

5-2015

State vs. Federal: marijuana legislation and its effect on taxes

Mamie G. Duckworth

University of Tennessee at Chattanooga, duckworthmg@gmail.com

Follow this and additional works at: <http://scholar.utc.edu/honors-theses>



Part of the [Accounting Commons](#)

Recommended Citation

Duckworth, Mamie G., "State vs. Federal: marijuana legislation and its effect on taxes" (2015). *Honors Theses*.

This Theses is brought to you for free and open access by the Student Research, Creative Works, and Publications at UTC Scholar. It has been accepted for inclusion in Honors Theses by an authorized administrator of UTC Scholar. For more information, please contact scholar@utc.edu.

“State vs. Federal: Marijuana Legislation and its Effect on Taxes”

Mamie Duckworth

Departmental Honors Thesis

The University of Tennessee at Chattanooga

Accounting

Project Director: Dr. Danny Hollingsworth

Examination Date: March 20, 2015

Examination Committee:

Dr. Danny Hollingsworth

Dr. Joanie Sompayrac

Dr. Greg Thibadoux

Professor Steven Cox

[Signatures]

Project Director

Department Examiner

Department Examiner

Liaison, Departmental Honors Committee

Chair, Departmental Honors Committee

ABSTRACT

Marijuana is becoming increasingly popular and accepted within our society; so much so that certain states have legalized it for medical or recreational use, despite marijuana remaining illegal with regards to the federal government. This has lead, and will continue to lead, to complicated and uncertain tax scenarios for the businesses that produce and sell marijuana.

Many problems stem from the federal government being unable to recognize or associate with businesses that deal with marijuana. This affects these otherwise legitimate businesses by disallowing the use of federally insured banks as well as taking away the ability to seek federal bankruptcy protection. An inability to operate as a normal business may lead marijuana businesses to explore other tax planning solutions such as organizing as a social welfare organization. At worst, they may be driven back underground. Additionally, it may be professionally risky for CPAs to perform services to these businesses for fear of violating ethical standards.

These smaller problems inevitably become one big problem, highlighting the power struggle between state and federal governments. Should the federal government have the ability to make these decisions for all of the states or should each state and each county of each state be allowed to regulate marijuana on their own? At the heart of this issue is its time sensitive nature. As potential government power changes, the future of marijuana businesses and their associates is unfairly unclear.

In order to solve these problems, the federal government has three choices; each with their own benefits and costs. They can legalize marijuana at a federal level, completely outlaw marijuana and begin enforcing laws against known state dispensaries, or they can change certain

areas of the tax codes and other select laws to offer clear directions for businesses and assurances of limited liability to those with whom they work.

Table of Contents

INTRODUCTION 5

SECTION 1: BANKRUPTCY LAW AND FEDERALLY INSURED BANKS 7

 FDIC-Insured Banks and Marijuana Dispensaries 7

 Bankruptcy and Marijuana Dispensaries 9

SECTION 2: FEDERAL AND STATE TAX PLANNING 12

 Tax Planning for Marijuana Dealers Featuring Benjamin Leff 13

 A Response to Leff 18

SECTION 3: LANDMARK CASE LAW 20

 A History of Cases and I.R.C. §280E 20

 Californians Helping to Alleviate Medical Problems (CHAMP) 21

 Champ Opinion 23

 Martin Olive V. Commissioner 25

 Olive Opinion 27

SECTION 4: ADMINISTRATIVE RULINGS 29

 AICPA Review of Chief Council Advice 29

 Focus of CCA 2015-04-011 30

 Analysis of CCA Issues: Issue 1 31

 Analysis of CCA Issues: Issue 2 32

 IRSAC Advice 33

SECTION 5: QUESTIONS TO BE RESOLVED 34

CONCLUSION 35

INTRODUCTION

Following California's decision to become the first state to legalize marijuana by passing the *Compassionate Use Act* (1996),¹ the drug has continued to gain widespread acceptance, first medically and, more recently, recreationally. In this *Act* marijuana was legalized for medical use. Over time, public opinion has begun to shift towards acceptance of medical marijuana. In even more recent events, multiple states now consider marijuana legal for recreational use as well. A 2013 Gallup poll showed 58% of Americans supporting legalization of marijuana.² Gallup has posed this question periodically since 1969, with the 2013 poll being the first time legalization was clearly supported by a majority. The 58% approval stood in sharp contrast to the 1969 poll where a mere 12% favored legalization. Additionally, there is a direct correlation between age and approval regarding medical marijuana, with the highest percentage approval in the 18-29 age bracket.³ This seems to suggest not only a general trend towards public approval currently, but a growing acceptance in younger generations.

The recent 2014 elections resulted in legalization of recreational marijuana in Oregon and Alaska as well as partial or medical legalization in other states, leading to twenty-three other states and the District of Columbia.⁴ *Bloomberg* reported in 2013 that Eric Holder, the U.S. Attorney General, announced to the governors of Colorado and Washington that the U.S. Attorney's office would concentrate on "priority areas" and work with the states to make rules

¹Compassionate Use Act, 1996, Prop. No. 215, California Department of Public Health, <http://www.cdph.ca.gov/programs/mmp/pages/compassionateuseact.aspx>, accessed January 23, 2015.

²*Gallup Inc.*, "For First Time, Americans Favor Legalizing Marijuana," October 22, 2013, Gallup website, www.gallup.com/poll/165539/first-time-americans-favor-legalizing-marijuana.aspx?version=print, accessed November 5, 2013.

³*Ibid.*

⁴*Time*, "Voters Lit Up for Marijuana in the Midterms," November 5, 2014, Time Website, <http://time.com/3557760/2014-midterm-elections-marijuana-pot/>, accessed January 22, 2015.

and regulations regarding the marijuana industry.⁵ This statement followed *Bloomberg's* report that the Justice Department would not challenge the legalization in Colorado or Washington for recreational use but instead focus on its possible “ties to organized crime, distribution to minors and transportation across state lines.” With the growing number of legalized states and increased social acceptance, marijuana has become an increasing topic of discussion in modern society.

While there are many different arguments regarding the safety of marijuana, rules regarding its consumption, and legal consequences for possession or sale, this paper focuses on marijuana from a business perspective, in five sections. The first section discusses the possible benefits and consequences of treating a state-legal marijuana establishment as a federally-legal business through and examination and explanation of bankruptcy law and federally insured banks. It will also explain excise taxes, one of the common types of tax introduced for a product such as marijuana. The second section of the paper discusses tax planning from a state and federal government as well as business perspective. It examines the need for tax planning in a marijuana business and the role that legality plays in such plans. It also explores the possible tax treatment at a federal and state levels, specifically income tax as well as franchise and excise tax. The third section reviews some of the landmark cases that will shape the future of tax legislation. The case law shows the history of marijuana legislation to enable a better prediction of the future of the marijuana industry with regard to its potential legality. The fourth section examines administrative rulings to outline the current guidance being given to CPAs and the businesses they advise with regard to the tax treatment of marijuana businesses. The fifth and final section

⁵*Bloomberg*, "U.S. Won't Sue to Block State Marijuana Legalization," August 30, 2013, Bloomberg website, <http://www.bloomberg.com/news/articles/2013-08-29/u-s-won-t-sue-to-block-state-marijuana-legalization>, accessed September 26, 2013.

introduces questions that must be resolved in order for the marijuana industry moves forward towards legality and out of the shadows of the streets.

