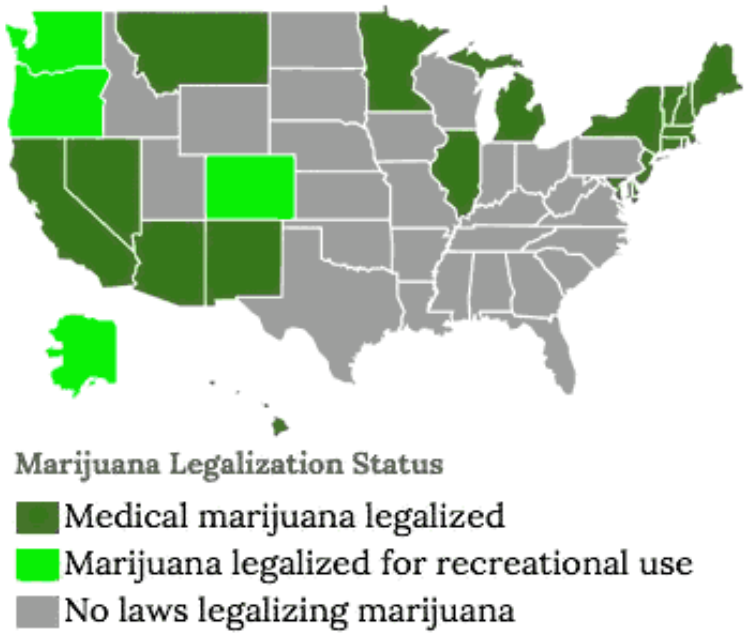
The Tax Aspects of Legal State/Illegal Federal Activity

Charles R. Goulding and Michael Wilshere discuss the potential tax planning techniques available for businesses that are legal for state purposes but illegal under federal law.



The 2014 midterm elections signaled voters' growing support for the legalization of marijuana. To date, a total of twenty-three states and the District of Columbia have laws legalizing medical cannabis.

The U.S. medical cannabis market has been estimated at $1.7 billion in 2013. As the number of states passing pro-medical marijuana laws multiplies, analysts predict that the market will quadruple in size over the next five years.

This expanding industry has attracted a growing number of corporate players. Privateer Holdings Headquartered in Seattle, Washington is America's first private equity firm to focus exclusively on the medical cannabis field. In San Francisco, ArcView aims to be the next premier hub for marijuana investment, data and progress, raising over $17 million since 2010.

However, despite the industry growth and widespread state legalization, there remains one troublesome issue. Namely, medical marijuana use is still prohibited by the federal government! This is problematic because according to the Supremacy Clause in article IV of the U.S. Constitution, any state or local laws in conflict with a federal law must be invalidated.

The legal issue came before the Supreme Court in 2005 in Gonzalez v. Raich. There the court held that an elderly California resident could not consume home grown cannabis for medical purposes because only the federal government had the authority to regulate it under the Commerce Clause and the Controlled Substance Act, even though medical marijuana was legal in California at the time.

Nonetheless, the States continue to approve cannabis production and distribution while the Federal government grapples with the issue. This creates concerns for businesses filing federal tax returns. Namely, it is not clear whether certain operating costs are deductible on business returns.

IRC Section 280E:

This code section provides: 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 consists of trafficking in controlled substances (within the meaning of schedule 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.

It is understood that, the cost of goods sold is always deductible even if the business is say selling cocaine or methamphetamine. The real issue lies with the operating expenses. Generally, per section 280E they are non-deductible. Nonetheless, there are potential tax planning techniques available. Some of these are identified below:

1. Use the Cloud: Not being able to deduct SGA might be an advantage in today's business environment since many functions needed by businesses are now available through the cloud with low cost SaaS (Software as a Service) offerings. This includes invoicing, accounting, IT and HR services.

2. Inventory Capitalization: Where ever permissible, capitalize into inventory all expenses on full absorption basis. As stated above, the cost of goods sold should remain deductible.

3. Separate Accounting for all legal product lines: There may be adjunct product offerings in the business that on a stand lone basis are legal for federal purposes and eligible for normal tax treatment.

4. Strive for variable SGA costs: Since SGA is not deductible, the strategy should be to minimize fixed SGA. For example, sales people that earn high commissions rather than fixed salaries will insure that there is a higher contribution margin available to absorb the sales commission cost which can only be deducted on a pretax basis.

The issues related to the legal state and illegal federal businesses are unique and complex meaning advisors should be informed and proceed cautiously.

