

# Tax Treatment of Cannabis Partnerships: Pass-Through Entity Selection Strategies to Minimize Tax

WEDNESDAY, DECEMBER 18, 2019, 1:00-2:50 pm Eastern

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# CANNABIS – A BRAVE NEW WORLD



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**JONATHAN KALINSKI** is a principal at Hochman Salkin Toscher Perez, and concentrates his practice in complex civil tax litigation and criminal tax. Mr. Kalinski represents individuals, corporations, pass-through entities, trusts, and estates in all stages of state and federal tax disputes, including audits and examinations, administrative appeals, trials, and appellate litigation. He also specializes in disclosures of undeclared foreign accounts and assets.

Mr. Kalinski represents businesses in both federal and state payroll tax and state sales tax issues.

He has successfully defended a CEO of a private equity firm against the IRS attempts to asset his client was a responsible person for unpaid payroll taxes. Additionally, Mr. Kalinski has handled several worker classification cases.

Mr. Kalinski routinely represents and advises U.S. taxpayers in sensitive issue civil tax examinations involving both domestic and foreign tax-related issues where substantial civil penalty issues or possible assertions of fraudulent conduct may arise, and in defending criminal tax fraud investigations and prosecutions. Mr. Kalinski was one of the lead attorneys in a high-profile case where he successfully overturned a Tax Court decision for over \$2 million based on fraud on the Court.



**STEVEN TOSCHER** specializes in civil and criminal tax controversy and litigation. He is a Certified Tax Specialist in Taxation, the State Bar of California Board of Legal Specialization, a Fellow of the American College of Tax Counsel and has received an “AV” rating from Martindale Hubbell. In addition to his law practice, Mr. Toscher has served as an Adjunct Professor at the USC Marshall School of Business since 1995, where he teaches tax procedure. He has also served on the faculty of the American Bar Association Criminal Tax Fraud Program since 1998. He is a former Internal Revenue Agent with the Internal Revenue Service and a trial attorney with the Tax Division of the United States Department of Justice in Washington where he received its Outstanding Attorney Award.

Mr. Toscher is past-Chair of the Taxation Section of the Los Angeles County Bar Association and served as a member of the Editorial Board for the Los Angeles Lawyer during 1996-1999. He is a member of the Accounting and Tax Advisory Board of California State University, Los Angeles, Office of Continuing Education.

Mr. Toscher was the 2018 recipient of the Joanne M. Garvey Award. The award is given annually to recognize lifetime achievement and outstanding contributions to the field of tax law by a senior member of the California tax bar.

Mr. Toscher is a frequent lecturer to professional groups and author on civil and criminal tax controversy topics. He is frequent contributor to the Los Angeles Lawyer, The Journal of Tax Practice and Procedure and Tax Management Bureau of National Affairs. He is a co-author of “Tax Crimes,” Bureau of National Affairs - Tax Management, Publication 636 2nd.

Mr. Toscher received his Bachelor’s Degree in Accounting from the University of Nevada, Las Vegas (with honors), and received his Law Degree from the University of San Diego (summa cum laude). Mr. Toscher is a member of the State Bars of California, Nevada, and Colorado. Mr. Toscher has been a member of the Faculty of the ABA Criminal Fraud Program for many years.

