Cannabis, Dude? Case

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Abstract

Students play the role of the key decision maker in this case, Dale Marin, who is attempting to offset his declining Colorado CPA firm practice, which has specialized in real estate and construction clients. His clients had suffered significantly from the economic slowdown resulting from the great recession of 2008. Dale was thinking about two potential expansions of his business: 1) accepting cannabis business clients into his CPA firm practice and 2) starting a real estate business that would own and rent cultivation centers (marijuana grow houses) to cannabis businesses, as well as helping such clients find dispensary rental space. He had found that none of the large or medium sized CPA firms operating in Colorado would accept cannabis business clients and found only two sole CPA practitioners who accepted such clients. Dale wanted to make these two business expansion decisions soon since his traditional CPA firm practice was still declining and he wanted somehow to reverse this trend.

Introduction

After graduating from a Colorado college with an accounting major in a business degree, Dale Marin went to work for a "Big 4" CPA firm for several years. He then decided to go into business for himself in 2000 and created his own CPA firm which was based in Pueblo, Colorado to take advantage of hometown family contacts built up over the years. With these contacts and the emerging housing boom from 2000 through 2006, his firm had specialized in real estate and construction clients and had grown to become one of the larger CPA firms in town. Then, the financial crisis occurred in the U.S. with the 2007-2009 housing plunge reducing average home prices by about 30%. Dale knew his practice had declined by over 50% since 2007 as real estate and construction activities had slowed down. Thus, he was looking for opportunities to revitalize his business.

Dale was intrigued by the newly emerging cannabis industry in Colorado. Colorado voters had approved two amendments to the state constitution. Amendment 20, which legalized medical marijuana use, was approved in 2000 by a 54% to 46% vote and Amendment 64, which legalized recreational marijuana use, was approved in 2012 by a similar voting margin. Dale was now thinking about two potential expansions of his business: 1) accepting cannabis business clients into his existing CPA firm practice and 2) starting a real estate business that would own and rent cultivation centers (marijuana grow houses) to cannabis businesses, as well as helping such clients find dispensary rental space. He had found that none of the large or medium sized CPA firms operating in Colorado would accept cannabis business clients and found only two sole CPA practitioners who accepted such clients. Dale wanted to make these two business expansion decisions soon since his CPA firm practice was still declining and he wanted somehow to reverse this trend. If not, he would have to terminate all of his staff and become a sole practitioner. Also, he figured he had equity capital of $2 million that could be used to start a cannabis real estate business.

Cannabis History

Marijuana is thought to have been cultivated since agriculture began 10,000 years ago. There is evidence that the Chinese Emperor, Shen Nung, who lived about 2,700 B.C., recommended marijuana use to treat more than 1,000 ailments. Colonial Americans were ordered by the English king to raise marijuana for export. George Washington grew marijuana at his Mount Vernon home.

The practice of smoking marijuana in the U.S. appeared in Texas border towns around 1900, brought by Mexican immigrants, who cultivated it for intoxicating and medicinal purposes. However, by the early 1930's, more than 30 states had prohibited it for non-medicinal purposes. The U.S. Marihuana Act of 1937 (actual old spelling of the word marijuana) tried to eliminate it through heavy taxation. The U.S. Controlled Substance Act of 1970 listed marihuana as a "Schedule I" drug, along with heroin and LSD, all having no accepted medicinal uses. However, the "Schedule II' drugs, cocaine and methamphetamine, did have legitimate medicinal uses, according to that law.

Many countries have decriminalized the possession of small quantities of cannabis, particularly in North and South America and Europe. In December 2013, Uruguay became the first country to fully legalize the sale, production, and distribution of marijuana on a country-wide basis for any citizens but they must be licensed by the government. Possession is legal or effectively legal in the Netherlands and North Korea. Iran has legal cultivation and regulated sale of cannabis while Switzerland and Spain have legal cultivation of cannabis.

