AN ANALYSIS OF THE ACCOUNTING AND FINANCIAL EFFECTS OF INCONSISTENT STATE AND FEDERAL LAWS IN THE RECREATIONAL MARIJUANA INDUSTRY

Kimberly Taylor, Murray State University
Randall B. Bunker, Murray State University
Leigh Redd Johnson, Murray State University
Ray Rodriguez, Idaho State University

ABSTRACT

The recreational marijuana industry exists in an environment of legislative uncertainty created by states legalizing recreational marijuana while it is still considered illegal at the federal level. The dichotomy between state and federal laws has created interesting accounting and financial effects; including how financial institutions, CPAs, and the individual marijuana businesses themselves are affected by the inconsistencies in the laws from an accounting and finance perspective. The purpose of this study is to identify and examine the accounting and financial effects of the inconsistencies between state and federal laws on the recreational marijuana industry.

INTRODUCTION

The recreational marijuana industry exists in an environment of legislative uncertainty resulting from states legalizing recreational marijuana while it is still considered illegal at the federal level. For the recreational marijuana industry, legalization did not occur until 2012 when Colorado first legalized it and has since been followed by three other states and Washington D.C. The dichotomy between state and federal laws has created interesting accounting and financial effects; including how financial institutions, CPAs, and the individual marijuana businesses themselves are affected by the inconsistencies in the laws from an accounting and finance perspective.

From a financial institution standpoint, one of the most important aspects that is influenced by the differing state and federal laws includes providing services to marijuana-related businesses while still adhering to federal banking regulations. Banks are subject to a number of federal regulations that they must follow regardless of states' stances on recreational marijuana. When considering the accounting and financial effects from a marijuana business owners perspective, there are a number of important aspects that can be considered. These include the tax rates applied to business owners, the environment in which the business operates, and the accounting methods used. From a CPAs perspective, there are numerous facets to consider such as following available guidance and providing services to marijuana businesses while remaining in accord with accounting standards.

The accounting and financial effects of the inconsistent laws from these perspectives are not mutually exclusive and often connect to each other so that an effect in one area often causes effects in the other areas as well. The purpose of this study is to identify and examine the

accounting and financial effects of the inconsistencies between state and federal laws on the recreational marijuana industry.

LITERATURE REVIEW

Federal Legislation and Considerations

Past regulation-related research explores differences in societal opinions regarding the ethicality of the use and legalization of certain drugs. For example, although the use of performing-enhancing drugs (PEDs) by athletes is viewed as creating an unfair advantage and an un-level playing field by some, Osei-Hwere, et al. note that sports fans are equally divided as to whether PED use should be allowed in certain sports (2014). Likewise, much has been written regarding the morality of the use and legalization of marijuana. On the one hand, some argue that marijuana smoke is toxic and could lead to the use of more serious, dangerous drugs; however, others note that marijuana is an effective treatment for certain conditions, thereby reducing suffering (Clark, 2000), and that its legalization would reduce crime rates, save taxpayer money and generally benefit both individuals and communities (Cussen, 2000).

Recreational marijuana is an emerging industry in the United States due to four states and Washington, D.C. recently passing measures to legalize the recreational use of the drug. However, marijuana is still illegal federally because it is a Schedule I drug under the Controlled Substances Act (CSA) (CSA, 2012). Schedule I drugs are those that the federal government lists as having a high potential for abuse, no accepted medical use, and lack of safety even under medical supervision (CSA, 2012). The illegality of marijuana at the federal level allows for a number of civil and criminal penalties that can be assessed against people who cultivate, sell, or distribute marijuana even if legal by state standards (Gramlich and Houser, 2015), and the federal government has prosecuted individuals for the use and possession of marijuana even when such use and possession was permitted under state law (Barkacs, 2010). This creates a unique dichotomy between federal and state laws.

According to the Internal Revenue Code (IRC), gross income is defined as all income from whatever source derived (26 U.S.C. §61(a), 2012). As recognized in *James v. United States* (1961), there is no inclusion of the word "lawful" when describing the sources through which income can be derived. This means that although marijuana is considered illegal by the federal government it is still subject to federal income taxes. It is treated the same as all other income, whether legal or illegal.