SECTION 1: BANKRUPTCY LAW AND FEDERALLY INSURED BANKS

Medical marijuana dispensaries have struggled to be accepted as legitimate businesses since *California's Compassionate Use Act of 1996* made them possible. The recent increase in laws legalizing marijuana for medical and recreational use shows that this industry is not just a fad, but it is a legitimate marketplace that could mean large tax revenues for the states that have made it legal.

However, current federal laws and, more importantly, fear and uncertainty of violating those laws has caused certain issues for the legitimate, state-legal dispensaries. These issues will continue to be an issue, not just in medical marijuana, but in the recreational sale and use as well. While this paper focuses mainly on these issues from a tax perspective, it should be noted that there are similar marijuana-specific problems in various aspects of businesses. The issues that surround taxation, specifically the struggle between state and federal government, can be seen in other business activities such as filing for bankruptcy protection, assistance, and keeping money in a financial institution insured by the FDIC.

FDIC-Insured Banks and Marijuana Dispensaries

In 2014, the *Financial Crimes Enforcement Network* (FinCEN) issued a guidance clarifying expectations for financial institutions involved in transactions with “marijuana-related businesses.”⁶ The guideline covers marijuana laws and the memo by Department of Justice (DOJ) Deputy Attorney General James M. Cole (Cole Memo) reiterating Congress’ assertion

⁶FinCEN, “BSA Expectations Regarding Marijuana-Related Businesses,” February 14, 2014, FinCEN website, http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-G001.pdf, accessed February 19, 2015.

that marijuana is a dangerous drug that contributes to and funds many more serious criminal activities. The Cole Memo lists the following eight items as a priority to enforce:

- Preventing sales and distribution of marijuana to minors;
- Obstructing marijuana businesses from providing revenue to criminal enterprises, cartels, and gangs;
- Blocking the distribution of marijuana from states that have legalized the drug to states that have not legalized it;
- Ensuring that state-authorized marijuana is not being used as a cover for the trafficking of different illegal drugs or activities;
- Ending the use of firearms and violence in the cultivation and trafficking of marijuana;
- Preventing driving while under the influence of marijuana and exacerbating other adverse health consequences to the public associated with the use of marijuana;
- Ensuring marijuana will not be grown on public lands and therefore addressing the public safety and environmental dangers and concerns posed by the production of marijuana on said public lands; and
- Prohibiting possession and use of marijuana on federal property.⁷

Based upon these guidelines, FinCEN clarifies how banks can do business with marijuana dispensaries while keeping up with their Bank Secrecy Act (BSA) expectations and obligations. They suggest due diligence and thorough risk assessment before taking on these riskier clients. This includes verifying licenses and registrations, examining specific marijuana licenses, requesting available information from the state about the “business and related parties, developing an understanding of the normal and expected activity for the business,”; monitoring of public sources for adverse information, monitoring for red flags or “suspicious activity,” and keeping all of this information up-to-date and accurate.

FinCEN’s overall goal in assisting banks is to encourage the availability of financial services, and financial transparency, to marijuana-related businesses.⁸ If this could be achieved,

⁷*Ibid.*

marijuana could move out of the shadows and into a safe and regulated industry while simultaneously injuring criminal enterprises. These guidelines focus on regulating and restricting the elements of marijuana that are dangerous to society while helping the legitimate, state-legal businesses move into a legitimate realm of commerce. However, while marijuana remains federally illegal, there can be no way to be absolutely sure that the producers, distributors, or users will not be prosecuted at a later date. There is also no way to ensure zero-risk as a business with ties to the marijuana industry. This creates excess liability for companies such as banks that would naturally like to work with the thriving businesses in the marijuana industry.

Bankruptcy and Marijuana Dispensaries

In 2013, Vivian Cheng wrote a comment entitled “Medical Marijuana Dispensaries in Ch. 11 Bankruptcy” that details the struggles faced by state-legal medical marijuana dispensaries in a scenario where bankruptcy filings would be the only way to save the business or to ensure fair payment to creditors.⁹

Marijuana dispensaries take on the same risks and day to day expenses as any other retail or production business. They sell goods, compete in the market with similar products, rent or own property, use utilities, hire employees, borrow money, operate using state licenses, and pay taxes. Therefore, they are just as likely to fall prey to financial troubles.¹⁰ Medical or recreational dispensaries incur the same types of expenses as any other business and are just as likely to succeed or fail. Cheng notes that while bankruptcy laws do not directly prohibit federally illegal marijuana businesses from filing for bankruptcy, some people have argued that these businesses are not entitled to this basic business right due to an inability to show a good

⁸*Ibid.*

⁹Vivian Cheng, “Medical Marijuana Dispensaries in Chapter 11 Bankruptcy,” *Emory Bankruptcy Developments Journal*, 2013, available from LexisNexis Academic, accessed September 19, 2014

¹⁰*Ibid.*

faith plan.¹¹ This is a concern of marijuana business advocates due to the fact that bankruptcy can be an important tool in helping a business recover and thrive for the economic benefit of everyone involved.

Generally, the goal of allowing a business to file for bankruptcy is to enable creditors to see some return on investment, in addition to attempting to save the business. US Bankruptcy Code §1129 (a)(3)¹² is a common reason for a bankruptcy proposal to be denied; it requires the plan be in “good faith” as well as “not by any means forbidden by law”-- however, there is a general agreement that this inquiry has been overshadowed by the “good faith” language. Undoubtedly, the ability to be considered in “good faith” requires an element of legality. However, bankruptcy courts have consulted both federal and state laws when considering good faith. Good faith has come to more narrowly examine whether a debtor’s conduct displays honesty and good intentions.

Another hurdle to deciding whether a plan is confirmable or not is the burden of proof regarding the feasibility standard, defined as “a reasonable chance of success.” Due to the current volatility in the market caused by uncertain legality, this usually “relatively low” threshold is much higher than in an ordinary business involved in selling goods. In the two cases of medical marijuana distributors attempting to file for bankruptcy protection, their cases were denied. Although the official reasons for denial were not related to the issues that have been and will continue to be discussed, issues of good faith constituted a significant part of the case against the two dispensaries.

Based on the *Settling States v. Carolina Tobacco Co.* case, Cheng notes that the federal bankruptcy system does not invalidate state laws. In fact, state laws must remain in place and a

¹¹ 11 U.S.C. §1112(b).

¹² 11 U.S.C. §1129(a)(3).

debtor must be able to comply with those state laws for a plan to be confirmed.¹³ The question remains: Unless preempted by federal law, what is the outcome when there is a conflict between federal and state government? In the case of bankruptcy, the scope of what the court is trying to determine as well as the way the federal bankruptcy code is written suggests that it is not the bankruptcy court's job to determine the preemption question regarding this conflict.

