CHAPTER 8

Pitfalls of Being (or Representing) a Cannabis Service Provider

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Synopsis

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¶ 800 INTRODUCTION

On January 1, 2018, California, the most populous state in the United States, and the fifth largest economy in the world, legalized recreational cannabis. Some estimates have California producing up to 80% of the cannabis in the U.S. California became the 8th state plus Washington D.C. to legalize recreational cannabis. Twenty-nine states plus Washington D.C. allow medical marijuana. Despite the continued growth in state legalization, the reality remains that marijuana is illegal under Federal law.

Marijuana is a Schedule I controlled substance under the Controlled Substances Act[1] ("CSA"). It is a Federal criminal violation to manufacture, distribute, or dispense marijuana. This does not, however, eliminate the need to pay income tax on proceeds from the sale of marijuana. Navigating the tax laws for a cannabis business is no easy task because such a business is not treated the same as a local dry cleaner or perhaps more relevant, a liquor store. Special rules exist that limit the expenses even state legal cannabis businesses can deduct. In addition to tax laws, there are many tax related areas of law that tax practitioners must take into account in representing cannabis related clients.

¶ 801 FEDERAL ENFORCEMENT

¶ 1 Cole Memorandum

On August 29, 2013, the Deputy Attorney General James Cole issued a memorandum to all United States Attorneys relating to marijuana, which described enforcement priorities under the CSA.[2] For matters falling outside Federal enforcement priorities, Federal law enforcement has historically relied on state and local law enforcement agencies to address marijuana activity through enforcement of its own drug laws. This memorandum provided assurance to cannabis businesses that as long as they did not implicate one of the Cole Memorandum priorities, Federal law enforcement would not come after them.

Under the Cole Memorandum Federal enforcement priorities included:

- Preventing the distribution of marijuana to minors;
- Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
- Preventing the diversion of marijuana from states where it is legal under state

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[1] 21 USC §§ 801 et seq.

[2] U.S. Department of Justice, Office of the Deputy Attorney General, James M. Cole, Deputy Attorney General, *Guidance Regarding Marijuana Enforcement*, August 29, 2013.

law in some form to other states;

– Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;

– Preventing violence and the use of firearms in the cultivation and distribution of marijuana;

– Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;

– Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands;

– Preventing marijuana possession or use on Federal property.

¶ 2 Rescission of the Cole Memorandum

On January 4, 2018, Attorney General Jefferson B. Sessions, III, a longtime advocate of "the war on drugs", rescinded the Cole Memorandum. Under the "Sessions Memo" prosecutions relating to the cultivation, distribution, and possession of marijuana will be governed by "well-established" principles of prosecution governing the Department of Justice since 1980. Basically, Attorney General Sessions believed that the Cole Memorandum was unnecessary because the Department of Justice always had a policy regarding marijuana prosecutions. Prosecutors will now weigh all relevant considerations, including Federal law enforcement priorities, the seriousness of the crime, the deterrent effect of criminal prosecution, and the impact of particular crimes on the community. The rescission of the Cole Memorandum gives significant discretion to local U.S. Attorneys to determine whether to prosecute. This action leaves not only cannabis businesses in a state of flux and unease, but also ancillary businesses, especially banks, as well.

¶ 3 Rohrabacher-Blumenauer (formerly Rohrabacher-Farr) Amendment

The Rohrabacher-Blumenauer amendment, which was first introduced in 2014[3] has been part of the last several appropriations bills, including the most recent one passed in February 2018. It prohibits the Justice Department from spending funds to interfere with the implementation of state medical cannabis laws. Under the amendment, DOJ funds should not be spent to prosecute state legal cannabis businesses.

Rohrabacher-Blumenauer has had an impact on the way courts handle cannabis cases in ways that are still developing. The Ninth Circuit held in *United States v.*

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[3] Known at the time as the Rohrabacher-Farr Amendment after Rep. Dana Rohrabacher (R-CA) and Rep. Sam Farr (D-CA). Rep. Farr retired in 2017, and Rep. Earl Blumenauer (D-OR) has become the co-sponsor.

McIntosh[4] that despite Rohrabacher-Farr, there is no immunity from prosecution. Trafficking in cannabis is still illegal after all, but defendants are entitled to an evidentiary hearing on their compliance with state laws. The prosecutions themselves could not be enjoined, but spending funds from the appropriations acts on the prosecutions could be.[5] The case was remanded for an evidentiary hearing on whether the defendants were in compliance with state laws and for the lower courts to determine the appropriate remedy.

