

Dearth of Pot Tax Evasion Charges Surprises Tax Defense Lawyers

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By Nathan J. Richman

Cash businesses generate lots of criminal tax charges, so it's surprising that more don't arise from the state-legal cannabis businesses forced to operate on a cash basis by the federal prohibition against marijuana, an attorney said.

As with any industry, if the owners of state-legal marijuana businesses live lifestyles that don't match their reported income, IRS fraud investigators [could become interested](#), Betty J. Williams of the Law Office of Williams & Associates PC said December 9.

She was speaking at a conference in Las Vegas hosted by the American Bar Association Section of Taxation. Another speaker, Jeffrey A. Neiman of Marcus, Neiman, Rashbaum & Pineiro LLP, said that IRS revenue agents and special agents should look at cash-intensive, state-legal marijuana businesses no differently than cash-intensive auto repair businesses. On the other hand, the federal restrictions on cannabis under the Controlled Substances Act could also [heighten revenue agent sensitivity](#) and increase the chance of a criminal tax referral for those businesses, he added.

"I'm, quite frankly, surprised we haven't seen more criminal investigations on the tax evasion of the marijuana businesses," Neiman said, adding, "We've seen only a handful of them, quite honestly."

While there have been [some reported](#) criminal tax enforcement actions targeting marijuana businesses, many have involved violations of state cannabis laws as well.

Neiman said that he'd expect traditional IRS tax fraud investigative techniques would apply at least equally to state-legal marijuana businesses because of their [difficulty in obtaining banking services](#). For example, finding taxpayers skimming cash before reporting or disclosing only one of several bank accounts to return preparers, he said, adding that "we're just not seeing those cases [despite] an increased risk."

Williams noted that the IRS has been looking carefully for approximately 10 years at the application of [section 280E](#) to state-legal marijuana businesses.

[Section 280E](#) denies all deductions except for cost of goods sold allowances to any business trafficking in substances as prohibited by the Controlled Substances Act.

In one example, an IRS audit of a Colorado cannabis business in 2016 and 2017 found \$43 million in unpaid federal income taxes, Williams said. That case, however, was only a civil audit and hasn't led to a criminal tax investigation, she noted.

"It's like they're afraid to make the referral" because of multiple administrations' Justice Department policies against devoting time and energy to investigating federal violations by marijuana businesses that are following state law, Neiman said.

From the audience, Jennifer E. Benda of Hall Estill suggested that the IRS isn't pursuing criminal tax cases because during civil tax examinations taxpayers are invoking the Fifth Amendment over concerns about federal drug charges.

According to Neiman, the IRS may be wary about the prohibition from *United States v. Tweel*, [550 F.2d 297](#) (5th Cir. 1977), and other cases against using a civil tax audit as cover for an existing criminal tax investigation. Despite those concerns, it's still possible to take a civil investigation and turn it into a criminal case, he said.

Jonathan Kalinski of Hochman Salkin Toscher Perez PC added that the line between civil and criminal tax investigations is no different for state-legal marijuana than for any other industry.

While most state-legal cannabis businesses seem to be flying under tax prosecutors' radars, Neiman said that a celebrity's involvement can attract enforcement attention. That just further emphasizes the unfairness of an appearance of selective prosecution and being left at the mercy of an assistant U.S. attorney's discretion, he added.

On the Return

Cannabis taxpayers should be careful about too aggressively trying to save deductions that would be denied under [section 280E](#) by labeling them as COGS on their tax returns, Neiman said. "That's a false item . . . put it in any industry, any return, that's a lie. And if it's a lie, you're filing a false return. It's no different than jamming in inflated invoices," he added.

The same caution should hold for CPAs and other tax return preparers, Williams said, adding that those professionals seem hard enough for marijuana businesses to find anyway.

Kalinski said it's one thing to blatantly mislabel things like rent and wages as COGS but quite another to take a reasoned, calculated position based on an interpretation of the inventory accounting rules in [section 471](#).

Plus, there's the practice in state-legal marijuana businesses of trying to separate cannabis-touching from cannabis-related entities to blunt the effect of [section 280E](#), Kalinski noted. This can be good, front-end planning, he said.

That said, taxpayers should avoid the appearance of absurd results like 127 employees of the separate business and just two in the cannabis-touching business, according to Williams. Kalinski agreed, because past attempts to do that sort of thing has generated some taxpayer-unfriendly case law.

