legal activity as a cover for illegal activity as a cover or pretext for drug trafficking or other illegal activity; preventing violence and the use of firearms in the cultivation and distribution of cannabis; preventing drugged driving and the exacerbation of other adverse public health consequences associated with cannabis use; preventing the growing of cannabis on public lands and the attendant public safety and environmental dangers posed by cannabis production on federal lands; and preventing cannabis possession or use on federal property.

The 2013 Cole Memo, in response to Colorado's legalization of adult use of cannabis, advised a more deferential approach towards the states. The 2013 Cole Memo noted that the federal government had traditionally relied upon state and local law enforcement agencies to address their own narcotic laws, such as prosecution of individuals who possessed small amounts of cannabis for personal use on private property. DOJ also expected state and local government to ''implement strong and effective regulatory and enforcement systems'' that would address any threat ''to public safety, public health and other law enforcement interests.''[19] In such circumstances where state and local governments tracked the growth, distribution, and sale of regulated cannabis, the 2013 Cole Memo stated that such actions would unlikely threaten the previously stated federal priorities. The Cole Memo did not preclude any investigation or prosecution in particular circumstances that otherwise served an important federal interest.

The 2013 Cole Memo did not address any banking issues such as how to handle proceeds from the sale of cannabis, access to banking, and money laundering. On February 14, 2014, the Department of the Treasury (Treasury) issued guidance for banks to address DOJ enforcement of money laundering and other banking laws.[20] The DOJ report reiterated the ''eight priority factors'' cited earlier by the DOJ.[21] In 2014, in response to increased raids on medical cannabis providers, Congress passed the Rohrabacher–Farr amendment.[22] The Amendment prohibited DOJ from prosecuting individuals acting in accordance with state law.[23] Congress also intended that the Drug Enforcement Administration (DEA) was prohibited from investigating medical cannabis companies,[24] provided that such dispensaries were acting in compliance with state law.[25] Finally, the Rohrabacher–Farr Amendment blocks DOJ from using federal funds to impede implementation of state medical cannabis laws.[26] It is unknown whether Congress will reauthorize the amendment in future fiscal years.[27]

[18] *See* Memorandum issued by James M. Cole, Guidance Regarding Marijuana Enforcement (2013 Cole Memo) (Aug. 29, 2013).

[19] *Id.*

[20] DOJ, Guidance Regarding Marijuana Related Financial Crimes (Feb. 14, 2014).

[21] On July 27, 2016, the Marijuana Business Daily published an interview between John Schroyer and then Deputy Attorney General James M. Cole. Deputy Attorney General Cole stated that the 2014 Report was an attempt to alleviate concerns of banks that did not want to work with law abiding licensed cannabis businesses.

[22] The Rohrabacher–Farr amendment (also known as the Rohrabacher–Blumenauer amendment) passed the House by a 219–189 vote in May 2014, and was signed into law in December as part of an omnibus spending bill. It was renewed following a 242–186 House vote in 2015, and was subsequently included in a number of short-term spending bills in 2016 and 2017.

[23] *Id.* Note that Maurice Hinchey, a Democrat from New York and a member of the House of Representatives, originally sponsored the federal spending provision in 2001. In 2003, Republican Congressman Dana Rohrabacher of California teamed up with Hinchey on the officially rebranded Hinchey-Rohrabacher measure.

[24] *See also United States v. McIntosh*, 833 F. 3d 1163 (9th Cir. 2016) (the Ninth Circuit cited the amendment in holding that DOJ cannot prosecute state complaint medical cannabis actors. The Ninth Circuit also held that such defendants are entitled to evidentiary hearings to determine whether they are complying with state law. Finally, if the amendment expires, DOJ has five years to prosecute such individuals).

[25] *Id.* A leaked DOJ Memo suggests that the DOJ's interpretation of the amendment only prevents actions from actual states, and not against individuals or businesses operating lawfully under state cannabis laws. *But see United States v. Marin All.*, 139 F. Supp.3d 1039 (N.D. Cal. 2015), where the U.S. District Court for the Northern District of California ruled that the DEA's interpretation of a recent medical marijuana bill ''defies language and logic,'' ''tortures the plain meaning of the statute,'' and is ''at odds with fundamental notions of the rule of law.'' The district court denied the business owner's Motion to Dissolve the government's injunction as it pertains to enforcement of the CSA. The district court did note that the government could not enforce an injunction to the extent that a business owner complied with California law.

[26] *Id.*

[27] *See* H.Amdt. 332 to H.R. 2578. *See also* Zach Harris, A Brief History of Rohrabacher-Farr: The Federal Amendment Protecting Medical Marijuana, The Merry Jane Blog (Dec. 19, 2017). On May 17, 2018, the House Appropriations Committee approved inclusion of the Rohrabacher–Farr amendment in the CJS appropriations bill for fiscal year 2019 in a voice vote led by sponsor Rep. David Joyce. *See* Jeff Smith, *Powerful congressional panel puts*

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On January 4, 2018, Attorney General Jeff Sessions rescinded nationwide guidance specific to cannabis enforcement (Sessions Memo).[28] The Sessions Memo, acknowledging that the DOJ had ''finite resources,'' stated that DOJ should follow well-established principles in determining which cannabis activity cases to prosecute. The Sessions Memo, in citing previous nationwide guidance issued by DOJ, stated that given the Department's well-established principles,[29] previous nationwide guidance specific to marijuana enforcement was unnecessary. The Sessions Memo provided prosecutorial discretion of United States attorneys to ''weigh all relevant considerations, including federal law enforcement priorities set by the Attorney General, the seriousness of the crime, the deterrent effect of criminal prosecution, and the cumulative impact of particular crimes on the community.''

The Sessions Memo appears to be more symbolic than substantive. There has not been a substantial increase in DOJ enforcement of the CSA. However, FinCEN guidance (discussed below), is still in effect.

TAX ISSUES FOR CANNABIS BUSINESS OPERATIONS

Excise Tax on Sale of Cannabis

From 1937 until the enactment of the CSA, the federal government assessed a tax on the sale of cannabis, known as the Marijuana Tax Act.[30] Only individuals who paid an excise tax for certain medical and industrial uses could possess cannabis.[31] Some have argued that the purpose of government regulation was to reduce the size of the hemp industry. Hemp had become a cheap substitute for paper pulp that was used in the newspaper industry. The American Medical Association (AMA) opposed the act because the tax was imposed on physicians prescribing cannabis, retail pharmacists selling cannabis, and medical cannabis cultivation/manufacturing.[32]

The federal government subsequently acknowledged that the Marijuana Tax Act did not raise a significant amount of revenue due to very few individuals who registered as part of the requirements.[33] In 1969, the Supreme Court held part of the Marijuana Tax Act to be unconstitutional.[34] Congress subsequently passed the CSA, repealing the Marijuana Tax Act.

Inclusion in Gross Income

Medical cannabis businesses, although illegal under federal law, are obligated to pay federal income tax on their taxable income.[35] The Internal Revenue Code (Code) does not distinguish between income derived from legal sources and income derived from illegal sources.[36] The purpose of the Code is not to punish unlawful behavior but to tax net income. Congress could change the tax code to include special tax rules for illegal conduct if desired.[37]

Adjusted gross income for businesses generally includes gross income less any listed deductions, including those attributable to a taxpayer's trade or business.[38] The Supreme Court has held that income in the context of a producer or re-seller means gross income and not gross receipts.[39] For a cannabis producer or re-seller, gross income includes net gains derived from dealings in property, including controlled

medical marijuana protections in federal budget, Marijuana Business Daily Blog (May 17, 2018). The Senate Appropriations Committee followed on June 12, 2018, by approving a base CJS appropriations bill with the amendment included. *See Marijuana Policy Project*, Press Release, June 12, 2018. The amendment was then renewed through a pair of short-term spending bills signed on Sept. 28, 2018, and Dec. 7, 2018, with the most recent extension effective through Dec. 21, 2018.

[28] Attorney General Jeff Sessions, Memorandum for all United States Attorneys regarding Marijuana Enforcement (Jan. 4, 2018).

[29] As reflected in Section 9-27.000 of the U.S. Attorney Manual.

[30] Pub. L. No. 75–238.

[31] *Id.* The Marijuana Tax Act was also incorporated into and included in Subchapter A of Chapter 39 of the 1954 Internal Revenue Code. In 1942, the federal government issued tax stamps for cultivation of fiber hemp to farmers.

[32] Statement of Doctor William C. Woodward, Legislative Counsel for the American Medical Association, testifying in front of the House of Representatives Ways and Means Committee on May 4, 1937.

[33] President Lyndon B. Johnson's Commission on Law Enforcement and Administration of Justice Report in 1967.

[34] The Marijuana Tax Act was overturned in *Leary v. United States*, 395 U.S. 6 (1969). The Supreme Court ruled that part of the Marijuana Tax Act was unconstitutional as a violation of the Fifth Amendment, because a person seeking the tax stamp would have to incriminate him/herself.

[35] U.S. Const. amend. XVI; *See also* §61(a), which includes in gross income ''all income from whatever source derived.'' *See also James v. United States*, 366 U.S. 213 (1961), *overruling Commissioner v. Wilcox*, 327 U.S. 404 (1946). All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

[36] *United States v. Sullivan*, 274 U.S. 259 (1927)(formed basis of Al Capone conviction pertaining to taxation of gains from illicit trafficking of liquor); *James v. United States*, 366 U.S. at 218.

[37] *Commissioner v. Tellier*, 383 U.S. 687, 691 (1966)(taxpayer found guilty of violating Securities Act of 1933 and subsequently tried to deduct from gross income the legal fees he spent in defending himself).

[38] §62(a).

[39] *Doyle v. Mitchell Bros. Co.,* 247 U.S. 179, 185 (1918)(Congress may not tax the return of capital), *cited in* CCA 201504011.

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substances produced or acquired for resale.[40] Gains derived from dealings in property mean gross receipts less cost of goods sold (COGS).[41] COGS pertain to ''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.''[42] Deductions are a matter of legislative grace.[43]

Effect of §280E

Section 280E was enacted by the Reagan Administration in response to *Edmondson v. Commissioner*.[44] In *Edmondson*, the Tax Court allowed the taxpayer to deduct expenses associated with selling amphetamines, cocaine, and marijuana that he incurred on consignment of such drugs in 1974.[45] He was also allowed to deduct two-thirds of his residence as a home office expense, the cost of a small scale, packing expenses, telephone bills, and automobile expenses (he drove 29,000 miles). Although the taxpayer kept poor business records, the taxpayer provided enough evidence at trial of business deduction amounts to enable the Tax Court to permit such deductions. However, the Tax Court denied travel and entertainment expenses because the taxpayer could not substantiate such expenses.

Section 280E states that ''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.''[46] Although §280E disallows any deduction for ordinary and necessary business expenses, it excepts the cost of goods sold (COGS) from this prohibition.[47] To preclude any challenges to the statute on constitutional grounds, Congress did not intend that any adjustment to gross receipts would be affected by any application of §280E.[48]

When enacting §280E, Congress exercised its authority to withhold the legislative grace. The statute disallows deductions for expenses that are not illegal per se, such as salaries, rent, and telephone. Thus, §280E appears to have a greater reach than §162(c), which disallows a deduction for specified illegal payments such as bribes and kickbacks.[49]

Although §280E does not define ''trafficking,'' the Tax Court has defined the term to mean ''engaging in commercial activity'' or to ''buy and sell regularly.''[50] The Tax Court has applied this definition broadly to merely providing medical cannabis to patients and customers, even if legal under state law.[51]

Section 280E provides a harsh tax result to cannabis business owners who are operating legally under state law. The IRS can assess income taxes on these sellers of controlled substances on their gross revenue instead of their net income.[52] The vigorous use of §280E to deny other valid business deductions will likely cause many state-sanctioned cannabis businesses to close and in some cases, file for bankruptcy.[53]

Several cases listed below address the disconnection between federal and state law. It is necessary to first review the definition and application of COGS.

COGS

CCA 201504011 provides guidance regarding the capitalization of inventory costs and deduction of cost

[40] §61(a)(3).

[41] Reg. §1.61-3(a). *See also* §1001(a), §1011(a), §1012(a).

[42] *Reading v. Commissioner,* 70 T.C. 730, 733 (1978).

[43] CCA 201504011, *also citing New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

[44] T.C. Memo 1981-623.

[45] Prior to the enactment of §280E, courts disallowed deductions for certain ordinary and necessary business expenses on the grounds that it frustrated the public policy doctrine. *See also* §162(c), which codified the public policy doctrine by denying deductions for illegal bribes, kickbacks, or other illegal payments under any law of the United States or any law of a state or any jurisdiction of the United States.