The federal government further allows for a business to deduct all ordinary and necessary business expenses from its gross income (26 U.S.C. §162(a), 2012). At the time the business expense deduction was created it did not differentiate between businesses participating in a legal trade from an illegal trade. This allowed for people conducting illegal businesses to continue to deduct their business expenses from gross income, thus reducing their amount of taxable income and, in turn, taxes due. This was highlighted in *Jeffery Edmondson v. Commissioner* (1981) where Edmondson made the argument, and won the argument, that he should be allowed to deduct the expenses related to his business of selling amphetamines, cocaine, and marijuana. However, this deduction is no longer available for businesses that are involved in trafficking Schedule I or II controlled substances as defined in the CSA due to the passage of Section 280E of the IRC (26 U.S.C. §280E, 2012).

To further explain why Section 280E was created, the Joint Committee's *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (1983) states that:

> *There is a sharply defined public policy against drug dealing. To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal enterprises. Congress believed that such deductions must be disallowed on public policy grounds. (p.264)*

This exclusion was created before any states legalized marijuana for medical or recreational use. The application of Section 280E to marijuana businesses that are legal at the state level but illegal at the federal level demonstrates how, although legal within their state, these businesses are still coping with the difficulties of complying with federal laws.

Although marijuana-related businesses cannot deduct their business expenses from gross income, Section 280E does not preclude businesses from deducting cost of goods sold (COGS). Continuing to allow businesses to adjust gross income by the amount of COGS was done to prevent possible challenges on the grounds of unconstitutionality (Joint Committee on Taxation, 1983). In *Californians Helping to Alleviate Medical Problems, Inc. (CHAMP) v. Commissioner of Internal Revenue* (2007), the government acknowledged that Section 280E prevents taxpayers from deducting business expenses, but it does not prevent businesses from claiming COGS. However, because marijuana-related businesses fall under Section 280E, the IRS Office of Chief Counsel issued Chief Counsel Advice which clarified that businesses should determine their COGS using the inventory costing methods that existed when Section 280E was enacted (McElroy, 2015).

A consequence of administering Section 280E in legalized states is that many cases have been brought against the Internal Revenue Service (IRS) on the basis of deducting Section 280E expenses with varying results. In *CHAMP v. Commissioner of Internal Revenue* (2007), the court held that the taxpayer's caregiving services and furnishing of medical marijuana were separate business for the purposes of Section 280E. This allowed the taxpayer to deduct the portion of expenses related to the primary, lawful caregiving portion of its business. However, in *Olive v. Commissioner of Internal Revenue* (2015), the court found that the taxpayer's business was of limited scope and consisted of trafficking marijuana, which places it under the constraints of Section 280E. Even where permitted by state law, marijuana businesses are considered to be trafficking Schedule I drugs for the purpose of determining the applicability of Section 280E (*Canna Care, Inc. v. Commissioner of Internal Revenue*, 2015).

As the number of states legalizing marijuana for medical and recreational use has increased, many have argued in federal courts that marijuana should no longer be subject to the Section 280E exclusion. However, this is not the judiciary's decision to make and must be addressed by Congress in order to be changed (*Olive v. Commissioner*, 2015). The same argument has also been made to the IRS to which the response was the same, Congress would have to change the IRC or the CSA (Keyso, 2011).

Due to the increasing number of states legalizing marijuana for medical and/or recreational use, the Department of Justice (DOJ) has issued numerous memos to address various aspects of the discrepancies in the legality of marijuana at the state and federal levels. The DOJ has focused its enforcement of the CSA to reflect the priorities of the federal government (Cole,

2013). These priorities include items that would be important to the federal government regardless of the state legalization of marijuana, including preventing the distribution of marijuana to minors and preventing driving while under the influence of marijuana (Cole, 2013). Although the DOJ has listed priorities for their enforcement of the CSA, they have also clearly stated that businesses involved in the cultivation, distribution, or sale of marijuana are in violation of the CSA and can be subject to potential prosecution (Cole, 2011). In addition to potential violations of the CSA, the DOJ also issued a memo addressing the potential violations of applicable laws that financial institutions could face in providing services to marijuana businesses (Cole, 2014).

Banks and financial institutions are subject to numerous federal laws that put the legality of working with state-legalized marijuana-related businesses into a gray area. The Money Laundering Control Act, the Prohibition of unlicensed money transmitting businesses statute, and the Bank Secrecy Act (BSA) are all laws that financial institutions must consider (Cole, 2014). Under the money laundering statutes, engaging in financial transactions with the proceeds of certain illegal activities is considered a criminal offense (Money Laundering Control Act of 1986, 2012). Similarly, a money transmitting business that is involved in the transportation of funds derived from criminal activities could be subject to fines or imprisonment for up to five years (Prohibition of unlicensed money transmitting businesses, 2012). Banks and financial institutions that fail to report transactions suspected of violating laws or regulations, the CSA in this case, would also be in violation of the BSA (BSA, 2012). Due to the illegal nature of marijuana at the federal level, it could serve as a basis for prosecution should an agency choose to do so under any of the previously mentioned laws (Cole, 2014).