Another key concern is costs: both monetary and temporal. To block the confirmation of plans based on the possibility of violation of certain laws creates problems regarding time and resources in the legal process. This would delay payments or settlements to creditors and waste judicial resources.¹⁴ The concerns are that the burden of involving each regulatory agency to police this process and provide the necessary expertise to be able to judge such cases would mean an amount of manpower that is unrealistic and would put an unmanageable burden on said agencies.

According to the IRS "Excise taxes are taxes paid when purchases are made on a specific good, such as gasoline. Excise taxes are often included in the price of the product."¹⁵ Each state is also capable of enacting its own excise tax on various goods. Some common examples of goods that include excise taxes are gasoline, cigarettes, and alcohol. While they are convenient government revenue sources, excise taxes serve a broader purpose. They are often designed to offset the perceived costs from the harm that they inflict on society, which causes excess government spending.¹⁶ Marijuana is the type of good that would typically have an excise tax

¹³See note 9

¹⁴*Ibid.*

¹⁵IRS, "Excise Tax," January 22, 2015, IRS website, <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Excise-Tax>, accessed March 9, 2015.

¹⁶Cnossen, Sijbren, "Theory and Practice of Excise Taxation: Smoking, Drinking, Gambling, Polluting, and Driving," *American Economic Association*, October 2005, JSTOR, accessed on March 9, 2015.

imposed on it. In fact, the Colorado Department of Revenue imposes a 15% tax rate on the market price of marijuana sold in a retail capacity.¹⁷

SECTION 2: FEDERAL AND STATE TAX PLANNING

In order to delve further into the issue of tax planning for a marijuana business, several laws and practices that surround a typical business when filing taxes must be reviewed. I.R.C. § 162¹⁸ is an important § for a marijuana business because it allows the deduction for ordinary business expenses incurred during the year while carrying on business. A notable exception in I.R.C. § 162(c) is the disallowance of deductions pertaining to “illegal bribes, kickbacks, and other payments.” The disallowance was created to prevent criminal enterprises from benefiting monetarily from committing illegal acts that are harmful and costly to law-abiding taxpayers. In addition to I.R.C. § 162, § 280E is often referred to when discussing a marijuana business. The section is as follows:

“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.”¹⁹

Essentially, with the exception of costs of goods sold (COGS), I.R.C. § 280E prevents illegal businesses from deducting otherwise normal business expenses when calculating their income for the year. This disallowance of an operating expense deduction is typically problematic for a business because it substantially increases the amount of taxes the business pays while the

¹⁷*Colorado Department of Revenue*, "Excise Tax on Retail Marijuana," April 2014, Colorado Department of Revenue website, <https://www.colorado.gov/pacific/sites/default/files/Excise23.pdf>, accessed March 9, 2015.

¹⁸I.R.C. § 162.

¹⁹I.R.C. § 280E.

revenues from the business never change. This causes a huge fluctuation in net income and profitability that could mean a significant barrier of entry to this new market.²⁰

Tax Planning for Marijuana Dealers Featuring Benjamin Leff

I.R.C. § 280E alone could mean the difference between a thriving enterprise and one that fails. In Benjamin Leff's article *Tax Planning for Marijuana Dealers*²¹ he gives a similar example like the following illustration on how an average dispensary (if not illegal) or business would calculate taxes:

Imagine a business with total revenues of \$3,000,000 that pays \$2,600,000 in Cost of Goods Sold) (COGS), or the wholesale cost of marijuana and marijuana accessories. An ordinary business would most likely have other expenses such as illustrated in Table 1.

Table 1

Utilities	\$ 5,000
Accounting	1,500
Advertising	4,000
Legal Services	30,000
Office Supplies	9,000
Rent Expense	18,000
Licenses Expense	4,000
Salaries and Wages Expense	160,000
Depreciation Expense	12,500
Miscellaneous Expense	10,000
Total	\$249,000

An ordinary business' taxes would be calculated by multiplying the taxable rate times the taxable income of the business. Taxable income is calculated by taking Total Revenues and

²⁰A barrier of entry is anything that is a factor in making it harder to be a part of or successful participates in a new industry.

²¹Leff, Benjamin M, "Tax Planning for Marijuana Dealers," *Iowa Law Review* 99.523 (n.d.): 523-69. University of Iowa, accessed 14 Sept. 2014.

subtracting both COGS and the other business expenses listed above. After applying a hypothetical tax rate of 30%, federal income taxes for the year would be \$45,300 and the after tax income for the year would be \$105,700.²²

However, if the same business were deemed illegal and thus paid taxes on income calculated under I.R.C. § 280E is upheld, the \$249,000 of additional business expenses would not be deductible, which would result in a \$31,000 income²³ instead of the \$105,700 income. This tax treatment could put significant and additional strain on these state legal and well-meaning businesses— a major point of Dr. Leff's article.

He argues two particularly interesting main points:

1. Could a marijuana dispensary organize itself in such a way as to allow for an exemption from federal income tax?, and
2. The idea that there is precedence that a state would have the deciding vote in these matters?

Leff's first point is an unusual approach to the questions of taxation for marijuana. The idea is that I.R.C. § 280E may be unavoidably harsh and that the best idea would be to just avoid it altogether by qualifying as a tax-exempt organization. A major argument against marijuana legalization and use is the effect on our society. President Obama's administration has stated that; "marijuana places a significant strain on our health care system, and poses considerable danger to the health and safety of the users themselves, their families, and our communities."²⁴ However, certain states (e.g., Massachusetts) require medical marijuana to be a non-profit or cooperative. It is important to note that qualifying as a non-profit at a state level does not automatically qualify an organization at a federal level.

²²(3,000,000-2,600,000-249,000)=\$151,000 income before taxes

²³(\$400,000×.3)= \$120,000 in taxes subtracted from the unchanging income of \$151,000, as well as the \$249,000 in other operating expenses are still costs to the business.

²⁴*White House*, "The Public Health Consequences of Marijuana Legalization," White House website, http://www.whitehouse.gov/sites/default/files/ondcp/issues-content/marijuana_and_public_health_one_pager_-_final.pdf, accessed February 5, 2015.

There are multiple ways for an organization to classify itself as a charitable organization.

This is usually done by adhering to I.R.C. § 501(c)(3), which can be paraphrased as:

Corporations organized and operated exclusively with well-meaning purposes such as charitable, scientific, or educational may be eligible. No portion of the net earnings may go to the benefit of private individuals or shareholders. Additionally, no substantial part of the organizations activities are allowed to carry on propaganda or attempt to influence legislation (with the exception of very specific situations in I.R.C. § 501(h)). The organization may not participate or intervene in (including publishing statements) any political campaign for or against a candidate for public office.²⁵

However, in some situations (usually when finding it hard to qualify for I.R.C. § 501(c)(3)), organizations will choose to classify themselves using I.R.C. § 501(c)(4), which includes charities. These are civic leagues or organizations that are not organized for profit but instead operated exclusively for the promotion of social welfare.²⁶

One argument is that if a marijuana-dispensing business could avoid distributing earnings to private individuals while providing social welfare for the community, they would be eligible for tax-exempt status from the federal government.²⁷ Leff notes that CDCs, or community development corporations, have long been recognized as proper charities. They typically help poor, distressed neighborhoods by operating some sort of retail store and employing the otherwise unemployable.²⁸ CDCs are in downtrodden communities for the purpose of reviving these communities through a positive business presence and rehabilitating and training of its citizens. Leff notes that a potential business goal could be hiring former sellers of illegal

²⁵I.R.C. §501 (c)(3).