[46] Added by Pub. L. No. 97–248, Title III, §351(a), Sept. 3, 1982.

[47] S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 309. *See also* Reg. §1.61-3(a); *Doyle v. Mitchell Bros. Co.,* 247 U.S. 179 (1918). *See also Peyton v. Commissioner*, T.C. Memo 2003-146; *Franklin v. Commissioner,* T.C. Memo 1993-184; *McHan v. Commissioner,* T.C. Memo 2006-84.

[48] *Id.*

[49] CCA 201504011.

[50] *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner,* 128 T.C. 173, 182 (2007).

[51] *Id.* Note that §7208 is only other provision in the Code that defines trafficking (knowingly or willfully buying, selling, offering for sale, or giving away washed or restored stamps to any person for use). *See also* 21 U.S.C. §801(2), which describes trafficking as ''the illegal importation, manufacture, distribution, and possession and improper use of controlled substances.''

[52] It has been estimated that if a cannabis business's expenses exceed 16.5% of gross receipts, the business will operate at a loss. *See* Wei-Chih Chiang et al., *Judicial Guidance on Medical Marijuana Tax Issues*, 92 Practical Tax Strategies 266, 270 (2014).

[53] By permitting state-sanctioned cannabis businesses to operate and take deductions similar to other types of operating businesses, such entities would remain profitable.

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of goods sold for taxpayers considered to be trafficking in Schedule I and II controlled substances. 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 re-seller) less ending inventories. The taxpayer determines gross income by subtracting COGS from gross receipts, and then determines taxable income.

When Congress enacted §280E, taxpayers using an inventory method of accounting were subject to the inventory-costing regulations under §471.[54] In 1986, Congress enacted the Tax Reform Act, which added the uniform capitalization rules of §263A to the Code. Re-Sellers and producers of merchandise were required to treat inventory costs as direct costs of property purchased or produced, and a proper share of such costs are allocable to such property.[55] Any cost but for the application of §263A that cannot be taken into account in computing taxable income, cannot be taken and/or deducted using §263A.

CCA 201504011 provides the method for determining the COGS for cannabis dispensaries.[56] To be deductible by a business enterprise, a business expense must be ''ordinary and necessary'' within the meaning of §162 and must satisfy the requirements of §461.[57] Once these requirements are satisfied, the amount of that expense is deducted in the current taxable year unless another provision of the Code or regulations requires the deduction to be deferred to a subsequent taxable year.[58] For producers of property, inventory-costing rules typically require the capitalization of costs that are incident to and necessary for the production or manufacturing operations or processes or costs that can be identified or associated with particular units or groups of units of specific property produced.[59]

The IRS takes the position in CCA 201504011 that a lawfully operating medical cannabis dispensary cannot use §263A to circumvent §280E. To permit such action would convert a non-deductible expense into a capitalized cost. For a re-seller, §471 inventory costs would include the invoice price of cannabis purchased minus trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the cannabis. For a producer, §471 inventory costs would include direct material costs for cannabis seeds or plants, direct labor costs of planting, cultivating, harvesting and sorting, and certain indirect costs.

To permit a medical cannabis dispensary to capitalize expenses under §263A would allow capitalization of 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 costs covered by §471 regulations.[60]

CCA 201504011 appears to ignore several issues.[61] First, it is unclear why any changes to §471 regulations subsequent to the enactment of §280E should not apply to businesses trafficking in cannabis. Second, the CCA does not point to any legislative history to interpret §280E. Third, the CCA provides no support for the provision that COGS may be defined differently for certain classes of taxpayers. Fourth, §280E has no impact on capitalization requirements. Fifth, the fact that §263A does not apply to indirect costs of a cannabis business does not mean that those costs cannot be capitalized. Cannabis businesses should be entitled to include in COGS all costs that may be included in COGS under all capitalization rules other than §263A. Sixth, it is unclear whether Congress has the authority to create a separate and narrower definition of COGS for these businesses. Finally, the concept of legislative grace should not apply to COGS, as it appears that Congress, in disallowing the use of §263A for COGS, is effectively taxing gross receipts.[62]

Unfortunately, the Tax Court appears to agree with how the IRS requires cannabis business owners to calculate COGS.[63]

Cannabis Business Owners' Challenges to §280E and §263A

CHAMP v. Commissioner

Cannabis business owners have had limited success in mounting challenges to the application of §280E.

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[54] CCA 201504011. Re-Sellers were subject to Reg. §1.471-3(b) and producers were subject to Reg. §1.471-3(c) and Reg. §1.471-11 (full absorption regulations).

[55] §263A(a).

[56] *See also* Reg.§1.162-1(a).

[57] §461 provides the general rule for the taxable year of deduction.

[58] CCA 201504011 provides examples of other Code sections such as §267(a)(2), §471(a), §263A(a), and §280E.

[59] *Id.*

[60] *Id.* The IRS views §263A as a timing provision only. Because Congress did not amend or repeal §280E when it enacted §263A, the IRS will challenge any capitalization of any §263A type of expenses. The IRS believes, contrary to this author's opinion, that medical cannabis dispensaries can determine inventory costs using only the applicable regulations under §471 as they existed when §280E was enacted. Also, the IRS can require a taxpayer to change from a memorandum of agreement (MOA) that does not clearly reflect income to a MOA that does. *See* §446(b).

[61] One article claims that the IRS's interpretation of COGS (CCA 201504011) is flawed (Lewis M. Horowitz and Justin E. Hobson, *Recreational Cannabis — Section 280E and Tax Efficient Structuring*, The Pipeline Cannabis Law Advisor (June 15, 2016).

[62] *Id.* The author also notes the insightful comment of a friend and colleague, attorney Marc Claybon, who asked, ''Who has a copy of the 1982 regulations?''

[63] *Alterman v. Commissioner*, T.C. Memo 2018-83.

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One successful victory for these taxpayers occurred in the *CHAMP* case.[64]

In *CHAMP*, the petitioner was organized on December 24, 1996, as a California Public Benefit Corporation. On May 6, 2002, the Board of Directors decided to dissolve the corporation. The petitioner provided counseling and other caregiving services to its members, who were individuals with debilitating diseases.

CHAMP's caregiving services were extensive. The staff held various weekly or biweekly support group sessions that could be attended only by petitioner's members. The ''wellness group'' discussed healing techniques and occasionally hosted a guest speaker. The HIV/AIDS group addressed issues of practical and emotional support. The women's group focused on women-specific issues in medical struggles. The ''Phoenix'' group helped elderly patients with lifelong addiction problems. The ''Force'' group focused on spiritual and emotional development. Petitioner provided its low-income members with daily lunches. Petitioner also made available to its members hygiene supplies such as toothbrushes and toothpaste. Petitioner allowed its members to consult with a counselor about benefits, health, housing, safety, and legal issues.

CHAMP also coordinated for its members weekend social events including a Friday night movie or guest speaker, as well as a Saturday night social with live music and a hot meal. Members went on monthly field trips to locations such as beaches, museums, or parks. The organization instructed its members on yoga and other topics such as how to participate in social services at its facilities and how to follow member guidelines. Petitioner provided its members with online computer access and delivered to them international services through its website. CHAMP even encouraged its members to participate in political activities.

CHAMP furnished its services at its main facility in San Francisco, and at an office in a community church in San Francisco. CHAMP also maintained a storage unit for confidential medical records at a third location in San Francisco. CHAMP did not use or distribute any medical cannabis at the church or at the storage unit. The main facility was approximately 1,350 square feet. The medical marijuana was dispensed there at a counter in the main room of the facility, taking up approximately 10% of the main facility. CHAMP required members to have a doctor's letter recommending marijuana as part of his or her therapy, and an unexpired photo identification card from the California Department of Public Health verifying the authenticity of the doctor's letter. CHAMP required that its members not resell or redistribute the medical marijuana received from the organization. Any violations were grounds for expulsion from membership.

On August 4, 2005, the IRS mailed petitioner a Statutory Notice of Deficiency, claiming all of CHAMP's expenses to be non-deductible under §280E. The IRS claimed that petitioner incurred the expenses in connection with the trafficking of a controlled substance.

The IRS determined deficiency in the amount of $355,056 for petitioner's 2002 federal income tax and a $71,011 accuracy-related penalty. In Tax Court, IRS made certain concessions, however: CHAMP was not liable for accuracy-related penalty; CHAMP was entitled to deduct COGs from its gross receipts; CHAMP substantiated its expenses underlying its deductions; §280E does not apply to COGs.[65]

The IRS still disputed petitioner's total deductions of $212,958, even though the expenses were ordinary, necessary, and reasonable expenses that petitioner incurred in operating its business. The IRS claimed the petitioner incurred these expenses in connection with the illegal sale of drugs. These expenses consisted of the following: compensation of officers; salaries and wages; repairs and maintenance; rents at the main facility, church, and storage facility; payroll taxes; depreciation; advertising; employee benefits (health insurance); internet services; accountant; legal/professional fees; insurance; other miscellaneous expenses. The Tax Court noted that the executive director directed overall operations but was not directly engaged in provision of medical marijuana, and seven of the 24 other employees (25 total) were involved in provision of medical marijuana.

CHAMP argued that it engaged in two trades or businesses, and that the supplying of medical marijuana to its members was a secondary trade or business. Therefore, the company should at least be able to deduct those expenses incurred in its primary trade or business.

The Tax Court held the following: §280E does not distinguish between marijuana for recreational use and marijuana prescribed by a physician for medical purposes;[66] §280E precludes the petitioner from deducting its expenses attributable to its provision of

[64] *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007).

[65] IRS Counsel did not disagree with the amounts allowed as deductions but instead argued that such expenses were not deductible because of the application of §280E. It is interesting how CCA 201504011 attempts to use §280E to limit COGS, however!

[66] *Id.* at 15-17, noting that *Raich v. Ashcroft*, 352 F. 3d 1222, 1228 (9th Cir. 2003) did make this distinction, but the Supreme Court [*Gonzales v. Raich*, 545 U.S. 1, 26-28, 31-33 (2005)] rejected this reasoning.

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medical marijuana; petitioner's caregiving services and its provision of medical marijuana were separate trades or businesses for purposes of §280E; §280E does not preclude petitioner from deducting the expenses attributable to the caregiving services.

Regarding the Tax Court's analysis of whether CHAMP's furnishing of its caregiving services is a separate trade or business from that of providing medical marijuana, the Tax Court noted that this was a question of fact.[67] This depended upon the degree of economic interrelationship between the two undertakings. The IRS will generally accept a taxpayer's characterization of two or more undertakings as separate activities unless the characterization is artificial or unreasonable. The Tax Court did not think the characterization was artificial or unreasonable. Petitioner was regularly and extensively involved in the provision of caregiving services. The caregiving services were substantially different from the provision of medical marijuana.

The Tax Court also noted that: The executive director testified credibly and without contradiction that the primary purpose was to provide caregiving services for terminally ill patients; a taxpayer can carry on more than one trade or business at the same time; the mere fact that an expenditure bears a remote relation to an illegal act does not make such an expenditure non-deductible; IRS counsel's assertion that petitioner's only income was from marijuana-related matters except for a couple of small donations was not supported by fact. The fact that a member had access to all of CHAMP's goods and services without further charge or explicit differentiation as to the portion of the fee that was paid for the goods versus services did not establish that CHAMP's operations were simply one trade or business.

How did the Tax Court apportion petitioner's overall expenses to account for the separate trades or businesses? The Tax Court noted that the record, while not offering a perfect allocation, permitted the Tax Court with ''sufficient confidence'' to allocate the expenses, based upon the number of employees and the portion of its facilities devoted to each business. The Tax Court allocated 18/25 of the expenses (18 of the 25 employees did not work directly in petitioner's provision of medical marijuana) to caregiving services expenses of salaries, wages, payroll taxes, employee benefits, employee development training, meals and entertainment, and parking and tolls. The Tax Court also allowed deductions for expenses incurred in renting facilities at the church because the church was not used to provide medical marijuana. The Tax Court also allowed CHAMP to deduct all truck and auto expenses, and laundry and cleaning expenses.

The Tax Court held that CHAMP could also deduct 9/10 of its remaining expenses (90% of the square footage of the main facility not used in provision of medical marijuana).[68] Finally, the Tax Court noted that IRS counsel conceded the costs of the medical marijuana business of $203,661 in labor and $43,783 in other costs were properly reported on the return as COGS.[69]

Although CHAMP might serve as a model for cannabis business owners, most cannot provide successful challenges to §280E due to poor business operations, including poor recordkeeping, operating only one trade or business, or failing to allocate specific locations or employees for providing cannabis to medical patients.

