ACCOUNTING

CONTINUING EDUCATION

Accounting, Auditing and Tax Considerations for the Cannabis Industry

(CANA4)

KAPLAN

Accounting, Auditing, and Tax Considerations for the Cannabis Industry

(CANA4)

2021

Edward K. Zollars, CPA

Kenneth Heaslip, MS, MBA, CPA, CGMA

KAPLAN

ACCOUNTING, AUDITING, AND TAX CONSIDERATIONS FOR THE CANNABIS INDUSTRY (CANA4)

Published in 2021 by Kaplan Financial Education.

Printed in the United States of America.

TABLE OF CONTENTS

Section 1

The Cannabis Industry

LEARNING OBJECTIVES

After completing this section, participants should be able to:

- ☐ Define the risks of taking on a client in the cannabis industry
- ☐ Explain the risks and ethics involved in cannabis entities
- ☐ Properly account for a cannabis business

OVERVIEW

The cultivation, transportation, and sale of cannabis has been illegal for decades. The movement to legalize the industry has been around almost as long. Groups like The National Organization for the Reform of Marijuana Laws (NORML) have lobbied aggressively for legalization. The political climate for legalization has grown and several states had public referendums where legalization was authorized.

Colorado has become a leader in the reform movement. In 2000, through voter referendum, use of the drug was legalized for medical use. In 2012, adult use was approved for legalization in 2014.

These actions created what is called "cannabis tourism" where people from other states could come to that state to purchase the drug. This caused some tension with other states, especially those that were Colorado neighbors. It also put pressure on other states to pass reform laws. As of November 2020, 41 states have decriminalized cannabis and legalized some or all forms of cannabis for medical use and 16 states (AK, AZ, CA, CO, IL, ME, MA, MI, MT, NV, NJ, OR, SD, VT, and WA) have legalized it for adult use. Only 3 states (ID, KS, and NE) have it fully prohibited[1].

The reason for legalization has been much more than pressure by users (both for medical and non-medical uses). The added tax revenue has been attractive to states and municipal governments. Recently, the issue has been part of the budget process when evaluating revenue sources. As more states legalize cannabis, it is becoming more accepted by other states.

[1] www.disa.com/map-of-marijuana-legality-by-state.

Supply Chain

In many ways, the accounting and operations of companies in the cannabis industry is like that of other agricultural industries. Like other industries, Companies need to run operations from the planting of the product to retail operations. They need to record transactions, transact with customers, and pay vendors. The nature of the business, however, creates some unique differences. The industry can be divided into several different areas of the supply chain:

- Producers/growers (planting, cultivating, harvesting, extracting)
- Processors (processing, packaging, extracting, testing, disposing)
- Transporters
- Retailers

Distributors/Dispensaries

What makes the industry unique is that the sale of product is illegal under United States federal laws and subject to severe penalties but legal under many state laws. Some of the states have legalized it for medical use only while others have extended the legalization to adult use. For various reasons, the industry prefers that the phrase "recreational use" be avoided.

The approved medical uses vary by state. In some states, obtaining medical permission for use of the drug is easy and can be as simple as claiming stress or anxiety. In other states, only specific conditions are eligible, and approvals are needed by medical practitioners. The form and structure of the entities are limited. For example, in New Jersey, originally only six distributors were approved for medical distribution and all were non-profit organizations. More recently, for-profit entities have entered the industry.

Federal Laws

Federal laws and regulations classify cannabis as a Schedule I drug which is characterized by:

- Having a high potential for abuse
- Having no medicinal value or use
- A lack of accepted safety for use under medical supervision

Schedule I drugs include meth, LSD, MDMA, and mescaline. This classification is controversial since many studies show medicinal value and it is not subject to abuse any more than other drugs not on the schedule. As a Schedule I drug, anyone involved in the industry can be arrested and prosecuted for drug trafficking, a serious federal crime. Some of the issues discussed in this program would be eliminated simply by changing the classification of the drug.

Secure and Fair Enforcement (SAFE) Banking Act[2]

Congress passed the Secure and Fair Enforcement Banking Act of 2019 (SAFE Banking Act) on September 26, 2019. This Act provides a safe harbor for depository institutions providing financial services to cannabis-related legitimate businesses and service providers. The Act does this by prohibiting a federal banking regulator from terminating or limiting deposit insurance or share insurance of a depository institution solely on the basis of it providing services to a legitimate cannabis-related business or service provider or by prohibiting, discouraging, or penalizing a depository institution from doing business with a legitimate cannabis-related business or service provider. It also prohibits a federal regulatory agent from incentivizing a depository institution not to offer services to legitimate cannabis-related businesses and service providers. With the passage of this Act, it is slowly allowing cannabis-related businesses the ability to operate less on a cash basis. More financial institutions that are FDIC insured are advertising that they will support cannabis-related businesses.

Industry Characteristics

Things that are unique to the cannabis industry are:

- It is illegal under federal laws. Technically, any person involved in the industry can be cited by federal law enforcement in violation and subject to punishment of drug trafficking laws.
- IRC Section 280E disallows all tax deductions for selling and administrative expenses related to a business for which the trafficking of a controlled substance occurs. Only expenses for cost of goods sold are allowed.
- Bank regulations, the lack of banking relationships, and the risks inherent in the business make it very difficult to obtain bank financing.
- It is highly regulated by states, requiring approvals, registrations, and legal filings. The laws and regulations vary by jurisdiction and are constantly changing as the industry matures.
- The cash nature of the business, as well as the type of inventory involved in the business, requires extensive internal control and security measures.
- State regulations regarding ownership, taxes, products to be sold, etc. are extensive and vary by state. More discussion follows in the Ownership section of this course.

This course will be an overview of the concepts related to the industry. It will cover the need to properly allocate expenses between product and period costs, internal controls, organizational structures, and the taxation of cannabis companies.

Medicine of Marijuana

Cannabis is more commonly referred to as marijuana and has several street names. Often the plant product is called hemp. Marijuana contains two key chemical compounds, tetrahydrocannabinol (THC)

[2] "Text – H.R. 1595-116th Congree (2019-2020): Secure and Fair Enforcement Banking Act of 2019. " Congress.gove,September 26, 2019 https://www.congress.gov/bill/116th congress/house-bill/1595/text

and cannabidiol (CBD). THC is psychotropic, causing the high feeling that is most commonly associated with the plant and produces the sought-after high feeling. CBD does not cause the high feeling and has been shown to help in treating insomnia, pain, epilepsy, depression, bone complications, nausea, and inflammation. Synthetic CBD has been used for years, but the FDA recently approved an epilepsy drug, Epidiolex, which is derived from the cannabis plant. This is the only FDA health approved use of CBD.

The 2018 Farm Bill removed legal restrictions on CBD, if it is derived from hemp plants which cannot contain more than 0.3% THC. Therefore, if CBD comes from a hemp plant with less than 0.3% THC, it is legal to buy it and possess it under federal law. Under federal law, a store can sell as much CBD as it wants as long as it does not make claims regarding its impact on health or put it in food or dietary supplements.

Adult Use

Cannabis-based products are sold as flower, vape, concentrates, and infused products. A key concern regarding the legalization is the lack of federal guidelines for contamination tolerances, testing, and potency.

ORGANIZATIONAL STRUCTURE

Type of Entity

As with other entities, a cannabis entity must decide the best legal structure. Options are:

- Limited Liability Company (LLC) – LLCs are the most popular type of organizational structure. Owners have found it gives the greatest advantages and flexibility. When selecting this option, the entity must decide whether to be taxed as a corporation or a partnership. For the purposes of this program, unless otherwise stated, it will be assumed the company is an LLC and the owners are referred to as owners or members.

- Corporation – Corporate structures are second in popularity behind LLCs. Once this decision is made, the entity should decide whether or not to make an S election, allowing it to be taxed as a pass-through entity.

- Partnership – Due to state regulations, it is sometimes preferable to operate as a partnership. Many Colorado businesses have opted for this structure. There is more liability for the general partner under this structure.

The tax structure is generally chosen via a member's operating agreement. The nature of the ownership can influence this decision. Since Colorado and California have the longest track record in this industry, we will look at regulations written by those states.

The company's capitalization can take many forms:

- Contribution of cash or other tangible assets

- Contribution of labor

- Contribution of intangible assets such as inventions or specialized knowledge

- Anything else of value

While all entities should have a well-drafted operating agreement, it is especially important for one in the cannabis industry. The agreement should cover such routine items as how member interests can be added, withdrawn, or transferred as well as provisions for making amendments to the agreement. It is common to require a supermajority or unanimous consent for such amendments. Some states require regulatory approval of all owners as well as transfers of ownership. If a member wishes to withdraw and sell his/her interest, the other members should be given first rights to the interest as well as the right to refuse who will receive the ownership interest.

Ownership

Many operating agreements have a moral character clause. In most cases, such clauses are general but they can contain specific items such as a requirement not to engage in illegal sales. In fact, it is required by the Marijuana Enforcement Division (MED) in Colorado. It is also advisable to have an expulsion provision with an allowance for the company to purchase the member's interest.

Colorado requires each owner/employee to have an Associated Key License, Owner License or Employee License, an occupational license for any stockholder with an interest in a marijuana licensee or any officer or director who acts as a key executive, employee, or agent while physically working in a licensed medical or retail marijuana business. This limits the ability to transfer membership interests and provide authorities with an accurate record of who is employed within the highly regulated business. The law is designed for maximum transparency so ownership cannot be hidden, and indirect interests such as the following must be disclosed:

- Convertible debt
- Profit-sharing provisions
- Stock options
- Intellectual property or other licensing agreements
- Secured notes or similar instruments
- Other economic interests

Due to the nature of the entity, the abundance of cash, and potential liabilities, it is important that owners have a high level of trust with each other. It is easy for events to arise that will cause disagreements or disputes. Such disputes are often addressed with the requirement to resolve them with an arbitration provision that provides for confidential proceedings and limited discovery.

When investing in a cannabis entity, the following should be considered:

- Know your partners
- Assure that good contracts are in place and all agreements are formally drafted
- Non-U.S. citizens have challenges due to the illegal nature of the business
- The use of bank accounts and obtaining financing is very difficult
- Due diligence is extremely important

RISKS

Although a majority of states have legalized cannabis for medical use, and some for adult use, the federal government continues to treat the industry as illegal. Under President Obama, the Justice Department was told not to pursue entities that were legally established in a state. Those policies were changed with the Trump administration. On January 4, 2018, Attorney General Jeff Sessions issued a memorandum announcing that the relaxations under Obama would be withdrawn. Even without the policy, the Justice Department will focus resources on the "most significant threats in the most effective, consistent, and rational way." Many have criticized this policy as being too arbitrary.

The biggest fear is that the sale of marijuana is subject to:

- Drug trafficking laws and the
- Racketeer Influenced and Corrupt Organizations Act (RICO).

Currently, the Justice Department has listed the following eight enforcement priorities:

1. Distribution of marijuana to minors
2. Revenue from marijuana sales going to criminal enterprises, gangs, and cartels
3. Diversion of marijuana from states where "legal under state law in some form" to other states
4. State-authorized marijuana activity from being used as a cover/pretext for trafficking other illegal drugs or illegal activity
5. Violence and use of firearms in marijuana cultivation and distribution
6. Driving under the influence and exacerbation of other adverse public health consequences associated with marijuana use
7. Growing of marijuana on public lands and attendant public safety and environmental dangers posed by marijuana production on public lands
8. Marijuana possession or use on federal property

Under the Sessions memorandum, the Justice Department will prosecute when they believe that conduct constitutes a federal offense, admissible evidence is sufficient to obtain/sustain a conviction, and a substantial federal interest would be served by prosecution. When determining if a substantial federal interest exists, the prosecutor must weigh:

- Federal law enforcement priorities
- Nature and seriousness of offense
- Deterrent effect of prosecution
- Person's culpability in connection with offense
- Person's history with respect to criminal activity
- Person's willingness to cooperate in investigation/prosecution of others

- Interests of any victims
- Probable sentence or other consequences if person is convicted

Drug trafficking laws and RICO are very open ended and can be interpreted broadly. Therefore, anyone related to the industry can fall within the scope of the law. This is particularly troublesome for ancillary industries such as:

- Advertising, public relations, and marketing agencies
- Banks and payment processors
- Professional services (accounting, legal, consulting)
- Insurance agencies

Legal Risks

As with all industries, entities in the cannabis industry face many risks in areas such as product liability, safety issues, warranties, and customer misuse. The problems are magnified by the fact that they are born by a company engaged in federally illegal activities. The Drug Dealer Liability Act establishes a liability to those injured by a driver under the influence of drugs, families losing a child to illegal drugs, and others injured by illegal drugs. In these cases, the plaintiff need not prove that the drug user received the specific defendant's illegal drugs but only that the defendant distributed the illegal drugs in the community, was distributing the same type of drug used by the user, and the distribution was when the user was using the drug.

As an illustration of this liability, and how mainstream cannabis sales have become, recently in Oregon it was found that 17 samples of a product had pesticide residue levels that exceeded state limits. This resulted in the Oregon Liquor Control Commission issuing a recall of the product under

the name Blue Magoo. This recall resulted in many discussions related to liability in single plaintiff and class action lawsuits. The case also shows the need for company resources to be directed toward:

- Additional regulatory requirements for compliance
- Developing/disseminating product warnings
- Instituting product recalls
- Deploying employee time to:
    - Investigate or mitigate claims
    - Test products
    - Assess risks
- Hiring expert consultants and attorneys

ETHICS

Many questions have been asked by lawyers and CPAs about the ethics in providing services to a business engaged in federally illegal acts. Guidance from the licensing bodies have been challenging. While they want to allow the professionals the right to provide services to the licensees that are in businesses legalized in the state, they must recognize that the services relate to an industry considered by the federal government to be drug trafficking.

Due to the above concerns, many state boards of accountancies are considering adding guidance in their regulations. For example, Vermont has added the following language adopted on December 10, 2019:

> Conflict of State and Federal Laws in Respect to Marijuana. The Board construes statutes and rules governing the practice of public accountancy in a manner consistent with the letter and intent of other State policy. It shall not be a basis for license discipline or denial that a licensee provided or offered to provide professional services to a client engaged in marijuana-related commerce in a manner lawful in the state of transaction. Licensees electing to provide professional services to clients engaged in marijuana-related commerce will be held to the professional standards, laws, and rules applicable to all licensees.

On March 15, 2018, Washington state governor Islee signed a bill, Engrossed Substitute Senate Bill 5928, which in part stated, "A certified public accountant or certified public accounting firm, which practices public accounting, does not commit a crime solely for providing professional accounting services…for a marijuana producer, marijuana processor, or marijuana retailer…[3]"

In Colorado, the Supreme Court issued the following ethical opinion in 2014:

> A lawyer may assist a client in conduct that the lawyer reasonably believes is permitted by these constitutional provisions and the statutes, regulations, order and other state and local provisions implementing them…Lawyers must advise their clients about federal marijuana laws and policies.

SEPARATING PRODUCT AND PERIOD COSTS

As will be discussed in the tax section of this course, it is important that a cannabis company properly allocate costs between product costs (before gross profit) and period costs (after gross profit). Many accountants outside of the manufacturing sectors are unaware of how to distinguish between product and period costs so it important that the concepts be covered carefully.

Types of Expenses

Expenses are broken up into two major categories

- Product costs – Costs related to making or acquiring the products or providing the services that directly generate the revenues of an entity. These are also called inventoriable costs. Components of these costs are:

[3] "CPAs and Cannabis." Board of Accountancy. Accessed February 5, 2020. https://acb.wa.gov/cpas-and -cannabis

- Direct Materials (DM) – Any material that is a readily-identifiable part of a product.
- Direct Labor (DL) – Costs related to the effort of individuals who manufacture a product or perform a service.
- Overhead Costs (OH) – Costs that are indirect to the product or service. This would include indirect labor for costs that cannot be traced to production efficiently. This will include indirect materials and indirect labor as well as all other production costs.

- Period costs – Costs related to business functions other than production, such as selling and administrative.

Classification of costs differ between manufacturers and retailers. For retailers, such as distributors and dispensaries, the costs are mostly limited to material costs and possibly some overhead for inventory storage. Manufacturers face a bigger challenge in allocating overhead to the process. Growers and processors will fall in the manufacturing category.

Cost Allocation

Since indirect overhead costs cannot be traced directly to production, allocation systems must be developed. Cost accountants have developed comprehensive ways to do this. The systems rely on the

assignment of an indirect cost to one or more cost objects using some reasonable allocation base or driver. The two main methods of cost allocation are:

- Actual Cost System – Direct material and direct labor costs are accumulated in Work in Process (WIP) Inventory as the costs are incurred and the actual production overhead costs are accumulated separately in an Overhead Control accounts and then assigned to WIP Inventory at the end of the period or completion of production.

- Normal Cost System – Direct material and direct labor costs are combined with overhead costs and allocated to WIP Inventory using a predetermined overhead rate.

EXAMPLE

California Growers, LLC, produces edibles for sale in their dispensaries. In producing a batch of chocolate edibles, the direct materials cost $1,000 and direct labor is $200. The company has incurred $5,000 in total overhead costs and allocates the cost based on $1.50 per direct labor dollar.

Total cost of goods produced will be $1,500 computed as follows:

Direct Materials	$1,000
Direct Labor	200
Overhead ($200 X 1.5)	300
	$1,500

The overhead allocation is based on a standard cost system which utilizes reliable estimates. Generally, the allocation rate is computed at the beginning of the year based on a determined driver. In the following case, the rate is computed using DL dollar as the driver. The standard rate (rate per DL dollar) is computed as follows:

Annual budgeted overhead costs/Annual budgeted DL cost

Budget costs, by definition, are estimated. Therefore, it is unlikely that the allocations will be exactly the actual amount spent, resulting in an over or under allocation at year end.

Material costs are divided into three major types:

- Raw Materials (RM) – Materials that have not yet been used in processing
- Work in Process (WIP) – Materials for products which have been started, but have not yet been completed
- Finished Goods (FG) – Work completed and ready for sale

Cost of goods manufactured is the total manufacturing costs of producing an item. It can be computed using the following formula:

Beginning Balance of WIP Inventory	$ 175,000		
Manufacturing Costs for the Period:			
Beginning RM balance	$ 250,000		
+ Purchases of materials	98,000		
RM available	348,000		
- End RM balance	(230,000)		
Total RM used		$ 118,000	
Direct Labor		260,000	
Variable overhead		120,000	
Fixed overhead		60,000	
Total manufacturing costs			558,000
Total costs to account for			733,000
Ending WIP balance			(196,000)
Cost of goods manufactured			$ 537,000

Cost of goods sold – Based on the above, cost of goods sold can be calculated as follows:

Beginning FG Inventory	$ 123,000
Cost of Goods Manufactured (above)	537,000
Cost of Goods Available for Sale	660,000
Ending FG Inventory	(116,000)
Cost of Goods Sold	$ 544,000

The above calculations illustrate that the entity must keep track of all costs by type and processing job. Labor and materials are easier to track than overhead since the overhead system must be based on a reliable standard cost system.

Absorption vs. Variable Costing

Overhead consists of both fixed and variable costs. Variable costs are always allocated to the manufacturing process. Fixed costs are handled differently under the following two methods:

- Variable Costing – This cost accounting method will only include variable costs (DM, DL, and variable OH). Fixed OH will be expensed in the year incurred and will not be added to inventory costs.
- Absorption Costing – Under this method, fixed OH costs are added to inventory and allocated as part of the standard OH rate. This will result in higher inventory costs.

Under the Internal Revenue Code Section 263A (uniform capitalization rules discussed later), certain non-product cost such as selling and administrative expenses are also allocated to inventory costs.

At year end, the allocated overhead costs will probably differ from the actual expenses, resulting in a debit or credit balance in the overhead account. If the amount is within normal ranges, it will be added to cost of goods sold at year end. If the difference is not within a normal range, it is allocated between cost of goods sold, WIP Inventory, and FG Inventory.

Conclusion

Since the tax law only allows for the deduction of product costs, it is advantageous to the entity to allocate as much overhead costs as possible to the costs of manufacturing. However, the tax law also imposes high penalties if the allocation improperly results in higher-than-allowed gross profits resulting in an incorrect low tax. Since IRS guidance in this area is virtually non-existent and there are few cases establishing what costs may be included in overhead, many entities have opted to approach the capitalization of such costs conservatively.

SEGMENT REPORTING

The strict limitations on tax deductions only apply to the sale of Schedule I drugs, specifically THC and CBD products with greater than 0.3% THC. Many dispensaries sell more than drugs. CBD and CBD-contained products that do not meet the definition of a Schedule I drug, drug paraphernalia, T-shirts, and novelties are examples of such products. If the sale of such goods are separate from the drug trade, expenses related to those goods would be deductible. The separation must be clear and clean. As such, the following should be considered:

- Establish a separate legal entity to record the transactions related to the peripheral business.
- Consider a separate cash register to negotiate the transactions.
- Clearly and accurately allocate expenses such as rent (by square footage), utilities, salaries, and insurance between the drug sales and the peripheral business. Also consider selling the items in a separate room from the product sale.

INTERNAL CONTROL

The cash nature of the business makes internal controls particularly challenging. Later in the manual, we will have a detailed discussion on internal controls. Some key areas related to internal controls are:

- A strong system of cash control. All sales must be recorded. At one dispensary, the employees don't touch the cash. Upon placing an order, the customer deposits money into an ATM that records the amount deposited and issues a receipt. The customer then shows the receipt when he picks up his product.
- There should be good security at the door. There are severe penalties for serving minors so someone at the door will ID everyone who comes in the shop. This person can also limit the number of customers in the shop at any time. In addition, the "bouncer" can check people entering for weapons because the cash on premises makes the shop vulnerable to robbery.
- Separation of duties is imperative due to the processing of cash.
- Proper record keeping. Since all bills are paid in cash, getting a proper receipt is imperative. It is especially important to record accurate payroll records.
- Tone at the top. It is important that management set a standard for all to adhere to.
- Regulatory compliance. State compliance can be burdensome and overwhelming. Care should be taken that there is compliance in all areas.
- Background checks for all employees.

FINANCIAL STATEMENTS AND AUDITS OF CANNABIS ENTITIES

Due to the lack of ability to finance and the nature of capital contributions, there is not yet a demand for audited financial statements. If the demand did exist, the cash nature of the business would create big challenges.

Several Canadian companies are public and listed on various exchanges. Since Canadian laws differ, the businesses are run very similarly to other industries and audits do not present the same challenges.

As with all entities, there is a need for financial statements to have added disclosures related to the industry. Due to the nature of the industry, the risk and regulatory environment of jurisdictions where the company operates should be part of the disclosures.

NOTES

Section

2

Internal Control for Cannabis Entities

LEARNING OBJECTIVES

After completing Section 2, participants should be able to:

- ☐ Understand the need for internal control in the cannabis industry
- ☐ Define three critical controls
- ☐ Identify and implement appropriate internal control procedures

OVERVIEW

A good system of internal controls is imperative for cannabis entities. In addition to the normal theft risks, the risks are higher because all transactions are in cash and there are severe punishments if regulatory procedures are not followed. As such, people in the industry must put a high priority on controls.

There are no standards to follow on internal controls. Instead, they are implemented based on long-standing guidelines and protocols. Most internal control procedures are focused on financial reporting. This is simply because the controls are based on the same principles as financial statement integrity, the preservation of assets and proper report of liabilities and operations of the business.

There are a few governing documents when evaluating internal controls:

- AICPA audit standards. These standards guide auditors through the process of determining if the financial statements are fairly presented. The reliance on internal controls is important in this process. These standards govern the audit of private companies and are referenced with a prefix AU-C.
- PCAOB audit standards. These are the audit standards that govern the audits of public companies.
- Committee of Sponsoring Organizations (COSO) Framework. This is considered to be the most comprehensive document of principles on internal control. It was updated in 2013 for post-Sarbanes-Oxley issues.

When obtaining an understanding of internal control over financial reporting, it is important to start with the entity level controls since they set the foundation for the activity level controls. AU-C 315, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*, states that the auditor should identify and understand the key entity level internal controls and then use that information to decide how many of the activity level controls need to be understood. This top- down approach is particularly important for smaller entities because as the COSO framework points out in its section on *Considerations for Smaller Entities*, the control environment and monitoring proportionately make up the majority of controls in smaller companies where segregation of duties is not as effective.

People generally tend to think of internal controls in terms of controls at the transaction or activity level such as segregation of duties, performance of bank reconciliations, authorization of transactions and analytical procedures on account balances.

Studies have been performed to understand the cause of corporate failures such as Enron, WorldCom, the Baptist Foundation of Arizona, and others. One such study by the International Federation of Accountants and the CIMA in 2004 noted that the main reasons for corporate failures were:

- Failure in communicating the tone at the top
- Ethics issues on the part of management
- A weak board of directors
- Lack of an internal control, compliance, and/or risk management function
- Aggressive earnings management

Therefore, it is just as important to have a strong foundation (corporate culture) at the entity level to reinforce the individual control activities. With the appropriate tone at the top and monitoring controls, employees are less likely to believe that they can "get away with inappropriate behavior".

Thus, entity level controls can serve as a deterrent to fraud and minimize conflicts of interest. It is not surprising that AU-C 265, *Communicating Internal Control Related Matters in an Audit*, identifies such issues as deficiencies to evaluate as significant deficiencies or material weaknesses.

INTERNAL CONTROLS FOR THE CANNABIS INDUSTRY

In general internal controls for the cannabis industry should focus on safeguarding assets and monitoring cash activities. "A cash-intensive business requires some unique internal controls to safeguard the asset and to maintain adequate records of cash transactions (Frazer 2016)."[4] Greenbooks recommends three internal controls to support the cannabis industry which include:

1. Physical Audit of Inventory

[4] Accounting and the US cannabis industry: federal financial regulations and the perspectives of Certified Public Accountants and cannabis businesses owners, Journal of Cannabis Research, posted by G. Suzanne Owens -Ott on December 3, 2020, access on December 8, 2020, https://jcannabisresearch.biomedcentral.com/articles/10.1186/s42238-020-00049-7

2. Monthly Trial Balances

3. Accounts Payable Matching Process

Physical Audit of Inventory: "A regularly scheduled physical audit of inventory should be a no-brainer in this industry. Although it can be a pain, taking both time and money to perform, the behavior it instills in an organization will pay off in spades. A few benefits your company would get from installing this procedure include more accurate seed to sale tracking, an increased accuracy in your stated cost of goods sold and inventory accounts as well as a better trained and monitored staff." [5]

Monthly Trial Balances: "A trial balance is a list of all the general ledger accounts (both revenue and capital) contained in the ledger of a business. This list will contain the name of each nominal ledger account and the value of that nominal ledger balance. Each nominal ledger account will hold either a debit balance or a credit balance."[6] Completing a trial balance should be an integral component of a monthly financial closing process and will ensure that financial statements are properly stated. A review of the trial balance should be in place to identify significant account fluctuations and react to potential anomalies in a timely manner.

3-Way Match in the Accounts Payable Process: Matching is a process performed for goods and services ordered through a purchase order that takes place during the online invoice approval process. Invoices are matched to purchase orders (2 way matching), receiving information (3 way matching), and inspection information (4 way matching) as applicable. The invoices must meet matching tolerances or a hold is placed on the invoice and payment cannot be made until the hold is resolved or manually released. In many cases, a single invoice can be matched to multiple purchase order shipments or multiple invoices can be matched to a single purchase order shipment. Internal controls within the accounts payable process ensure that you match only to valid purchase orders for the supplier on an open invoice and that the purchase order, date, and invoice currency match.

When an invoice is matched to a purchase order, the accounts payable process creates an invoice distribution using the purchase order distribution accounting information. An Invoice distribution created through matching cannot be deleted. However, if an accounts payable associate incorrectly matches an invoice to a purchase order, the individual distributions usually are voided with supervisory override to cancel the match.

REGULATORY CONSIDERATIONS

"Cannabis businesses are also greatly affected by the Bank Secrecy Act (BSA) and anti-money laundering regulations that are designed to help identify and report money laundering activity (Sanders 2015). The Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Department of Treasury, exists to "safeguard the financial system from illicit use and combat money laundering" (Financial Crimes Enforcement Network n.d.). In practical terms, FinCEN guidance stated that providing banking services to cannabis businesses was illegal

[5] "Three Internal Controls Every Cannabis Company Should Have," Greenbooks, posted on November 26, 2019, accessed on December 6, 2020, https://www.greenbookscpa.com/blog/three-internal-controls-every-cannabis-company-should-have

[6] "Trail Balance," Wikipedia, accessed December 6, 2020, https://en.wikipedia.org/wiki/Trial_balance#:~:text=A%20trial%20balance%20is%20a,balance%20or%20a%20credit%20balance.

and required banks to self-report this federally illegal activity (Houser and Rosacker 2014; Shu-Acquaye 2016). Due to the BSA risks and FinCEN reporting requirements, most large banks will not provide accounts for cannabis-related businesses (Drayton 2017). However, there is evidence that some banks and credit unions are serving the industry. According to FinCEN, as of June 2020, 695 financial institutions in the USA are reportedly serving the cannabis industry; this is down from a high of 747 institutions in November 2019 (Financial Crimes Enforcement Network [FinCEN], 2020)."[7]

SMALLER ENTITIES AND CHALLENGES IN IMPLEMENTING INTERNAL CONTROLS

The COSO framework does not provide a definition of smaller entities in terms of revenues, assets or capitalization. It provides some characteristics that may be indicative of a smaller entity. When these characteristics are present, the board, management, and auditors should expect a different set of challenges to implementing effective internal control.

Characteristics of a smaller entity:

- Few lines of business and fewer products within lines
- Concentration of marketing focus by channel or geography
- Leadership by management with significant ownership interest or rights
- Fewer levels of management with wider spans of control
- Less complex transaction processing systems
- Fewer personnel having a wider range of duties
- Limited ability to maintain deep resources in line as well as support staff positions such as legal, human resources, accounting, and internal auditing

These characteristics may cause management to view internal controls as an "add on" rather than an integral part of business processes. Major challenges for small entities are:

- Adequate personnel to segregate duties.
- Management's ability to dominate activities and override the system because they have the ability to control the activities of others and the board does not serve as a challenge on their actions. Therefore, it may appear that business performance objectives have been met when, in fact, controls have been circumvented.

[7] Accounting and the US cannabis industry: federal financial regulations and the perspectives of Certified Public Accountants and cannabis businesses owners, Journal of Cannabis Research, posted by G. Suzanne Owens -Ott on December 3, 2020, access on December 8, 2020, https://jcannabisresearch.biomedcentral.com/articles/10.1186/s42238-020-00049-7

- Obtaining independent, outside parties with financial and operational expertise to serve on the board of directors and the audit committee.
- Obtaining qualified accounting and compliance personnel with sufficient experience and skill.
- Lack of time and focus on internal control due to other pressing business demands.
- Controlling information technology (IT). Frequently, smaller entities place extensive reliance on one IT professional because others in the entity do not understand technology.

Auditors should be aware that these challenges do not mean that internal controls are nonexistent, not effective, or cannot be improved. It simply means that the entity may need to be creative in finding ways to mitigate these apparent deficiencies. Assisting entities in this regard is a valuable client service. It will also give the auditors the ability to place reliance on controls, especially for classes of transactions.

Although segregation of duties is technically an activity level control, the controls that may be put in place to help mitigate management's inability to properly segregate duties are at the entity level.

Therefore, segregation of duties, as well as the other challenges noted above, will be discussed in this section.

Formal vs. Informal Controls

One big challenge for small- to mid-sized entities is striking the balance between formal controls and informal controls. Where formalization provides structure and helps others in the organization to understand the various roles and responsibilities, formalization can be burdensome. On the other hand, informal controls are more difficult to apply on a consistent basis because they are not a documented part of a routine.

EXAMPLE

A small retail company has five shareholders who are all on the board of directors. Management consists of a president, chief financial officer, operations manager, accounting manager, and 3 accounting staff.

Management is directly involved in all decision making that relates to the reliability of financial reporting. Board meetings are not regularly scheduled and when held consist of discussions of operations topics. Analytical procedures are performed on the financial statements by senior management on at least a monthly basis. The financial statements are reviewed with the board once a year. Risk is discussed among senior management but the discussion is not documented.

Although management and the board value accurate information and accountability, the company does not have a conflict of interest policy or code of conduct. Everyone assumes that management and the employees are honest. Entity level controls are not formally documented because there are so few people in the company.

Without clear guidelines and expectations set by management, conflicts of interest are more likely to arise. Without formally documented policies and controls, employees may rationalize their behavior saying that they were not aware of any policies.

Sometimes it may appear that the control environment and monitoring components are well designed. The deficiency may be in implementation. Therefore, in understanding these very important components, especially as they are deemed to be factors in mitigating the lack of segregation of duties, the competencies of those individuals performing the controls must be considered.

THE THREE CRITICAL CONTROLS

Along with the three recommended controls for the cannabis industry, there are three critical controls that should be "operationalized" into your company's business processes or transactional “DNA” and monitored by the applicable internal control programs.

The most critical controls are: 1) segregation of duties, 2) systems access, and 3) delegation of authority. Many controls have implemented these controls as “core controls” but need to keep them updated by following some of the leading practices that are recommended below.

1. **The Segregation of Duties (SoD)** control is most of the most important controls that your company can have. Adequate segregation of duties reduces the likelihood that errors (intentional or unintentional) will remain undetected by providing for individual processing by different individuals at various stages of a transaction and for independent reviews (and approval) of the work performed.

   The SoD control provides four primary benefits: 1) the risk of a deliberate fraud is mitigated as the collusion of two or more persons would be required in order to circumvent controls; 2) the risk of legitimate errors is mitigated as the likelihood of detection is increased; 3) the cost of corrective actions is mitigated as errors are generally detected relatively earlier in their lifecycle; and 4) the organization’s reputation for integrity and quality is enhanced through a system of checks and balances.

   Although SoD is a basic, key internal control and one of the most difficult to accomplish often due to limited headcount, broadly defined responsibilities, and constantly changing responsibilities. Basically, the general duties to be segregated are: planning/initiation, authorization, custody of assets, and recording or reporting of transactions. Additionally, control tasks such as review, audit, and reconcile should not be performed by the same individual responsible for recording or reporting the transaction.