The Financial Crimes Enforcement Network (FinCEN), a bureau of the Department of the Treasury, has also issued guidance to complement the 2014 DOJ memorandum with the goal of improving the availability and clarity of financial services for marijuana-related businesses (FinCEN, 2014). The guidance outlines multiple items that financial institutions should take into consideration when determining the risks involved with providing services to marijuana businesses. The basis of these items is rooted in conducting customer due diligence to ensure that the institution can evaluate the risks associated with offering their services and also effectively manage those risks (FinCEN, 2014). Furthermore, should the financial institution decide to conduct business with the marijuana-related client, the institution would be required to file suspicious activity reports (SARs) to be in compliance with FinCEN regulations (FinCEN, 2014). According to the FinCEN regulations, if the financial institution knows of or has a reason to suspect that a transaction includes funds resulting from an illegal activity, was designed to avoid regulations set forth in the BSA, or lacks a business or lawful purpose, then the institution is required to file a SAR (FinCEN, 2012).

In addition to the laws and guidance issued by the DOJ and FinCEN, it is expected that states that have legalized marijuana should have a strong regulatory environment in place to ensure that the federal interests prioritized by the DOJ are protected (Cole, 2013). Although the DOJ has issued memoranda concerning various aspects of marijuana-related businesses, they have also made it clear that even in areas with strong regulatory systems, federal enforcement action can be taken if evidence shows a person is violating any of the federal priorities (Cole, 2014). Federal guidance such as the DOJ memoranda and FinCEN guidance are not law, do not protect people from prosecution, and merely "represent exercises of prosecutorial discretion" (*Canna Care, Inc. v. Commissioner of Internal Revenue*, 2015, p. 9).

California was the first state to legalize medical marijuana in 1996 and Colorado and Washington became the first states to legalize marijuana for recreational use in 2012 (AICPA, 2016). Colorado, Washington, Oregon, Alaska, and Washington, D.C. have approved initiatives legalizing marijuana for recreational use. However, Washington, D.C. does not allow for the legal sale of marijuana that the other states have approved. Washington, D.C. only approved legalizing growing small amounts of marijuana for personal use on private property. Voter initiatives have facilitated the legalization in these states and currently no state legislature has legalized marijuana separately from a voter initiative (National Conference of State Legislatures, 2016). Although these states have legalized marijuana for recreational use, it is important to note that marijuana is still illegal at the federal level due to the CSA. Table 1 compares the tax structure for retail marijuana sales in the four states that have legalized sales.

Table 1
TAX STRUCTURES FOR RETAIL MARIJUANA SALES AS OF JANUARY 2016

State	State Excise Tax	Sales/Other Taxes	Local Sales Tax
Alaska	$50 per ounce of marijuana sold at the wholesale level	None (no statewide sales tax)	Option to apply existing local sales taxes (0-7.5%)
Colorado	15% tax on average market sale rate + 10% retail sales tax	2.9% state sales tax	Option to apply existing local sales taxes (0-8%)
Oregon	25% retail sales tax	None (no statewide sales tax)	Optional local sales taxes not to exceed 3%
Washington	37% retail sales tax	6.5% state sales tax + Business & Occupation gross receipts tax	Option to apply existing local sales taxes (0.5%-3.1%)
Source: Institute of Taxation and Economic Policy (ITEP)			

Effects on Financial Institutions

In memoranda issued by the DOJ, the agency outlined eight priorities that it believes are important to the federal government (Cole, 2013, pp. 1-2):

1. Preventing the distribution of marijuana to minors;
2. Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
3. Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;
4. Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
5. Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
6. Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
7. Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
8. Preventing marijuana possession or use on federal property.

The issuance of the 2014 DOJ memo and concurrently issued FinCEN guidance provided some clarity on the federal policies pertaining to potential marijuana-related financial crimes (Gard, 2014). However, even with the issued guidance, financial institutions are still hesitant to provide services to marijuana-related businesses because banks can be held liable for financial crimes even when acting in accordance with issued guidance and laws to their fullest abilities (Gard, 2014). To date, there has been no definitive rule made that will protect financial institutions from prosecution for providing services to state legal marijuana businesses. Although creating enforcement priorities does assist banks in their determination of whether to provide services, there is no guarantee that these priorities will continue to stay the same due to the high turnover of political leaders in Washington (Gard, 2014). In addition to the possibility of violating federal priorities and laws, large national banks are wary to provide services to marijuana clients due to the fear of losing their federal insurance (Huddleston, 2014).