Olive v. Commissioner

Although taxpayers are required to maintain sufficient records to determine their correct tax liability,[70] many either keep incomplete or incoherent records, or none at all. One example of poor recordkeeping is reflected in *Olive v. Commissioner*.[71] In *Olive,* the taxpayer operated an establishment known as the ''Vapor Room'' so that its patrons, almost all of whom were seriously ill Californians, could socialize and purchase and consume medical marijuana there. The petitioner designed the Vapor Room with a comfortable lounge-like, community center atmosphere, placing couches, chairs, and tables throughout the premises. He placed vaporizers, games, books, and art supplies on the premises for patrons to use at their desire.

Neither the staff members nor the other patrons paid petitioner a stated fee to frequent the Vapor Room. Nor did petitioner require that any patron purchase medical marijuana from him to frequent the Vapor Room or to take part in its activities or services. Patrons had access to all of the activities and services that the Vapor Room provided and marijuana was routinely passed throughout the room for consumption without cost to patrons who wanted to partake.

The Vapor Room's sole source of revenue was its sale of medical marijuana. Patrons did not specifically

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[67] *Id.* Whether an activity is a separate trade or business is a question of fact. It depends on: The degree of economic interrelationship between the two undertakings; the business purpose served by carrying on the undertakings separately or together; the similarity of the undertakings. *See* Reg. §1.183-1(d)(1); *Schlafer v. Commissioner*, T.C. Memo. 1990-66. *See also Tobin v. Commissioner*, T.C. Memo. 1999-328; *Trupp v. Commissioner*, T.C. Memo. 2012-108 (April 12, 2012).

[68] The Tax Court was silent about the storage unit rental, but this presumably includes such expenses.

[69] *Id.* The author notes that IRS counsel never challenged the accuracy of these costs!

[70] §6001.

[71] 139 T.C. 19, *aff'd* 792 F. 3rd 1146 (9th Cir. 2015).

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pay for anything else connected with or offered by the Vapor Room. Petitioner purchased for cash (or sometimes received for free) the Vapor Room's medical marijuana inventory from suppliers.

Petitioner sold to the patrons for cash 93.5% of the marijuana that he received and he gave the rest to patrons (including himself and the other staff members) for free. Staff members would explain to patrons the attributes and effects of the different types of medical marijuana in the Vapor Room's inventory. Petitioner set each patron's cost for the medical marijuana according to the quantity desired, the quality of the marijuana, and the amount petitioner decided the patron should pay. Petitioner sometimes gave patrons medical marijuana for free. Petitioner and the other staff members occasionally sampled the medical marijuana inventory for free and they would regularly ''hang out'' at the Vapor Room after business hours and consume marijuana. Staff members and other patrons sometimes consumed medical marijuana together.

Petitioner provided regular activities at the Vapor Room, such as yoga classes, chess and other board games, and movies (with complimentary popcorn and drinks). Patrons sometimes consumed medical marijuana while participating in these activities. The Vapor Room regularly offered chair massages with a therapist. Patrons sometimes consumed medical marijuana before or after a massage. Patrons, while at the Vapor Room, regularly drank complimentary tea or water and they occasionally ate complimentary snacks or light food such as pizza and sandwiches.

Olive appeared to operate its cannabis business at the opposite extreme of that in *CHAMP*. Olive was not forthcoming about his prices. He did not provide any formula for determining a price or whether a discount price had a set floor such as the Vapor Room's cost. Petitioner regularly took cash from the cash register to use personally, including to pay for personal trips. He coded these withdrawals in the recording books so that the Vapor Room's employees would not know the amount of money he was taking from the business.

Olive used ledgers to support his income/deductions. The ledgers show categories of cash received and expenditures but could be self-serving and unreliable, the Tax Court said. The credible evidence in the record failed to establish when the ledgers were prepared.

Olive claimed that the ledgers alone were sufficient substantiation for taxpayers operating in the medical marijuana industry. The Tax Court, in rejecting Olive's arguments, held that the ledgers standing alone were not sufficient substantiation. The ledgers did not specifically identify the marijuana vendors or reflect any marijuana that was received or given away. The ledgers neither were independently prepared nor bore sufficient indicia of reliability or trustworthiness.

Although the Tax Court declined to rely on the COGS entries stated in Olive's ledgers, noting that Olive transacted business in cash and did not have supporting documentation, the Tax Court was able to ascertain the Vapor Room's COGS on the basis of the record. An expert CPA for Olive testified that average COGS for his clients was 75.16%. The Tax Court noted that Olive gave away some of the inventory for free and parties disputed whether Vapor Room's cost of that portion of the medical marijuana was includable in the Vapor Room's COGS. The Tax Court said no and determined that Olive gave away 6.5% of inventory. Therefore, COGS for 2004 and 2005 was the Annual Amount x 75.16% x 93.5%.

Olive argued that he should be permitted to deduct all of the Vapor Room's expenses attributable to the Vapor Room's caregiving business. He claimed that he trafficked marijuana only during the short time it took for the staff members to pass the medical marijuana to the patrons in exchange for payment and that the rest of the Vapor Room's business was providing caregiving services.[72] The Tax Court rejected Olive's argument, stating that he conducted a single business known as the dispensing of medical cannabis. All services and activities provided by Olive pertained to that business.

The Tax Court noted that the differences between CHAMP and Olive's operations are ''almost too numerous to list.'' Olive incorrectly surmised that a medical cannabis dispensary that permits consumption on its premises is a caregiver if the dispensary also provides customers with incidental activities, consultation, or advice.

In determining whether Olive conducted two separate lines of business, the Tax Court looked to all facts and circumstances, as well as the degree of the economic interrelationship between the two activities. The Tax Court stated that the IRS usually will accept a taxpayer's characterization of several undertakings either as a single activity or as separate activities. The IRS will reject the characterization if it is artificial and cannot be reasonably supported under the facts and circumstances of the case.

The Tax Court determined that under the facts and circumstances, the Vapor Room's dispensing of medical cannabis and its providing of services and activities shared a ''close and inseparable organizational and economic relationship.'' Therefore they were one and the same business. Olive formed and operated the Vapor Room to sell medical cannabis to the patrons

[72] Olive tried to compare his alleged caregiving business to the caregiving business provided by CHAMP.

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and to advise them on what he considered to be the best cannabis to consume and the best way to consume it. Olive provided the additional services and activities incident to, and as part of, the Vapor Room's dispensing of medical cannabis.

The Tax Court detailed the many reasons why Olive operated as a single business: Olive and the Vapor Room's employees were already in the room helping the patrons receive and consume medical cannabis; the entire site of the Vapor Room was used for that purpose; the record did not establish that the Vapor Room paid any additional wages or rent to provide the incidental services and activities; the Vapor Room did not make any other significant payment to provide the incidental activities or services; Olive oversaw all aspects of the Vapor Room's operations; Olive had a single bookkeeper and a single independent accountant for its business; the Vapor Room's expenses to dispense medical cannabis allowed it to fulfill its business purpose of selling medical cannabis, that in turn allowed the Vapor Room to offer its incidental services and activities in support of that purpose; the Vapor Room's only revenue was from patrons' purchase of cannabis.[73]

On appeal, Olive argued that Congress only intended §280E to be directed at businesses engaged exclusively in ''drug trafficking,'' and not at those whose activities merely include drug trafficking.[74] Olive also argued that the IRS could not defend the appeal, given Congress's decision in 2015 not to appropriate funds for raids or arrests for medical cannabis-related conduct. A three-judge panel rejected both arguments and affirmed the Tax Court decision.

Comparison of *CHAMP* and *Olive*

How can one compare cases such as *CHAMP* and *Olive* that are on opposite ends of the cannabis business spectrum? The differences start with the name. CHAMP's name stresses the dispensary's caregiving mission. The Vapor Room stresses the sale and consumption (through vaporization) of cannabis.[75]

Olive is not a caregiver just because his company provided individuals with incidental activities, consultation, or advice. A business that sells goods does not necessarily consist simply of passing out those goods. Olive provided the additional services incidental to and as part of the dispensing of medical marijuana. Olive even helped his customers receive and consume it. He also did not pay any additional wages or rent to provide these incidental services. The employees performed various tasks but did not have any particular titles or stated duties. The company also had a single bookkeeper and accountant.[76] Moreover, the company would not have had any revenue if none of the patrons purchased medical cannabis.

The Tax Court did not apply any of the *Trupp/Tobin* factors in *CHAMP*.[77] A question may arise as to how the Tax Court would have decided *CHAMP* using such factors.

The first factor is whether the undertakings are conducted at the same place. CHAMP furnished its services at its main facility in San Francisco, and at an office in a community church in San Francisco. CHAMP also maintained a storage unit for medical records at a third location in San Francisco. The medical cannabis was dispensed at a counter in the main room of the facility, taking up approximately 10% of the main facility.

The second factor is whether the undertakings were part of a taxpayer's efforts to find sources of revenue from his or her land. CHAMP rented its facilities and used such facilities to conduct its business.

The third factor is whether the undertakings were formed as separate activities. CHAMP provided counseling and other caregiving services to its members, who were individuals with debilitating diseases. The Tax Court did not think the characterization was artificial or unreasonable. CHAMP was regularly and extensively involved in the provision of caregiving services. The caregiving services were substantially different from the provision of medical marijuana. The mere fact that an expenditure bears a remote relation to an illegal act does not make such an expenditure non-deductible. CHAMP's membership fees paid for both caregiving and medical cannabis. Management set the fee for both services. Their caregiving services were extensive.

The fourth factor is whether one undertaking benefited from the other. For CHAMP, there was no direct benefit between the undertakings. One who received caregiving services did not necessarily require a prescription for medical cannabis.

The fifth factor is whether the taxpayer used one undertaking to advertise the other. This did not happen in *CHAMP*. CHAMP notified its members that the membership fee covered both of these costs and did not charge an additional fee. Members received a set

[73] The Tax Court stated, ''The Vapor Room would not have had any revenues at all (and could not have operated) if none of the patrons had purchased marijuana from petitioner. The Vapor Room did not spawn a second business simply by occasionally providing the patrons with snacks, a massage, or a movie, or allowing the patrons to play games in the room and to talk there to each other.''

[74] *Olive v. Commissioner,* 72 F.3rd 1146 (9th Cir. 2015).

[75] The author opines that it may not be a good idea to name your business ''Toking on us,'' or ''To Toke or not to Toke.''

[76] CHAMP also had only one bookkeeper and accountant.

[77] *See Tobin v. Commissioner*, T.C. Memo. 1999-328; *Trupp v. Commissioner*, T.C. Memo. 2012-108 (April 12, 2012).

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amount of medical marijuana and were not entitled to unlimited supplies.

The sixth factor is the degree to which the undertakings shared management. The CEO for CHAMP was not involved in the medical cannabis aspect of the business.

The seventh factor is the degree to which one caretaker oversaw the assets of both undertakings. CHAMP had separate employees for medical cannabis.

The eighth factor is whether the taxpayers used the same accountant for the undertakings. CHAMP used only one accountant.

The final factor is the degree to which the undertakings shared books and records. This is unknown, but CHAMP controlled which employees performed medical cannabis services, as well as the location of the dispensary and the uses of the dispensary. CHAMP also ''categorized'' jobs. The Tax Court noted that the record, while not offering a perfect allocation, permitted the Tax Court with ''sufficient confidence'' to allocate the expenses, based upon the number of employees and the portion of its facilities devoted to each business.

Alterman v. Commissioner

Another example of poor recordkeeping occurred in the *Alterman* case.[78] Laurel Alterman and William A. Gibson (collectively known as ''Alterman'') filed joint income tax returns for 2010 and 2011. On March 13, 2014, the IRS issued a notice of deficiency to Alterman. The notice of deficiency made adjustments to the income of a Colorado medical-marijuana business owned by Alterman, including Schedule C deductions.

Alterman, acting lawfully under Colorado law, opened up a medical cannabis retail store under the business name of ''Altermeds.'' The dispensary sold smokable cannabis, either as pre-rolled marijuana cigarettes (i.e., joints) or as dried marijuana buds. It also sold marijuana in edible form, such as brownies and cakes, and orally-consumed tinctures.

During 2010 and 2011, the dispensary also sold products that contained no cannabis, such as pipes, papers, and other items used to consume cannabis (non-cannabis merchandise). Altermeds acquired these items from third-party sellers. Alterman shared the management responsibilities for the dispensary with her son. Alterman was responsible recordkeeping and finances, such as making bank deposits, paying for merchandise, and paying expenses. Altermeds, LLC purchased cannabis merchandise from third-party sellers.

[78] *Alterman v. Commissioner*, T.C. Memo 2018-83.

