



## PROFESSIONAL LIABILITY SPOTLIGHT

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# Providing services to cannabis clients

By Deborah K. Rood, CPA

Legalized cannabis is one of the fastest growing industries in the United States. Every year, additional states legalize marijuana for medical and/or recreational purposes. At the federal level, several draft bills would continue the trend toward legalization.

With the growing acceptance of cannabis as a legitimate business industry, it is no wonder this budding new practice area has many CPA firms seeing green.

### WHY IS CANNABIS DIFFERENT?

At the federal level, cannabis is classified as a Schedule I controlled substance, making it illegal under the Controlled Substances Act (21 U.S.C. §§812(b)(1) and 812(c), Schedule I(c)(10)). However, a growing number of states permit its use for medical and/or recreational purposes. This dichotomy creates complexities other businesses do not face, which, in turn, create additional risk to CPAs providing services to cannabis businesses. For example:

- Federally insured banks may not accept deposits from federally illegal enterprises because of potential money-laundering or aiding-and-abetting charges. As a result, cannabis clients deal primarily in cash, increasing the risk of both unreported revenue and defalcation, which increases a CPA's professional liability risk, irrespective of the service provided to the business.
- Cannabis businesses may have limited access to the U.S. judicial system, including the bankruptcy process. Cannabis businesses face high operating costs, and many struggle financially or fail. While state courts may be accessible, the client's ability to discharge or restructure debt is limited. Investors and vendors who lose money in a cannabis venture may seek recovery against the firm.
- The Sec. 7525 tax preparer-client privilege may not apply to cannabis clients. If the client is under investigation, the CPA may be placed in the awkward position of being required to testify against that client.
- Where cannabis is legal, states subject cannabis businesses to unique and complex regulations. CPAs servicing cannabis clients should generally understand a state's regulatory system in order to assess a client's regard for applicable law. Clients who disregard their legal obligations pose an integrity threat to the CPA.

- Multiple taxing authorities may impose taxes or fees on the product. With so many returns to prepare, the likelihood that a return could be audited or that the CPA could make an error or omission increases.
- Operating cash flow needs may take precedence over payroll tax and estimated tax payment obligations, which could result in penalties. Clients may blame the CPA for not advising them of their tax obligations.

### CPA FIRM CONSIDERATIONS

Firms contemplating services to the cannabis industry should consider the risks applicable to the firm such as:

- **Ethical considerations:** Does the relevant state board of accountancy consider services to cannabis clients an act discreditable? If a CPA is sanctioned by a state board, the AICPA bylaws may require discipline against the CPA.
- **Reputational risk:** What is the perception of the CPA by other clients or the business community?
- **Insurance coverage:** How would your professional liability policy respond to a claim related to a cannabis client?

### WHAT CAN A CPA DO TO MITIGATE THE RISKS?

Risk management procedures for a cannabis client are fundamentally the same as for any other client. But due to the heightened risks, procedures for cannabis clients should be consistently applied and more robust.

### Client acceptance

- **Develop a specialty:** Dabbling in any industry is always a professional liability risk, but, combined with the unique considerations associated with cannabis clients and the evolving regulatory and legal landscape, the risk of dabbling is even greater. Consult with CPA firms specializing in cannabis businesses, alliance firms, and your state CPA society. Some firms may offer training programs.
- **Enhance the acceptance process:** Reliance on management's integrity, professional acumen, and knowledge of the industry

*Continued.*

is crucial. Don't be afraid to walk away from a prospect; many CPAs turn away more cannabis opportunities than they accept. In addition:

- o Conduct your own criminal background and credit checks on management, owners, and those charged with governance.
- o Meet management and owners.
- o Discuss the engagement with the prospect's attorneys to assess the client's expertise and its commitment to compliance.
- o Understand a prospective client's reason for switching CPAs and speak with the prior CPA to determine if there were service or billing problems.

### Engagement letter

- Obtain an annual, signed engagement letter that clearly delineates the scope of services.
- Include a provision that requires the client to affirm it is operating legally under applicable state law. This may assist CPAs if the U.S. Department of Justice's Office of Professional Responsibility pursues a CPA serving the cannabis industry.
- Require a new, signed engagement letter or amendment when the scope of services changes.

### Billing

- Require a retainer at the onset of an engagement and maintain a positive balance through sound billing and collection practices. CPAs have experienced counterclaims for negligence in response to the CPA's collection actions.
- Do not allow clients to pay with cash. This reduces the risk of theft and further distances the firm from illegal activities. Suspend or terminate services for nonpayment.

### Engagement delivery

- Obtain a management representation letter for all services provided to cannabis clients, including tax, accounting, and consulting, that contains the following:
  - o The business is operating legally under applicable state law.
  - o The client's records are accurate and complete.
  - o Required tax filings are current.
  - o The client agrees to indemnify and hold the CPA harmless for knowing misrepresentations or intentional concealment of information by the client from the CPA.
  - o The client understands and approves of IRC Sec. 280E's limitations. Sec. 280E disallows deductions and credits for amounts paid or incurred in carrying on a trade or business that consists of trafficking in controlled substances, although several tax court cases and Chief Counsel Advice memoranda have stated that cost of goods sold is allowed as a deduction from gross income.

- Document significant discussions with and decisions made by the client. While this is important in every engagement, the stakes are higher for cannabis clients.
- Consider how different areas of practice may be impacted. For example:
  - o Financial statements may require additional disclosures for contingencies, compliance with laws and regulations, or going concern.
  - o Attest reports may need to be modified to include an emphasis-of-matter or other matters paragraph.
  - o Areas such as inventory and income taxes, and controls over cash and inventory may need to be considered high-risk and addressed accordingly by the firm's procedures.
  - o Tax return preparation may not be as straightforward as anticipated due to the difference between IRS rules allowing a deduction for cost of goods sold but denying a deduction for other business expenses under Sec. 280E.
  - o Sales tax compliance for cannabis clients may be more complex than for other businesses due to the multitude of tax jurisdictions.

### WHAT ELSE?

Many CPAs provide services to marijuana-adjacent businesses such as the local hardware store that sells fertilizer to a grower or the real estate company that leases space to a distributor. Some firms may be considering a hemp client. While the 2018 farm bill (the Agriculture Improvement Act of 2018, P.L. 115-334) removed hemp from Schedule I status, each state has its own set of regulations, which may not conform to the 2018 farm bill. The risks of providing services to hemp and marijuana-adjacent clients may be lower than for cannabis clients, but they still exist.

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