Canada has prohibited the possession and trafficking of all marijuana products under subsection 4(1) and Schedule II of its 1996 Controlled Drugs and Substances Act but subsection 55(1) allowed for exemptions. A 2013 annex to that act, Marihuana for Medical Purposes Regulations, updated and replaced similar 2001 regulations. These regulations have allowed people with medical need and authorization to access medicinal marijuana through Health Canada approved companies or by permission to grow it themselves. Such access is limited to just dried marijuana, not any cannabis resin or various extracts or derivatives of the cannabis plant.

However, in August 2014, a British Columbia Court of Appeal judge ruled that this limited access to medical marijuana "is arbitrary and cannot be justified in a free and democratic society." She further stated that when patients choose to use edible forms of marijuana, it "was a matter of necessity, or put another way, the restrictions to dried marijuana interfered with their physical or psychological integrity." Parliament was given one year to redo regulations to allow medicinal marijuana users to use products made from cannabis extract which can include creams, salves, oils, brownies, cakes, cookies, and chocolate bars. Per the annual Canadian Alcohol and Drug Use Monitoring survey among Canadians aged 15 years and older, 10.2% or about 3.5 million Canadians used cannabis in the past year versus about 30 million Canadians who don't smoke pot.

In the U.S., marijuana usage is not legal on a country-wide basis, per the 1970 federal law, but many individual states are ignoring it. Since 2000, 35 states and Washington, D.C. have legalized some form of medicinal marijuana use. California was the first state to do so in 2000. A contributing factor was a medical research study concluding that marijuana use is safe and effective for the treatment of certain cancers and epilepsy. Additional medical benefits included alleviating chronic pain, reducing eye pressure caused by glaucoma, relaxing muscle tension, acting as an anti-nausea and anti-vomiting agent, relieving acute anxiety and insomnia, and stimulating the appetites of people with AIDS, cancer, and eating disorders.

On the negative side, a 1999 study by the U.S. Institute of Medicine found the following percentages of a sample of substance users had developed dependence: 32% tobacco, 23% heroin, 17% cocaine, 15% alcohol, and 9% marijuana. A number of recent medical studies have found that casual marijuana use is linked to brain changes in emotion, motivation, and some types of mental illness as the young brain continues to develop well in the 20's and even into the 30's. Another study found a decline in IQ points among regular marijuana users.

Colorado Cannabis History

On May 28, 2013, Colorado became the world's first fully regulated recreational cannabis market for adults with the opening of its pot shops. The state of Washington became the second state to legalize recreational marijuana usage with its pot shops opening in mid-2014. Oregon, Alaska, and Washington D.C. recently approved ballot initiatives to legalize recreational marijuana usage in the Fall 2014 mid-term elections, and five other states, California, Arizona, Maine, Massachusetts, and Nevada, have committees to create similar ballot initiatives for the Fall 2016 elections. Since Colorado was the first state to deal with the various issues associated with a legal cannabis recreational industry created by voters, there were no other state guidelines to follow. In fact, other states are now looking to Colorado's experiences as the initial or "beta" test site for recreational marijuana usage.

In creating and developing this new legal cannabis industry in Colorado, there were several key events in the following chronological order. In 2000, Colorado voters approved Amendment 20 to the state constitution for medical marijuana usage which included a sales tax. In 2009, a U.S. Department of Justice attorney, James Cole, issued a memo stating that legal enforcement of the 1970 federal law prohibiting any marijuana usage was a low federal priority.

In 2010, the Colorado House of Representatives created House Bill 1284 which was then passed by the Colorado Senate and signed by the Colorado Governor. This bill established a regulatory framework for the cannabis industry in Colorado. Major provisions included:

- Cannabis businesses had to be integrated with a product line mix of 70% as a grower and 30% as a dispenser. (As of July 1, 2014, this integration requirement has been eliminated in Colorado.)
- A separate Cannabis Division at the Department of Revenue was established to regulate this new legal industry.
- A cannabis cultivation center (grow house) could only cultivate up to 10,200 plants at one time and a digital inventory system has been established to track every plant from "seed to sale."
- Cannabis businesses had to establish hours of operation, security measures, and plant monitoring processes.
- Recreational cannabis could only be dispensed to persons 21 years old or older, i.e. the "adult use" provision of the law.