Neither Altermeds, LLC employees nor Alterman recorded the hours worked by particular employees at the grow site versus the dispensary. Given the lack of information in the record, the Tax Court could not determine what part of the payments treated by Altermeds, LLC as employee wages was paid for work performed at the grow site versus the dispensary. The record did not reveal whether the receipts for purchases of merchandise given by Alterman to the IRS were receipts for non-cannabis merchandise or cannabis merchandise, or both.

Alterman provided a general ledger for the purchase of cannabis and non-cannabis products. Purchases were categorized as either: Smokable, for cannabis buds and pre-rolled joints; edible, for food items, tinctures, and other infused items; non-cannabis, for papers and other paraphernalia; and a fourth grouping mysteriously labeled ''Meds-C'' (undefined merchandise). It was unclear as to whether these amounts were aggregated. The general ledger did not reflect the dollar amount of each particular transaction. According to the gross receipts in the 2010 general ledger, Altermeds, LLC derived 86.5% of its gross receipts from cannabis, 8.6 % from edible merchandise, 1.4% from non-cannabis, and 3.6% from the undefined items. Alterman purchased some edible cannabis using cash from unknown sources. Alterman also used a Visa card to pay expenses.[79]

Alterman documented the physical inventory, but did not show how such costs were assigned to particular units (i.e. cannabis or non-cannabis items).

Alterman conceded that the company trafficked in controlled substances but also contended that the company had a separate line of business of selling non-cannabis merchandise. The Tax Court, in rejecting Alterman's separate line of business argument, noted that the company derived all of its revenue from cannabis merchandise and the non-cannabis products that complemented the cannabis merchandise such as pipes and other cannabis paraphernalia. The Court held that under such circumstances, Alterman had only one unitary business – selling cannabis.[80]

Besides cannabis paraphernalia, Alterman testified that the dispensary also sold hats and T-shirts with the name and business logo of Altermeds, LLC, magazines about marijuana, and chicken soup. No documentary evidence corroborated the existence or extent of these sales, however. On a preponderance of evidence, the Tax Court found that no such items were sold. Furthermore, these types of products as de-

[79] Alterman provide incomplete statements to the IRS. The Tax Court noted that it was likely that Alterman's CPAs aggregated into single sums and transferred to the general ledger.

[80] *Id. citing Canna Care, Inc. v. Commissioner*, T.C. Memo 2015-206 at 12, *aff'd* 694 F. App'x 570 (9th Cir. 2017).

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scribed by Alterman would generally complement the sales of marijuana by the dispensary. Such items bore the name and business logo of Altermeds. Selling those items would have helped advertise medical cannabis.

Alterman tried to assert the *Cohan* rule with COGS, but there was nothing in the record to enable the Tax Court to even try (no reasonable basis or an industry average) to estimate COGS.[81] Alterman did not even attempt to assert the *Cohan* rule regarding the alleged second business. Furthermore, Alterman, having failed to properly brief their entitlement to deductions for business expenses they claim relate to Altermeds, LLC's putative second business, also failed to properly brief their entitlement to deductions for any other business expenses of Altermeds, LLC. They did not even allege the amounts of such deductions, much less any specific payments, provide record citations, or propose findings of fact. Therefore Alterman was not entitled to any business-expense deductions for Altermeds, LLC. The Tax Court held that Alterman could use only the IRS conceded amounts for COGS ($452,292 for 2010 and $232,772 for 2011).

Alterman met a worse outcome than the taxpayer in *Olive*.[82] Olive estimated COGS by multiplying gross receipts by a comparative ratio of gross receipts to COGS determined ratio from testimony of two expert witnesses.[83] Alterman tried to call an expert to testify but the Tax Court ruled the testimony to be inadmissible.

The Tax Court assessed accuracy-related penalties against Alterman. The Tax Court noted that Alterman never asked advisors about whether businesses that sell medical cannabis in violation of federal law would be taxed differently than other businesses. This lack of inquiry evidenced a lack of interest in complying with federal tax laws.

Patients Mut. Assistance Collective Corp v. Commissioner (Harborside)

The *Harborside* case presents an intriguing challenge on the language contained in §280E, as well as the interplay between DOJ and the IRS.[84] Harborside is known as one of the largest medical dispensaries in California.[85] At all relevant times Harborside operated out of an approximately 7,500 square foot space that had a reception area, healing room, purchasing office, processing room, clone room, and multipurpose room. The facility also had a large sales floor, offices, storage areas, restrooms, and a break room with a kitchen. Harborside's business included the sale of cannabis, along with the sale of non-controlled substances (apparel, books, papers, glassware, etc.), a variety of wellness services, and the Harborside Brand.

Harborside sold a variety of products, divided into small groups (clones, marijuana flowers, cannabis-containing products and non-cannabis containing products).[86] Harborside bought clones from clone nurseries, cared for them while they were in its store, repackaged them, and then sold them to patients. They dedicated a portion of the floor space to clone sales. Harborside during the years in question had at least four employees who spent their time entirely in the purchase and sale of clones. Harborside purchased all of its marijuana flowers or buds from patient-growers. Some of these growers even promised to sell what they cultivated back to Harborside.

Harborside's cannabis-containing products included edibles, beverages, extracts, concentrates, oils, topicals, and tinctures—cannabis-infused alcohol, vinegar, or glycerin. Harborside bought these items from other collectives, tested them, repackaged them if they came in bulk or needed child-proof packaging, relabeled them, and then sold them to its own patients. Harborside's human resources director estimated that Harborside employees spent 55-60% of their time of buying and processing cannabis and 25-30% of their time selling it.

Harborside's branded gear included hats, shirts, pins, socks, and hemp bags, as well as other products such as dabbing equipment (heating products that contain cannabis so as to create an intoxicating vapor), rolling paper, and lighters.

Harborside was a C corporation for federal tax purposes, but to comply with California's non-profit re-

[81] Under the rule in *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930), the court can estimate the amount of deductible expenses if there is a reasonable basis for making such an estimate.

[82] The worst outcome so far involving Cannabis COGS Calamities may be the case of *Beck v. Commissioner,* T.C. Memo 2015-149. Jason Beck's "Health Care" business tried to include DEA-seized cannabis worth $600,000 in Beck's COGS. The Tax Court denied the inclusion of the seized and confiscated cannabis in COGS, denied a §165 loss deduction, and upheld penalties because Beck did not keep complete records and intentionally destroyed some records. Beck owed more than $1.2 million in tax and penalties, which was higher than the tax stated in the Statutory Notice of Deficiency.

[83] Alterman argued that the IRS did not comply with the supervisory-approval requirement because the revenue agent did not allow petitioners enough time to fully present a reasonable-cause defense to the accuracy-related penalty before he submitted their case to his supervisor. Section 6751(b)(1) requires only that the penalty be "personally approved (in writing) by the immediate supervisor," and does not require the supervisor to follow specific procedures in determining whether to approve the penalty.

[84] *Patients Mut. Assistance Collective Corp. v. Commissioner (Harborside)*, 151 T.C. No. 11 (Nov. 29, 2018).

[85] Harborside opened in 2006 and had over 100,000 patient visits per year at the time the opinion was issued.

[86] Clones are cutting from a female cannabis plant that can be transplanted and used to cultivate cannabis.

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quirement, its bylaws prohibited it from paying dividends or selling equity, and required it to use any excess revenue for the benefit of its patients or the community.[87]

Harborside provided additional services at no additional costs. The company told patients that part of the purchase price for cannabis was used to pay for patient services and community outreach. Some of the services included therapeutic sessions such as reiki, acupuncture, chiropractic sessions, yoga, and tai chi.

In July 2012, the federal government filed a civil forfeiture action against Harborside in the U.S. District Court for the Northern District of California. The lawsuit alleged that the property that Harborside rented and where it operated its business was subject to forfeiture because it was used to commit the distribution, cultivation, and possession of marijuana in violation of 21 U.S.C. §841(a) and §856.[88] The district court dismissed the action with prejudice in May 2016 by stipulation of the parties.[89]

Harborside also argued that it could not be subject to §280E because of the doctrine of res judicata (claim preclusion). The dismissal of the 2012 forfeiture action with prejudice meant that Harborside is not considered to have engaged in drug trafficking and therefore cannot be subject to §280E.

The concept of res judicata is defined as follows: When a court of competent jurisdiction has entered a final judgment on the merits of a cause of action, the parties to the suit and their privies are thereafter bound ''not only as to every matter which was offered and received to sustain or defeat the claim or demand, but as to any other admissible matter which might have been offered for that purpose.''

Harborside would therefore have to show the following: An identity of claims between the actions; privity between the parties in the actions; and a final judgment on the merits in the civil-forfeiture action. The Tax Court held that the government's dismissal with prejudice of a civil forfeiture action against Harborside does not bar a tax deficiency determination by the IRS. The tax matter and the civil forfeiture shared some of the same elements, but it was not the same scenario as comparing civil and criminal forfeiture (different paths to the same goal).

Harborside argued that §280E applied to businesses that exclusively or solely engage in trafficking controlled substances. The Tax Court rejected that argument, however. The Tax Court, in commending Harborside for its excellent secondary sources used to define the word ''consist'' and recognizing its different interpretations, nevertheless noted that canons of construction preferred textual readings that would not render the statute to be ineffective. The Tax Court stated that if it interpreted §280E employing the most common usage of ''consists,'' it would render the statute ineffective. The Tax Court used an example of a street-level dealer circumventing the statute by selling a single item that was not a controlled substance.

The Tax Court noted that Harborside presented a subtle argument about the play between literal meaning and statutory purpose. Harborside argued[90] that dispensaries that are legal under state law didn't exist in 1982 and Congress even today ''won't let the DOJ prosecute them as if they were street-corner drug dealers.''[91]

The Tax Court, in rejecting Harborside's argument, stated that ''although section 280E predates states' legalization of medical cannabis '[t]hat Congress might not have imagined what some states would do in future years has no bearing on our analysis' '' (citation omitted). The Tax Court noted that it is common for statutes to apply to new situations, and the application of §280 is clear. The restriction on how DOJ used funds is irrelevant here because the government is enforcing only a tax, not preventing one from using, dis-

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[87] The IRS has determined that a marijuana dispensary generally cannot qualify as a tax-exempt organization under §501(c)(3) because it is engaged in what federal law regards as a criminal enterprise and thus is not operated exclusively for charitable purposes. Rev. Rul. 75-384; *see also* PLR 201224036. California laws decriminalizing medical marijuana specifically stated that they did not ''authorize any individual or group to cultivate or distribute cannabis for profit.'' Cal. Health & Safety Code §11362.765(a) (West 2007).

[88] 21 U.S.C. §841(a)(1) states that ''it shall be unlawful for any person knowingly or intentionally. . .to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance.'' 21 U.S.C. §856(a)(1) states that it shall be unlawful to ''knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance.''

[89] This also caught the attention of the IRS. Harborside is a C corporation for federal tax purposes with tax years ending July 31. It filed Forms 1120, U.S. Corporation Income Tax Return, for 2007 to 2012 and later amended its 2007, 2008, and 2009 returns. These returns were selected for audits that led to the issuance of three notices of deficiency—one for 2007 and 2008, one for 2009 and 2010, and one for 2011 and 2012. The notices denied most of Harborside's claimed deductions and costs of goods sold, and asserted tens of millions in deficiencies and accuracy-related penalties. The Supremacy Clause has not stifled the spread of state attempts at legalizing what remained illegal under federal law. Congress had complicated the situation by enacting a series of appropriations riders that prevent the DOJ from using any funds to prevent states that permit medical-cannabis use from implementing their own laws. *United States v. McIntosh*, 833 F.3d 1163, 1177-78 (9th Cir. 2016).

[90] *See also Olive*, 792 F.3d at 1150-51.

[91] *See also* Consolidated Appropriations Act, 2017, §537; Consolidated Appropriations Act, 2016, §542; Consolidated and Further Continuing Appropriations Act, 2015, §538; *McIntosh*, 833 F.3d at 1177.

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tributing, processing, or cultivating cannabis in California. ''Enforcing these laws might make it more costly to run a dispensary, but it does not change whether these activities are **authorized** in the state,'' the Tax Court said. Section 280 only prevents Harborside from deducting these expenses.

Harborside also argued that the language of §280E that stated ''carrying on any trade or business. . .that consists of trafficking in controlled substances. . .'' does not apply to the sale of articles and the offering of services. The Tax Court, in rejecting Harborside's separate line of business argument, held that selling cannabis and products containing cannabis was Harborside's primary purpose. Sixty percent of the members that Harborside's security checked in were there to buy cannabis in one form or another. Cannabis and cannabis products took up around 75% of Harborside's sales floor. Harborside's employees spent 80-90% of their time purchasing, processing, and selling these products, and those sales generated at least 98.7% of Harborside's revenue during each of the years at issue.