In *United States v. Kleinman*,[6] a case similar to *McIntosh*, the Ninth Circuit refused to remand where the record clearly demonstrated that the defendant's conduct violated state law.[7]

In August 2017, a District Court in the Norther District of California temporarily stayed a prosecution prior to sentencing of two defendants who pleaded guilty to conspiracy to manufacture and possess with the intent to distribute marijuana.[8] The defendants, Moore and Pisarski, moved to have the Department of Justice enjoined from expending funds on their prosecution. The Court held that the defendants showed by a preponderance of the evidence that they strictly complied with all relevant conditions imposed by California law on the use, distribution, possession, and cultivation of medical marijuana.[9] To effectuate the injunction, the Court stayed the matter until and unless a future appropriations bill permits the government to proceed.[10] This case is significant because with the repeal of the Cole Memorandum, theoretically, the number of marijuana prosecutions could grow, but Rohrabacher-Blumenauer appears to provide a substantial check, at least in the Ninth Circuit.

¶ 802 IRC § 280E AND THE TAX COURT

¶ 1 Edmundson v. Commissioner

Jeffrey Edmundson was a drug dealer.[11] He sold amphetamines, cocaine, and marijuana. As a self-employed drug dealer, he incurred expenses such as car and truck, air fare, packaging, and rent. He also deducted cost of goods sold. Because he was a drug dealer, Mr. Edmundson did not keep books and records and the IRS disallowed his expenses. The Court allowed certain expenses as ordinary and necessary to the

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[4] *United States v. McIntosh*, 833 F3d 1163 (9th Cir 2016).

[5] Id. at 1176.

[6] *United States v. Kleinman*, 859 F3d 825, 880 F3d 1020 (9th Cir 2017).

[7] See also *United States v. Gloor*, 2018 US App LEXIS 4004 (9th Cir 2018).

[8] *United States v. Moore*, 274 FSupp 3d 1032 (ND Cal 2017).

[9] Id. at 17.

[10] Id.

[11] *Edmundson v. Commr*, TC Memo 1981-623.

trade or business of drug dealing. It is important to note that this case was strictly a substantiation case. Congress was aghast with the outcome of Edmundson, and in response passed IRC § 280E.

¶ 2 IRC § 280E

Everyone knows that businesses can generally deduct ordinary and necessary expenses under IRC § 162(a). IRC § 280E takes that away. Under IRC § 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."

Marijuana is a schedule I controlled substance, and therefore, those trafficking marijuana cannot deduct ordinary and necessary expenses.[12]

¶ 3 CHAMP

IRC § 280E has been the focal point of cannabis litigation in the Tax Court for over a decade. The seminal case remains *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*,[13] better known as CHAMP. *CHAMP* held that IRC § 280E prohibits a business trafficking in marijuana from deducting ordinary and necessary business expenses, but allowed a deduction for the separate, but related care giving business. *CHAMP* was decided on the specific facts of the case. As a consequence, an understanding of the factual foundation for the *CHAMP* decision is critical.

The taxpayer was organized pursuant to the California Nonprofit Public Benefit Corporation Law and stated its purpose was charitable, educational, and scientific. It was not a tax-exempt organization, but operated at break even. Approximately 47% of its patients suffered from AIDS, with the remainder suffering from cancer, multiple sclerosis, and other serious illnesses.[14]

The taxpayer's primary purpose was to provide caregiving services to its members and its care giving services were extensive.[15] It held specific support group sessions for patients with HIV/AIDS, women, and elderly. Sessions focused on spiritual and emotional support. The taxpayer also provided its low-income members with meals,

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[12] *Sundel v. Commissioner*, TC Memo 1998-78.

[13] *CHAMP v. Commr*, 128 TC 173 (2007).

[14] Id. at 174.

[15] Id.

and made hygiene supplies available. Members could also consult with a counselor about benefits, health, housing, safety, and legal issues.[16] Its secondary purpose was to provide medical marijuana and to instruct its members how to use medical marijuana to benefit their health.[17] Each member was required to have a doctor's letter recommending marijuana, and the taxpayer required the members not to resell or redistribute the medical marijuana received. Each member paid a fee to receive care giving services and marijuana.

The taxpayer provided its services primarily at its main facility in San Francisco and at an office in a community church. The membership fee approximated the cost of care giving services and marijuana. Members received a set amount of marijuana.

On its tax return the taxpayer notably deducted cost of goods sold, officer compensation, wages, insurance and rents. The IRS disallowed all expenses and cost of goods sold on the Statutory Notice of Deficiency as prohibited under IRC § 280E. Eventually the IRS conceded the cost of goods sold, and that the expenses were substantiated.

