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This blog by a tax professor is about tax reform and moving tax systems into the 21st century. It focuses on tax system weaknesses, critiques selected reform proposals, and offers new ideas, with an emphasis on federal, California and multistate matters. Additional information - articles, reports and links, can be found at the 21st Century Taxation website (see link below right). I welcome your comments.

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Thursday, March 22, 2018

Guest Post - California Cannabis Businesses Need to Prepare for Possibility of IRS Audit

I'm please to present a guest post on a hot topic by Bruce Braverman, Braverman & Epstein, APC, and David Frankel.* They share their expertise in assisting clients operating businesses in the cannabis space.

Cannabis Tax Enforcement Comes Full Circle

The federal marijuana prohibition and enforcement program now comes full circle with front line lawfare being focused on the tax front. History buffs may remember that the entire Cannabis prohibition started with the Marihuana Tax Act of 1937 (Pub.L. 75-238, 50 Stat. 551) which imposed a "Marihuana stamp tax" and reporting requirement. The Marihuana Tax Act of 1937 was invalidated by the U.S. Supreme Court in *Leary v. United States*, 395 U.S. 6 (1969).

"The Colorado Experience": Coming Soon to California

On January 1, 2018, California launched its own licensing of recreational cannabis businesses. Since legalizing recreational cannabis in 2012, Colorado's cannabis businesses have seen a sharp increase in IRS audits. See, e.g., <https://mjbizdaily.com/new-irs-audits-colorado-worry-cannabis-companies/>.

The thrust of IRS audits of Colorado's cannabis-related businesses has been two-fold:

Internal Revenue Code §280E (banning expense deductions by drug traffickers) 26 U.S.C. §280E, and

IRS Form 8300 (a form prescribed by the IRS for reporting certain cash transactions) - see 26 U.S.C. § 6050I - 'Returns relating to cash received in trade or business, etc.'

[Internal Revenue Code §280E](#)

IRC §280E forbids businesses from deducting certain business costs associated with the trafficking of Schedule I or Schedule II controlled substances. Because Cannabis

Welcome!

The world is changing yet tax systems have been slow to change in the same direction. This can hinder economic progress, lead to a loss in tax revenue, and frustrate taxpayers. Here, I explain some of the problems at the federal, multistate and California levels, offer ideas for reform, and an opportunity to comment on what I post. These views are my own and not necessarily those of my employer or any organization I'm connected with. Thanks for reading and posting comments (this page gets over 11,000 visits per month)! For more on tax reform, please visit <http://www.21stcenturytaxation.com>. You can reach me at annette.nellen@sjsu.edu.

Annette Nellen



Professor Annette Nellen

About Me

[Professor Nellen](#)

I am a tax professor and Director of the MS

is a Schedule I controlled substance, Cannabis-related businesses must comply with Section 280E. ⁽¹⁾ Those Cannabis businesses that claim ordinary business deductions and credits should anticipate an audit by the IRS.

The IRS's current stance on what cannabis-related businesses are permitted to deduct is summarized in [Chief Counsel Advice 201504011](#). It allows for cannabis businesses to deduct some of their cost of goods sold (COGS). However, taxpayers must follow pre- section 263A guidance under Reg. 1.471-1 and 1.471-11.

The IRS memo separates cannabis businesses into resellers and producers. For resellers, such as dispensaries, the only deductions they can claim are for the invoice price of purchased cannabis and the transportation costs necessary to gain possession of cannabis. Producers, such as cultivators or manufacturers, are allowed to deduct "indirect production costs", which has been construed broadly to allow for deductions of repairs; maintenance; indirect labor and supplies; and the costs of quality control.

On February 2, 2018, the IRS reaffirmed their authority to "...investigate and determine whether a business is engaged in illegal drug trafficking activity for the purposes of applying 26 USC 280E..." in a [legal brief](#) filed with the U.S. Supreme Court.

Section 280E compliance requires a taxpayer to file tax returns that do not show any 'below-the-line' expenses. Allocations to 'cost of goods' should be precise, documented and in accordance with inventory-costing regulations under IRC Section 471 as they existed when Section 280E was enacted in 1982. The IRS has taken the position that IRC Section 263A should not be used to determine inventory costing for Cannabis businesses (see CCA 201504011 above).

CA State 280E Treatment

California corporation tax law does not conform to IRC Section 280E. According to a representative of the CA Franchise Tax Board, the corporation tax law does not conform to IRC Section 280E but the personal income tax law does conform to IRC Section 280E.

Any business entity operating under the California corporation tax law (including S-corps at the corporate level, and LLCs that have elected to be treated as a corporation under the "check-the-box" rules) is not affected by IRC Section 280E.

Any entity operating under the personal income tax law is impacted. This includes sole proprietorships, shareholders of S-corporations, LLCs (that have not elected corporate treatment), and partnerships.

Any change to this would require legislative action.

