

ETHICAL AND TAX CONSIDERATIONS FOR PROFESSIONALS ADVISING MARIJUANA BUSINESSES

I. Federal Conduct Standards

A. Internal Revenue Code (IRC”) Return Preparer Standards – IRC § 6694

1. Disclosed Position – Reasonable Basis
2. Undisclosed Position – Substantial Authority
3. Tax Shelter – More Likely Than Not
4. Who is a “return preparer”? See Treas. Reg. § 301. 7701-15.

B. Circular 230

1. Discipline Enforced by IRS Office of Professional Responsibility
2. § 10.34 Return Preparer Standards
 - a. Largely parallel to IRC § 6694
 - b. Referrals of § 6694 penalty cases
 - c. Generally looking for a pattern of conduct, not foot faults
 - d. Status uncertain in light of decisions in *Loving v. IRS*, 742 F.3d

1013 (D.C. Cir. 2014) (Treasury Department has no statutory authority to regulate return preparers) and *Ridgely v. Lew*, 55 F. Supp. 3d 89 (D.D.C. 2014) (following *Loving*, Treasury Department has no authority to regulate (prohibit) CPA’s charging contingent fee for preparation of basic refund claim).

3. § 10.35 – Competence – similar to Model Rule
4. § 10.37 – Written Advice
 - a. Process Rule
 - b. No Accuracy Standard
 - c. No Rule for Oral Advice – IRS authority unclear; see Circular 230,

§ 10.2(a)(4).

II. Advice

A. In General

1. A professional may advise and assist a client regarding compliance with California’s marijuana laws. This may include advice with respect to forming a medical marijuana dispensary and related matters permitted by California law. However, the professional

must explain that federal law prohibits trafficking in marijuana or marijuana products and explain the potential penalties that may be imposed on the client for violation of the federal law. The professional should make it clear that he or she is not advising the client to violate federal law. See L.A. County Bar Ass'n Ethics Op. 527 (2015); San Francisco Bar Ass'n Ethics Op. 2015-1. The latter opinion includes a summary of ethics opinions from other states and related materials. Some of the opinions from the Model Rules of Professional Conduct for Attorneys states do not agree that a professional may advise the client as stated above.

2. Congressional Non-Enforcement Mandate – Advice to a client should be sufficient to allow the client to make informed decisions. See Model Rule 1.4(b). Accordingly, a professional advising a client regarding a medical marijuana dispensary or related matters permitted under California law should explain the then current enforcement status of the Federal law prohibiting trafficking in marijuana. This should include an explanation of the twice-enacted mandate that the Justice Department not expend funds to prevent enumerated states, including California, from implementing their own State laws with respect to medical marijuana, the likelihood that the mandate will be extended again, and a warning that if not extended, the Justice Department can be expected to initiate enforcement measures again.

3. Justice Department Priorities - The professional must also explain that the Justice Department enforcement policy is focused on eight priorities (the “8 Deadly Sins”) and that it intends to rely on state enforcement in other areas. This approach appears to apply to recreational marijuana businesses subject to a state regulatory system as well as to state-regulated medical marijuana businesses.

4. The “8 Deadly Sins” are:
- a. Preventing the distribution of marijuana to minors;
 - b. Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
 - c. Preventing the diversion of marijuana from states where it is legal under state law in some form from going to other states;
 - d. Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
 - e. Preventing violence and the use of firearms in the cultivation and use of marijuana;

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

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

h. Preventing marijuana possession or use on federal property.

5. If a professional knows or should know that a client's intended actions are likely to make the client a target of federal enforcement in one or more of the priority areas, the professional should not take on the representation or should terminate the representation, if possible. The professional may also consider persuading the client to revise the client's plan of action to avoid triggering any of the federal enforcement priorities. However, this may be regarded as advising the client to engage in criminal activity.

6. Regardless of whether federal enforcement priorities are involved, the professional should advise the client that because trafficking in marijuana is illegal under federal law, the federal government may at any time change its enforcement priorities or take action against anyone who is trafficking in marijuana despite the stated enforcement priorities. The professional should explain the penalties to which the client may be subject, including criminal liability and the seizure of property. The professional for his or her own protection would be wise to require the client to acknowledge having been informed of this risk in a signed and dated writing.

7. The bottom line is that the effect of the Congressional mandate not to use funds to enforce the illegal drug trafficking statute against medical marijuana businesses operating under a state regulatory regime of a listed state has the effect of nullifying the law in such cases during term of the mandate. The Justice Department enforcement priorities have no legal effect, although providing information on the priorities to a client is important to the client's decision-making process.

TAX CONSIDERATIONS FOR PROFESSIONALS ADVISING MARIJUANA BUSINESS

I. Introduction

A. The Big Picture

1. See *U.S. v. Marin Alliance for Medical Marijuana* (“MAMM”), 2015 WL 6123062 (N.D. Cal.), holding that, as long as Congress precludes Justice Department from expending funds as specified in statute, permanent injunction against MAMM “will only be enforced against MAMM insofar as that organization is in violation of California ‘State laws that authorize the use, distribution, possession, or cultivation of medical marijuana.’”