The IRS' position was that the taxpayer was engaged in a single trade or business, trafficking in marijuana. The taxpayer argued that its primary business was providing caregiving services. The Court held that the provision of caregiving services was a trade or business separate and apart from the provision of medical marijuana, and to the extent the expenses related to the caregiving business IRC § 280E did not apply.[18]

¶ 4 OLIVE

Subsequent to the decision in *CHAMP* cannabis dispensaries regularly used this opinion as a guide for the allocation of expenses to separate non-trafficking businesses in order to avoid the impact of IRC § 280E. It wasn't long until the issue arose before the Tax Court again in the *Olive* case.[19] The taxpayer operated the Vapor Room, where its patrons visited primarily to consume marijuana. It provided couches, chairs and tables, games, and books for patrons to use on site. The marijuana was kept in jars in a jewelry-store-like glass counter and behind the counter. The Vapor Room's sole source of revenue was from the sale of medical marijuana. The Vapor Room provided other activities such as yoga, chess, and movies, where patrons consumed marijuana while participating. The taxpayer deducted expenses such as utilities, wages, and rent. In addition to the expense issue, the taxpayer also underreported gross receipts, a common issue in the cannabis industry.

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[16] The taxpayer also coordinated social events such as trips to the beach, museum, or parks, as well as a Friday night movie or Saturday night social with live music.

[17] Id.

[18] The Court disagreed with the taxpayer's position that the provision of marijuana was not trafficking.

[19] *Olive v. Commr*, 139 TC 19 (2012).

Before examining the effect of IRC § 280E, the Court determined that the taxpayer failed to maintain adequate records and was not entitled to the benefit of the Cohan rule. As is noted above, poor recordkeeping has long been an issue in the cannabis industry.

The Court rejected the taxpayer's argument that he operated a separate caregiving business like the taxpayer in *CHAMP*. The Court found that dispensing of marijuana and providing services shared a close and inseparable organizational and economic relationship. The Court found the taxpayer's witnesses not credible and their testimony rehearsed. The employees all worked on dispensary activities unlike in *CHAMP*, and witnesses were hard pressed to list any caregiving services. The *Olive* establishes that a clear separation between dispensary activities and caregiving activities must exist in order to deduct the caregiving expenses. If a taxpayer claims to have two separate businesses they must be separately operated. Because it is a facts and circumstances determination there isn't one thing that tips the scales.

The Tax Court has heard[20] and continues to hear[21] cases challenging the validity of IRC § 280E as it applies to state legal medical marijuana.

¶ 5 Alterman

The importance of proper recordkeeping and accounting was highlighted in the recent Alterman case.[22] The taxpayer operated a Colorado dispensary and cultivation operation. The taxpayer reduced gross revenue for COGS and deducted business expenses to determine taxable income. Needless to say the business expenses were disallowed pursuant to IRC § 280E. The taxpayer had some records relating to COGS, but the taxpayer's records were inadequate and incomplete. The taxpayer failed to keep a proper general ledger. As a consequence, the taxpayer could not establish its beginning or ending inventory, its production costs or its purchases. The taxpayer asked the Court to apply the Cohan rule to estimate COGS. The Court declined to do so because the taxpayer's recordkeeping was so inadequate. Complete and accurate recordkeeping along with sophisticated accounting systems is very likely more important for cannabis businesses than for mainstream businesses. The Tax Court has now held in multiple cases that sloppy recordkeeping and accounting practices will not

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[20] *Canna Care, Inc. v. Commr*, TC Memo 2015-206. On Appeal to the Ninth Circuit, the taxpayer in *Canna Care* argued that IRC § 280E violates the excessive fines clause of the Eighth Amendment. In affirming, the Ninth Circuit did not consider this argument because the issue was not raised in the Tax Court.

[21] *Patients Mutual Assistance Collective Corp. d.b.a. Harborside Health Center v. Commr*, Tax Court Docket No. 29212-11.

[22] *Alterman v. Commr*, TC Memo 2018-83.

be excused.

¶ 803 COLLECTION ISSUES

Once a taxpayer is saddled with a tax liability, the IRS will eventually come to collect. A cannabis business seeking an Offer In Compromise ("OIC") may find it difficult. In calculating the reasonable collection potential, the IRS will not consider deductions not allowed under IRC § 280E.[23] The effect is that many, if not most, offers will not be viable. If an OIC is not an option, the taxpayer can consider an installment agreement, which requires full payment of the liability. Another issue of course is that the IRS believes the taxpayer has money that the taxpayer is unlikely to actually have.

