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Tax Practice: Hazy Marijuana Laws Cause Headaches for IRS, Side Effects for Practitioners

By Laura Davison

Unclear laws about what expenses marijuana-related businesses can deduct is creating a big problem for the Internal Revenue Service, an agency official said.

“It's causing a lot of headaches for the IRS, particularly in Colorado,” Karen L. Hawkins, director of the IRS's Office of Professional Responsibility, told practitioners at an American Bar Association Section of Taxation meeting May 8.

“The dispensaries and growers want to pay their taxes. They're going into IRS service centers with bags of cash. It's like the Wild West,” she said.

Marijuana is legal for medical or recreational use in 23 states and the District of Columbia but illegal at the federal level. Its use has tax practitioners confused about whether they will run afoul of professional responsibilities and in need procedural guidance to spell out what can and can't be deducted under tax code Section 280E.

Rocket Science.

“It's a hard area to prepare returns in,”Phil Falco, an attorney and certified public accountant based in Denver, told Bloomberg BNA on May 13. “It can be done legitimately, without fraud or hiding the ball,”if marijuana businesses have access to some of the same deductions and exclusions as other businesses.

A IRS chief counsel advice memorandum (CCA 201504011) released in January said that some marijuana businesses could exclude the costs of goods sold for income. The document, however, was too inscrutable for most people to use it, Hawkins said (16 DTR K-1, 1/26/15).

“The folks that I have become aware of in the marijuana growing and dispensing industry are not rocket scientists,”Hawkins said. “I'm not sure—unless they're going to pay a lot of money to hire some of the smartest big accounting firms to do their cost-of-goods-sold analysis—they will understand what that advice is saying to them.”

Section 280E, the part of the tax code causing the confusion, disallows deductions related to the sale of a schedule 1 or schedule 2 substance. Marijuana is a schedule 1 drug.

Championing the Cause.

A 2007 U.S. Tax Court decision known as CHAMP, Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner, said that a medical marijuana dispensary could deduct expenditures that weren't directly linked to the substance (94 DTR K-1, 5/16/07).

“I think CHAMP is probably the road map for the time being for the due diligence that needs to be done by the return preparer,” Hawkins said.

Tax professionals will have to determine, based on the CHAMP case, which expenses can be deducted and which ones the taxpayer will “have to eat” until there are changes in the law, Hawkins said.

Sen. Ron Wyden (D-Ore.) and Rep. Earl Blumenauer(D-Ore.) introduced a bill in April proposing an exemption to tax code Section 280E, which would allow marijuana-related businesses access to such tax benefits as small business deductions for payroll or remodeling, or to the Work Opportunity Tax Credit (69 DTR G-6, 4/10/15).

“No one wants to file a return where they kill a business,” Falco said.

Akin to Illegal Immigration.

Twenty-three states, the District of Columbia and Guam have either legalized medical marijuana or recreational marijuana, though business owners can often find it difficult to pay federal taxes or obtain banking services because the federal government still considers the drug illegal.

Hawkins clarified that the IRS wouldn't seek to target marijuana or their tax preparers who were reasonably implementing previous guidance and case law about what to deduct.

“From the Internal Revenue Service point of view, we view these activities the same way we view the illegal immigration issues. The IRS is about getting as many people as possible reporting their income and paying the right amount of tax into the system without worrying about whatever other illegal activities they might be involved with.”