2. Cash Deposit Penalty – Employers must make deposits of employment taxes electronically. Failure to do so results in imposition of a penalty. Since marijuana businesses do not have ready access to banking services, they often need to make deposits in cash. Allgreens, a Colorado marijuana dispensary, challenged the penalty in a filing in the Tax Court. It has been reported that the IRS settled the case by agreeing to abate the penalty. Will the principle of the Allgreens settlement apply to other taxpayers?

3. Internal Revenue Code (“IRC”) § 280E – Which items can be deducted in some way for federal income tax purposes?

II. Substantive Federal Tax Law – Statutes and Regulations

A. Business Expenses – Ordinary and necessary expenses “paid or incurred in the taxable year in carrying on any trade or business” are generally deductible under IRC § 162(a).

B. Expenditures in Connection with the Illegal Sale of Drugs – IRC § 280E denies a deduction for “any amount paid or incurred during the taxable year in carrying on any trade or business” if the trade or business consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act (“CSA”)) which is prohibited by Federal law. Marijuana has been a Schedule I substance for many years.

C. Cost of Goods Sold (“COGS”) - The legislative history of § 280E indicates that the provision did not disallow offsetting gross receipts from sales of a controlled substance by the cost of goods sold. Thus, to the extent expenses not otherwise deductible because of § 280E can be properly capitalized into inventory costs, they may ultimately be taken into account for federal income tax purposes as part of the COGS.

D. Applicable Inventory-Costing Regulations – The Internal Revenue Service (“IRS”) has concluded that a taxpayer subject to § 280E may determine inventoriable costs using the applicable inventory-costing regulations under § 471 as they existed when § 280E was enacted. This position was explained in an internal memorandum (201504011), released on Jan. 23, 2015, which basically holds that the newer Regulations based on § 263A, which calls for capitalization of additional categories of costs into inventory costs, cannot be applied by traffickers in controlled substances. The IRS position on this issue appears to be supported by the legislative history of § 263A.

E. Depreciation? – The express language of § 280E does not generally lend itself to denying a deduction for depreciation of property used in carrying on a trade or business, since depreciation is not an “amount paid or incurred during the taxable year,” except in the case of the depreciation allowable for the year of purchasing the item being depreciated. It is possible that Congress would have expressly included depreciation and other analogous deductions in the § 280E disallowance rule if the matter had been brought to the attention of a relevant Committee member or staff member. Nonetheless, there is an argument that the language of the statute does not apply to depreciation. This argument may satisfy the “reasonable basis” standard, but it is not supported by “substantial authority”.

F. Advice about Federal Tax Law

1. Income from an illegal business is subject to tax. Providing advice on complying with the income tax law is clearly permitted.

2. Planning

a. The principal planning issue in federal tax law is to limit the impact of IRC § 280E.

i. Allocation of Business Expenses and Income – Ordinary and necessary business expenses allocable to a legal business other than marijuana growth, use, distribution, possession or sale should be deductible under the usual rules. If both the marijuana business and the other business are conducted together, however, proving which expenses are allocable to the non-marijuana business may be difficult. The IRS and the courts will resolve any uncertainty against the taxpayer. Detailed records should be maintained.

ii. Compare *Olive v. Comm’r*, 792 F.3d 1146 (9th Cir. 2015) (where only income-generating activity was sale of medical marijuana, § 280E disallowed all

business expense deductions despite the fact that patrons were also provided other services at no cost; provision of other services was not an income-generating business) with *Californians Helping to Alleviate Medical Problems, Inc. v. Comm’r*, 128 T.C. 173 (2007) (taxpayer involved in both caretaking and counseling business and sale of medical marijuana allowed to deduct expenses allocated to caretaking and counseling business, which Tax Court had found was taxpayer’s primary purpose; allocation made by the Tax Court based on taxpayer’s detailed records).

iii. Use of Separate Entities – Placing the marijuana business and the non-marijuana business in separate entities may be helpful in assuring that the deduction of expenses allocable to the non-marijuana business is not disallowed in whole or in part. Nonetheless, since the IRS has the authority to reallocate items between related taxpayers, careful records of expenses should still be kept and the allocation of expenses should have economic substance.

b. Items that may be capitalized into inventory under the inventory cost regulations under IRC § 471 in effect when § 280E was enacted should be capitalized, and thus recoverable as part of the cost of goods sold.

c. Use of Partnership – It may be possible to structure a marijuana business as a partnership, so that in lieu of compensation, all partners simply received shares of partnership income, deductions and other items.

3. Other

a. Nontrade or business items - Some other items may be deductible despite § 280E, such as taxes that would be deductible without regard to being an expense of carrying on a trade or business, See IRC § 164(a).

b. Losses - See *James R. Beck v. Comm’r*, T.C. Memo. 2015-149, disallowing deduction for value of seized marijuana for lack of substantiation and because the deduction under § 165 is not allowed under § 280E, citing *Holt v. Comm’r*, 69 T.C. 75 (1977), which relied on the fact that allowing the deduction would be contrary to public policy, rather than on § 280E. It is unclear whether § 280E would disallow a deduction of losses of items other than contraband.

c. Depreciation. As noted previously, it is unclear whether depreciation and similar items are covered by the language of § 280E. Some depreciation may be an inventory cost.