   Leading Practice: One of the most common "root causes" of fraud is the lack of SoD controls, weak SoD controls, inappropriate compensating controls, or failure to update SoD controls when responsibilities change. As a best practice, many organizations review their SoD controls on a quarterly basis as part of their control self-assessment (CSA) process. As a result of this review, the applicable SoD controls are updated appropriately.

Applications: 1) The same individual should not be able to set up a supplier and issue a disbursement. 2) The same employee should not be able to issue disbursements and reconcile the cash account. 3) The individual reconciling a clearing account should not be the one approving it.

9. **System Access:** The principle of segregation of duties in an information system environment is also critical as it ensures the separation of different functions such as transaction entry, on-line approval of the transactions, master file initiation, master file maintenance, system access rights, and the review of transactions.

   In the context of application level controls, this means that one individual should not have access rights which permit them to enter, approve and review transactions. Therefore, assigning different security profiles to various individuals supports the principle of segregation of duties. As an example, operational or process segregation of duties within an accounts payable department will determine the system access rights that should be granted.

   Leading Practice: System access rights are reviewed on a periodic basis (usually monthly or quarterly) to ensure that system access capabilities are appropriate for current staff members and reflect any changes in responsibilities or movements to other departments.

   Applications: 1) Employees in accounts payable only have rights for those transactions. 2) An employee in accounts receivable cannot access the supplier master file. 3) No one outside human resources can access the employee master file.

10. **Delegation of Authority (DoA):** The last critical control is the delegation of authority (DoA) policy and control. The purpose of the DoA is to ensure the efficient operation of the company while maintaining fiscal integrity and adherence to policy. Accountability for the overall management of the property, assets, financial, and human resources of the company rests with the Chief Executive Officer (CEO). In many cases the "governance" of the DoA is the responsibility of the controller.

    Best Practice: Many companies assign levels of authority to the job grades or levels within the organization and apply workflow to streamline the approval process. If an individual is promoted or moves to another department, his or her level of authority is automatically updated in the employee master file.

    Applications: 1) Approvals are assigned based on job levels with the company's employee master file. 2) Transactions are approved with a workflow system with built escalation and exception management.

EXAMPLE

A small retail entity had a board that appeared to be functioning very well. The minutes of meetings were very descriptive and it was clear that the board spent a significant amount of time evaluating the budget to actual and current period to prior period fluctuations. The board members asked questions of management. However, even with that level of involvement, one year an independent third party was sitting in on a meeting and in a meeting noted that one line item appeared to be particularly high. He asked a question about why it was so high and the board asked management to investigate. Upon investigation, the board learned that the bookkeeper was stealing and putting the charge in that line item. The dollar value of that line item had not fluctuated in years so the board did not think to ask any questions about it. Over seven years, the bookkeeper stole $1.8 million by creating a fictitious vendor and approving the invoices. Even though the board appeared to be very conscientious, they did not have an adequate understanding of the entity's internal controls (lack of a master vendor list, lack of adequate procurement policy requiring bids) or how to properly perform analytical procedures (expectations are important when performing analytical procedures).

Segregation of Duties (SoD)

An entity should segregate duties among personnel in order to ensure that no one person has control over two or more phases of a transaction or operation. Segregation of duties reduces the opportunity to perpetrate and conceal errors or fraud in the normal course of employees' assigned functions.

As noted, SoD is a basic, key internal control and one of the most difficult to achieve. It is used to ensure that errors or irregularities are prevented or detected on a timely basis by employees in the normal course of business. Segregation of duties provides two benefits: 1) a deliberate fraud is more difficult because it requires collusion of two or more persons, and 2) it is much more likely that innocent errors will be found. At the most basic level, it means that no single individual should have control over two or more phases of a transaction or operation. Management should assign responsibilities to ensure a crosscheck of duties.

If a single person can carry out and conceal errors and/or irregularities in the course of performing their day-to-day activities they have generally been assigned or allowed access to incompatible duties or responsibilities. Some examples of incompatible duties are:

- Authorizing a transaction, receiving and maintaining custody of the asset that resulted from the transaction.
- Receiving checks (payment on account) and approving write-offs.
- Depositing cash and reconciling bank statements.
- Authorizing purchases and receiving goods purchased from the transaction
- Maintaining custody of department inventory and performing inventory counts
- Entering a sales order and approving the terms of sale
- Ability to modify an evaluated-receipts contract and receive against a PO
- Shipping product and modifying sales order tolerances

- Setting up a vendor in A/P and executing the payments
- Approving time cards and having custody of pay checks.

Having unlimited access to assets, accounting records and computer terminals and programs. For instance having access and using checks as the source documents to post to accounting records rather than using a check log or receipts.

Although, Separation of duties (SoD) is one of the key concepts of internal control and is the most difficult and sometimes the most costly one to achieve. Actual job titles and organizational structure may vary greatly from one organization to another, depending on the size and nature of the business. When implementing a SoD policy, the separation of duties pattern is applied to functions the performance of which requires power that can be abused. The steps to take for developing a policy are:

1. Start with a function that is indispensable, but potentially subject to abuse.
2. Divide the function into separate steps, each necessary for the function to work or for the power that enables that function to be abused.
3. Assign each step to a different person or organization.

EXAMPLE

If one person processes sales, they should not have access to cash receipts, should not reconcile the bank account, or have the ability to "write off" accounts receivable. Cannabis entities will have a problem in separating the cash receipts with the sales since all sales are cash and there are no bank accounts. Some dispensaries have set up an ATM to receive the cash and issue a receipt. The customer would then use the receipt for receipt of the product.

In segregating duties, an entity may utilize people in and out of the accounting and financial reporting area, as well as people on the board of directors. Some not-for-profits use volunteers; this may be risky in that volunteers may not use the same care in performing duties as employees would.

And as discussed above, people may be able to perform tasks but the risk lies in whether they actually know what they are looking for as they perform those tasks.

Management should segregate duties, to the best of their ability, given the personnel on hand. This is an important place for management to perform a GAP analysis.

Compensating Controls

In those instances where duties cannot be fully segregated, mitigating or compensating controls must be established. Mitigating or compensating controls are additional procedures designed to reduce the risk of errors or irregularities. For instance, if the record keeper also performs a reconciliation process a detailed review of the reconciliation could be performed and documented by a supervisor to provide additional control over the assignment of incompatible functions. Segregation of duties is more difficult to achieve in a centralized,

computerized environment. Compensating controls in that arena include passwords, inquiry only access, logs, dual authorization requirements, and documented reviews of input/output.

Actually it is not hard to determine whether control weakness exists. If a single person can carry out and conceal errors and/or irregularities in the course of performing his/her day-to-day activities, he/she has been assigned a SoD incompatible duty. Several control mechanisms that can help to enforce the segregation of duties.

1. Audit trails enable auditors to recreate the actual transaction flow from the point of origination to its existence on an updated file. Good audit trails should be enable to provide information on who initiated the transaction, the time of day and date of entry, the type of entry, what fields of information it contained, and what files it updated.

2. Reconciliation of applications, an independent verification process is ultimately the responsibility of users, which can be used to increase the level of confident that application ran successfully.

3. Exception reports are handled at supervisory level, backed up by evidence noting that exceptions are handled properly and in timely fashion. Signature of the person who prepares the report normally is required.

4. Manual or automated system or application transaction logs should be maintained, which record all processed system commands or application transactions.

5. Supervisory review should performed through observation and inquiry or remotely.

6. To compensate mistakes or intentional failures by following a prescribed procedure, independent reviews are recommended. Such reviews can help detect errors and irregularities.

EXAMPLE

A small distribution entity had insufficient personnel to properly segregate duties, resulting in a risk that a salesperson could sell goods at little or no charge to customers and record the understated charge in the accounting system. Then they could receive a kickback or simply collect more money and not remit it to the entity.

If the owner/manager performed a reconciliation of changes in inventory on hand with sales reported by the salesperson, it would become apparent that there was a discrepancy. In addition, the owner/manager could review the price per unit sold to see if it was consistent with the price list and follow-up on significant discounts.

Following are examples of other compensating controls that can help a small entity mitigate its lack of ability to segregate duties:

Compensating Control	How It Works
Review of reports of detailed transactions	Management reviews reports of detailed transactions to identify errors or fraud. In the sales example above, the manager would consider the transaction date, customer description, dollar amount, and any offsetting account (i.e., discounts).
Review sample of transactions	Management selects a sample of transactions that are chosen from a system-generated report or data query program. Data extraction software could also be used to choose transactions. The review would consist of the transaction date, customer description, dollar amount, and any offsetting account (i.e., discounts).
Periodic counts of assets and reconciliation with accounting records	Management would periodically count sections of inventory and compare it with inventory records, investigating differences.
Review budget analysis and cost trends	This may be the least effective of these techniques if small thefts or errors.

The issue becomes, "Is management going to consistently perform the monitoring function?" If the monitoring function is consistently applied, the lack of segregation of duties is less important because the monitoring is a compensating control. If it is not consistently applied, then errors or fraud could remain undetected.

Consistent performance of these techniques will also send a message to employees that management cares about asset accountability and will take action against employees who commit fraud. As it relates to errors, it will send a message to employees that care in performing duties is important.

Management Override

Smaller businesses and not-for-profit organizations may have one strong individual who dominates the entity and has a lot of discretion and provides personal direction to employees. Sometimes this is due to the size of the organization and sometimes due to the fact that they either own the business, or in the case of not-for-profit organizations, have a strong personality and believe that they know what is best for their constituents.

On one hand, this can be helpful because that person has significant knowledge of the entity's processes, operations, policies and procedures, contractual obligations, and generally has a good handle on the entity's risks. But there is a downside.

With this situation, there is a high possibility that management could override controls. Clearly, the best guard against this is a strong committed independent board of directors that will challenge the chief executive on issues of financial accountability and accurate financial reporting. However, in closely-held companies, this is not likely to be the case making the prevention of management override very challenging.

Following are some ways that there is potential for management override:

- Instill and maintain a corporate culture that focuses on and stresses the need for integrity and ethical values. This can be supported and reinforced through recruiting, compensating, and promoting people where values are reflected in their behavior.

- Implement and maintain an effective audit committee chair. Whistleblowers should have direct access to the audit committee chair or a board member (depending on whether the entity has an audit committee).

  There are some very inexpensive services that will establish and monitor a hotline for people to call. Fraud studies have shown that if employees believe in the ethics and integrity of the entity, they are more likely to report suspicious behavior and less likely to commit fraud themselves. Of course, to accompany the whistleblower program is a commitment to follow up on issues and to punish violations, no matter how high the person may rank in the entity.

  Note that the cost of anonymous reporting vehicles such as hotlines have come down over the past several years. Companies such as Ethics Point, Allegiance and Lighthouse provide hotline solutions and other assistance to entities based on the number of employees and services needed.

- Attract and retain qualified members for the board. The audit committee or equivalent should be comprised of knowledgeable independent individuals who are not reluctant to challenge management on issues that arise. They should meet privately with the external auditor. The board should thoroughly understand the entity and be able to identify activities that would have an impact on financial reporting.

- If the entity is large enough and can afford it, an internal audit function that reports to the audit committee would be an excellent mitigating control.

Smaller entities may want to consider the following:

- Instead of a hotline, a designated board member could field calls or even emails. The purpose of the anonymous reporting vehicle is to send a message to employees that their concerns are important. It gives them an outlet to report any suspicious behavior and helps to overcome the presumption of inappropriate management override if the system is effective.

- Add a financial expert to their boards if they believe an audit committee is not needed. A financial expert would be important if management does not have the skills to prepare its own financial statements. That person could be called upon to assist. It is important to remember that the smaller the management team, the more difficult it is to overcome the presumption of inappropriate management override, especially if the persons are related. An entity may want to contact the state society of CPAs to determine if there are any willing CPAs to serve on boards. Many states have a Center for Nonprofits that will assist not-for-profit organizations in finding board members.

Qualified Accounting Personnel

Sometimes smaller entities have a difficult time attracting and retaining qualified accounting personnel who understand and can implement generally accepted accounting principles, and understand the intricacies of financial reporting and have the ability to draft financial statements and disclosures. In many cases, these entities have relied heavily on their external auditors to provide them with

advice and expertise in this area. External auditors of non-public entities, except those who are required to report under Government Auditing Standards,[8] can still assist management with these functions.

However, this circumstance may result in an AU-C 265 comment. AU-C 265 notes that if the entity lacks controls over the selection and application of accounting principles that are in conformity with GAAP (or a special purpose framework if that is the case), this may be a significant deficiency.[9] This involves the entity having enough expertise in selecting and applying the accounting principles.

Another circumstance that could result in an AU-C 265 comment is the lack of qualified personnel in the accounting and reporting function. This involves being able to properly apply GAAP and prepare financial statements, including footnotes. This essentially means the entity does not have someone who has the skills to prepare the financial statements, including notes. Note: There would be no significant deficiency or material weakness if the company outsources the preparation of financial statements to their auditors, as long as the company has personnel with the skills to review the statements, fully understands them, and takes responsibility for them, including whether the disclosures are complete. The auditor would determine if this deficiency would be considered a deficiency in internal control, a significant deficiency, or a material weakness. To prevent AU-C 265 comments, it may be advisable for companies to seek this advice from someone other than an external auditor. No matter who is consulted, entity personnel still need to have enough expertise to make their own decisions based on external advice.

Payment Controls

Payments are defined as the act of paying out or disbursing money. The Accounts Payable department is responsible for the oversight of all payments issued. The disbursement process is the last step in the purchase order (PO) process. Organizations need to plan disbursement of company funds in a systematic manner in order to capture discounts and reduce the costs associated with late payment penalties. While paper checks still dominate as the number one method of payments, electronic payments are gaining momentum due to reduced transaction costs and increased accountability.

Payment Process Definitions:

Checks – Paper checks can be used to pay money from one company to another. Two parties involved in check transactions are the payee and the drawer. The drawer is the person/company who issues or writes the check, and the payee is the company getting the check as payment. The payee deposits the check into the bank and if the drawer has enough funds in his account, the money will be credited to the payees account, usually within 2 to 3 business days.

ACH – Automated Clearing House is a secure payment transfer system that connects all U.S. financial institutions. The ACH network acts as the central clearing facility for all Electronic Fund Transfer (EFT) transactions that occur nationwide. ACH payments are frequently used by end-user organizations as the payment method by which to pay their issuer.

---

[8] Under GAS, the auditor is able to draft financial statements, including footnotes, but is not able to implement accounting principles for them. The auditor can always provide advice and give management tools and templates to use.

[9] AU-C 265 does not provide examples of circumstances that are ordinarily considered significant deficiencies.

Wire Transfers – Bank wire transfers are immediate transfers of funds from one bank to another. Wire transfers are fast and provide real-time processing.

P-Cards – P-Cards are a form of company charge card that allows goods and services to be procured without using a traditional process. Please refer to section 3.3 of this manual for more detailed information on Purchasing Cards.

There are a number of ways to effectively manage payments. A P2P professional should consider the following six ways to effectively manage the disbursement process as described in the table below.

1.	***Controlled Disbursement –*** Is a method employed in corporate cash management and is used to regulate the flow of checks through the banking system on a daily basis. Controlled Payments mandate a once-daily distribution of checks, which usually occurs early in the day. Through Controlled Disbursement, organizations can keep only the funds required to clear the checks presented for the day in the account, and the rest can be efficiently invested. Organizations simply need to fund the account with the exact amount needed, pooling the remaining funds for investment or debt reduction; thus eliminating balances and overdraft charges. Invested funds earn interest up to the time they are needed to fund payments.
2.	***Positive Payee -*** Delivers an additional layer of positive pay protection against alteration of only the payee name on the check
3.	***Positive Pay –*** A cash management service deployed to deter check fraud. Banks utilize Positive Pay to match the checks a company issues with those it presents for payment. Any check that is considered to be potentially fraudulent is sent back to the issuer for examination. Positive Pay identifies the mismatches in check numbers and amount between what was sent across by the bank in terms of details of checks that have been issued by them, and the actual checks presented. The company is immediately notified of any suspicion of fraud, in which event transactions can be stopped.
4.	***Reverse Pay –*** This method of disbursement management is similar to Positive Pay but in reverse. With Reverse Pay, banks provide details of the checks presented – serial number, account number, amount, etc., and the company compares the information with its internal records. The company then lets the bank know which checks match their internal information, and the bank pays those checks. The bank verifies the checks that do not match, with the company's records and will correct any misreads or encoding errors that may have occurred and will then determine if the cause is due to fraudulent behavior or is an error. The bank pays only some exceptions, those that can be reconciled with the company's internal records.
5.	***Teller Positive Pay -*** Enables bank tellers to access the client issue information to determine if a check presented for cashing at a branch is valid
6.	***Pooling –*** This technique is used to offset the cash deficit in one business unit with the cash surplus in another, which reduces the short term borrowing cost and increases the short term refunds from investments. This makes the best use of the company's net cash position.

Risk Management and Monitoring Activities

Monitoring activities can be performed by management or by the board. It is important that they are performed thoroughly and with the knowledge of what to look for. Sometimes people who start small businesses, executive directors of nonprofits and board members, may have significant content knowledge related to the entity but know little about accounting processes and internal controls. A well-designed control performed by someone who doesn't really understand it is not effective.

Many companies have ineffective internal controls programs due to an overwhelming amount of controls that don't adequately consider risk. These organizations are only focused on testing the controls and not properly evaluating the effectiveness of the control when conducting a self–assessment or preparing for the annual SOX 404 internal controls assessment process. A risk-based controls approach properly leverages resources and can reduce the cost of an overall internal controls program and, more importantly, this approach ensures that the control properly mitigates the risk. Risk-based controls focus on the key controls that will mitigate risk within the business process. Failing to take a true risk-based approach, may result in identifying more controls that the operation needs. The operation may erroneously focus on perceived "key controls" that do not properly address the risk for a specific business process.

All companies, regardless of size, structure, nature, or industry, encounter risks at all levels within their organization. Risks affect each company's ability to survive, successfully compete within its industry, maintain financial strength and positive public image, and maintain the overall quality of its products, services, and people. Since there is no practical way to reduce risk to zero, management should determine how much risk should be prudently accepted, and strive to maintain risk within acceptable levels by considering the implementation of risk- based controls.

Risk is exposure to a potential loss as a consequence of uncertainty. There are global risks and risks in every phase and stage of a business process, with certain risks of greater importance during each stage. Understanding the types of risk faced in the within each process sets the foundation for the development of risk-based controls. Refer to the "Ten Tips for Implementing Risk-Based Controls," to get more information on the implementation process.

Ten Tips for Implementing Risk Based Controls

1. The focus should be on the business process and any sub-processes rather than just the audit process.

2. The control should be focused on the end-to-end process and its dependencies rather than just on transactions. Although, the control should address the accuracy of a transaction, a risk based control addresses the total business process – not just a single transaction.

3. The expected outcome is to identify and mitigate risk as well determine opportunities for process improvements within the operation.

4. There should be a focus on risk management rather than solely on current policies and procedures. Current policies and procedures may be outdated or incorrect.

5. The goal should be on continual risk assessment coverage through a continuous controls monitoring (CCM) process.

6. Risk based internal controls facilitate change since they should be updated when there is a significant change to the business process or if the control is found to inadequately mitigate a potential risk.

7. This approach should set the foundation for implementing operational metrics and analytics.

8. Risk based controls can identify risks and business process gaps across financial operations.

9. Risk based controls can help prevent and detect fraud since they should represent the end-to-end business process.

10. Risk based controls should always be developed by the business process owners, but approved by management with well-defined implementation and remediation plans.

CONTROL ENVIRONMENT

The COSO framework lists the following 5 principles related to the control environment.

CONTROL ENVIRONMENT

Principle 1. The organization demonstrates a commitment to integrity and ethical values.

There are several points of focus.

Setting the Tone at the Top

The board and management *demonstrate* the importance of integrity and ethical values to support the functioning of internal control. Together they set their expectations that values, philosophy, and operating style will be followed. Some of the documents where this is evident could be:

- Mission and values statements
- Standards or codes of conduct
- Policies and practices
- Operating principles
- Directives, guidelines, and other supporting communications
- Timely inquiries and investigations into alleged conduct that is inconsistent with the code of conduct
- Actions and decisions of management at various levels and of the board of directors
- Prompt responses to deviations from expected standards of conduct

- Informal and routine actions and communication of leaders at all levels of the entity

EXAMPLE

The executive director of a nonprofit organization wanted to find ways to instill the need for ethical behavior in its staff. Due to the type of entity and its activities, it was difficult to get people together in person. The organization started a monthly newsletter to communicate with not only the staff but also outsourced service providers, business partners and other parties to stress the importance of exercising sound integrity and ethical values. Each edition of the newsletter contained examples of ethical decision making along with a list of resources that could be accessed to discuss ethical decisions.

Establishing Standards of Conduct

The board's expectations of management for integrity and ethical values are defined in standards of conduct and understood at all levels. These standards of conduct guide the organization by:

- Establishing what is right and wrong
- Providing guidance for considering associated risks in navigating gray areas
- Reflecting legal and regulatory expectations by stakeholders

Management is ultimately accountable for activities delegated to outsourced service providers. To ensure compliance with the entity's standards of conduct, they must be subject to oversight. The following principles support the effectiveness of an established standard of conduct.

- The company has an established code of conduct that reflects core values of the entity and provides guidance to employees in making appropriate decisions with respect to ethics and business conduct matters.
- The company requires periodic written confirmation that knowledge/compliance with the code is received from various levels of management within the Company.
- The code is printed in a formal document that can be conveniently referenced.
- Management has a process to assess whether employees understand and comply with the written code of conduct (e.g., confirmations, employee surveys). Results of employee surveys convey that ethics and business conduct pervades throughout the organization.
- The company, through the ethics office, provides a confidential mechanism for reporting actual or suspected unethical behavior, suspected impropriety of overriding controls, violations of the code of conduct or ethics policy, and inquiries regarding appropriate ethical and business conduct decisions.

- The confidential reporting systems are tested on an annual basis to ensure that they are functioning as intended. (Calls placed, emails sent, web used, security—physical/logical, tested etc.)
    - Tested by employees, and the company effectively measures its usage.
    - A database is in place to track and report all business conduct and ethics cases for the company.
    - Remedial action is taken as necessary for every business conduct and ethics case raised.

EXAMPLE

Management of a restaurant chain has created and maintains and distributes the code of conduct and ethical standards to all the employees. It was originally a model provided by a trade group but it was tailored to the entity. It is on the company's website. All of the employees are required to read it at the inception of their employment. And every year the employees go through a web-based training to further instill these values.

Since the restaurant business has a reputation of improper dealings with vendors and suppliers, the company also provides this code to the vendors as part of any agreement they sign with them.

The document focuses on the responsibility of the individual to identify and report breaches of the code of conduct and provides directions on how to report any suspicious behavior or violations observed. Senior management reviews this document annually with the board and they discuss any risks to the entity. The code of conduct is revised when there are changes in laws or regulations or new modes of doing business.

Evaluates Adherence to Standards of Conduct and Addresses Deviations in a Timely Manner

- Management should have *processes* in place to evaluate conformity of individuals and teams to the standards of conduct. Some red flags that may indicate a lack of adherence to standards are:
    - Tone at top does not effectively convey expectations
    - Board does not provide impartial oversight of management
    - Decentralization without adequate oversight
    - Coercion by superiors, peers, or external parties
    - Performance goals that create pressure to cut corners
    - Inadequate channels for employee feedback
    - Failure to remedy non-existent or ineffective controls
    - Inadequate complaint response process

- Weak internal audit function
- Inconsistent, insignificant, or unpublicized misconduct penalties

- Deviations from the standards of conduct are identified and remedied timely and consistently, using a process that includes:
  - Defining a set of indicators to identify issues and trends related to the standards of conduct
  - Establishing continual and periodic compliance procedures to confirm that expectations and requirements are being met
  - Identifying, analyzing, and reporting business conduct issues and trends to senior management and the board
  - Evaluating the strength of leadership in the demonstration of integrity and ethical values for performance reviews, compensation, and promotions
  - Compiling allegations centrally and have them independently evaluated
  - Investigating allegations using defined investigation protocols
  - Implementing corrections timely and consistently
  - Periodically reviewing issues; searching for causes in order to modify policy, communications, training, or controls

---

EXAMPLE

A company has policies and procedures to address illegal acts and other violations of the code of ethics such as kickbacks to suppliers or theft. The policy states that if such an act is identified, it is investigated, and if it is confirmed, then the entity will terminate the person, revoke access privileges, and then file charges with the appropriate authorities. The human resources manager will document these steps and then analyze the root cause of the issue and implement steps to avoid its recurrence. The audit committee gets this report.

An instance of violation was identified by an employee where an employee was obtaining free trips including lodging and other benefits from a supplier in exchange for continued business. The policy clearly states that employees are not permitted to accept gifts over $25 from vendors and that all benefits such as free lodging would be the property of the company. The person who received the kickback was a senior level operations employee who had been with the organization since its inception. This did not deter the entity from terminating the person. Since this was not against the law, no charges were filed with the authorities.

Principle 2. The board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control. There are several points of focus.

Establishes Oversight Responsibilities

- The board identifies and accepts its oversight responsibilities
- Public companies in many jurisdictions are required to have board committees in specific areas such as Nominating/Governance, Compensation, Audit, Investment, Finance, Human Resources, Operations, Legal

Applies Relevant Expertise

- The board defines, maintains, and evaluates the skills needed among its members. Specialized skills needed among board members may include:
  - Internal control mindset
  - Market and entity knowledge
  - Financial expertise
  - Legal and regulatory expertise
  - Social and environmental expertise
  - Incentives and compensation
  - Relevant systems and technology

Operates Independently

The board has sufficient members who are independent and objective.

Provides Oversight for the System of Internal Control

The board maintains oversight of management's design, implementation, and conduct of internal control. This includes Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities.

Principle 3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives. There are several points of focus.

Consideration of All Structures of the Entity & Establishment of Reporting Lines of Responsibility

Entities are often structured along various dimensions such as management operating model, legal entity structures, geographic markets, and relationships with outsourced service providers. Many variables must be considered when establishing organizational structures, including:

- Nature, size, and geographic distribution of the entity's business
- Risks related to the entity's objectives and business processes
- Nature of the assignment of authority
- Definition of reporting lines
- Financial, tax, regulatory, and other reporting requirements
- Management and governance consider these variables and the risk when establishing or changing the organizational structure

Defines, Assigns, and Limits Authorities and Responsibilities

- The board of directors delegates authority and defines and assigns responsibility. Key roles and responsibilities assigned typically include:
  - Board stays informed and challenges senior management for guidance on significant decisions
  - Senior management establishes directives, guidance, and control to enable staff to understand and carry out their duties
  - Management executes senior management's directives
  - Personnel understand standards and objectives for their area
  - Management and responsible personnel oversee outsourced service providers
  - Authority empowers, but limitations of authority are needed so that:
    - Delegation occurs only as required
    - Inappropriate risks are not accepted
    - Duties are segregated to reduce risk of inappropriate conduct
    - Technology is leveraged as appropriate to facilitate definition and limitation of roles and responsibilities
    - Third-party service providers clearly understand the extent of their decision-making authority

Principle 4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives. There are several points of focus.

Management and the Board Establish Policies and Practices

Policies and practices are the entity-level guidance and behavior that reflect the expectations and requirements of stakeholders. They provide:

- Requirements and rationale
- Skills and conduct necessary to support internal control
- Defined accountability for performance of key business functions
- Basis for evaluating shortcomings and defining remedial actions
- Means to react dynamically to change

Evaluates Competence and Addresses Shortcomings

Entities define competence requirements needed to support achievement of objectives, considering, for example:

- Knowledge, skills, and experience needed
- Nature and degree of judgment needed for a specific position
- Cost-benefit analysis of different skill and experience levels

Attracts, Develops, and Retains Individuals

Management at different levels establishes structures and processes to attract, train, mentor, evaluate, and retain employees who fit the entity's culture and have the needed skills.

Plans and Prepares for Succession

Management develops contingency plans for assigning responsibilities important to internal control. The board, along with executive management, develops succession plans for key executives; trains and coaches succession candidates for each target role.

EXAMPLE

Periodic Performance Assessment

A software company periodically reviews the performance of employees with responsibility for owning, executing, or testing controls over financial reporting. Performance expectations are set at the beginning of each year, and actual performance is evaluated versus those expectations. Progress is reviewed with employees each quarter, and more formally at year end. Career advancement is based on these performance ratings. Management identifies specific areas for improvement, and employees are expected to confer with their manager to agree on a training and development plan to address these areas.

Principle 5. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives. There are several points of focus.

Enforces Accountability through Structures, Authorities, and Responsibilities

The tone at the top helps to establish and enforce accountability, morale, and a common purpose through:

- Clarity of expectations
- Guidance through philosophy and operating style
- Control and information flow
- Anonymous or confidential communication channels for reporting ethical violations
- Employee commitment toward collective objectives
- Management's response to deviation from standards

Establish and Evaluate Performance Measures, Incentives, and Rewards

- Good performance measures, incentives, and rewards support an effective system of internal control. Key success measures include:
  - Clear Objectives – consider all levels of personnel and the multiple dimensions of expected conduct and performance
  - Defined Implications – communicate objectives, review relevant market events, and communicate consequences of failure
  - Meaningful Metrics – define metrics, measure expected vs. actual, and assess the expected impact
  - Adjustment to Changes – regularly adjust performance measures based on continual risk/reward evaluation

Management and the Board Consider Excessive Pressures

Excessive pressures can cause undesirable side effects. Excessive pressures are most commonly associated with:

- Unrealistic targets, especially short-term
- Conflicting objectives of different stakeholders
- Imbalance between rewards for short-term vs. long-term objectives

Evaluates Performance and Rewards or Disciplines Individuals

At each level, adherence to standards of conduct and expected levels of competence are evaluated, and rewards allocated or disciplinary action exercised as appropriate.

EXAMPLE

Defining and Communicating the Basis for Reward

Plymouth Life, a regional distributor of cannabis, has implemented a plan designed to identify control deficiencies as early as possible. This is done by providing departments with credit on their internal audit grade when they self-report deficiencies which they have identified, rather than waiting for the internal audit department to find the problem. The company's rewards system requires departments to achieve certain defined performance measures; reaching the target is easier for a department which has received an internal audit credit for self-reported control deficiencies, and a department's internal control score can affect its compensation and benefits.

Example Controls

Following are examples of approaches that small- to mid-sized entities can use to implement controls at the control environment, along with documentation that they should consider to evidence that control's implementation. Adequate documentation makes it easier for the auditor to perform risk assessment procedures. When the entity does not provide adequate documentary evidence, the auditor is challenged to accomplish the observation and inspection. Practitioners Publishing Company (PPC) suggests that the auditor observe management's and director's actions and attitudes. The author believes that more tangible support is necessary, along with corroborative inquiry, since the control environment plays such a vital role in setting the stage for all the other components of internal control.

Note that the examples listed below are options for the entity. Not every entity will implement every control. The auditor's task is to determine that the control environment is appropriately designed as a whole, not that every possible control is implemented.

Principle 1. The organization demonstrates a commitment to integrity and ethical values.

Example Approaches that Small- to Mid-Sized Entities Can Use

- A process exists by which those charged with governance are made aware of key developments that may affect financial reporting.
- Management, employees, and others are made familiar with the entity's policies and practices with regard to ethics, accepted operating practices, and positive control environment.
- Management acts to remove or reduce incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.
- The organization has adopted and communicated to employees and board members, donors, volunteers, and vendors a specific policy on conflict of interest that specifies that personnel in a position of trust are not related to each other; employees are prohibited from having business dealings with companies affiliated with, or who act as major customers or suppliers of, the organization; transactions with officials of the organization are adequately controlled and disclosed in the records; and such transactions occur only in the normal course of business and are approved by the governing board.
- Rewards, such as merit pay and other incentives, foster an appropriate ethical tone.
- Management sets realistic financial targets and expectations.
- Management follows ethical guidelines in dealing with external audiences, including suppliers, contributors, creditors, insurers, etc.
- Relationships with professional third parties are periodically reviewed to ensure the entity maintains association with reputable parties.
- "Risk appetite," or amount of risk the entity is willing to accept, associated with each new venture is discussed and influenced by the entity's culture and operating practices.
- Management exemplifies attitudes and actions in line with its mission, vision, and values to support an effective control environment.
- Management gives appropriate attention to internal controls and corrects any known weaknesses in internal controls on a timely basis.
- Management regards the accounting function as a means for monitoring and exercising control over the entity's various activities.
- Management adopts accounting policies that are appropriate for the entity and consistent with GAAP or an other comprehensive basis of accounting (OCBOA).
- Management sets the tone that high-quality and transparent financial reporting is expected.
- Management establishes human resources policies and procedures that demonstrate its commitment to integrity, ethical behavior, and competence.
- Employee recruitment and retention practices for key financial positions are guided by principles of integrity and by the necessary competencies associated with the positions.

- There are formal policies and procedures to evaluate employee performance and compensation.
- Job performance and competencies are periodically evaluated and reviewed with each employee.

Principle 2: The governing board demonstrates independence from management in exercising oversight of the development and performance of internal control over financial reporting.

- The makeup and general construction of the governing board and its committees are appropriate and adequate given the nature of the entity.
- Those charged with governance are sufficiently involved with the entity to address important oversight responsibilities.
- Those charged with governance provide input and oversight of the entity's financial statements, including the application of GAAP or a Special Purpose Framework (SPF) and use of accounting judgments.
- A process exists by which those charged with governance are made aware of key developments that may affect financial reporting.
- The governing board is sufficiently independent of management so that necessary questions are raised.

Principle 3: With board oversight, management establishes structures, reporting lines, and appropriate authorities and responsibilities to achieve financial reporting objectives.

- The organizational structure is commensurate with the entity's activities.
- Management periodically evaluates the entity's organizational structure and makes necessary changes based on changes in its activities and/or industry.
- The entity defines key areas of authority and responsibility, including management's responsibility for entity activities, and how they affect the entity as a whole.
- There is a structure for assigning ownership of data, including who is authorized to make and/or modify transactions.
- There are policies for offering new services, conflicts of interest, and security practices that are adequately communicated to all employees in the organization.
- A process exists to support the identification and disclosure of related party relationships and transactions.