The Tax Increase Prevention Act of 2014



Many of your clients expect you to not only calculate their estimated income tax each year, but they expect you to do so accurately. They expect you to be knowledgeable regarding the tax laws that impact them so that they will not owe an exorbitant amount at year end and may, in fact, actually receive a reasonable (and not excessive) refund.

Unfortunately, Congress has not really cooperated in terms of providing timely tax legislation. The end of 2014 was no exception. On December 19, 2014, after the tax legislation had finally passed both the House and the Senate, President Obama signed into law legislation that, in effect, extended some tax breaks for one year – through the end of 2014. Obviously, that did not allow much time for tax practitioners to revise tax estimates for 2014. It certainly did not allow enough time for taxpayers to take advantage of some of the items that were extended through the end of the year.

And it certainly does not make tax planning for 2015 any easier, since it is unknown whether or not any of these same measures will be extended through 2015, and it is certainly doubtful that anything will be decided until much closer to the end of 2015.

H.R. 5771 was signed by the President on December 19, 2014. It contained Division A, the Tax Increase Prevention Act of 2014, and Division B, the Achieving a Better Life Experience Act of 2014.

The Tax Increase Prevention Act of 2014 contains four subtitles:

1. Subtitle A – Individual Tax Extenders
2. Subtitle B – Business Tax Extenders
3. Subtitle C – Energy Tax Extenders
4. Subtitle D – Extenders Relating to Multiemployer Defined Benefit Pension Plans

Many of the provisions extended by the 2014 Tax Increase Prevention Act were introduced in previous years as temporary measures, but have been extended multiple times since then. Note that each of the tax "extenders" presented below have been extended only through the end of 2014. Therefore, unless Congress takes further action, the provisions will not be in place in the tax year 2015.

Key tax breaks extended for individuals include the deduction of $250 for expenses of elementary and secondary school teachers, the above-the-line deduction for qualified tuition and related expenses, and the deduction of state and local general sales tax. The Act also extended the exclusion from gross income of discharge of qualified personal residence indebtedness, and the treatment of mortgage insurance premiums as interest on qualified residence interest.

In addition to individual tax extenders, several key business provisions were extended. Among others, they include an extension of the work opportunity tax credit, available to businesses that employ qualified members of targeted groups and an extension of the employer wage credit for employers of active duty members of the armed services. From a PP&E perspective, the Act provides an extension of bonus depreciation, Section 179 property exclusions, and depreciation provisions for qualified leasehold improvements.

For more information about the provisions in this Act, consider taking the Checkpoint Learning®course, Introduction to the Tax Increase Prevention Act of 2014.

How Dynamic Scoring May Impact Tax Reform



Charles R. Goulding and Jennifer Pariante discuss how the integration of dynamic scoring can be used to help policy makers and legislators determine the overall economic impact of tax provisions during the furthering tax reform debate.

With the Republican controlled Congress, there is increased interest in utilizing dynamic scoring concepts when implementing longer term policies pursuant to major tax reform. There is a uniform consensus that the current tax system is overly complex

and subject to the vagaries of special interest groups rather than serving the countries major policy goals. Dynamic scoring is a tool that can be used to help policy makers and legislators determine the overall economic impact of a particular tax provision. The results can be used to rate or compare the overall economic impact of a specific tax provision as compared to an alternative tax provision. Tax provisions with very high dynamic score ratings actually cost the country less (or even be tax revenue positive) and may enable the enactment of more important tax incentives. Although there are important national policy goals that are unrelated to tax, tax considerations are economic decision making criteria so tax provisions in particular should be subject to dynamic scoring.

Technical Definition of Dynamic Scoring

Dynamic scoring predicts the impact of fiscal policy changes by forecasting the effects of economic agents' reactions to incentives created by policy. It is an adaptation of static scoring, the traditional method for analyzing policy changes.

The method gives way to a more accurate prediction of a policy's impact on a country's fiscal balance and economic output, when feasible. The potential for heightened accuracy occurs from recognizing that households and firms will change their behavior to continue maximizing welfare (households) or profits (firms) under the new policy. Dynamic scoring is more accurate than static scoring when the econometric model correctly captures how households and firms will react to a policy change.

