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Tax Structuring of U.S. Cannabis Companies for Higher Returns and Foreign Investment

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"Make the most you can of the Indian Hemp seed and sow it everywhere."

—George Washington, President of the United States (1789–1797)

"It also generated a gusher of revenue during the years at issue. . . ."—Mark V. Holmes, Judge, *Patients*

Mutual Assistance Corporation d.b.a. Harborside Health Center v. Commissioner of Internal Revenue

Despite being a Schedule I controlled substance,[1] cannabis[2] is now legal to possess under the laws of 33 states, 10 of which also permit recreational use.[3] This inconsistency between federal and state law not only drives the planning which this article discusses, but also is a business reality which every foreign investor in the U.S. cannabis industry should carefully weigh. Inconsistent federal enforcement should not obscure the fact that interstate and international transactions fall within the exclusive domain of the United States federal government. Repatriation of cannabis proceeds to foreign investors creates a risk of prosecution for international money laundering.[4] Despite this and other business risks which are beyond the scope of this article, domestic and foreign investment in the U.S. cannabis industry continues. Where there is investment, there is a need for tax planning.

SECTION 280E

The tax consequences of the illegal status of cannabis cultivation, manufacture, and sale under federal law is addressed by §280E:[5] "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. . . ." Despite the statutory prohibition of §280E on deduction of business expenses incurred in a trade or business of trafficking in controlled substances, taxpayers are permitted to deduct the cost of goods sold to arrive at gross income on which federal income tax is imposed.[6] Thus, taxable income in the cannabis business is not

[1] *See* Controlled Substances Act, Pub. L. No. 91-513, §202, 84 Stat. at 1249 (codified as 21 U.S.C. §812 (2012)).

[2] For purposes of this article, the term "cannabis" is used to refer to materials, compounds, mixtures, or preparations which contain tetrahydrocannabinols, and is to be distinguished from "the plant Cannabis sativa L. and any part of that plant, including the seeds thereof and all derivatives, extracts, cannabinoids, isomers, acids, salts, and salts of isomers, whether growing or not, with a delta-9 tetrahydrocannabinol concentration of not more than 0.3 percent on a dry weight basis." Agriculture Improvement Act of 2018 (Pub. L. No. 115-334) (the "Farm Bill"), §10113.

[3] Jeremy Berke and Skye Gould, *New Jersey Lawmakers Postponed a Critical Vote to Legalize Marijuana — Here Are All the States Where Pot Is Legal*, Business Insider (Mar. 26, 2019).

[4] "In January 2018, the U.S. Department of Justice (DOJ) issued a marijuana enforcement memorandum noting '. . .Congress's determination that marijuana is a dangerous drug and that marijuana activity is a serious crime.'" *Investor Alert:Marijuana Investments and Fraud* (Sept. 5, 2018).

[5] All section references are to the Internal Revenue Code, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

[6] *See , e.g., New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); *Californians Helping to Alleviate Med. Problems v.*

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based on gross receipts. Instead, gross receipts are reduced by the cost of goods sold to arrive at gross income subject to tax.

COST OF GOODS SOLD

> [Duke of York]
>
> ''Grandam, one night, as we did sit at supper,
>
> My uncle Rivers talk'd how I did grow
>
> More than my brother: 'Ay,' quoth my uncle Gloucester,
>
> 'Small herbs have grace, great weeds do grow apace' ''
>
> —William Shakespeare,
> *Richard III: Act II, Scene IV*

Of the cannabis cases decided by the Tax Court, *Patients Mutual Assistance Collective Corporation d.b.a. Harborside Health Center v. Commissioner*[7] (''*Harborside*'') is the first to address the proper measurement of the cost of goods sold. The Tax Court adopted the Commissioner's position that the cost of goods sold is limited by its regulations under §471. Indirect expenses required to be capitalized by §263A do not expand the scope of cost of goods sold.[8] Regulations under §471 distinguish the computation of cost of goods sold for resellers and producers.[9] In the case of a reseller, cost of goods sold includes not only amounts paid for inventory but also ''transportation and other necessary charges incurred in acquiring possession of the goods.''[10] In contrast, producers are entitled to include costs of materials and supplies expended to grow the product, direct labor expenditures, and indirect production costs including an appropriate share of management expenses.[11]