²⁶I.R.C. §501 (c)(4)(A).

²⁷This would not nullify any taxes the state chose to impose.

²⁸For example, employing someone with a criminal record, homeless, or recovering alcoholics.

marijuana, especially youth, and train them to operate legitimate retail operations, which hopefully would draw them away from the illegal marijuana industry.²⁹

The last hurdle to establishing a marijuana business as a I.R.C. § 501(c)(4) organization is also the second point that Leff makes, which pertains to the public policy doctrine and is relevant to the scope of this paper. Generally, in order to qualify as I.R.C. § 501(c)(3) charity, the primary activity of the organization cannot be illegal or harmful to the public.

However, even if the IRS has made it clear that an organization that sells marijuana cannot classify itself as a charity under I.R.C. § 501(c)(3), an I.R.C. § 501(c)(4) organization may be possible. There is currently no guidance from any court addressing public policy doctrine and I.R.C. § 501(c)(4) organizations. Additionally, the existing public policy doctrine comes from charity laws, of which it is clear that I.R.C. § 501(c)(4) organizations have no part. The IRS has made some decisions that disqualified potential I.R.C. § 501(c)(4) organizations due to violations of law. However, none of these examples included a state and federal law conflict of legality.

One of the main reasons that a charitable organization cannot participate in illegal activities is the tax breaks associated with such an organization. Governments cannot afford to give tax breaks, seen as a form of government subsidy and encouragement, to organizations that are openly breaking laws or encouraging citizens to break the law. While the U.S. Supreme Court has ruled that way for I.R.C. § 501(c)(3) cases, the courts have never ruled that an I.R.C. § 501(c)(4) organization is a charity. Therefore, I.R.C. § 501(c)(4) organizations are not necessarily bound by charitable laws. This is not to say the I.R.C. § 501(c)(4) organizations are able to participate in whatever activities they choose, regardless of legality. The IRS had turned

²⁹Pg. 541. Leff, Benjamin M, "Tax Planning for Marijuana Dealers," *Iowa Law Review* 99.523 (n.d.): 523-69. University of Iowa, accessed 14 Sept. 2014.

down I.R.C. § 501(c)(4) hopeful organizations due to participation in illegal activities that “violate the minimum standards of acceptable conduct necessary to the preservation of an orderly society.”³⁰

“Thus, the IRS has on several occasions taken the position that promoting certain activities is contrary to social welfare based at least in part on the fact that such activities are illegal in all or almost all of the states.”³¹ Leff establishes the former statement to be unequivocally true. However, the statement no longer applies to marijuana, as it is legal in half of the United States, at least in a medical capacity. While the federal government continues to categorize marijuana as harmful to communities, certain states have legalized marijuana, suggesting certain communities see legal marijuana as beneficial.

Leff proposes: “The IRS should only recognize a social welfare organization that sells marijuana when state and local indications align in support of legal marijuana sales.”³² This proposal is based off the determination that local and state laws should be able to better determine what promotes social welfare in their area better than the federal government. A nonprofit, legal marijuana seller would be specifically operating to improve and preserve order in local communities.

The marijuana legalization of present day creates a very real and potentially serious Federalism problem. The tug of war between the federal government and certain states can only continue for so long; either the federal government or the states will eventually be required to change the existing laws. Leff argues that due to the federal government’s unwillingness to prosecute known marijuana businesses (in states that have legalized), they are already ceding

³⁰Leff, Benjamin M. "Tax Planning for Marijuana Dealers," *Iowa Law Review* 99.523 (n.d.): 523-69. University of Iowa. Web, accessed September 14, 2014.

³¹Ibid.

³²Ibid.

control of the issue to the states. Additionally, marijuana legalization continues to garner increased public support and approval. This suggests that states should have the ability to decide which organizations are beneficial to their community and thus which organizations deserve to qualify for tax-exempt status under I.R.C. § 501(c)(4).

A Response to Leff

Although Professor Leff makes several well-reasoned and innovative suggestions for tax planning in his article, *Tax Planning for Marijuana Dealers*, there are definite concerns to seriously suggesting such liberal tax planning. Phillip Hackney has written a response to Leff's views.³³ This summary of his response will cover an alternative belief that I.R.C. § 501(c)(4) status is unattainable, that a taxpayer may not use the I.R.C. to promote illegal activities, and that Leff's plan would inevitably fail due to its conflict with Federal law.

Hackney argues that organization under I.R.C. § 501(c)(4) would be impossible to marijuana distributing organizations because the public policy doctrine applies not only to I.R.C. § 501(c)(3) charities as Leff suggested, but also to I.R.C. § 501(c)(4) social welfare organizations. An analysis of I.R.C. § 501 suggests that not-for-profit organizations operated for social welfare are qualified to exempt federal income tax. An examination of the organizations in existence at the time of the passage may suggest what Congress originally envisioned as qualified organizations. This will take the place of actual legislation on the matter, as Leff noted, none exists. Generally, the organizations that have qualified include organizations involved in health maintenance, certain causes, community beautification, transportation, as well as certain home owner associations. It is worth noting that none of the previously mentioned organizations were violating federal laws.

³³Hackney, Phillip T, "A Response to Professor Leff 's Tax Planning "Olive Branch" for Marijuana Dealers," *Louisiana State University Law Center*, accessed February 16, 2014, accessed January 20, 2015.

Additionally, Hackney points out that the phrase “people of the community,” while perhaps directed towards smaller groups such as states or counties, does not allow for disregard of the over-arching federal law. As the final point for disqualification under I.R.C. § 501(c)(4), social welfare organizations are to be operated exclusively to achieve such ends. This suggests that any non-welfare related purpose would disqualify an organization. Treasury Regulations for I.R.C. § 501(c)(3) have subsequently stated that an organization may not have “more than an insubstantial part” related to a non-exempt purpose. Hackney asserts that, due to their slight differences, Congress did not intend to regard I.R.C. § 501(c)(3) and 501(c)(4) organizations so differently, and that it is nearly impossible that an I.R.C. § 501(c)(4) organization would be allowed to ignore federal law.

Tax exemptions are essentially subsidies. The government reduces or does not tax certain industries and organizations in order to help these specific endeavors be successful. Due to this reasoning, the government has enacted provisions such as I.R.C. § 280E to prevent tax benefits for illegal activities. This reasoning shapes the public policy doctrine that Hackney asserts should apply to I.R.C. § 501(c)(4) organizations. As an extension of this logic, the idea that a tax-exempt organization could use illegal means such as selling marijuana to further their tax exempt purpose is flawed. The IRS has held that social welfare organizations are not allowed to violate laws because it is not acceptable conduct for a tax-exempt organization. Ultimately, Hackney argues, federal law trumps state law. Subsequently, the federal government cannot provide tax breaks to federally illegal businesses.

