



Polston
Tax Resolution & Accounting

Starting a Cannabis Business:

Everything You
Need to Know.



Introduction

Medical marijuana first became legalized in **1996** in California due to the approval of Proposition 215. **23 years later, 33 states** along with the District of Columbia have either legalized medical marijuana or recreational marijuana. With more states moving to de-criminalizing marijuana, the role of cannabis accountants and tax preparers has grown. Owning a cannabis business can be profitable and be a great way to become a small business owner. While your business will have similarities to owning a restaurant, a clothing store, or even a vape store, it will create bigger obstacles for you than if you chose to go into a different industry.



✓ Why is it different?

Despite being legalized at a state level, the federal government has not legalized marijuana medically or recreationally. In fact, the federal government still considers marijuana to be a controlled substance and the sale of it is considered trafficking. The federal government considers marijuana a Schedule 1 drug. This creates many different obstacles and challenges for business owners. For instance, this affects your taxes as you will not be treated to the same tax deductions and tax credits as other businesses will. You also have little to no options for banking as most banks are federally insured and will not be able to take your money. You will have to stick to stricter rules and laws when it comes to tracking and inventory. Starting a cannabis business can seem next to impossible because it's very difficult to get loans or funding to apply for a license and pay for start-up costs.

So, what does this mean for you if you want to own a cannabis business?

It means it won't be easy. You will have to spend more money and time than if you were to open something like a hair salon or a tobacco store. It means you will have to have a diligent bookkeeper, practice meticulous tracking and spend time reading the tax code and tax court cases to stay up to date on current rules and how they apply to your business. If you aren't diligent or careful, you could end up getting into serious tax trouble. The IRS knows that cannabis businesses are going to be profitable and know that without the standard tax deductions, they will be taxed at an extremely high rate. Cannabis businesses on average pay an effective tax rate of up to **90% compared to the rate of around 30%** paid by other businesses. That's a lot of cash and the IRS is not going to let cannabis companies pay anything less. As a cannabis business, it's not a matter of **if** you get audited, but a matter of **when** you will get audited.



If you want to own a cannabis business, you need to decide if you're going to be able to run the business, track the inventory, run the books, pay the taxes and file your tax return. It can feel impossible to accomplish all those tasks, especially if you don't have a lot of employees to help you. That's why it's important to ask for help. Business owners in every industry realize that sometimes it's best to stick to what you do best and hire help for the rest. If crunching numbers and filling out reports isn't something you like, it's in

your best interest to hire an accountant that knows how to do it correctly. The financial side of your business should never take the backseat. Not paying your taxes or not filing quarterly reports can put you in a tough predicament with the IRS or your state's tax agency. It's better to hire someone from the beginning to get you started on the right foot rather than trying to get someone to come in after the fact and clean up the mess. It will not only save you money, but it can save you time and stress. Especially as a cannabis business owner, it's important that you make sure your books and your taxes are done correctly from the very beginning as the IRS is going to be taking a close look at your financials to see if you're paying the correct amount.



When looking for an accountant or tax preparer, make sure this person is knowledgeable – and not just in typical tax and accounting. You want someone who not only knows how to run the accounting for your business but knows the specific laws and regulations that are placed on cannabis businesses. They should be keeping up with all the tax court decisions that are being handed down concerning cannabis businesses as it will directly affect your business. They need to be meticulous with your records and should be asking you questions frequently to make sure everything is correct.



Owning a cannabis business can be a rewarding experience and could also allow you to make a decent living wage. It can also lead you into financial trouble, however, if you're not careful. Make sure to think over all the aspects of the business and decide if and where you need help. If you're not familiar with accounting, then it's important to get someone who is trained and knowledgeable about Cost GAAP accounting.



What does 280e mean for my business?

If you're opening a cannabis business or even thinking about opening one, chances are you have heard about 280E. 280E is a small section of tax code that has a drastic effect on cannabis businesses. While it may just be a small part among pages and pages of tax code, this sentence is why cannabis businesses will be paying a much higher tax rate than any other business. Before you do anything financially with your cannabis business, it's important that you understand what 280E means and its effect on your business.

Section 280E in the U.S. tax code is the federal statute that states that "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." This means if your business engages in the trafficking of a Schedule 1 or 2 controlled substance, you are barred from taking any necessary and ordinary tax deductions or tax credits. Cannabis is currently considered a Schedule 1 controlled substance by the government. That means cannabis businesses must pay taxes on all their revenue without the benefit of being able to use business expenses to reduce their taxable income. While something like a hair salon can deduct their rent, labor, payroll, and other expenses, cannabis companies can only deduct the cost of goods sold. While other businesses will be paying an average effective tax rate of around 30%, cannabis companies could be paying a tax rate as high as 90%.