- Local jurisdictions, such as cities and counties, were allowed to approve or ban cannabis businesses in their areas.
- Only Colorado residents who have lived in Colorado for at least two years could obtain a license to operate a Colorado cannabis business.
- Only Colorado residents could have an equity investment in a Colorado cannabis business.
- Non-Colorado residents could have a debt investment or debt financing in a Colorado cannabis business.

In 2012, Colorado voters approved Amendment 64 to the state constitution which legalized all recreational marijuana usage in the state of Colorado. This amendment included a 10% state sales tax and a 15% state excise tax on recreational marijuana in addition to the 2.9% state sales tax on both medical and recreational marijuana. Accordingly, many Colorado medical marijuana users are not buying recreational marijuana.

In 2013, the same U.S. Department of Justice attorney, James Cole, issued another memo stating that legal enforcement of the 1970 federal law prohibiting any marijuana usage would only be considered for enforcement of eight key items: sales to minors, sales by criminal enterprises, sales used as a cover for other drugs, sales across state lines, sales associated with violence, sales near schools, sales or use on federal property, and marijuana being grown on public lands.. Also, such federal enforcement would be a low priority in states that have installed strong cannabis regulations.

In July 2014, both editorial boards of The New York Times and The Denver Post stated that the federal government should repeal its ban on marijuana and let the individual states decide. A subsequent New York Times editorial column further observed: “For now the Colorado experiment remains firmly on the rails, and moving, along with public opinion, toward a future ever further from the failed war on drugs.”

Marijuana Industry Financial Rules of Thumb and Developments

Dale had talked to a CPA in Longmont, Colorado, who was the first Colorado CPA firm to take cannabis clients, both for accounting and real estate services, which are the two business expansion decisions Dale is considering. This CPA had developed the following financial rules of thumb for the marijuana industry in Colorado.

Cost of Equity:

- 40%; similar to a tech start-up. This rate will decline as the uncertainties for the industry decrease.

Cost of Debt:

- 15%-20%; loans typically from family, friends, and other business partners. This rate will also decline with less uncertainty in the industry.
- Most banks will not make loans

Startup costs:

- Cultivation Center (marijuana grow house): $1 million-$3 million; mean: $2 million
- State and City Licenses and Permits: around $80,000
- Real-estate: a premium is charged for facilities used for marijuana operations (grow house and dispensary), due to strict zoning regulations that limit available rentable properties, often up to $20 per square foot for a 20,000 square foot grow house and $120 per square foot for a 1,000 square foot dispensary

Marijuana Economics:

- A $2 million, 20,000 square foot grow house has the ability to produce 7,200 pounds of marijuana per year.
- Wholesale price: $2,000 per pound
- Retail price: $3,000 - $5,000 per pound
- A grower is allowed to sell 30% of his/her marijuana in the wholesale market; the other 70% is sold to a dispensary.
- Cost to grow marijuana : $1,000 per pound (assuming efficient operations)
- Security, rent, and other selling, general and administrative costs can be as much as 40% of the operating income before these expenses.
- For a combined grow house and dispensary business, typical gross margins are 70% - 80% and typical net profit margins are 20% - 30%.
- For a 20,000 square foot grow house, one acre (43,560 square feet) would be needed to allow for zoning requirements (set-backs, access, parking, etc.)
- Cost of one commercial acre: $40,000 in Denver; $3,000 in rural Colorado areas
- Property taxes on one acre: $4,000 in Denver; $300 in rural Colorado areas
- $2,000,000 commercial property loan: 15% interest rate by a community bank
- Average depreciation rate ($2,000,000 commercial building and equipment): 5%

Tax Issues: U.S. Code § 280E - Expenditures in connection with the illegal sale of drugs:

- No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of Schedules I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.
- Expenses related to dispensary operations cannot be deducted for tax purposes, except for the cost of marijuana sold.
- Expenses related to growing marijuana can be deducted as cost of goods sold.
- Thus, both marijuana grow houses and dispensaries are taxed at the gross profit level: (Revenue – Cost of Goods Sold).
- Federal corporate statutory income tax rate is 35% and Colorado state income tax rate is 5%.