Harborside tried to argue that because an activity needs a profit motive to be a separate trade or business, a portion of each marijuana sale was actually a purchase of its free holistic services. Harborside compared its operations to that in *CHAMP*, stating that CHAMP members paid a set fee for unlimited access to extensive services and also received a fixed amount of marijuana—the services' price wasn't ''bundled'' into the amount paid for marijuana. Also, the services in CHAMP were the taxpayer's primary purpose, took up most of its employees' time, and used almost all of its three facilities. Harborside operated its dispensary more like in *Olive*—the Harborside patrons paid according to the amount and type of marijuana they wanted and in return gained access to incidental services. Harborside claimed it offered many more services than Olive but services were still incidental.[92]

Harborside finally argued that its brand-development activity was a separate trade or business. Harborside insisted it was a trade or business eligible for §162 deductions because from the outset, it performed them with an independent profit motive. To show a profit motive without any revenue, Harborside said its branding activities were part of a ''unified business enterprise'' with its activities that did make money during the years at issue.[93] The Tax Court, in rejecting Harborside's argument, stated that there was no actual evidence to suggest that Harborside's brand development was in any way a separate trade or business.[94]

The Tax Court held that Harborside was engaged in only one trade or business, which was trafficking a controlled substance. Therefore, §280E prevented Harborside from deducting ordinary and necessary business expenses. Harborside must also adjust for COGS according to §471 regulations for re-sellers, the Tax Court said.[95]

Harborside tried to use the *Anderson* case to limit its tax liability to the amount realized on sale minus basis. The Tax Court rejected this argument.[96]

Harborside also claimed that it acted as producer and that it could include in COGS its indirect inventory price and transportation costs. The Tax Court, in evaluating Harborside's claim, stated that it needed to determine the meaning of ''produce.'' The Tax Court looked to *Suzy's Zoo*, a §263A case for guidance.[97] In *Suzy's Zoo*, the taxpayer, a greeting-card company, designed images and sent them to a contract printer who did color separations, made proofs, and printed them using its own materials. A trucking company then picked up the prints and took them to a finisher. The finisher cut and folded the prints into greeting cards and returned them to the taxpayer. The printer and finisher each bore the risk of loss while they had the materials. The Tax Court held, and the Ninth Circuit affirmed, that the taxpayer was a producer because it re-

[92] *Id.*

[93] The Tax Court stated that a separate entity purposely operating at a loss is still a trade or business eligible for deductions if it and entities related to it together form a unified business enterprise that itself has a profit motive. *See Campbell v. Commissioner*, 868 F.2d 833, 836-37 (6th Cir. 1989)(partnership leasing airplane to sister corporation at loss had profit motive because common owners benefited), *aff'g in part, rev'g in part* T.C. Memo. 1986-569; *Kuhn v. Commissioner*, T.C. Memo. 1992-460 (partnership's below-market lease of land to sister corporation had profit motive because corporation benefited); *Morton v. United States*, 98 Fed. Cl. 596 (Fed. Cl. 2011)(S corporation that owned airplane was part of unified business enterprise with shareholder's other businesses and therefore had a profit motive).

[94] The Tax Court reviewed the unified business-enterprise doctrine Harborside relied on and stated that separate but related entities can share a single profit motive; the doctrine did not say that a single entity's unprofitable activities are a separate trade or business. The unified business-enterprise doctrine suggested that the branding was part of a single overall trade or business.

[95] The Tax Court also noted that no court had ever ruled §471 to be unconstitutional.

[96] Anderson used a statute to deny a COG adjustment for part of its direct cost to purchasing inventory. Anderson paid more for inventory than since repealed federal price controls allowed and the IRS tried to limit its COGS to the highest legal price. The Tax Court stated that *Anderson* held that taxpayers can adjust for COGS whether or not direct costs are legal. This was nothing new. The issue with Harborside was denying it the right to capitalize indirect costs under §263A.

[97] *Suzy's Zoo v. Commissioner*, 273 F. 3d 875 (9th Cir. 2001) *aff'g* 114 T.C. 1 (2000) (Case not about §471 but §263A(g)(1) definition of ''produce'').

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tained title to the items throughout the contract-production process.[98]

The Tax Court noted that in *Suzy's Zoo*, the taxpayer acquired ownership when it first designed the characters because that was the most important step and the one that required the most skill and expertise. Contractors could not sell copy or use these characters without breaching Suzy Zoo's license. In contrast, Harborside neither created the clones nor maintained tight control over them. Harborside bought clones from nurseries, and either sold them to growers with no strings attached or gave clones to growers expecting that they would sell them back to Harborside. There were no controls in place to ensure that the grower would sell back to the collective.

The Tax Court held in a subsequent opinion that Harborside acted with reasonable cause and was not liable for penalties.[99] The Tax Court pointed out that there was very limited guidance regarding compliance with the tax laws available to cannabis dispensaries. The IRS has never promulgated regulations for §280E and did not issue any guidance on cannabis businesses' capitalization of inventory costs until 2015.

The Tax Court held that Harborside's reporting position was reasonable. Not only had its main argument for the inapplicability of §280E to its business not yet been the subject of a final unappealable decision, but the meaning of ''consists of'' as used in §280E was subject to more than one reasonable interpretation. Also in 2012, *Olive* was still years away from a final appellate decision.

Although Harborside wasn't primarily a caregiver like the taxpayer in *CHAMP*, its non-drug trafficking activities were less negligible than those in *Olive*. The Tax Court sustained a portion of the accuracy-related penalty in *Olive* because the taxpayer did not keep good books and records.[100] The Tax Court also believed that testimony of Steve DeAngelo, Harborside's co-founder and boss, that he actively sought to comply with California law and existing case law. Therefore, the Tax Court held that Harborside acted with reasonable cause and acted in good faith when taking tax positions for the years at issue and Harborside was not liable for the penalties.[101]

Constitutional Attacks on §280E

Cannabis business owners that have argued that Congress's enactment of §280E is unconstitutional have been unsuccessful. Among the alleged constitutional violations are: Fifth Amendment (self-incrimination);[102] Fifth Amendment (double jeopardy);[103] Eighth Amendment;[104] Tenth Amendment;[105] Sixteenth Amendment;[106] and the Commerce Clause.[107]

In *High Desert Relief*, the taxpayer, in response to a summons for bank records, department of health records, and utility company records, alleged that the IRS used §280 as a ''wedge'' to obtain information that would be used in criminal prosecution for sale and distribution of dangerous and controlled substances.[108] The U.S. District Court for the District of New Mexico, in reviewing the validity of the IRS summons, employed the *Powell* Test.[109] The district court upheld the summons, based on the affidavit of the revenue agent, that the IRS had a legitimate purpose, the inquiry was relevant to the purpose, the information was not already in IRS's possession, the IRS followed proper administrative procedure, and there was no DOJ referral.

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[98] The Ninth Circuit emphasized the degree of control.

[99] *Patients Mut. Assistance Collective Corp. v. Commissioner*, T.C. Memo 2018-208.

[100] The Tax Court noted that one of Harborside's strength's was keeping good books and records.

[101] The Tax Court noted that it previously declined to impose accuracy-related penalties when there was no clear authority to guide taxpayers. *Petersen v. Commissioner*, 148 T.C. 463, 481 (2017); *Williams v. Commissioner*, 123 T.C. 144, 153 (2004); *See also Foster v. Commissioner*, 756 F. 2d 1430, 1439 (9th Cir. 1985) *aff'g in part, vac'g in part* 80 T.C. 34 (1983).

[102] *High Desert Relief, Inc. v. United States*, No. 16-CV-469 MCA/SCY, 2017 BL 108288 (D. N. M. Mar. 31, 2017). *See also United States v. Oakland Cannabis Buyers' Coop.*, 532 U.S. 483 (2001) (no medical necessity defense to alleged violations of the CSA).

[103] *Dept. of Revenue of Montana v. Kurth Ranch*, 511 U.S. 767, 783 (1994) (The Supreme Court invalidated Montana's Dangerous Drug Tax because its imposition subsequent to the plaintiffs' guilty plea of cannabis possession violated the plaintiffs' Fifth Amendment protection from double jeopardy).

[104] *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187 (10th Cir. 2018) (excessive fines); *The Green Sol. Retail, Inc. v. United States*, 855 F.3d 1111 (10th Cir. 2017) (request to cease audit).

[105] *United States v. McIntosh*, 833 F.3d 1163, 1177-78 (9th Cir. 2016). Even though federal law supersedes state law in the event of a conflict, the federal government does not have the authority to dictate state law. *See also Safe Streets v. Hickenlooper*, 859 F.3d 865 (10th Cir. 2017) (CSA §903 does not permit injunctive relief to stop Colorado from issuing licenses permitting citizens the right to grow cannabis under Colorado Amendment 64. However, private plaintiffs do not have any substantive rights under such provision and cannot enforce it).

[106] *Patients Mut. Assistance Collective Corp. v. Commissioner (Harborside)*, T.C. Memo 2018-208.

[107] *Gonzales v. Raich (previously Ashcroft v. Raich),* 545 U.S. 1 (2005). (The Supreme Court ruled that under the Commerce Clause of the Constitution, Congress may criminalize the production and use of homegrown cannabis even if state law allows its use for medicinal purposes).

[108] *High Desert Relief, Inc. v. United States*, No. 16-CV-469 MCA/SCY, 2017 BL 108288 (D. N. M. Mar. 31, 2017)

[109] *United States v. Powell*, 379 U.S. 48 (1964) (the *Powell* Test provides a very low threshold to show the validity of a summons).

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The district court also noted the following: The IRS can apply §280E without conducting a criminal investigation; the IRS criminal investigator did not waive any sovereign immunity in connection with investigation; the IRS must provide notice to the taxpayer about contacting third parties in connection with determining tax liability;[110] just because New Mexico law says it is acceptable does not mean that the IRS cannot apply §280E — there is no exception in this Code provision for the lack of enforcement of the CSA by state or federal authorities; the current Deputy Attorney General could displace any memoranda of non-enforcement at any time; the IRS had not even referred the matter to DOJ.

The Fifth Amendment does not protect the recipient from prosecution for the willful refusal to make a return.[111] Requiring a person to declare income on a federal income tax return does not violate an individual's right to remain silent. If disclosures are privileged then the taxpayer should assert the privilege in the return. The Fifth Amendment privilege may apply to allow a person from revealing the source of the income.[112]

Alleged Eighth Amendment violations focus on whether §280E amounts to an excessive fine or penalty proscribed by the Amendment and that applying it would drive a cannabis business owner out of business.[113] Alternatively, the Eighth Amendment argument focuses on whether the Constitution forbids a taxpayer from including ordinary and necessary business expenses in gross income.[114]

In *Alpenglow*, the taxpayer, a medical cannabis dispensary licensed under Colorado law, challenged the IRS's application under §280E.[115] As in *Canna Care*, Alpenglow argued that §280E amounted to an excessive fine or penalty proscribed by the Eighth Amendment and that applying it would drive it (and ''all of Colorado's legalized marijuana industry'') out of business. The U.S. District Court for the District of Colorado noted that Alpenglow had already paid the tax liability in full and yet remained in business, but nevertheless declined to decide the Eighth Amendment question because it was not pleaded in the operative complaint.[116] The district court also rejected Alpenglow's argument that the Constitution forbids including ordinary and necessary business expenses in gross income.

Alpenglow appealed to the Tenth Circuit. The Tenth Circuit affirmed the district court's dismissal of Alpenglow's lawsuit, as well as the denial of Alpenglow's Motion to Alter or Amend the Judgment.

On appeal, Alpenglow presented three arguments: The IRS does not have the authority to disallow deductions under §280E without a criminal conviction; §280E violates the Sixteenth Amendment's definition of gross income; §280E is an excessive fine that violates the Eighth Amendment. Alpenglow did not raise a Fifth Amendment challenge on appeal.

The Tenth Circuit held that it is within the IRS's statutory authority to determine whether a taxpayer has trafficked in controlled substances. Therefore, the IRS did not exceed its authority in denying Alpenglow's business deductions under §280E. In rejecting Alpenglow's Eighth Amendment claim, the appeals court noted that its recent decision in *Green Solution* ''foreclosed'' this argument.

In *Green Solutions*, the Tenth Circuit held that §280E is not a penalty because the disallowance of a deduction ''is not an exaction imposed as a punishment.''[117] The Tenth Circuit noted that deductions were not a matter of right. The appeals court also noted that one could not assert any equitable arguments to obtain a deduction. The Tenth Circuit held that Alpenglow failed to state a claim entitling it to relief because §280E does not violate the Eighth or Sixteenth Amendments, and the IRS did not exceed its statutory authority in applying it to deny Alpenglow's business deductions. The Tenth Circuit affirmed the district court's Rule 12(b)(6) Dismissal.