✔ Cost of Goods Sold

When passing the 280E legislation, Congress feared constitutional challenges to the law and so it added an exclusion that allowed a deduction for the cost of goods sold, even when the goods are considered illegal under federal law. The cost of goods sold covers basically inventory costs. This includes the cost of the product, the cost to ship it in and any directly related expenses.

What we have seen in other states is that cannabis companies have tried to use the cost of goods sold deduction to try and save money on their taxes. Unfortunately, the IRS is applying the definition of cost of goods sold very narrowly to cannabis companies. They are going to make sure that they are getting as much money as possible from cannabis companies. For example, the IRS is not allowing the use of tax changes made by the Tax Cuts and Jobs Act that would allow more indirect costs to be included in the costs of goods sold because those changes were made after Section 280E went into effect. This will affect the type of accounting methods cannabis companies will be able to use.



There is currently very little guidance by the IRS on what all can be included in the cost of goods sold. A lot of decisions being handed down by the Tax Court have slowly shaped what can be included and what can't be included. For instance, we

know that the following are included:

- ✱ The cost of the product or raw materials, including freight
- ✱ The cost of the storage of the product
- ✱ The direct labor costs for workers who produce the products
- ✱ Factory Overhead

Now depending on if you're a cultivator, processor or dispensary, you may be able to get other costs included in the cost of goods sold if you can tie it directly to the growth of the product. If you're a dispensary, typically your cost of goods sold will usually be the amount you paid for the product, plus the costs that are necessary to acquire the inventory. Costs that are necessary to acquire your inventory can include things like freight charges and other costs to ship the product. If you're a grower, your inventory costs would be things like the cost of the raw materials, the direct labor costs and the indirect production costs. Processors and dispensaries will also need to include in their cost of goods sold indirect service costs such as purchasing, handling, security, warehousing and cost accounting costs.

The cost of goods sold and 280E has been a large point of contention for cannabis businesses and the IRS as several cases have come before the U.S. Tax Court regarding the deduction of the cost of goods sold.

✔ **Alterman v. Commissioner**

Lauren Alterman formed a medical marijuana dispensary named Altermeds LLC. Altermeds was strictly just a retail operation. It grew none of the marijuana it sold to its customers. Along with selling pre-rolled joints, dried buds, and edibles, Altermeds also sold products that didn't contain marijuana like pipes, papers, and other products that are used to consume marijuana. After a Colorado law required marijuana facilities to grow at least 70% of the marijuana it sold, Altermeds began producing its own inventory while also purchasing some products from a third party. Altermeds was audited for two different tax years. Altermeds had claimed a deduction G&A expenses along with the cost of goods sold. The IRS denied all the G&A expenses except for the depreciation deductions, enforcing Section 280E. In addition, the IRS reduced the company's cost of goods sold deduction by thousands of dollars. This resulted in an underpayment of over \$150,000 in taxes. The IRS also tacked on penalties and interest to the tax debt.

Altermeds appealed the IRS's findings arguing that Altermeds sold other non-marijuana products that constituted a second business that was not subject to Section 280E. While that argument had worked in *CHAMP v Commissioner*, the Tax Court did not accept Altermed's argument. Firstly, Altermeds sales of non-marijuana merchandise were less than 4% of their revenue. Due to the low amount of sales, the Tax Court concluded that the sale of the non-marijuana merchandise was not a separate business, it was just something that complemented its efforts to sell marijuana.



A second problem was that Altermeds had horrible bookkeeping. Even if the Tax Court had ruled in their favor regarding the two separate businesses, no deductions attributable to the non-marijuana business would have been allowable as Altermeds did not substantiate the expenses attributable to the business line. Altermeds had just taken a percentage of the total G&A expenses and said it was attributed to the sale of non-marijuana merchandise. The Tax Court did not accept this either. The court instead ruled all the G&A expenses -- aside from a small amount of depreciation -- were attributable to Altermed's sole business of trafficking in a controlled substance and were nondeductible under Section 280E. Not only did Altermeds not separate the marijuana and the non-marijuana businesses, but it didn't run its books accordingly and attribute each expense to the correct business.