Principle 4: The entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with financial reporting objectives.

- Management establishes human resources policies and procedures that demonstrate its commitment to integrity, ethical behavior, and competence.
- Human resources policies and procedures are clearly communicated to employees and issued, updated, and revised on a timely basis.

- Employee recruitment and retention practices for key financial positions are guided by principles of integrity and by the necessary competencies associated with the positions.
- There are formal procedures for the hiring (recruiting) and retention of employees.
- There are formal policies and procedures to evaluate employee performance and compensation.
- Job descriptions, reference manuals, or other forms of communication inform personnel of their duties.
- The entity establishes competencies (knowledge, skills, abilities, and credentials) prior to hiring of key positions.
- Employees tend to have the competence and training necessary for their assigned level of responsibility or the nature and complexity of the entity's activities.
- Job performance and competencies are periodically evaluated and reviewed with each employee.
- All departments are appropriately staffed.
- Management demonstrates a commitment to provide sufficient accounting and financial personnel to keep pace with the growth and/or complexity of the entity's activities.

Principle 5: The entity holds individuals accountable for their internal control responsibilities.

- A code of conduct or ethics policy exists.
- Management, employees, and others are made familiar with the entity's policies and practices with regard to ethics, accepted operating practices, and positive control environment.
- Management acts to remove or reduce incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.
- Rewards, such as merit pay and other incentives, foster an appropriate ethical tone.
- Management sets realistic financial targets and expectations.
- There are formal policies and procedures to evaluate employee performance and compensation.
- Employees are empowered to correct problems or implement improvements in their assigned processes.
- Job performance and competencies are periodically evaluated and reviewed with each employee.

Auditor's Understanding of the Control Environment

The auditor is required to perform risk assessment procedures on the entity's control environment. This is also referred to as the auditor's understanding of internal controls. A strong control environment will be very important in setting the tone from the top and will encourage commitment to competency and accountability, thereby helping to prevent errors. A strong control environment will also help to prevent fraud.

AU-C 315 states that as a part of understanding the control environment, the auditor should consider the design and implementation of the entity's programs and controls to address fraud that are discussed in AU-C 240, *Consideration of Fraud in a Financial Statement Audit*. For example, one of the controls noted above is the prompt follow-up on communication of unethical behavior and the punishment of employees, regardless of their position in the entity, if there is a fraudulent act or conflict of interest. The auditor will want to consider the various facets of the control environment.

The number of controls that the entity has is less important than whether they, taken as whole, evidence an adequate control environment.

AU-C 315 provides guidance as to the extent of understanding of the control environment that is required.

> "The auditor should obtain sufficient knowledge of the control environment to understand attitudes, awareness and actions of those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting. In understanding the control environment, the auditor should concentrate on the implementation of controls because controls may be established but not acted upon."

The following template could be used by the auditor to document the auditor's understanding of the control environment.

EXAMPLE 1A

TEMPLATE FOR AUDITOR'S DOCUMENTATION OF UNDERSTANDING

Control	**Procedures Performed**
Employees are provided with a vehicle to report any observed behavior or suspicions of behavior that violate the code of ethics. When employees are hired, they are told about the hotline and given a card with the telephone number on it. There are also notices that are conspicuously posted in the employee break room with the hotline number.	Discussed procedure with the audit committee chair and corroborated with CFO. Also discussed with various employees whether or not they knew there was a hotline and their beliefs about whether or not it is effective. From the discussions, I believe that the control is well designed.
Due to the size of the entity, the chair of the audit committee receives reports from the hotline entity and assigns follow-up to management unless management is implicated in the call.	I inspected the communications to employees about the hotline on the intranet and in the break room. Also inspected the hotline log and discussed the calls and procedure with the audit committee chair. Also noted evidence of follow-up and disposition of calls. Control appears to be implemented.
Audit committee chair follows up on the disposition of all calls.	Operating effectiveness of the control was tested by the same procedures used in gaining understanding. Due to the nature of the control, no further testing is necessary. Control appears to be operating effectively during the period under audit.

Following is another example of how the auditor's risk assessment procedures might be documented.

EXAMPLE 1B

TEMPLATE FOR AUDITOR'S DOCUMENTATION OF UNDERSTANDING

Control Environment Principle	Summary of Control	Designed Effectively?	Summary Evidence of Control?	Observation and Inspection of Implementation and Corroborative Inquiry	Operating Effectiveness (If Control is Tested)
Integrity and ethical values	Top management has developed a clear statement of values or ethical concepts that is understood by key employees and the board	Yes	Code of ethics	Noted code of ethics in new employee packets. Noted evidence in board minutes of discussion of code of ethics.	Operating effectiveness of the control was tested by the same procedures used in gaining understanding. Due to the nature of the control, no further testing is necessary. Control appears to be operating effectively during the period under audit.
Integrity and ethical values	Processes are in place to monitor the entity's compliance with principles of sound integrity and ethical values	Yes	Hotline run by an independent entity and with calls reported to the chair of the board of directors	Discussed hotline procedures with chair of the BOD and inspected hotline log.	Operating effectiveness of the control was tested by the same procedures used in gaining understanding. Due to the nature of the control, no further testing is necessary. Control appears to be operating effectively during the period under audit.
Integrity and ethical values	Deviations from principles are identified in a timely manner, addressed, and remediated at the appropriate level of the entity	Yes	Hotline log evidences follow up	Inspected hotline log noting follow-up and disposition of the calls during the year.	Operating effectiveness of the control was tested by the same procedures used in gaining understanding. Due to the nature of the control, no further testing is necessary. Control appears to be operating effectively during the period under audit.

EXAMPLE 2A

TEMPLATE FOR AUDITOR'S DOCUMENTATION OF UNDERSTANDING

Control	Procedures Performed
The board of directors participates in establishing the strategic direction of the entity. Management reviews the financial statements with the board of directors before they are issued.	Reviewed the minutes of the board meetings, noting that management reviewed the financial statements with the board before they were issued (prior year), that the meetings were held quarterly and that a member of the board reviewed management's estimates.
Board meetings are held every quarter and a majority of the board members participate. A member of the board with financial expertise reviews estimates made by management.	Also corroborated with the chair of the board that they are committed to accurate financial reporting and challenge management when there are issues/decisions that they do not understand or with which they disagree.

EXAMPLE 2B

TEMPLATE FOR AUDITOR'S DOCUMENTATION OF UNDERSTANDING

Control Environment Principle	Summary of Control	Designed Effectively?	Summary Evidence of Control?	Observation and Inspection of Implementation	Operating Effectiveness (If Control is Tested)
Active participation by members of the board in the governance process.	The board of directors participates in establishing the strategic direction of the entity. Management reviews the financial statements with the board of directors before they are issued. Board meetings are held every quarter and a majority of the board members participate. A member of the board with financial expertise reviews estimates made by management.	Yes	Minutes of the board meetings	Noted evidence of controls, including commentary by the board.	Operating effectiveness of the control was tested by the same procedures used in gaining understanding. Due to the nature of the control, no further testing is necessary. Based on review of all of the quarterly board minutes, control appears to be operating effectively during the period under audit.

Note that in the case of entity level controls, the procedures performed to gain an understanding may be sufficient to constitute a test of controls. In the example above, there is nothing further for the auditor to examine. In the case of a control such as employee acknowledgements of the code of conduct, the auditor could take a sample of board members and employees and obtain acknowledgements for them.

Examples of internal control objectives and related anti-fraud programs and controls follow:

Control Objective	**Example Control**
Create an ethical culture	■ Management is evaluated, in part, on the standard and example that they set for employees ■ Management creates policies that create a positive environment for employees without fear of reprisal for reporting unusual occurrences ■ Background checks and other policies reduce the risk of hiring employees that are not ethical ■ All incidents of alleged fraud are investigated promptly and action is taken to discipline offenders regardless of position in the entity
Periodically assess anti-fraud controls	■ Management performs an assessment of the risk of fraud and identifies areas where fraud could possibly occur ■ Management makes changes to the entity's process and controls to mitigate identified risks ■ Internal controls are specifically put in place to address identified fraud risks
Anti-fraud oversight process	Board of directors provides effective oversight and has the appropriate level of financial expertise ■ Management's identification of fraud risks Implementation of effective anti-fraud measures

The topic of fraud is discussed more fully in the following Risk Assessment section.

RISK ASSESSMENT

The COSO framework lists the following four principles related to the risk assessment process:

RISK ASSESSMENT

Principle 6. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.

There are several points of focus.

Operations Objectives

- Reflects management's choices
- Considers tolerances for risk
- Includes operations and financial performance goals
- Forms a basis for committing of resources

External Financial Reporting Objectives

- Complies with applicable accounting standards
- Considers materiality
- Reflects entity activities accurately and clearly

External Non-Financial Reporting Objectives

- Complies with externally-established standards and frameworks
- Considers the required level of precision
- Reflects entity activities accurately and clearly

Internal Reporting Objectives

- Reflects management and the board's choices
- Considers the required level of precision
- Reflects entity activities

Compliance Objectives

- Reflects external laws and regulations and provisions of contracts and grants, if applicable
- Considers tolerances for risk

EXAMPLE

Specifying Objectives

The board of directors and management of Seaboard Yacht Charter LLC set an overall financial reporting objective of preparing reliable financial statements in conformity with U.S. GAAP. Then management set more detailed financial reporting objectives and sub-objectives for major accounts and activities of Seaboard's multinational operations, including financial statement assertions, accounting policies, and qualitative characteristics of accounts and activities.

For example, management has created objectives related to the existence and completeness of financial statement assertions of related transactions in the areas of sales, purchasing, and payroll.

These objectives and sub-objectives are reviewed annually by financial management, taking into account their continued relevance and suitability to the company's accounts and activities, as well as environmental changes such as issuance of new or revised accounting standards or changing commercial trends.

Principle 7. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed. There are several points of focus.

Includes Entity, Subsidiary, Division, Operating Unit, and Functional Levels

Entity-level risk identification is at a high level and does not include assessing transaction-level risks. Process-level risk identification is more detailed and includes transaction-level risks. Management also assesses risks from outsourced service providers, key suppliers, and channel partners.

Analyzes Internal and External Factors

- Management realizes that risk is dynamic and considers the rate of change in risks. If a rate of change increases, management will accelerate the frequency of risk assessment.
- Management evaluates the external factors affecting entity-level risk including:
  - Economic
  - Natural environment
  - Regulatory
  - Foreign operations
  - Social
  - Technological
- Management evaluates the internal factors affecting entity-level risk including:
  - Infrastructure and use of capital resources

- Management structure
- Personnel, including quality, training and motivation
- Access to assets, including possibilities for misappropriation
- Technology, including possibility of IT disruption

- Management solicits input from employees as to transaction-level risks (also see control activities).

Involves Appropriate Levels of Management

Effective risk assessment mechanisms match an appropriate level of management expertise to each risk.

Estimates Significance of Risks Identified

- Management assesses the significance of risks using criteria such as:
  - Likelihood of risk occurring and impact
  - Velocity or speed to impact upon occurrence of the risk
  - Persistence or duration of time of impact after occurrence of risk

Management Determines How to Respond to Risks

- Risk responses fall within the following categories:
  - Acceptance – no action taken
  - Avoidance – exiting the risky activities
  - Reduction – action taken to reduce likelihood, impact, or both
  - Sharing – transferring part of the risk, for example, insurance, joint venture, hedging, or outsourcing
- In relation to risk responses, management should consider:
  - Which response aligns with entity's risk tolerance
  - Segregation of duties needed to get intended significance reduction
  - Cost/benefit of response options

EXAMPLE

Considering Changes in Information Systems

Compassion LLC cultivates and dispenses cannabis-related products with operations in three locations. Ram Gupta, the CEO, conducts monthly meetings with senior managers to solicit their insights, and present his, on any newly-identified risks. This includes risks related to changes in activities, systems, or personnel processes, as well as any others that may impact financial reporting. The group then develops response strategies to address these new risks.

Principle 8. The organization considers the potential for fraud in assessing risks to the achievement of objectives. There are several points of focus.

Management and the Board Have an Awareness of How Fraud Can Occur and Considers Various Types of Fraud

- They consider the potential for fraud in the following areas:
  - Fraudulent financial reporting
  - Fraudulent non-financial reporting
  - Misappropriation of assets
  - Illegal acts
- As part of the risk assessment process, management identifies various fraud possibilities, considering:
  - Management bias
  - Degree of estimates and judgments in external reporting
  - Fraud schemes and scenarios common in the industry
  - Geographic regions
  - Incentives
  - Technology and management's ability to manipulate information
  - Unusual or complex transactions
  - Vulnerability to management override

Management Assesses Incentives and Pressures

Management reviews the entity's incentives structure to identify incentives that may be too strong and become pressured to commit fraud. This review is performed in the context of opportunities, attitudes, and rationalizations that may allow or support fraud related to each incentive.

Management Assesses Opportunities for Fraud to Occur

- Opportunity refers to the ability to acquire, use, or dispose of assets, which may be accompanied by altering the entity's records.
- The likelihood of loss of assets or fraudulent external reporting increases when there is:
  - A complex or unstable organizational structure
  - High employee turnover, especially in accounting, operations, risk management, internal audit, or technology
  - Ineffectively-designed or poorly-executed controls
  - Ineffective technology systems

Management Assesses Attitudes and Rationalizations

Attitudes and rationalizations by individuals engaging in or justifying inappropriate actions may include:

- Considers it "borrowing," intends to repay
- Believes entity "owes" them something because of some form of job dissatisfaction
- Doesn't understand or care about consequences
- Doesn't understand or care about accepted ideas of decency and trust

---

EXAMPLE

Assessing Fraud Risk

Miriam Watson is Chief Compliance Officer at CanniGrow, LLC. During her annual fraud risk assessment, Miriam interviews management at all of its locations about the state of fraud issues. The risk assessment continues with her review of inventory and shrinkage methodology, whistleblower reports, and historical fraud activities. She also looks at the number of manual versus automated journal entries and the number of entries that are made late due to subjective estimates, interviews HR personnel, and reviews staff files. Applying her historical knowledge to this information, she develops a preliminary assessment of the current fraud risk situation, including the attitude of local management toward fraud tolerance.

After completing her assessment, Ms. Watson submits her report to the audit committee.

Principle 9. The organization identifies and assesses changes that could significantly impact the system of internal control. There are several points of focus.

Management Assesses Changes in the External Environment

Management considers changes that have taken place or will occur shortly in:

- Regulatory environment
- Economic environment
- Physical environment

Management Assesses Changes in the Business Model

Management considers changes in the business model, such as:

- New or dramatically altered business lines
- Altered service delivery system
- Significant acquisitions and divestitures
- Foreign operations, especially expansion or acquisition
- Rapid growth
- New technology

Management Assesses Changes in Leadership

Management considers significant personnel changes:

- A new member of senior management may not understand the entity's culture, or may reflect a different philosophy or focus on performance to the exclusion of control-related activities.

RISK ASSESSMENT PROCESS

The focus risk of fraud and error is not new but it is one of the points highlighted as changed in the 2013 framework. When management assesses the risk of fraud or error, the various internal and external factors noted above are considered. Then they are evaluated against the likelihood that they could occur and the magnitude if they did.

Risk assessments can be improved using benchmarking techniques and analytics. Some financial benchmarks that could be used might be financial such as sales (per location), gross margin (total and by significant product), payroll in total, other significant inputs in total, days in accounts receivable, inventory turnover, days in accounts payable, level of reserves, current ratio, and debt service coverage.

To test the volume out of the changes in financial stamen accounts, statistics that can be used are units sold, units produced, inventory units on hand, and full-time equivalent employees.

Management should perform a vertical analysis that compares the expense categories as a percentage of revenue. This will help to evaluate the level of expenses considering changes in volume due to sales. The horizontal review should be conducted as well to see the changes overall. In addition, a comparison of budget to actual is a meaningful and helpful review procedure.

Diagnostics could be run using data extraction software to help understand risk which might include:

- Vendors with the same addresses as employees
- Vendors with P.O. boxes
- Duplicate payments
- Cash levels from week to week (focus on cash received)
- Journal entries to examine (evaluate those that are not routine, especially as it relates to writing off assets)

Depending on the industry, there may be other types of queries that are meaningful.

Following are examples of approaches that small- to mid-sized entities can use to implement controls dealing with the client's risk assessment process along with documentation that they should consider to evidence that control's implementation. Adequate documentation makes it easier for the auditor to perform risk assessment procedures. When the entity does not provide adequate documentary evidence, the auditor is challenged to accomplish the observation and inspection. Since many smaller entities do not have formal risk assessment processes, the only procedures the auditor may be able to perform are corroborative inquiry.

Note that the examples listed below are options for the entity. Not every entity will implement every control. In fact, smaller companies may not have formal risk assessments. The auditor's task is to determine that the risk assessment function is appropriately designed as a whole, not that every possible control is implemented.

Example Approaches that Small- to Mid-Sized Entities Can Use

Principle 6: The entity specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to financial reporting objectives.

- Management adopts accounting policies that are appropriate for the entity and consistent with GAAP (or a SPF).
- Entity objectives are established, communicated, and monitored. The key elements of the entity's strategic plan are communicated throughout the entity.
- Financial reporting objectives align with the requirements of GAAP (or a SPF).
- Management identifies risks related to laws or regulations that may affect financial reporting.
- The accounting department has a process in place to identify and address changes in GAAP (or a SPF).

Principle 7: The entity identifies risks to achieving its objectives and analyzes risks to determine how the risks should be managed.

- Mechanisms are in place to identify risks potentially affecting the achievement of the entity's objectives, including (1) changes in operating, economic, and regulatory environments; (2) participating in new programs or activities; (3) offering new services; (4) communication at various levels of management; (5) application processes; and (6) information technology infrastructure and processes.
- Periodic reviews are performed to, among other things, anticipate and identify routine events or activities that may affect the entity's ability to achieve its objectives.
- Risks potentially affecting the achievement of financial reporting objectives are identified.
- Management identifies risks related to laws or regulations that may affect financial reporting.
- Risks related to the ability of an employee to initiate and process unauthorized transactions are appropriately identified.
- Management identifies all significant relationships including service providers, suppliers, donors, volunteers, creditors, etc.
- Periodic risk assessments are reviewed by management.
- Management develops plans to mitigate significant identified risks, including designing and implementing appropriate controls.

Principle 8: The entity considers the potential for fraud in assessing risks to the achievement of financial reporting objectives.

- Fraud risk assessments are an integral part of the risk identification process.
- The entity's assessment of fraud risk considers incentives and pressures, attitudes, and rationalizations as well as the opportunity to commit fraud.
- The entity's assessment of fraud risk considers risk factors relevant to its activities and to the geographic region in which it operates.
- The entity assesses the potential for fraud in high-risk areas, including revenue recognition, management override, accounting estimates, and nonstandard journal entries.
- Those charged with governance (if separate from management) understand and exercise oversight of the entity's fraud risk assessment process.

Principle 9: The entity identifies and assesses changes that could significantly impact the system of internal control.

- Management has established triggers for reassessment of risks as changes occur that may impact financial reporting objectives (e.g., new accounting principles, nonroutine transactions, new products, etc.).
- Management communicates the risk assessment and changes in the business environment to all appropriate employees.

- Budgets/forecasts are updated during the year to reflect changes in the entity's activities.

Given the extent of risk in today's business environment and the prevalence of fraud, it is important for management to consider performing a more formal risk assessment to include the risk of fraud or error. For each financial statement line item, the entity would assess the quantitative and qualitative aspects involved.

- Impact on the financial statements (quantitative) – this would be as a percentage of the total; that is, for balance sheet accounts, a percentage of total assets; for income statement accounts, a percentage of revenue.
    - A manufacturing company looks at the impact of changes in the price of inputs which have increased over the year to determine the risk and relates the magnitude to cost of sales and inventory accounts.
- Account characteristics – these would be quantitative and qualitative assessments considering the volume of transactions processed through the account, accounting complexity, judgment required, and regulations.
    - A small city government that recently annexed a portion of a previously-unincorporated county assesses the impact of the change in volume to the information technology presently used.
- Business process characteristics – complexity of the process, centralization of the process, presence of external relationships within the process (vendors, customers, creditors, other related parties).
    - A chain of retail stores with locations in several cities assesses the risk of a shared-services arrangement to improve economies of scale.
- Fraud risk – assess each account for the potential for fraudulent financial reporting or misappropriation of assets.
    - A cannabis dispensary assesses the risk of misappropriation of assets in light of the organization's characteristics – risk of management override, lack of segregation of duties, and a significant amount of revenue received in the form of cash.
- External factors – consider competition, market forces, industry conditions, regulatory and political environment, and changes in technology, supply sources, customer demands, or creditor requirements.
- Entity level factors – numbers of personnel, qualifications, disruptions in information systems processing, changes in personnel or responsibilities, employee access to assets, and segregation of duties.
    - A small family-owned company has inexperienced accounting staff. There is also a lack of segregation of duties. The owners performed a "risk assessment" to determine how to best handle the risk associated with error as well as fraud.

Documentation could take the form of a rating for each risk identified from 1-5 (low to high). Risks could be prioritized as to their likelihood of occurrence and the magnitude of the misstatement that could result if they did occur.

Auditor's Risk Assessment Procedures Related to the Risk Assessment Process

The auditor is required to perform risk assessment procedures on the client's risk assessment process. AU-C 315 provides guidance on the extent of understanding of the risk assessment process that is required.

> "The auditor should obtain sufficient knowledge of the entity's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides about actions to address those risks."

Since many smaller entities do not have a formal risk assessment process, the auditor will want to focus on management's processes and decisions, as follows:

- What process does management use to identify business risks relevant to financial reporting?
- How does management evaluate and prioritize risks?
- What process is used to estimate the likelihood of their occurrence and the magnitude of the impact on the financial statements if they did?
- How does management decide what actions to take to manage risks?

AU-C 315 acknowledges that most smaller entities do not have a formal risk assessment process and states that, in this case, the auditor should discuss with management and those charged with governance how they identify and address risks to the business. This can be accomplished in the form of a paragraph. However, with the new focus by the COSO on the risk assessment process, the auditor should consider whether the procedures performed are sufficient.

EXAMPLE

The entity does not document a formal risk assessment process. Based on my discussions with management, it appears that risks are adequately evaluated by the entity. The president reviews the financial statements and performs analytical reviews on the statements monthly. In addition, she discusses risk with her attorney and members of her family who sit on the board. Management believes that the fraud programs and controls are effective and would prevent or detect fraud.

INFORMATION AND COMMUNICATION

The COSO framework lists the following three principles related to the information and communication components of internalcontrol.

Principle 13. The organization obtains or generates and uses relevant, quality information to support the functioning of internal control. There are several points of focus.

Management Identifies Information Requirements

Obtaining relevant information requires management to identify and define information requirements at the relevant level and with requisite specificity. This is an ongoing and iterative process.

Management Captures Internal and External Sources of Data

Information is received from a variety of sources and in a variety of forms, for example:

- Internal data:
  - Organizational changes
  - On-time and quality production experience
  - Actions in response to energy consumption metrics
  - Hours incurred on time-based projects
  - Units shipped in a month
  - Factors impacting customer attrition
  - Complaint on manager's behavior
- Internal data sources:
  - Email
  - Inspections of production processing
  - Committee minutes, notes
  - Personnel time reports
  - Manufacturing systems reports
  - Customer surveys
  - Whistleblower hotline
- External data:
  - Products drop-shipped
  - Competitor information
  - Market and industry metrics
  - New or expanded requirements

  - Opinions about the entity
  - Customer preferences
  - Claim of misuse of funds, bribery
- External data sources:
  - Data from outsourced providers
  - Industry research reports
  - Peer company earnings reports
  - Regulatory bodies
  - Social media, blogs
  - Trade shows
  - Whistleblower hotline

Risks can arise in several ways that are internal or external to the entity. For example:

Management Ensures that the Systems Processes Relevant Data into Information

Information systems capture and process large volumes of data from internal and external sources into meaningful, actionable information to meet defined information requirements.

Management Ensures that Systems Maintain Quality throughout Processing

Maintaining quality of information is necessary to an effective internal control system. The quality of information depends on whether it is:

- Accessible – easy to obtain by those who need it
- Correct – accurate and complete
- Current – most recent
- Protected – access to sensitive data restricted to authorized personnel
- Retained – properly and securely stored
- Sufficient – enough information, right level of detail, extraneous eliminated
- Timely – available when needed
- Valid – represents events that actually occurred
- Verifiable – supported by evidence from the source

Management Considers Costs and Benefits of Internal Controls

The nature, quantity, and precision of information communicated are commensurate with and support the achievement of objectives.

EXAMPLE

Conducting Quarterly Interviews of Operations and Other Management

Newfeel, LLC is a supplier of cannabis edibles to local dispensaries. The controller, Arnold Zimmer, is responsible for a monthly evaluation of inventory reserves. In the past, there were problems with this evaluation because of significant fluctuations in usage trends, customer product preferences, purchase commitments and other unanticipated changes.

As a result, Arnold now uses reports from the company's information system to identify unanticipated or unusual trends or changes in inventory inflows, outflows, and balances. He then meets monthly with several department heads to collect additional information affecting inventory. Based on these meetings, Arnold reviews inventory reserve policies including how they were calculated in the past, and prepares updated reserve requirements. He then submits his report to the CFO for review and approval.

Principle 14. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of internal control. There are several points of focus.

Management Communicates Internal Control Information

Communication of information conveyed across the entity include:

- Policies and procedures that support personnel in performing their internal control responsibilities
- Specified objectives
- Importance, relevance, and benefits of effective internal control
- Roles and responsibilities of management and other personnel in performing controls
- Expectations of the organization to communicate within the organization any significant internal control matters including weakness, deterioration, or non-adherence

Management Communicates with the Board of Directors

Communication between management and the board provides the board with information needed to exercise its oversight responsibility for internal control. Frequency and detail must be sufficient to enable the board to timely respond to indications of ineffective internal control.

Management Provides Separate Communication Lines

For information to flow up, down, and across the organization, there must be open channels of communication and a clear willingness to report and listen. In some circumstances, separate lines of communication are needed, such as whistleblower and ethics hotlines and anonymous or confidential reporting via information systems.

Management Selects Relevant Method of Communication

Clarity of information and effectiveness with which it is communicated are important to ensure messages are received as intended. Communication can take such forms as:

- Dashboards
- Email
- Live or on-line training
- Memos
- One-on-one discussions
- Performance evaluations
- Policies and procedures
- Presentations
- Social media postings
- Text messages
- Webcast and other video
- Website or collaboration site postings

Management considers that when choosing a communication medium, for messages that are transmitted orally, tone of voice and nonverbal cues are very important. In addition, cultural, ethnic, and generational differences can affect how messages are received.

Management is aware that communications relevant to internal control may require long-term retention or employee review and acknowledgement (e.g., code of conduct, corporate security).

Management is aware that time-sensitive communications may be more cost-effectively delivered through informal media such as email, text messaging, or social media.

Management is aware that communications solely through formal means (e.g., official memos) may not reach their intended audience and may not receive return communications from those more comfortable with email, text messages, social postings, etc.

EXAMPLE

Using Communications Programs to Reinforce Internal Control

Casas Por Todos is an international charity that operates in four countries in South America, constructing houses for those who could not otherwise afford them. The CEO, Jim Carrera, frequently travels to Casas Por Todos sites around the world to keep in contact with the charity's local staff, but between visits uses broadcast emails to keep relevant staff updated on accounting, finance, and other external financial reporting related issues. He also uses local visits to reinforce expectations that staff follow internal control policies and practice strict adherence to laws and regulations. The CFO, Tammy Vining, also travels and uses emails to discuss topics on business objectives and goals, and progress toward them. On her local visits, she meets with staff to find out how well they understand the charity's key business and financial goals and to also reinforce understanding and appreciation of internal control policies.

EXAMPLE

Preparing Financial and Internal Control Reporting Package for Discussion with the Board

Beyond Logistics Corp. is a private space launch firm and has a contract with NASA to deliver cargoes to the International Space Station. Senior management at Beyond Logistics has prepared a financial and internal control report package for the upcoming board of directors' meeting. The package includes quantitative and qualitative internal control as well as financial reporting information, highlighting trends and other matters requiring the board's attention. It includes discussion of the dollar impact of significant adjustments, estimated impact of deficiencies, new regulatory requirements, changes in accounting policies, and significant changes in the company's financial statements and disclosures. Management prepares an analytical review for the board. The analytic not only evaluates the changes from one period to the next, it also looks at quantitative information by unit. This type of review is very important because the operating statement line items will fluctuate due to volume and this analysis helps the board to understand which fluctuations are due to changes in volume of sales and which are due to price increases.

Management delivers the package to board members early enough to allow members adequate time to review it before the meeting.

Principle 15. The organization communicates with external parties regarding matters affecting the functioning of internal control. There are several points of focus.

Management Ensures that the Level of Communication to External Parties is Appropriate

Management develops and implements controls that facilitate external communication. Outbound communication should be viewed distinctly from external reporting. Communication to external parties allows them to readily understand events, activities, or other circumstances that may affect how they interact with the entity.

Management Enables Inbound Communications

Communications from external parties may provide important information on the functioning of the entity's internal control system. These can include:

- Outsourced independent internal control assessment
- Auditor's internal control assessment
- Customer feedback, especially complaints
- New or changed laws, regulations, etc.
- Regulatory compliance review results
- Vendor questions, especially payment complaints
- Social media postings, especially on entity-sponsored site

Management Enables Communications from External Parties to the Board of Directors

Relevant information resulting from assessments conducted by external parties is communicated to the board.

Management Provides Separate Communication Lines

Separate communication channels, such as whistleblower hotlines, are in place and serve as fail-safe mechanisms to enable anonymous or confidential communication when normal channels are inoperative or ineffective.

Management Selects Relevant Method of Communication

The medium by which management communicates externally affects its ability to obtain information needed as well as to ensure that key messages about the organization are received and understood. It should take into account the audience, nature of the communication, timeliness, and any legal or regulatory requirements.

Following are examples of approaches that small- to mid-sized entities can use to implement controls related to communication, along with documentation that they should consider to evidence that control's implementation. Adequate documentation makes it easier for the auditor to perform risk assessment procedures. When the entity does not provide adequate documentary evidence, the auditor is challenged to accomplish the observation and inspection.

Note that the examples listed below are options for the entity. Not every entity will implement every control. The auditor's task is to determine that the communications process is appropriately designed as a whole, not that every possible control is implemented.

Example Approaches that Small- to Mid-Sized Entities Can Use

Principle 13: The entity obtains or generates and uses relevant, quality information to support the functioning of internal control over financial reporting.

- Relevant operating information is used to develop accounting and financial information and serves as a basis for reliable financial reporting. Operating information is used as the basis for accounting estimates.
- Accounting procedures are sufficiently formal that management can determine whether the control objective is met, documentation supporting the procedures is in place, and personnel routinely know the procedures that need to be performed.
- Data underlying financial statements are captured completely, accurately, and timely, in accordance with the entity's policies and procedures and in compliance with laws and regulations.

Principle 14: The entity internally communicates information, including objectives and responsibilities for internal control, to support the functioning of internal control over financial reporting.

- Financial personnel meet with line management to discuss operating results.
- Information is collected in time to permit effective monitoring. Established and agreed-upon deadlines exist for period end reporting, which include review by management.
- The current chart of accounts is adequate to maintain accountability and provide for the level of detail that is required for the entity to manage.
- Management communicates information about the functioning of internal control over financial reporting on a timely basis with those charged with governance.
- Employees receive adequate information to complete their job responsibilities.
- Management has developed communication approaches that specify individual responsibilities in dealing with inappropriate behavior.
- Upstream communication is encouraged by management to improve performance and enhance internal control.
- All reported potential improprieties are reviewed, investigated, and resolved in a timely manner.

Principle 15: The entity internally communicates with external parties regarding matters affecting the functioning of internal control.

- Management communicates information about the functioning of internal control over financial reporting on a timely basis with those charged with governance.
- All reported potential improprieties are reviewed, investigated, and resolved in a timely manner.

- There is a process for tracking communications from customers, contributors, vendors, regulators, and other external parties.

Note that communication needs to be two-way on multiple levels:

- Between management and employees
- Between management and vendors
- Between management and customers
- Between management and the board of directors

With regard to employees, they should feel free and welcome to discuss issues with management. Channels should be available above senior management in case employees do not feel comfortable; for example, with a board member.

The templates illustrated earlier relative to the control environment could be used by the auditor to document the auditor's understanding of the communication component of internal control.

MONITORING

The COSO framework lists the following two principles related to monitoring.

Principle 16. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning. There are several points of focus.

Management Considers a Mix of Ongoing and Separate Evaluations

Management selects, develops, and performs a mix of monitoring activities, usually including both ongoing and separate evaluations, to ascertain whether each of the five components of internal control is present and functioning.

Management Considers Rate of Change

Management considers the rate that an entity or its industry is expected to change. In a quickly changing industry, an entity may need more frequent separate evaluations and may reconsider its ongoing/separate mix.

Management Establishes Baseline Understanding of the System of Internal Controls

Understanding the design and current state of a system of internal control provides useful baseline information for establishing ongoing and separate evaluations. If an entity lacks a baseline understanding in higher risk areas, it may need a separate evaluation to establish the baseline for those areas.

Management Uses Knowledgeable Personnel for Monitoring Tasks

Since separate evaluations are conducted periodically by independent managers, employees, or external reviewers to provide feedback with greater objectivity, evaluators need to be knowledgeable about the entity's activities and how the monitoring activities function, and understand what is being evaluated.

There are a variety of approaches available to perform separate evaluations, including:

- Internal audit evaluations
- Other objective evaluations
- Cross-operating unit or functional evaluations
- Benchmarking/peer evaluations
- Self-assessments

Management Integrates Ongoing Evaluations with Business Processes

Ongoing evaluations are built into the business processes and adjust to changing conditions.

Management Adjusts Scope and Frequency of Separate Evaluations Depending on Risk and Makes Objective Evaluations to Provide Good Feedback

Principle 17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate. There are several points of focus.