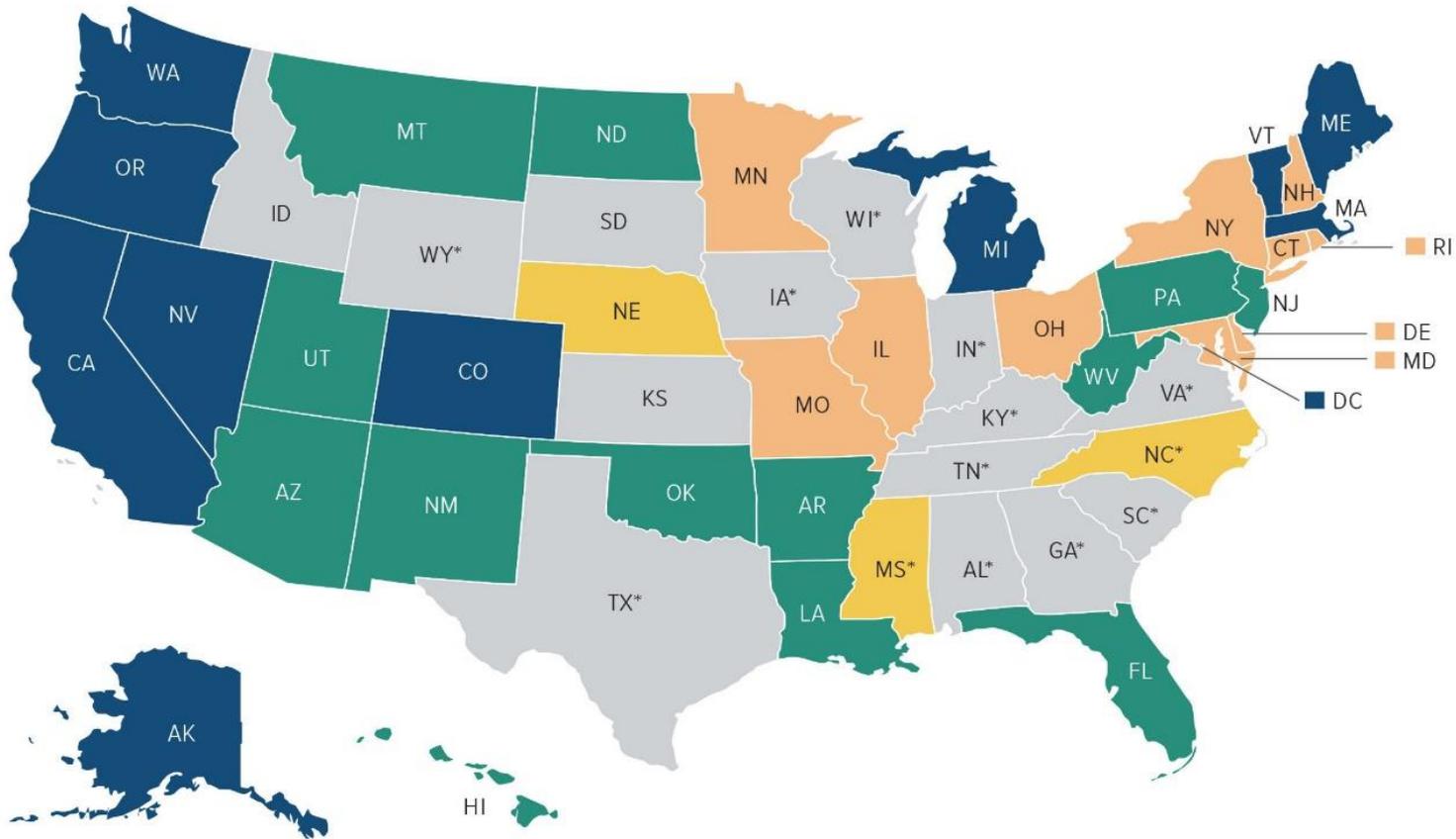
# Overview

- Current Legal Status
  - Federal
  - State Laws
    - Legal, but regulated and taxed in some states
    - Local Laws
- Income Taxation
- California Taxation Regime – Income, Sales and Excise Taxes
- Ethical Issues for Lawyers
- Problems With Federal Illegality
  - Banking
  - Forfeiture
  - Prosecution

# Map of Marijuana Laws

## Current marijuana laws by state

■ Fully legal   ■ Medical use legal and recreational use decriminalized   ■ Medical use legal   ■ Recreational use decriminalized   ■ Fully illegal



\*CBD/Low THC medical program.  
Source: National Journal; Ballotpedia, 2019.



# Federal Law Overview

- Marijuana is a Schedule I controlled substance under the Controlled Substances Act.
- Federal criminal violation to manufacture, distribute, or dispense marijuana.
- Under IRC Section 280E, taxpayers cannot deduct any amount for a trade or business engaged in trafficking in controlled substances.
  - No deductions for rent and wages
  - Case challenges, but it's a loser argument...so far
    - Canna Care, Inc. v. Comm'r, 694 Fed. Appx. 570 (9th Cir. 2017)
- Taxpayers can deduct Cost of Goods Sold (COGS).
- You are subject to federal criminal prosecution and forfeiture.