Leading Policy-Makers and Dynamic Scoring

Rep. Paul Ryan (R-Wis.) stated that he would push to make sure that the two congressional budget scorekeepers use the accounting method of dynamic scoring when evaluating GOP tax reform legislation. Sen. Orrin Hatch (R-Utah), who will chair the Senate finance committee starting in January, responded that he was open to implementing the change. Ryan and Hatch can implement dynamic scoring by directing the two budget scorekeepers to accept this budgeting method. Congress could require the Congressional Budget Office and Joint Committee on Taxation to use assumptions about how tax cuts affect the economy. Examples of such assumptions include how they can see how tax cuts influence people's motivation to work, the moves of the Federal Reserve, and household and business decisions on savings and investment. Budget analysts then can plug said assumptions into several models to estimate economic growth.

Dynamic Scoring Constraints

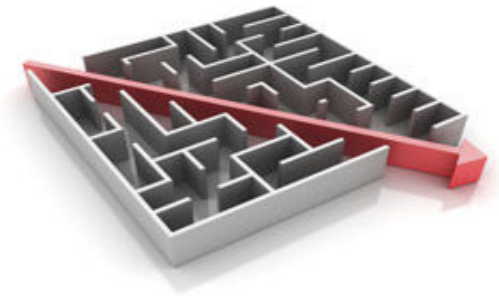
One of the main criticisms of dynamic scoring is that the determination and calculation of the economic impacts may be very difficult and also subjective. Although this is a well founded criticism today's predictive analytics and software are making this process more quantifiable and understandable.

Conclusion

Prospective debate on integrating dynamic scoring with tax reform should prove interesting. Before reacting with traditional criticism opponents may want to evaluate the improving science of predictive analysis.

Extraordinary Items Eliminated

Background



In 2014, the FASB launched a tightly-focused initiative to make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects. The projects included in the initiative are intended to improve or maintain the usefulness of the information reported to investors while reducing cost and complexity in financial reporting. In January 2015, the FASB issued ASU 2015-01, Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items, as part of that initiative. The FASB decided to simplify the income statement presentation requirements in ASC 225, Income Statement, by eliminating the concept of extraordinary items from U.S. GAAP.

Examples of items that could be classified as extraordinary are the destruction of facilities by an earthquake, or the destruction of a vineyard by a hailstorm in a region where hailstorm damage is rare. Conversely, an example of an item that does not qualify as extraordinary is weather-related crop damage in a region where such crop damage is relatively frequent.

Before this amendment, ASC 225-20 required that an entity separately classify, present, and disclose extraordinary events and transactions. An event or transaction was presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supported its classification as an extraordinary item. ASC 225-20-45-2 contained the following criteria that must both be met for extraordinary classification:

Unusual nature. The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.

Infrequency of occurrence. The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

If an event or transaction met the criteria for extraordinary classification, an entity was required to segregate the extraordinary item from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. The entity also was required to disclose applicable income taxes and either present or disclose earnings-per-share data applicable to the extraordinary item.

The concept of extraordinary items has been interpreted narrowly in practice so entities rarely, if ever, reach a conclusion that the conditions for presentation have been met. In fact, it is extremely rare in current practice for an event or transaction to be presented as an extraordinary item. The term

extraordinary also causes uncertainty because it is often unclear when an item should be considered both unusual and infrequent and what might be considered extraordinary in one industry may not be considered extraordinary to another. However, even though the conditions for presenting an extraordinary item are rarely met, preparers, auditors, and regulators often are required to spend time and expend resources deciding whether an unusual and/or infrequent event or transaction meets the conditions for extraordinary classification.

The FASB believes that eliminating the concept of extraordinary items will save time and reduce costs for preparers because they will not have to assess whether a particular event or transaction event is extraordinary, even if they ultimately would conclude it is not. This also alleviates uncertainty for preparers, auditors, and regulators because auditors and regulators no longer will need to evaluate whether a preparer treated an unusual and/or infrequent item appropriately.

Further, the FASB concluded that the amendments in this ASU will not result in a loss of information because although the amendments will eliminate the requirements in ASC 225-20 for reporting entities to consider whether an underlying event or transaction is extraordinary, the presentation and disclosure guidance for items that are unusual in nature or occur infrequently will be retained and will be expanded to include items that are both unusual in nature and infrequently occurring.

ASU 2015-01 will align U.S. GAAP income statement presentation guidance more closely with the International Financial Reporting Standards guidance in International Accounting Standard (IAS) 1, Presentation of Financial Statements, which prohibits the presentation and disclosure of extraordinary items.

Effective Date and Transition

The amendments in ASU 2015-01 are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. A reporting entity may apply the amendments prospectively. A reporting entity also may apply the amendments retrospectively to all prior periods presented in the financial statements. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The effective date is the same for both public business entities and all other entities.