Management and the Board Assess Results of Monitoring Procedures

Management and the board regularly assess internal control for deficiencies; information comes from a variety of sources, including:

- Ongoing evaluations
- Separate evaluations
- Other internal control components
- External parties such as customers, vendors, external auditors, and regulators

Management Communicates Deficiencies in Internal Control

Communicating internal control deficiencies to the right parties to take corrective actions is critical for entities to achieve objectives. In some cases, external reporting of a deficiency may be required by laws, regulations, or standards.

Management Monitors Corrective Actions

- After internal control deficiencies are evaluated and communicated to those parties responsible for taking corrective action, management tracks whether remediation efforts are timely conducted.

- When deficiencies are not corrected on a timely basis, management revisits the selection and deployment of monitoring activities, until corrective actions have remediated the internal control deficiency.

Monitoring is a very important component of internal control, especially in a small business. Monitoring consists of almost any process that is used to ensure that controls are operating as designed. Monitoring can point out indications or evidence of fraud or error. Poor monitoring controls can allow fraud or error to remain undetected.

One of the most effective parts of internal control is monitoring. It can be used to help streamline management's assessment and review process so that they can be sure that their internal controls are functioning as designed. The COSO believes that some management may not fully appreciate the power of monitoring when considering their effectiveness of internal controls. In 2009, COSO published its *Guidance on Monitoring Internal Control Systems*. This guidance is not intended to replace the COSO framework but is designed to highlight and expand the basic principles in both documents. This publication can be purchased from the AICPA's CPA2BIZ website.

Monitoring activities can be ongoing or separate evaluations to determine if the controls continue to function over time. Another benefit of monitoring is that internal control deficiencies are identified more timely and can be communicated to management, and in some cases, the board, so they can take corrective action.

It is important that the entity establish a foundation for monitoring that includes the proper tone at the top. It is also important that the organization has a structure that contains monitoring roles. The people in those roles should be objective, have authority, and of course, the capability to perform the function. It is also important to establish a benchmark or baseline so that performance can be measured over time.

The benchmarks will likely be a key control. Key controls are those that management primarily relies on to prevent or detect misstatement and fraud. Documents, databases, or other mechanisms would be developed and as the controls are initially assessed for operating effectiveness, management would record how well they are functioning. Then, periodically, management would reassess or monitor the effectiveness of the controls by testing, or having another party test them. The testers would need to be independent of those who perform the control, although management may also create a self- assessment component.

The tools, once created, would be updated and a summary report presented to senior management and perhaps those charged with governance, if appropriate. When deficiencies are noted, they should be promptly addressed and a follow-up mechanism established to ensure that corrective action was taken.

Separate evaluations can be performed by:

- Those responsible for the controls (control self-assessments)

- Internal audit

- Consultants

Examples of ongoing monitoring include:

- Periodic evaluation and testing of controls by internal audit (if any)
- Analysis of, and appropriate follow-up on, operating reports or metrics that might identify indications of a control failure
- Management and supervisory activities where controls are reviewed
- Comparisons of budget to actual, comparisons from current year/periods to prior year/periods
- Reconciliations of account detail to the general ledger as part of the ongoing processing
- Continuous monitoring programs built into information systems that include a review of exception reports generated by the system
- Audit committee (if applicable) inquiries of internal and external auditors
- Quality assurance reviews of the internal audit department, if applicable
- Self-assessments by boards and management regarding the tone they set in the organization and the effectiveness of their oversight functions

Following are examples of approaches that small- to mid-sized entities can use to implement controls related to monitoring, along with documentation that they should consider to evidence that control's implementation. Adequate documentation makes it easier for the auditor to perform risk assessment procedures. When the entity does not provide adequate documentary evidence, the auditor is challenged to accomplish the observation and inspection.

Note that the examples listed below are options for the entity. Not every entity will implement every control. The auditor's task is to determine that the monitoring is appropriately designed as a whole, not that every possible control is implemented.

EXAMPLE

Establishing Reporting Protocols for Identified Deficiencies

Senior management at Transformation, LLC, reviews control deficiencies found during monitoring activities and analyzes their effect on the company. These deficiencies are reported to management of the affected business unit. If needed, management works with the internal audit staff to develop a remediation plan, and internal audit follows up to ensure the plan is timely and effectively implemented.

The plan calls for deficiencies to be prioritized, with remediation deadlines set for each and responsibility assigned to one individual within the business unit.

EXAMPLE

Reporting Deficiencies to the Board

At O'Neil & Steenburgen, LLC, management periodically creates a report of significant deficiencies and material weaknesses, together with summaries of minor deficiencies and of past deficiencies. These reports are intended to facilitate determination of whether deficiencies are being remedied in a timely fashion, and they are sent to the board of directors for review.

Management has agreed with the audit committee that it will report all deficiencies that are a result of illegal or improper acts, significant loss of assets, or intentional external financial reporting misstatements and omissions, regardless of previous categorization. The audit committee is briefed on causes of reported deficiencies and provides oversight of management's deficiency assessments, actions, and remediation plan progress.

EXAMPLE APPROACHES THAT SMALL- TO MID-SIZED ENTITIES CAN USE

Principle 16: The entity selects, develops, and performs ongoing and/or separate evaluations to determine whether the components of internal control are present and functioning.

- Ongoing monitoring is built into operations throughout the entity and includes explicit identification of what constitutes a deviation from expected control design or performance, thereby signaling a need to investigate both potential control problems and changes in risk profiles.
- Management's ongoing monitoring provides feedback on the effective design and operation of controls integrated into processes, and on the processes themselves.
- Management's ongoing monitoring serves as a primary indicator of both control design and operating effectiveness and of risk conditions.

Principle 17: The entity evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the governing board, as appropriate.

Reports from external sources (e.g., external auditors, regulators) are considered for their internal control implications, and timely corrective actions are identified and taken.

The templates illustrated earlier relative to the control environment could be used by the auditor to document the auditor's understanding of the communication component of internal control.

NOTES

Section

3

Federal Income Taxation of Cannabis Businesses

LEARNING OBJECTIVES

After completing this section, the participant will be able to:

- ☐ Differentiate federal income tax issues between an ordinary business and a cannabis business
- ☐ List the items that are and are not deductible for federal tax purposes for a business deemed trafficking in cannabis
- ☐ Recognize Federal reporting rules for a cannabis business

FEDERAL TAXATION OF AN ORDINARY BUSINESS VS. A CANNABIS BUSINESS

Generally, under federal law, businesses are taxed based on their net income. That net income should be viewed as consisting of two components, each with various components that make them up.

Gross Income

- Revenue
- Less cost of sales
  - Inventory expenses under § 471 (a)(including costs of a similar nature to other expenses except related to production or acquisition of items for sale)
  - Additional uniform capitalization costs under § 263A (taken from costs that otherwise would be other business expenses)
  - Adjusted for beginning / ending inventory
- Less refunds/allowances

Other Business Expenses

- Ordinary and necessary expenses under IRS § 162(a), specifically including sales related costs which are excluded from both § 471 costs (normal inventory) and § 263A costs (uniform capitalization rules)
- Business related interest under § 163
- Business related taxes under § 164
- Allowance for depreciation and cost recovery under § 167 and § 168

However, in the unusual nature of the cannabis industry, consideration needs to be made to the fact that under federal law the sale of cannabis is illegal as cannabis is a Schedule I drug and considered a controlled substance under the Controlled Substances Act. According to the Internal Revenue Code Section 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." Therefore, because cannabis is considered a controlled substance, §280E prohibits the deduction of ordinary business expenses from gross income associated with trafficking activities related to its sales. That said, it's important for cannabis-related businesses to appropriately track the inputs that comprise cost of goods sold.

INVENTORY COSTS

Obviously, with §280E's limit on deductions for items other than cost of goods sold, a key issue for cannabis-related businesses is the proper computation of tax basis cost of goods sold. As inventory consists of costs that will flow through cost of goods sold when the property is sold, it's not surprising that we find the key definitions for what will constitute allowable cost of goods sold by looking at items that are meant to be part of inventory, governed by IRC §471.

IRC §471 itself does not have information related to what constitutes costs that are to be capitalized. However, the IRS has issued regulations under IRC §471. There are 11 different regulations issued under §471, but two are of key interest to cannabis businesses—Reg. §§1.471-3 and 1.471-11.

Types of Cannabis Businesses

The key to looking at the two regulations are to understand the two broad classes of cannabis businesses we are looking at. The categories are similar to those that are found in other businesses involving tangible property.

- Reseller – What we most often think of when someone mentions cannabis businesses are retail locations or, for medical products, what we most often refer to as dispensaries. These are part of a broad class of business known as resellers. In addition to retail businesses, businesses that are wholesalers/distributors also fall into this category. For purposes of costs that end up in inventory, these businesses primarily look to rules found in Reg. §1.471-3, Inventories at Cost.

- Manufacturer – The second broad category of businesses for tax purposes are those deemed to be manufacturers. Unlike resellers, which buy already processed product, a manufacturing business creates (such as a grower) or modifies the product. Inventory costs for manufacturers tend to be more complicated, so in addition to the general rules found at Reg. §1.471-3, additional rules apply to manufacturers found at Reg. §1.471-11, Inventories of Manufacturers.

Note, some businesses will have both types of operations—the entity may purchase some product ready to sell, while it may process in some form other items.

In this section, we'll look at what the regulations require, as well as how these rules would apply to a cannabis business.

Reg. §1.471-3 – Dispensaries, Retailers, Distributors, and the Like

Inventory for resellers is relatively simple since, unlike manufacturers, resellers do not need to accumulate various costs that need to be accumulated when a business's purpose is to create the product, as opposed to simply reselling the items.

Reg. §1.471-3(b) defines the costs that are considered part of cost of sales for a reseller organization. For items purchased during the year, cost is:

> ...the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.[10]

Or, to put it simply, the costs that will be deductible as costs of sales for product actually sold under IRC §280E will be:

- Invoice cost of purchased products, less trade or other discounts on such items;
- Transportation costs incurred in acquiring the product (that is, freight in); and
- Any other costs incurred in acquiring the goods (such as brokerage fees, excise taxes paid on acquisition, etc.).[11]

Those who have worked with other manufacturers, at least those with revenues in excess of $25 million, might be looking for another source of costs—the uniform capitalization rules of §263A generally adds a portion of a number of other expenses to inventory and costs of sales for a reseller.

But §263A(a)'s final sentence, added in 1988, states that §263A won't convert a nondeductible expense into a deductible one. Specifically, it states:

> Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.[12]

The Tax Court ruled that such a treatment of §263A costs was not in violation of the 16th Amendment rules for taxation of gains in the case of *Patients Mutual Assistance Collect Corp. dba Harborside Health Center v. Commissioner*, 151 TC No. 11. The Court noted:

---

[10] Reg. § 1.471-3(b)

[11] Ibid

[12] IRC §263A(a)

> The section 263A capitalization rules don't apply to drug traffickers. Unlike most businesses, drug traffickers can't capitalize indirect expenses beyond what's listed in the section 471 regulations. Section 263A expressly prohibits capitalizing expenses that wouldn't otherwise be deductible, and drug traffickers don't get deductions.
>
> Because federal law labels Harborside a drug trafficker, it must calculate its COGS according to section 471.[13]

Reg. §1.471-3(c) and Reg. §1.471-11 – Producers

If a taxpayer is a producer, IRC §471 captures a broader category of expenses as part of cost of sales than the limited list found for resellers. Reg. §1.471-3(c) provides a general list of items that make up costs for producers. For those, cost is defined as:

> In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.[14]

So, for a producer, the costs that will be allowed as a deduction under IRC §280E as costs of sales will be the following:

- Costs of raw materials and supplies entering into or consumed in connection with the product;
- Expenditures for direct labor; and
- Indirect costs incident to and necessary for the production of the product.[15]

The first two categories are what we generally refer to as direct costs—and those are, like the costs for the reseller, a somewhat limited subset of overall costs incurred.

The final category is the one where things get a bit more interesting for a producer—indirect costs. The phrase "incident to and necessary" is the key to dealing with these costs. Specifically, Reg. §1.471-3(c) provides that these costs include an "appropriate percentage" of management expenses.

These expenses will need to be allocated between those incident to and necessary for production and those that do not meet this test.[16]

---

[13] *Patients Mutual Assistance Collect Corp. dba Harborside Health Center v. Commissioner*, 151 TC No. 11, November 29, 2018, https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=11828, p. 56

[14] Reg. §1.471-3(c)

[15] Reg. §1.471-3(c)

[16] Ibid

Finally, the regulation tells us that costs of selling and return on capital are *not* to be considered part of costs of sale. These costs will be excluded entirely from the calculation of costs of sale.

Being a producer does not change the bar on using §263A to increase deductible cost of goods sold for those in the cannabis business, so advisers need to keep in mind that expenses that are treated as

§263A items in a similar context in other businesses will not be deductible for a cannabis producer.

Tax Full Absorption Inventory Costing

Reg. §1.471-11 goes into the details of how to determine these three categories of costs. The regulation notes that producers are required to use a tax-based full absorption method of inventory costing. As the regulation notes:

> In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income (as required by section 471 of the Code), both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the "full absorption" method of inventory costing. Under the full absorption method of inventory costing production costs must be allocated to goods produced during the taxable year, whether sold during the taxable year or in inventory at the close of the taxable year determined in accordance with the taxpayer's method of identifying goods in inventory. Thus, the taxpayer must include as inventoriable costs all direct production costs and, to the extent provided by paragraphs (c) and (d) of this section, all indirect production costs.[17]

Direct Production Costs

The regulation first deals with direct production costs. It provides that:

> Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product. See section 1.471-3 for the elements of direct material costs. Direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.[18]

Such direct costs generally must be entirely reported as part of cost of goods sold—which, for a cannabis business is good news.[14] [19]Thus, a cannabis business will generally wish to ensure all direct costs are accumulated in specific accounts on the taxpayer's books.

---

[17] Reg. §1.471-11(a)

[18] Reg. §1.471-11(b)(2)(i)

[19] Reg. §1.471-11(b)(2)(ii)

Indirect Production Costs

The regulation divides indirect production costs into three categories. These categories are:

1. Indirect production costs included in inventoriable costs;
2. Costs not included in inventoriable costs; and
3. Indirect production costs includible in inventoriable costs depending upon treatment in taxpayer's financial reports.[20]

For purposes of that final category, *financial reports* means reports "(including consolidated financial statements) to shareholders, partners, beneficiaries, or other proprietors and for credit purposes."[21]

Only that third category is impacted by inclusion in the taxpayer's financial reports.

Indirect Costs That Must Be Included in Inventoriable Costs

Regardless of how the following costs are treated in the taxpayer's financial reports, the following indirect costs must be included in cost of sales and inventory for the taxpayer to the extent they are incident to and necessary for production or manufacturing operations or processes:

- Repair expenses,
- Maintenance,
- Utilities, such as heat, power and light,
- Rent,
- Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan,
- Indirect materials and supplies,
- Tools and equipment not capitalized, and
- Costs of quality control and inspection.[22]
- Thus, to defend these costs as being fully deductible, the taxpayer must concentrate on having evidence of how the expense meets the *incident to and necessary* test. If only a portion of them relate to production, the taxpayer will need to come up with a way to measure the portion that meets the incident to and necessary test.

[20] Reg. §1.471-11(c)(2)

[21] IRC §1.471-11(a)

[22] Reg. §1.471-11(c)(2)(i)

EXAMPLE

Tony County Growers incurs $29,500 in utility bills related to a greenhouse it uses for growing cannabis plants. As well, it incurs $10,000 for repairs to a water delivery system for the same greenhouse. The repairs and utilities in this case represent expenses incident to and necessary for the production of the company's product and are properly treated as part of cost of sales.

The company maintains a separate sales office in a nearby major metropolitan area. The sales staff all work out of this location. The company incurs $11,000 of utility expense for that office and incurred $1,500 of repair expense related to fixing a leaking water line to the office. These expenses are neither incident to nor necessary for the production of the company's product, but rather are sales expenses. As such, none of these expenses would be properly treated as part of cost of sales.

Costs Not Included in Inventoriable Costs

Again, this category of costs is not impacted by how the taxpayer treats the expense in its financial reports—even if the taxpayer places some or all of these expenses in financial statement cost of sales, the taxpayer cannot treat these expenses as a cost of sale—and thus, they are not deductible in a trafficking business due to §280E. The barred expenses provided for in the regulation are:

- Marketing expenses,
- Advertising expenses,
- Selling expenses,
- Other distribution expenses,
- Interest,
- Research and experimental expenses including engineering and product development expenses,
- Losses under §165 and the regulations thereunder,
- Percentage depletion in excess of cost depletion,
- Depreciation and amortization reported for federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports (note that §179 is technically not depreciation, though it seems very possible the IRS would argue that a taxpayer could not use §179 to get around this limit),
- Income taxes attributable to income received on the sale of inventory (note, this would appear to bar a deduction for state income taxes under §280E's provisions),
- Pension contributions to the extent that they represent past services cost,

- General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

- Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities taken as a whole rather than to production or manufacturing operations or processes.[23]

The last two limits serve to block the taxpayer's ability to attempt to more broadly include those expenses in costs of sale.

EXAMPLE

Carly Growers, Inc. pays Carly $190,000 annually as president of the operation. The company determines that 10% of her salary relates to annual meetings, board meetings, and general governance issues for the corporation. Even though it may be that virtually all of the activities of the company relate to the production of cannabis-related items with only a very minor amount of sales related expenses, the entire $19,000 allocated to these corporation governance items is barred from being treated as part of the cost of sales.

Indirect Production Costs Includible in Inventoriable Costs Depending Upon Treatment in Taxpayer's Financial Reports

The regulation provides special treatment for certain specified expenses that are dependent on how they are treated in the taxpayer's financial reports. However, the treatment in the financial statements govern in these areas only if the treatment in those financial statements is consistent with generally accepted accounting principles.[24]

The following specific costs are covered by this provision:

- Taxes. Taxes that are allowed as a deduction under §164 other than state, local, and foreign income taxes that are attributable to assets incidental and necessary for production or manufacturing operations or processes. The regulation offers up the example of state and local property taxes imposed on a production facility—they will be included or excluded from cost of sales based on their treatment in the financial reports.[25]

- Depreciation and depletion. Depreciation and depletion on assets meeting the incidental and necessary test reported in financial reports are part of the cost of sales.[26]

---

[23] Reg. §1.471-11(c)(3)(ii)

[24]Reg. §1.471-11(c)(2)(iii)

[25] Reg. §1.471-11(c)(2)(iii)(a)

[26] Reg. §1.471-11(c)(2)(iii)(b)

- Employee benefits. Pension and profit sharing costs representing current service costs which are currently deductible under §404 and other employee benefits incurred on behalf of labor meeting the incidental and necessary test. Such other benefits include workers' compensation insurance, payments includable in employee's income under a nonqualified plan, etc.[27]

- Costs attributable to strikes, rework labor, scrap, and spoilage.[28]

- Factory administrative expenses, other than costs of selling or return of capital.[29]

- Officers' salaries. Salaries tied to the manufacturing and production functions, but no portion of any such salaries attributable to operations as a whole.[30]

- Insurance costs. For example, insurance on production equipment.[31]

Other Costs

What if the taxpayer has costs that aren't specifically found in one of the categories listed above? In that case, the regulation provides that the taxpayer should first see if they are like any costs in the first two categories (mandatorily included or mandatorily excluded). If so, then they are treated like the expense in the category they are most like.[32]

If they are not like either a mandatory or barred expense, then the treatment in financial reports test is used.[33]

Taxpayer on a Book Method Not Comparable to Tax Method

If a taxpayer is on a method of accounting in his financial reports that is not comparable to the taxpayer's method for accounting, then the special rules for applying costs to inventory found at Reg. §1.471-11(c)(3) must be used. That regulation provides a list of required and barred costs to be included in cost of sales.

The included cost provisions list the following costs so long as they meet the incidental and necessary test:

a. Repair expenses,

b. Maintenance,

---

[27] Reg. §1.471-11(c)(2)(iii)(c)

[28] Reg. §1.471-11(c)(2)(iii)(d

[29] Reg. §1.471-11(c)(2)(iii)(e)

[30] Reg. §1.471-11(c)(2)(iii)(f)

[31] Reg. §1.471-11(c)(2)(iii)(g)

[32] Reg. §1.471-11(c)(2)(iii)

[33] Ibid

c. Utilities, such as heat, power, and light,

d. Rent,

e. Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)),[34] shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan,

f. Indirect materials and supplies,

g. Tools and equipment not capitalized,

h. Costs of quality control and inspection,

i. Taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes),

j. Depreciation and amortization reported for financial purposes and cost depletion,

k. Administrative costs of production (but not including any cost of selling or any return on capital) incident to and necessary for production or manufacturing operations or processes,

l. Salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes, and

m. Insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment.[35]

Similarly, the following expenses may not be used as part of inventory costs (and therefore cost of goods sold) in this situation:

a. Marketing expenses,

b. Advertising expenses,

c. Selling expenses,

d. Other distribution expenses,

e. Interest,

f. Research and experimental expenses including engineering and product development expenses,

---

[34] This particular portion of §105(d) no longer exists in the IRC, having been repealed

[35] Reg. §1.471-11(c)(3)(i)

g. Losses under section 165 and the regulations thereunder,

h. Percentage depletion in excess of cost depletion,

i. Depreciation reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports,

j. Income taxes attributable to income received on the sale of inventory,

k. Pension and profit-sharing contributions representing either past service costs or representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor. These other benefits include workmen's compensation expenses, payments under a wage continuation plan described in section 105(d),[36] amounts of a type which would be includible in the gross income of employees under nonqualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees such as safety, medical treatment, cafeteria, recreational facilities, membership dues, etc., which are otherwise allowable as deductions under chapter 1 of the Code,

l. Cost attributable to strikes, rework labor, scrap and spoilage,

m. General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

n. Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes.[37]

Allocation Methods

Methods of allocating indirect costs are described in Reg. §1.471-11(d). Generally, the regulation requires allocating expenses to goods using a method of allocation which fairly apportions such costs among the various items produced.[38]

The regulation then gives two acceptable allocation methods:

1. Manufacturing burden rate method (found at Reg. §1.471-11(d)(2)); and

2. Standard cost method (found at Reg. §1.471-11(d)(3)).[39]

---

[36] As was noted earlier, §105(d) no longer has such a provision.

[37] Reg. §1.471-11(c)(3)(ii)

[38] Reg. §1.471-11(d)(1)

[39] Ibid

As well, the practical capacity concept as described at Reg. §1.471-11(d)(4) may be used in conjunction with either approved method.[40]

Lack of Case Law on Producers

To date, the cases the IRS has taken to court for cannabis businesses have been primarily limited to resellers. The litigation with regard to the production has been limited to the IRS claiming a business was not a producer.[41]

Many observers believe the IRS has gone this route because they present fewer issues regarding which costs should be in costs of sale. As well, the agency is likely aware that a cannabis case where the agency wins by excluding broad classes of costs from costs of sales could have undesirable impacts from the agency's perspective with regard to taxpayers in other industries (after all, if they aren't part of cost of goods sold, then, especially for businesses with revenues of less than $25 million, they are probably fully deductible).

The good news is that, for the moment, producers seem to be of less interest to the IRS than are resellers. But that could change at any time.

What should be clear is that the issue of properly classifying expenses that fit in the indirect category will be important to the producer. As well, more flexibility exists if the taxpayer issues financial reports that are comparable to its tax reporting, though taxpayers must remember that some expenses are going to be allowed to be allocated only if the taxpayer can show that allocation is permissible under generally accepted accounting principles.

As well, the IRS is likely to argue long and hard that a business is not a producer whenever that issue is in question. So taxpayers taking the position they are a producer for some or all of their operations will need to carefully document why they are a producer. The Court in *Harborside* looked to the tests applied in the case of *Suzy's Zoo v. Commissioner*, 273 F.3d 875 (9th Cir. 2001), aff'g 114 T.C. 1 (2000), especially in the case where the taxpayer contracts out the manufacturing process.

The producer must show that it is the actual owner of the product—*Harborside* tried to argue that because the growers it bought product from used its buds (either purchased from *Harborside* or provided to the producer for free). But the court found the buds were provided without any restrictions attached—the grower could still sell the produced product to third parties and *Harborside* did not tightly control the growing process. Thus, the court found that, unlike the taxpayer in *Suzy's Zoo, Harborside* was not the owner of the product for these purposes and therefore not a producer.[42]

---

[40] Ibid

[41] The IRS carried that position in the case of Patients Mutual Assistance Collect Corp. dba Harborside Health Center v. Commissioner, 151 TC No. 11, November 29, 2018.

[42] Patients Mutual Assistance Collect Corp. dba Harborside Health Center v. Commissioner, 151 TC No. 11, November 29, 2018, https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=11828,

Uniform Capitalization Rule

In the Tax Reform Act of 1986, Congress added to the expenses that must be capitalized expenses not captured by IRC §471 by adding IRC §263A to the law. While §471 included direct costs and other costs generally included in inventories on financial statements,[43] the uniform capitalization rules of IRC §263A reached out to include portions of other costs that support the acquisition or production of inventory. Thus, a portion of most costs was allocated to production costs, increasing year-end inventories and, by extension, taxable income.

Certain costs were excluded from the uniform capitalization rules by the regulations. Such costs include:

- Selling and distribution costs;
- Research and experimental expenditures;
- IRC §179 costs;
- Losses under IRC §165; and
- Depreciation, amortization and cost recovery allowances on temporarily-idle equipment and facilities.[44]

OTHER ORDINARY AND NECESSARY BUSINESS DEDUCTIONS (§162)

Taxpayers in a trade or business also generally qualify for deductions under IRC §162(a). That section provides as follows:

> a. In general
>
> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> 1. a reasonable allowance for salaries or other compensation for personal services actually rendered;
> 2. traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
> 3. rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Regulation §1.162-1(a) explains the type of deductions allowed in more detail:

---

[43] Reg. §1.263A-1(d)(2)

[44] Reg. §1.263A-1(d)(3)(iii)

> Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. See paragraph (a) of §1.61-3.

The regulation continues by noting specific items that are allowed in computing such "other deductions" for computing the taxable income related to a trade or business:

> Among the items included in business expenses are management expenses, commissions (but see section 263 and the regulations thereunder), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see §1.162-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property.

However, the cost of sales rules for §471 and §263(a) take precedence over a deduction under IRC §162. As the regulation continues:

> No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property. See section 1054 and the regulations thereunder.

The regulations reference specific sections, rather than a broad public policy rule, for denial of deductions that are against public policy. As we'll note, a separate provision of the IRC, outside the ones defined in this section, will deny deductions for businesses dealing in cannabis merchandise:

> A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy. See section 162(c), (f), and (g) and the regulations thereunder.

The three provisions noted here with specific rules denying deductions for §162 expenses relate to:

- Illegal bribes, kickbacks, and rebates, including those under Medicare and Medicaid (IRC §162(c));
- Fines, penalties, and similar payments (IRC §162(f)); and
- Treble damages imposed under antitrust laws.

Additional provisions have been added to bar other deductions after these regulations were issued, including most recently in the Tax Cuts and Jobs Act, a bar on the deduction of items related to sexual harassment and sexual abuse subject to a nondisclosure agreement.[45]

[45] IRC § 162(q)

> The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business. In the case of any sports program to which section 114 (relating to sports programs conducted for the American National Red Cross) applies, expenses described in section 114(a)(2) shall be allowable as deductions under section 162(a) only to the extent that such expenses exceed the amount excluded from gross income under section 114(a).

HOW THIS WORKS FOR A CANNABIS BUSINESS

In 1982, Congress took action to reverse the result of the Tax Court's decision in the case of *Edmondson v. Commissioner*, T.C. Memo. 1981-623, which allowed a deduction for ordinary and necessary business expenses for a person found in the business of selling amphetamines, cocaine, and marijuana, all of which were being distributed illegally in violation of state and federal laws.

In that case, the Tax Court analyzed the case just like any other trade or business case, something Congress was not terribly pleased with. Thus, Congress moved to block most deductions for businesses trafficking in controlled substances.

To see the impact of this, let's look at an example first of an ordinary business that is not in the trade or business of controlled substances.

EXAMPLE 1

Wilma's Floral Shop (Non-Cannabis Business)

Wilma runs a flower shop from which she sells flowers. For purposes of this example, we will assume she has no timing differences between book and tax income that would affect her financial statement provision for taxes. Her taxable income and Schedule M-1 for the business are provided below:

Gross Income			
Total Revenue	$ 532,000		
Less returns	(5,000)		
Less allowances	(5,000)		
Net revenue		$	522,000
Cost of Sales			
§471 Inventory – Beg	7,000		
§263A Costs – Beg.	1,250		
Purchases	390,000		
Freight in	12,000		
§263 Costs	4,100		
§471 Inventory – End	(6,300)		
§263A Costs – End.	(925)		
Cost of Sales			407,125
Gross Income			**114,875**

Other Expenses		
§162(a) Expenses		
Office supplies	4,200	
Utilities	2,000	
Accounting and Legal	2,000	
Rent	6,000	
Wages	70,000	
Advertising	6,700	
§163 Interest Expense	1,780	
§164 Taxes		
Property taxes	1,400	
State income taxes (9%)	2,241	
Less §263A Costs	(4,100)	
Other Expenses		**92,221**
Federal Taxable Income		**22,654**
Federal Tax at 21%		**$ 4,757**

Schedule M – 1		
Income per books	**$**	**18,222**
Deductions on books not on return		
Federal income taxes		4,757
Ending §263A adjustment		925
Deductions on return not on books		
Beginning §263A adjustment		(1,250)
Income per tax return	**$**	**22,654**

In addition, Wilma has collected $41,760 of sales taxes on her sales, all of which were transmitted to the state government with her sales tax reports. As that represents funds being collected for others, the sales tax is treated as neither revenue of Wilma's business nor a deduction for her business.

EXAMPLE 2

Wilma's Cannabis Shop (Cannabis Business)

Instead of selling floral arrangements, what happens from a tax standpoint if Wilma's business is selling cannabis merchandise that is treated as trafficking business. Although recreational marijuana sales are legal from a state perspective in Wilma's state, it is still considered to be a sale of a Schedule I controlled substance for federal purposes. As such, Wilma's deductions are greatly limited.

As well, while the sale may be legal in Wilma's state, the tax law in Wilma's state still conforms to the federal law with regard to such businesses.

Here is Wilma's new computation of taxable income and Schedule M-1 to that from the floral business.

The only difference in the computation of gross income is the removal of the §263A adjustment, which brings the calculation into agreement with the computation of gross profit on Wilma's GAAP financial statement.

Gross Income		
Total Revenue	$ 532,000	
Less returns	(5,000)	
Less allowances	(5,000)	
Net revenue		$ 522,000
Cost of Sales		
§471 Inventory – Beg	7,000	
§263A Costs – Beg.	0	
Purchases	390,000	
Freight in	12,000	
§263 Costs	4,100	
§471 Inventory – End	(6,300)	
§263A Costs – End.	0	
Cost of Sales		402,700
Gross Income		**119,300**

While the removal of §263A adjustments may seem like good news for Wilma, it's actually not. The §263A adjustment is not allowed because, as we'll discuss later, the taxpayer cannot deduct as a §263A cost any amount that would not otherwise be deductible.

As well, Wilma still gets a deduction for returns and allowances. Those items are not considered a deduction, but rather a reduction of gross income—and thus they will escape Congress's limitation on deductions.

A major difference appears on the deduction for other business expenses. Under §280E, none of the other business expenses under §162, interest under §163, or taxes under §164 are allowed as a deduction in computing taxable income.

Other Expenses			
§162(a) Expenses			
Office supplies	0		
Utilities	0		
Accounting and Legal	0		
Rent	0		
Wages	0		
Advertising	0		
§163 Interest Expense	0		
§164 Taxes			
Property taxes	0		
State income taxes (9%)	0		
Less §263A Costs	0		
Other Expenses			**0**
Federal Taxable Income			**119,300**
Federal Tax at 21%		**$**	**25,053**
State Tax at 9%		**$**	**10,737**

Not surprisingly, this leads to a much higher amount of federal and state taxes due from the business.

The Schedule M-1 shows the effect of these higher taxes. Due to the increased federal and state taxes, Wilma's financial statement income has turned to a loss, going from income of $18,222 to a financial statement loss of $10,570.

Schedule M – 1

Income per books	**$ (10,570)**
Deductions on books not on return	
Federal income taxes	25,053
State income taxes	10,737
Office supplies	4,200
Utilities	2,000
Accounting and Legal	2,000
Rent	6,000
Wages	70,000
Advertising	6,700
§163 Interest Expense	1,780
Property taxes	1,400
Income per tax return	**$ 119,300**

What about the sales taxes? Luckily for Wilma, the amounts she received for sales taxes on the sale of her product which she remits to the state are still not considered to be either taxable revenue or a deductible expense.

As this example should make clear, the greatly increased income tax burden on cannabis businesses is a key factor that has to be taken into account to have a successful business. The business must operate at a high margin to assure there will be enough margin to both cover the combined federal and state taxes and the overhead the business will incur.

Management must also recognize that the lack of a deduction for the overhead expenses means such expenses are far more expensive than they would be for a traditional business. The tax adviser, conversely, has to overcome the bias to want to find a justification to move expenses out of costs that go into inventory. In this case, only costs that go through inventory give the business a tax benefit.

IRC §280E – The Key Problem Provision for Cannabis Businesses

Allowed deductions for a cannabis business are far more restricted than is true for other businesses a CPA may be used to dealing with. The majority of the expenses discussed in the previous section are not available to the cannabis business.

The starting point for understanding the unique problems of cannabis businesses for federal tax purposes is found at IRC §280E. That provision, which is relatively short, reads as follows:

§280E Expenditures in connection with the illegal sale of drugs.

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.

The provision was added by the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA). The Senate committee report[46] explanation of the reason for adding this provision stated:

Present Law.

Ordinary and necessary trade of business expenses are generally deductible in computing taxable income. A recent U.S. Tax Court case allowed deductions for telephone, auto, and rental expenses incurred in the illegal drug trade. In that case, the Internal Revenue Service challenged the amount of the taxpayer's deduction for cost of goods (illegal drugs) sold, but did not challenge the principal that such amounts were deductible.

