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Why the IRS Treats You Like a Drug Cartel When You Decide to Grow, Process or Distribute Medical Cannabis

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Sayre was recognized by his colleagues in West Virginia in 2016 and 2012 as *Best Lawyers'* Lawyer of the Year for Controversy and Litigation – Tax. Kin also is recognized as a leader in matters before the West Virginia Alcohol Beverage Control Administration and West Virginia Lottery Commission, including compliance and licensing.

He currently serves as the city attorney for Martinsburg, West Virginia, and is a member of the West Virginia Home Rule Board. He is a former staff attorney for the West Virginia State Tax Department.

On June 13, 2018, the U.S. Tax Court issued Laurel Alterman and William A. Gibson, Petitioners v. Commissioner of Internal Revenue, Respondent Docket No. 13666-14, its most recent opinion on the taxation of medical cannabis. The decision provided guidance on the application of IRC § 280E of the U.S. Tax Code on the medical cannabis industry and rejects the use of deductions and credits enjoyed by every other legal business in the United States. This decision is in line with several cases that disallow business deductions for taxpayers operating in either adult use or medical cannabis.

According to IRC §280E:

> "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."

The state of West Virginia passed SB 386 – the West Virginia Medical Cannabis Act (the "Act") – on February 28, 2018, allowing for patients suffering from certain specified "serious medical conditions" to obtain cannabis for medical purposes and making West Virginia one of 30+ states that have legalized the production, processing and dispensing of medical cannabis. The federal government, however, still considers all forms of cannabis a controlled substance and, therefore, an illegal trade.

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The U.S. Tax Court has consistently found that medical cannabis is a Schedule I controlled substance. Therefore, the sale of medical marijuana is always considered trafficking under IRC §280E, even when permitted by state law. Thus, operating expenses associated with the sale, manufacturing or production of cannabis are always disallowed under IRC §280E.

All segments of the medical cannabis supply chain must understand the impact of IRC §280E upon their tax liability. If you decide to report your business activity like any other business, the IRS will apply IRC §280E and you will be subject to additional taxes, penalties and interest.

IRC §162 allows a deduction for the expenses of carrying on a business. IRC §167 and

IRC §179 allow deductions for depreciation of assets used in a business. Because of the IRC §280E modification, no deduction is allowed for an amount paid or incurred in carrying on a business if the business consists of trafficking in controlled substances – an example that is compounded by the state of West Virginia. Your state taxes are based upon your reported federal income; therefore, your West Virginia taxes will be higher because of the IRS disallowance of the expense and depreciation. Many states that have legalized medical cannabis recognize this disparity and have allowed for a modification on the state income tax returns.

Another way taxpayers have tried to avoid the harsh effect of §280E is the operation of a hybrid business model wherein the taxpayer would sell other items along with the medical cannabis business. The IRS takes a jaundiced eye to this practice and requires very detailed record keeping. Even when there is legitimate non-cannabis activity, the IRS has disallowed the deductions. The only way to ensure that your other business is allowed to take the deduction would be the creation of an independent third-party business.

The IRS does allow for a taxpayer to deduct the cost of goods sold in calculating the taxable income. When you compute the cost of goods sold, you will need to have detailed records concerning:

1) The cost of merchandise on hand at the beginning of the taxable year ("beginning inventory"), sec. 1.471-3(a), Income Tax Regs.,
2) plus the cost of merchandise purchased since the beginning of the taxable year ("purchase costs"), id. para. (b),
3) plus the direct and indirect cost of producing merchandise ("production costs"), id. para. (c), sec. 1.471-11, Income Tax Regs., and
4) minus the cost of inventory on hand at the end of the tax year ("ending inventory"), sec. 1.471-1, Income Tax Regs. This will be most helpful for those that want to enter on the level of the dispensary.

Before you enter the medical cannabis industry, it is very important to understand the impact IRC §280E will have on your cash flow and profitability. You should talk with your tax consultant before you invest your money, considering you will not be able to take normal business deductions, which could adversely impact your new venture. Good luck and stay tuned … the landscape of the industry is changing rapidly. V