¶ 804 CALIFORNIA—DAWN OF A NEW ERA

¶ 1 Excise and Cultivation Tax

Beginning January 1, 2018, recreation sales of cannabis became legal. With legalization come taxes. California has two new taxes. A 15% excise tax is imposed upon purchasers of cannabis and cannabis products. Retailers of cannabis and cannabis products are required to collect the 15% tax from the purchaser based on the average market price of any retail sale and pay it to their cannabis distributor.

A cultivation tax is imposed upon cannabis cultivators on all harvested cannabis that enter the commercial market. Cannabis cultivators are required to pay the cultivation tax to either their distributor or their manufacturer.

The responsibility to collect both the excise tax and the cultivation tax falls on the distributor who then must pay it over to the California Department of Tax and Fees Administration ("CDTFA"). On its face this tax structure may appear simple to implement and collect. In reality, there are many complexities. Identifying the parties can be far more complex than a simple A to B to C transaction. In addition, such a heavy reliance on cannabis distributors may not be the wisest decision given the inherent nature of the business. California has lofty goals for revenue from these two cannabis taxes. It will remain to be seen how successful California will be.

In addition to these new taxes at the state level, many cities and counties have their own taxes. Making things even more complicated, different rates can apply depending on who the retail purchaser is. Medical marijuana is subject to different tax rates than recreational marijuana. The regulatory and tax burden is cumbersome, and it highlights the importance businesses must place on accounting and recordkeeping.

How effective the CDTFA will be in auditing and enforcing the new laws remains to be seen.[24] As with all government entities, a lack of resources provides difficulties.

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[23] Internal Revenue Manual § 5.8.8.5.8.7.

[24] Initial reports in California indicate legal marijuana sales are as much as 50% less than expected by

For taxpayers, the complex laws and the recordkeeping are burdensome. As discussed above, recordkeeping has not been the strong suit of cannabis businesses, but California will now expect, and essentially, requires the industry to change.

¶ 2 California Tax Differences

Under Federal law, IRC § 280E prevents taxpayers from deducting expenses related to trafficking. Because California has a Franchise tax for businesses, and not an income tax, depending on a businesses choice of entity, businesses may be able to deduct certain core expenses. Businesses organized as C corporations, S corporations or LLCs treated as corporations are allowed to deduct ordinary and necessary business expenses for California purposes. For an industry where IRC § 280E dramatically reduces profitability, every little bit helps. Sole proprietorships, partnerships, and LLCs treated as a partnership cannot deduct ordinary business expenses.

¶ 805 ETHICS OF REPRESENTING CANNABIS RELATED BUSINESSES

¶ 1 ABA Model Rules

No client is worth risking your license for. With cannabis related clients, this could be all too real if lawyers and accountants are not careful. Under ABA Model Rule 1.2(d), "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law."[25]

¶ 2 State Ethical Standards

Cannabis related businesses are acting in violation of Federal criminal. This is a problem. At the same time, several states have some form of legalization, and depriving such business of legal assistance is problematic. This issue is being handled on a state basis with states generally being divided between "counsel" and "assist".

Counsel states typically allow lawyers to inform cannabis related clients as to current law, but not assist in compliance with the law, such as preparing forms. Assist states allow attorneys to assist clients with compliance of state laws. In California,[26]

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the State. The failure to achieve anticipated sales may be the product of over-optimistic projections by California, but legal sales are certainly impacted by the substantial California and local taxes. The taxes on legal cannabis undoubtedly fuels the underground market.

[25] ABA Model Rule 1.2(d).

[26] California Rules of Professional Conduct, Rule 3-210 states that a member shall not advise the violation of any law, rule, or ruling of a tribunal unless the member believes in good faith that such law, rule, or ruling is invalid. The California Supreme Court recently approved new Rules of Professional Conduct that are effective November 1, 2018. Under new rule 1.2.1, "A lawyer shall not knowingly assist

both the Los Angeles County Bar Association and the San Francisco Bar Association come down on the "assist" side.[27, 28] The Los Angeles County Bar opinion states that if a lawyer is permitted to advise a client on how to comply with state law, the lawyer should be able to assist the client in carrying out that advice so the crime does not occur. Not allowing assistance disconnects lawyers from their function, namely assisting clients in complying with laws.[29]

¶ 3 Crime-Fraud Exception

The representation itself is just one of the many ethical issues that representing cannabis clients presents. The attorney-client privilege is at the heart of every representation. With cannabis clients, attorneys should be aware of the crime-fraud exception. This exception to attorney-client privilege applies when the communications between attorney and client are used by the client in furtherance of a crime. Merely advising a client on the law does not invoke the crime-fraud exception. In San Diego, CA, the District Attorney is continuing to prosecute attorney Jessica McElfresh for conspiracy with a cannabis client to hide evidence from city inspectors. The prosecution argues that the crime-fraud exception applies so it can access McElfresh's records.

