



## **Managing Audits**

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## Overview

- General Principles – More than IRC Sec. 280E
- Compliance – Strike a Balance
- IRS Audits
  - Field Observations
  - Challenging IRC Sec. 280E – Alpenglow Botanicals, LLC
- Representing the Cannabis Enterprise
  - Conflicts/Attorney Client Privilege
  - The “Eggshell” Audit



## General Principles – Best Practices

- Applicable to Regulatory Audits and Beyond
  - State Regulators (e.g., Bureau of Cannabis Control, WLCB)
  - Sales Tax
  - L&I and Payroll Tax
  - Cash Reporting
  - State and Federal Income Tax
  - Due Diligence
- Set up processes at the beginning. Periodically, self-audit.



## Substantiation – What is Enough?

- **Baseline** : What is required by State Cannabis Regulators? (e.g., WAC 314-55-087).
- **Third Party Substantiation**
  - Bank Records ( Problem Number One).
  - Point of Sale/Seed-to-Sale Systems.
  - IRS use of Third Party Summons.



## Substantiation – What is Enough?

- Written Policies (e.g., cash management)
- Automation (Process Integrity)
- *Alterman v. C.I.R.*, T.C. Memo. 2018 - 83
  - Not Binding – Court performs detailed analysis of records. Held: Taxpayer failed to substantiate COGS; Court imposes 20% penalty for negligence.



## IRS Audits – Field Observations

- IRS follows the Audit Techniques Guide for Cash Intensive Business (Rev. April, 2010)
- Audit scope includes individual returns of owners
  - Could lead to Client Conflict issues
- Aggressive sampling of transactions
- Less willing to apply Cohan rule
- Scoping out payroll tax and reporting issues



## IRS Audits – Field Observations

- IRC 280E workpapers – segregate planning computations from tax return workpapers.
- Tour of Business and Interviews
- Scrutiny of Holding Companies
- Installment Agreements – Expect a review of assets and cash.
  - What can be sold?
    - Spectrometers are used in various businesses to analyze organic material and do not constitute drug paraphernalia. IRS can sell to satisfy tax liability. CCA: 2018042616201420 ( Released May 18, 2018)



## IRS Audits – Challenging IRC Sec. 280E

- Alternative to Substantiation is Direct Challenge of IRC Sec. 280E
  - File Form 8275-R or refund claim.
- *Alpenglow Botanicals, LLC v. U.S.A.*, No. 17-1223 (10<sup>th</sup> Cir. 2018)
  - Court denies medical marijuana business a refund of tax paid because the IRS acted within their authority to deny deductions under IRC Sec. 280E.
  - Held: The IRS has the authority to determine if taxpayer engaged in trafficking for purposes of applying IRC Sec. 280E. A prior criminal conviction is not required before the IRS applies IRC 280E.
  - Held: IRC Sec. 280E does not violate either the 8<sup>th</sup> or 16<sup>th</sup> Amendments to the U.S. Constitution.
- IRS winning most cases in the area.





## Representing the Cannabis Enterprise

- The “Eggshell Audit” – What Is it?
  - A civil audit moves toward a Criminal Investigation.
  - A risk where parties have participated in the Medical Marijuana market.
  - A risk if the audit focus’ disproportionality on the movement of funds.
  - Holding Company for banking purposes.
- Signs
  - Radio Silence from the agent.
  - Push for interview.
  - Focus on taxpayer intent.
  - Focus on history of taxpayer.



## Representing the Cannabis Enterprise

- The IRS can not conduct a CI under the guise of a civil exam. *United States v. Tweel*, 550 F. 2d 297 (5<sup>th</sup> Cir. 1977).
- When asked if a CI is being developed, the IRS may:
  - Decline to respond;
  - Advise that when elements of a fraud are discovered, a referral to CI is required.
  - See IRM 25.1.3.2.
- In the past, the IRS has used the Cole Memo to assure taxpayers that the audit is not a criminal investigation. See *Feinberg v. Comm.*, 808 F.3d. 813 (Cir. 10<sup>th</sup>, 2015).
- The Path forward?



## State Audits

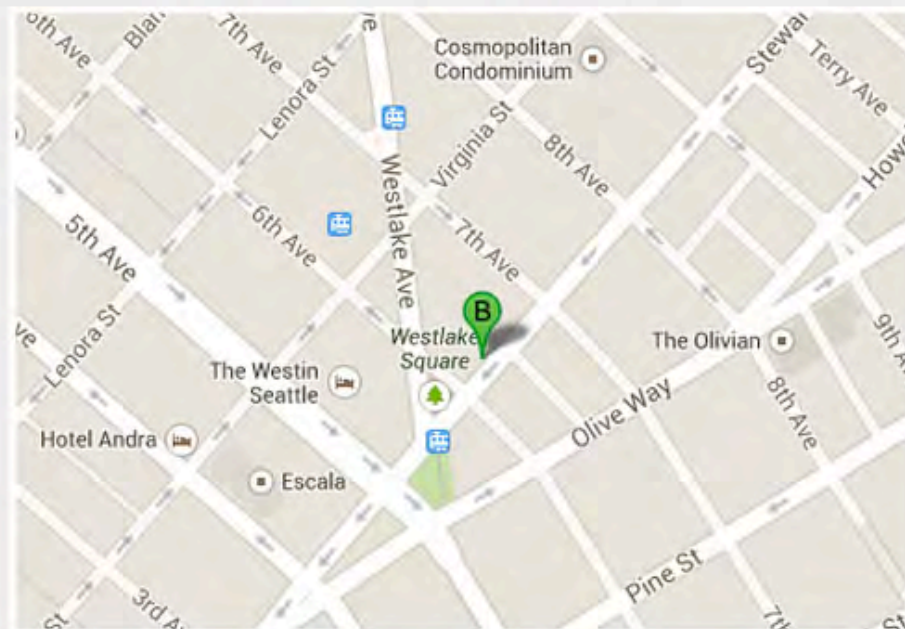
- Expect audit of sales/use taxes; personal property taxes; income taxes and cannabis excise taxes.
- A State DOR often starts with information bulletins and moves to strict enforcement.
- Audits closely aligned to seed-to-sale processes.
- Little room for settlement of “aggressive issues” (i.e., cannabis is a prescription drug exempt from sales tax).
- Non-compliance will put you out of business.
- Need integrated systems.

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