On public policy grounds, the Code makes certain otherwise ordinary and necessary expenses incurred in a trade or business nondeductible in computing taxable income. These nondeductible expenses include fines, illegal bribes and kickbacks, and certain other illegal payments.

The taxpayer, while conceding it did conduct a trade or business that involved trafficking in marijuana, argued its principal trade or business was caregiving services.

Reasons for Change.

There is a sharply-defined public policy against drug dealing to allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other legal enterprises. Such deductions must be disallowed on public policy grounds.

Explanation of Provision.

All deductions and credits for amounts paid or incurred in the illegal trafficking in drugs listed in the Controlled Substances Act are disallowed. To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill.

The last sentence in the explanation of provisions is key. Congress did not believe it had the power under the 16th Amendment to deny a deduction for costs of sales, since it was granted the authority to

[46] Senate Committee Report, 1982 Tax Equity and Fiscal Responsibility Act, PL 97-248, September 3, 1982

tax gains as income. Congress was concerned that denying a deduction for the cost of the controlled substance could lead to the courts determining the statute violated the U.S. Constitution.

This leads to the surprising result that, for a business trafficking in controlled substances, the only item allowed as a deduction from income is the costs properly allocated to the controlled substance itself.

Trafficking in Controlled Substances

Schedule I and II of the Controlled Substances Act is defined as follows:

a. Placement on schedules; findings required

Except where control is required by United States obligations under an international treaty, convention, or protocol, in effect on October 27, 1970, and except in the case of an immediate precursor, a drug or other substance may not be placed in any schedule unless the findings required for such schedule are made with respect to such drug or other substance. The findings required for each of the schedules are as follows:

1. Schedule I.—

    a. The drug or other substance has a high potential for abuse.

    b. The drug or other substance has no currently accepted medical use in treatment in the United States.

    c. There is a lack of accepted safety for use of the drug or other substance under medical supervision.

2. Schedule II.—

    d. The drug or other substance has a high potential for abuse.

    e. The drug or other substance has a currently accepted medical use in treatment in the United States or a currently accepted medical use with severe restrictions.

    f. Abuse of the drug or other substances may lead to severe psychological or physical dependence.[47]

Marijuana is a Schedule I drug.[48] But what is trafficking?

[47] 21 USC §821(b)(1) and (2)

[48] See https://www.dea.gov/drug-scheduling and Controlled Substances – Alphabetical Order, https://www.deadiversion.usdoj.gov/schedules/orangebook/c_cs_alpha.pdf, p. 17

The Tax Court, noting that IRC §280E itself does not define trafficking, had the following discussion of the definition of this term in the case of Alternative Health Care Advocates v. *Commissioner*, 151 T.C. No. 13:

> Section 280E does not define "trafficking" in controlled substances. In CHAMP, 128 T.C. at 182, we defined "trafficking" as the act of engaging in a commercial activity —that is, to buy and sell regularly. In Olive v. Commissioner, 139 T.C. at 38, we held that "dispensing *** medical marijuana pursuant to *** [California law] was 'trafficking' within the meaning of section 280E." In the Controlled Substances Act, "[t]he term 'dispense' means to deliver a controlled substance to an ultimate user". 21 U.S.C. sec. 802(10); see id. sec. 841(a)(1) (prohibiting the manufacture, distribution, dispensation, or possession of marijuana).
>
> Section 7208, which criminalizes certain offenses relating to stamps, is the only section in the Internal Revenue Code that explicitly defines the term "trafficking". Section 7208(4)(B) defines "trafficking" as "[k]nowingly or willfully buy[ing], sell[ing], offer[ing] for sale, or giv[ing] away *** washed or restored stamp[s] to any person for use". While the Internal Revenue Code is silent with respect to trafficking in controlled substances, congressional findings and declarations on controlled substances, see 21 U.S.C. sec. 801(2), describe it as "[t]he illegal importation, manufacture, distribution, and possession and improper use of controlled substances". Further, the Federal statute criminalizing trafficking in counterfeit goods or services provides that "the term 'traffic' means to transport, transfer, or otherwise dispose of, to another, for purposes of commercial advantage or private financial gain, or to make, import, export, obtain control of, or possess, with intent to so transport, transfer, or otherwise dispose of". 18 U.S.C. sec. 2320(f)(5) (2012).

State Legalization Does Stop the Application of §280E

The fact that states have legalized the sale of marijuana, either for medical reasons or recreational purposes, has not been ruled to impact the ability of the federal government to continue to deny deductions.

The U.S. Supreme Court in 2001 ruled, in the case of *United States v. Oakland Cannabis Buyers' Cooperative*, 532 U.S. 483, that Congress was allowed to mandate that marijuana be listed on Schedule I and that any medical benefit could not be used to remove it from the list. As Justice Thomas, writing for the Court, noted:

> The Cooperative points out, however, that the Attorney General did not place marijuana into schedule. Congress put it there, and Congress was not required to find that a drug lacks an accepted medical use before including the drug in Schedule
>
> I. We are not persuaded that this distinction has any significance to our inquiry. Under the Cooperative's logic, drugs that Congress places in Schedule I could be distributed when medically necessary whereas drugs that the Attorney General places in Schedule I could not. Nothing in the statute, however, suggests that there are two tiers of Schedule I narcotics, with drugs in one tier more readily available than drugs in the other. On the contrary, the statute consistently treats all Schedule I drugs alike. See,

> e.g., §823(a) (providing criteria for Attorney General to consider when determining whether to register an applicant to manufacture Schedule I controlled substances), §823(b) (providing criteria for Attorney General to consider when determining whether to register an applicant to distribute Schedule I controlled substances), §823(f) (providing procedures for becoming a government-approved research project), §826 (establishing production quotas for Schedule I drugs).
>
> Moreover, the Cooperative offers no convincing explanation for why drugs that Congress placed on Schedule I should be subject to fewer controls than the drugs that the Attorney General placed on the schedule. Indeed, the Cooperative argues that, in placing marijuana and other drugs on Schedule I, Congress "wishe[d] to assert the most restrictive level of controls created by the [Controlled Substances Act]." Brief for Respondents 24. If marijuana should be subject to the most restrictive level of controls, it should not be treated any less restrictively than other Schedule I drugs.
>
> ... It is clear from the text of the Act that Congress has made a determination that marijuana has no medical benefits worthy of an exception. The statute expressly contemplates that many drugs "have a useful and legitimate medical purpose and are necessary to maintain the health and general welfare of the American people,"
>
> §801(1), but it includes no exception at all for any medical use of marijuana. Unwilling to view this omission as an accident, and unable in any event to override a legislative determination manifest in a statute, we reject the Cooperative's argument.

In the case of *Californians Helping to Alleviate Medical Problems Inc. v. Commissioner*, 128 T.C. 173 (2007), the Tax Court found that the Supreme Court's holding in *Oakland Cannabis Buyers' Cooperative* carried over to require §280E to apply to those distributing marijuana for medical reasons:

> Petitioner argues that its supplying of medical marijuana to its members was not "trafficking" within the meaning of section 280E. We disagree. We define and apply the gerund "trafficking" by reference to the verb "traffic", which as relevant herein denotes "to engage in commercial activity: buy and sell regularly". Webster's Third New International Dictionary 2423 (2002). Petitioner's supplying of medical marijuana to its members is within that definition in that petitioner regularly bought and sold the marijuana, such sales occurring when petitioner distributed the medical marijuana to its members in exchange for part of their membership fees.

While we do not currently have a similar ruling under the newer recreational marijuana laws, there's little reason to believe those businesses will get more favorable treatment than the medical marijuana businesses.

Items Included in Cost of Sales Under §471

As was noted above in the discussion of §162, expenses associated with the cost of sales are not considered to be §162 expenses. Normally, taxpayers prefer for an expenditure to be treated as not part of cost of sales and immediately available for deduction under IRC §162.

But the deduction prohibition under §280E reverses this bias—those impacted by §280E generally are going to be biased towards including items by taking a broad reading of what is included in expenditures to which §471 applies, while the IRS will have just the opposite bias.

IRC §63(a) defines taxable income as gross income less deductions allowed under the IRC for income taxes. IRC §280E bars those deductions, so a cannabis business pays tax on gross income— but gross income has a technical meaning for income taxes that is different from what you might expect.

Cost of sales is considered part of the computation of gross revenue. As Reg. §1.63-1(a) provides:

> (a) In general. In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income to the extent that it exceeds cost depletion which may be required to be included in the amount of inventoriable costs as provided in §1.471-11 and without subtraction of selling expenses, losses or other items not ordinarily used in computing costs of goods sold or amounts which are of a type for which a deduction would be disallowed under section 162(c), (f), or (g) in the case of a business expense. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer. Thus, for example, an amount cannot be taken into account in the computation of cost of goods sold any earlier than the taxable year in which economic performance occurs with respect to the amount (see §1.446-1(c)(1)(ii)).

An important note is found in the underlined text above. Selling expenses cannot be considered part of cost of sales per the above regulation. For a cannabis business, that means that selling expenses cannot be considered a cost of sales.

As for costs that must be in inventory, Reg. §1.471-3 provides the details of those items, with separate rules for those businesses that are resellers and for those who are producers.

For resellers, Reg. §1.471-3(b) provides:

> In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. But see §1.263A-1(d)(2)(iv)(C) for special rules for certain direct
>
> material costs that in certain cases are permitted to be capitalized as additional section 263A costs by taxpayers using a simplified method under §1.263A-2(b) or
>
> or §1.263A-3(d). For taxpayers acquiring merchandise for resale that are subject to the provisions of section 263A, see §§1.263A-1 and 1.263A-3 for additional amounts that must be included in inventory costs.

If a taxpayer is producing property, Reg. §1.471-3(c) provides the types of costs that must be capitalized:

> In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of

management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit. See §§1.263A-1 and 1.263A-2 for more specific rules regarding the treatment of production costs.

Inventory Costs for Resellers	Inventory Costs for Producers
• Invoice price paid for merchandise • Transportation costs	• Seeds • Fertilizer • Water • Labor directly involved with cultivation • Reasonable portion of indirect costs, including management

One key thing that the adviser must note here—only if the controlled substance is sold will there be a deduction available, since any amount not treated as a reduction in gross income will be caught in the §280E trap, the disallowance of otherwise ordinary business expenses from gross income if the activity performed is associated with "trafficking" of a Schedule I or II substance.

EXAMPLE

ABC, Inc. is in the business of selling medical marijuana in a state where such a sale is legal. One evening, their store is broken into and thieves make off with product that ABC had paid $25,000 for. The IRS will likely argue that this loss, being a theft loss under IRC §165, is not deductible as a business expense to ABC, being a cost of carrying on a business of the trafficking in controlled substances. Such a loss does not reduce gross income and, therefore, is subject to §280E's broad disallowance rule.

Similarly, if federal agents were to confiscate the product from ABC, the amounts paid for that product would not represent a deductible loss to ABC, rather being barred by IRC §280E from any deduction by a business trafficking in controlled substances.

Uniform Capitalization Rules Under §263A for Businesses Impacted by §280E

The IRS, in Chief Counsel Memorandum 201504011, decided that a class of taxpayers is effectively "exempt" from the provisions of IRC §263A. But it turns out not to be a win for these taxpayers.

Because the group of taxpayers who are found to not be subject to the rules of §263A are those who are growing marijuana under various state laws that make their business legal at the state law level, although the production and sale of the product remains illegal at the federal level.

Under IRC §280E, the following limitation applies to businesses that traffic in controlled substances (such as marijuana):

> 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.

But, despite what this says, that does not mean the entity is taxable on its gross receipts. Rather, the memorandum notes:

> Though a medical marijuana business is illegal under federal law, it remains obligated to pay federal income tax on its taxable income because §61(a) does not differentiate between income derived from legal sources and income derived from illegal sources. See, e.g., James v. United States, 366 U.S. 213, 218 (1961). Under the Sixteenth Amendment of the United States Constitution ("Sixteenth Amendment"), Congress is authorized to lay and collect taxes on income. In a series of cases, the United States Supreme Court has held that income in the context of a reseller or producer means gross income, not gross receipts. In other words, Congress may not tax the return of capital. See, e.g., Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 ("As was said in Stratton's Independence v. Howbert, [citation omitted], 'Income may be defined as the gain derived from capital, from labor, or from both combined.'"); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) ("The power to tax income like that of the new corporation is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.").
>
> Section 61(a) defines "gross income" broadly using 15 examples of items that are includible in gross income. Consistent with the Sixteenth Amendment, §61(a)(3)
>
> provides that gross income includes net gains derived from dealings in property, which includes controlled substances produced or acquired for resale. "Gains derived from dealings in property" means gross receipts less COGS, which is the term given to the adjusted basis of merchandise sold during the taxable year. Section 1.61-3(a) of the Income Tax Regulations. See also §§1001(a); 1011(a); 1012(a). As the Tax Court explained in Reading v. Commissioner, 70 T.C. 730, 733 (1978), "[t]he 'cost of goods sold' concept embraces 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." 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 reseller) less ending inventories. In general, the taxpayer first determines gross income by subtracting COGS from gross receipts, and then determines taxable income by subtracting all ordinary and necessary business expenses (e.g., §162(a)) from gross income.

When Congress enacted §280E in 1982, it did so to reverse the Tax Court's decision in *Jeffrey Edmondson v. Commissioner*, TC Memo 1981-263, that allowed deductions related to the illegal sale of controlled substances. However, due to concerns about the Constitutional issues raised above, Congress intentionally did not address the deduction for cost of goods sold related to the illegal drugs.

So, for such taxpayers, it would appear that 1986's adoption of the uniform capitalization rules under IRC §263A actually reduced his/her taxes, taking what would have been nondeductible expenses into cost of goods sold that will be deductible once the drugs are sold.

However, the IRS concluded that this was not truly the case. Rather, the IRS noted that when §280E was adopted what was includable in inventory was governed only by the rules found in IRC §471, with resellers subject to §1.471-3(b) and producers subject to rules found at Regs. §§1.471-3(c) and 1.471-11 otherwise known as the full-absorption regulations.

The memorandum notes that §263A was not added to the law until four years later. The language at the end of §263A(a)(2) states "[a]ny cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph."

The memorandum holds that this language means that something that would not be deductible without §263A does not become taxable via the application of §263A. In support of this position, the memorandum cites the Senate Report of the provision in TAMRA describing the retroactive technical correction that added this provision that provided:

> The bill also clarifies that a cost is subject to capitalization under this provision only to the extent it would otherwise be taken into account in computing taxable income for any taxable year. Thus, for example, the portion of a taxpayer's interest expense that is allocable to personal loans, and hence is disallowed under section 163(h), may not be included in a capital or inventory account and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner. [Rep. No. 100-445, at 104 (1988)]

The memorandum therefore holds:

> Section 263A is a timing provision. It does not change the character of any expense from "nondeductible" to "deductible," or vice versa. For a taxpayer to be permitted to treat an expense as an inventoriable cost, that expense must not run afoul of the flush language at the end of §263A(a)(2) — "Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph." See §1.263A- 1(c)(2)(i).
>
> Read together, §280E and the flush language at the end of §263A(a)(2) prevent a taxpayer trafficking in a Schedule I or Schedule II controlled substance from obtaining a tax benefit by capitalizing disallowed deductions. Congress did not repeal or amend §280E when it enacted §263A. Furthermore, nothing in the legislative history of §263A suggests that Congress intended to permit a taxpayer to circumvent §280E by treating a disallowed deduction as an inventoriable cost or as any other type of capitalized cost.

Thus, no amounts will be added to the cost of goods sold of an entity trafficking in marijuana via §263A.

Overall Basis of Accounting Issues

Not all is "bad news" for the marijuana trafficker, though. The memo next goes on to look at issues that would arise if the trafficker used the cash method of accounting.

The ruling concludes generally that if a trafficker was using the cash method, the IRS generally properly could force the trafficker to use the accrual basis. The memorandum concluded:

> A cash-method producer of a Schedule I or Schedule II controlled substance, such as marijuana, typically will deduct all production costs in the taxable year paid and, thus, will not have any adjusted basis in the product that it produces. When §280E is applied in the case of a producer trafficking in a Schedule I or Schedule II controlled substance, and all deductions from gross income are disallowed, the producer's taxable income for each taxable year will be significantly higher than what it would have been if the producer had used a permissible inventory method and recouped its production costs through COGS. Furthermore, the producer will not be able to take those disallowed production costs into account in any future taxable year. Thus, in this scenario, the overall cash method does not clearly reflect income because of the operation of §280E. Stated differently, even a producer trafficking in a Schedule I or Schedule II controlled substance is subject to tax on "gains derived from dealings in property," not on gross receipts. Section 61(a)(3).
>
> This rule regarding "gains derived from dealings in property" applies equally to a reseller trafficking in a Schedule I or Schedule II controlled substance.
>
> In our view, Examination and Appeals have the authority under §446(b) to require a taxpayer to change from a method of accounting that does not clearly reflect income to a method that does clearly reflect income regardless of whether that change results in a positive or negative §481(a) adjustment. When a producer or reseller of a Schedule I or Schedule II controlled substance uses a method of accounting that causes a tax result contrary to the Sixteenth Amendment, to §61(a)(3), and to the legislative history of §280E, the proper exercise of the above-mentioned authority is warranted. Section 446(b). See also Rev. Proc. 2002-18. See also IRM 4.11.6.7.1 (05-13-2005). Consequently, if a producer or reseller of a Schedule I or Schedule II controlled substance is deducting from gross income the types of costs that would be inventoriable if that taxpayer were properly using an inventory method under §471, it is an appropriate exercise of authority for Examination or Appeals to require that taxpayer to use an inventory method, to use the applicable inventory-costing regime (as discussed under Issue (1) of this memo), and to change from the overall cash method to an overall accrual method.

That seems like not good news—but it turns out that the taxpayer may qualify for the various relief provisions that will allow the use of the cash basis of accounting and, in that case, they will get a deduction for product costs. The availability of these relief provisions was greatly expanded in the Tax Cuts and Jobs Act.

The memorandum concludes:

> However, if that taxpayer is not required to use an inventory method (for example, small taxpayers properly using the modified cash method under Rev. Proc. 2001-10 or Rev. Proc. 2002-28 or farmers), it is not an appropriate exercise of authority for Examination or Appeals to require that taxpayer to use an inventory method.

Instead, Examination or Appeals should permit that taxpayer to continue recovering, as a return of capital deductible from gross income, the same types of costs that are properly recoverable by a taxpayer both trafficking in a Schedule I or Schedule II controlled substance and using an inventory method under §471. Thus, for example, a producer of a Schedule I or Schedule II controlled substance should be permitted to deduct wages, rents, and repair expenses attributable to its production activities, but should not be permitted to deduct wages, rents, or repair expenses attributable to its general business activities or its marketing activities.

§199A AND THE CANNABIS BUSINESS

The Tax Cuts and Jobs Act added a new provision to the IRC, IRC §199A. A key question that should have immediately occurred to advisers dealing with cannabis businesses is whether those businesses will get the benefit of §199A.

Basics of IRC §199A

The deduction is the total of:

- The "combined qualified business income amount" of the taxpayer (subject to an adjusted taxable income limit) plus
- 20% of the aggregate amount of qualified real estate investment trust (REIT) dividends and publicly-traded partnership (PTP) income (subject to a separate adjusted taxable income limit)

The qualified business income deduction is not adjusted for preferences and adjustments in the computation of alternative minimum taxable income. [IRC §199(f)(2)]

Where the Deduction is Claimed

The deduction is not used in calculating adjusting gross income, nor is it an itemized deduction. The deduction, available whether or not a taxpayer itemizes, serves to simply reduce taxable income directly. [Act Section 11011(b)]

This location of the deduction is going to complicate state income issues in states that base their tax systems on federal tax numbers other than simply starting with federal taxable income. If, as is true with many states, it starts with federal adjusted gross income and then adopts federal itemized deductions, there is no current structure in state law to absorb this subtraction unless the state adds a new provision in the law to deal with this additional type of deduction.

Qualified Business Income

The deduction is calculated based on qualified business income (QBI), so the definition of that is key. For a tax year, "qualified business income" is defined as "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer." [IRC §199A(c)(1)]

More specifically, the final regulations provide the following definition of qualified business income. Qualified items of income, deduction, gain, or loss are items of gross income, gain, deduction, and loss to the extent such items are:

- Effectively connected with the conduct of a trade or business within the United States (within the meaning of Section 864(c), determined by substituting "trade or business (within the meaning of Section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears), and

- Included or allowed in determining taxable income for the taxable year.[49]

Note that for cannabis businesses, the final regulations limiting the items reducing QBI to those allowed in determining taxable income is a significant benefit, as the QBI is not reduced by any expense for which a deduction is disallowed under IRC §280E.

Threshold Amount

The threshold amount, above which both the W-2 wages and capital limitation and the restrictions on the deduction for a specified trade or business applies, is set at taxable income (before the deduction allowed by §199A) of $315,000 for a married couple filing a joint return and $157,500 for all other taxpayers. The threshold amounts will be adjusted for inflation in future years. [IRC §199A(e)(2)]

In both cases, the limitation phases in over $100,000 for a married couple filing a joint return and $50,000 for all other taxpayers. [IRC §199A(b)(3)(B)] For 2019, the inflation adjusted threshold amounts are:

- Married couple filing a joint return – $321,400

- Married individual filing a separate return and trusts – $160,725

- Single or head of household – $160,700[50]

W-2 Wages and Unadjusted Basis Immediately After Acquisition (UBIA) Limit

While the specialized service trade or business limitations should not impact cannabis businesses, the W-2 wage and UBIA limits will impact cannabis businesses where the taxpayer's taxable income is above the threshold amount.

Luckily, these limits are apparently tied to items other than amounts deducted for W-2 wages. However, it's not clear if the IRS will allow assets for which no depreciation is allowed to be part of

UBIA. So far, we don't have a ruling on that issue. But this likely is not a major problem, since most likely the 50% of W-2 wages limit will be the more useful limit for cannabis businesses.

For affected taxpayers, the qualified business income deduction is limited to the greater of the following:

- 50% of W-2 wages related to the qualified business, or

[49] Reg. §1.199A-3(b)(2)(i)

[50] Revenue Procedure 2018-57

- The total of:
  - 25% of W-2 wages related to the qualified business, plus
  - 2.5% of the unadjusted basis of qualified property used in the qualified business. [IRC §199A(b)(2)(B)]

Qualified property is tangible property used in the qualified business which is subject to depreciation and:

- Which is held by, and available for use in, the qualified trade or business at the close of the taxable year,
- Which is used at any point during the taxable year in the production of qualified business income, and
- Either:
  - The property had not been acquired more than 10 years before the end of the taxable year, or
  - The last day of the recovery period for the property had not passed by the end of the taxable year.

Wages include payments described in IRC §6051(a)(3) (wages shown on the W-2 subject to income tax withholding) plus those described in IRC §6051(a)(8) (specified elective deferrals to retirement programs: employee contributions to §401(k) plans, compensation deferred under IRC §457, and elective Roth deferrals under §402A).[51]

The regulations provide for looking to W-2s filed during the calendar year ending during the individual's or relevant pass-through entity (RPE)'s taxable year.

> For this purpose, except as provided in paragraphs (b)(2)(iv)(C)(2)[52] and (b)(2)(iv)(D)[53] of this section, the Forms W-2, "Wage and Tax Statement," or any subsequent form or document used in determining the amount of W-2 wages, are those issued for the calendar year ending during the individual's or RPE's taxable year for wages paid to employees (or former employees) of the individual or RPE for employment by the individual or RPE.[54]

Employees for this purpose are limited to employees defined under:

- IRC §3121(d)(1) – corporate officers, and
- IRC §3121(d)(2) – common law employees,

---

[51] Reg. §1.119A-2(b)(2)(i)

[52] Related to short taxable years

[53] Services performed in the Commonwealth of Puerto Rico

[54] Reg. §1.199A-2(b)(2)(i)

including officers of an S corporation and employees of an RPE under common law.[55] That excludes from the classification as employee any statutory employees.

The final regulations under §199A state that the IRS may provide for methods of computing taxable wages.[56] At the same time as the final regulations were issued, the IRS finalized a revenue procedure to provide for acceptable methods of computing W-2 wages.

Revenue Procedure 2019-11 provides for methods of computing W-2 wages for purposes of IRC §199A.

Employees for this purpose are limited to employees defined under:

- IRC §3121(d)(1) – corporate officers, and
- IRC §3121(d)(2) – common law employees,

including officers of an S corporation and employees of an RPE under common law.[50] That excludes from the classification as employee any statutory employees.

The final regulations under §199A state that the IRS may provide for methods of computing taxable wages.[51] At the same time as the final regulations were issued, the IRS finalized a revenue procedure to provide for acceptable methods of computing W-2 wages.

Revenue Procedure 2019-11 provides for methods of computing W-2 wages for purposes of IRC §199A.

The Revenue Procedure begins the Rules of Application in Section 3 with the following caution on wages that can and cannot be included in the calculation of §199A W-2 wages:

> In calculating W-2 wages for a taxable year under the methods described in this revenue procedure, include only wages properly reported on Forms W-2 that meet the applicable rules of §1.199A-2(b). Specifically, §1.199A-2(b)(2)(i) provides that, except as provided in §1.199A-2(b)(2)(iv)(C)(2) (concerning short taxable years that do not include December 31) and §1.199A-2(b)(2)(iv)(D) (concerning remuneration for services performed in the Commonwealth of Puerto Rico), the Forms W-2, "Wage and Tax Statement," or any subsequent form or document used in determining the amount of W-2 wages are those that are issued for the calendar year ending during the person's taxable year for wages paid to employees (or former employees) of the person for employment by the person. Section 1.199A-2(b)(2)(i) also provides that, for purposes of §1.199A-2, employees of the person are limited to employees of the person as defined in section 3121(d)(1) and (2) (that is, officers of a corporation and employees of the person under the common law rules). Therefore, Forms W-2 provided to statutory employees described in section 3121(d)(3) (that is, Forms W-2 in which the "Statutory Employee" box in Box 13 is checked) should not be included in calculating W-2 wages under any of the methods described in this revenue procedure.

---

[55] Reg. §1.119A-2(b)(2)(i)

[56] Reg. § 1.199A-2(b)(2)(iv)(A)

The Revenue Procedure at Section 3.02 warns that this Revenue Procedure's determination of wages is solely for §199A purposes, and the procedure has no application in determining wages for other purposes such as for FICA taxation, FUTA taxation or payments subject to federal income tax withholding.

After reciting the W-2 wages definition from the proposed regulations, in Section 4.02, the IRS provides a mapping of W-2 information to what are wages for IRC §199A purposes.

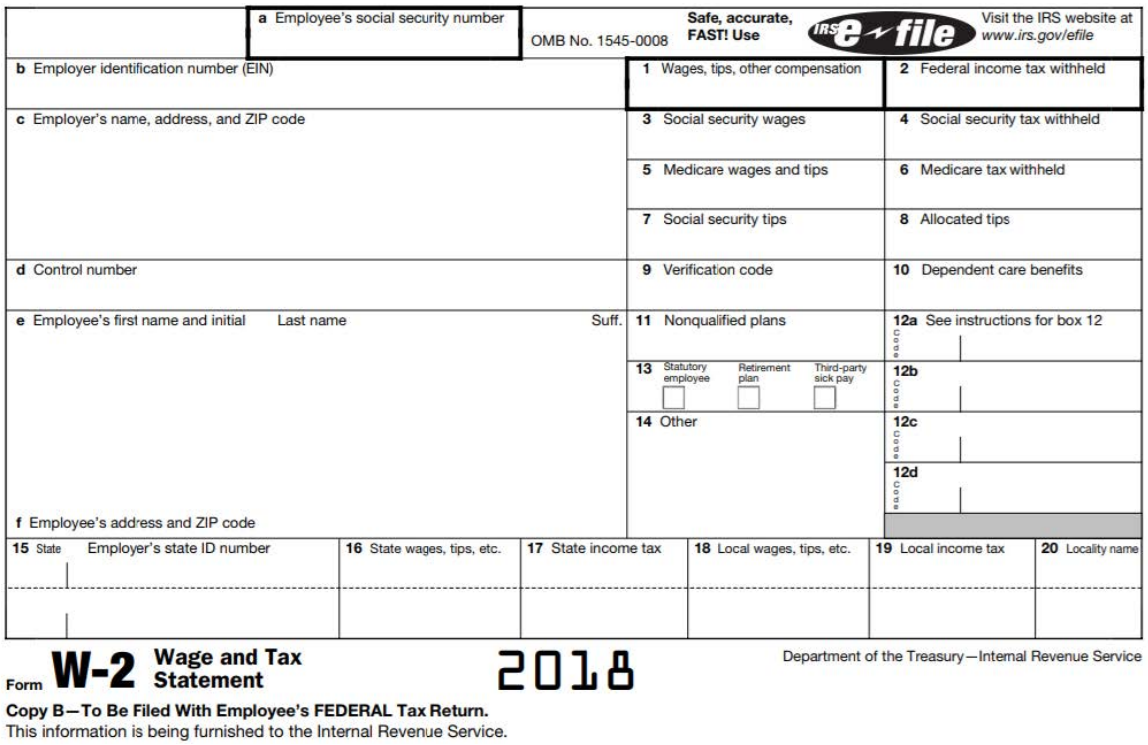
> .02 Correlation with Form W-2. Under the 2018 Forms W-2, the elective deferrals under section 402(g)(3) and the amounts deferred under section 457 directly correlate to coded items reported in Box 12 on Form W-2. Box 12, Code D, is for elective deferrals to a section 401(k) cash or deferred arrangement plan (including a SIMPLE 401(k) arrangement); Box 12, Code E, is for elective deferrals under a section 403(b) salary reduction agreement; Box 12, Code F, is for elective deferrals under a section 408(k)(6) salary reduction Simplified Employee Pension (SEP); Box 12, Code G, is for elective deferrals and employer contributions (including nonelective deferrals) to any governmental or nongovernmental section 457(b) deferred compensation plan; Box 12, Code S, is for employee salary reduction contributions under a section 408(p) SIMPLE (simple retirement account); Box 12, Code AA, is for designated Roth contributions (as defined in section 402A) under a section 401(k) plan; and Box 12, Code BB, is for designated Roth contributions (as defined in section 402A) under a section 403(b) salary reduction agreement.
>
> However, designated Roth contributions are also reported in Box 1, Wages, tips, other compensation, and are subject to income tax withholding.

The proposed Revenue Procedure provides three methods that can be used to compute W-2 wages for §199A purposes. They are:

1. Unmodified Box Method;
2. Modified Box 1 Method; and
3. Tracking Wages Method.[57]

The methods are described below. For reference, here is a copy of 2018 Form W-2 that will be referred to in the proposed Revenue Procedure.

[57] Revenue Procedure 2019-11, Section 5



	a Employee's social security number	OMB No. 1545-0008	Safe, accurate, FAST! Use — Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN)		1 Wages, tips, other compensation	2 Federal income tax withheld
c Employer's name, address, and ZIP code		3 Social security wages	4 Social security tax withheld
		5 Medicare wages and tips	6 Medicare tax withheld
		7 Social security tips	8 Allocated tips
d Control number		9 Verification code	10 Dependent care benefits
e Employee's first name and initial Last name Suff.		11 Nonqualified plans	12a See instructions for box 12
		13 Statutory employee / Retirement plan / Third-party sick pay	12b
		14 Other	12c
			12d
f Employee's address and ZIP code			

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** Wage and Tax Statement 2018 — Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Unmodified Box Method

The proposed Revenue Procedure defines the unmodified box method as follows:

> Under the unmodified box method, W-2 wages are calculated by taking, without modification, the lesser of—
>
> > (A) The total entries in Box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or
> >
> > (B) The total entries in Box 5 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.[58]

Box 1 is the box holding taxable wages, tips, and compensation. Box 5 represents the Medicare wages and tips.

[58] Revenue Procedure 2019-11, Section 5.01

Modified Box 1 Method

The second method described in the proposed Revenue Procedure is the modified Box 1 method.

> Under the Modified Box 1 method, the taxpayer makes modifications to the total entries in Box 1 of Forms W-2 filed with respect to employees of the taxpayer. W-2 wages under this method are calculated as follows—
>
> > (A) Total the amounts in Box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer;
> >
> > (B) Subtract from the total in paragraph .02(A) of this section amounts included in Box 1 of Forms W-2 that are not wages for Federal income tax withholding purposes, including amounts that are treated as wages for purposes of income tax withholding under section 3402(o) (for example, supplemental unemployment compensation benefits within the meaning of Rev. Rul. 90-72); and
> >
> > (C) Add to the amount obtained after paragraph .02(B) of this section the total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.[59]

Tracking Wages Method

The final method taxpayers would be able to choose from under the proposed Revenue Procedure is the tracking wages method. The procedure describes that method as follows:

> Under the tracking wages method, the taxpayer actually tracks total wages subject to federal income tax withholding and makes appropriate modifications. W-2 wages under this method are calculated as follows—
>
> > (A) Total the amounts of wages subject to federal income tax withholding that are paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 filed with SSA by the taxpayer for the calendar year; plus
> >
> > (B) The total of the amounts that are reported in Box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.[60]

[59] Revenue Procedure 2019-11, Section 5.02

[60] Revenue Procedure 2019-11, Section 5.03

Short Tax Years

The Revenue Procedure describes special rules for a short tax year. In Section 6.01, the proposed Revenue Procedure begins:

> .01 Special rule for taxpayers with a short taxable year. In the case of a taxpayer with a short taxable year, subject to the rules of application described in section 3 of this revenue procedure, the W-2 wages of the taxpayer for the short taxable year shall include only those wages paid during the short taxable year to employees of the taxpayer, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the taxpayer, and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the taxpayer. See §1.199A-2(b)(2)(iv)(C) of the regulations.