# Cole Memorandum

- On August 29, 2013, then Deputy Attorney General James Cole issued a memorandum to all United States Attorneys relating to marijuana, providing guidance enforcement priorities under the CSA.
- For matters falling outside federal enforcement priorities, federal law enforcement has historically relied on state and local law enforcement agencies to address marijuana activity through enforcement of their own drug laws.
- Federal Enforcement Priorities include:
  - Preventing the distribution of marijuana to minors;
  - Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
  - Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;

# Cole Memorandum (cont.)

- Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
- Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Preventing marijuana possession or use on federal property.

# Sessions Memorandum

January 4, 2018

- On January 4th, 2018 Attorney General Jefferson B. Sessions, III, rescinded the Cole Memorandum.
- Prosecution relating to the cultivation, distribution and possession of marijuana will be governed by “well-established” principles of prosecution governing the Department of Justice since 1980.
- Prosecutors will now weigh all relevant considerations, including federal law enforcement priorities, the seriousness of the crime, the deterrent effect of criminal prosecution and the impact of particular crimes on the community.
- Implications for the legal cannabis industry in California.

# Rohrabacher-Farr Amendment

- Prohibits Justice Department from spending funds to interfere with the implementation of state medical cannabis laws.
- In U.S. v. McIntosh, Ninth Circuit held that despite Rohrabacher-Farr, no immunity from prosecution, but entitled to evidentiary hearing on compliance with state laws.
- Pisarski and Moore cases, 274 F. Supp.3d 1032 (N.D. Cal. 2017).
  - U.S District Court Judge Richard Seeborg temporarily stayed prosecution prior to sentencing, of defendants who pleaded guilty – 2017 U.S. Dist. LEXIS 131830. Determined defendants were in strict compliance with state laws.

# Key Tax Court Cases

- Edmundson v. Comm’r, T.C. Memo. 1981-623
  - Allowed business expense deductions for taxpayer who sold drugs.
  - In 1982, Congress enacts IRC 280E in direct response.
- Californians Helping to Alleviate Med. Problems, Inc. (CHAMP) v. Comm’r, 128 T.C. 173 (2007)
  - Taxpayer operating a separate wellness business can deduct business expenses.
- Olive v. Comm’r, 139 T.C. 19 (2012)
  - Not allowed to deduct business expenses because dispensing of marijuana and the providing of services and activities shared a close and inseparable organizational and economic relationship.
- Canna Care, Inc. v. Comm’r, T.C. Memo. 2015-206
  - IRC §280E precludes deduction of business expenses; no Excessive Fines Clause defense.

# Key Tax Court Cases (cont.)

- Alterman v. Comm’r, T.C. Memo. 2018-83
  - Tax Court could not use Cohan rule to estimate COGS because inadequate recordkeeping.
  - In 1982, Congress enacts IRC §280E in direct response.
- Alternative Health Care Advocates v. Comm’r, 151 T.C. No. 13 (2018)
  - S Corporation that exclusively managed a separate dispensary entity cannot deduct business expenses under IRC §280E.
  - Dispensary operated as a C corporation
  - S Corporation handled hiring employees, paying expenses, including advertising, wages, and rent.
  - Court holds only difference was that C corp. had title to marijuana.

# Patients Mutual I and II

- Patients Mutual Assistance Collective Corporation d.b.a. Harborside Health Center, 151 T.C. No. 11 (2018)
  - Harborside argued that because it was CA compliant, IRC §280E did not apply.
  - Raised some of the same issues as prior cases and also new ones. Whether res judicata precludes IRS from arguing it was engaged in trafficking in controlled substance (Based on dismissed forfeiture action)
    - Whether its business “consisted” of trafficking in a controlled substance under IRC 280E (Argued that consist of meant 280E applied only to businesses that exclusively trafficked in controlled substances)
    - What it could include in COGS
- Patients Mutual II, T.C. Memo. 2018-208
  - Harborside not liable for accuracy-related penalty.

