

Federal Income Tax Planning for Cannabis Businesses

Preparing for Reclassification

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Today's Speakers



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Mark is a tax partner at the law firm of Mayer Brown. Mark's professional practice focuses on the tax consequences of a variety of capital markets products and strategies and emerging asset classes, including over-the-counter derivative transactions, swaps, tax-exempt derivatives and working with credit funds, offshore insurance companies, cannabis businesses and hedge funds. Prior to joining Mayer Brown, Mark was a partner at another International law firm, served as a Managing Director at Deutsche Bank, general counsel of a credit derivative company and, prior to that, Mark was a partner at Deloitte, where he led the Capital Markets Tax Practice.



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Michael Harlow is the Cannabis Industry Group leader for CohnReznick and the Office Managing Partner of the Bethesda, Maryland office. As such, Michael enjoys working with a variety of clients across country in the Cannabis industry and representing the firm in the Washington, D.C. region. He has more than 20 years of experience in public accounting.

For the past 7 years Michael has focused on growing the Cannabis Industry Group as a client serving Tax Partner, with clients throughout the nation and the regulated cannabis ecosystem from single dispensaries through the largest MSOs in the country. He is a Certified Public Accountant in the state of Maryland.

Current Federal Income Tax Rules Affecting Cannabis Businesses

Code § 280E Disallowance

Code § 195 Start-Up Expenses

Code § 41 Research Credit

Code § 199A Production Deduction

Code § 263A Capitalization Rules

Code § 1202 Qualified Small Business Stock

Code § 172 Net Operating Loss Carryovers

Overview of Deduction Disallowance Rule

- **Tax Code § 280E denies deductions and credits for amounts paid or incurred in any trade or business that “consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act).”**
- **Cannabis is a schedule I controlled substance.**
- **Statute limits disallowance to amounts paid or incurred “during the taxable year.”**
- **Cost of goods sold is not a deduction, so CGS creates an offset to the amount taxed.**

Full Text of Code § 280E

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 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.

Start-Up Expenses (Code § 195)

- **Start-up expenses are allowed as a deduction claimed ratably over 180 months beginning in the year in which business commences.**
- **Start-up expenses are not incurred in carrying on a trade or business; they are prefatory costs.**
- **Cannabis businesses should be entitled to deduct these expenses without regard to Code § 280E**

DEA Research Authorizations

- Research authorizations granted by the DEA could provide protection from Code § 280E for researchers engaged in marijuana research projects.
- Pharmaceutical companies have a strong position that DEA permission negates the federal illegality condition in Code § 280E.
 - Negation would not extend to selling activities

Medical Marijuana – Eligible for Research Tax Credit?

- In December 2022, President Biden signed the Medical Marijuana and Cannabidiol Research Expansion Act into law.
- Code § 41 provides a 20% tax credit for “basic research payments”
- Open issue as to whether Code § 280E denies the Code § 41 research credit for medical cannabis research projects.
- If a cannabis business engages in medical research, how can it distinguish research activities from sales activities?
 - Separate entities
 - Arm’s length transfer pricing
 - Separate facilities
 - Separate payrolls

Qualified Business Income – Code § 199A Deduction

- **Non-corporate taxpayers are entitled to a 20% deduction for qualified business income (excluding capital gains) which is to 50% of payroll, if that is a lesser amount**
- **Specified services businesses are ineligible, which should not affect cannabis businesses**
- **Special rules apply to agricultural businesses, which would affect growing activities**
- **Deduction is taken at S corporation shareholder or partner level, not at business level**

Code § 199A Deductions for Cannabis Businesses

- **The Internal Revenue Service (IRS) has informally stated that it will not automatically challenge Code § 199A deductions claimed by cannabis business owners**
 - **Code § 199A deduction does not arise from an amount paid or incurred, so Code § 280E disallowance should not impact deduction**
 - **IRS had previously conceded that the predecessor rule (Code § 199) was available to cannabis businesses. *Lord v. Comm’r.***
- **Wage limitation could be an impediment because non-deductible wages do not increase credit limit (challengeable regulation?)**
 - **Limitation results in deduction creating more opportunity for cannabis producers than sellers**