Concerning industry developments, the legal U.S. marijuana industry is expected to grow to $2.6 billion sales in 2014, a 73% increase from $1.5 billion sales in 2013. MarijuanaIndex.org has listed more than 40 publicly-held companies in the industry with a total market capitalization of over $4 billion. However, the Securities and Exchange Commission (SEC) suspended trading of five marijuana-related companies in early 2014 for possible unlawful sales of securities and market manipulation. In May 2014, the SEC issued an alert, reminding investors that cannabis companies may be at risk of federal and perhaps state criminal prosecution. The majority of these public companies just supplied goods to the cannabis industry, like water systems, soil nutrients, and lighting systems, or developed related products, like a marijuana vending machine, an e-cigarette vaporizer that can be used with oil from marijuana, and mobile apps.

The first annual Weedstock Conference for marijuana investors, entrepreneurs, and innovators was held in Denver at the end of June, 2014 with hundreds of attendees. In one panel discussion, panelists acknowledged the danger that some future federal crackdown, especially by conservative politicians, could send them all to prison but expressed hope that momentum to legalize marijuana by various states would force the federal government to let the states decide the cannabis industry issues.

An example of private companies in both Colorado and Washington with cannabis-related services is weed delivery service with websites featuring weed products. In Colorado, marijuana regulations require sales to be done in licensed dispensaries but there is a flourishing online market for marijuana deliveries made in exchange for donations. The Colorado law allows adults over 21 to give one another up to one ounce of marijuana, provided it is done without remuneration. Criminal charges were brought against one Colorado Springs delivery service in 2013 for felony distribution of marijuana but the owner committed suicide before the trial.

Colorado Cannabis Legal Developments

Dale had done some preliminary research on the Colorado cannabis law provision that allowed local jurisdictions, such as cities and counties, to approve or ban cannabis businesses in their areas. He found that the first three jurisdictions to allow such recreational cannabis usage were Central City, Denver, and Aspen. Other jurisdictions appeared to be waiting on the Denver experiences before deciding whether to allow recreational marijuana usage. However, Boulder, where the University of Colorado is located, and Ft. Collins, where the Colorado State University is located, subsequently have allowed such usage. The Ft. Collins city council had initially voted to prohibit such usage but a ballot initiative overturned this prohibition. Also, the small, non-urban town of Manitou Springs recently approved such usage as a potential tourism strategy. A similar and very successful tourism strategy was used by the small, non-urban towns of Black Hawk, Central City, and Cripple Creek after Colorado voters had approved legalized gambling for just these three towns.

Other jurisdictions have prohibited such cannabis usage, like Golden, where the Coors brewery plant is located, and 46 of Colorado's 64 counties, many of which are very conservative. However, 18 counties, including conservative jurisdictions, like Pueblo and Park counties, had approved such usage, in part, because they resented the federal government or the state government telling them what to do. Also, libertarians, such as the U.S. senator from Kentucky, Rand Paul, and various Tea Party members, are in favor of such local decision making authority.

Another large challenge is the fact that marijuana businesses cannot accept credit cards as a method of payment, and it is very difficult for them to find a bank that will allow them to have accounts or get loans. The problem is that banking regulations prohibit banks from providing their services to businesses involved in illegal activities. Since marijuana is still illegal at the federal level, banks that do business with the Colorado marijuana businesses could be charged with laundering money from illegal acts. The banks could be fined, the bankers could be criminally charged, and the bank could lose its charter. However, a community bank in Pueblo and a community bank in Ft. Collins, possibly libertarians, have started to accept marijuana business customers.

In early 2014, the Obama administration issued guidelines to give banks confidence that they will not be criminally penalized if they provide banking services to the legal marijuana businesses in the states where marijuana is now legal. However, the banking industry feels that these guidelines do not do enough to alleviate its fears. For example, Frank Keating, president of the American Bankers Association, said: "While we appreciate the efforts by the U.S. Department of Justice and FinCEN, guidance or regulation doesn't alter the underlying challenge for banks." Also, Don Childears, president and CEO of the Colorado Bankers Association, said: "Only Congress can resolve the issue of banking marijuana businesses."