# Northern California Small Business Assistants, Inc.

- Northern California Small Business Assistants, Inc. v. Comm’r, 153 T.C. No. 4 (2019).
  - Majority holds that 280E is not a penalty and therefore does not violate the 8<sup>th</sup> Amendment
  - Dissent would require additional arguments on whether 280E violated 8<sup>th</sup> Amendment. Agreed with Petitioner that 280E was a fine and penalty
- Difference between majority and dissent is starting point

# IRS Offers in Compromise

Calculation of reasonable collection potential involving businesses cultivating and selling marijuana in states where activity is permitted. Memorandum for Director, Specialty – Offers, Liens and Advisory, Control No. SBSE-5-0416-0016, Expiration April 28, 2017 impacting IRM 5.8.5. 5.8.7.

Offer will not be rejected just on “public policy” grounds.

Reasonable collection potential will be determined without regard to deductions not allowed by IRS Section §280E. This will make most offers in compromise not viable.

# Entity Formation

- Prior to recreational legalization in CA, entities were non-profits and non-profit mutual benefit corporations
- Now all types of entities are options, but have different consequences for business and tax
- C Corporations
  - Tax rate now 21% - for how long?
  - Double Taxation, but dividends taxed at lower rate – for how long?
  - No individual liability for taxes
  - Easy to expand and raise additional capital

# Entity Formation

- LLC
  - Flow through entity
  - 199A Deduction – Maybe?
  - Limited Liability
- Partnerships
  - Flow through entity
  - 199A Deduction – Maybe?
  - General Partners personally liable
  - What impact does new partnership audit rules have?
- S Corporation
  - No double taxation
  - Restrictions on number of shareholders and type

# Entity Formation

- S Corporation (Continued)
  - Flow through entity
  - 199A Deduction – Maybe?



# Intersection of IRC §280E and IRC §199A

- IRC §280E disallows deductions or credits paid or incurred in carrying on a trade or business whose activities consist of trafficking in a controlled substance.
- IRC 199A allows a deduction at the individual level for qualified business income (QBI)
- Can owners of cannabis passthrough entities take the 199A deduction?
  - Distinction between amounts incurred as expense vs. amount reported as income
  - Medical marijuana – is it in the field of health?
  - Enough wages?

## More on IRC §199A

- Specified Service Trade or Business
  - No deduction if Specified Service Trade or Business income, unless below threshold amounts
  - Of note for cannabis industry is trade or business involving the performance of health services
- Health Services
  - Provision of medical services by physicians, pharmacists, nurses, dentists, vets, physical therapists, psychologist...
  - Does NOT include operation of health club or spa, research, testing, and manufacture/sale of pharmaceuticals or medical devices
  - Appears to exclude retail pharmacy

## More on IRC §199A

- Wages Allocable to QBI
  - Not simply wages on W-2
  - W-2 wages are properly allocable to QBI if associated wage expense taken into account in reporting QBI
  - Can you include wages in the COGS amount, which is deductible?

# Voluntary Disclosure

- In November 2018, IRS issued an Interim Guidance Memo updating Voluntary Disclosure rules.
- Includes both domestic and foreign disclosures.
- Intended for taxpayers with criminal exposure.
- Preclearance Request
  - Form 14457 asks whether income from illegal source
    - What to do if legal under state law?
- Expected to include 6 years, IRS has discretion to include more years.
- Imposition of one civil fraud penalty – either under IRC 6663 or IRC 6651(f)
  - Can argue for reduced penalty in exceptional circumstances

# Summons Enforcement

- High Desert Relief, Inc. v. United States, 917 F.3d 1170 (10th Cir. 2019)
- Taxpayer under IRS audit refused to comply with administrative summons.
- IRS issued third party summonses to obtain records.
- Taxpayer moved to quash third party summons on grounds that the IRS, in seeking to determine the deductibility of expenses under IRC 280E was mounting a de facto criminal investigation under CSA, and that enforcement of IRC 280E was improper under non-enforcement policy against medical marijuana dispensaries.
- Government burden to prove that it has not made a criminal referral to the DOJ and that it meets Powell factors is a slight one.
- Court holds summons enforceable and does not quash

# California Taxes

- Beginning January 1, 2018, California has two new cannabis excise taxes:
  - **15% Excise tax** imposed upon purchasers of cannabis and cannabis products. Retailers of cannabis and cannabis products are required to collect the 15% tax from the purchaser **based on the average market price** of any retail sale and pay it to their cannabis distributor.
  - A **cultivation tax** is imposed upon cannabis cultivators on all harvested cannabis that enters the commercial market. Cannabis cultivators are required to pay the cultivation tax to either their distributor or their manufacturer.
  - Distributors must collect the cannabis excise tax from retailers and the cultivation tax from cultivators or manufacturers.

