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## Taxes and the Cannabis Business

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### Cannabis and the Law

On January 5, 2018, the Pew Research Center released the results of a survey of the support in America for the legalization of marijuana. About six in ten (61%) Americans said the use of marijuana should be legalized, an increase from 57% one year prior but nearly double what it was in 2000 (31%). As of 2018, 29 states plus the territories of Guam and Puerto Rico and the District of Columbia allowed marijuana use for medical purposes. Eight of these states and Washington, DC, also permitted marijuana use for recreational purposes.<sup>1</sup>

Marijuana was largely a cash business because its sale was prohibited by federal law under the Controlled Substances Act of 1970. No bank was likely to open an account for a cannabis business. This created a whole new set of issues, including whether entrepreneurs would declare the appropriate amount of taxable income and pay their fair share. Since selling marijuana in any form was prohibited by federal law, the seller needed to pay taxes on the revenue less cost of goods sold; administrative, marketing, and other costs were not deductible. Businesses would have to use cash for employee salaries, sales taxes, and income taxes. Other issues included the importance of internal controls in an all-cash business.

The following situation was created based on an assumed set of facts to introduce the tax issues surrounding marijuana use given it was still against federal law and to show a scenario whereby a tax accountant was being pressured by her superiors to reduce taxable income (tax income reported to the Internal Revenue Service). The case involved developing a scripted response for the tax accountant to give her an ethical basis to voice her values in a meeting with the tax manager and the partner in charge of the tax practice.

### A CPA's Cannabis Conundrum

Central Coast Cannabis (CCC) was in the marijuana growing and distribution business. The company operated in a state where the sale of marijuana for medical and recreational purposes was legal. Hailey Delaney, a certified public accountant (CPA), sent the tax return that she prepared for CCC to Harry Johnson, the manager of the tax department. Johnson had just fielded a phone call from CCC's president, who gave him an earful because Delaney insisted on reporting all of the cash sales from the marijuana business on the 2019 tax return.

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<sup>1</sup> Abigail Geiger, "About Six-in-Ten Americans Support Marijuana Legalization," *Pew Research Center*, January 5, 2018, <http://www.pewresearch.org/fact-tank/2018/01/05/americans-support-marijuana-legalization/> (accessed Sept. 5, 2018).

The next morning, Johnson asked to see Delaney. When she arrived at his office, the following conversation ensued.

“Hailey, come in,” Johnson said.

“Thank you, Harry,” Delaney responded.

“Do you know why I asked to see you?”

“I’m not sure. Does it have something to do with the tax return for CCC?” asked Delaney.

“That’s right,” he answered.

“Is there a problem?” Delaney asked.

Johnson answered, “I just spoke with the company’s president. He said you insisted on reporting 100% of the cash sales from the marijuana business. He’s upset. He wants to hold back 25% of that amount and figures no one will be the wiser because marijuana is a cash business.” He reminded Delaney that the company couldn’t get a bank account in the state because, even though the cannabis business was legal in the state, it was still prohibited under federal law under the Controlled Substances Act. He added, “There is no audit trail for these transactions, so we need to be more understanding about the client’s position.”

“Why would we risk our reputation by going along with the client’s position?” Delaney asked.

“It’s not that simple,” Johnson responded. “The client needs an audit report under state regulations. We have been pushing hard to get that business. It’s lucrative and may open the door to additional compliance services and consulting arrangements.”

Johnson knew he could simply change the tax return and submit it for the client. However, he wanted Delaney to get on board because the firm intended to go after other clients in the marijuana business. So Johnson asked Delaney to meet with him and the partner in charge of the tax practice, both of whom were CPAs, first thing on Monday morning. Delaney said she would be there and returned to her office.

### **What to Do?**

Back in her office, Delaney reflected on her situation. The manufacture, distribution, and sale of marijuana was legal in the state. Delaney knew that she should conform her behavior to the rules of conduct of the state board of accountancy. One such rule in most states precluded “acts discreditable” to the profession, which included violating federal laws.