“The [Supreme] Court has found the criminalization of marijuana to be constitutional.”³⁴
The U.S. Department of Justice still asserts that marijuana is dangerous to public safety and should be illegal. Marijuana is illegal federally and is considered to be a clear public problem.

³⁴*Ibid.*

There is no way for the federal law to allow tax breaks to organizations that so clearly stand against their public policy and the laws of the United States of America.

SECTION 3: LANDMARK CASE LAW

While the previous sections have discussed bankruptcy codes, federally insured banks and financial planning issues, this § will be singularly focused on case law and the landmark marijuana cases to date. As of present day, marijuana is illegal under federal laws and may be quite some time away from legalization at the federal level, if at all. However, as an increasing amount of states legalize for medical and recreational use, it is an increasingly popular topic of discussion. Medical marijuana has been legal in select states beginning in 1996. As such, there have been important cases involving the tax issues that this paper is meant to discuss.

A History of Cases and I.R.C. §280E

1981: In *Jeffrey Edmondson v. Commissioner*³⁵ an illegal business was allowed to recover the cost of the controlled substances that were being held on consignment and also claimed a deduction on some other operating business expenses such as rent, packaging costs, phone, travel (in the form of auto expenses), and the cost of a scale.

1982: I.R.C. § 280E was created in response to Edmondson's ability to deduct business expenses other than COGS. The *Senate Report*³⁶ further explains that income will not be adjusted with regards to COGS to insure that no possible challenges of the decision can be brought based on constitutional grounds. It is important to note that Congress purposefully disallowed many normally legal expenses, not just the illegal ones that I.R.C. § 162(c) disallows.

³⁵*Jeffrey Edmondson v. Commissioner*, T.C., 623, 1981.

³⁶*Joint Committee on Taxation*, "General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982," United States Senate, 97th Congress, S. REP. NO. 97-494 (Vol. I), at 309 (1982).

1986: *The Tax Reform Act*³⁷ is passed in Congress, which “added the uniform capitalization rules of §263A to the code.”³⁸ As a result of I.R.C. § 263A(a), resellers of goods are required to treat direct costs of property “purchased or produced” as inventoriable costs. Indirect costs that are allocable (even partially) should also be part of inventory.

1988: *The Technical and Miscellaneous Revenue Act (TAMRA)*, Section 1008(b)(1) explains that a cost is subject to capitalization only to the extent that it would be used in calculating that specific year’s taxable income.

Californians Helping to Alleviate Medical Problems (CHAMP)

Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner,³⁹ is a commonly used example to describe the effect of I.R.C. § 280E and the previously discussed timeline of events. In 2002, a marijuana business petitioned the Commissioner of the Internal Revenue Service for tax-favored treatment. This business was Californians Helping to Alleviate Medical Problems., Inc. (CHAMP): A corporation organized for the purposes of charity, education, and science. The corporation and its property were also dedicated to serving a charitable purpose. CHAMP was designed to operate at a relative breakeven point⁴⁰ and be a place in the community for those with debilitating disease. Around 47% of the members at that time suffered from AIDS⁴¹ with the rest of the members suffering from cancer, multiple sclerosis, and other deadly or debilitating diseases. The executive director of CHAMP had 13 years of experience as a coordinator of a program designed to train worker in AIDS prevention work.

³⁷Tax Reform Act, 1986, Pub. L. No. 99-514.

³⁸C.C.A. 2015-04-011, 1/23/2015.

³⁹*Californians Helping to Alleviate Medical Problems., Inc. v. Comm.*, 128 TC 173 (2007).

⁴⁰Breakeven point is simply defined as making as much in revenues so as to compensate for all the expenses of a business.

⁴¹Acquired Immune Deficiency Syndrome

CHAMP had two purposes. First and foremost, it was to provide caregiving services, and second, and more relevantly to this paper, it was to distribute marijuana and instruct individuals on how to use marijuana as part of their healing process. Patients were required to have a doctor's note, photo identification, and were prohibited from reselling or redistributing the product to a non-member. As for income, the business operated solely by collecting membership fees. These fees entitled members to certain benefits, including but not limited to caregiving services and marijuana. It is important to note that the membership fee was calculated to cover all costs and that no additional fees were charged for marijuana or health services such as caregiving. Members were also not entitled to limitless marijuana.

The business had three locations:

1. A main office space. This space was the site of many different events and daily tasks, with marijuana or marijuana activities occupying around 10% of those tasks.
2. A church, which CHAMP paid to allow use of the facilities for certain classes or activities. There was no marijuana allowed on site, per church policy.
3. A storage unit for confidential medical records. No marijuana was ever stored at this facility.

In 2002, CHAMP's board of directors discontinued all activities and a final (1120) return was filed. They reported the following figures found in Table 2:

Table 2

Sales less returns and allowances:	\$1,048,031
Cost of Goods Sold	835,312
Total Deductions ⁴²	212,958
Taxable Loss	\$239

⁴²Including labor, beginning inventory, purchases, and other costs. Ending inventory was 0, as it was a final return.

In 2005, a notice of deficiency was mailed to the petitioner, CHAMP, disallowing all COGS and other deductions under the premise that those items were connected to expenditures from the illegal sale of drugs pursuant to I.R.C. § 280E. The respondent (Commissioner) then conceded that COGS was permissible and that the other deductions, although not allowed, were substantiated.

Inevitably, the other total deductions were broken down into more specific categories, as they related to marijuana. For example, the \$14,914 deducted for officer compensation reflects the salary of the executive director who was never directly involved in the marijuana aspect of the business. In contrast, the \$44,799 in salaries and wages included pay for 24 employees, 7 of which worked in the marijuana area of the business.

Champ Opinion

Obviously, the petitioner had at least part of the overall business that is subject to the purposes of I.R.C. § 280E. However, the petitioner argued that it had the trades, the main focus being caregiving, and that furthermore those trades are not precluded by I.R.C. § 280E, as the way they dispersed marijuana did not constitute “trafficking”. The respondent argued that I.R.C. §280E did preclude the trades and that all deductions should be disallowed.

Before I.R.C. § 280E was enacted, illegal businesses were able to deduct all of the expenses mentioned in the above summary of expenses, not only COGS. In fact, I.R.C. § 280E was created as a reaction to such scenarios.⁴³ The Senate Finance Committee report acknowledges that these types of expenses are and should be deductible in an ordinary business. However, the report also states that I.R.C. § 280E should make certain expenses nondeductible when computing income. This theory is based in public policy and the concept that illegal expenses should not result in a tax benefit to criminals.

⁴³*Californians Helping to Alleviate Medical Problems, Inc. v. Comm.*, 128 TC 173 (2007).

The report expresses the following committee sentiments: “There is a sharply defined 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 much be disallowed on public policy grounds.”⁴⁴ It goes further and clarifies that Cost of Goods Sold is not challenged, as it would hamper Constitutional rights. However, all other deductions and credits are supported to be disallowed when trafficking in a Schedule 1 drug.