When the tax court denied their separate business argument, Altermeds tried arguing that it had understated its deductible cost of goods sold by over \$150,000 for both years. The problem with their argument was that their bookkeeping was not efficient and hard to define. As a simple formula for determining the cost of goods, you can take your beginning inventory and add in any purchases of inventory and your production costs and subtract your ending inventory. With Altermeds, they had reported less than \$13,000 and \$0 in ending inventory for the two years they were audited. The Tax Court did not believe that Altermeds had been cleaned out of all and any inventory at the end of the year. Because of that, the Tax Court said Altermeds had improperly deducted every dollar for cannabis, both that they purchased and produced in their cost of goods sold, even if they still had that marijuana in their store. Altermeds did not keep a detailed inventory count which led the court to not believe its calculation for the cost of goods sold. Altermeds tried to argue that the court should take a percentage of its total revenue as its supportable cost of goods sold as it had done in other cases. The court declined.

This is why your business structure and bookkeeping are so critical. We will cover bookkeeping tips and accounting in the next chapter, but it's cases like these that really highlight the need for good bookkeeping as it could be what saves you thousands of dollars in the end. Another thing to remember is that when your business deals with cannabis, you can deduct your cost of goods sold, but you cannot deduct your G&A expenses. We will also take a look at the different tax court case rulings that have been handed down this year and what it means for cannabis businesses.



✔ Section 280E and Section 263A

Before the passing of Section 263A to the U.S. tax code, taxpayers would determine their cost of goods sold by using Section 471. This meant growers or producers could capitalize on direct material costs like seeds or physical plants, direct labor costs like planting, harvesting or cultivating. If you were a dispensary you could deduct the price of the marijuana purchased along with the costs of acquiring marijuana, like shipping, transportation, and other necessary expenses. Congress added Section 263A in 1986 which increased the types of costs that are included in inventory costs. Section 263A has taxpayers include indirect costs in their cost of goods. This can allow businesses to decrease the amount of income that is taxed by the IRS. Unfortunately, the IRS ruled that Section 263A does not apply to cannabis companies as cannabis businesses are trafficking a controlled substance. They stated that a taxpayer in the marijuana industry could not use the provisions of Section 263A because those G&A expenses the taxpayer would be deducting are not deductible under Section 280E. Section 280E renders any G&A expenses nondeductible. Cannabis businesses must use Section 471 when determining it's cost of goods sold.

Section 280E will cause problems and cost money for cannabis businesses as long as cannabis is considered a controlled substance. There is no "easy fix" or easy way around it and trying to go around it could cost you more money in the end. That's why it's important to get an accountant that knows the tax law and knows what will be deductible and what won't. Having a good bookkeeper could save you and your business major dollars in the end.





✓ Accounting

One of the most important parts of running a business is practicing proper accounting. This not only helps you keep track of your profit versus your expenses, but it also helps you know how much taxes you need to pay and when you need to pay them. If you own any type of business, you want to make sure you have a knowledgeable accountant. If you own a cannabis business, this is especially important. Just as we discussed in Chapter 2, complex tax implications for cannabis businesses make it especially important that you're doing your accounting correctly.

Because cannabis is still a relatively new industry, rules are changing constantly and how the tax law is applied is evolving. This means either you or someone you trust must stay on top of the new changes and apply them to your business. Not knowing is not an acceptable excuse in Tax Court.

As a cannabis business, everything you do financially matters. First, because you don't have the ability to deduct most expenses, and second because you must make sure you are meeting all the requirements by the state and the federal government. Cannabis businesses have to use cost accounting when doing their internal accounting. There are **U.S. GAAP** cost accounting requirements you must meet on a regular basis. This means making sure your books are straight every month and that you have the right reports ready to meet those requirements.



The structure and entity of your business matter too. Structuring your company correctly can help you avoid unnecessary taxation as well as help you maximize your deductions. How your business is structured lays the foundation for your entire financial situation. There are pros and cons to setting up an LLC, an S-Corp or a C-Corp. It is important to know what each of those means for you financially.

The accounting software you choose even plays a role. If you don't have the right accounting software, this could mean trouble for your business. Your software needs to be able to integrate with Point of Sale systems and the Cannabis Tracking System. This will help you create and pull the necessary reports to stay compliant with the state and the federal government.

Accounting



Along with cannabis sale reports, you as a business will also need to have reports regarding employees and sales. You will need to process payroll and make sure you prepare the payroll tax return and pay the necessary payroll taxes. You will also need to prepare sales and excise tax returns and pay those on time as well. Missing those can result in penalties and interest. As a business, it is important to make quarterly estimated tax payments so you aren't left with a large tax balance at the end of the year. And although it's easy to forget, but you will have to prepare your tax return for the business each year. This is where you, unfortunately, will lose out on most business deductions under Section 280E. If you are wanting to maximize the deductions you do get, it's important to define those activities as soon as you do them so they can be appropriately allocated to 280E if they fall under the cost of goods sold. Waiting until you file your federal tax return to decide if it's subject to 280E is not a good idea.

