



Has Your Marijuana Client Considered Tax Planning and Compliance?

By Marc Seyburn

Marijuana establishments have begun the process to become licensed and operate in Michigan under the Medical Marijuana Facilities Licensing Act (MMFLA).¹ Some businesses will be legally manufacturing, distributing, dispensing, or possessing marijuana under state law even though marijuana remains illegal under federal law.

Internal Revenue Code Section 280E

Based on current taxing authority, IRC 280E will apply to businesses operating under the MMFLA. IRC 280E was enacted in 1981 during the Reagan administration's war on drugs in response to *Edmondson v Commissioner*, a tax court case in which the taxpayer, a convicted drug dealer, successfully argued for the right to take federal tax deductions.² IRC 280E

disallows all operating expenses from being deducted for any trade or business trafficking a controlled substance (within the meaning of Schedule I or Schedule II of the Controlled Substances Act). Since its enactment, there has been very little guidance. No exceptions currently exist and "trafficking" is undefined.³ That leaves all licensees under the MMFLA exposed to the potential application of IRC 280E. All potential MMFLA licensees should consult with a tax-planning expert given the significant impact of IRC 280E.

The importance of proper planning

When adding the 3 percent excise tax under MCLA 333.27601, the federal and state combined rates, licensees will have to deal with both an effective combined tax rate

that could exceed 50 percent—after considering the 3 percent state excise tax, 6 percent state sales tax, 4.25 percent state income tax, 3.8 percent net investment income tax, and the highest individual federal rate in 2018 of 37 percent—and exposure to IRC 280E. The combined effect of these two tax issues could be costly without proper planning before beginning operations (and preferably before submitting a stage 2 license application). If a marijuana business is spending 50 percent of gross profits on operational expenses, there will only be enough cash profit available to pay taxes. This example nets the taxpayer no profit whatsoever. This alone should illustrate the significant risk of failing to properly develop and timely implement a tax plan.

Achieving the best results and avoiding effective tax rates higher than 50 percent is difficult, especially when considering factors such as:

- The five categories of licenses within the MMFLA have distinct structure and planning issues⁴
- The new Tax Cuts and Jobs Act of 2017⁵
- The lack of federal guidance interpreting IRC 280E⁶

Fortunately, there is some authority that can facilitate proper planning; for example, *Californians Helping to Alleviate Medical Problems, Inc v Commissioner (CHAMP)* and *Olive v Commissioner*⁷ as well as IRS Gen Couns Mem 201504011 (December 10, 2014).⁸ This combined guidance suggests that licensed marijuana businesses may have more than one line of business, thereby justifying federal tax deductions for the part of the business that is not subject to IRC 280E. In other words, a business trafficking in marijuana can also have other products and services that comprise a separate line of business, and IRC 280E may not apply to the separate business. However, while the 2014 IRS memorandum provides taxpayers with some insight into how the IRS Office of Chief Counsel interprets IRC 280E, there are conflicting opinions on whether that interpretation is correct.

Choosing the right entity

Many factors influence the proper operating and legal structure for a business, including the choice of entity or entities needed to implement the objectives of the client. After the 2017 tax law changes, many taxpayers are looking more closely at whether a regular C corporation should be used as opposed to an entity that allows for flow-through taxation of its owners (i.e., partnerships, subchapter S corporations, and

At a Glance

All license holders under the Medical Marihuana Facilities Licensing Act are subject to IRC 280E; currently, there are no exceptions.

The effective combined federal and state tax rates for marijuana businesses in Michigan will be more than 50 percent.

If IRC 280E applies and more than 50 percent of your client's gross profits are paid toward operating expenses, all profits will be used to pay taxes.

limited liability companies). This is a critical analysis that all MMFLA licensees must go through to determine if their situation justifies a regular corporate structure. Many clients are better off using limited liability companies. Investors in LLCs should be aware of the new centralized partnership audit regulations that became mandatory as of January 1, 2018.⁹ Under proposed federal tax regulations, partnership income adjusted in an audit can be taxed at the partnership level *and* at the highest rates.¹⁰ The rules are too new and complicated to address here, but there are ways to opt out of the new provisions. Investors who are worried about having to pay more taxes on partnership income in the event of an audit may want to talk to tax counsel about the provisions.

Proper execution is important

Once a structure has been implemented, compliance should be the primary focus and concern of all businesses operating under the MMFLA. Attention should go toward designing, implementing, and maintaining systems and procedures to eliminate all gaps in handling inventory and cash. The financial reporting and tax compliance must be consistent with the chosen structure, systems, and procedures.

