Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

purposes with qualifying conditions varying from state to state. Depending on the ...

Craig Smalley • Oct. 02, 2017

As of 2017, cannabis is legal in 29 states and the District of Columbia. In some states, it is legal for recreational use and in others it's only allowed for medicinal purposes with qualifying conditions varying from state to state. Depending on the state, it can either be easy to get medical cannabis or it may require considerable hoops to jump through before attaining a card.

But with all the talk of state legalization, cannabis remains an illegal Federal Class I Controlled Substance under the 1970 Controlled Substance Act. In 1996, California was the first state to legalize cannabis for medical reasons and in those early days it was not uncommon for cannabis growers and dispensary owners to be raided by the DEA, who would promptly confiscate the cannabis and destroy it. As more and more states legalized cannabis, the raids diminished. Today, it would almost be impossible to shut down the tens of thousands of growers and dispensaries country-wide.

One way to shut down someone in the cannabis industry would be to tax them so much that the company would have to liquidate all of their assets to pay the Federal Tax due, and indeed this is essentially what happened. Which leads us to several questions:

1. How did this system of taxation get on the books to begin with?
2. What are the ways to get around the crippling Federal Tax?
3. How are Cannabis Dispensaries supposed to run a business without a Federally Regulated bank account?

Where It All Started with Cannabis Taxation

The law on the books right now that is causing problems for those in the cannabis

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).

Income that is taxed can be any income, such as from where you work, your business income, and even income derived from illegal activities.

In fact, in 1974, a drug dealer by the name of Jeffery Edmundson, after being convicted of drug trafficking serving his prison term for selling marijuana, cocaine, and amphetamines, was contacted by the IRS, who reconstructed the income that he made selling drugs in order to tax it.

Generally speaking, the IRS had several different ways of reconstructing that income, including the Specific Item Method, Indirect Method, and Formal Indirect Method. It is not at all uncommon for the IRS to nab a person upon their release from prison for not claiming the income that they made engaging in illegal activities.

Mr. Edmondson received a Notice of Deficiency from the IRS for the taxes that he didn't pay on the drugs he sold. In 1980, Mr. Edmondson petitioned the US Tax Court to fight the amount of taxes that the IRS said that he owed. The next year, Edmondson v. Commissioner was heard before the Court.
Mr. Edmondson's argument was that he did in fact make money selling drugs but he also had expenses that it took to make that income. Now, while most people that are involved in illegal activities don't keep records of income and expense, there does exist something called the Cohen Rule , whereas the US Tax Court allows testimony of estimated expenses, in lieu of records.

The case was heard by Judge Goffe of the US Tax Court. In his ruling, the Judge repeated over and over how impressed he is with accuracy and honest of Mr. Edmondson's testimony. In his ruling, he gives Mr. Edmondson the cost of the drugs that he sold as an expense. However, it went even further than that – he also allowed him to take his home office, telephone charges, and some travel expenses as

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

Act) which is prohibited by Federal law, or the law of any State in which such trade or business is conducted.

What is interesting about Section 280E is that it only applies to the sale of federally illegal drugs. If you engage in other illegal activities that make money, like human trafficking, you can deduct other expenses.

But if you keep in mind what was going on in 1982, Section 280E makes perfect sense. The US Government had declared its highly politicized "War on Drugs." During this so-called war, if even so much as a pot seed was found in your home or car, the Government would seize that asset.

The first challenge to Section 280E happened in 2007, when a dispensary out of California went to Tax Court. Californians Helping to Alleviate Medical Problems (CHAMPS) v. Commissioner, was heard by the Court on May 15, 2007.

CHAMPS was a dispensary that had a different approach from most others in the business. They charged a membership fee that included cannabis, but which also included alternative treatments like yoga, essential oils, and other things as part of the membership fee. As such, CHAMPS deducted on their tax return other items besides cost of goods sold (COGS). In audit, those expenses were thrown out, so CHAMPS appealed the case, and appeals agreed with the auditor, so the appeal went to the US Tax Court.

In the Tax Court Ruling, Judge Laro determined that the company was actually running two different businesses under one roof. The Court divided the expenses between the non-Section 280E business and the cannabis business.

This was groundbreaking for the cannabis industry. A dispensary could now have an ancillary business that ran alongside their cannabis business, thus making some expenses tax deductible. Not only that, but dispensaries now had case law and a business strategy that they could follow to save the business tens of thousands of

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

Internal Revenue Code, expenses that can be claimed when a business is not engaged in making a profit are drastically reduced.

How Can Cannabis Businesses Avoid This Crippling Federal Tax?

Tax Advisors that specialize in taxation for the cannabis industry have something to wrestle with: How does a dispensary offer and charge for an ancillary business and stay competitive in the cannabis industry?

One way is to set up two different businesses. One that sells cannabis and another that does something else. With medical cannabis, this is easier to do than it is with recreational because it goes hand in hand with caregiving. Things like consulting, essential oils, yoga classes, and other alternative healing methods make sense alongside the sale of medical cannabis.

To make this strategy work, a portion of your dispensary's floor space must be dedicated to these other services, ideally half of the dispensary. When someone comes in with a medical cannabis card and they want to purchase cannabis, they should sign a contract that lists the cost of the cannabis and the cost of the alternative business separately.