While it might seem like a cheaper option to try doing your cannabis business's accounting on your own, in the long run, it may cost you more. Because of all the requirements and the special reports you must have as a cannabis business, it may be best to hire someone who understands all the needs and requirements that come with a cannabis business from the start. That way you can focus on the other aspects of running the business, like marketing, hiring new employees, tracking inventory or buying new products. Hiring someone who knows what they're doing can help you also avoid owing large amounts of taxes at the end of the year or having to deal with penalties and interest because you didn't file or pay on time.



What Tax Court Cases Mean

As a cannabis business, the chances of your business getting audited by the IRS is very likely. The IRS has already said that they will look closely at cannabis business and we've already seen them go after several cannabis companies. They are hiring more employees for this very reason. The IRS knows that cannabis companies will attempt to find creative ways to cut down on the taxes they'll owe. Because cannabis companies have such a high tax rate, the IRS is going to make sure they get every dollar they are due. 280E not only puts cannabis companies in a hard position tax-wise, but it also gives the IRS more power when determining taxes owed. The IRS is not letting any cannabis companies sneak by. We've already seen the tax court hand down several rulings that back the IRS's findings. Here are just a few tax court cases that have either changed the rules for cannabis businesses or reinforced them.

Californians Helping to Alleviate Medical Problems (CHAMP) v Commissioner



Let's first talk about one case that helped give more guidance to cannabis companies. CHAMP is the case cited most frequently by cannabis business owners claiming their deductions are exempt from **\$280E** and therefore are allowable. Mostly because it's been the only successful business to overcome an attack by the IRS over 280E. CHAMP had two distinct businesses, focusing primarily on counseling and caregiving services with a secondary focus on dispensing medical marijuana. The first business offered several weekly group sessions focusing on different subjects. They also offered food and hygiene products to low-income clients and allowed its members to consult with a counselor about different items including housing, health, safety, and legal issues. These are just a few of the many different services CHAMP provided to its clients. Because of this, CHAMP was able to successfully deduct ordinary and necessary business expenses (distinguished from its cost of goods) as they fell under their primary business of counseling and caregiving services. For purposes of determining the applicability of **\$280E**, the court looked to the degree of economic interrelationship between the two business undertakings. Unlike in the Alterman case we talked about in Chapter 2, CHAMP's non-cannabis activities were substantial enough that it was enough to be a standalone business and didn't need the cannabis activities to survive. The court also noted CHAMP was ***"regularly and extensively involved in the provision of caregiving services, and those services are substantially different from the petitioner's provision of medical marijuana."***



▶ Olive v Commissioner

Martin Olive is one of the many cannabis business owners that tried to apply CHAMP's winning argument in tax court to their business. Unfortunately, Olive's CHAMP argument was denied by the tax court. Olive owned a California facility, The Vapor Room, where the sole source of revenue was from its sale of marijuana. Customers went to the Vapor Room to smoke or inhale vaporize marijuana. Along with being able to consume cannabis, customers could also do other activities. The business was set up like a community center with couches for people to sit on and games, books, and art supplies available for customers to use. They also offered yoga, movies, and massage therapy. The Vapor Room offered all of these items for free. Olive tried to argue that because of these services offered, he should be able to deduct more operating expenses than just the cost of goods sold.

The court distinguished the facts in his case from those in **CHAMP**. The court stated that the business sole purpose was to sell medical marijuana and that he offered the other services as part of the cannabis business. The court pointed out that all of the testimony from Olive and from his other witnesses was rehearsed, not impartial and not credible, which undoubtedly played into its decision to rule for the IRS.



The court perceived Olive's claim at court that the Vapor Room actually consisted of two businesses as simply an after-the-fact attempt to artificially equate the Vapor Room with the medical marijuana dispensary in CHAMP so as to avoid the disallowance of all of the Vapor Room's expenses under §280E. Olive attempted to apply CHAMP after the fact, and his arguments did not match his actual business practices. The court concluded that **§ 280E** applied to preclude Olive from deducting any of the Vapor Room's claimed expenses.



▶ *Loughman v Commissioner*

We've previously mentioned how important your business structure is when it comes to your taxes, and no case illustrates that more than *Loughman v Commissioner*. The case revolves around a Colorado cannabis dispensary that was set up as an S-Corporation. Loughman was advised to set his business up as an S Corporation. The IRS requires S Corporation shareholders to take a salary and Loughman followed the law and paid himself a reasonable salary. When it came time to file the business tax return, Loughman tried to deduct his wages under the cost of goods sold. The IRS disallowed the deduction under the premise of 280E. This led to double taxation of the income. Loughman took the case to Tax Court arguing that for cannabis businesses operating as an S Corporation, 280E discriminates against them by double taxing income paid to shareholders. The court ruled that it was not discriminatory and that their salaries were not attributed to the cost of goods sold and therefore could not be deducted.

