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MARIJUANA TAXATION: STRATEGIES IN THE CURRENT LANDSCAPE

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In 2001, the Nevada Legislature decriminalized the sale and use of medical marijuana by passing Assembly Bill 453 (AB 453). AB 453 legalized the use of marijuana for "treatment of certain medical conditions," in spite of the fact that marijuana remains illegal under federal law. This dichotomy of state and federal legislative directive has created an uncertain landscape for businesses engaging in the production and sale of marijuana—although not, surprisingly, for prosecution under criminal statutes. One of the greatest obstacles the marijuana industry faces is that of state and federal taxation.

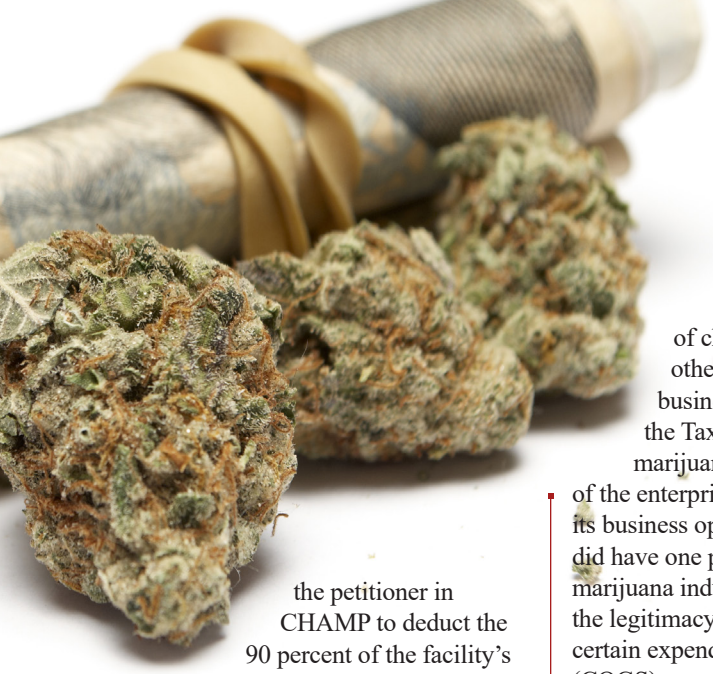
Federal Taxation

Internal Revenue Code (IRC) §280E, once an obscure and often overlooked provision in the code, has recently risen to relative notoriety amongst those in the marijuana industry; this is due to its dreaded tax impact. Under §280E:

> "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."[1]

A strict interpretation of IRC §280E prohibits a marijuana business from deducting anything, including salaries, wages, employee benefits, training, rent, travel, security and inventory purchases. In effect, such a business would be taxed on its gross profit and not its net profit, creating the potential for taxation on losses. For example, suppose company "M" makes $500,000 gross profits in a given year. In the same year, M pays out $150,000 for salaries, $50,000 for rent, $50,000 for utilities and $300,000 for its inventory. A normal company, allowed all of the above deductions, would report a net profit of $50,000. However, under IRC §280E, M would instead end up paying taxes on its initial $500,000 gross.

Fortunately, IRC §280E is tempered by other tax court case findings that can provide some reprieve. In the seminal case of *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r* (CHAMP), 128 T.C. 14 (2007), the Tax Court ruled that the taxpayers could separate the ordinary and necessary expenses incurred by the portion of the business dealing with "illegal" marijuana sales, from those accrued by other, perfectly legal, wellness and consultation services offered by the same business.[2] This means that a portion of the operating expenses are deductible when they can be attributed to another trade or business under the same corporate/business umbrella. In making its determination, the Tax Court paid particular attention to whether or not the legal aspects of the business generated income "attributable to those services."[3] The Tax Court also noted that overlapping operating expenses, such as rent and staff, could be allocated proportionally based on the company record. For example, the Tax Court allowed



the petitioner in CHAMP to deduct the 90 percent of the facility's square footage that was not being used for or by the medical marijuana service.

Taking note of the success of CHAMP, the taxpayer in *Olive v. Comm'r*, 139 T.C. 19 (2012), attempted to make a similar case for separation. Unfortunately, this case failed to establish that their other services constituted a separate trade or business. Unlike CHAMP, the taxpayer in *Olive* provided its other services free of charge to its patrons. As the other services provided by the business did not generate income, the Tax Court found that selling marijuana was the sole purpose of the enterprise, and disallowed all of its business operating expenses. *Olive* did have one positive outcome for the marijuana industry: it further solidified the legitimacy of deducting inventory and certain expenditures as Cost of Goods Sold (COGS).