A taxpayer is required to use the tracking wages method for a short taxable year. The method is applied in the following manner:

> .02 Method required for a short taxable year and modifications required in application of method. The W-2 wages of a taxpayer with a short taxable year shall be determined under the tracking wages method described in section 5.03 of this revenue procedure. In applying the tracking wages method in the case of a short taxable year, the taxpayer must apply the method as follows—
>
> > (A) For purposes of section 5.03(A), the total amount of wages subject to federal income tax withholding and reported on Form W-2 must include only those wages subject to federal income tax withholding that are actually or constructively paid to employees during the short taxable year and reported on Form W-2 for the calendar year ending with or within that short taxable year (or, for a short taxable year that does not contain a calendar year ending with or within such short taxable year, wages subject to federal income tax withholding that are actually or constructively paid to employees during the short taxable year and reported on Form W-2 for the calendar year containing such short taxable year); and
> >
> > (B) For purposes of section 5.03(B), only the portion of the total amounts reported in Box 12, Codes D, E, F, G, and S, on Forms W-2, that are actually deferred or contributed during the short taxable year are included in W-2 wages.

Additional Computations May Be Needed

The Revenue Procedure warns in Section 2 that adjustments may need to be made to any of these figures to obtain the W-2 wages properly allocable to a particular trade or business:

> W-2 wages calculated under this revenue procedure are not necessarily the W-2 wages that are properly allocable to QBI and eligible for use in computing the section 199A limitations. As mentioned above, only W-2 wages that are properly

> allocable to QBI may be taken into account in computing the section 199A(b)(2) W-2 wage limitations. Thus, after computing W-2 wages under this revenue procedure, under §1.199A-2(b)(3), the taxpayer must determine the extent to which the W-2 wages are properly allocable to QBI. Then, the properly allocable W-2 wages amount is used in determining the W-2 wages limitation under section 199A(b)(2) for that trade or business as well as any reduction for income received from cooperatives under section 199A(b)(7).

What About §280E?

The wording of IRC §280E tells us that the deductions that are denied are those that arise from "any amount *paid or incurred* during the taxable year in carrying on any trade or business if such trade or business..." Clearly the §199A amount is not paid in carrying on a cannabis trade or business.

But not so clear is if the IRS will see this as an amount "incurred" in carrying on a trade or business. Similarly, the deduction is claimed on the return of the pass-through entity owner, not that of the business that is involved in the trafficking directly—so does that change the result?

The purpose of this provision was to effectively lower the tax rate and the deduction is only a method of doing so. So a court might view this not as a deduction or credit, but just a rate adjustment.

But a case that was decided in late 2019 suggested that §280E is going to bar all such deductions. In the case of *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4,[61] the taxpayer argued that §280E's bar on deductions only applied to those allowed under IRC §162 (for ordinary and necessary business expenses). As the majority opinion notes:

> Petitioner would have us find that section 280E applies only to section 162 deductions. According to petitioner, the text of section 280E "tracks" that of section 162, which allows for all ordinary and necessary business expense deductions, suggesting that section 280E should apply only to limit section 162 deductions.[62]

IRC §164 allows a deduction for taxes paid by the taxpayer, while §167 allows the deduction for depreciation. Applying the taxpayer's logic, the dispensary would also apparently be allowed deductions under §179 (for expensing equipment purchases) and §199A (the qualified business income deduction).

But the Tax Court determined that §280E broadly denies *any* deduction aside from cost of sales, ruling:

> However, petitioner's argument misses the first line of section 280E: "No deduction or credit shall be allowed". (Emphasis added.) Congress could not have been clearer in drafting this section of the Code.

---

[61] *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4, October 23, 2019, https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12102, .

[62] Northern California Small Business Assistants Inc. v. Commissioner, 153 TC No. 4, pp. 11-13.

> The broader statutory scheme also supports our conclusion that section 280E means what it says — no deductions under any section shall be allowed for businesses that traffic in a controlled substance. Section 261, in part IX of subchapter B of chapter 1 of the Code, provides that "no deduction shall in any case be allowed in respect of the items specified in this part." Section 280E is in part IX. Similarly, section 161 provides that deductions found in part VI of subchapter B of chapter 1 of the Code are allowed "subject to the exceptions provided in part IX". Part VI provides a comprehensive list of allowable deductions for taxpayers. This list includes section 162 and section 165 deductions, which we have previously disallowed pursuant to section 280E. See *CHAMP*, 128 T.C. at 180-181 (disallowing section 162 deductions under section 280E); *Beck v. Commissioner*, T.C. Memo. 2015-149, at
>
> *18 (disallowing a section 165 loss deduction under section 280E). As relevant here, part VI also includes sections 164 and 167, two additional sections petitioner believes would allow it a deduction. Clearly, sections 164 and 167 are limited by the exceptions in part IX, including section 280E. Thus, section 280E precluded petitioner from taking any deductions under sections 164 and 167 that are tied to its medical marijuana dispensary.[63]

Note IRC §199A is also found in part VI of subchapter B of chapter 1 of the Code, so the reference in §161 limiting such deductions to those not barred by part IX would also appear to apply to that provision. As well, IRC §164 would be the provision under which state income taxes are deducted, so the decision also appears to bar the deduction for corporate income taxes paid by a dispensary organized as a C corporation. What all this means is that we can't be sure whether or not a cannabis pass-through business equity holder will or will not be able to claim the deduction under IRC §280E. The IRS has given no guidance in this area, and given the number of items on the agency's "to do" list for guidance related to TCJA, it would not be surprising to see the agency remain silent in this area. The first we may know about the agency's view in this area may come when the IRS examines the first cannabis business in which the §199A deduction has been claimed by equity holders.

Given the uncertainty, advisers whose clients decide to take the position these businesses can generate a §199A deduction for the equity holders should consider filing a Form 8275 disclosure form on taking a position that a §199A deduction is available to the cannabis business equity holder.

[63] Northern California Small Business Assistants Inc. v. Commissioner, 153 TC No. 4, pp. 14-15.

Form **8275**

(Rev. August 2013)

Department of the Treasury
Internal Revenue Service

Disclosure Statement

Do not use this form to disclose items or positions that are contrary to Treasury regulations. Instead, use Form 8275-R, Regulation Disclosure Statement.

▶ **Information about Form 8275 and its separate instructions is at *www.irs.gov/form8275*.**

▶ **Attach to your tax return.**

OMB No. 1545-0889

Attachment
Sequence No. **92**

Name(s) shown on return

Identifying number shown on return

If Form 8275 relates to an information return for a foreign entity (for example, Form 5471), enter:
Name of foreign entity ▶
Employer identification number, if any ▶
Reference ID number (see instructions) ▶

Part I **General Information** (see instructions)

	(a) Rev. Rul., Rev. Proc., etc.	(b) Item or Group of Items	(c) Detailed Description of Items	(d) Form or Schedule	(e) Line No.	(f) Amount
1						
2						
3						
4						
5						
6						

Part II **Detailed Explanation** (see instructions)

1
2
3
4
5
6

Part III **Information About Pass-Through Entity.** To be completed by partners, shareholders, beneficiaries, or residual interest holders.

Complete this part only if you are making adequate disclosure for a pass-through item.

Note: *A pass-through entity is a partnership, S corporation, estate, trust, regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC).*

1 Name, address, and ZIP code of pass-through entity	**2** Identifying number of pass-through entity
	3 Tax year of pass-through entity / / to / /
	4 Internal Revenue Service Center where the pass-through entity filed its return

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 61935M Form **8275** (Rev. 8-2013)

Part IV **Explanations** *(continued from Parts I and/or II)*

WHAT IF §199A DOESN'T APPLY TO A CANNABIS BUSINESS?

While there may be a question regarding whether a cannabis business can obtain the benefit of

§199A, there is no question a cannabis business operating in a C corporation does get the benefit of the 21% corporate tax rate.

And while a potential second tax on liquidation is a consideration with a C corporation, two issues need to be considered. First, the shareholder's basis in his/her state would not appear to be at risk to denial of a deduction under §280E, so the shareholders will get some benefit to their initial investment that likely will be lost in a pass-through (the disallowed deductions will still reduce the basis of the shares or partnership interest for the equity holder).

Second, it would appear such C corporations would qualify for a partial or complete exclusion of gain under IRC §1202 for the sale of the stock at a later date. This rule would appear to apply even if the corporation sells its assets and then immediately redeems the stock of the shareholder. Because many CPAs may not have considered C corporations previously, a review of §1202 issues follows.

Especially given the impact of the amount of tax due annually on a cannabis business due to §280E, serious consideration should be given to C corporation status. Obviously, the adviser must consider any difference in personal vs. corporate tax rates imposed by the state or states involved.

Qualified Small Business Stock

Prior to the Tax Reform Act of 1986, far more closely-held businesses operated as C corporations than do now. The major reason why advisers moved closely-held businesses away from C corporation status was the repeal in the Tax Reform Act of 1986 of what was known as the *General Utilities* doctrine.

Generally, what was left of the doctrine just before its final repeal in 1986 allowed a corporation that was planning on liquidating because, for instance, it had been approached by a party interested in buying the assets of the corporation, would recognize no gain on the sale of assets that were part of the plan of liquidation if the liquidation was completed within one year.

While a shareholder would still pay tax on the gain realized on disposing of his/her shares, that would only amount to a single tax on the appreciated assets of the corporation. Most often those appreciated assets would be the goodwill, customer lists, and other intangible assets which had no basis but were the real value of buying the operating business.

Seven years after the repeal of the General Utilities doctrine in 1993, Congress enacted a new provision that provided a similar type of relief on the sale of certain businesses that were operated as a C corporation. Originally, this provision simply provided for reduced level of tax if the stock were sold or disposed of after a minimum holding period, as well as a tax-free rollover option into another qualified entity's stock. But beginning in 2010, the provision was modified to allow for a total exclusion of the gain on the sale of stock acquired after September 27, 2010.

The §1202 exclusion for some or all gain on the sale of stock may help make the use of a C corporation, with lower annual tax obligations, more palatable for owners concerned about the tax impact of a sale of the cannabis business.

Tax Cuts and Jobs Act's Impact

While the Tax Cuts and Jobs Act did not change §1202 directly, it did make other changes that now make an understanding of that provision crucial for any CPA advising taxpayers on the type of entity he/she should be using for a new business. Corporate rates are now set at 21%, significantly below individual rates even after taking into account the deduction under IRC §199A for qualified business income that would be available if a pass-through entity was used.

As that is a 20% deduction, that only reduces the maximum 37% individual rate to 29.6% on such income. Thus, if a taxpayer is in the maximum individual tax bracket, there will be a significantly higher rate of federal tax imposed on the income earned.

While a double tax would still apply if the income was paid out as a dividend, prior to the 1986 Act, this rarely proved to be a major problem. If the corporation has a use for the funds, they can be retained to grow the business without having to turn to borrowing—a fact that may be particularly important if the business could run into the business interest limitations added by the Tax Cuts and Jobs Act at IRC §163(j).

For a qualifying business, while the corporation would still pay tax on a sale of its assets to a buyer, the subsequent redemption of a shareholder holding qualified §1202 stock would be tax free up to

$10 million of gain if the requirements are met.

This does not mean that all potentially qualified entities should be a C corporation. There are a number of issues, especially if the business does not plan to grow and/or the owner is going to drain all earnings out of the enterprise each year for personal spending.

But it does mean that the CPA who was advising the taxpayer when the entity was formed may have to show that the §1202 option was considered and why it was ultimately rejected at a time when the stockholder is facing a capital gains tax on a $10 million gain that would not exist had the

C corporation option been considered.

Exclusion of Gain Rules

IRC §1202(a) provides for an exclusion of varying amounts of gain from the sale of qualified small business stock held more than 5 years.

Definition of Qualified Small Business Stock

Qualified small business stock (QSBS) is defined at IRC §1202(c). The basic requirements for such stock are:

- As of the date of issuance, the corporation must be a "qualified small business" as defined at IRC §1202(d)

- Except for stock acquired by conversion of other stock (as defined at IRC §1202(f)) or via certain tax free transfers detailed at IRC §1202(h), the stock must be acquired by the taxpayer at its original issue (directly or via an underwriter):
  - In exchange for money or other property (but not stock), or
  - As compensation for services provided to the corporation (other than services as an underwriter of the stock). [IRC §1202(c)(1)]

Anti-Evasion Rules

Stock will not be treated as QSBS if certain purchases are made by the corporation of its own stock surrounding the date the shareholder acquired his/her own stock. This is meant to prevent evasion of the rules by having a shareholder sell his/her shares back to the corporation and then have the corporation sell shares to a new shareholder as a method of allowing the new shareholder acquire the shares of the old shareholder and still have QSBS.

The anti-evasion rules will treat stock acquired as not QSBS stock if:

- At any time during the four-year period beginning two years before the new shareholder acquired his/her shares, the corporation purchased more than a *de minimis* amount of its stock from the taxpayer or a person related to the taxpayer [IRC §1202(c)(3)(A)] *or*
- During the two-year period beginning one year before the acquisition of the stock from the corporation, the corporation made one or more purchases of its stock with an aggregate value at the time of purchase exceeding 5% of the value of all of its stock at the beginning of the two-year period. [IRC §1202(c)(3)(B)]

For purposes of the four-year rule, purchases are more than *de minimis* if the total shares purchased exceed 5% of the aggregate value of the corporation's stock as of the beginning of the four-year period. [Reg. §1.1202-2(a)(2)]

The IRS has created four exceptions to the above rules by regulations found at Reg. §1.1202-1(d). The regulations provide that a stock purchase will be disregarded if the stock is being acquired in any of the following circumstances:

- The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services;
- Prior to a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and—
  - The stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and
  - The stock is purchased within 3 years and 9 months from the date of the decedent's death;
- The stock is purchased incident to the disability or mental incompetency of the selling shareholder; or

- The stock is purchased incident to the divorce (within the meaning of section 1041(c)) of the selling shareholder.

Active Business Requirement

To retain its status as qualified small business stock, the corporation must also meet an active business requirement as defined at IRC §1202(e).

Under the general active business rules, the corporation must meet two tests:

- At least 80% (by value) of the assets of such corporation are used by such corporation in the active conduct of 1 or more qualified trades or businesses, and
- The corporation is an eligible corporation.

A special set of rules found at IRC §1202(e)(2) expand the active conduct test to cover activities, generally of a start-up company, that generally qualify as active conduct of a business to qualify as such for this rule. Assets used in an activity shall be considered used in connection with the active conduct of a trade or business if, in connection with any future qualified trade or business, the corporation is engaged in:

- Start-up activities described in Section 195(c)(1)(A);
- Activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under Section 174; or
- Activities with respect to in-house research expenses described in Section 41(b)(4).

Not all businesses qualify for stock issued to be treated as QSBS. Rather, the business in question must <u>not</u> be:

- Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services,
- Any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,
- Any banking, insurance, financing, leasing, investing, or similar business,
- Any farming business (see note following the list for the impact on certain cannabis businesses),
- Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A (percentage depletion), and
- Any business of operating a hotel, motel, restaurant, or similar business. [IRC §1202(e)(3)]

As was noted above, a farming business is not a qualified business for §1202 purposes. Thus, a cannabis business that cultivates the plants will not be eligible to obtain the benefits of §1202.

Similarly, the law also blocks certain corporations from issuing QSBS. QSBS may not be issued by:

- A DISC or former DISC,
- A corporation that is eligible for the §936 possessions tax credit or which has a direct or indirect subsidiary eligible for that credit,
- A regulated investment company (mutual fund), real estate investment trust (REIT) or REMIC, or
- A cooperative. [IRC §1202(c)(4)]

For purposes of the 80% of assets test, stock and debt of a subsidiary corporation will be disregarded, with the parent deemed to own its ratable share of the subsidiary's assets and to conduct a ratable share of the subsidiary's activities. [IRC §1202(c)(5)(A)] A corporation will be deemed a subsidiary for these purposes if the parent owns more than 50% of the combined voting power of all classes of stock entitled to vote *or* more than 50% in value of all outstanding stock of the subsidiary.

[IRC §1202(c)(5)(C)]

Conversely, if a corporation holds a portfolio of stock and securities in other corporations that are not its subsidiary, it will not be able to issue QSBS for any period where the value of that portfolio exceeds 10% of the value of its assets in excess of liabilities. Or, to put it more simply, its equity, not its total assets. [IRC §1202(c)(5)(B)]

The same equity-based test will disqualify the corporation from issuing QSBS for any period where it holds real property not used in the active conduct of a trade or business whose value exceeds the same 10% of equity threshold. [IRC §1202(c)(7)]

A special test applies to determine if working capital will be deemed to be an asset that can be counted in meeting the 80% test described above. Subject to the limitation described below, assets will be considered used in the active conduct of a trade or business if:

- The assets are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or
- The assets are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business.

However, if the business has been in existence more than 2 years, no more than 50% of the assets of the corporation qualify as used in the active conduct of a qualified trade or business for these working capital reasons. [IRC §1202(e)(6)]

Qualified Small Business

The corporation also needs to be a qualified small business at the time the stock is issued. To be a qualified small business, the corporation must meet all three of the following criteria:

- The corporation must be a domestic corporation which is taxed as a C corporation (thus this provision is not open to an S corporation);

- The aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 and before the issuance did not exceed $50,000,000;

- The aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) do not exceed $50,000,000; and

- Such corporation agrees to submit such reports to the IRS and to shareholders as the IRS may require to carry out the purposes of this section. Note that, to date, no such reporting requirements have been published by the IRS. [IRC§1202(d)(1)]

For purposes of the gross assets test, the gross assets shall be the total of the cash and aggregate adjusted basis of other property held by the corporation. However, in computing the adjusted basis of other property, the adjusted basis of any property contributed to the corporation shall be computed as if the basis of such property were equal to its fair value at the time of the contribution.

[IRC §1202(d)(2)]

For purposes of these tests, all corporations which are members of the same parent-subsidiary controlled group are treated as a single corporation. However, the test for a parent-subsidiary relationship shall be based on a "more than 50%" rather than "more than 80%" test for such control, and insurance companies subject to tax under §801 will not be treated as a controlled group separate from the controlled group they otherwise would be part of. [IRC §1202(d)(3)]

Exclusion Amounts

Generally, the taxpayer qualifies for an exclusion of some (or all) of the gain on disposition if the stock is held for at least five years. The amount to be excluded is:

- 100% of the gain for stock acquired after September 27, 2010;

- 75% of the gain for stock acquired after February 17, 2009 and before September 28, 2010;

- For stock acquired before February 18, 2009:

  - Generally, 50% of the gain,

  - However, 60% of the gain from the sale of stock of that was a "qualified business entity" as defined at IRC §1397C(b) during substantially all of the taxpayer's holding period attributable to periods before January 1, 2019.

A qualified business entity for purposes of the 60% exclusion is an entity that meets all of the following requirements:

- Every trade or business of such entity is the active conduct of a qualified business within an empowerment zone,
- At least 50% of the total gross income of such entity is derived from the active conduct of such business,
- A substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone,
- A substantial portion of the intangible property of such entity is used in the active conduct of any such business,
- A substantial portion of the services performed for such entity by its employees are performed in an empowerment zone,
- At least 35% of its employees are residents of an empowerment zone,
- Less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles (as defined in section 408(m)(2)) other than collectibles that are held primarily for sale to customers in the ordinary course of such business, and
- Less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.

Elective Rollover Exclusion Provision

Rather than make use of the exclusion provisions above, a taxpayer may elect to take advantage of the rollover rules found at IRC §1045 to exclude gain from the disposition of QSBS stock.

The rollover rules can be advantageous if:

- The taxpayer has held the stock for more than 6 months, but not more than 5 years (and thus does not qualify for exclusion on sale rules described above), or
- The stock was acquired before the date when the 100% exclusion applies.

If the provision is elected, gain on the disposition of the QSBS is recognized only to the extent that the amount realized on sale exceeds:

- The cost of any qualified small business stock purchased by the taxpayer during the 60-day period beginning on the date of such sale, reduced by
- Any portion of such cost previously taken into account under this provision.

The second condition would apply if a taxpayer had multiple sales of QSBS shares for which an election was made during the period and beginning 59 days before the date of purchase. [IRC §1045(a)]

Any gain not recognized pursuant to this provision, the basis of the QSBS acquired is reduced by that unrecognized gain. [IRC §1045(b)(3)]

The election must be made on or before the due date (including extensions) of the taxpayer's tax return for the year in which the stock was sold. [Revenue Procedure 98-48]

The election is made by:

- Reporting the entire gain from the sale of QSB stock on Schedule D, Capital Gains and Losses, of the return in accordance with the instructions for Schedule D;
- Writing "Section 1045 rollover" directly below the line on which the gain is reported; and
- Entering the amount of the gain deferred under Section 1045 on the same line as the rollover notation, as a loss, in accordance with the instructions for Schedule D. [Revenue Procedure 98-48]

C Corporation vs. Pass-through for Cannabis Business

Considering the issues just noted, how does it look practically for structuring a cannabis business either as a pass-through entity or a C corporation? Does the lower annual rate of tax on the

C corporation outweigh the potential second tax?

Let's revisit Wilma's Cannabis Shop from Example 2 and look at her situation if the business is operated as an S corporation.

EXAMPLE 3:

Wilma's Cannabis Shop (Pass-through with §199A)

For purposes of this example, we'll assume Wilma has the income and expenses noted in Example 2.

Wilma's Cannabis Shop except for federal and state income taxes. As well, we'll assume that Wilma's taxable income is below the threshold amount so we won't have to control for W-2 wages to make this example a bit simpler to follow. We will also decide that it turns out that §280E does not limit the business's ability to claim the §199A deduction (an assumption that may or may not turn out to be correct—but that's to be decided at a later date, likely in a court challenge if the IRS takes the contrary position).

In that case, the amount of income that Wilma will pay tax on is computed as follows:

Income from Schedule K-1	$	119,300
Qualified business income deduction under IRC §199A		23,860
Net income taxable to Wilma	$	95,440

Since we are assuming Wilma is below the threshold amount, her maximum federal tax bracket is 24%. We'll assume, based on her income, she is subject to a state tax at 4%. Since most states did not conform to the §199A deduction, we'll assume her state tax is imposed on the income from the K-1 before the §199A deduction.

Federal tax at 24%	$	22,906
State tax at 4% (assuming state does not allow §199A deductions)		4,772
Total taxes – individual level	$	27,678

What if Wilma had formed her business as a C corporation? The rates are lower (at least at the federal level) but she loses the 20%. As well, she faces the double taxation problem (although this is a bit different, as we'll discuss).

Federal corporate rates are at a flat 21%. While states are more likely to have flat corporate taxes, we'll still assume the 4% rate for these purposes (obviously, in a real case you'd use the actual expected state tax rate). Here is her tax:

C corporation taxable income	**$**	**119,300**
Federal tax at 21%	$	25,053
State tax at 4%		4,772
Total corporate taxes	**$**	**29,825**

In this case, despite the lower tax rate for the C corporation, the fact is that the rate isn't that much lower than the individual rate at the threshold level.

EXAMPLE 4:

Wilma's Cannabis Shop (Pass-through with §199A and Top Marginal Rate)

Let's modify the example. We will assume Wilma has the same net income, but is well above the threshold amount and is being taxed at the highest marginal rates. We will also assume now that the business has sufficient W-2 wages paid during the year so that she can claim the full §199A deduction on her flow-through income.

Federal tax at 37%	$	35,313
State tax at 4% (assuming state does not allow §199A deductions)		4,772
Total taxes – individual level	$	40,085

The corporate tax is not affected by Wilma's marginal tax rates, so that total tax remains at $29,285. Now the corporation has a significant tax (and cash flow) advantage.

In the above cases, on an annual basis (ignoring any extra tax on distribution or on the final sale of the business) the more beneficial structure depends on the marginal tax rate of the owner.

But what if ultimately it is held that §280E does prohibit any deduction under §199A for a cannabis business?

EXAMPLE 5

(Passthrough without §199A with 24% Marginal Rate)

This time we'll assume that, while Wilma's tax rate for federal purposes is 24% again, the §199A deduction is not allowed to cannabis businesses. Now her tax results look like this:

Federal tax at 24%	$	28,632
State tax at 4% (assuming state does not allow §199A deductions)		4,772
Total taxes – individual level	$	33,404

Again, this will not impact the tax for the alternative C corporation, so that tax remains at $29,825. While there is an advantage to the C corporation, it's relatively minor.

Now the double tax can be considered. Normally, you'd see a calculation run by distributing the income of

$119,300 less the $29,285, or $90,015. But that isn't appropriate here since there are the following non-deductible expenses that would absorb available cash for distributions:

Office supplies	$	4,200
Utilities		2,000
Accounting and Legal		2,000
Rent		6,000
Wages		70,000
Advertising		6,700
§163 Interest Expense		1,780
Property taxes		1,400
Total Nondeductible Expenses	**$**	**94,080**

In this case, the double tax on the distribution of earnings is not a problem—rather, the negative cash flow is more likely to be fatal to this business over time.

While, hopefully, a cannabis business will structure its pricing and expenses to avoid the negative cash flow that Wilma is experiencing, there will be a significant amount of earnings that will not be available for double taxation in your entity analysis.

NOTES

Section

4

Federal Income Tax Issues for Cannabis Businesses

LEARNING OBJECTIVES

After completing this section, participants should be able to:

- ☐ Understand how the IRS and courts have applied the provisions of §280E in specific situations
- ☐ Deal with recent cases and rulings

Given the rapidly-changing environment for state-legal cannabis businesses and the fact that no regulations have ever been issued by the IRS under §280E, advisers need to keep up with developments that arise from IRS rulings (both those binding on the IRS and those that are merely advisory) and court decisions.

In this unit, we look at court and IRS rulings that have an impact on cannabis businesses.

TAX COURT DECIDES THAT §280E DOES NOT VIOLATE THE EIGHTH AMENDMENT

A majority of the Tax Court concluded in the case of *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4,[64] that the denial of deductions for those

[64] *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4, October 23, 2019, https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12102,

operating businesses trafficking in cannabis is not a fine. Therefore, the provision could not be found to be an excessive fine.

The Eighth Amendment to the U.S. Constitution provides:

> Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.

The taxpayer, a medical marijuana dispensary operating under California law that allows such operations, argued that IRC §280E served as an excessive fine under the Eighth Amendment and thus should be disregarded by the court.

IRC §280E provides:

> 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 defined by statute to be a controlled substance, and thus all deductions or credits related to the operations are denied by the statute aside from those properly deducted as a cost of sale.

The majority opinion finds that the denial of a deduction is not a fine under this provision of the Constitution. First, the Court notes that the 16th Amendment gives Congress the absolute right to tax income and that deductions are also left to Congress' discretion.

> Congress has the power to lay and collect income taxes under Article I, Section 8 of the Constitution. The Sixteenth Amendment grants Congress the power to lay and collect taxes on "incomes, from whatever source derived" without requiring apportionment among the States as required by Article I. The Supreme Court has held that any deductions from gross income are a matter of legislative grace and can be reduced or expanded in accordance with Congress' policy objectives. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *New Colonial Ice Co. v. Helvering*, 292
>
> U.S. 435, 440 (1934); see *Keeler v. Commissioner*, 70 T.C. 279, 284-285 (1978). Under the Sixteenth Amendment, "[t]he power of Congress to tax gross income is unquestionable." *Bagnall v. Commissioner*, 96 F.2d 956, 957 (9th Cir. 1938), *aff'g* 35
>
> B.T.A. 1 (1936).
>
> ... Deductions from gross income do not turn on equitable considerations; rather they are pure acts of legislative grace, the prudence of which is left to Congress.
>
> *Deputy v. du Pont*, 308 U.S. 488, 493 (1940); *White v. United States*, 305 U.S. 281,
>
> 292 (1938); *Hokanson v. Commissioner*, 730 F.2d 1245, 1250 (9th Cir. 1984), *aff'g*

T.C. Memo. 1982-414; *United States v. Akin*, 248 F.2d 742, 743 (10th Cir. 1957); *Gen. Fin. Co. v. Commissioner*, 32 B.T.A. 949, 954 (1935), *aff'd*, 85 F.2d 846 (3d Cir. 1936). Congress is free to grant, restrict, and deny deductions as it sees fit. *J.E. Riley Inv. Co. v. Commissioner*, 110 F.2d 655, 658 (9th Cir. 1940), *aff'd*, 311 U.S. 55 (1940); *Barbour Coal Co. v. Commissioner*, 74 F.2d 163 (10th Cir. 1934).[65]

The majority opinion therefore concludes:

Petitioner does not cite, and we are not aware of, any case where the disallowance of a deduction was construed a penalty. This is especially telling given that Congress enacted section 280E over 37 years ago in 1982, and over that 37 years it has never been held to be a penalty by any Federal court. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, sec. 351(a), 96 Stat. at 640. The overwhelming precedent establishing that deductions from gross income are a matter purely left to congressional discretion by the Sixteenth Amendment explains why over the last 37 years an Eighth Amendment attack on any section of the Code that limits deductions from gross income has been a nonstarter. ... The Sixteenth Amendment does not accommodate the assertion that the disallowance of a deduction is a penalty. There is simply no way to reconcile the argument that section 280E creates a penalty with the authority of Congress to tax gross income. Therefore, we hold that section 280E is not a penalty provision and, consequently, the Eighth Amendment's Excessive Fines Clause does not apply.[66]

While all Tax Court judges agreed in the result of this case (the taxpayer should not prevail in its claim that §280E represented an excessive fine), five judges held that the taxpayer failed to show the amount was excessive. Two judges specifically declined to rule on whether §280E was a penalty or not (finding it wasn't relevant if there was no evidence of it being excessive),[67] while three held that

§280E did operate as a fine but since there was no evidence presented that it was excessive, the taxpayer could not prevail.[68]

For those wondering if the Fifth Amendment might offer an opportunity to avoid issues with §280E, the Tenth Circuit Court of Appeals also rejected this approach in the case of *Feinberg, et al., v.*

Commissioner, Case No. 18-9005, CA10.

[65] Northern California Small Business Assistants Inc. v. Commissioner, 153 TC No. 4, pp. 7-8

[66] Northern California Small Business Assistants Inc. v. Commissioner, 153 TC No. 4, pp. 11-13

[67] Northern California Small Business Assistants Inc. v. Commissioner, 153 TC No. 4, p. 21

[68] Northern California Small Business Assistants Inc. v. Commissioner, 153 TC No. 4, pp. 22, 44

IRS USING STATE REPORTS FILED BY LEGAL SELLERS TO TARGET §280E EXAMINATIONS

A taxpayer seeking to quash a summons from the IRS to the Colorado Department of Revenue's Marijuana Enforcement Division (MED) failed to obtain the requested relief in the case of *Rifle Remedies, LLC v. United States,* USDC Colorado, Case No. 1:17-mc-00062.

The taxpayer had claimed that this subpoena was really a front for conducting a criminal investigation into the taxpayer's marijuana business and, if the court didn't accept that objection, the taxpayer had a series of other objections.

But the Court found none of them met the requirements to quash a summons. The standard that would apply is the one outlined by the Tenth Circuit Court of Appeals (who would hear any appeal in this case). The burden is first on the IRS but, as the Tenth Circuit noted in the case of *Villareal v. United States*, 524 F. App'x 419, 422-423 (10th Cir. 2013), that burden is slight. The IRS must simply initially show:

- The investigation is being conducted pursuant to a legitimate purpose;
- The information being sought may be (as opposed to will be) relevant to that purpose;
- The information is not already in the possession of the IRS; and
- The IRS has followed the administrative steps required in the IRC.

Once it is shown that the burden shifts to the taxpayer, a burden the Tenth Circuit labels a "heavy one," to show enforcement would constitute an abuse on the court's process or that the IRS lacked institutional good faith in issuing the summons.

The opinion notes:

> The declaration from IRS Revenue Agent Jean Walker ("Walker") satisfies respondent's slight burden of establishing a legitimate purpose for its investigation. Notably, in her declaration, Walker stated that she is investigating petitioner's federal tax liabilities, and the purpose of the summons is to verify petitioner's financial records and to determine whether information reported in petitioner's tax returns can be substantiated. (ECF No. 5-1 at ¶¶ 4, 15.) The Court, thus, finds the IRS's investigation to have a legitimate purpose.

The taxpayer objected that the IRS's "real" motivation was to obtain information for a criminal investigation. The Court rejected this position, noting:

> Suffice to say, the Court does not find that the IRS is engaging in a criminal investigation when it investigates, for purposes of 26 U.S.C. §280E ("§280E"), whether a business involves trafficking in a controlled substance. The purpose of such an investigation, as the statutory provision provides, is to determine whether a business is entitled to a deduction or credit; not to determine whether a business (or its proprietors) may be subject to criminal

> prosecution. See 26 U.S.C. §280E. Moreover, none of the arguments that petitioner makes in this case have changed the Court's opinion. As such, the Court rejects petitioner's argument in this regard.

IRC §280E is an interesting provision in the law, providing 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.

This provision denies deductions for expenses (other than cost of sales) for carrying on a trade or business where the business traffics in items that are controlled substances under federal law. As the Court notes here, the question of whether this entity traffics in controlled substances is important in deciding if the entity is entitled to deductions for things like office supplies, rent, utilities, etc.

Obtaining information from the State of Colorado regarding the entity's reporting of sales of what is controlled substance (marijuana) would seem clearly relevant in determining if IRC §280E applies to this business.

The taxpayer then advances a series of additional arguments about why this summons should be quashed, all of which the Court also rejected.

MAINTENANCE OF BOOKS AND RECORDS – RECONSTRUCTION OF INCOME ISSUES

One fact of life in cannabis businesses is that the business is often a purely cash business due to the difficulties such businesses have obtaining traditional banking services. Closely related to this is the fact that record keeping is often an issue with these cash heavy businesses—and that creates problems for tax compliance.

In the case of *Feinberg v. Commissioner*, T.C. Memo 2017-211, a taxpayer attempted to use the expert opinion of a CPA whom was claimed to be an expert in cost accounting, with an emphasis in the marijuana industry.

The taxpayers were shareholders in an LLC that ran a marijuana dispensary in Colorado. On the original tax return filed for their S corporation, the taxpayers had claimed several deductions as ordinary trade or business deductions that the IRS determined were costs of sales—an important issue, since under IRC §280E only costs of goods sold may be deducted by a business that traffics in controlled substances under federal law. Despite being legalized in Colorado, marijuana remains a controlled substance under federal law.

All expenses not so reclassified by the IRS were disallowed pursuant to IRC §280E.