In my experience, an IRS audit typically places marijuana business owners at risk for civil penalties; however, since



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these are cash businesses with a high volume, no federal banking, and a history of illegality, audits could lead to criminal exposure for the owners. All potential MMFLA licensees should consult with their tax professionals to make certain that tax issues don't lead to business failures or, more importantly, criminal fraud audits.

Failing to choose the proper operating and business structure can saddle new MMFLA licensees with significant handicaps. Proper financial reporting and tax compliance dramatically increase the odds of maintaining the desired business structure. Once a business structure has been compromised, there is a heightened risk for MMFLA licensees in the event of an IRS audit. Marijuana is a new industry in Michigan, and marijuana businesses have the once-in-a-lifetime opportunity to be at the forefront. Other states have demonstrated an ability to generate billions in gross yearly revenue in only a few years of operation.¹¹ Proper planning, financial reporting, and compliance are critical factors for creating a successful marijuana business.

Two recent tax court cases highlight the need for thorough tax planning and compliance. In *Alterman v Commissioner*, the tax court created further precedent that it will hold a medical marijuana facility to a strict standard if the facility attempts to establish under *CHAMP* that it offers multiple lines of businesses. The court dismissed Alterman's argument that the sale of merchandise was a second line of business because of poor and inconsistent records.¹² One week later, the tax court in *Loughman v Commissioner* held that IRC 280E applied to the salaries of owners and officers of S corporations,

thereby creating a double tax on the reasonable compensation paid to the owners and officers—taxed once as wages and again as net profits after those wages were disallowed under IRC 280E.¹³ ■



Marc Seyburn has developed a unique skill set over his 25-year legal career. He holds degrees in both law and accounting. His legal practice is focused on structural planning, transactional documentation, and cash-flow financial modeling spanning many different industries; see www.seyburnlawpllc.com. Recently, he founded Tax Help Compliance, PLLC, for providing the full services needed for owners of marijuana businesses in Michigan; see www.taxhelpcomp.com.

ENDNOTES

1. MCL 333.27101 *et seq.*
2. *Edmondson v Comm'r*, 42 TCM (CCH) 1533 (1981).
3. E.g., see Brandon, *Don't Fear the Reefer: Embracing the Nuances of Federal and State Taxation of Cannabis* (December 12, 2015) ("Trafficking, as generally understood under federal law, appears to be an expansive concept spanning every phase of marijuana production, processing, and retailing.") <<http://www.millernash.com/dont-fear-the-reefer-embracing-the-nuances-of-federal-and-state-taxation-of-cannabis-06-03-2015/>>. All websites cited in this article were accessed July 11, 2018.
4. MCL 333.27501 ("Grower"), MCL 333.27502 ("Processor"), MCL 333.27503 ("Secure Transporter"), MCL 333.27504 ("Provisioning Center"), and MCL 333.27505 ("Safety Compliance Facility").
5. HR 1, 115th Cong (2017).
6. Hunt, *Cannabis Taxation: Another Day, Another 280E Case (or Two)*, Canna Law Blog (June 25, 2018) <<https://www.cannalawblog.com/category/cannabis-case-summaries/>>.
7. *Californians Helping to Alleviate Medical Problems, Inc v Comm'r*, 128 TC 173 (2007) and *Olive v Comm'r*, 139 TC 19 (2012), *aff'd* 792 F3d 1146 (CA 9, 2015).
8. Available at <<https://www.irs.gov/pub/irs-wd/201504011.pdf>>.
9. Centralized Partnership Audit Regime, 82 Fed Reg 27334 (proposed June 14, 2017) (to be codified at 26 CFR 301).
10. *Id.* See also Ernst & Young, *IRS releases proposed regulations implementing new partnership audit regime*, Tax News Update US Edition (January 25, 2017) <<https://taxnews.ey.com/news/2017-0168-irs-releases-proposed-regulations-implementing-new-partnership-audit-regime>>.
11. New Frontier Data, *Cannabis Taxes Could Generate \$106 Billion, Create 1 Million Jobs by 2025* (March 13, 2018) <<https://newfrontierdata.com/marijuana-insights/cannabis-taxes-generate-106-billion-create-1-million-jobs-2025/>>.
12. *Alterman v Comm'r*, TCM (RIA) 2018-083 (June 13, 2018).
13. *Loughman v Comm'r*, TCM (RIA) 2018-085 (June 13, 2018).