Further, the Money Laundering Control Act, the BSA, and the Prohibition of unlicensed money transmitting businesses statute provide a possible basis for the prosecution of financial institutions working with marijuana-related clients and constitute much of the basis for resistance from banks (Cole, 2014). Financial institutions are hesitant to put themselves in a situation of receiving money, directly or indirectly, from marijuana sales for fear of violating various laws at the federal level (Stinson, 2015).

The DOJ also expects states to have a strong and effective regulatory system in place. If a strong regulatory environment is not present then providing services to marijuana-related businesses could conflict with the priorities set forth by the DOJ not by any particular fault of the bank, but merely because of a lack of substantial, effective regulations in the state (Cole, 2014). The evaluation of how strong and appropriate state regulations are in addition to the federal laws currently in place are two important factors for financial institutions to consider when determining their position on providing services to the marijuana industry.

The uncertainties that banks face when determining whether to allow marijuana-related clients often lead them to err on the side of caution and causing them to not provide services to the marijuana industry (ArcView Market Research, 2016). As such, many of the basic financial functions that ordinary businesses and citizens utilize on a daily basis are not available to marijuana-related businesses, including basic checking and credit card services (Stinson, 2015). In addition to these basic functions, marijuana-related businesses are also generally unable to receive loans and utilize electronic funds transfer systems (ArcView Market Research, 2016). According to the director of the FinCEN, only 105 banks accept money from legal marijuana businesses out of the 100,000 in the U.S. (Stinson, 2015). That amounts to approximately 0.105% of all banks in the nation.

Effects on Marijuana Business Owners

Although marijuana businesses are operating legally under certain state laws, much of their business is still considered illegal by the federal government (Huddleston, 2015). Section 280E not only affects retail marijuana businesses but also any business that participates in the cultivation, processing, or sale of marijuana whether for medical or recreational use (National Cannabis, 2015). Marijuana businesses are disallowed from claiming the basic expenses that other ordinary businesses are allowed to deduct such as advertising and employees' salaries (Huddleston, 2015).

Due to the existence of Section 280E, these marijuana businesses legalized by state law are facing an effective federal income tax rate of up to 75 percent (Hargreaves, 2013). These

comparatively high effective tax rates stem from the inability to deduct business expenses when determining taxable income for federal purposes (National Cannabis, 2015). The impact of the high effective tax rates were mitigated slightly by high profits achieved by businesses with an early mover advantage in the beginning. However, as more businesses enter the market and the industry becomes more competitive, the impact will increasingly affect businesses (ArcView Research, 2016). All things remaining equal, a marijuana business and an ordinary business with the same revenue, COGS, and business expenses, can experience largely different effective tax rates (National Cannabis, 2015). The tax burden experienced by marijuana businesses, coupled with the lack of access to services provided by financial institutions, makes operating and remaining profitable in the industry difficult (Barreras, Ittleman, & Fuerst, 2014).

As businesses attempt to navigate and comply with complex laws and regulations, the guidance issued to assist them can sometimes have the opposite effect. Rather than encouraging businesses to create a working relationship with the IRS, a recent IRS memo regarding how to calculate COGS for the purposes of Section 280E is more likely to prompt businesses to consider sidestepping the IRS (National Cannabis, 2015). This is because the memo narrowed the scope of what expenses were considered to be a part of COGS, especially for retailers who are disallowed from deducting the costs of storing and handling marijuana and general administrative expenses (Huddleston, 2015). The current situation with Section 280E has led some people to ignore the exclusion or choose to not pay taxes at all rather than lose the revenue they would have made had the Section 280E exclusion not been in place (National Cannabis, 2015).

Although some businesses have chosen to circumvent the IRS when it comes to taxes, most marijuana businesses that are licensed with a state want to pay state and federal taxes; this legitimizes their businesses and the industry (National Cannabis, 2015). However, the complex laws, exclusions, and guidance issued are often more than the average business owner can understand. According to Karen Hawkins, director of the IRS's Office of Professional Responsibility, the recently issued memo regarding COGS calculations was too indecipherable for most people to comprehend (Davison, 2015). This furthers the difficulties faced by businesses when trying to correctly determine their taxable income and file their federal and state taxes.