For an entity that prospectively applies the guidance, the only required transition disclosure will be to disclose, if applicable, both the nature and the amount of an item included in income from continuing operations after adoption that adjusts an extraordinary item previously classified and presented before the date of adoption.

Working With Introverts and Extroverts



Do you feel at ease in large groups? Prefer to work closely with other people or multitask? Think and talk simultaneously? Then it is likely you are an extrovert.

Are you detail-oriented? Known for completing difficult projects? Need quiet time during the day to recharge? If so, you are more likely an introvert.

The biggest difference between introverts and extroverts is how they replenish their own energy. Extroverts are energized by the world around them (e.g., having new experiences and talking to others). Introverts, on the other hand, recharge internally by taking a quiet moment to think through what they have experienced.

Both personality types have important roles to fill in the workplace. Extroverts are doers, while introverts serve as advisors. Introverts needs extroverts to propel them into action, and extroverts need introverts to curb their impulses and give direction to their forward momentum.

Today's corporate culture often assigns a higher value to extroverted traits. Extroverts are known for their people skills, which allow them to easily facilitate meetings, address large groups, and manage social situations. Extroverts' preference for multitasking makes them well suited for collaboration and brainstorming. They are also adept at self-promotion.

The skills of introverts should not be devalued, however. Their ability to focus deeply allows them to think outside of the box and create a complete project from the seed of an idea. They work thoroughly and need little supervision. They are also good listeners and observers, which makes them ideal candidates for meeting facilitation.

In addition to their varied skill sets, introverts and extroverts work best in different types of environments. Extroverts need a location with lots of stimulation—maybe a cube in a busy area or an open office concept. Their energy will flag when forced to focus quietly on one task for too long. Introverts, however, work best in a quiet space with few interruptions—perhaps a secluded cube or an office with a door. Their deep focus is more difficult to maintain with constant interruptions.

Another key difference between the two personality types is how they communicate. Extroverts think **while** they speak—the act of speaking clarifies their thoughts. Introverts, however, need time to think out their ideas **before** they speak, slows down their conversation. Not understanding this fundamental difference can lead to misunderstandings. Introverts might judge extroverts to be flighty and unknowledgeable, while extroverts believe introverts are trying to hide things.

For better communication with an extrovert, introverts should address them face-to-face, expect the conversation to jump around, and allow the conversation to keep moving. They should also realize that the conversation is likely to result in immediate action.

To improve their communications with an introvert, extroverts should use email when possible. When talking face-to-face, the extrovert should ask questions, listen to the answers without interrupting, and give

the introvert time to formulate a response.

Ensuring both extroverts and introverts have comfortable places to work and learning to communicate well with both personality types will allow employees to thrive in the workplace. Ultimately, a positive environment where all types of employees can do their best work benefits both the employees and the employer.

For more information about introverts and extroverts at work, consider taking the Checkpoint Learning® course, Introverts and Extroverts at Work.

SEC Staff Review of the Disclosure Requirements in Regulation S-K



In December 2013, the SEC staff issued a report to Congress, as required by the Jumpstart Our Business Startups (JOBS) Act, about its review of the disclosure requirements in Regulation S-K. The SEC staff reviewed how Regulation S-K disclosure requirements can be updated to modernize and simplify the securities registration process and reduce costs and disclosure burdens for emerging growth companies. Specifically, the SEC staff conducted a detailed study of the disclosure items in Regulation S-K, the SEC's industry guides, and related rules and forms. The mandate from Congress was to focus on emerging growth companies; however, the SEC staff acknowledged that simplifications, modernizations, revisions, or eliminations may be suitable for all companies.

The SEC staff recommended developing a plan to systematically review the disclosure requirements in its rules and forms, including Regulation S-K and Regulation S-X, and the related rules concerning the presentation and delivery of information to investors and the marketplace. The SEC staff believes that further information gathering and review is warranted before making recommendations about disclosure requirements. The SEC staff requested input from market participants about:

- Disclosure that is material to an investment or voting decision;
- Ways to streamline and simplify disclosure requirements;
- Ways to enhance presentation and communication of information; and
- How technology can play a role in addressing these issues.

The SEC staff identified two alternative frameworks for structuring its review. The first is a comprehensive approach in which all reporting requirements and presentation and delivery issues would be addressed. The second is a targeted approach where the SEC staff would perform an in-depth analysis of each topic. The SEC staff recommended the comprehensive approach because it would achieve the dual goals of streamlining requirements for companies and identifying useful and material information for investors.