The trick is that the cannabis has to be charged at the going rate of cannabis in the area. So, for example, our company does a cost analysis of the different dispensaries within a 20-mile radius and then we use the lowest price. If the cost of a quarter ounce of cannabis ranges between $80 and $150 in the area, we would list the price of the cannabis at $80 and then the cost of the alternative medicine and consulting would be figured in at $80 as well for a total price of $160. The patient would receive a treatment plan with suggestions as to alternative medicine treatments to compliment the cannabis, and that would be signed by the patient.

When handled in this way, a large portion of nondeductible expenses can be placed

Hello. It looks like you’re using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

That is true, and tax professionals may lose some business because of this strategy. However, the decision must be made whether a dispensary is willing to pay 70% in taxes, which more than likely would put them out of business, or just lose some customers. The amount of people in the cannabis industry that don’t receive any professional, cannabis-specific taxation advice is probably about 60%. When they file their first tax return and pay hundreds of thousands of dollars in taxes, most dispensaries simply are forced out of business.

An ancillary business in some states can’t be done. For instance, in Nevada, if you have a license to have a dispensary, then that is the only business that you can run. In that case, you have to look at different ways of calculating COGS.

A Creative Look at Cost of Goods Sold (COGS)

There exists a substantial amount of incorrect information out there about how COGS are calculated. First of all, let’s take a look at Chief Council Advice (CCA) 201504011 issued in 2014. It’s important to understand what CCA is and the weight that it is given in audit, appeals, and the US Tax Court. CCA is basically a General Counsel Memorandum (GCM), which is issued by the Office of Chief Counsel and provides the reasoning behind revenue rulings, letter rulings, and technical advice memoranda. GCMs do not have precedential value, so they do not really carry any weight.

In this particular CCA, it states that COGS must to be calculated the same way it was done when Section 280E became law. There was a complete overhaul of the Tax Code in 1986 which changed the way COGS is calculated:

Cost of goods sold is calculated in one of two ways. One way is to adjust the cost of the goods purchased or manufactured by the change in inventory of finished goods.

For example, if 1,000 units were purchased or manufactured but inventory increased

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

assumed. Cost flow assumptions include FIFO, LIFO, and average.

Simply put, COGS for a dispensary reflects the cost of the cannabis. However, if your financial statements are produced under Generally Accepted Accounting Principles (GAAP), you can use a more favorable calculation of COGS.

For example, you buy cannabis and that becomes your inventory. You sell the cannabis and the inventory is now a COGS expense. In your dispensary, you dedicate 25% of the space to inventory, which must be closed off to the rest of the business for storing your inventory. Now, 25% of your rent and utility bills have just become a COGS expense. Then the owner becomes the manager of inventory. They order inventory, handle inventory, and take care of shipping – in short, they do nothing else but deal with inventory, and the salary and payroll taxes of the owner are now a COGS expense. Finally, the shipping costs from the grower to the dispensary are also a COGS expense.

Another way to do this is to form a management company. The dispensary orders the cannabis but it is shipped to the management company. When the inventory is needed, the management company ships it to the dispensary, which then pays a predetermined fee to the management company for doing all of this. This, too, becomes a COGS expense. Another plus is that the management company has no problem getting a bank account or deducting expenses.

Cannabis and the Problem of Banking

I am going to debunk a myth for you. There is no Federal Law that precludes a Federal Bank from opening an account for cannabis businesses. The reason that they don't is because the compliance work required for a cannabis business is quadruple that of other commercial enterprises. Most banks just don't want to deal with it. However, it's usually possible to open an account in a smaller bank or credit union.

If you don't take the time to find a bank that will open an account for your cannabis

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

A soon our firm engages with a cash-based cannabis business, the first thing we do is visit the dispensary and set up internal controls that can be closely monitored on a daily basis. This is very expensive for the owner because it entails a lot of work. But when employees know that someone is watching them, behavior with cash quickly changes.

An Easy Ride for Growers

We have spent most of our time talking about dispensaries. Now I want to shift focus for a moment to growers, who don't have to jump through hoops the way dispensaries do. If you think about it, they are producing the cannabis from seed to flower and most expenses under GAAP are deductible. The depletion of the land, the seeds, the labor to work the land (even for owners), the depreciation on the equipment used to cultivate the land, transportation to the dispensary, depreciation on the trucks that are used to transport the cannabis – are all COGS under GAAP. Those expenses make up most of the costs entailed in growing cannabis.

Get Backed by a Knowledgeable Tax Professional

In the early days of the legalized cannabis industry, there was a preponderance of misinformation that to this day many accountants still believe. The myth was that if you helped someone in a federally illegal business, then you, as an accountant, could lose your license. That is incorrect. You couple that with the Accounting Industry, which is known for being very conservative, and you have a very small portion of accountants willing to go near cannabis. Not to mention the new rules that must be learned and all new ways to maximize tax savings that must be developed – cannabis business owners really need someone in their corner who knows the industry inside and out.

===========-

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

publications including the Wall Street Journal, The New York Times, and Christian Science Monitor, and he has been interviewed and appeared as a featured guest on numerous radio shows and podcasts. Craig can be reached at craig@craigwsmalleyea.com.

CPA Practice Advisor is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors.

© 2024 Firmworks, LLC. All rights reserved