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[110] *High Desert Relief, citing* §7602(c)(1). The IRS website provides general notice, however, if unable to obtain certain information or to verify certain information.

[111] *United States v. Sullivan*, 274 U.S. 259, 263-264 (1964).

[112] *Gamer v. United States*, 424 U.S. 648 (1976).

[113] *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187 (10th Cir. 2018)(excessive fines); *The Green Sol. Retail, Inc. v. United States*, 855 F. 3d 1111 (10th Cir. 2017).

[114] *Id. See also Canna Care, Inc. v. Commissioner,* T.C. Memo 2015-206 (Canna Care did not raise this argument in Tax Court, but raised the Eighth Amendment issue on appeal, claiming the denial of ordinary and necessary business expenses caused the taxpayer to incur tax liability in amount greater than 10 times the taxpayer's gross income. The Ninth Circuit rejected this argument on both substantive and procedural grounds, and dismissed the appeal (694 Fed. Appx. 570 (9th Cir. 2017)).

[115] *Alpenglow Botanicals, LLC*, 894 F.3d 1187, appeal from *Alpenglow Botanicals, LLC v. United States*, No. 16-cv-00258-RM-CBS, 2017 BL 142360 (D. Colo. Apr. 28, 2017).

[116] *Id.* Note that the district court, in its Order to Dismiss, stated that it did not have subject matter jurisdiction to issue injunctive relief requested by Alpenglow in its complaint. Alpenglow did not appeal this part of the district court's ruling, however. In the Amended Complaint and Motion for Partial Summary Judgment briefing, Alpenglow also raised a Fifth Amendment claim, ''alleging that the IRS should have informed plaintiffs that they were under investigation for violating the CSA.'' The district court denied this motion and Alpenglow did not challenge that ruling on appeal.

[117] *The Green Sol. Retail, Inc. v. United States*, 855 F. 3d 1111 (10th Cir. 2017). In *Green Solution*, the taxpayer argued the district court could assert subject matter jurisdiction over its injunction action against the IRS because §280E is a penalty, not a tax subject to the Anti-Injunction Act. The appeals court rejected that argument. Alpenglow did not present any reason as to why the result should be different under its Eighth Amendment claim.

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What may be more noteworthy about *Alpenglow* is that the taxpayer raised two distinct but related policy arguments to support its claim that the IRS should not be permitted to apply §280E to tax the gross income, rather than the net income, of cannabis dispensaries operating in accordance with state law. The Tenth Circuit rejected both arguments.

Alpenglow's Dead Letter Rule argument claimed that the IRS is prohibited from denying deductions under a law ''when there is a public policy of non-enforcement of the law.'' The Tenth Circuit, in rejecting this argument, held that a public policy analysis on the disallowance of deductions under the Tax Code is only appropriate ''where Congress has been wholly silent.'' The appeals court also noted that Alpenglow failed to demonstrate any widespread acceptance or adoption of the ''Dead Letter Rule.''

Furthermore, Congress had not been silent. By enacting §280E, Congress had spoken expressly on its intent to prohibit the deduction of business expenses related to drug trafficking illegal under federal law, the Tenth Circuit said. Additionally, Alpenglow failed to raise this argument during proceedings in district court. Finally, Attorney General Sessions rescinded any policies of non-prosecution for cannabis dispensaries complying with state law, evidencing government intent to enforce the CSA and related statutes.[118]

BANKING ISSUES FOR CANNABIS BUSINESSES

Cannabis business owners must be cognizant of the banking law minefield so as to avoid committing federal financial crimes. It is unlawful for these business owners to engage in certain financial and monetary transactions with the proceeds from marijuana-related violations of the CSA.[119] One who deceives a banking institution about this is engaging in money laundering. Banking institutions have to beware of the Bank Secrecy Act,[120] which permits the federal government to prosecute entities that conduct transactions with money generated by marijuana-related conduct if they fail to identify or report financial transactions that involved the proceeds of marijuana-related transactions.

The Bank Secrecy Act requires banking institutions to file Suspicious Activity Reports with the Financial Crimes Enforcement Network (FinCEN) for any suspected illegal activity to the federal government, including all transactions that are associated with a cannabis business, even if operating legally under state law. Banks are also required to file a Marijuana Priority Suspicious Activity Report (SAR) with the Financial Industry Regulatory Authority (FINRA) if they believe a business is acting illegally, or a ''Marijuana Limited'' SAR if they believe the business is following state guidelines for legal sales. There are also Marijuana Termination SARs.[121]

FinCEN, a division of Treasury, is the regulatory body that is responsible for setting expectations for financial institutions that deal with cannabis businesses.

The goal of FinCEN is to safeguard the U.S. financial system from illicit use and to combat money laundering through the collection, analysis, and dissemination of financial intelligence. On February 14, 2014, FinCEN issued guidance based on the Cole Memorandum, clarifying the Bank Secrecy Act expectations for financial institutions that service cannabis-related businesses.

The FinCEN guidance provides assistance to financial institutions on how to file a suspicious activity report.[122] A ''Marijuana Limited'' SAR occurs when one of the cannabis business customers does not set forth one of the Cole Memo priorities[123] or violate state law.[124] The Marijuana Limited SAR includes identifying information on the subject and related parties, addresses of the subject and related parties, details regarding the enforcement priorities of the financial institutions that have been implicated, and the dates, amounts, and other relevant details of financial transactions involved in this suspicious activity. A ''Marijuana Termination'' filing occurs when the financial institution terminates a relationship with the marijuana-related business so it can avoid violating the money laundering compliance program. If the financial institution believes that the business owner will go to a second financial institution, the financial

[118] *See* Attorney General Jeff Session's Memorandum to all United States Attorneys regarding Marijuana Enforcement (Jan. 4, 2018).

[119] 18 U.S.C. §1956 (money laundering).

[120] 31 U.S.C. §5318(g). There are also issues concerning terrorist financing (drug cartels engaging in multinational operations), securities fraud, and RICO violations. *See Safe Streets v. Hickenlooper*, 859 F.3d 865 (10th Cir. 2017).

[121] Also referred to as ''Termination Filings.'' *See* Dorsey and Whitney LLP Blog, Clarification From FinCEN — Updating Marijuana Limited SARs (June 27, 2018).

[122] *See* Hilary Bricken, *Breaking Cannabis Banking: Tips on Getting an Account*, Canna Law Blog (June 14, 2018); Joseph Lynyak, *FinCEN Guidance on Banking Marijuana—Increased Legal Risk to Banks*, Dorsey & Whitney LLP (Jan. 23, 2018). There is still this obligation even if a cannabis business owner is operating legally under state law.

[123] A transaction may involve funds from an illegal activity or be an attempt to disguise funds derived from an illegal activity. A transaction may also lack a general lawful purpose.

[124] Note that the author understands that the Sessions Memo essentially wipes out prior DOJ guidance, including the Cole Memo on this issue. Until additional FinCEN or DOJ guidance comes out, the author opines that banking institutions will continue to submit these SARs where appropriate.

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institution should alert the second financial entity of the potential illegal activity.

FinCEN guidance lists warning signs or ''red flags'' that suggest that a cannabis business owner may be engaged in an activity implicating a Cole Memorandum enforcement penalty or violating state law. This distinguishes Priority SARS from Limited or Termination SARs. These red flags may indicate a need for additional banking customer due diligence. Examples of ''Red Flags'' include: A business owner receiving substantially more revenue than may reasonably be expected given the relevant limitations imposed by the state in which it operates; the appearance that the business owner is using a state-licensed marijuana-related business as a front to launder money; the inability of the business owner to produce satisfactory evidence of licensing; the business receives substantially more revenue than its local competitors and then might be expected given the population/ demographics; the business is deposing more cash that is commensurate with the amount of marijuana-related revenue than it is reporting for federal or state tax purposes; the inability to demonstrate a legitimate source of significant outside investments; the customer seeks to conceal or disguise involvement in marijuana-related business activity; the business is unable to demonstrate that its revenues are derived exclusively from the sale of marijuana in compliance with state law; the business makes cash deposits and withdrawals over a short period of time that are excessive related to local competitors or the expected activity of the business; deposits are apparently structured to avoid Currency Transaction Report requirements.

Other examples of ''Red Flags'' include: A rapid movement of funds such as cash deposits followed by immediate cash withdrawals; there are deposits by third parties with no apparent connection to the account holder; there is excessive combining of funds with the personal accounts of the business owners, managers, and accounts of seemingly unrelated businesses; publicly available information about the business, its owners and managers or other related parties discloses negative information such as prior criminal activity or a criminal record of such persons; the business, its owners, managers, or other related parties are or have been subject to an enforcement action by the appropriate state or local authorities; the business engages in international or interstate activity; the owners or managers reside outside the state in which the business is located; the business is on federal property or the marijuana is sold on federal property; the business is located near a school in violation of state law; individuals conducting transactions for the business are acting on behalf of other undisclosed parties; the financial statements provided by the business owner are inconsistent with actual account activity; there is a surge in activity by third parties offering goods or services to marijuana-related businesses, such as equipment suppliers or shipping servicers; a marijuana-related business purporting to be a non-profit entity is engaging in commercial activity inconsistent with that classification or is making excessive payments to its managers or employees.

FinCEN guidance requires a case-by-case analysis of institution-specific factors, including business objectives, an evaluation of the risks associated with offering a particular project or service, and the capacity to manage those risk effectively. This customer due diligence should include: Verifying that the business is licensed and registered; reviewing the license application and related documentation submitted by the business to operate its business; requesting information from state licensing and enforcement authorities; understanding the normal and expected activity for the business, including the types of products sold and types of customers; ongoing monitoring of adverse public information; ongoing monitoring for suspicious activity; and periodically reviewing the information obtained in customer due diligence.[125]

How can banks and medical cannabis business owners operating lawfully under state law co-exist? Unfortunately it has been difficult if not impossible. 2017 FinCEN data showed only 400 banks in the United States serviced cannabis business owners.[126]

Cannabis business owners typically do not have access to checking accounts or access to electronic fund transfers. Many cannabis businesses have to operate as cash-only, as banks are understandably reluctant to accept money from businesses engaged in activities considered illegal under federal laws.[127] Banks also typically do not extend credit to these cannabis business owners. The result is that cannabis businesses are susceptible to theft and robberies, requiring expensive security measures.

Members of Congress have introduced banking legislation to help cannabis business owners. On April 30, 2015, Reps. Ed Perlmutter (D-Colo.) and Denny Heck (D-Wash.), along with a bipartisan group of 16 other Republicans and Democrats, reintroduced H.R. 2076, the Marijuana Business Access to Banking Act

[125] *See* Slides from Carina Federico, Crowell & Moring LLP, co-presenter with the author regarding a panel on Section 280E, American Bar Association Tax Section Winter 2019 Meeting in New Orleans, Louisiana, Jan. 18, 2019.

[126] FinCEN, *Marijuana Banking Update*.

[127] Even if a banking institution elects to work with cannabis business owners, the U.S. Patriot Act states that cash transactions over $10,000 are assumed to be suspicious. The IRS also requires banking institutions to notify the IRS for any cash deposit over $10,000 (see FinCEN Form 104) as well as multiple cash deposits for less than the $10,000 threshold (''structuring'').

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of 2015 (reintroduction of the 2013 Bill). The purpose of the bill is ''to create protections for depository institutions that provide financial services to marijuana-related businesses'' and to resolve the banking crisis that marijuana-related businesses are facing. The proposed legislation has been unsuccessful to date. In 2017, Congressman Ed Perlmutter (D-Colo.), introduced SAFE ACT Legislation to provide a legal safe harbor for marijuana banking. The bill is pending.

Cannabis business owners may resort to the use of certain cryptocurrencies, such as PotCoin and Paragon, developed exclusively for the cannabis industry.[128] However, many dispensaries currently do not accept these cryptocurrencies. Also, no one wants to buy a currency that they cannot use. In addition, there may be a fear of increased federal intervention to regulate the widespread use of cryptocurrency. There are other cryptocurrency issues that are beyond the scope of this article, but are relevant to advising cannabis business owners.[129]

IMPACT OF TAX REFORM—WHICH ENTITY MAKES SENSE?

The 2017 Tax Cuts and Jobs Act (2017 tax act)[130] makes it attractive for a cannabis business owner to operate as a C corporation for liability protection and the 21% tax rate. A cannabis owner may also want to issue stock, participate in a foreign stock exchange, or enter into a cross-border mergers and acquisition transaction.

There may be issues with a cannabis owner operating as a pass-through entity. There are no pass-through deductions if the deductions are disallowed by §280E. There is also personal tax liability. There is also uncertainty regarding the qualified business income deduction (QBID) wage limitations under the 2017 tax act.