Code § 471 Inventory Capitalization

- **Code § 471(c) permits small businesses (>\$25 million of annual gross receipts over prior 3 years) to treat inventory as non-incidental materials**
- **ILM 202114019 ruled Code § 471(c) capitalization rule permits capitalization of the invoice price of the goods, plus the transportation costs and the other necessary charges Taxpayer incurred in having the goods shipped from the producer**
- **The ILM concludes purchasing costs, the storage and handling costs, the costs of preparing the goods for resale, including any inspection costs, packaging costs, and the labor associated with these activities, and selling expenses, including the associated labor, are not considered to be part of the “cost”**

Code § 1202 Qualified Small Business Stock

- **Code § 1202 allows sellers of qualified small business stock (QSBS) to exclude 100% of the gain on the sale of QSBS up to the greater of \$10 million & 10x the stock basis**
- **QSBS must be issued by a domestic C corporation and the corporation must be engaged in the active conduct of a trade or business**
- **Gross assets of the C corporation cannot exceed \$50 million at the time of the QSBS issuance**
- **Stock must be acquired from issuer and can be issued for money, property or services**
- **QSBS cannot be issued by a farming business, but cannabis dispensaries should be eligible issuers**

Code § 172 Net Operating Loss Carryovers

- **Code § 280E prohibits deductions for “any amount paid or incurred during the taxable year.”**
- **If a cannabis business has net operating loss (NOL) carryovers available to it, even from prior cannabis operations, it can argue that Code § 280E doesn’t apply to the deduction because it does not arise from an “amount paid or incurred during the taxable year.”**
- **Code § 461(l) works in this manner. The loss is characterized as an excess business loss in the year incurred. If it is carried forward as an NOL, however, the NOL is not characterized as an excess business loss.**

Current Strategies For Addressing Limitations Imposed by Code § 280E

Segregation
Cost Capitalization

Business Line Segregation

- Segregation of Business Activities
 - Cannabis businesses have segregated business activities that directly involve cannabis production, distribution, or sale from other parts of their business, which include ancillary services and cannabis-related products.
 - In implementing this strategy, many cannabis businesses rely heavily on the Tax Court decision in *Californians Helping to Alleviate Medical Problems, Inc. v. Comm’r* . (CHAMP).

The Facts of CHAMP

- Taxpayer was a public benefit corporation, but subject to federal income tax
- 47% of constituency served had AIDS, the remainder suffered from cancer & other illnesses
- Provided medical marijuana to constituents in addition to providing medical services
- Operated in a church in San Francisco
- Medical marijuana used 10% space at one of 3 facilities
- IRS sought to disallow all deductions
- Court bifurcated activities into two businesses – providing healthcare services and selling cannabis. *See Hoyer v. Comm’r.* Court permitted deductions attributable to providing healthcare services
 - 18 of 25 employees were not engaged in medical marijuana activities
 - 90% of lease was not attributable to marijuana distribution
 - Costs directly allocable to healthcare are not attributable to marijuana distribution

Other Taxpayers Have Been Less Successful

- ***Northern California Small Business Assistants* (Tax Court 2019) – Cannabis dispensary unsuccessful in attempt to limit Code § 280E to trade or business expenses**
- ***Patients Mutual Assistance Collective Corporation* (Tax Court 2018) – Largest dispensary in the US argued it had 4 businesses (cannabis (98.7%), other product sales(.5%), therapeutic services (-0-) and brand development (-0-))**
- ***Canna Care* (Tax Court 2015) – Income from sales of ancillary items (books, T-shirts and other items) did not create two trades or businesses**
- ***Alterman* (Tax Court 2018) – Inability to provide separate financial information from non-cannabis business resulted in a finding of a single cannabis business**
- ***Olive* (9th Cir. 2015) – Court held that taxpayer had a single trade or business and complementary services including movies, board games, yoga classes, massages, snacks, personal counseling, and advice on how to best consume marijuana – were part of the cannabis business (close and inseparable organizational and economic relationship):**
 - Complementary services were not invoiced (bundled into cannabis price)
 - Same employees in cannabis sales and other services
 - Single bookkeeper and accountant