[IRS Form 8300](#)

IRS auditors are further focusing on Form 8300, which is the form used to report cash transactions over \$10,000. It is common knowledge in the cannabis industry that banks and other financial institutions are required to report to the IRS cash deposits over \$10,000. Form 8300 requires reporting to the IRS of identifying

Taxation Program at San Jose State University. I teach courses on tax research, tax accounting methods, taxation of property transactions, advanced individual tax, employment tax, ethics, and tax policy. I am active in the tax sections of the AICPA, ABA and CA Lawyers Association (CLA). I currently serve on the AICPA Tax Practice & Procedures Committee following serving almost seven years on the AICPA Tax Executive Committee including as chair. I am a past chair of the AICPA Individual Taxation Technical Resource Panel and a past vice chair of the Executive Committee of the California Bar Tax Section. I am a regular contributor to State Tax Notes (Moving Forward? column) and co-author/co-editor for four tax textbooks (Cengage/SWFT). I welcome your comments to my blog posts.

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information about the person from whom the cash was received, the business that received the cash, the person on whose behalf the transaction was conducted, and a description of the transaction.

However, it is less commonly known that all businesses, including those engaged in the cannabis industry, that receive over \$10,000 in cash for a single transaction or related transactions are required to file IRS Form 8300. Failing to do so for each such transaction can result in substantial fines and interest owed to the IRS, as well as civil and criminal penalties.

The IRS also investigates these large cash transactions for evidence of money laundering or other drug related criminal activities that would invoke the application of §280E, as well as under reporting of income.

Here's some helpful information concerning the risks of civil and criminal penalties related to Form 8300 -

Statute of Limitations for failure to file Form 8300 – 3 years

Failure to File – IRC 6721(a)(1) provides a \$100 penalty for failure to file a timely and correct Form 8300. The annual limitation for businesses with gross receipts exceeding \$5 million is \$1,500,000. For businesses with gross receipts not exceeding \$5 million the aggregate annual limitation is to \$500,000.

Failure to File Intentional Disregard - IRC 6721(e)(2)(C) provides for a penalty equal to the greater of \$25,000 or the amount of cash received in such transaction not to exceed \$100,000 for the intentional disregard for a failure to file a timely and correct Form 8300. There is no aggregate annual limitation for intentional disregard of Form 8300.

Criminal Prosecution - violations of an obligation to file an IRS Form 8300 can create criminal liability. A person required to file Form 8300 who willfully fails to file, fails to file timely, or fails to include complete and correct information is subject to criminal sanctions as a felony under IRC 7203. Sanctions include a fine up to \$25,000 (\$100,000 in the case of a corporation), and/or imprisonment up to five years, plus the costs of prosecution. Any person who willfully files a Form 8300 which is false with regard to a material matter may be fined up to \$100,000 (\$500,000 in the case of a corporation), and/or imprisoned up to three years, plus the costs of prosecution. IRC 7206(1).

Tightening the Noose

There is an interesting interplay between the following dynamics:

- Exclusion of Cannabis business from banking leads to practical result that Cannabis business do business primarily in cash[2]
- Cash based businesses are required to disclose information on Form 8300 that implicates criminal liability by such businesses and their vendors for violations of the Controlled Substances Act
- Failure to file the required information subjects such businesses and individuals related thereto to criminal liability
- Conflict with Right Against Self-Incrimination - US 5th Amendment; CA Const. Art. I, Section 24.



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In *Leary v. United States*, 395 U.S. 6 (1969), the Court held that the Fifth Amendment privilege against compelled self-incrimination barred a criminal prosecution for failing to notify the IRS of taxable marijuana transactions that were themselves illegal.

“Since the effect of the Act’s terms were such that.... compliance with the transfer tax provisions would have required petitioner, as one not registered but obliged to obtain an order form, unmistakably to identify himself as a member of a "selective group inherently suspect of criminal activities," and thus those provisions created a "real and appreciable" hazard of incrimination within the meaning of Marchetti, Grosso, and Haynes. pp. 395 U. S. 16-18.” *Leary v. United States*, 395 U.S. 6 (1969) at 7.

Proposed Solution

The solution lies in de-scheduling Cannabis under the Controlled Substances Act.

What do you think?

*Author Biographies

Bruce Braverman is President of [Braverman & Epstein, APC.](#), a law firm with offices in Sacramento and Irvine, California, which provides tax law and consulting services to cannabis businesses. Bruce Braverman is a retired California Deputy Attorney General with over thirty years of public service. He has provided legal advice to cannabis cultivators, manufacturers, and dispensaries on state and local licensing matters over the past 5 years.

David Frankel has over 20 years’ experience representing parties in cannabis related activities. Mr. Frankel focuses his practice on business formations, LLC and corporate transactions, startups, negotiations, contracts, venture capital, and cannabis licensing and compliance.

[1] See *Californians Helping to Alleviate Medical Problems, Inc., v. Commissioner*, 128 T.C. 173 (2007); Tax Court held that taxpayer trafficked in medical marijuana, which is a Schedule I controlled substance, and that §280E disallows all deductions attributable to that trade or business. Tax Court also held that §280E does not disallow the deductions attributable to the taxpayer’s separate and lawful trade or business.

[2] See Department of the Treasury Financial Crimes Enforcement Network Guidance FIN-2014-G001

Posted by [Professor Nellen](#) at 11:23 AM 

Labels: [cannabis](#), [guest post](#), [IRS examination](#), [marijuana](#)

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