In the case of *Californians Helping to Alleviate Medical Problems*, the courts held that while the deductions should be disallowed for an illegal, Schedule 1 business, there is no ground to prohibit deductions and expenses arising from ordinary (legal) components of the business. Additionally, it was decided that any regular buying, selling, and distributing of an illegal drug (if marijuana) was considered, for the purposes of applying Section 280E, to be trafficking.

It is important to note that a taxpayer may, in fact, have two different businesses. The key factor in deductibility of expenses in the second legal business is whether or not the two businesses are reasonably separate. The general standard is that they are believed to be separate unless the characterization of separatism is artificial or unreasonable. This was not found to be the case for CHAMP. They were able to clearly define the parameters of the services they offered, thus proving that their business was more substantial than only the trafficking of marijuana.

Given the obvious separation, CHAMP was allowed to apportion the other expenses of the business accordingly. The expenses originally considered nondeductible due to I.R.C. §

⁴⁴*Ibid.*

280E were allocated based on some of the previously discussed figures. For example, eighteen out of twenty-five of the expenses regarding general employees were expensed because the other seven employees worked with marijuana. However, both the storage locker and the church location expenses were completely deductible, as they were never used for the purpose of trafficking in marijuana in any way.

Martin Olive V. Commissioner

The case of *Martin Olive v. Commissioner*⁴⁵ can be examined as an example of a business that operated and was taxed very differently than the Californians Helping to Alleviate Medical problems, due to sloppy record keeping and an inability to separate trades within the overall business.

The courts note that the sole proprietor of this medical marijuana dispensary did not keep sufficient records and even though the marijuana industry is typically cash based, and shies away from documentation, does not mean that the burden to keep accurate records is lighter. The case had two chief problems: the first related to COGS and I.R.C. § 280E; the second was a substantial accuracy problem. While both are certainly important, this summary will focus on the first problem as it is more relevant to the topic at hand. This is not to say a marijuana business should not keep accurate records; there is simply not much to discuss while remaining in the scope of this paper.

The dispensary, known also as the Vapor Room, operated in San Francisco, California, beginning in January 2004. It was organized solely as a marijuana dispensary from its inception, and was also unlicensed. The Vapor Room's goal was to allow its patrons, some of whom had terminal illnesses, to socialize, purchase, and consume medical marijuana in a community

⁴⁵*Martin Olive v. Comm.*, 139 TC 19 (2012).

atmosphere. In order to achieve this the petitioner, Martin Olive, placed comfortable furniture, vaporizers, games, books, and art supplies all around the business area for patrons to use at their own convenience. He had marijuana displayed in glass jewelry cases and behind the register.

The Vapor Room sold nothing but three forms of medical marijuana. People visited the establishment to procure marijuana as well as socialize with others who were also consuming marijuana. In order to participate, a patron was required to have either a doctor's recommendation or a certificate from the San Francisco government. The staff members as well as an undisclosed number of volunteers, qualified to consume marijuana under *California's Compassionate Use Act* as well.⁴⁶ There was no fee to socialize or enter the Vapor Room nor were participants required to purchase their marijuana there.

Although the petitioner provided other activities such as yoga, chess, and movies, there were no additional charges for these services. The only revenue was from the sales of marijuana which was originally purchased from licensed medical marijuana suppliers. The patrons did not have to smoke the marijuana purchased at the Vapor Room. Additionally, a patron could have marijuana delivered to a secondary location. There was the occasional counseling session as well as intimate discussions of other personal, legal, or political matters; however, no one was ever paid for their advice.

Table 3 provides the Vapor Room's expenses in 2004 and 2005.⁴⁷

⁴⁶See note 1

⁴⁷Although these amounts would eventually vary due to inaccurate record keeping, this initial account was acceptable given the focus of this article.

Table 3

	2004	2005
Gross Receipts	\$1,068,830	\$3,131,605
Less: COGS	993,377	2,812,478
Gross Income	75,453	319,127
Less: Other Expenses	10,783	285,349
Net Profit	\$64,670	\$33,778

The audit of these expenses and the Vapor Room as a whole began in 2006. A deficiency notice was issued stating that all COGS were non-deductible due to lack of substantiation. Section 280E was cited as to the reason none of the other expenses were deductible.

Olive Opinion

The Tax Court first discussed the burden of proof.⁴⁸ It was found that the burden of proof lies with the business. This reiterates the need for accurate and reliable record keeping; this may turn out to be especially true in an industry that has been only partially legitimized. Accurate records indicate a responsible, serious, and legitimate business. With respect to the substantiation of COGS, the petitioner argued that the ledgers he kept (separate from the recording books) should be enough to substantiate his claims, as the marijuana industry “shuns formal ‘substantiation’ in the form of receipts.”⁴⁹ As discussed, the courts held Mr. Olive to the same standard of proof and integrity as any legitimate business.

COGS was ultimately determined by an approximation due to an inability to trust the records kept by the Vapor Room and an inability to accept the unreasonably small amount suggested by the respondent (\$23,776 in 2004 and \$27,370 in 2005.) The petitioner was also

⁴⁸*Martin Olive v. Comm.*, 139 TC 19 (2012).

⁴⁹*Ibid.*, page 8.

unable to deduct COGS for marijuana that given away, and thus provided no income because it was never truly for sale.

The petitioner had a variety of other expenses, all of which the court found questionable. Olive argued that I.R.C. § 280E did not apply and that all of the Vapor Room's expenses were deductible. It was ultimately determined that any deduction of those expenses would have to fall outside of the realm of I.R.C. § 280E (as it definitely applies to this case) and at the discretion of the respondent (due to significant documentation issues.) The court once again held that I.R.C. § 280E applies even in situations where marijuana is legal within a certain state; additionally, they held that selling medical marijuana was still considered trafficking by federal standards.

Mr. Olive asserted that the Vapor Room also provided caregiving similar to the structure of the previously discussed Californians Helping to Alleviate Medical Problems. The courts disagreed, finding it impossible to separate the caregiving services from the dispensing of medical marijuana. This was partially based off an inability to believe that the Vapor Room could operate successfully without medical marijuana.

Martin Olive v. Commissioner makes it clear that the federal tax courts will not be giving marijuana businesses an easy pass. The courts took this opportunity to make it very clear that in order to deduct expenses for a separate part of the business, those expenses need to be well documented and the business needs to be a legitimate separate part- as seen in CHAMP. They go on to further clarify that just because a marijuana dispensary may provide additional services that is not an inherent business, as any other retail store might offer additional perks besides the mere purchase and passing off of goods.

SECTION 4: ADMINISTRATIVE RULINGS

AICPA Review of Chief Council Advice

The Internal Revenue Service (IRS) has issued limited guidance on the taxation of marijuana issue in the form of Chief Council Advice (CCA) 2015-04-011.⁵⁰ In reference to this IRS authority by Annette Nellen in an article written for the American Institute of Certified Public Accountants (AICPA) called it “the most that has been issued by the IRS to date.”⁵¹ Her article begins by taking the marijuana taxation argument all the way back to the Sixteenth Amendment that permits taxation on incomes. Nellen notes that Treasury Department Regulations have not been issued for I.R.C. § 280E.

