



MEDICAL MARIJUANA EMERGES FROM THE SHADOWS

**AND INTO THE MAINSTREAM
FINANCIAL SYSTEM**

By Kevin Harper

The legal marijuana market is one of the fastest growing industries in the United States.¹ Some 54 California cities and counties have accepted the change in society's view of marijuana and have adopted ordinances allowing medical marijuana dispensaries in their jurisdictions.²

If marijuana is fully legalized for recreational sale to adults in 2016 as predicted by some analysts, then more local governments will be considering similar actions. Those localities that allow dispensaries stand to gain substantial tax revenues.

California's 2013 marijuana harvest (legal and illegal), for example, was worth \$31 billion.³ Legal medical marijuana sales in California totaled a little over a billion dollars in 2014.⁴ If recreational use of marijuana is legalized, a large portion of the annual marijuana harvest will begin generating tax revenues for the state and for the local jurisdictions that allow dispensaries.

Since marijuana remains illegal under federal law, banks fear being implicated as money launderers, so they frequently decline medical marijuana organizations as customers. This puts retailers' safety at risk and creates problems for the collectives when paying taxes and managing employee payroll.

"The crime potential for an all-cash business, whether that's robbery, burglary or assault—violent crimes—or tax evasion, fraud, and skimming—white-collar crimes—is pretty substantial," observed Colorado Representative Ed Perlmutter.⁵

He added that "It is not fair to small businesses and employees in Colorado,

and in 33 other states and the District of Columbia, where some form of marijuana is legal or decriminalized, to be forced out of the banking system and discriminated against by the federal government."⁶

In February 2014, the Obama administration allowed the banking industry to do business with legal marijuana sellers.⁷ For the first time, legal distributors can set up checking and savings accounts with major banks.

This lays out a path for bringing marijuana commerce out of the shadows and into the mainstream financial system. Banks, however, remain reluctant because nothing in the guidance protects a bank from future prosecution if a new administration decides to prosecute state-licensed companies for violating federal drug laws, analysts say.⁸

Case History: Richmond

In 2010, the city council of Richmond, California, amended its municipal code to permit up to three medical marijuana collectives in the city. An ordinance

approved by citizens in the November 2, 2010, general election requires that a business license tax be collected. The code requires each dispensary to:

- File an application for a permit and pay a nonrefundable permit processing and notification fee.
- Obtain a seller's permit from the California Board of Equalization.
- Demonstrate evidence of a computerized telephonic system for communicating with other dispensaries in the city to ensure a patient does not receive more than one ounce of marijuana per day.
- Provide for monitoring of the property at all times by closed-circuit television.
- Maintain written accounting of all cash, in-kind contributions, reimbursements, compensation, and expenditures received or paid by the dispensary.
- Maintain inventory records of dates and quantities of marijuana cultivated and stored.
- File quarterly business license tax returns and pay 5 percent of gross revenues to the city.

Three dispensaries began operations in the city during 2012. Gross sales for the three dispensaries in calendar 2013, the first full year of operations, totaled approximately \$5 million, with approximately 75 percent being generated by the largest. The three dispensaries paid approximately \$250,000 of business license tax to the city for calendar year 2013.

Finance Director James Goins decided an audit of the dispensaries was needed to determine whether they were paying

CALIFORNIA STATE LAW VERSUS FEDERAL LAW

APPROVED BY CALIFORNIA VOTERS, Proposition 215--the Compassionate Use Act of 1996--allows seriously ill Californians the right to obtain and use marijuana for medical purposes when it has been recommended by a physician.

The California state legislature passed the Medical Marijuana Program Act in 2004, establishing a voluntary identification card program and a legal framework for collectives and cooperatives to distribute medical marijuana. Each county's health department issues optional identification cards for patients.

These identification cards are issued after the county verifies the cardholder's status as a patient or primary caregiver. The cards offer legal protection from arrest for possession of up to eight ounces of usable marijuana and cultivation of up to six mature or 12 immature plants. Only 2 percent of the approximately 500,000 California patients obtained identification cards in fiscal year 2012-13.⁸

The Medical Marijuana Program Act allows patients to form not-for-profit collectives or cooperatives to cultivate and distribute medical marijuana. These cooperatives and collectives may operate dispensaries that sell to qualified patients.

A cooperative or collective must be a not-for-profit organization and properly organized under state law. It cannot purchase marijuana from or sell to nonmembers, but instead can only provide a means for facilitating transactions between members.

Medical marijuana patients must have a recommendation from a licensed physician. Physicians may not prescribe marijuana because the Food and Drug Administration, which regulates prescription drugs, and federal law--the 1970 Controlled Substances Act (CSA)--make it unlawful to manufacture, distribute, dispense, or possess any controlled substance.

The CSA identified marijuana as a drug with "no currently accepted medical use." Physicians, however, may issue a verbal or written recommendation under state law indicating that marijuana would be a beneficial treatment for a serious or persistent medical condition.