Cost Capitalization

- **Businesses may offset their gross receipts by the cost of goods sold when calculating their gross income.**
- **Amounts properly added to inventory in a cannabis business are effectively deductible as such amounts reduce gross income.**
- **Code § 263A(a)(2) does not permit the capitalization of nondeductible costs.**
- **However, Code § 263A does not apply to businesses with annual average gross receipts of less than \$25 million.**

Public Announcements Pointing to Successful Strategies to Mitigate Code § 280E Impacts

Trulieve

- **At the end of February 2024, Trulieve, a publicly-traded multi-state cannabis business, reported that it had received federal tax refunds of \$113 million attributable to claims that Code § 280E did not apply to all business expenses incurred by the company.**
- **Company said strategy underlying the refund is a “trade secret.”**

SIRA Naturals

- In 2022, SIRA Naturals filed a Tax Court petition asserting that all costs disallowed under Code § 280E should be capitalized under Code § 471(c).
- Case is still pending.

Ascend Wellness Holdings

- In March 2024, Ascend publicly announced it filed amended tax returns for 2020 through 2022 “to seek the return of tariffs paid under Section 280E.”
- Ascend stated that it expected the refund to cover its entire 2023 tax liability.

IRS News Release

- In June 2024, the IRS published News Release IR-2024-177.
- The News Release said the Code § 280E refund claims are “not valid.”
- The News Release further stated that the Justice Department proposed reclassification of cannabis is not effective to mitigate the impact of Code § 280E until a final rule is issued.

Reclassification of Cannabis From a Schedule I to a Schedule III Controlled Substance

DEA Reclassification Proposal

- On May 16, 2024, the Justice Department and the Drug Enforcement Administration released a proposed rule to reschedule marijuana under the Controlled Substance Act, moving it from Schedule I to the less restrictive Schedule III.
- The effective date of the final rule, and what it means for the availability of deductions for cannabis businesses, will be the biggest issue needing IRS guidance.
 - Will Code § 280E no longer apply from the date the final rule is published, or will it be inapplicable beginning in the entire year in which the rule is published?
 - Protective refund claims? Mitchell Britten (Thrive CEO & Nevada Advisory Commission member) has proposed full retroactive relief

Reclassification Tax Planning

- A cannabis company might want to delay triggering a loss under Code §165(f) or acquiring depreciable property until after the effective date of reclassification.
- Code § 197 Intangibles – If intellectual property purchased prior to reclassification becomes amortizable under Code § 197, is the deduction limited to the years remaining in the amortization schedule?
- Can a cannabis business that has been using straight-line depreciation file an accounting method change request to catch up on bonus depreciation once Code § 280E no longer applies.
- How are previously-incurred research & development expenses accounted for?

Cannabis Excise Tax Legislation

New York Excise Tax Legislation

- New York state cannabis businesses are now subject to a 9% excise tax, effective June 2023.
- A sampling of Manhattan dispensaries suggests the new excise tax will reduce the total tax burden of dispensaries from around 23% to 18%.
- The excise tax burden will be significantly higher for microbusinesses because the government has chosen to approximate their wholesale cost as 75% of their retail selling price.
- Microbusinesses are small cannabis businesses that cultivate up to 3,500 square feet indoors or 10,000 square feet outdoors and sell the product at retail—don't purchase from a distributor.
- The excise tax burden affects them negatively tax-wise, because the cost of goods sold of most retail cannabis enterprises is only 50% of retail or less, with the cost of flower closer to 25% of retail because of the glut in the market.

Proposed Federal Excise Tax

- Initial rate will be 10% but will scale up to 25% beginning 5 years after enactment
- Excise tax will be based prevailing prices of cannabis not actual sales price
- Tax would be capped at \$2 million scaling up to \$5 million beginning 5 years after enactment (for legally grown domestically produced cannabis only)
- Cannabis grown for export would not be subject to the excise tax
- Tax would be reduced by $\frac{1}{2}$ for cannabis produced by authorized cannabis growers