¶ 806 FINCEN RULES

The Financial Crimes Enforcement Network ("FinCEN") is a part of the Department of the Treasury that collects information and analyzes financial transactions to police financial crimes such as money laundering. Financial institutions must file Suspicious Transaction Reports ("SARs") for transactions involving marijuana-related businesses. The SARs have been divided into three levels depending on compliance with state laws and the Cole Memorandum priorities.

Financial institutions must file a Marijuana Limited SAR if it provides services to a marijuana-related business that it reasonably believes, based on due diligence, does not implicate one of the Cole Memorandum priorities or violate state law.[30] The Marijuana Limited SAR includes the identifying information of the subject and related parties, address of the subject and related parties, the fact that the institution is filing a SAR solely because of a marijuana-related business, and that there is no additional suspicious information.

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in, solicit, or induce any violation of these rules or the State Bar Act." Comments on the new rules appear to offer some protection for lawyers advising and assisting in compliance with California laws that conflict with existing Federal law. Although cannabis is not explicitly mentioned, the new rule and the comments appear to have been drafted to specifically address representation of cannabis businesses.

[27] Los Angeles County Bar Association Opinion No. 527.

[28] San Francisco Bar Association Opinion No. 2015-1.

[29] Los Angeles County Bar Association Opinion No. 527, p. 11.

[30] FIN-2014-G001.

A Marijuana Priority SAR is filed if the financial institution reasonably believes, based on due diligence, that the marijuana-related business does implicate or violate one of the Cole Memorandum priorities.[31] This includes the same information as a Marijuana Limited SAR and adds details regarding the enforcement priority implicated.

Finally, a Marijuana Termination SAR is filed when the financial institution deems it necessary to terminate a relationship with a marijuana-related business in order to maintain effective anti-money laundering compliance program. The financial institution should note the reason for filing. If the financial institution becomes aware that the business seeks to move to another financial institution, it should alert the second institution of potential illegal activity.[32]

Over time more and more financial institutions have accepted marijuana related businesses. FinCEN estimated over 400 as of September 2017. As of September 30, 2017, FinCEN received over 39,000 marijuana related SARs. Of the over 39,000, over 28,000 were marijuana limited SARs, over 2,000 were marijuana priority SARs, and over 9,000 were marijuana termination SARs.[33]

The filing of marijuana related SARs are tied to the Cole Memorandum, and when Attorney General Sessions rescinded the Cole Memorandum, it called into question whether the FinCEN guidelines were still valid. About a week after Attorney General Session announcement, FinCEN announced that the SAR reporting as outlined in FIN-2014-G001 would remain in place.

¶ 807 FORFEITURE

Cannabis businesses like most businesses need physical space to operate. Such businesses rent retail space for dispensaries, warehouse facilities for growing operations, and other types of properties. Landowners who rent to cannabis businesses risk forfeiture. Under 21 U.S.C. § 881(a)(7), all real property, including, any right, title, and interest used or intended to be used to commit or facilitate a violation of the Controlled Substances Act is subject to forfeiture.[34] Renting space to cannabis businesses can be appealing to certain landowners because they can typically charge substantially higher rent and may receive up front payments. The risk, however, is substantial.

¶ 808 RICO AND NUISANCE LAWS

The increased presence of marijuana is not only having an impact in government enforcement areas, but private actions as well. In *Safe Streets Alliance v. Hicken-*

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[31] Id.

[32] Id.

[33] https://www.fincen.gov/sites/default/files/shared/273281%20EA%204th%20Q%20MJ%20Stats_Public_Web.pdf.

[34] 21 U.S.C. § 881(a)(7).

looper,[35] the Tenth Circuit Court of Appeals held that private landowners were allowed to bring RICO claims against marijuana growers. The landowners argued that because the cultivation of marijuana was in violation of Federal law, the marijuana growers created a nuisance with the noxious odors that directly harmed their neighbors' property.

¶ 809 CONCLUSION

Polls continue to show an increase in the support for legalization of marijuana. The industry is certainly growing, but it remains illegal under Federal law, and is heavily regulated in states that allow medical or recreational use. The legal issues are numerous and complex. Taxation is often a secondary concern to the basic regulatory ones, but must not be overlooked. The inability of cannabis related businesses to deduct ordinary and necessary business expenses remains a significant impediment to operating a successful business. Tax professionals practicing in this area need to be aware of the many pitfalls that can affect you and your client.

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[35] *Safe Streets Alliance v. Hickenlooper*, 859 F3d 865 (10th Cir 2017).