While the Joint Committee's *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* stated that the Section 280E exclusion was created for public policy reasons (1982), some have questioned whether disallowing the deductions for the legalized state licensed businesses is in line with the original legislative intent of the exclusion (Barreras, Ittleman, & Fuerst, 2014). Regardless of whether the exclusion's current application is consistent with its original purpose, it is part of the federal law that is applicable to all businesses that fall within its described bounds, which are those businesses trafficking Schedule I and II controlled substances.

The high tax rates experienced by marijuana businesses and the inability to form relationships with financial institutions are increasing hindrances to industry growth as a whole (Huddleston, 2015; ArcView Research, 2016). High taxes are also often seen as an incentive for businesses to commit tax evasion and a reason that the black market is still present even in states that have legalized marijuana for recreational use (Merriman, 2010). One of the primary reasons for legalizing marijuana is to bring it into a legal market and in turn eliminate the black market where it was originally sold (Tax Policy Issues, 2016). According to a Marijuana Business Daily research report, in states that have legalized marijuana for recreational use, 17 percent of users

still purchase solely from the black market and 16 percent purchase from both the black market and legal market (Olson, 2015).

Effects on Certified Public Accountants

In addition to the lack of clear guidance for financial institutions, CPAs face similar uncertainties when approaching the decision to provide services to marijuana-related clients. Although almost half of the United States has legalized some form of marijuana, and four states have completely legalized it, only seven state boards of accountancy have issued guidance in relation to CPAs providing services to marijuana clients (AICPA, 2016). Of those seven state boards, three are in states that have legalized marijuana for recreational use. The Colorado, Oregon, and Washington state boards of accountancy have issued guidance for CPAs licensed in their states, while Alaska has yet to issue any specific information in relation to providing services for the marijuana industry (AICPA, 2016).

The Colorado State Board of Accountancy's statement on providing services to the marijuana industry states that there is nothing specifically prohibiting CPAs from providing services for marijuana-related clients who are in compliance with the Colorado Medical Marijuana Code and Colorado Retail Marijuana Code (AICPA, 2016). The guidance also expresses that the Board's position statement is not an endorsement for CPAs to work with marijuana clients, does not act as a statement on the practicality of complying with all applicable standards when providing services to marijuana-related businesses, and is not a statement about marijuana enforcement outside of its jurisdiction (Colorado State Board of Accountancy, 2015).

Similar to Colorado, the Washington State Board of Accountancy's position statement on performing professional services to clients in the marijuana industry states that there is nothing specifically prohibiting CPAs from providing these services (AICPA, 2016). However, Washington's Board of Accountancy is also careful to begin its statement with the phrase, "Pending changes in federal marijuana enforcement policy" (Washington State Board of Accountancy, 2014, p. 1). Beginning their position statement in this manner addresses the dichotomy between state and federal laws and conveys that there is potential for the federal government to adjust its position on marijuana. It also makes clear that the Board's position statement in regards to CPAs providing services to the marijuana industry is dependent on federal policy. Through the position statement, the Executive Director also recommends that CPAs providing services to the emerging marijuana industry carefully evaluate the potential risks associated with providing these services and address them appropriately (Washington State Board of Accountancy, 2014).

The Oregon Board of Accountancy took a similar but slightly different approach to its guidance regarding providing services to the marijuana industry. The guidance provides that the decision to offer services to marijuana clients is up to each individual CPA or firm and that should they choose to provide any services they should consider all the potential risks involved, including those that arise from the inconsistencies in state and federal laws (Oregon Board of Accountancy, 2015). However, differing from Colorado and Washington, the Oregon State Board of Accountancy's guidance states that CPAs and CPA firms that choose to provide services to the marijuana industry will not face action by the Board based solely on providing services to marijuana businesses (AICPA, 2016).

In an issue brief prepared by AICPA staff in conjunction with the Colorado and Washington state CPA societies, the AICPA recommended that firms considering the idea of providing services to marijuana-related clients should review all guidance issued by the DOJ

(AICPA, 2016). According to the DOJ memo, *Guidance Regarding Marijuana Enforcement*, providing services in states that have an effective regulatory system in place, but that threaten the federal priorities listed previously, "will subject that person or entity to federal enforcement action, based on the circumstances" (Cole, 2013, p.4). The lack of clear, explicit guidance and rules relating to services that CPAs could offer makes it difficult for these licensed accountants to determine what will put them in jeopardy of violating federal priorities (AICPA, 2016).