# California (cont.)

- Distributors must report and pay the cannabis excise tax and the cultivation tax to the CDTFA.
- Proposed Regulations – Regulation 3700, Regulation 3701.
- If you own a business that sells cannabis or cannabis products, you must register with the CDTFA for a seller's permit and regularly file sales and use taxes.
- CDTFA Tax  
Guide:<https://www.cdtfa.ca.gov/industry/cannabis.htm#Overview>.
- Register with the CA Sec. of State: [cannabiz.sos.ca.gov](http://cannabiz.sos.ca.gov).

# California Tax Differences – AB 37

- CA recently passed AB 37, which allows state legal cannabis businesses to deduct expenses and explicitly disavows IRC 280E.

# Local Laws

- Be sure to know your local laws.
- Cities are passing laws to address recreational cannabis, and laws can and will vary by city and county.
  - More taxes?
  - Zoning laws.

# Hemp Cultivation

- Agriculture Improvement Act of 2018 legalized hemp cultivation
- Hemp defined as cannabis with 0.3% or less THC.
  - Not trafficking in a controlled substance so businesses can deduct expenses.
  - In California, SB 1409 – Permits cultivation of industrial hemp

# RICO and Nuisance Laws

- Safe Streets Alliance v. Hickenlooper, 859 F.3d 865 (10th Cir. 2017).
  - Private landowners allowed to bring RICO claims against marijuana growers.
  - Engaged in cultivation of marijuana in violation of Federal law.
  - Directly injured landowners property by creating a nuisance from noxious odors.
- Ainsworth v. Owenby, 2019 WL 0387681, (D. Or. 2019)
  - Plaintiffs could not prove harm.

# Ethics of Representing Cannabis and Related Businesses

- ABA Model Rule 1.2(d) – “A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.”
- States take different approaches to this issue
- E & O Issues.
- How to advise a client.
- How to protect yourself.

# Problem of Banking

- Estimated that about 500 banks work with marijuana companies, but most won't.
- Cash Business.
  - Pay taxes using cash
- SARs, Marijuana Limited SARs, Marijuana Priority SARs, Marijuana Termination SARs.
- SAFE Banking Act – Would allow financial institutions to service cannabis businesses. Passed House Financial Services Committee, and awaiting floor vote.
- Use of Bitcoin and Cryptocurrency?

# Problems for Other Businesses

- Landlords
  - CSA prohibits leasing property to distribute a controlled substance.
  - Subject to criminal prosecution.
  - Subject to forfeiture.
  - Check Local laws.

# FinCEN Rules

- Obligation to file a Suspicious Transaction Report (SAR) is unaffected by state law that legalizes marijuana-related activity.
- Marijuana Limited SAR
  - Financial institution providing financial services to marijuana-related business that it reasonably believes, based on due diligence, does not implicate one of the Cole Memo priorities or violate state law should file a Marijuana Limited SAR.
  - Identifying information of subject and related parties.
    - Address of subject and related parties.
    - Fact that institution is filing a SAR solely because of marijuana-related business.
    - No additional suspicious information.

# FinCEN Rules (cont.)

- Marijuana Priority SAR
  - Financial institution providing financial services to marijuana-related businesses that it reasonably believes, based on due diligence, DOES implicate or violate one of Cole Memo priorities should file a Marijuana Priority SAR.
    - Identifying information of subject and related parties.
    - Address of subject and related parties.
    - Details regarding the enforcement priorities implicated.
    - Dates, amounts, and other relevant details involved.
- Marijuana Termination SAR
  - Financial institution deems it necessary to terminate a relationship with a marijuana-related business in order to maintain effective anti-money laundering compliance program, should file a SAR and note the reason for filing. If financial institution becomes aware business seeks to move to another financial institution, it should alert second institution of potential illegal activity.