

Accounting and 280E for Medical Marijuana Businesses

By David Smith, CPA, MBA, CM&AA

The Missouri Department of Health and Senior Services is working diligently to review license applications and award licenses within the timeline dictated by the recently passed Amendment 2 legislation, which legalized the selling of medical marijuana in Missouri. As you're reading this, applicants who received their license will likely be preparing to open their business. Once approved, these new businesses will have to comply not only with the regulations established by the state of Missouri, but also with tax and accounting matters just like any other business.

The challenge: marijuana related businesses (MRBs) are not just like any other business. Though MRBs are now legal in some state laws, they are still illegal under federal law. These businesses need ethical and competent professional tax advice. CPAs should be cautious when working with MRBs to ensure they are providing proper guidance.

For CPAs who have investigated providing services to this market, a commonly heard caution is "be aware of 280E." Federal statute 280E, or more specifically, U.S. Code, Title 26, Subtitle A, Chapter 1, Subchapter B, Part IX, §280E, refers to a single sentence in the tax code. That single sentence is: *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.*

Section 280E *does* allow a cannabis business to deduct expenses related to cost of goods sold, but *does not* allow for the deduction of selling, general, or administrative expenses.

CPAs often emphasize to clients the importance of understanding their financial reports. Understanding financial reports, and more specifically the tax impact on the bottom line, is critical in this industry. Once the owner knows how taxes affect their costs, they can better manage those costs and price their products accordingly.

A comparison of the tax impact of 280E on a traditional business and a marijuana business can best be shown with the following sample profit and loss statement.

In this example, none of the overhead expenses are deductible for the cannabis business, per 280E. This extra tax burden can be an unwelcome surprise for the unprepared business owner.

Bear in mind, however, this unwelcome tax surprise is *not* a justification for aggressively and improperly allocating costs to inventory.

Numerous court cases have upheld the provisions of 280E in judgments that favor the IRS. While there is no answer for avoiding the provisions of 280E, the best strategy for minimizing its tax impact on an MRB is to become well versed in accounting for inventory. When required to use an inventory method, a taxpayer is also

required to use an accrual method for purchases and expenses. A good starting point for understanding the specific rules on accounting for inventory is IRS §471 (IRS §263A rules are not applicable here).

Organizations that have been successful in their challenges to IRS audits have done so with sound accounting policies and well-documented procedures.

Given the ease with which the IRS can reclassify

	Traditional	Cannabis Business
Revenue		
Sales Revenue	1,000,000	1,000,000
Less: Cost of Sales (purchases)	500,000	500,000
Gross Profit	500,000	500,000
Expenses		
Rent	50,000	50,000
Marketing	50,000	50,000
Utilities	25,000	25,000
Wages	125,000	125,000
Other	50,000	50,000
Total Non-Direct Expenses	300,000	300,000
Net Income	200,000	200,000
Plus Non-Deductible Expenses	-	300,000
Taxable Income	200,000	500,000
Income Tax (35%)	70,000	175,000
Net Income, After Tax	\$ 130,000	\$ 25,000

MRB expenses as non-deductible, it is critical to be consistent in your allocation methods and document your methodology. Many of us have had less than ideal records to support a tax position in an IRS audit. Often, a reasonable and justifiable explanation may be sufficient evidence. If you are representing an MRB with the IRS, you should not expect any leniency for missing or poor recordkeeping. Anecdotal stories and verbal justification will be of little use.

Should you choose to provide guidance to MRBs, it is imperative that you follow proper accounting procedures and have a zero-tolerance policy for shortcuts. You should also become familiar with recent and pending court cases. There is a long list of MRB business owners who are now facing significant fines and jail time for choosing to neglect the tax rules. Our clients depend on us, as their CPA, for accurate and proper advice. We must continue to maintain the highest level of ethics and professional standards as we do for all our clients.

This brief article touches on only a few aspects of a CPA's role in this growing industry. Other areas to consider include: internal controls, cash handling, banking matters, security, and state-specific compliance requirements. For further research, relevant court cases involving MRBs and tax matters include:

- *Alternative Health Care Advocates v. Commissioner*, 151 TC No.13, Dec. 20, 2018;
- *Harborside v. Commissioner*, 151 TC No. 11, Nov. 29, 2018;
- *Californians Helping to Alleviate Medical Problems v. Commissioner*, 128 TC 173, May 15, 2007; and
- *Martin Olive v. Commissioner*, 139 TC No. 2, Aug. 2, 2012.

MOSBA Guidance

The Missouri State Board of Accountancy (MOSBA) has provided guidance on the uncertainty surrounding potential disciplinary action to CPAs who provide services to the cannabis industry. The state

board will not generally pursue disciplinary action absent additional evidence that constitutes cause to discipline under the board's statutes and regulations. For details, please visit MOSBA's website (pr.mo.gov/accountancy.asp).

Choosing to add MRB services can be one way to add a fun and exciting niche to your practice. If you choose to work in this rapidly changing industry, you should monitor developments and proceed with caution. 



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