At trial, the taxpayers recognized that expenses that were cost of goods sold were clearly much more valuable if IRC §280E applied to the operation, so the taxpayer took the position that even though

the IRS was now allowing more cost of goods sold than were originally claimed on the return, that number was below the "real" cost of goods sold for their operation.

However, there was a complication with the taxpayer being able to prove that assertion—the entity did not produce any business records to support these claimed expenses. Instead, they brought forward a CPA as an expert to give his expert opinion on the proper cost of goods sold for this business.

The Court opinion describes the expert report as follows:

> The report states that during the tax years in issue the average wholesale purchase price for medical marijuana remained between $2,000 and $3,000 per pound. The report later posits an average purchase price of $2,500 per pound and reconstructs an income and expense schedule for THC "assuming" that COGS equaled 55% of gross sales. The report does not explain how or on what basis Marty determined these sales figures, and the exhibits do not include any sales records or other documents that would support them. The report asserts that tax returns Marty's firm prepared show that "actual" COGS for medical marijuana businesses during the tax years in issue was between 66% and 100% (or more) of gross sales.

The Tax Court was not impressed by this evidence of the cost of goods sold. The Court's opinion first notes:

> The Marty report is brief and summary, and its content is unreliable. Multiple statements in the report refer to no underlying source of information. For other statements that do cite an underlying source, Marty has failed to include the information or data on which he relied. In many instances, the report does not reference or provide sufficient information or data for us to conclude that the opinions expressed are based on anything other than his own conjecture.

The Court objects as well to the fact that this report was not based on any knowledge of the taxpayer's business:

> The conclusions in the Marty report are an attempt to present reconstructed income tax returns as evidence of petitioners' correct tax liabilities. The report is not based on personal knowledge of THC's business. To determine the correct COGS for THC, substantiation of THC's expenses is necessary. A reconstructed income tax return based on industry averages does not take the place of substantiation and does not help determine a fact in issue.

Finally, the Court concludes that the expert committed what is the unforgivable sin for an expert witness—giving testimony about the proper application of the law, a responsibility reserved to the Court:

> By relying on returns that Marty and his firm prepared for other businesses, the Marty report provides the Court with legal conclusions as to which types of expenses may be treated as COGS. Expert testimony about what the law is or that directs the finder of fact on how to apply the law does not assist the trier of

fact. Stobie Creek Invs., LLC v. United States, 81 Fed. Cl. 358, 364 (2008). Expert opinions on law are inadmissible. Fed. R. Evid. 702(a); see Hosp. Corp. of Am. v. Commissioner, 109 T.C. 21, 59 (1997).

The Court concludes that the report was not admissible in the case, thus removing from the case all evidence the taxpayer had submitted. The IRS's computation of tax due was therefore sustained.

This case is instructive about the limits of using "expert testimony," especially to attempt to reconstruct records that either the taxpayer didn't want to make available or failed to keep. It also gives a good outline of the types of information any expert needs to be able to provide for his/her report to be useful in a tax matter.

MULTIPLE TRADES OR BUSINESSES

The bar on deducting expenses found at IRC §280E only applies to a trade or business involved in the trafficking of controlled substances that are illegal at either the federal or state level. Thus, if the taxpayer has more than a single trade or business, the bar on deductions only applies to the trafficking business.

But to carry this point, the taxpayer must show he/she has more than one trade or business.

A test for multiple trades or businesses exists at Reg. §1.446-1(d) for the use of different methods of accounting, even if it's not quite a "bright line" test for what is a separate trade or business. That regulation provides:

> (c) Taxpayer engaged in more than one business.
>
> (1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.
>
> (2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.
>
> (3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

In Chief Counsel Advice 201430013, the IRS National Office looked at a case where a subsidiary converted to a single member LLC disregarded entity. The memorandum concludes that, in fact, there are two distinct trades or businesses in this organization.

The activities undertaken by the LLC and its corporate owner were summarized as follows:

> Company's activities include sales, marketing, distribution, sales support, research and development, and administrative and headquarters functions. LLC primarily manufactures products but does provide some research and development services to the purchaser of its products, Purchaser A. Purchaser A will subsequently sell these products to Purchaser B, who will ultimately sell the products to Company.
>
> Company and LLC have separate books and records. These books and records are prepared at Company's location. Company and LLC are in different geographical locations. Further, Company and LLC do not share employees, but, do share the highest-level executives. Company and LLC use the same accounting method, presumably, that method is an accrual accounting method.

The memorandum concludes:

> Deciding whether Company and LLC are separate and distinct trades or businesses requires a factual determination. The currently-available information fails to convince us that Company and LLC are not separate and distinct trades or businesses. The fact that LLC has failed to make an election to be taxed as a corporation and is thus, disregarded as an entity separate from Company for federal income tax purposes, does not mean that LLC can never be a separate and distinct trade or business. Accordingly, based on the available information, our view is that Company and LLC are separate and distinct trades or businesses within the meaning of IRC §446(d).

So does that mean that a single entity can be divided into multiple trades or businesses—likely yes, but they need to be truly distinct.

This issue has been litigated for cannabis businesses—with one major success and mostly a series of follow-up losses by cannabis businesses in this area.

CHAMP – A TRULY SEPARATE TRADE OR BUSINESS

The key case outlining the test for a separate trade or business for purposes of IRC §280E is the case of *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 TC 173 (2007), most often referred to by the organization's acronym as the *CHAMP* case.

The opinion described the organization's operations as follows:

> Its articles of incorporation stated that it "is organized and operated exclusively for charitable, educational and scientific purposes" and "The property of this
>
> S corporation is irrevocably dedicated to charitable purposes". Petitioner did not have Federal tax-exempt status, and it operated as an approximately break-even (i.e., the amount of its income approximated the amount of its expenses)

community center for members with debilitating diseases. Approximately 47 percent of petitioner's members suffered from Acquired Immune Deficiency Syndrome

(AIDS); the remainder suffered from cancer, multiple sclerosis, and other serious illnesses. Before joining petitioner, petitioner's executive director had 13 years of experience in health services as a coordinator of a statewide program that trained outreach workers in AIDS prevention work.

Petitioner operated with a dual purpose. Its primary purpose was to provide caregiving services to its members. Its secondary purpose was to provide its members with medical marijuana pursuant to the California Compassionate Use Act of 1996 and to instruct those individuals on how to use medical marijuana to benefit their health. Petitioner required that each member 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. Petitioner required that its members not resell or redistribute the medical marijuana received from petitioner, and petitioner considered any violation of this requirement to be grounds to expel the violator from membership in petitioner's organization.

Each of petitioner's members paid petitioner a membership fee in consideration for the right to receive caregiving services and medical marijuana from petitioner.

Petitioner's caregiving services were extensive. First, petitioner's 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. Second, petitioner provided its low-income members with daily lunches consisting of salads, fruit, water, soda, and hot food. Petitioner also made available to its members hygiene supplies such as toothbrushes, toothpaste, feminine hygiene products, combs, and bottles of bleach. Third, petitioner allowed its members to consult one-on-one with a counselor about benefits, health, housing, safety, and legal issues. Petitioner also provided its members with biweekly masseuse services. Fourth, petitioner coordinated for its members weekend social events including a Friday night movie or guest speaker and a Saturday night social with live music and a hot meal. Petitioner also coordinated for its members monthly field trips to locations such as beaches, museums, or parks. Fifth, petitioner instructed its members on yoga and on topics such as how to participate in social services at petitioner's facilities and how to follow member guidelines. Sixth, petitioner provided its members with online computer access and delivered to them informational services through its Web site. Seventh, petitioner encouraged its members to participate in political activities.

The organization got its income from a membership fee which the organization sets to cover the cost of both providing the services and the marijuana for each member. The members were provided a set amount of marijuana and did not have rights to any additional supplies.

In the case, the IRS conceded that $212,958 of deductions other than the cost of the marijuana were substantiated, but argued that the deduction for any of this was disallowed since the entity was in the trade or business of trafficking in controlled substances that were illegal under federal law. Thus, the IRS argued, the taint affected all of the entity's business deduction.

But the Tax Court disagreed that the mere fact that the organization was trafficking in controlled substances meant that no deductions were allowed if they related to a distinct and different trade or business. As the opinion noted:

> Section 280E and its legislative history express a congressional intent to disallow deductions attributable to a trade or business of trafficking in controlled substances. They do not express an intent to deny the deduction of all of a taxpayer's business expenses simply because the taxpayer was involved in trafficking in a controlled substance. We hold that section 280E does not preclude petitioner from deducting expenses attributable to a trade or business other than that of illegal trafficking in controlled substances simply because petitioner also is involved in the trafficking in a controlled substance.

But the Court rejected the opposite view that the conduct of a distinct trade or business made the provision of marijuana not a trade or business, a position advanced by the taxpayer:

> Petitioner argues that its supplying of medical marijuana to its members was not "trafficking" within the meaning of section 280E. We disagree. We define and apply the gerund "trafficking" by reference to the verb "traffic", which as relevant herein denotes "to engage in commercial activity: buy and sell regularly". Webster's Third New International Dictionary 2423 (2002). Petitioner's supplying of medical marijuana to its members is within that definition in that petitioner regularly bought and sold the marijuana, such sales occurring when petitioner distributed the medical marijuana to its members in exchange for part of their membership fees.

The Court then looks to see if CHAMP had two separate trades or businesses. The Court outlines the requirements to have multiple trades or businesses.

> Taxpayers may be involved in more than one trade or business, see, e.g., Hoye v. Commissioner, T.C. Memo. 1990-57, and whether an activity is a trade or business separate from another trade or business is a question of fact that depends on (among other things) the degree of economic interrelationship between the two undertakings, see Collins v. Commissioner, 34 T.C. 592 (1960); sec. 1.183-1(d)(1), Income Tax Regs. The Commissioner generally accepts a taxpayer's characterization of two or more undertakings as separate activities unless the characterization is artificial or unreasonable. See sec. 1.183-1(d)(1), Income Tax Regs.
>
> ...As stated by the Board of Tax Appeals in Alverson v. Commissioner, 35 B.T.A. 482, 488 (1937): "The statute is not so restricted as to confine deductions to a single business or principal business of the taxpayer. A taxpayer may carry on more than one trade or business at the same time." Moreover, as the

> Supreme Court has observed in the context of illegal, nondeductible expenditures: "It has never been
>
> thought *** that the mere fact that an expenditure bears a remote relation to an illegal act makes it non-deductible." Commissioner v. Heininger, 320 U.S. 467, 474 (1943).

A key finding in favor of CHAMP was that it was truly providing caregiving services to its members, and the provision of marijuana was just one aspect of such services:

> We do not believe it to have been artificial or unreasonable for petitioner to have characterized as separate activities its provision of caregiving services and its provision of medical marijuana. Petitioner was regularly and extensively involved in the provision of caregiving services, and those services are substantially different from petitioner's provision of medical marijuana. By conducting its recurring discussion groups, regularly distributing food and hygiene supplies, advertising and making available the services of personal counselors, coordinating social events and field trips, hosting educational classes, and providing other social services, petitioner's caregiving business stood on its own, separate and apart from petitioner's provision of medical marijuana. On the basis of all of the facts and circumstances of this case, we hold that petitioner's provision of caregiving services was a trade or business separate and apart from its provision of medical marijuana.

As the other cases we discuss will illustrate, showing the true provision of significant other services that the customers paying for is crucial to success in establishing an additional business not subject to

§280E. The IRS has been very successful in arguing that the facts in later taxpayer cases can be distinguished from CHAMP—and, therefore, there is only a single trafficking trade or business.

Rather, in those other cases, the IRS has been far more successful in getting the Court to accept the following view of the arrangement:

> Respondent argues that the "evidence indicates that petitioner's principal purpose was to provide access to marijuana, that petitioner's principal activity was providing access to marijuana, and that the principal service that petitioner provided was access to marijuana *** and that all of petitioner's activities were merely incidental to petitioner's activity of trafficking in marijuana."

It is crucial, therefore, to pay close attention to the details the Court focused on in *CHAMP* to find the other services that were truly something members were paying for rather than mere window dressing.

The Court noted:

> Petitioner's executive director testified credibly and without contradiction that petitioner's primary purpose was to provide caregiving services for terminally ill patients. He stated: "Right from the start we considered our primary function as being a community center for seriously ill patients in San Francisco. And only secondarily as a place where they could access their medicine." The evidence suggests that petitioner's operations were conducted

> with that primary function in mind, not with the principal purpose of providing marijuana to members.
>
> ...the record leads us to make the contrary finding that petitioner's caregiving services generated income attributable to those services. In making this finding, we rely on the testimony of petitioner's executive director, whom we had an opportunity to hear and view at trial. We found his testimony to be coherent and credible, as well as supported by the record. He testified that petitioner's members paid their membership fees as consideration for both caregiving services and medical marijuana, and respondent opted not to challenge the substance of that testimony. While a member may have acquired, in return for his or her payment of a membership fee, access to all of petitioner's goods and services without further charge and without explicit differentiation as to the portion of the fee that was paid for goods versus services, we do not believe that such a fact establishes that petitioner's operations were simply one trade or business. As the record reveals, and as we find as a fact, petitioner's management set the total amount of the membership fees as the amount that management consciously and reasonably judged equaled petitioner's costs of the caregiving services and the costs of the medical marijuana.

Some key factors to note from the analysis of the Court:

- The director made a good impression in his testimony before the Court—most importantly, the director was believable and appeared to have a reasonable basis for the statement he was making.
- The Court found that the enterprise *actually earned fees for those care services* rather than merely receiving payment in exchange for providing the controlled substance. This is actually somewhat surprising given that CHAMP did not actually charge separate fees for those services.

Of course, the fact that the charges weren't separated does lead to another problem—is it truly possible to separate out income and expense of the non-trafficking trade or business and the separate trafficking trade or business? The IRS argued that there was no basis provided to divide up the businesses even if there might be a non-trafficking business somewhere in the operation.

In a highly fact-dependent finding the Tax Court found that there was a reasonable basis in this case to divide up the income and expenses:

> Respondent concedes that many of petitioner's activities are legal and unrelated to petitioner's provision of medical marijuana. The evidence at hand permits an allocation of expenses to those activities. Although the record may not lend itself to a perfect allocation with pinpoint accuracy, the record permits us with sufficient confidence to allocate petitioner's expenses between its two trades or businesses on the basis of the number of petitioner's employees and the portion of its facilities devoted to each business. Accordingly, in a manner that is most consistent with petitioner's breakdown of the disputed expenses, we allocate to petitioner's caregiving services 18/25 of the expenses for salaries, wages, payroll taxes, employee benefits, employee development training, meals and entertainment, and parking and tolls (18 of petitioner's 25 employees did not

> work directly in petitioner's provision of medical marijuana), all expenses incurred in renting facilities at the church (petitioner did not use the church to any extent to provide medical marijuana), all
>
> expenses incurred for "truck and auto" and "laundry and cleaning" (those expenses did not relate to any extent to petitioner's provision of medical marijuana), and 9/10 of the remaining expenses (90 percent of the square footage of petitioner's main facility was not used in petitioner's provision of medical marijuana). We disagree with respondent that petitioner must further justify the allocation of its expenses, reluctant to substitute our judgment for the judgment of petitioner's management as to its understanding of the expenses that petitioner incurred as to each of its trades or businesses. Cf. Boyd Gaming Corp. v. Commissioner, 177 F.3d 1096 (9th Cir.
>
> 1999), revg. T.C. Memo. 1997-445.

The case suggests that a taxpayer looking to establish the existence of a separate trade or business should look at establishing the following factors:

- Establish that the business provides other goods or services not related to the provision of marijuana that have a value of their own which customers would be willing to pay for even if no marijuana was available. Actually having more than minimal sales of those services to customers that are not paying for access to marijuana would be helpful as well. While CHAMP prevailed without having any such customers, later cases have shown this result is very dependent on the exact facts of CHAMP, facts other taxpayers have had trouble duplicating.

- Resist the urge to resort to "window dressing" additional services. As will be noted, later cases tried to use the provision of limited additional goods and services that appeared to be clearly ancillary to the provision of the controlled substance.

- Keep separate books and records for the separate businesses. Again, CHAMP prevailed without this being the case, but again this appears related to unique facts. The IRS is likely to push hard for the standard to establish a separate trade or business found in Reg. §1.446-1(d), especially after relying heavily on that regulation in defining what represents a separate trade or business in the final regulations under IRC §199A.

OLIVE – DID NOT HAVE A SEPARATE TRADE OR BUSINESS

In this case, the taxpayer attempted to argue that other amenities it provided established the second trade or business—but those amenities were found to simply be providing other services only to people that were buying the controlled substance. And the courts also found that the very name the organization operated under (the Vapor Room) served to indicate it had a single business—the sale of a controlled substance.

The taxation of medical marijuana clinics came back into the Tax Court in the case of *Olive v. Commissioner*, 139 TC No. 2, later appealed to the Ninth Circuit who affirmed the lower court. In this case, in addition to reminding us of the Tax Court's previous holding that IRC §280E holds to prevent the deduction of expenses other than costs of sales related to the operation of such a clinic (a position the Court put forward in the 2007 case of *Californians Helping to Alleviate Med. Problems, Inc.*, 128 TC 173), the Court dealt with some additional items.

First among these was the taxpayer's assertion that he should be allowed to retain less formal documentation than other businesses because the industry tends to operate in cash and shuns formal documentation. Thus, he should be allowed to use his rather informal ledgers to support his deductions.

As you might expect, the Tax Court wasn't terribly impressed with that view. As the Court noted:

> Neither Congress nor the Commissioner has prescribed a rule stating that a medical marijuana dispensary may meet that substantiation requirement merely by maintaining a self-prepared ledger listing the amounts and general categories of its expenditures. It is not this Court's role to prescribe the special substantiation rule that petitioner desires for medical marijuana dispensaries and we decline to do so.

The Court did decide that it had sufficient information to compute an estimated cost of sales pursuant to the *Cohan* rule. The taxpayer's expert had testified, based on his experience, to a percentage of sales that generally represented the cost of sales in the medical marijuana industry. The Court used that as its starting point to estimate a cost of sales.

However, the Court found that all of the other expenses would be disallowed under the provisions of IRC §280E. IRC §280E provides:

> 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.

Although the sale of medical marijuana was legal under the state law in question (California), federal law still prohibits the sale of marijuana. In *Californians Helping to Alleviate Med. Problems, Inc.*, the Tax Court had found that the fact the business might be considered legal under state law did not impact the application of §280E in determining the federal tax status.

In the *Californians Helping to Alleviate Med. Problems, Inc.* case, the Court had found that taxpayer had other business operations in addition to its medical marijuana dispensing operation and thus only disallowed a portion of the general expenses. However, in this case, the Court found that the other real business being operated was the medical marijuana operation and thus no deduction should be allowed.

Specifically, the fact that the taxpayer operated a lounge of sorts and had a social area was deemed primarily to support the marijuana operation. The Court specifically noted that the name of the business (the Vapor Room) certainly indicated a primary emphasis on the medical marijuana operation, as well the source of revenue for the operation.

The Court did find that only a portion of the tax would be subject to the accuracy-related penalty under §6662. The portions of the assessments where adjustments were made due to sloppy documentation were found to be items of a type where a penalty was justified.

However, the IRS had agreed the taxpayer had documentation for some of the claimed business expenses that the Court disallowed under §280E. The Court noted that the tax years in question

were before 2007 when the Court had first ruled on the question of the deductibility of such expenses for medical marijuana operations. As that was an unsettled area of the law when the returns were filed, the Court found it was not appropriate to impose an accuracy-related penalty on the portion of the tax due that related to substantiated general business expenses.

The taxpayer, not happy with the decision appealed to the Ninth Circuit Court of Appeals (Case No. 13-70510, 2015 TNT 132-13), argued the Tax Court had erred in not looking at whether the entity's entire business consisted of trafficking in controlled substances. He argued that since the organization provided other services, §280E could not apply at all to him.

And, the taxpayer pointed out, in the interim, Congress had spoken on the issue and, in any event, his business wasn't what Congress was looking to control.

The Ninth Circuit didn't accept any of this. First, the Court pointed out that the phrasing of the statute properly allows for an entity to have more than one trade or business. But, the Court noted, the Vapor Room provided other services at no cost to the individuals there. The Court likened this to a bookstore that allowed individuals to sit in a relaxing area and provided coffee at no cost—in that case, the sole trade or business of the entity would be selling books and the provision of coffee and seating served solely to support the book sales.

It would be different, the Court noted, if the bookstore also contained a full service coffee shop where coffee and pastries were consumed in a café-like setting and the items were not provided at cost, that bookstore would have more than one trade or business. But that was not the case here.

The panel also rejected the taxpayer's view that since state legal marijuana dispensaries did not exist when Congress passed §280E, that it should only apply to street dealers. The opinion notes:

> That Congress might not have imagined what some states would do in future years has no bearing on our analysis. It is common for statutes to apply to new situations. And here, application of the statute is clear. See Chamber of Commerce of U.S. v. Whiting, 131 S. Ct. 1968, 1980 (2011) (stating that "Congress's authoritative statement is the statutory text" (internal quotation marks omitted)). Application of the statute does not depend on the illegality of marijuana sales under state law; the only question Congress allows us to ask is whether marijuana is a controlled substance "prohibited by Federal law." I.R.C. §280E. If Congress now thinks that the policy embodied in §280E is unwise as applied to medical marijuana sold in conformance with state law, it can change the statute. We may not.

But, the taxpayer argued, Congress had prohibited the use of funds to prevent states from implementing such laws. Clearly that indicated that Congress did not intend for the law to apply to him and, in fact, the government was prohibited from doing so.

The Court disagreed, noting:

> Finally, for three reasons, we are not persuaded by Petitioner's argument that section 538 of the Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, 128 Stat. 2130, precludes the government from continuing to defend Petitioner's appeal. First, statements by a later Congress do not inform us about the intent of a previous Congress. See Mackey v. Lanier Collection Agency & Serv., Inc., 486 U.S. 825, 840 (1988) ("The views of a subsequent Congress form a hazardous basis for inferring the intent of an

> earlier one." (internal quotation marks and brackets omitted)). Second, a decision not to expend funds to enforce a particular statute says nothing about the meaning of that statute. "What one house of Congress thinks, in the 2010s, about enforcement priorities for the agency is entirely uninformative about the intent of Congress when it enacted a statute in [an earlier year]." Navarro v. Encino Motorcars, LLC, 780 F.3d 1267, 1277 n.5 (9th Cir. 2015). Third, section 538 does not apply. It provides that certain funds may not be used to prevent states, such as California, "from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana." Pub. L. No. 113-235, §538 (emphasis added). Here, the government is enforcing only a tax, which does not prevent people from using, distributing, possessing, or cultivating marijuana 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.

ALTERMAN – TAXPAYER AGAIN FAILS TO MEET THE CHAMP STANDARD

In the next case, the taxpayer actually did charge separately for certain non-marijuana merchandise. But the Court noted that the merchandise it sold that wasn't itself marijuana was directly tied to marijuana (such as pipes), creating a single unitary trafficking business.

As marijuana has become, at the state level in certain states, legal to sell in some form (medical or recreational), those looking to enter that market find that federal law does not condone this business. In addition to still being treated as an illegal substance under federal law, the Internal Code has a nasty treatment for any such business found at IRC §280E. The taxpayer in the case of *Alterman v. Commissioner*, TC Memo 2018-83, discovered just how harsh the federal tax law is in this area.

IRC §280E provides:

> 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.

The provision bans a deduction for any business expenses aside from the cost of the product (that is, the marijuana) for such a business.

The taxpayer in this case operated Altermeds, LLC, a disregarded entity. That entity sold marijuana-based products and, after initially buying the marijuana from a third party, began growing its own marijuana for sale.

The Tax Court described the following income and deductions reported by the taxpayer for the years at issue on the Altermeds Schedule C:

> For 2010, the Schedule C reported gross receipts of $894,922. The Schedule C reduced gross receipts by cost of goods sold of $464,119. The Schedule C also reported business-expense deductions of $385,489.
>
> For 2011, the Schedule C reported gross receipts of $657,126. The Schedule C reduced gross receipts by cost of goods sold of $253,089. The Schedule C also reported business-expense deductions of $384,817.

Obviously, all the expenses aside from the cost of sales were at risk once IRC §280E is considered. Faced with that prospect, the taxpayers presented the following argument:

> Although Alterman and Gibson concede that Altermeds, LLC, trafficked in controlled substances, they contend that it had a separate business of selling non-marijuana merchandise and that the business-expense deductions of this separate business are not disallowed by section 280E.

The "other line of business defense" is an acceptable one, but taxpayers must be able to show that there is a separate business and account for those expenses that are tied to each business being conducted (the marijuana businesses and the others). As the Court notes:

> Whether selling non-marijuana merchandise was a separate business from selling marijuana merchandise is an issue of fact that depends on, among other things, the degree of economic interrelationship between the two activities. See Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner (CHAMP), 128 T.C. 173, 183 (2007). ...
>
> If, however, selling non-marijuana merchandise was considered a separate business, then the expenses of that business would be deductible. See CHAMP, 128 T.C. at 183-185 (stating that caregiving services were a business separate from provision of marijuana; expenses of providing caregiving services were deductible).

The Court, however, did not find that the taxpayers had multiple businesses in this context, noting:

> Under the circumstances, we hold that selling non-marijuana merchandise was not separate from the business of selling marijuana merchandise. First, Altermeds, LLC, derived almost all of its revenue from marijuana merchandise. Second, the types of non-marijuana products that it sold (pipes and other marijuana paraphernalia) complemented its efforts to sell marijuana. Altermeds, LLC, had only one unitary business, selling marijuana. See Canna Care, Inc. v. Commissioner, T.C. Memo. 2015-206, at *12, aff'd, 694 F. App'x 570 (9th Cir. 2017).

The Court specifically dealt with the taxpayer's amount of claimed "non-marijuana" business-related expenses:

> Alterman and Gibson argue that these deductible expenses are $54,707.03 in 2010 and $57,517.93 in 2011. These amounts are equal to 40% of a list of subtotals in a table in the brief filed by Alterman and Gibson after trial. Each subtotal bears a vague description, for example "Non-COGS Utilities".

> However, the brief fails to adequately explain why any portion of those subtotals is deductible. In particular, the brief fails to:
>
> - identify any specific payments that make up these subtotals;
> - provide record citations to support these subtotals; and
> - propose findings of facts regarding these subtotals.
>
> Alterman and Gibson's argument regarding the amounts of business-expense deductions attributable to a putative second business was not briefed properly. See Rule 151(e)(3) (brief must include proposed findings of fact with references to the record); Rule 151(e)(5) (brief must include arguments regarding any disputed questions of fact). Even if we thought that the sale of non-marijuana merchandise was a separate business, Alterman and Gibson's failure to properly brief the amount of deductions that would be attributable to this business would preclude us from allowing any deductions for the separate business.

Thus, the Tax Court limited deductions to the cost of goods sold amounts that the IRS had conceded in the case. Even there, the taxpayer's poor and inconsistent records resulted in the allowed deductions being less than the amounts the taxpayer had originally claimed.

BUSINESSES RELATED TO CANNABIS BUSINESSES

A business does not have to have title to marijuana to be engaged in trafficking in controlled substances, triggering the denial of deductions under IRC §280E, the Tax Court ruled in *Alternative Health Care Advocates, et al., v. Commissioner*, 151 TC No. 13.

IRC §280E bars deductions, other than those for the cost of sales, to businesses that traffic in items considered controlled substances by federal law. The fact that certain states have legalized the sale of marijuana in some situations does not change that federal tax result.

In this case, there were two entities that were formed to handle the sale of marijuana under California law. Alternative Health Care Advocates (Advanced) was formed as a dispensary which grew and provided medical marijuana for patients. Advanced was a C corporation.

The taxpayers also formed Wellness Management Group, Inc. (Wellness), which taxed as an S corporation. The reason for the formation was described by the Court as follows:

> In 2008, Mr. Duncan also organized a second entity, Wellness — a California corporation that elected S corporation status for Federal tax purposes — to handle daily operations for Alternative. At the time Alternative was organized, Mr. Duncan was uncertain what dispensaries could do legally under California State law aside from growing and providing medical marijuana to patients. So Wellness was organized to perform functions for the medical marijuana dispensary such as hiring employees and paying expenses, including advertising, wages, and rent. While Mr. Duncan anticipated that Wellness might offer its management and operations services to other medical marijuana dispensaries, Wellness performed services solely for Alternative during the tax years at issue.

> ...During the taxable years at issue, Alternative intended to distribute medical marijuana to its patient-members in accordance with California law. The dispensary employed (through Wellness) administrators, security personnel, marijuana processors, salespersons, and receptionists.

The taxpayers argued that Wellness was not involved in such trafficking as it never held title to the controlled substance. As the Court noted:

> Specifically, petitioners argue that because Wellness is a management company that does not engage in the sale and purchase of marijuana, section 280E does not apply. Petitioners cite Davis v. Commissioner, 29 T.C. 878 (1958), and Roselle v.
>
> Commissioner, T.C. Memo. 1981-394, to support their argument that a management services company can engage in a separate line of business from the entity it manages.

The IRS claimed that, despite not having title to the controlled substance, Wellness was nevertheless still trafficking in a controlled substance.

The Tax Court agreed with the IRS that what Wellness was doing still constituted trafficking in a controlled substance, and thus §280E applied. The Court came to its conclusion as follows:

> Because Alternative and Wellness are legally separate entities, we must analyze whether Wellness' own business activities also constituted "trafficking in controlled substances" as contemplated by section 280E. Petitioners argue that, as a management services company, Wellness did not itself engage in the purchase and sale of marijuana. But 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); that was Wellness' primary business. We do not read the term "trafficking" to require Wellness to have had title to the marijuana its employees
>
> were purchasing and selling. Neither that section nor the nontax statute on trafficking limits application to sales on one's own behalf rather than on behalf of another. Without clear authority, we will not read such a limitation into these provisions.

Since the deductions for these payments had been disallowed on Alternative's return when it had paid Wellness, the taxpayers argued it would be unfair to deny them again on Wellness's return. The Tax Court basically responded by saying "tough luck." Specifically, the Court said:

> Petitioners also argue that applying section 280E to both Alternative and Wellness is inequitable because deductions for the same activities would be disallowed twice.
>
> These tax consequences are a direct result of the organizational structure petitioners employed, and petitioners have identified no legal basis for remedy.

So, effectively, the taxpayers had created taxable income by having Alternative pay Wellness for managing the clinic (creating taxable income for Wellness, but no deduction for Alternative). Since Wellness recognized that income but received no deduction for paying expenses, the structure ended up with an even less favorable tax result than normally takes place for a marijuana dispensary.

This case opens the door to treating a business that facilitates a trafficking business as being a trafficking business itself. While this case involved businesses under common control, the logic of the decision could be expanded to cover businesses not under common control. Advisers will need to watch to see if the IRS decides to try and use this case to pursue businesses that might spring up to primarily serve marijuana dispensaries, arguing they are trafficking businesses since they actively support the businesses that actually sell the controlled substances.

IMPACT OF STATE LEVEL TAXES ON FEDERAL TAXABLE INCOME

While advisers tend to concentrate on what is in cost of sales to obtain reductions in taxable income for those subject to §280E, an IRS Chief Counsel Advice reminds us that certain other options exist to reduce income—including looking to see if some of the proceeds collected from the sale of product are properly viewed as funds collected for another entity—in this case, the state that imposed a tax on the sale. As well, another tax imposed by the state was found to be part of the cost of sales.

With the increasing number of states enacting statutes that authorize legal marijuana sales in various circumstances, the provisions of IRC §280E are becoming an increasingly frequent topic in both court cases and IRS guidance. Chief Counsel Advice 201531016 looks at the impact of an excise tax imposed by the state of Washington on sales of marijuana on federal taxes.

Under IRC §280E, no deductions or credits (aside from cost of sales) are allowed to taxpayers trafficking in federally-controlled substances, of which marijuana is one. That is true regardless of whether the sale of such a substance is deemed legal in the state in question.

The voters of the State of Washington passed an initiative in 2012 that removed authorized sales of marijuana in the state from the list of illegal drugs subject to criminal or civil penalties. The state, not wishing to waste a revenue source, enacted a 25% excise tax on the sale of marijuana, whether wholesale or retail, in addition to all otherwise applicable sales or use taxes.

The question this memorandum looks at is how (if at all) the seller is to report this tax on a federal income tax return.

The memorandum concludes that IRC §164(a) (which deals with deductions for taxes) controls this situation. The final sentence of that provision provides "...any tax (not described in the first sentence of this subsection) which is paid or accrued by the taxpayer in connection with an acquisition or disposition of property shall be treated as part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition."

That sentence was added to §164(a) by the Tax Reform Act of 1986 to clarify that such taxes paid for the acquisition or disposition of property are to be capitalized. Thus, the memorandum concludes that the amount paid by the taxpayer in this case is treated as a reduction of the sales price.

As the reduction in sales price is neither, for federal tax purposes, a deduction nor a credit, there is no impact of §280E on this amount—rather the taxpayer simply reports the net sales price on the tax return.

RISKS IN USING THE SPECIAL INVENTORY RULES UNDER §471(C)

An interesting article appeared in *Tax Notes Today* on February 1, 2019[69] that raised a question regarding whether a business that is deemed to be trafficking in a federally-controlled substance might significantly increase its federal tax if it makes the election added by the Tax Cuts and Jobs Act to escape the provisions of IRC §471(a) and account for its inventory either:

- By accounting for such inventory as non-incidental materials and supplies pursuant to Reg. §1.162-3, or
- Conforms to such taxpayer's method of accounting reflected in an applicable financial statement of the taxpayer with respect to such taxable year or, if the taxpayer does not have any applicable financial statement with respect to such taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures.[70]

This election is open to businesses that have average annual gross receipts of $25 million or less for the prior three years (adjusted for inflation)[71] and which is not a tax shelter as defined by IRC §448(a)(3).[72]

The most significant of such controlled substance trafficking businesses that are arising in tax controversies are those selling marijuana in states where such sales are now legal (either for medical or recreational use, depending on the state).

IRC §280E strictly limits deductions for such businesses, providing:

> 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.

The bar on deduction of expenses does not extend to cost of goods sold.