FinCEN is the Federal Crimes Enforcement Network to whom banks are required to send a Suspicious Activity Report (SAR) any time they think they may have money that has come from an illegal activity. A six-month FinCEN report from February 1, 2014 through July 31, 2014, stated that banks had filed hundreds of SAR reports, indicating a banking relationship with cannabis-related businesses. These SARs were marked "marijuana limited," stating that these cannabis businesses did not violate any of the eight rules that the prior U.S. Justice Department memo had warned against, such as selling to minors or trafficking across state lines. However, nearly as many banks had filed SAR reports saying they had terminated cannabis business relationships. In summary, 105 banks said their customers included at least one pot-related business but an undetermined number of banks reporting closing almost 500 such accounts. Those 105 banks represented less than one percent of all U.S. banks and financial institutions and no breakdown by individual U.S. states was reported.

In mid-2014, the Colorado state legislature approved the country's first-ever banking system for cannabis businesses. This bill creates cannabis-specific financial cooperatives to be overseen by the state's financial services commissioner. These co-ops will function similarly to credit unions and will not require deposit insurance. Although the governor has not yet signed the bill, the Colorado Bankers Association has already rejected the bill, due to marijuana's inclusion in the Controlled Substances Act. Also, the plan requires the approval of the U.S. Federal Reserve Banking System since the plan does not require deposit insurance. In Washington, the state's largest credit union with 100,000 members will also test the Justice Department guidelines when it begins offering accounts to marijuana cultivators and processors in 2014.

In November 2014, the state of Colorado changed its plan. The Colorado Division of Financial Services issued an unconditional charter to Fourth Corner Credit Union, the first new state-chartered credit union in nearly a decade. Fourth Corner will provide financial services for any legal marijuana enterprise in Colorado. It must obtain insurance from the National Credit Union

Administration and a master account from the Federal Reserve System. While the process to obtain insurance can take up to 2 years, Colorado law allows a state-chartered credit union to operate during this time. The master account from the Federal Reserve System is expected by mid-December 2014. Thus, Fourth Corner Credit Union could be open for business by January 1, 2015.

There have also been unexpected consequences in other financial areas. The Internal Revenue Service (IRS) requires businesses to pay quarterly federal payroll withholding taxes electronically via a bank wire. This is not possible for most marijuana businesses since they do not have bank accounts. Failure to make these payments electronically results in a 10% financial penalty imposed by the IRS. Even though the IRS will accept cash for these payroll tax payments (but only at its Denver office), it will not waive the financial penalty. This restriction means that someone from a Colorado medical or recreational marijuana business must make the trip to Denver from wherever the business is located in the state.

One Colorado marijuana business has filed a petition in the U.S. Tax Court on this 10% penalty issue. The IRS has suggested that marijuana businesses could funnel their federal payroll withholding taxes to a third party who could then pay the taxes electronically on their behalf. Ironically, this plaintiff's attorney has described this IRS suggested solution as the very definition of money laundering. Thus, there is reluctance by marijuana businesses to follow this IRS procedure because it could easily be viewed as money laundering, resulting in possible criminal charges to both the marijuana business and the third party.

There is also evidence that the reluctance of commercial banks to work with marijuana businesses is expanding to their employees and their suppliers. Marijuana business employee problems include rejected and closed bank accounts, rejected apartment rental applications, closed retirement and investment accounts, and difficulty obtaining mortgages. For example, a part-time bookkeeper, who works for a Seattle, Washington business that grows marijuana, recently had her retirement account closed by Morgan Stanley Wealth Management. There have been reports of mortgage lenders expressing skepticism over a potential borrower's income stream if it is from a marijuana business or marijuana-related business. Also, some Colorado commercial property owners will not rent space for marijuana grow houses and marijuana dispensary retail stores. Again, the fact that marijuana is illegal at the federal level with possible penalties from dealing with this illegal activity is causing these banks and other businesses to behave this way.