Corporations and pass-through entities may have capitalization issues, where one member provides cash and another provides skill and labor.[131] The use of promissory notes for company or owner loans may cause the company to have a high debt-equity ratio and become undercapitalized.[132] The IRS will likely scrutinize a company with a debt-equity ratio of over 3:1. Owners of an undercapitalized company may be exposed to vicarious liability based on a ''piercing a corporate veil'' theory. In addition to the high effective tax rate for cannabis companies because of the impact of §280E, cannabis companies may have to pay a 10% penalty on federal employee-withholding taxes because they are unable to pay them electronically.[133] Conversions to notes to pay tax may also trigger the application of §351, which may classify this as Boot and thus taxable. There may be also be exit-strategy issues.

Loughman v. Commissioner

Although cannabis business owners may want to consider operating as either a C corporation or an S corporation, they should consider the impact of §280E. In *Loughman v. Commissioner*,[134] the taxpayers were the sole owners of Palisades, also known as Colorado Alternative Health Care LTD, an S corporation. They also served as its officers during the years in issue. The company was licensed to grow and sell medical marijuana. Palisades did not report any S corporation wages on Form 1040 in 2010, although they conceded that some of the wages should have been reported. Palisades acknowledged that some of the petitioners' wages were not subject to COGS pursuant to §471 and Reg. §1.471-11. The IRS disallowed Palisades's wage deductions, causing Palisades members' flow-through income from Palisades to increase. Palisades argued that respondent's treatment of its wage income as an expense subject to §280E caused the same income to be taxed twice, once as wages, and a second time as S corporation income. They contended that this resulted in the disallowed officer wages attributable to trafficking being included in Palisades's earnings, which flowed through to their members without any deduction for the wages.

Palisades claimed that this treatment was contrary to the purpose and legislative intent of subchapter S of the Code. Specifically, Palisades contended that discriminatory treatment results from the requirement of an S corporation (unlike other types of entities) to pay a reasonable wage as a salary to its officers.

The Tax Court, in rejecting the taxpayer's argument, stated that the Code sections referred to in Palisades's argument (§3111, §3121, §3301, and §3306) pertained to administration of employment taxes. No one disputed the reasonableness of the wages. Pali-

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[128] Meredith Kinner and John McGowan, ''Search for Banking Options Heats up after AG Pushes 'Return to Law and Order,' '' Vol. 2, No. 1, *Attorney at Law Magazine (DC Suburbs).*

[129] *See* Notice 2014-21 (classifying virtual currency as property rather than true currency, triggering a taxable transaction on its disposition); IR-2018-71 (Taxpayers reminded to report virtual currency transactions). Note that the 2017 tax act prohibits the use of a §1031 Exchange for personal property, which encompasses virtual currency. There are also withholding issues.

[130] Pub. L. No. 115-97.

[131] There may be an issue of phantom income for the ''sweat equity partner.''

[132] *See* Hilary V. Bricken, *Careful Legal and Tax Panning Needed as Weed Businesses Face Myriad Tax Hurdles*, 33 Real Est. J. 215 (Aug. 4, 2017).

[133] *Id.*

[134] T.C. Memo 2018-85.

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sades claimed that the reasonable wage requirement resulted in double taxation.

The Tax Court noted that petitioners' argument of double taxation assumed that there was no distinction between gross income from wages and pass-through income from the ownership of an S corporation. The economic considerations for these two items of income differ, as do their tax treatments.[135]

The Tax Court also noted that if Palisades hired a third party to perform duties of the entity, the S corporation would ultimately have less income to pass through to the shareholders, but the shareholders would not owe any income tax on wages paid to that third party. Furthermore the application of §280E is non-discriminatory, because it applies equally, regardless of whether petitioners themselves or a third party receives the wages. Petitioners were free to operate as any business entity and in other trades.[136]

Alternative Health Care Advocates v. Commissioner

Another Tax Court case illustrates the disastrous tax consequences for C corporations who cannot successfully overcome the devastating grip of §280E. The long reach of §280E also extends to management companies that provide employees to these cannabis business entities.

In *Alternative Health Care Advocates v. Commissioner*,[137] the taxpayers argued that because its management company, known as Wellness, did not engage in the sale and purchase of marijuana, Wellness should be shielded from the effects of §280E. Alternative cited prior tax court cases that stated that a management services company can engage in a separate line of business from the entity it manages.[138]

The Tax Court rejected Alternative's argument, stating that the only difference between what Alternative did and what Wellness did (since Alternative acted only through Wellness) is that Alternative had title to the marijuana and Wellness did not. Wellness employees were directly involved in the provision of medical marijuana to the patient members of Alternative's dispensary. While Wellness and Alternative were legally separate, Wellness employees were engaged in the purchase and sale of marijuana (albeit on behalf of Alternative).

The Tax Court noted that the term ''trafficking'' did not require Wellness to have had title to the marijuana its employees were purchasing and selling. Neither that section nor the non-tax statute on trafficking limited application to sales on one's own behalf rather than on behalf of another. Without clear authority, the Tax Court would not read such a limitation into these provisions.

Alternative argued that it was a ''producer'' of the marijuana products it purchased from its patient-members. The Tax Court recognized that some of Alternative's product offerings required some additional preparation and maintenance. The Tax Court could not conclude that the dispensary grew, created, or improved its marijuana products to the extent required by §263A or §471 when Alternative could only show that it inspected, packaged, trimmed, dried, and maintained the stock. Alternative also did not provide a reasonable basis upon which to compute the additional amounts of COGS.

The Tax Court also rejected Alternative's argument that, it was a ''producer'' as it was the owner of the marijuana produced by its patient-members. Alternative did not have any written agreements evidencing this assertion. Even if patient-members had to sell to Alternative, employees had complete discretion over whether to purchase the marijuana products from the patient-members and compensated the patient-members only if their marijuana was purchased.

The Tax Court held that Alternative could not claim a COGS deductions for the costs of the following items because of the operation of §280E: Books, T-shirts, hats, rolling papers, pipes, grinders, incense, lighters, ashtrays, and cleaning supplies for pipes and bongs. The Tax Court found that these unrelated sales did not constitute a separate business from the marijuana sale business and that the taxpayer was entitled to no COGS deduction for costs allocable to these activities.

Alternative provides a horrible result for a cannabis company operating as a C corporation. There was a disallowance of deductions of $751,981 in two years. The taxpayer only had approximately $5.58 million in gross receipts in those two years and was allowed a total of approximately $3.33 million in actual COGS, presumably the cost of the cannabis and related items. Thus, before the disallowed deductions, the taxpayer only had approximately $2.25 million in cash. After the disallowed deductions, the taxpayer was left with only $1.5 million. The tax deficiency (without taking into account penalties, interest, or state tax) was approximately $752,000. Thus the cash left, before tak-

[135] Per §1366(a), pass-through income is passed pro-rata. Per §1366(c), gross income includes pro-rata share and wage compensation.

[136] The Tax Court also denied §530 relief from employment taxes because it was inapplicable to the case. Petitioners wanted relief to exempt trafficking-related officer wages from the reasonable wage requirement because they had a reasonable basis, which was to eliminate tax disparity. Section 530 relief is limited to controversies regarding the employment tax status of service providers under the common law and does not apply with respect to statutory employees, such as corporate officers.

[137] 151 T.C. No. 13 (Dec. 20, 2018).

[138] *Davis v. Commissioner*, 29 T.C. 878 (1958); *Roselle v. Commissioner*, T.C. Memo. 1981-394.

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ing account of any tax on the profit that the taxpayer had conceded was due, was only about $746,000.[139]

The principals of the taxpayer had formed a management company that performed services for the taxpayer. That corporation was an S corporation. In the same two years in question, the S corporation had gross receipts of roughly $1.8 million, all of which came from the taxpayer. The S corporation reported total deductions of roughly $1.7 million. All of these deductions that the S corporation took were denied under §280E. In effect, Alternative, as a C corporation and the owners of the S corporation lost the deduction not once, but twice. It is not clear from the opinion, but since the owners of the S corporation took much of the S corporation's income into account as wages, effectively the same income was being taxed three times.[140]

One commentator provides additional insights and points out flaws in the *Alternative* opinion. First, the opinion ignores any contractual relationship between Alternative and Wellness. Second, it ignores the principal and agent relationship between Alternative and the employees provided by Wellness. Third, the holding violates the tax principle that ambiguity in revenue-raising provisions should be construed in the taxpayer's favor rather than the government's favor.[141]

Cannabis business owners will have to navigate state and local laws regarding licensing, zoning, and other non-tax related issues. States will most likely assess sales or excise tax upon such businesses.[142]

COMMON ACCOUNTING AND IRS AUDIT ISSUES

Many cannabis business owners keep inadequate books and records. There may also be inconsistencies within whatever records exist. It is unlikely that financial statements are audited. There is a lack of industry knowledge and best practices, especially with the complexities presented by the interplay between §471 and §280E.

The question of what comprises a separate trade or business presents issues. There are challenges regarding inventory methods, as well as depreciation challenges.

Cannabis business owners face increased scrutiny from the IRS, state, and local tax authorities. This type of business is a ''red flag'' and will subject the business owner to audits on a regular basis. There may be additional liabilities for CPAs who prepare returns for cannabis business owners. There are also limits on accountant-client privilege.[143]

KEY TAX ISSUES IN M&A TRANSACTIONS: RAISING CAPITAL

Many cannabis businesses, because of the intimidating effects of §280E, do not generate material after-tax revenue and cash flows to pay investors or to even reinvest in the company. There are also challenges pertaining to traditional banking and public markets.

For those businesses that enter into a merger and acquisition transaction, there are business valuation issues. There are concerns estimating the impact of §280E or how to exercise due diligence in alleviating its effects. There are cash flow concerns because of the punitive nature of the statute. Can a cannabis business insure its assets?

There are also securities law obstacles, assuming a company can issue securities. The raising of capital from individual investors, even family and friends, may constitute the offering of securities, which requires the registration of the securities under the Securities Act of 1933 and state securities laws (Blue Sky laws). Is the business owner exempted from any registration requirements?[144] There are also investor concerns as to whether there are sufficient mecha-

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[139] But it gets worse!!!!

[140] But it gets worse! The Tax Court assessed §6662(a) accuracy-related penalties against Alternative!

[141] *See*, Justin E. Hobson, *Tax Court Takes Second (and Even Larger) Bite From the Cannabis Tax Planning Apple*, The Pipeline Cannabis Law Advisor (Jan. 9, 2019).

[142] *See* Jeremy M. Vaida,*The Altered State of American Drug Taxes* , Tax Lawyer Vol. 68, No. 4. Colorado and Washington have multi-tiered sales tax regimes. Oregon imposes a ''privilege tax'' based on weight. Alaska also taxes cannabis by weight. New York and Nevada impose excise taxes with specific requirements. Illinois imposes a ''cultivation privilege tax measured by weight.'' Rhode Island assesses a Compassion Center Surcharge on 4% on profits. Tennessee issued a ''Crack Tax'' (although later found to be unconstitutional).

[143] In Maryland, it does not apply to criminal or bankruptcy proceedings. Maryland Code Courts and Judicial Proceedings Section 9-110(d)(2). *See also* §7525(a). A tax attorney should use a *Kovel* Agreement, which is when an attorney hires outside accountants. The attorney may want the accountant to meet with the client and obtain information directly from the accountant, and cloak that information in the attorney-client privilege just as if the attorney obtained it directly from the client. The attorney-client privilege then extends to the accountant. *See United States v. Kovel*, 296 F.2d 918 (2nd Cir. 1961).

[144] Securities Act §4(a)(2) has certain registration of securities requirements. An entity may be exempt from a public offering if the entity complies with the following: No limit to number of investors, but it is recommended to have only a few; no general advertising or solicitation permitted. There is also a Regulation D Safe Harbor that states that there is no requirement for the SEC to review registration statement. Issuers must file a very simple short notice form called Form D within 15 days of the first sale of securities. *See also* Rules 504, 506(b), and 506(c) Accredited Investors required – include bank, insurance company, registered in-

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nisms in place to mitigate the impact of §280E. Do the shareholder agreements have indemnification clauses to protect investors against flow-through tax liability (Seek contribution from company)?

NON-TAX LEGAL ISSUES

Assuming the cannabis business owner is able to successfully navigate the daunting reach of §280E, there are other business operation issues. Neighboring business owners and individual residents may file suit against the business under a cause of action under RICO.[145] In *Safe Streets Alliance*, the plaintiffs claimed the cannabis business owner caused plaintiff's property to suffer a reduction in value because of strong marijuana smell and the potential of places attracting thieves because of the large quantity of valuable drugs. The appeals court found that the odor is injurious to property under Colorado common law.[146]

Even if the cannabis business owner prevailed, the cost to defend lawsuits can put these companies out of business. Banks may also drop these companies as a business client or may accelerate amounts due and/or declare the business owner to be in default on any mortgage encumbering the property.

