FEDERAL TAXATION OF CONTROLLED SUBSTANCES

Presented by:

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The focus of this presentation is the federal taxation of the marijuana businesses "legally operating" in Washington State. Of course the "legally operating" is only legal under State Law. That doesn't make the business any less taxable under federal law. We will be discussing those federal taxation issues in this presentation.

Let's start with an overview of the State regulations:

- It all started with the passing of the Washington State I-502 Initiative NOVEMBER 6, 2012
- Then the immediate release WSLCB November 7, 2012 (The WSLCB is now the Washington State Liquor Cannabis Board)

I-502 established a precedent for growing, producing, retailing and possessing cannabis. Following is some overview information:

- No one can be both producer-processor and retailer
- WAC 314-55-020(4)
- WAC 314-55-020(7)
- WAC 315-55-020(3)
- WAC 315-55-045
- WAC 315-55-040
- Prospective licensees were required to sign an attestation that they are current on their taxes.
- All income/bank/books and records must be maintained at the facility and are subject to examination by any state agency.

- WACC 314-55-089
- HB 2135
- HB 5052
- HB 2136
- State Tax reporting requirements
    - Producer subject to business and occupation tax/manufacturing
    - Processer subject to business and occupation tax/wholesaling
    - Retailer subject to business and occupation tax as well as excise tax and retail sales tax.
- Limited use of Independent Contractors
- For the Producer-Processor only an employee is allowed to tend the crop.
- Strict Transportation rules; and
- Traceability Software is required.

Federal Taxation of Marijuana

1. *Comprehensive Drug Abuse Prevention and Control Act of 1970 21, U.S.C. §801-971 (1970), ("Controlled Substance Act" or "CSA")*

- Congress created a regime to curtail the unlawful manufacture, distribution and abuse of dangerous drugs ("controlled substances"). Congress assigned each controlled substance to one of five lists (Schedule I through Schedule V). See §812 of the CSA.

- Schedule I includes: (a) opiates; (b) opium derivatives (e.g., heroin; morphine); and (c) hallucinogenic substances (e.g., LSD; marihuana (a/k/a ***marijuana***); mescaline; peyote)

2. The Supreme Court ruled in

United States v. Oakland Cannabis Buyers' Cooperative and Gonzales v. Raich

- that the federal government has a right to regulate and to criminalize marijuana sales and use, even when the person is residing in a state where the law permits the production, distribution, and use of it.

Taxation of federal illegal business

- Businesses that are considered illegal at the Federal level are still required to file returns and pay taxes.

- The Internal Revenue Service has made it perfectly clear that they intend to enforce 280E for Marijuana businesses.

> IRC 280 states: 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.

3. Cost Of Goods Sold

- Section 280E disallows any deduction for ordinary and necessary business expenses for illegal controlled substance businesses.

- Although the Service has issued strict guidance for enforcing 280E and disallowing ordinary and necessary business expenses, they have also stated that the will allow a deduction for the Cost of Goods Sold. (Chief Counsel Memorandum 201504011, release date 1/23/2015)

- Cost of Goods sold is not considered an expense, but rather an adjustment taken into account in arriving at gross income.

- By allowing the COGS deduction a taxpayer would be able to reduce their gross income received by certain qualified expenses and only be taxed on the gross profit.

- COGS include all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. Costs of goods made by the business include material, labor, and allocated overhead. The costs of those goods not yet sold are deferred as costs of inventory until the inventory is sold or written down in value.

- Examples of possible COGS items:

    - The cost of products or raw materials,
    - Including freight or shipping charges:
    - The cost of storing products the business sells;
    - Direct labor costs for workers who produce the products; and
    - Factory overhead expenses.

    - ***I502 PRODUCER-PROCESSOR possible COGS items***

        - Rent
        - Electricity
        - Water
        - Nutrients
        - Security
        - Insurance

- Scales
- Grinders
- Packaging Material
- Delivery Vans
- Labor
- WSLCB Excise Tax / B&O Excise Tax (Chief Counsel Memorandum 201531016 release 7/31/2015)
- Accounting Software
- Traceability Software

○ ***I502 RETAILERS – possible COGS items***

- Rent
- Electricity
- Security
- Insurance
- Delivery Vans
- Labor
- WSLCB Excise Tax / B&O Excise Tax / Sales Tax (Chief Counsel Memorandum 201531016 release 7/31/2015)
- Accounting Software
- Traceability Software

4. Gross Income Defined § 61(a)(2)

(a) General definition

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(2) Gross income derived from business;

Regulation section 1.61-3(a) provides, "gross income" means the total sales, less the cost of goods sold.

5. § 280E / Ordinary and Necessary Business Expenses

- Denies a taxpayer any deduction for any amount paid or incurred in the year in carrying on any trade or business if such trade or business consists of trafficking in controlled substances.
- The Supreme Court has consistently ruled that deductions are a matter of "legislative grace" rather than constitutional requirements.

Interstate Transit Lines v. Commissioner
Deputy v. Du Pont
New Colonial Ice Co., Inc. v. Helvering
Knight v. Commissioner

6. Full Absorption Inventory Cost Method

- A business must use an inventory method of accounting whenever "the production, purchase or sale of goods is an income producing factor." Reg. § 1.471-1

- Under an inventory method, costs related to producing, acquiring, storing, and handling goods are not currently deductible. These costs must be included in the costs of inventory and deducted when inventory is sold. § 263A ; Reg. § 1.471-3(b)

- Generally the inventory costs are added to the beginning inventory amount and reduced by the costs of inventory on hand at the end of the year to calculate costs of goods sold for the year. § 263A; Reg. § 1.471-3(b)

*7. **Uniform Capitalization Rules*** (Under Section 263A)

- UNICAP rules require more indirect costs to be allocated to inventory than the full absorption rules require under § 471.

- The UNICAP rules require a producer of inventory to include in the cost of its inventory:

  The direct costs of such property and such property's proper share of those indirect costs, part or all of which is allocable to such property. § 263A(a)(2); Reg § 1.263A-1,3.

- Under UNICAP direct costs include direct material costs and direct labor costs. Reg. § 1.263A-a(e)(2)(i).

Additional information

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MARTIN OLIVE v. COMMISSIONER

- Section 280E: A taxpayer may not deduct any amount for a trade or business where the trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances…
- COGS is not a deduction within the meaning of sec 162(a) but is subtracted from gross receipts in determining a taxpayer's gross income.
- ***Max Sobel Wholesale Liquors v. Commissioner***, 69 T.C. 477 (1977), aff'd, 630 F.2d 670 (9^{th} Cir. 1980); sec. 1.162-1(a), Income Tax Regs.
- Substantiation rules require a taxpayer to maintain sufficient reliable records to allow the Commissioner to verify the taxpayer's income and expenditures.

There isn't enough case law to cover all the circumstances you may come across when serving the tax needs of your Cannabis clients. So do your best due diligence, make good sound judgments based on the information that is available to you and include full disclosure when you file the tax returns.

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