The US Department of Justice (DOJ) had offered insight on how it would enforce the Controlled Substances Act in light of state laws allowing marijuana sales. The most recent guidance, adopted in the Obama administration as issued by Deputy Attorney James M. Cole on August 29, 2013, noted that the federal government viewed marijuana as a “dangerous drug” and its distribution as a “serious crime,” but given its limited resources for investigations and prosecutions, the DOJ’s focus was on eight enforcement priorities, none of which included prosecuting those involved in the marijuana business in states where it was legal. Priorities included, for example, distributing marijuana to minors and preventing revenue from going to

criminal enterprises, gangs, and cartels.<sup>2</sup> A more relevant concern for CPAs with respect to these priorities was to prevent the transport of marijuana from states where it was legal under state law in some form to other states. Consequently, CPAs needed to take care that their clients in the marijuana business in a state that permitted it did not cross state borders and operate in states where it was illegal.

Attorney General Jeff Sessions of the Trump administration rescinded these Obama-era guidelines in January 2018. However, in a statement on July 26, 2018, Sessions stated that while the federal marijuana prohibition existed, states still had the right to pass their own laws.<sup>3</sup> This didn't appear to be a substantive change in prior policy and, as of September 2018, there had been no criminal investigations against those in the marijuana business in states where it was legal. It would be important to monitor these legal issues.

According to guidance provided by the American Institute of Certified Public Accountants (AICPA), in those states where marijuana was legal for recreational and/or medical purposes, the state boards made it clear they would not take action against licensees and firms that elected to provide services to the marijuana industry based solely on the fact that the licensee or firm provided such services. However, licensees were reminded that the federal government viewed such activity as a federal offense and that the board's position would not negate the possibility that disciplinary action could be taken by the board should a licensee be found guilty of a federal criminal act.<sup>4</sup>

The manufacture, distribution, and sale of marijuana was legal in the state. Delaney knew that she should conform her behavior to the rules of conduct of the state board of accountancy. One such rule in most states precluded "acts discreditable" to the profession, which included violating federal laws. Delaney knew what the right thing to do was, and knew she needed to find a way to influence the position of the tax manager and partner in charge of the tax practice at Monday's meeting.

## Questions

Think of your responses through the eyes of Delaney.

1. What are the main arguments, reasons, and rationalizations that Delaney would need to address when she met with Johnson and the tax partner?
2. What was at stake for Delaney, Johnson, the tax partner, and the firm?
3. What levers could Delaney use to influence Johnson and the tax partner to reverse their position?
4. What was Delaney's most powerful and persuasive response to the reasons and rationalizations she needed to address? To whom should the argument be made? When and in what context?

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<sup>2</sup> Annette Nellen, "Ethical Considerations When Your Potential Tax Client is a Marijuana Business," *The Federal Lawyer*, (July 2014) [http://www.fedbar.org/Resources\\_1/Federal-Lawyer-Magazine/2014/July/Columns/Tax-Talk.aspx?FT=pdf](http://www.fedbar.org/Resources_1/Federal-Lawyer-Magazine/2014/July/Columns/Tax-Talk.aspx?FT=pdf) (accessed Sept. 5, 2018).

<sup>3</sup> Giantautas Dumcias, "Attorney General Jeff Sessions, Marijuana Legalization Opponent, Says States Have a 'Right to Set Their Own Laws,'" *MassLive*, July 26, 2018, <https://www.masslive.com/news/index.ssf/2018/07/attorney-general-jeff-sessions.html> (accessed Sept. 5, 2018).

<sup>4</sup> American Institute of CPAs (AICPA), *An Issue Brief on State Marijuana Laws and the CPA Profession*, updated January 8, 2016, <https://www.aicpa.org/advocacy/state/downloadabledocuments/marijuanacpasissuebrief.pdf> (accessed Sept. 5, 2018).