In the case of *Patients Mutual Assistance Collective Corp., et al., v. Commissioner,* 151 TC No. 11, the Tax Court pointed out that:

---

[69] Nathan J. Richman, "Small Business Inventory Accounting Exception May Not Fit Pot," *Tax Notes Today*, February 1, 2019, 2019 TNT 22-5

[70] IRC §471(c)

[71] IRC §448(c)(4)

[72] IRC §471(c)

> All taxpayers—even drug traffickers—pay tax only on gross income, which is gross receipts minus the cost of goods sold (COGS). See, e.g., New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934); CHAMP, 128 T.C. at 178 n.4; secs. 1.61-
>
> 3(a), 1.162-1(a), Income Tax Regs. Congress understood that when it enacted section 280E. See S. Rept. No. 97-494, supra at 309, 1982 U.S.C.C.A.N. at 1050. We've understood it ourselves. See Olive, 139 T.C. at 32-36.

But that same opinion continues on to determine that such deductions are determined under the provisions of IRC §471 without regard to the uniform capitalization rules of §263A. As the Court notes:

> The section 263A capitalization rules don't apply to drug traffickers. Unlike most businesses, drug traffickers can't capitalize indirect expenses beyond what's listed in the section 471 regulations. Section 263A expressly prohibits capitalizing expenses that wouldn't otherwise be deductible, and drug traffickers don't get deductions.
>
> Because federal law labels Harborside a drug trafficker, it must calculate its COGS according to section 471.

The question that is poised in the article regards the impact of making the election to avoid the use of the provisions of §471(a) added by the Tax Cuts and Jobs Act on such enterprises. In the *Patients Mutual Assistance Collective Corp.* case, the Court specifically applied the provisions of Reg. §1.471-3 to determine the type of costs that were included in the cost of sales of the taxpayer.

But such rules would not appear to be applicable to a taxpayer that elects under IRC §471(c) to avoid IRC §471(a). So the question then arises regarding what expenditures, if any, would now be part of cost of goods sold for purposes of §280E?

The article cited above quotes Scott H. Rabinowitz of Skadden, Arps, Slate, Meagher & Flom, LLP, that making this small business inventory simplification election could significantly increase the amount of taxable income for a seller subject to §280E. As the article notes from the author's conversation with Mr. Rabinowitz:

> Losing the potential argument that inventory accounting proves cost of goods sold would probably override any other relief from the exception, he said.
>
> However, even without the inventory accounting rules, which allow indirect costs for some businesses, there would still be a question whether a small marijuana business would be allowed to account for direct costs as cost of goods sold offsets, Rabinowitz said. Without the section 471 rules, indirect costs would clearly not be deductible, but the constitutional mandate to pare gross receipts down to

> gross income would leave treatment of particular direct cost items uncertain, he said.[73]

The article goes on to cite other advisers who conclude that this level of uncertainty regarding what would happen to cost of sales under §280E suggests that such sellers should avoid making this simplifying election[74]—at least until such time as either the IRS or the courts clarify the impact of switching away from the rules under §471(a) on what is considered cost of sales under §280E.

Although this election to avoid §471(a)'s provisions would arguably simplify accounting for inventories (that was the reason Congress put it into the law), most likely at least some of the costs currently rolled into inventory by the rules developed by the IRS under §471(a) would not be captured under the simplified inventory methods allowed by §471(c). Any client that wants to push forward regardless should be warned in writing about the potential risks of making this election.

---

[73] Nathan J. Richman, "Small Business Inventory Accounting Exception May Not Fit Pot," *Tax Notes Today*, February 1, 2019, 2019 TNT 22-5

[74] Nathan J. Richman, "Small Business Inventory Accounting Exception May Not Fit Pot," *Tax Notes Today*, February 1, 2019, 2019 TNT 22-5

NOTES

Section

5

State and Local Tax Issues for Cannabis Businesses

LEARNING OBJECTIVES

After completing this section, participants should be able to:

- ☐ Understand state and local tax issues that arise for cannabis businesses

INTRODUCTION

The National Council for State Legislatures (NCSL) notes that in 1996 California voters passed the first law that legalized the use of marijuana for medical purposes.[75] In 2012, the states of Colorado and Washington were the first to provide for retail/adult use outside the medical context.[76]

States that have fully legalized marijuana as of November 2020[77] are:

- Alaska
- Arizona
- California

[75] State Medical Marijuana Laws, National Conference of State Legislatures, http://www.ncsl.org/research/health/statemedical-marijuana-laws.aspx,

[76] Deep Dive Marijuana, National Conference of State Legislatures, http://www.ncsl.org/bookstore/state-legislatures-magazine/marijuana-deep-dive.aspx,

[77] www.disa.com/map-of-marijuana-legality-by-state

- Colorado
- District of Columbia
- Illinois
- Maine
- Massachusetts
- Michigan
- Montana
- Nevada
- New Jersey
- Oregon
- South Dakota[78]
- Vermont
- Washington

The following states, while not fully legalizing marijuana, have legalized at least some medical uses of the product:[79]

- Arkansas
- Connecticut
- Delaware
- Florida
- Georgia
- Hawaii
- Indiana
- Iowa

[78] Effective July 1, 2021, but the South Dakota Department of Revenue has until April 1, 2022 to get regulations in place. https://static1.squarespace.com/static/5d7188a29079ce0001c4dd3b/t/5f6b780919c0a62208e00e10/1600878601199/Amendment+A+with+AG+Explanation.pdf

[79] www.disa.com/map-of-marijuana-legality-by-state

- Kentucky
- Louisiana
- Maryland
- Minnesota
- Missouri
- New Hampshire
- New Mexico
- New York
- North Dakota
- Ohio
- Oklahoma
- Pennsylvania
- Rhode Island
- Texas
- Utah
- Virginia
- West Virginia
- Wisconsin

STATE TAXATION IN GENERAL

In addition to other regulations these states impose on cannabis businesses, the states impose various taxes on the marijuana businesses. These taxes include general taxes, such as general income, sales, use and gross receipts taxes, as well as specialized excise taxes on marijuana of the type commonly referred to as "sin taxes."

The additional revenue that states have expected to gain from creating legal outlets to obtain marijuana has been touted by advocates of legalization. This means those beginning a cannabis business should expect additional tax obligations more in line with liquor and tobacco businesses (other areas where sin taxes are often imposed) than the tax issues faced by other businesses.

We will concentrate in this chapter on the states with full legalization. This unit is not meant to be a comprehensive reference to the taxation of cannabis businesses at the state level, but rather an overview of the area at a particular point in time. Those looking to work with such businesses in

the tax arena will need to do detailed research into the particular issues of the states and localities involved as well as keep updated on changes that occur in this area.

SALES AND USE TAX ISSUES

Arizona

Marijuana will be subject to the normal sales tax rate of 5.6% in addition to a 16% excise tax.[80]

Alaska

Alaska does not impose a statewide sales or use tax, though individual localities are allowed to impose such a tax.

California

California treats the sale of cannabis products as a sale of tangible personal property, subject to the applicable state and local sales or use tax. Certain sales of medicinal cannabinoids are exempt from sales and use taxes in California.[81]

Colorado

Colorado imposes its regular state sales tax at 2.9% on the sale of medical marijuana and marijuana products, along with a 15% state sales tax on retail sales of marijuana.[82]

District of Columbia

The District of Columbia imposes a 6% sales tax on the sale of medical marijuana.[83]

Illinois[84]

The State of Illinois imposes a 6.25% general sales tax on cannabis sales referred to as State Retailers' Occupation Tax on adult-use and a 1% State Retailers' Occupation Tax on medical cannabis sales.

---

[80] http://tax.alaska.gov/programs/programs/help/faq/faq.aspx?60000, visited December 2020

[81] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Getting Started Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Started, website visited December 2020

[82] Colorado Department of Revenue, Marijuana Tax Data, https://www.colorado.gov/pacific/revenue/colorado-marijuana- tax-data, website visited December 2020

[83] State Sales Tax Handbook, District of Columbia, https://www.salestaxhandbook.com/district-of-columbia, website visited December 2020

[84] https://www2.illinois.gov/rev/research/taxinformation/other/Pages/Cannabis-Tax-Frequently-Asked-Questions.aspx#qst1, website visited December 2020

Maine

The State of Maine imposes a 10% sales tax on recreation marijuana retail sales.[85]

Massachusetts

The State of Massachusetts treats sales of recreational marijuana as subject to the state's general sales tax, which is 6.25%. The state excise tax on consumer (which functions similarly to a sales tax) in 2017 was increased to 10.75%, with state and localities can impose an excise tax of up to 3%, for a total tax on the sale of recreational marijuana of 20%.[86]

Michigan

The state's standard 6% sales tax applies.[87]

Nevada

The State of Nevada imposes sales taxes at the local rates on the sale of recreational marijuana.[88]

Oregon

The State of Oregon does not impose a general sales tax.

South Dakota

A 15% tax on marijuana sales is proposed[89], but the South Dakota Department of Revenue has until April 1, 2022 to have regulations in place.[90]

Vermont

State sales tax on retail sales of cannabis is 6%.[91]

STATE INCOME TAXATION OF CANNABIS BUSINESSES

States may or may not enact legislation that overrides IRC §280E when they legalize marijuana.

---

[85] MRSA §1811

[86] https://www.mass.gov/regulations/830-CMR-64n11-marijuana-retail-taxes, website visited December 2020

[87] https://www.mpp.org/states/michigan/michigans-adult-use-marijuana-regulation-law/, website visited December 2020

[88] https://tax.nv.gov/FAQs/Retail_Marijuana/, website visited December 2020

[89] https://static1.squarespace.com/static/5d7188a29079ce0001c4dd3b/t/5f6b780919c0a62208e00e10/1600878601199/Amendment+A+with+AG+Explanation.pdf, website visited December 2020

[90] https://dor.sd.gov/businesses/marijuana/, website visited December 2020

[91] https://www.mpp.org/states/vermont/summary-of-s-54-the-bill-to-regulate-and-tax-cannabis-in-vermont/, website visited December 2020.

Maine does allow registered caregivers and registered dispensaries to claim a state income deduction equal to the amount disallowed under IRC §280E. But the largest state that has legalized marijuana (California) still follows federal §280E when computing state income taxes other than for C corporations.

STATE AND LOCAL EXCISE TAXES SPECIFIC TO CANNABIS BUSINESSES

Excise taxes have been imposed by the states that have legalized recreational use of marijuana. Initially, such taxes were imposed at extremely high rates. The Tax Foundation reported that the four states that had legalized recreational marijuana by 2016 had the following excise taxes in place initially:

- Alaska – 25%
- Colorado – 29%
- Oregon – 25%
- Washington – 37%

All of those states except Washington have reduced their rates in subsequent years.[92]

As is most often the case, the state rules for taxing cannabis vary widely from state to state. As well, states are still experimenting to find the proper rates of taxes that achieve the hoped-for goals of raising revenue from capturing sales now in the illegal market rather than raising the price on legal product so high that users continue to shop primarily in the illegal market.

Alaska

Effective January 1, 2019, the state of Alaska revised its excise tax on marijuana. Prior to this date, the tax was imposed at $50 per ounce of marijuana sold or transferred to a retail store.[93] The tax is imposed on the marijuana cultivation facility.[94]

New rates apply effective January 1, 2019, replacing the prior per ounce tax. The new rates are:

- Mature bud/flower – $50 per ounce;

---

[92] Jared Walczak, "Tax Trends Heading Into 2019," Tax Foundation, https://taxfoundation.org/state-tax-trends-2019/, publication date December 19, 2018, website visited December 2020

[93] "Marijuana Tax News," Alaska Department of Revenue – Tax Division, http://tax.alaska.gov/programs/programs/index.aspx?60000, website visited December 2020

[94] Marijuana Tax Frequently Asked Questions, Alaska Department of Revenue – Tax Division, http://tax.alaska.gov/programs/programs/help/faq/faq.aspx?60000, website visited December 2020

- Immature or abnormal bud – $25 per ounce;
- Trim – $15 per ounce; and
- Clones – $1 per clone.[95]

The tax is due whenever the marijuana is sold *or transferred* to a retail sales or product manufacturing facility by a cultivator. Thus, if an entity has a cultivation facility but also has a retail sales and/or product manufacturing facility, the tax is due as soon as it is recorded in the inventory of the sales or manufacturing facility. However, product transferred between cultivation facilities are not subject to the tax.[96]

Returns must be filed electronically on *Form 450 – Marijuana Tax Return* at https://online- tax.alaska.gov/ by the end of the month following the month in which the sale or transfer of marijuana took place.[97] The following information is required to file the return:

- The date of each sale;
- For each buyer or transferee:
  - Name;
  - Marijuana Control Board license number; and
  - Address.
- The number of ounces of bud and flower and ounces of the remainder of the plant that were sold or transferred.[98]

Payments of the tax can be made by:

- Wire transfer;
- Cashier's check;
- Money order;
- Bank check; or

---

[95] Marijuana Tax Frequently Asked Questions, Alaska Department of Revenue – Tax Division, http://tax.alaska.gov/programs/programs/help/faq/faq.aspx?60000, website visited December 2020

[96] Marijuana Tax Frequently Asked Questions, Alaska Department of Revenue – Tax Division, http://tax.alaska.gov/programs/programs/help/faq/faq.aspx?60000, website visited December 2020

[97] Marijuana Tax Frequently Asked Questions, Alaska Department of Revenue – Tax Division, http://tax.alaska.gov/programs/programs/help/faq/faq.aspx?60000, website visited December 2020

[98] Marijuana Tax Frequently Asked Questions, Alaska Department of Revenue – Tax Division, http://tax.alaska.gov/programs/programs/help/faq/faq.aspx?60000, website visited December 2020

- Cash[99]

Cash payment of taxes is accepted only at a drop box in Anchorage and must be made in an approved deposit bag. Details of the cash payment procedures can be found in the "Cash Payment Instructions" published by the Department of Revenue.[100]

The Department's FAQ has the following information regarding the failure to file such returns:

> Failure to file a return or submit a payment by the due date can result in a 5% civil penalty being assessed for every 30-day period, or portion of a period, until the return is filed and the payment is made. The penalty cannot exceed 25%. Other civil penalties may apply. In addition, the Tax Division may notify the Marijuana Control Board to initiate license suspension or revocation proceedings.

From the inception of the tax in October 2016 through December 2018, the state of Alaska Department of Revenue reports receiving $22,010,290 in revenue from the marijuana tax.[101]

The Alaska Department of Revenue maintains a page on the marijuana tax at:

http://tax.alaska.gov/programs/programs/index.aspx?60000

Arizona

The State of Arizona will charge a 16% excise tax in addition to the normal sales tax of 5.6%.[102]

California

The largest state in the nation moved from allowing medical marijuana use to legalizing recreational marijuana usage on January 1, 2018.[103] The state, like most others, imposed special taxes on the industry, looking to raise additional money for the state from a new source of sin tax revenue.

---

[99] Marijuana Tax Frequently Asked Questions, Alaska Department of Revenue – Tax Division, http://tax.alaska.gov/programs/programs/help/faq/faq.aspx?60000, website visited December 2020

[100] Cash Payment Instructions, http://tax.alaska.gov/programs/documentviewer/viewer.aspx?97n, site visited December 2020

[101] Alaska Department of Revenue, Marijuana Tax Information, http://tax.alaska.gov/programs/programs/reports/monthly/Marijuana.aspx?ReportDate=12/2018, website visited December 2020

[102] https://www.mpp.org/states/arizona/summary-of-arizona-2020-adult-use-initiative/, website visited on December 2020

[103] Thomas Fuller, "Recreational Pot is Officially Legal in California," New York Times, January 1, 2018, https://www.nytimes.com/2018/01/01/us/legal-pot-california.html,

The California Department of Tax and Fee Administration (CDTFA) maintains the *Tax Guide for Cannabis Businesses* online at http://www.cdtfa.ca.gov/industry/cannabis.htm.

The California tax system generally imposed requirements to collect and remit taxes on parties other than the party on which the tax is assessed.

Excise Tax on Purchasers

A 15% excise tax on the *average price of sale* is imposed on retail purchasers of cannabis and cannabis products.[104] This excise tax is in addition to the general sales tax due on such transactions. Cannabis products on which the tax is imposed include, but are not limited to, balms, buds and flowers, capsules, edibles (cookies, butters, honey, chocolates, candies, sodas, bars), extracts, gum, hash, infused feminine hygiene products, lotions, oils, plants and clones, pre-rolls, teas, tinctures, tonics, topicals, and waxes. However, cannabis accessories such as pipes, rolling machines, vape pens (without cannabis), rolling papers, shirts, hats, books, and magazines are subject only to the sales tax, but not the 15% excise tax.[105]

The *average price of sale* depends on whether the sale is determined to be an arm's-length sale or a nonarm's-length sale.

An arm's-length sale is defined as "a sale that reflects the fair market price in the open market between two informed and willing parties, neither required to participate in the transaction."[106] The CDTFA's website for retailers describes the tax on an "arm's-length" sale as follows:

> In an arm's-length transaction, the average market price means the average retail price determined by the wholesale cost of the cannabis or cannabis products sold or transferred to a cannabis retailer, plus a mark-up. The wholesale cost is the amount you, the retailer, paid for the cannabis or cannabis products, including transportation charges. Prior to January 1, 2020, the wholesale cost was the amount you, the retailer paid including transportation costs adding back in any discounts or trade allowances.
>
> The mark-up will be determined by the CDTFA on a biannual basis in six month intervals. A special notice will be mailed to cannabis businesses informing them of the mark-up rate. The mark-up rate will also be posted on the Special Taxes and Fees Rate Page, under Cannabis Taxes.
>
> The mark-up rate that is determined by CDTFA is not intended to be used to determine the amount for which each party sells their products, only to calculate the amount of excise tax due in an arm's-length transaction. Each party in the supply

[104] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Getting Started Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Retailers, page visited December 2020

[105] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Retailers Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Retailers, page visited December 2020

[106] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Retailers Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Retailers, page visited December 2020

> chain can use any mark-up they would like to establish their selling price. Your actual selling price may be different than the average market price.
>
> In an arm's-length transaction, you are not required to reconcile the average market price the distributor calculates for determining the excise tax with your retail selling price of cannabis or cannabis products.[107]

The markup rate for the six months beginning January 1, 2020 is set at 80%.[108]

For nonarm's-length sales, the CDTFA provides the following detailed explanation:

> A "nonarm's-length transaction" is a sale that does not meet the definition of an "arm's-length transaction." The sale does not reflect the fair market price in the open market or is not between two informed and willing parties, neither required to participate in the transaction. An example of a nonarm's-length transaction would be a business that is both a distributor and retailer of their cannabis product or a microbusiness engaging in those activities. In a nonarm's-length transaction, the average market price means the cannabis retailer's gross receipts from the retail sale of the cannabis or cannabis products.
>
> The cannabis excise tax should be reported and paid based on 15 percent of the cannabis retailer's gross receipts. Gross receipts include all charges related to your sales, such as labor, service, and certain transportation charges. For example, if you, as the retailer, deliver cannabis or cannabis products to your customers with your own vehicles and there is no explicit written agreement executed prior to the delivery that title passes to the purchaser before delivery, the charge for that delivery is included in the gross receipts subject to the cannabis excise tax. Additionally, if you add a separate amount to your customers' invoices or receipts to cover a cannabis business tax required by your city, that amount is included in the gross receipts subject to the cannabis excise tax. For more information on gross receipts, see Revenue and Taxation Code section 6012.[109]

The CDTFA provides the following example of calculating the tax due in nonarm's-length transactions:

---

[107] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Retailers Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Retailers, page visited December 2020

[108] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Overview Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Overview, page visited December 2020

[109] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Retailers Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Retailers, page visited December 2020

EXAMPLE

(From CDTFA Tax Guide for Cannabis Businesses)

A microbusiness (which is licensed to be a cultivator, distributor, manufacturer, and retailer) grows cannabis flowers and sells the flowers at retail to their customers for $35.00 per eighth of an ounce. The microbusiness also charges $5.00 for delivery. This example assumes an 8.5% sales tax rate and a 10% business tax, but your actual rates may differ. You must use the rates in effect at the time of sale. Current sales tax rates can be found on our website.

The average market price is determined by the type of transaction (either arm's length or nonarm's length) that occurred when the seller (cultivator, manufacturer or distributor) sold the product to the retailer.

Since the microbusiness is both the cultivator and the retailer, there is no sale between two parties that reflects the fair market price in the open market. As such, this is a nonarm's-length transaction and the average market price is the retailer's gross receipts from the retail sale of the cannabis flowers.

Excise tax calculation:

Selling price of cannabis	*$ 35.00*
Cannabis business tax	*3.50*
Delivery	*5.00*
Subtotal ($35.00 + $3.50 + $5.00)	*43.50*
Excise tax ($43.50 x 15%)	*6.53*

Sales tax calculation:

Subtotal ($43.50 + $6.53)	*$ 50.03*
Sales tax ($50.03 x 8.5%)	*4.25*
Total due ($50.03 + $4.25)	*$ 54.28*

The microbusiness is responsible for reporting and paying the cannabis excise tax of $6.53 ($43.50 × 15%) to the CDTFA on their cannabis tax return along with the cultivation tax that is due on the cannabis flowers that entered the commercial market. The microbusiness is also responsible for reporting and paying the sales tax of $4.25 ($50.03 x 8.5%) to the CDTFA on their sales and use tax return.[110]

Cultivation Tax on Cultivators

California also imposes a tax on cultivation of marijuana. That tax is paid by the cultivator to the distributor. The CDTFA is required to adjust the cultivation tax rates for inflation beginning January 1, 2020. The rates for each cultivation tax category shown below will reflect on the monthly and quarterly cannabis tax returns beginning on January 1 of each year. The tax is imposed on all harvested marijuana that enters the commercial market at the following rates, as of January 1, 2020 to December 31, 2021:

[110] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Retailers Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Retailers, page visited December 2020

- $9.65 per dry-weight ounce of cannabis flowers,
- $2.87 per dry-weight ounce of cannabis leaves, and
- $1.35 per ounce of fresh cannabis plant (the unprocessed cannabis must be weighed within two hours of harvesting to qualify for this rate).[111]

Due to recent legislation (Assembly Bill 1872), the cultivation tax rates for the 2020 calendar year remain unchanged for the 2021 calendar year. The CDTFA will adjust the cultivation tax rates annually for inflation beginning with the 2022 calendar year.[112]

Distributor Tax Summary

The CDTFA lists the following requirements for distributors of cannabis under California law:

- Register with the CDTFA for a seller's permit, if you make sales of cannabis, cannabis products, or tangible personal property in California.
- Register with the CDTFA for a cannabis tax permit (this is separate from your seller's permit).
- Collect the cannabis cultivation tax from cultivators and manufacturers from which you receive cannabis and/or cannabis products.
- Collect the cannabis excise tax from cannabis retailers you supply (sell and/or transfer) with cannabis and/or cannabis products.
- Provide an invoice or receipt to the businesses from which you collect the cultivation tax and the cannabis excise tax.
- Electronically file both your sales and use tax and cannabis tax returns and pay the amounts due to the CDTFA.[113]

The definition of a distributor found on the CDTFA's webpage is:

> A cannabis distributor is a person who procures, sells, and/or transports cannabis between licensed cannabis businesses, such as a cultivator, manufacturer, or retailer.[114]

---

[111] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Getting Started Tab, http://www.cdtfa.ca.gov/taxes-and-fees/tax-rates-stfd.htm page visited December 2020

[112] https://www.cdtfa.ca.gov/taxes-and-fees/tax-rates-stfd.htm, website visited December 2020

[113] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Distributors Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Distributors, page visited December 2020

[114] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Distributors Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Distributors, page visited December 2020

Retailers Tax Summary

The CDTFA's rules for a cannabis retailer are summarized on the agency's website as follows:

- Register with the CDTFA for a seller's permit.
- Charge and collect sales tax on your taxable retail sales of cannabis and/or cannabis products, and other products.
- Electronically file your sales and use tax returns and pay the sales and/or use tax to the CDTFA.
- Charge and collect the cannabis excise tax from your customers who purchase cannabis and/or cannabis products.
- Pay the cannabis excise tax that is due to your distributor. DO NOT remit cannabis excise tax on your sales and use tax return.
- Provide your customer with an invoice, receipt, or other document which includes the statement: "The cannabis excise taxes are included in the total amount of this invoice." (Your customers are liable for the cannabis excise tax until it has been paid to the state or you provide them with such an invoice or receipt.)[115]

The definition of a cannabis retailer found on the CDTFA website is:

> A cannabis retailer is a person who sells cannabis and/or cannabis products directly to a consumer.[116]

Cultivators Tax Summary

The CDTFA's rules for cultivators are summarized on the agency's website as follows:

- Register with the CDTFA for a seller's permit.
- Pay the cultivation tax to your distributor or manufacturer.
- Electronically file your sales and use tax returns and pay the tax due, if any, to the CDTFA. Even if you do not make taxable sales of cannabis, you are still required to file a return indicating your total sales with your claimed nontaxable or exempt sales during that particular reporting period.[117]

---

[115] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Retailers Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Retailers, page visited December 2020

[116] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Retailers Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Retailers, page visited December 2020

[117] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Cultivators Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Cultivators, page visited on December 2020

The definition of a cannabis cultivator found on the CDTFA website is:

> A cannabis cultivator is a person who is engaged in the business of planting, growing, harvesting, drying, curing, grading or trimming cannabis.[118]

Manufacturers Tax Summary

The CDTFA's rules for manufacturers are summarized on the agency's website as follows:

- Register with the CDTFA for a seller's permit.
- Collect the cannabis cultivation tax from cultivators from which you receive unprocessed cannabis and provide the cultivator with a receipt.
- Pay the cultivation tax collected from cultivators to your distributor.
- Electronically file your sales and use tax returns and pay any sales and/or use tax owed to the CDTFA. Even if you do not make taxable sales of cannabis, you are still required to file a return indicating your total sales with your claimed nontaxable or exempt sales during that particular reporting period.[119]

The definition of a cannabis cultivator found on the CDTFA website is:

> A cannabis manufacturer is a person who produces or prepares cannabis or cannabis products at a fixed location, that packages or repackages cannabis or cannabis products, or labels or relabels its container.

[118] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Cultivators Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Cultivators, page visited on December 2020

[119] California Department of Tax and Fee Administration, Tax Guide for Cannabis Businesses, Manufacturers Tab, http://www.cdtfa.ca.gov/industry/cannabis.htm#Manufacturers, page visited on December 2020

Colorado

In addition to a special sales tax imposed on the sale of marijuana, Colorado also imposes excise taxes on marijuana. The Colorado Department of Revenue describes the excise taxes as follows:

> Excise tax is imposed on the first sale or transfer from a retail marijuana cultivation facility to a retail marijuana store or retail marijuana product manufacturing facility.
>
> Medical marijuana is not subject to the 15% state retail marijuana excise tax. Beginning August 9, 2017, sales or transfers between licensed cultivation facilities are exempt from state excise tax.
>
> State Retail Marijuana Excise Tax Rate: Retail marijuana is subject to a 15% excise tax on the Average Market Rate (AMR) or contract price of retail marijuana. The excise tax is based on the average market rate for Bud, Trim, Immature Plant, Wet Whole Plant, Seed, Bud Allocated for Extraction and Trim Allocated for Extraction. One marijuana excise tax return is required for each retail marijuana cultivation facility.

Affiliated retail marijuana businesses and unaffiliated retail marijuana businesses who do not have a contract price at the time of the sale calculate their excise tax at 15% of the AMR. Unaffiliated retail marijuana businesses with a contract price at the time of sale calculate their excise tax at 15% of the contract price.[120]

The excise tax is due by the 20th day of the month following the month when the transfer or sale is made to retail customers. The return is filed electronically.[121]

District of Columbia

While the District of Columbia has legalized marijuana, disputes with Congress have prevented the District from imposing taxes on marijuana sales.

---

[120] Colorado Department of Revenue, Marijuana Taxes, https://www.tax.colorado.gov/marijuana-excise-tax, website visited December 2020

[121] https://www.tax.colorado.gove/sites/tax/files/Excise23.pdf, website visited December 2020

Illinois

The State of Illinois imposes a Cannabis Cultivation Privilege Tax at a rate of 7% of gross receipts from the first sale of adult use cannabis by a cultivator or craft grower ; a Cannabis Purchaser Excise Tax of 10% of taxable receipts from adult use cannabis sold with 35% THC or less, 25% of taxable receipts from adult use cannabis sold with greater than 35% THC, or 20% of taxable receipts from adult use cannabis infused products sold. It also imposes a Medical Cannabis Cultivation Privilege Tax upon the privilege of cultivating medical cannabis at a rate of 7% of the sales price per ounce.[122]

Maine

Although Maine's voters legalized marijuana in an extremely close vote, it took time before laws regulating and taxing the industry were enacted in the state when the state legislature overrode the Governor's veto on May 2, 2018.

The tax imposed by 28-B MRSA §1001 imposes taxes based on weight as noted:

1. Excise tax on marijuana flower and mature marijuana plants. A cultivation facility licensee shall pay an excise tax of $335 per pound of marijuana flower or mature marijuana plants sold to other licensees in the State.

2. Excise tax on marijuana trim. A cultivation facility licensee shall pay an excise tax of $94 per pound of marijuana trim sold to other licensees in the State.

3. Excise tax on immature marijuana plants and seedlings. A cultivation facility licensee shall pay an excise tax of $1.50 per immature marijuana plant or seedling sold to other licensees in the State.

4. Excise tax on marijuana seeds. A cultivation facility licensee shall pay an excise tax of $0.30 per marijuana seed sold to other licensees in the State.

Massachusetts

The Massachusetts excise tax was discussed earlier in the discussion of state sales taxes.

Michigan

Michigan has determined a 10% excise tax will be charged on all sales of marijuana products by retailers and microbusinesses, in addition to the state's standard 6% sales tax. It expects to collect the tax in the state's fiscal year 2020, which begins October 1, 2020.[123]

---

[122] State of Illinois, "Excise Tax Rates and Fees," https://www2.illinois.gov/rev/research/taxinformation/other/Pages/Cannabis-Tax-Frequently-Asked-Questions.aspx#qst1 webpage visited on December 2020

[123] https://www.mpp.org/states/michigan/michigans-adult-use-marijuana-regulation-law/, website visited December 2020

Montana

The state will impose a 20% tax on all non-medical marijuana sales.[124]

Nevada

The excise taxes imposed by the state of Nevada on the sale of marijuana are:

- 15% excise tax on the wholesale sale; paid by the cultivator
- 10% excise tax on the retail sale; paid by the retail store[125]

The state's website explained the tax as follows:

> During the 2017 legislative session, the tax structure for medical marijuana was changed from 2 percent excise tax on each sale to 15 percent excise tax on the wholesale sale, paid by the cultivator. This change means marijuana establishments that hold both medical registration certificates and retail licenses do not have to designate which portion of their inventory is medical and which is retail. Marijuana inventory can be kept as a single stream until the point it is sold to the consumer. If it is sold to a retail customer, the additional 10 percent retail excise tax will be applied. If it is sold to a medical cardholder, the 10 percent will not be applied to
>
> the sale. Regular sales tax at the local rate will be charged to both medical and retail customers.[126]

New Jersey

New Jersey will impose a 12% excise tax on cannabis products. Local governments may impose an additional tax of 2% on the sale or transfer within the local entity.[127]

Oregon

The State of Oregon imposes a 17% tax on recreational marijuana sold. The tax is paid monthly but reports are filed quarterly.[128]

---

[124] https://www.mpp.org/states/montana/overview-of-ci-118-and-i-190/, website visited December 2020

[125] https://tax.nv.gov/FAQs/Retail_Marijuana/web page visited on December 2020

[126] State of Nevada, "Marijuana in Nevada," http://marijuana.nv.gov/Businesses/Taxes/, web page visited on March 3, 2019

[127] https://www.insidernj.com/wp-content/uploads/2018/11/NEW-JERSEY-CANNABIS-REGULATORY-ACT.pdf, website visited December 2020

[128] Oregon Department of Revenue, "Marijuana Tax Program," https://www.oregon.gov/DOR/programs/businesses/Pages/marijuana.aspx, web page visited on December 2020

Localities in Oregon can also impose their own taxes, up to 3%, some of which are filed with the locality and some with the Oregon Department of Revenue. Information on such filings can be found online at:

https://www.oregon.gov/DOR/programs/businesses/Pages/marijuana-local-tax.aspx

South Dakota

It is proposed that the State of South Dakota will charge a 15% tax on marijuana sales, however, the Department of Revenue has until April 1, 2022 to have all regulations in place.[129]

Vermont

The State of Vermont's legislature has determined 20% retail sales tax comprised of a 14% cannabis excise tax plus the 6% Vermont state sales tax, with no local option tax. Medical cannabis is not to be taxed.[130]

Washington

The State of Washington has the nation's highest excise tax on marijuana at 37% that is imposed on marijuana, marijuana concentrates, useable marijuana, and marijuana-infused products.[131]

The excise tax report and payment are due monthly on the 20th day following the month the product is sold. If a taxpayer fails to pay the tax when due, a penalty is imposed at 2% per month on the unpaid balance. If a taxpayer fails to file the report entirely, that could be grounds for revocation of the marijuana license.[132]

FUTURE STATE DEVELOPMENTS

As this chapter makes clear, the states also are not consistent in how they tax such operations. Small entities in all industries often fail to understand how wildly different state level rules can be, and there is little reason to believe clients in this industry will be better at recognizing that issue than those in other industries. Thus, the CPA will need to remind such entities that entering or selling into additional states should only be undertaken after consultation with tax and legal counsel regarding operating in those other states.

---

[129] https://static1.squarespace.com/static/5d7188a29079ce0001c4dd3b/t/5f6b780919c0a62208e00e10/1600878601199/Amendment+A+with+AG+Explanation.pdf, website visited December 2020

[130] https://www.mpp.org/states/vermont/summary-of-s-54-the-bill-to-regulate-and-tax-cannabis-in-vermont/, website visited December 2020

[131] https://www.gleamlaw.com/wa-state-mj-tax/ web page visited on December 2020

[132] Washington State Liquor and Cannabis Board, "FAQs on Taxes," https://lcb.wa.gov/mj2015/faqs-on-taxes, web page visited on December 2020

NOTES