For an example of a potential negative impact on a business sector two levels removed from the marijuana business sector, a construction materials supply business, owned by a Colorado private equity (PE) firm, sold drywall to a drywall installation company which, in turn, installed the drywall at several marijuana grow houses. Having no bank account, these grow house owners had to pay their bills of almost $50,000 in cash to the drywall construction firm which, in turn, paid this same cash to the Colorado PE firm in 20-dollar bills, packed into a big cardboard box (see picture at end of case). The PE firm then had to convince its own bank to accept this cash deposit, hoping that the smell of marijuana on this cash would not cause the bank to reject both the deposit and the depositor as a customer which is happening in Colorado. This bank ultimately did accept this $50,000 cash deposit but had to send a SAR report to FinCEN which triggered a

Drug Enforcement Agency (DEA) audit of this PE firm. The question for the PE firm is whether it just participated in an illegal act of money laundering, although about two levels removed from the actual marijuana business. The PE firm resolved this question to the satisfaction of the DEA but the DEA continues quarterly audits of this PE firm.

However, for an example of a positive impact on a business sector two levels removed from the marijuana business sector, the 2014 industrial rental space in Denver is at an average of $4.74 per square foot, an increase of 21 percent in the past two years. For grow house rental space in warehouses, many cannabis businesses have willingly agreed to pay $18 per square foot, the same rate that some oil and gas companies are paying for offices. A commercial real estate broker explained that the Denver grow house rental supply is deficient but demand is excessive with a lot of marijuana business people out looking and ready to make even higher offers.

There seems to be ongoing new challenges for either marijuana businesses, or their employees, or their business suppliers of goods or services. As one Colorado CPA said: "When something is illegal for 75 years and then suddenly becomes legal, there are a lot of loose ends to work out." Similarly, one CFO of a Colorado cannabis business said: "It's a black market legitimizing itself, not a new market growing from zero. There are companies in the industry that used to be smugglers of cannabis."

Another emerging challenge relates to Colorado drivers traveling through adjoining states that have not legalized marijuana. A Denver television channel did an investigative report in mid-2014 on Colorado drivers being profiled for pot by Highway Patrol officers in adjoining states. Along I-25, the major freeway heading north out of Colorado into Wyoming, there were 294 marijuana related incidents reported by the Wyoming Highway Patrol from January 2008 – February 2014. The top three states of residence for the offenders were Wyoming (44%), Colorado (31%), and Montana (9%).

Along I-80, the major freeway heading east out of Colorado into Nebraska, Colorado drivers were issued 334 marijuana citations by the Nebraska Highway Patrol in the counties surrounding I-80 from January 2011 – March 2014. Nearly half of those Colorado drivers had one ounce or less of marijuana. In one of these Nebraska counties adjoining Colorado, Colorado drivers' marijuana offenses were almost twice as high as Nebraska drivers' citations. Nebraska and Oklahoma have recently filed a lawsuit directly with the U.S. Supreme Court, alleging that the Colorado recreational marijuana law is unconstitutional under the Supremacy Clause of the U.S. Constitution.

Along I-70, the major freeway heading east out of Colorado into Kansas, the Kansas Highway Patrol made one marijuana bust a day from June 2008 – December 2013. Although the Kansas Highway Patrol does not keep records on drivers' state locations, 285 of these citations were in Colby, Kansas, which is just 50 miles from the border of Kansas and Colorado. One police officer said: "the reason we are searching these vehicles is generally because of the odor. When you walk up to the vehicle and as soon as they roll down the window to give the driver's license and registration, there is an overwhelming odor if there is marijuana in the vehicle."

Final Thoughts

Dale was thinking about two potential expansions of his business: 1) accepting cannabis business clients into his CPA firm practice and 2) starting a real estate business that would own and rent cultivation centers (marijuana grow houses) to cannabis businesses, as well as helping such clients find dispensary rental spaces. He had found that none of the large or medium sized CPA firms operating in Colorado had accepted cannabis business clients and found only two sole Colorado CPA practitioners who provided such services. Dale wanted to make these two business expansion decisions soon since his traditional CPA firm practice was still declining and he wanted somehow to reverse this trend. He thought that each of these two potential expansions could increase his CPA practice by 25% or more if the Colorado cannabis business continued to grow.

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