From an attestation standpoint, it is difficult for CPAs to determine what will and will not violate federal priorities when comprehensive auditing standards for marijuana-related clients are nonexistent (Barreras, Ittleman, & Fuerst, 2014). Although there is no explicit guidance for providing services to the marijuana industry, there are a number of standards that are applicable to all CPAs regardless of the industry in which they work that must be complied with throughout an audit. According to the AICPA Code of Professional Conduct, Rule 1.400.001, members should not act in a way that is discreditable to the accounting profession which includes failing to follow the requirements of governmental bodies, commissions, or other regulatory bodies (AICPA, 2014).

The difficulties for CPAs providing attestation services are especially prevalent in states such as New Mexico and Minnesota, which have legalized marijuana for medicinal use. Both states require annual audits of producers to be performed by independent CPAs (Minnesota Statutes, 2015; New Mexico Administrative Code, 2015). According to an AICPA brief on state marijuana laws and the CPA profession, a CPA in New Mexico sought advice from the New Mexico Department of Health, who in turn wrote to the New Mexico Public Accountancy Board, for direction on how to provide services to marijuana businesses (AICPA, 2016). The Board responded by saying that it could not issue a letter authorizing CPAs to conduct audits of marijuana businesses because it did not have the authority and that the Department of Health should remove its audit requirement until federal and state laws no longer conflict (AICPA, 2016).

Another part of the AICPA Code of Professional Conduct is Rule 1.300.001 which addresses the general standards that accountants in practice are expected to follow including: professional competence, due professional care, planning and supervision, and sufficient relevant data (AICPA, 2014). In terms of competency, CPAs who consider providing services to the marijuana industry must decide whether they have sufficient knowledge to plan the engagement properly. Although CPAs can gain competence through research, continuing professional education, and working with people experienced and knowledgeable in the industry, this is not easy due to the recent emergence of the industry and limited availability of such resources (AICPA, 2016).

In addition to competency, when planning an engagement, CPAs must have a complete understanding of a business entity, including the regulatory and legal environment of the industry, in order to assess the risk of material misstatement for that client (AICPA, 2016). This is an ever-present challenge for CPAs when the marijuana industry is constantly changing, there are inconsistencies between the state and federal laws, and the possibility exists that the federal government could criminalize the industry at the state level at any time (Borchardt, 2015). This can also make it difficult for CPAs to obtain sufficient relevant data in relation to a client's compliance with laws and regulations, especially when the industry is illegal in itself from a federal perspective (AICPA, 2016).

In determining the risk of material misstatement CPAs must consider the risks associated with businesses participating in the marijuana industry (AICPA, 2016). The risks for marijuana-

related businesses are especially numerous. These risks result from multiple factors but one of the most noticeable is the fact that marijuana businesses currently operate in an almost entirely cash based industry (Gard, 2014). Operating solely in cash results in a lack of transparency for accounting and auditing purposes (Stinson, 2015). This lack of transparency stems from bookkeeping difficulties that result from working on a cash-only basis (Tax Policy Issues, 2016). Auditors also typically reconcile a client's count of funds to a bank's count to increase the reliability of information, however, this reliability is eliminated when businesses do not have a relationship with a bank and CPAs must rely solely on the business's record of cash (AICPA, 2016). Another concern for CPAs to consider is that operating on a cash basis provides businesses with the opportunity to underreport revenues in order to report lower income for tax purposes (Tax Policy Issues, 2016).

The difficulties CPAs face for providing services to marijuana-related clients from a tax perspective are just as pervasive as for providing attestation services. There are numerous issues that arise when businesses must determine their amount of taxable income for state and federal purposes. These issues stem, in part, from the Section 280E exclusion that disallows the deduction of business expenses from gross income for marijuana businesses (26 U.S.C. §280E, 2012). Tax practitioners are in need of clear guidance as to what can and cannot be deducted under Section 280E (Davison, 2015). In order for CPAs to provide tax services to clients in an industry that is characterized by legislative ambiguity, they must exercise due diligence throughout the process of providing these services (AICPA, 2016). Part of the CPA's due diligence includes considering all information that is available to them to determine whether they can ethically and practically perform the services. The Statements on Standards for Tax Services (SSTS) and AICPA Code of Professional Conduct are particularly helpful when determining the ethicality of providing services to marijuana-related clients (AICPA, 2016).