▶ *Alternative Health Care Advocates v Commissioner*

One strategy we've seen attempted with many cannabis businesses is the attempt to use a management company to try and bypass 280E. Our next case looks at what happens when you try a quick fix to save money. Alternative Health Care Advocates provided medical marijuana to individuals in California at their business. Another company, Wellness Management Group, Inc., provided management services to Alternative Health Advocates. These services included hiring employees and managing HR for those employees, paying wages for those employees, and paying advertising expenses, rent, and other expenses.

Wellness did not provide services of that nature to any other business. It only provided services to Alternative Health Care Advocates. Wellness made money by collecting fees for its services to Alternative Health Care Advocates. The IRS audited the companies and decided both companies were subject to 280E and assessed taxes, penalties, and interest. The businesses took the case to Tax Court and the tax court decided that the management company was "**trafficking**" just as much as Alternative Health Care Advocates' activities were because the funds came from the same pot of money. Because of this, the **\$500,000** Alternative paid to the management company was taxed twice!





The value in setting up a management company comes from the ability to get banking and utilize other electronic transactions, such as payroll services. However, setting up a management company to get around 280E is risky and can backfire. When you have one business involved in trafficking, the risk is exponentially higher. Businesses must plan their transactions involving management companies as if management company revenue is subject to 280E. Some management companies that offer broader services to a variety of different businesses may have some additional arguments that they are not engaged in “**trafficking**.” But if your management company is just a stand-in for your operating marijuana company, the Tax Court has indicated that it will approve of the IRS considering you to be trafficking as well.

Studying tax court cases not only helps us understand how the IRS is going to handle certain tax areas of cannabis businesses, but it also gives us guidance on what to do and what not to do when it comes to setting up and running your business. It’s important that business owners read the court rulings to make sure they don’t make the same mistakes as the businesses before them. It can also give them ideas on how to make their business more tax efficient. This is why it’s important to have the right people on your team. You need someone who is looking at every tax court ruling and seeing how it applies to your business.

▶ **Getting the Help You Need**

The cannabis tax world is constantly evolving. As long as 280E applies to cannabis businesses, there will always be new rulings and decisions that decide how cannabis businesses operate around the tax code. As more states legalize either medical or recreational cannabis, we will see more pressure to change the classification of cannabis. Until then, it’s vital to your business to get a tax accountant that understands the difficulties and complications of owning a cannabis business.





Remember, the IRS knows that **cannabis businesses** are going to be paying a high tax rate and they aren't going to give you any wiggle room when it comes to deductions. They're going to make sure they get every dollar they can from your business. They will disallow any deductions they don't think fit into the cost of goods sold category. This is why having someone on your team that understands the requirements that need to be met for something to fall under the cost of goods sold category is important. You don't want to go try and save money by deducting other expenses and then get hit with penalties and interest when the IRS audits you and takes away those deductions. It's not a matter of if you will be audited, it is a matter of when you will be audited. If you get audited, you will want to make sure you get audit representation that will fight for you. They will need to know the tax code and know how specific the IRS is on the tax code when applying it to cannabis businesses.

If you want to own a cannabis business, you need to decide what's important to you. On the top of that list needs to be your business's accounting - and doing it yourself may not cut it. There are so many aspects to running a business, sometimes it is better to hand off the difficult tax and accounting tasks to someone who specializes in it. The financial side of your business should never take a backseat. Not paying your taxes or not filing quarterly reports can put you in a tough predicament with the IRS or your state's tax agency. It's better to hire someone from the beginning to get you started on the right foot than trying to get someone to come in after the fact and clean up the mess. It will not only save you money, but it can save you time and stress. Especially as a cannabis business owner, it's important that you make sure your books and your taxes are done correctly as the IRS is going to be taking a close look at your financials to see if you're paying the correct amount.



Taxes aren't easy for anyone and the IRS isn't making it any easier for cannabis businesses. What we have learned so far is business structure, bookkeeping and record keeping all play a vital role in how you are taxed and how the IRS will treat you. Taxes can seem like guesswork, and you need to know exactly what the law is and how it can apply to you. Don't wait until the IRS is auditing you to get the help you need. Hire a tax accountant that you can trust!



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