There is no federal trademark protection for actual marijuana products.[147] Some states offer trademark protection, however.[148]

Cannabis business owners may have trouble obtaining homeowners insurance for their marijuana items. Title insurance underwrites may not want to insure any real estate transactions for property used in connection with cannabis.

There may also be estate planning issues for a landowner bequeathing real estate used in the cannabis business to descendants, as well as cannabis plants and equipment. This dilemma may result in the utilization of a special cannabis trust, similar to gun trusts.

ATTORNEYS REPRESENTING CANNABIS BUSINESSES

Rule 1.2(d) of the American Bar Association's Model Rule of Professional Conduct states, in part, that a lawyer shall not counsel or assist a client in engaging in conduct that the lawyer knows is criminal or fraudulent. However, some state bars have changed their professional rules to permit attorneys to advise clients in the cannabis business so long as they explain federal law and policy. Other states have issued advisory opinions.[149]

Attorneys should consider adding disclaimers and warnings to their client-retainer agreements. Counsel should clearly define in the retainer letter the limitations of the attorney-client privilege, as well as specify the conditions under which counsel will need to fully disclose information to regulatory and/or legal bodies.[150] There should be disclosures that although operating a cannabis business is legal under state law, it is not under federal law. There may be a need for a disclosure regarding §280E. Attorneys should be aware of the possibility of service of a subpoena for documents and/or testimony.

OPEN QUESTIONS ON THE IMPACT OF §280E ON A CANNABIS BUSINESS

Cannabis retailers, wholesalers, and distributers must pay attention to §280E because of this Code provision's highly significant impact on business operations. For cannabis producers, the impact is not as significant due to a COGS reduction and the ability to include additional §471 costs. Section 280E does not appear to have a significant effect on paraphernalia and branded merchandise if the business owner can establish that these products are part of a separate line of business.

Section 280E may have a significant effect on intellectual property, as well as other non-tax issues. There is also an issue with using management companies, employee leasing companies, professional employer

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vestment company, employee benefit plan if a bank, insurance company or registered investment company makes the decisions. See also tax exempt organizations and corporations/partnerships with assets > $ 5 Million. Individuals must have net worth of at least $ 1 million, not including personal residence. Regulation CF allows issuers to raise capital from non-accredited investors and to seek capital form a large number of investors. There are fairly detailed requirements and can take more time than using the exception under Regulation D.

[145] Safe Sts. All. v. Hickenlooper, 859 F.3d 865 (10th Cir. 2017), *see* Lorelei Laird, *To Colorado, marijuana is a business—to the federal government, it's a criminal conspiracy*, ABA Journal (Nov. 2017)(RICO can be applied outside of organized crime.)

[146] The article states that it would be hard to prove damages, and states that have legalized cannabis have extraordinary high property values. Also note that Oregon has a ''Right to Farm'' law.

[147] Cannabidiol (CBD), the non-psychotropic active cannabinoid in marijuana, receives federal trademark protection.

[148] California introduced Assembly Bill 64 in 2017. The Assembly voted in favor of the Bill.

[149] A discussion of specific state ethical rules is beyond the scope of this article.

[150] A San Diego DA accused Jessica McElfresh, a San Diego attorney, of scheming with a client (by hiding evidence) who sought to illegally manufacture and sell hash oil across the country. *See* Jonah Valdez, *San Diego DA's Prosecution of Pot Attorney Has Sent Chills Through the Legal Community*, Voice of San Diego (Aug. 9, 2017). Prosecutors wanted to look through all of her records. There was a big concern about protecting the attorney-client privilege of past clients.

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organizations (PEOs), and agents, as illustrated by the *Harborside* case. Aside from §280E, cannabis business owners should beware of using these third-party companies to launder money.

What can a medical cannabis dispensary do? The business owner must tread carefully. Such persons should utilize separate employment agreements for cannabis and non-cannabis employees. What if there are renegade employees, such as an employee who is engaged in drug trafficking in a side business and elects to use the cannabis business place of employment to conduct this side business? Is the cannabis business owner liable for respondeat superior? There may be an issue with using independent contractors.

Although *CHAMP* used only one CPA and set of books, it would be advisable to use a separate CPA and a separate set of books for each line of business. It may also be advisable to have separate entities for each line of business (for example, what about the use of armored trucks?). There are asset forfeiture issues. There are difficulties with determining the exact square footage devoted to the provision of medical cannabis.

Not only may there be issues with employees, but there may also be issues between multiple owners of a medical cannabis business. It may advisable to include disclaimers or an indemnity clause in partnership or shareholder agreements, or any other documents of the corporate entity. Do the shareholder agreements have indemnification clauses to protect investors against flow-through tax liability (therefore seeking contribution from the company in the event a shareholder is exposed to liability)?

What about the business owner who wants to do business in Canada or Mexico, where the use, manufacture, and/or sale of controlled substances is legal? Does the CSA apply to domestic conduct only?[151] What if the acts committed in these foreign countries have an effect on the United States?[152] What if the cannabis business owner, a U.S. citizen or national, operates exclusively outside of the United States?[153] There is a need to prevent international discord.[154]

A cannabis business owner challenging an IRS assessment under §280E should raise all arguments in its petition to avoid dismissal of the arguments based on procedural grounds. There is also an issue of obtaining a refund if a taxpayer prevails in a district court or the Court of Claims. Because of the standard three-year statute of limitation to file refund claims, a taxpayer should file a Protective Refund Claim to keep the statute open.

So where do we go from here? A cannabis business owner may have three options, with each option presenting some pitfalls: Model one's business after CHAMP; create a C corporation; cultivate hemp.

Model the Business After CHAMP. CHAMP opened its caregiving business with an experienced caregiver as its CEO. It is unlikely that most cannabis businesses have this luxury. Most of these businesses are created by individuals with limited experience but envision a financial opportunity.

Create a C Corporation. §280E provides (at this point) an impenetrable wall for medical cannabis business owners. It is likely that a large C corporation cannabis entity would approach such small business owners with an offer to purchase the business for pennies on the dollar, with the sales pitch that some funds are better than no funds and possible bankruptcy. Unless a business owner is a producer of medical cannabis, it is likely that the effective tax rate for such entities will be at least 70%. A C corporation is taxed at a 21% rate under the 2017 tax act, and business owners of pass-through entities may fear individual liability.

It appears that the IRS has become emboldened in its pursuit of cannabis business owners as a result of

[151] Some statutes have potential extraterritorial application: 21 U.S.C. §955, which prohibits the bringing or possessing controlled substances on board a vessel or aircraft "arriving in or departing from the United States." 21 U.S.C. §952 prohibits importing controlled substances into the United States "from any place outside thereof." 21 U.S.C. §959 prohibits "manufacturing or distributing a controlled substance" with the intent or knowledge that the substance will be imported into the United States. Section 959(c) provides that the statute is intended to reach acts of manufacture or distributed that are committed outside the territorial jurisdiction of the United States. See also Slides from Brandon King, Baker McKenzie LLP, co-presenter with the author regarding a panel on §280E, American Bar Association Tax Section Winter 2019 Meeting in New Orleans, Louisiana, Jan. 18, 2019.

[152] *See Strassheim v. Daily*, 221 U.S. 280, 285 (1911) in which a defendant was convicted of fraudulently selling defective machinery in Michigan by means of bribery, even though the bribery occurred in Illinois. The Court ruled that "acts done outside a jurisdiction, but intended to produce detrimental effects within it, justify a state punishing a cause of the harm as if he had been present at the effect." This could be applied to actions occurring outside of the United States. Restatement Third, Section 403(3) also states that where the laws of two nations conflict, "a state should defer to the other state if that state's interest is clearly greater."

[153] Restatement Third, Section 402(2) states that a sovereign nation generally cannot punish conduct outside its borders, unless it seeks to regulate "the activities, interest, status or relations of its nationals outside as well as within its territory." *See also EEOC v. American Oil Co.*, 499 U.S. 244, 248 (1991) (The presumption against extraterritoriality provides that "unless a contrary intent appears, legislation applies only within the territorial jurisdiction of the United States). *See also Morrison v. Nat'l Australia Bank, Ltd.*, 561 U.S. 247, 255 (2010) (When a statute gives no clear indication of an extraterritorial application, it has none).

[154] *See EEOC v. American Oil Co. See also* Slides from Brandon King, Baker McKenzie LLP, co-presenter with the author regarding a panel on Section 280E, n. 156, above.

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the IRS's recent victories in Tax Court. It is unlikely that a business owner will attain success on an IRS audit, an encounter with IRS Appeals, or in Tax Court. A business owner may attain success in a federal appeals court or perhaps the Supreme Court with the arguments previously mentioned in these cases, but such entities often do not have the resources to hire counsel or otherwise bring a case to such courts. A large C corporation may have the resources to battle in such courts, however. Large companies may also create a separate entity providing consulting services to circumvent §280E.

A business owner could use a separate entity to hold real estate,[155] another to provide payroll services, and another to handle retail services. This process would be difficult to manage because taxpayers usually make the mistake of keeping a single set of books, writing checks from a single bank account, and using a single management team for decision-making across the different entities. Furthermore, a business owner may neglect to keep inventory or employ an Inventory Method of Accounting.

There may be issues with licensing if one uses different names or entities to hold cannabis or non-cannabis assets such as real estate. Also, conversions from one entity to another may result in a taxable transaction. Another problem that may surface with a conversion from a flow-through entity to a C corporation pertains to cash flow. Usually a flow-through business entity has already made distributions to its owners. The newly converted C corporation may face IRS audits from prior tax years when the entity was a pass-through, however. There are large tax liabilities, and the newly converted C corporation does not have any cash flow! The C corporation cannot issue a dividend because it is subject to tax. The C corporation may have to take out a large business loan to cover the tax liability but cannot deduct the interest expense from debt financing. The entity cannot allocate the interest expense to COGS.

Regarding the qualified business income deduction (QBID) under the 2017 tax act, the IRS will likely deny QBID for medical cannabis business owners, even though QBID is income based (in contrast, §280E is deduction based). One could argue that QBID applies to all applicable businesses under the 2017 tax act, before determining the proper deductions. There is no IRS guidance on this issue, however.

[155] Marijuana REITs may be an option for one who would like to invest in such businesses. *See* Sean Williams, *A Marijuana REIT? Yeah, That's a Real Thing*, The Motley Fool (April 27, 2018).

Cultivate Hemp. Congress enacted the Agricultural Improvement Act of 2018 (The Hemp Act).[156] The Hemp Act contains a hemp provision that removes hemp from the federal list of controlled substances and allows it to be grown and sold as an agricultural product. Therefore, farmers who cultivate hemp or hemp oil are not subject to §280E.

Hemp is a product of cannabis sativa that contains no psychoactive properties, unlike marijuana. Hemp is also bred for industrial uses such as oils and topical ointments, as well as fiber for clothing and construction. Hemp contains less than 0.3 THC, a psychoactive ingredient. It is likely that the government will investigate hemp farmers to ensure that such persons are actually cultivating hemp and not marijuana.

CONCLUSION

It is unlikely that a taxpayer will obtain a favorable resolution regarding an interpretation of the application of §280E in the Tax Court. One hopes for a Supreme Court showdown. Perhaps the Supreme Court would issue a narrowly tailored opinion exempting lawfully regulated and run medical cannabis dispensaries under §280E.

It is more likely one could obtain a medical cannabis dispensary exception under §280E through legislation. There are several current proposals in Congress regarding §280E.[157] The proposals would exempt businesses selling cannabis in compliance with state law from the requirements of §280E. The proposals would permit banking, take state-compliant cannabis out of the jurisdiction of the CSA,[158] and provide bankruptcy protection from forfeiture provisions.[159] There would also be a federal excise tax on cannabis sales based upon a national average price and for an occupational tax, permit to operate a cannabis business, and federal regulation of such businesses.[160] On January 10, 2019, Rep. Earl Blumenauer (D-OR) introduced H.R. 420, known as the ''Regulate Marijuana like Alcohol Act'' that would remove marijuana from the Controlled Substances Act and instead regulate cannabis like alcohol.

[156] Pub. L. No. 115-334, signed into law by the President on Dec. 20, 2018.

[157] S. 777, H.R. 1810 (Amended by H.R. 1824); *See also* H.R. 1985.

[158] *See also* S. 3032 (strengthening the Tenth Amendment Entrusting States Act).

[159] S. 777, H.R. 1810 (Amended by H.R. 1824); *See also* H.R. 1985.

[160] H.R. 1834.

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