In 2007, the California Board of Equalization confirmed its policy of taxing medical marijuana transactions, as well as its requirement that businesses engaged in such transactions hold a seller's permit. Sales are taxable even if the seller does not make a profit.⁹

Cities and counties have the authority to adopt local ordinances that ban or regulate the location, operation, or establishment of a medical marijuana cooperative or collective in their jurisdictions.¹⁰

The incongruity between California state law and federal law has given rise to understandable confusion. Congress has provided that states are free to regulate in the area of controlled substances, provided that state law does not positively conflict with the CSA.

Neither Proposition 215 nor the Medical Marijuana Program Act conflict with the CSA because, in adopting these laws, California did not legalize medical marijuana, but instead exercised the state's right to not punish certain marijuana offenses under state law when a physician has recommended its use to treat a serious medical condition.

the correct amount of business license taxes. My company was engaged to audit the collectives for the period from their inception to December 31, 2013, and to provide Richmond's finance staff with procedures they could use to conduct a reasonableness test of tax amounts remitted by collectives in future quarters.

Insights from the Audits

Audits of the city's three medical marijuana collectives included:

- Reading the city's ordinances.
- Discussing concerns and issues with city finance and police management.
- Requesting and reviewing documents from the collectives that included:
 - » Revenue reports showing each revenue transaction, including cash collected, credit received, and in-kind contributions received.
 - » Inventory record showing dates and quantities of marijuana added to inventory and sold each day.
 - » California sales tax returns.
 - » Federal income tax returns.
 - » Bank statements and related bank reconciliations.
 - » General ledger reports and profit-and-loss statements.
 - » Narrative description of procedures followed by the collectives related to collection, billing, depositing, and recording revenue.
- Testing the reasonableness of reported gross revenues by:
 - » Verifying the mathematical accuracy of the business tax returns.
 - » Tracing reported gross revenue to the collective's general ledger report and profit-and-loss statement.
 - » Reconciling reported gross revenue to revenue per state sales tax returns and federal income tax returns.
 - » Selecting a sample of individual revenue transactions, tracing to bank statement, and examining supporting documents.
 - » Reviewing allowable deductions (cash discounts, volume discounts, promotional discounts, inven-

tory clearance discounts, refunds, federal excise tax, and sales and use tax) for reasonableness.

- » Reviewing the cash reconciliations for unusual items, verifying mathematical accuracy, and tracing to bank statements and general ledger reports.
- Preparing a report, including procedures performed, schedules of gross revenues and tax collected for each collective, and recommendations for improvement in collective procedures or city procedures

Those localities that allow marijuana dispensaries need to have procedures in place to assure that they comply with local laws and remit the full amount of business taxes owed.

We noted that most sales of marijuana are cash sales. Because medical marijuana collectives often have difficulty establishing banking relationships (see sidebar, “California State Law Versus Federal Law”), most of the collectives’ revenues were not deposited in the bank. This created the unusual auditing issues of being unable to confirm cash balances by reviewing bank records and being unable to compare amounts of revenues and expenditures to bank debits and credits.

The three dispensaries began operations in 2012. Two of them are small businesses and like many of the city’s other community-based organizations, did not maintain good accounting and inventory records nor document important procedures. Examples of missing or inadequate accounting information included:

- » Lack of inventory records.
- » No list of sales transactions.
- » Tardy filing of federal tax returns (by two years).

» No federal income tax returns.

Another audit issue is tied to the confidentiality laws regarding patient names. Depending on how the dispensary maintained its records of sales transactions, patient names needed to be removed from documents before being provided to us.

If there is no other field used to identify an individual patient—a unique patient number—then it’s not possible to test whether patients are being sold more than one ounce per day or to ensure receipts relate to the transaction being tested.

We noted that the city did not have adequate procedures in place to test the reasonableness of the quarterly business license taxes that were being collected from the collectives. The city also was not complying with the municipal code related to timing of tax collections and assessing late penalties and interest.

As a result of these issues, we were not able to conclude whether the dispensaries were paying the correct amount of business license taxes. Instead, our audit recommendations focused on the issues the city needed to address in order to adequately oversee the dispensaries going forward, including complying with the code, improving communications with the collectives, and testing the reasonableness of the quarterly taxes remitted.

Substantial Tax Revenues

A growing number of California cities and counties are adopting ordinances allowing medical marijuana dispensaries to operate in their jurisdictions and

again, because the market for marijuana is large, the tax revenues that will be generated are expected to be substantial. Those localities that allow marijuana dispensaries need to have procedures in place to assure that they comply with local laws and remit the full amount of business taxes owed.

As local governments begin regulating marijuana dispensaries, and as the federal government allows them to participate in the U.S. banking system, it appears that marijuana operations are emerging from the shadows. **PM**

FOOTNOTES AND RESOURCES

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- 10 California Assembly Bill 1300, Date of Hearing April 26, 2011.



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