SSTS No. 1, 2, and 3 can help guide practitioners throughout the process of providing services to marijuana-related clients. SSTS No. 1 provides practitioners with guidance on recommending tax return positions. This is especially important for CPAs providing services in the marijuana industry because due to the lack of firm guidance, practitioners must ensure positions recommended to the client have a reasonable basis and are properly disclosed, if necessary (AICPA, 2010). A prime example of this would be the COGS calculation, practitioners should determine whether the taxpayer's calculation is reasonable and if it should be disclosed or not. The practitioner should also advise the taxpayer of any potential penalties that could be a consequence of not disclosing certain tax return positions (AICPA, 2010).

SSTS No. 2 states that practitioners should make a reasonable effort to obtain all necessary information for appropriate answers to questions on a tax return (AICPA, 2010). In addition, SSTS No. 3 provides that a practitioner can, in good faith, use information provided by the taxpayer without verification, unless the law requires supporting documentation (AICPA, 2010). It also provides that they should attempt to obtain support for tax information provided whether through inquiry or referring to the prior year's return, if feasible (AICPA, 2010). When operating in a cash-based industry there is likely to be little verification available for much of a marijuana business's tax information. As such, practitioners should refer to SSTS No. 2 and 3 to obtain answers to all necessary questions to sign the return, to determine whether information can be included on the return, and the possible penalties that could arise from not including information or including inaccurate information.

Due to the numerous concerns CPAs face when determining whether to provide services to marijuana businesses, the AICPA provided the following eight questions for CPAs to consider prior to providing services to the industry (AICPA, 2016, pp.12-13):

1. What, if any, is the position of my State Board of Accountancy on CPAs providing services to marijuana growers/distributors?
2. What are the legal risks of providing services to these businesses in my state?
3. Is there a risk of prosecution to a CPA firm that provides services to marijuana-related businesses?
4. What is the likelihood that the Drug Enforcement Administration (DEA) or the Department of Justice is going to prosecute this marijuana-related business?
5. How are CPAs in my state currently offering services to state-recognized medical marijuana dispensaries?
6. How will providing the contemplated services affect my malpractice insurance? How will it affect my professional liability insurance?
7. What is the likelihood that I may be disciplined, sanctioned, or lose my license for providing services to these businesses?
8. What procedures/policies should I consider to assess whether the prospective client understands the laws of his or her state concerning marijuana-related businesses and does the client follow those rules?

The AICPA also recommends that CPAs consult with their lawyer and state board of accountancy when venturing into the legal gray area that is involved with providing services to the marijuana industry (AICPA, 2016). Although marijuana may be legal at the state level, the illegality of the substance at the federal level results in an uncertain and risky area of business for CPAs providing tax and audit services (Gramlich and Houser, 2014).

In addition to considering the preceding questions, prior to providing services to clients in the marijuana industry, CPAs should also determine how their state board of accountancy defines the "good moral character" requirement (AICPA, 2016). The issue with determining what is considered good moral character is that few states define what it is, they merely state that a CPA must have it in order to obtain a license (AICPA, 2016). As such, there is the potential for states to consider providing services to the marijuana industry as violating the good moral character requirement (Gramlich and Houser, 2015). This in turn could result in states choosing to not grant or renew a license (Borchardt, 2015). CPAs could also theoretically face difficulties in obtaining a reciprocal license from a state that has not legalized marijuana after providing services to a marijuana business in a state that has legalized it (AICPA, 2016).

In addition to the potential difficulties with licensing, CPAs could face issues with their malpractice insurance as well. A CPA must know what is specifically included and excluded in their insurance coverage because liability policies typically have an exclusion for criminal acts (AICPA, 2016). An example of this occurred in the legal profession where a Denver lawyer lost her insurance coverage for providing services to marijuana clients even though the substance is legal in Colorado (Wilson, 2014).

CONCLUSIONS AND COMMENTS

The dichotomy between state and federal laws concerning the marijuana industry has created numerous issues for financial institutions, the accounting profession, and for business owners. To date, no action has been taken on the part of the federal government to specifically prohibit or encourage it. If this trend continues, of states legalizing recreational marijuana and

the federal government not taking explicit action, there are number of consequences that could occur from an accounting and financial perspective.

If the federal government continues to issue limited guidance concerning recreational marijuana and the enforcement of policies in regards to it, then businesses will continue to operate in an environment of legal uncertainty. Consequently, as states continue to legalize recreational use, it is likely that more precedents will be set in court for which businesses will be able to use as a form of guidance. This would be similar to that of the CHAMP case that set the precedent for entities with separate business activities being allowed to deduct expenses related to the non-marijuana portion of the business. The experiences of businesses that have been in practice for a number of years will essentially become the guidance and standards for the industry due to the lack of federal guidance.