The IRS and courts have historically applied I.R.C. § 280E to the sale of medical marijuana (as allowed by the state, of course). A further constraint is the *Controlled Substances Act* makes no exception for medical marijuana. The IRS has noted that any exception to this current system would require Congress to change the Controlled Substances Act or the I.R.C..

Nellen stresses the importance of not only being able to determine the issues of the business and what steps may need to be taken to preserve the proper return, but also the potential ethical risk marijuana poses to a CPA or other tax practitioners. While the federal treatment of marijuana remains murky and subject to change as the political whims or administrations themselves change, practitioners are taking on additional risk by potentially violating rules of conduct. However, as Nellen notes, amending I.R.C. § 280E may not be enough. To truly rid the situation of risk and uncertainty, the *Controlled Substances Act* should also be amended.

⁵⁰ C.C.A. 2015-04-011, accessed January 23, 2015.

⁵¹ AICPA, "Measuring the Taxable Income of a Marijuana Business," February 12, 2015, AICPA Store website, http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2015/Tax/taxable-income-of-a-marijuana-business.jsp#.VONkOzfl7MM.email, accessed February 19, 2015.

The *Comprehensive Drug Abuse Prevention and Control Act* of 1970, otherwise known as the Controlled Substances Act or the CSA, created a way to discourage the “unlawful manufacture, distribution, and abuse of dangerous drugs.”⁵² Additionally, each drug or substance was assigned to one of five potential schedules of severity. Marijuana was labeled as a Schedule I Drug. Federal law does not distinguish between income produced from legal versus illegal means, and the Sixteenth Amendment allows the federal government to tax all income for whatever source derived.

Focus of CCA 2015-04-011

While CCA 2015-04-011 is clear to specify that the advice it contains is “not to be used or cited as precedent,” it nonetheless highlights the areas pertaining to taxation of marijuana businesses that the IRS is most likely to find important as well as providing some unofficial guidance to marijuana businesses. CCA 2015-04-011 itself covers two main issues:

1. How to use I.R.C. § 280E of the I.R.C. to determine Cost of Goods Sold (COGS) when a taxpayer’s business is trafficking in a “Schedule I or II controlled substance,” and
2. Whether taxpayer examinations or appeals will result in a change in inventory methods when the taxpayer is currently deducting inventoriable costs from their gross income?⁵³

COGS should always be deductible from income under the theory that it is impossible to have a gain or income until the recovery of the economic investment made in the item that has been sold. CCA 2015-04-011 calculates COGS as the amount of beginning inventory plus the amount expended to produce/purchase current year goods minus the amount of ending inventory. COGS is also affected by inventory costing methods such as Last-In-First-Out (LIFO) or First-In-First-Out (FIFO). These inventory methods are necessary in order to determine what the

⁵²*Ibid.*

⁵³C.C.A. 2015-04-011, accessed January 23, 2015.

COGS actually are for a specific set of goods used because the prices of goods are always changing, regardless of the industry.

Additionally, the Commissioner has the authority to require a change in accounting methods whenever the method currently being used does not clearly reflect income. I.R.C. § 446(b) allows this change at the discretion of the Commissioner, with the exception of cases where the ruling is seen as clearly unlawful. Once it has been established that a change in method should be made, such changes will result in the inclusion of a form 3115 “Application for Change in Accounting Method” in the return for the year of the change. The resulting adjustment is an I.R.C. § 481(a) adjustment, simply representing the change between the old and new methods. This adjustment can result in positive or negative income from the change of methods.

Analysis of CCA Issues: Issue 1

In order to solve Issue 1, CCA considered when a product becomes an inventoriable costs, what Congress intended with regards to the meaning of said costs, and if Congress’ intended definition changed with I.R.C. § 263A. In order to be a deductible expense, the expense must be ordinary and necessary as defined by I.R.C. § 162 and must satisfy certain timing requirements described in I.R.C. § 471.⁵⁴ These requirements arise when the use of inventories is necessary to determine income. In this situation, inventory should be taken in the best accounting practice for the business that most clearly reflects income. Once these stipulations are satisfied, the expense is deducted in the current taxable year, providing another provision or regulation does not impede this process.

I.R.C. § 263A defines more types of inventoriable costs than I.R.C. § 471, but it did not “revolutionize inventory costing.” Retailers and producers both have an obligation to capitalize

⁵⁴I.R.C. § 471.

(at least portions) of their service costs- essentially treating some deductions as inventoriable costs.

It is important to remember that I.R.C. § 263A is a timing position; it cannot change an expense from deductible to nondeductible. I.R.C. § 263A(a)(2) states: “Any cost which (but for this sub§) 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.”⁵⁵ Together, I.R.C. §§ 280E and 263A(a)(2) prevent taxpayers that are trafficking in a Schedule 1 substance from obtaining a possible tax benefit through capitalizing any disallowed deductions. CCA 2015-04-011 stresses that the history of I.R.C. § 263A does not suggest that it was meant to help the taxpayers capitalize disallowed deductions. Therefore, the final Memorandum conclusion is that a federally illegal marijuana business is “entitled to determine inventoriable costs using the applicable inventory-costing regulations under I.R.C. § 471 as they existed when I.R.C. § 280E was enacted.”⁵⁶

Analysis of CCA Issues: Issue 2

The second issue addressed in the CCA 2015-04-011 is that of inventory methods. Specifically, whether or not a Schedule 1 trafficker (such as marijuana dispensaries) is required to change accounting methods for better or for worse due to the effect of some of the previously discussed §§ of the I.R.C.. The problem is, for example, a cash basis taxpayer’s income as affected by I.R.C. § 280E. Normally, a cash method is acceptable; however, when the deductions for gross income are disallowed by I.R.C. § 280E, the taxable income is significantly higher which results in an inability to accurately reflect income.

The IRS Examination and Appeals Division has authority through I.R.C. § 446(b) to require accounting method changes, regardless of whether it results in a positive or negative

⁵⁵I.R.C. § 263A(a)(2).

⁵⁶C.C.A. 2015-04-011, accessed January 23, 2015.

adjustment. The section states: “If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”⁵⁷ Therefore, accounting method changes are required when the current inventory method is not accurately reflecting income. This continues to hold true with the exception of small taxpayers using the modified cash method and farmers. In that situation, they are able to deduct production expenses, but are not allowed to deduct expenses attributable to general business activities or marketing activities.

IRSAC Advice

CPAs are bound by an ethical code and could potentially be risking their careers and their licenses to associate and provide services to state legal marijuana businesses. However, marijuana businesses need tax advice and return preparation just as much as any other retail business. The CPAs that will be asked to supply these services need assurance that their professional lives are not at stake. The Internal Revenue Service Advisory Council (IRSAC)⁵⁸ addressed this issue in their 2014 Public Report.⁵⁹ IRSAC members urged for clarification regarding the recent development of state legalization of marijuana. They believe that either I.R.C. § 280E or the referenced controlled substances schedules should be clarified. Additionally, they recommend published guidance clarifying that tax professionals will not be considered “in violation of Treasury Circular 230” due solely to the fact that they are representing or preparing returns for Federally illegal but state legal marijuana businesses.