Industry data indicates that the COGS accounts for approximately 75 percent of the expenditures in a marijuana venture.[4] COGS is reported under the accrual method of accounting, and the Tax Court has held, on multiple occasions, that even businesses subject to IRC §280E can still subtract the COGS from their gross sales, because it is not considered a deduction under the code.[5]

Under IRC §471, a taxpayer is allowed to capitalize costs "incident to and necessary for production or manufacturing operations or processes. Production costs include direct … [and] indirect production costs."[6] IRC §263A further expanded the type of expenditures categorized as a part of COGS, by allowing taxpayers to allocate a portion of their operating costs as COGS, as long as they can be related to inventory. To demonstrate, COGS for a marijuana seller would be calculated using the following simplified formula:

> Purchase Price of Marijuana Inventory + Costs Associated with Purchase (e.g. transportation, insurance, maintenance and legal fees, etc.) = COGS

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Similarly, COGS for a marijuana producer/grower would be calculated with the following formula:

> Direct Material Costs (marijuana seeds or plants) + Direct Labor Costs (e.g., planting, cultivating, harvesting, and sorting) + Indirect costs (e.g. payroll, transportation, machinery and quality control) = COGS[7]

Consequently, though the federal tax structure is still quite burdensome for those in the marijuana industry, the ability to allocate at least some costs, as COGS renders it slightly less draconian.

Unfortunately, a recent memo from the IRS' Office of Chief Counsel seeks to limit COGS to only §471, effectively rendering most capitalizations for operating expenses invalid. Without §263A, §471 precludes, with few exception, all costs of marketing, distribution, research expenses, administrative expenses not directly related to production of the product and the salaries of the company's officers.[8]

According to the memo, a taxpayer cannot capitalize/allocate non-deductible expenses under §263A, because §263A prohibits conversion of non-deductible expenses into deductible expenses. As §280E renders nearly all operating expenses non-deductible, it precludes taxpayers from claiming the amount as a part of COGS.[9]

For example, under the guidelines posted by the IRS' Office of Chief Counsel, a dispensary with $1,000,000 in gross revenue, $500,000 in COGS prior to application of §263A, and $300,000 in operating expenses ($100,000 of which would be attributable to inventory), the dispensary would pay tax on $600,000. However, if §263A was applied, the additional $100,000 in gross revenue would be counted as COGS and the total taxable income would be reduced to $500,000.

It is important to note that, though memorandums from the Office of Chief Counsel can help a taxpayer anticipate IRS actions, it is not precedent. Until the matter is litigated, the applicability of §263A is still arguable.

Nevada State Taxation

One area where the IRS' Office of Chief Counsel *has* relented relates to state excise taxes. In a memorandum dated June 9, 2015, the IRS' Office of Chief Counsel issued a blanket determination stating that, "though §280E prohibits deductions and credits …the excise tax is neither a deduction from gross income nor a credit. Consequently, §280E does not preclude a taxpayer from accounting for this excise tax as a reduction…."[10]

This concession is particularly helpful for the marijuana industry in light of current state taxation models. Specifically, in Nevada, the law requires all businesses engaged in the cultivation, production or dispensation of marijuana to pay the Medical Marijuana Tax (MMT).

The MMT is a 2 percent excise tax levied on top of any state or local taxes for each sale of marijuana, regardless of whether it is wholesale or retail.[11] To illustrate: If a dispensary buys $1,000 in marijuana from a producer, the dispensary would pay $1,000 plus 2 percent excise tax, for a total of $1,020. If the dispensary then turns around and sells that same batch of marijuana to its patrons, the patrons would also be obligated to pay a 2 percent excise fee, regardless of it being a second sale. If the medical marijuana industry were forced to pay federal income tax on the "income" attributed to the excise tax, it would create a potential for double and triple taxation on utterly phantom funds.

Despite the unfavorable tax situation created by the conflicting federal and state legislation, the marijuana industry should always keep detailed business records as Congress may yet revise the tax code to retroactively approve currently disallowed expenses. **NL**

1. 26 U.S. Code § 280E.
2. *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r*, 128 T.C. 173 (2007) .
3. Id.
4. See *Olive v. Commissioner,* 139 T.C. 19, 38 (2012).
5. See id., CHAMP, 128 T.C. 173, *Peyton v. Comm'r,* T.C. Memo. 2003-146; *Franklin v. Comm'r,* T.C. Memo. 1993-184; *Vasta v. Comm'r,* T.C. Memo. 1989-531; see also Rept. 91-494 (Vol. 1), at 309 (1982).
6. 26 CFR §1.471-11.
7. Id., Office of Chief Counsel IRS Memorandum CCA 201504011.
8. Office of Chief Counsel IRS Memorandum CCA 201504011, 26 CFR §1.471-11.
9. Office of Chief Counsel IRS Memorandum CCA 201504011.
10. Office of Chief Counsel IRS Memorandum CCA 201531016
11. "Medical Marijuana Tax," State of Nevada Department of Taxation, http://tax.nv.gov/FAQs/MMT/

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