A lack of action at the federal level may also encourage more states to consider the legalization of recreational marijuana if they believe businesses in the state will not be penalized by the federal government for choosing to do so. More states legalizing marijuana will result in the creation of additional marijuana-related businesses and, as such, the issues that are already present for the businesses will continue and new issues are likely to arise. As new problems come about, businesses will seek further guidance on how to approach them, which may not be available due to the inconsistencies between the state and federal laws.

As the dichotomy between the state and federal governments continues, financial institutions will remain wary of providing services to marijuana-related businesses due to the possibility of being penalized by the federal government under a number of federal regulations. The federal government has issued some guidance in regards to financial institutions providing services to marijuana clients, stating that they must ensure they are in compliance with the applicable federal regulations. This requires increased effort and diligence by the financial institutions that many are currently not willing to engage in, the cost and potential risks of providing services are not yet worth the benefits from the banks' perspectives. If banks continue to remain wary of providing services to the industry, it is likely that the number of intermediary institutions that have begun to develop in recent years will increase in order to service the growing marijuana business market.

However, if states continue to legalize recreational marijuana and the number of marijuana-related businesses increases, it is possible that banks may reconsider their stance on providing services if they believe the situation has reached a point where the benefits will outweigh the potential costs. This situation is likely a long ways away though due to the high number of regulations banks must adhere to, that if not complied with can be a criminal offense. Financial institutions are currently not willing to risk their established positions in federally legal industries to obtain a comparatively small portion of the federally illegal recreational marijuana industry.

In order to comply with all existing standards and guidance, financial institutions must be very knowledgeable of their potential clients. This includes performing customer due diligence when considering providing services. As listed in Table 2 below, there are a number of activities that can be performed in order to obtain this knowledge of the customer. By implementing these activities, financial institutions are more likely to adhere to applicable standards and lessen the risk of federal scrutiny.

Table 2
SAMPLE DUE DILIGENCE ACTIVITIES

1. Verifying with the appropriate state authorities whether the business is duly licensed and registered;
2. Reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate its marijuana-related business;
3. Requesting from state licensing and enforcement authorities available information about the business and related parties;
4. Developing an understanding of the normal and expected activity for the business, including the types of products to be sold and the type of customers to be served (e.g., medical versus recreational customers);
5. Ongoing monitoring of publicly available sources for adverse information about the business and related parties;
6. Ongoing monitoring for suspicious activity;
7. Refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk.

Source: Financial Crimes Enforcement Network

From the perspective of the marijuana business owner, if new precedents arise from court cases, proprietors will be able to implement those precedents accordingly into their businesses if applicable. This provides for the possibility that business owners may find other legal ways to reduce their taxable income and thus reduce their effective tax rates. As long as financial institutions remain wary of providing services to the marijuana industry and business owners are unable to establish relationships with banks, the recreational marijuana industry will continue to work in a cash-only environment. This will result in businesses still being a target for theft due to the large amounts of cash they have on hand. However, if financial institutions begin to offer services to marijuana businesses or intermediary institutions grow, the industry will have the opportunity to move away from a cash-only basis and the dangers for business owners and their employees will be reduced.

If states continue to legalize recreational marijuana and the federal government maintains their current position on the substance, CPAs will have to choose what they want to do. There is nothing specific that prohibits CPAs from providing services to marijuana clients, however there are standards that must be followed for all services they provide that they must consider. CPAs, like financial institutions, would have to increase their level of due diligence when performing work and be aware of the potential consequences should they do something incorrectly. Understanding and applying the SSTS and the AICPA Code of Professional Conduct would be beneficial from this perspective.

CPAs should also be careful to review their malpractice insurance coverage to ensure that providing services to marijuana clients will not cause them to lose their insurance. As long as marijuana remains illegal at the federal level it is possible that insurance carriers can consider marijuana businesses to be taking part in a criminal act. In addition, each state board of accountancy has separate and distinct rules governing CPAs licensed within the state. Practitioners should ensure they are in compliance with all state regulations and that they do not act in a way that could jeopardize their license. It is also worthy to note that there is the potential for an uptick in IRS audits of marijuana-related businesses due to the increased opportunities for tax evasion. These increased opportunities arise from the cash-only environment of the industry and the lack of clear regulations and guidance that can result in business taking varying tax positions, that may not all be correct.

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