⁵⁷I.R.C. § 466(b).

⁵⁸IRSAC is the successor of the Commissioners Advisory Group. They serve in an advisory capacity to the Commissioner of the IRS.

⁵⁹IRS, "Internal Revenue Service Advisory Council 2014 Public Report," IRS website, http://www.americanbar.org/content/dam/aba/publishing/tax_lawyer/ttlstyle.authcheckdam.pdf, accessed March 8, 2015.

SECTION 5: QUESTIONS TO BE RESOLVED

From the previous discussion, it is apparent that there are many unanswered questions regarding the future of marijuana business in the U.S. This paper has unearthed a variety of questions, which are summarized below. The problems will be defined with possible solutions as well as possible problems within the solutions themselves.

- Federally insured banks are unable to associate with businesses dealing with marijuana. This is a problem because not only are banks being denied customers in tough economic times, but the marijuana industry is forced to be cash-basis only; this makes it more difficult to tax and police. To solve this problem banks could be specifically instructed to make an exception regarding state-legal marijuana businesses. However, one main issue with this solution is that it would give a tremendous amount of power to financial institutions or face insurmountable additional spending to further regulate the banking industry.
- State-legal marijuana businesses are not allowed to file for bankruptcy and have a reasonable chance of success of receiving assistance. This increases the likelihood that a marijuana business will permanently fail, thereby making them even riskier than they already are. This is another problem that could be solved by legalization or a specific exception within the Federal Bankruptcy Code. Although this seems to be a simple solution, one could argue that a business is a questionable industry such as marijuana sales should not be able to count on government assistance to stay afloat.
- Is there a way that a potentially legal marijuana business could plan for increased taxes, or avoid this federal problem altogether? As detailed earlier, these businesses could organize as an I.R.C. § 501(c)(4) social welfare organization. However, this solution is only questionably legal and presents the same types of problems as earlier situations: that is, asking the federal government to provide assistance or tax breaks to an illegal business. While the federal government has been clear that they do not intend to prosecute the state-legal dispensaries, they are still against marijuana usage. This policy is, at best, a loose interpretation of the I.R.C..
- Will CPAs be putting their professional careers in danger to assist marijuana organizations? If a marijuana business is not able to have access to these services, it has no chance of thriving. This is particularly true considering the harsher than average taxes they are likely to face. Short of legalization on a federal level, CPAs can only be certain of immunity after an official ruling on the matter has been issued. However, any official guidance on ethical standards for CPAs in favor of association is just another step towards acceptance and subsequent legalization.

- There are any number of potential problems arising from the current conflict between state and federal rights and laws. Although the federal government is ultimately imbued with the power to decide the fate of marijuana legalization, there is the larger question of should they be allowed to tell individual states what products are, or are not, allowed for residents to purchase and consume? Or, should this be a matter for each individual state to decide much like the way alcohol laws change from state to state, county to county?
- The marijuana legalization issue is on shaky ground. At the heart of the American political system is a belief that leadership should periodically be questioned and subsequently changed. As President Obama's second term draws to a close, a new administration will inevitably take over with any number of political opinions with regards to marijuana legalization. This provides an unsteady business climate of which there is no solution other than legalization of marijuana or strict enforcement of the current federal laws, thereby stopping medical and recreational marijuana even on a state level. While there would undoubtedly be problems (at the very least time and intense political effort), this is most certainly a problem worth addressing.

CONCLUSION

Regardless of whether a person is for or against legalization, there is a clearly a developing issue regarding marijuana use in the U.S. This is a problem that can no longer be ignored by law enforcement agencies, Congress, and the IRS. Whether or not marijuana becomes legal federally is not for this paper to decide. This paper has given its reader the ability to make an informed decision on the issues of taxation and general business practices. This paper provides some facts from all perspectives on the issue, but does not propose making any final developments. These developments will ultimately come from new cases, time, change in the federal laws, including the I.R.C. As the future remains unknown, these decisions and developments are unknown in the present.

References

11 U.S.C. §1112(b).

11 U.S.C. §1129(a)(3).

AICPA, "Measuring the Taxable Income of a Marijuana Business," February 12, 2015, AICPA Store website, http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2015/Tax/taxable-income-of-a-marijuana-business.jsp#.VONkOzfl7MM.email, accessed February 19, 2015.

Bloomberg, "U.S. Won't Sue to Block State Marijuana Legalization," August 30, 2013, Bloomberg website, <http://www.bloomberg.com/news/articles/2013-08-29/u-s-won-t-sue-to-block-state-marijuana-legalization>, accessed September 26, 2013.

Californians Helping to Alleviate Medical Problems., Inc. v. Comm., 128 T.C. 173 (2007).
C.C.A. 2015-04-011, accessed January 23, 2015.

Cnossen, Sijbren, "Theory and Practice of Excise Taxation: Smoking, Drinking, Gambling, Polluting, and Driving," American Economic Association, October 2005, JSTOR, accessed on March 9, 2015.

Colorado Department of Revenue, "Excise Tax on Retail Marijuana," April 2014, Colorado Department of Revenue website, <https://www.colorado.gov/pacific/sites/default/files/Excise23.pdf>, accessed March 9, 2015.

FinCEN, "BSA Expectations Regarding Marijuana-Related Businesses," February 14, 2014, FinCEN website, http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-G001.pdf, accessed February 19, 2015.

Hackney, Phillip T, "A Response to Professor Leff 's Tax Planning "Olive Branch" for Marijuana Dealers," *Louisiana State University Law Center*, accessed February 16, 2014, accessed January 20, 2015.

I.R.C. §162.

I.R.C. §263A(a)(2).

I.R.C. §280E.

I.R.C. §466(b).

I.R.C. §471.

I.R.C. §501 (c)(3).

I.R.C. §501 (c)(4)(A).

IRS, "Excise Tax," January 22, 2015, IRS website, <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Excise-Tax>, accessed March 9, 2015.

IRS, "Internal Revenue Service Advisory Council 2014 Public Report," IRS website, http://www.americanbar.org/content/dam/aba/publishing/tax_lawyer/ttlstyle.authcheckdam.pdf, accessed March 8, 2015.

Jeffrey Edmondson v. Commissioner, 42 T.C., 623, 1981.

Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982," United States Senate, 97th Congress, *S. REP. NO. 97-494* (Vol. I), at 309 (1982).

Leff, Benjamin M, "Tax Planning for Marijuana Dealers," *Iowa Law Review* 99.523 (n.d.): 523-69. University of Iowa, accessed 14 Sept. 2014.

Martin Olive v. Comm., 139 T.C. 19 (2012).

Tax Reform Act, 1986, Pub. L. No. 99-514.

Vivian Cheng, "Medical Marijuana Dispensaries in Chapter 11 Bankruptcy," *Emory Bankruptcy Developments Journal*, 2013, available from LexisNexis Academic, accessed September 19, 2014

White House, "The Public Health Consequences of Marijuana Legalization," White House website, http://www.whitehouse.gov/sites/default/files/ondcp/issues-content/marijuana_and_public_health_one_pager_-_final.pdf, accessed February 5, 2015.