It appears possible to approximate costs of production when done on a reasonable basis in conformity with standard trade practices in the cannabis industry.[12] Examples of indirect costs include rent, property taxes, and depreciation and amortization on buildings and machinery involved in the growing and processing of cannabis; repair and maintenance expenses; utilities; costs of indirect labor and production supervisors including overtime, vacation and holiday pay, sick leave, payroll taxes, and contributions to supplemental employment benefit plans; tools and equipment; costs of quality control and inspection; administrative costs of production (other than cost of selling or any return on capital); officers' salaries; and insurance costs.[13] However, for these expenses to be allocated to the cost of goods sold they must be ''incident to and necessary for the production or manufacturing operations or processes.''[14] Examples of costs not included in the cost of goods sold include marketing, advertising, selling, distribution, and research and experimentation expenses, income taxes, pension contributions (but only for past services), officers' salaries, and general administrative expenses ''incident and necessary to the taxpayer's activities as a whole rather than to production or manufacturing operations or processes.''[15]

The list of indirect costs properly included in cost of goods sold expands further if the cannabis producer prepares financial statements in accordance with Generally Accepted Accounting Principles (GAAP): taxes deductible under §164 other than state, local, and foreign income taxes; depreciation and depletion; employee benefits including pension and profit sharing contributions representing current service costs; workmen's compensation expenses; payments under wage continuation plans; non-qualified retirement plan contributions included in the gross income of employees; premiums on life and health insurance; costs attributable to strikes, rework labor, scrap, and spoilage; administrative expenses and officers' salaries necessary for production operations; and insurance costs related to production machinery and equipment. Inclusion of these additional expenses in cost of goods sold may well justify the switch from cash to accrual accounting and preparation of GAAP financial statements even if the average annual gross receipts of the cannabis business is below the $25 million threshold of §448(c)(1). Any change in accounting method is elected on Form 3115, *Application for Change in Accounting Method*, and is eligible for transition methods described in the Treasury regulations.[16]

SEPARATING LINES OF BUSINESS: PICKING OUT THE STEMS AND SEEDS

Beyond cost of goods sold, §280E makes it clear that the ordinary and necessary expenses paid or in-

Commissioner (''*CHAMP*''), 128 T.C. 173, 178 n.4; Reg. §1.61-3(a). Reduction of gross receipts by cost of goods sold is also recognized in the legislative history of §280E. *See* S. Rpt. No. 97-494, at 309 (1982), 1982 U.S.C.C.A.N. at 1050.

[7] 151 T.C. No. 11 (Nov. 29, 2018).

[8] 151 T.C. No. 11, at 56

[9] *See* Reg. §1.471-3(b), §1.471-3(c), §1.471-11.

[10] Reg. §1.471-3(b).

[11] Reg. §1.471-3(c).

[12] *See* Reg. §1.471-3(d) (''In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are. . .[f]armers. . .and. . .retail merchants who use what is known as the 'retail method' in ascertaining approximate cost (see §1.471-8).'').

[13] Reg. §1.471-11(b)(3)(ii), §1.471-11(c)(3)(i).

[14] Reg. §1.471-11(c)(3)(i).

[15] Reg. §1.471-11(c)(2)(ii).

[16] *See* Reg. §1.471-11(e)(1)(ii), §1.471-11(e)(3).

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curred in carrying on a trade or business which are otherwise deductible under §162(a) are prohibited as deductions against gross income derived from the production and sale of cannabis. What the Code section does not address is whether a cannabis business can deduct ordinary and necessary expenses incurred in sales of non-cannabis products such as books, branded clothing, or even drug paraphernalia. However, the case law does. In *Californians Helping to Alleviate Medical Problems Inc. v. Commissioner*[17] (''*CHAMP*''), the Tax Court held that the prohibition of §280E did not extend to a separate business distinct from production and sale of cannabis. The taxpayer was allowed to allocate its business expenses between cannabis and non-cannabis activities based on the number of employees and facility space dedicated to each activity.[18] However, any elation created by the Tax Court's decision in *CHAMP* has proven to be short-lived. Subsequent Tax Court decisions have distinguished the holding in *CHAMP* by finding the sale of non-cannabis products was merely incidental to the selling of cannabis.[19] In *Olive v. Commissioner*, the activities and services provided without charge to the patrons of a marijuana dispensary were not sufficient to create a separate line of business. In *Canna Care, Inc. v. Commissioner*, the sale of non-cannabis items including books and socks ''was an activity incident to its business of distributing medical marijuana,'' instead of a separate line of business.[20] Finally, the effort of the taxpayer to distinguish sales of non-cannabis products such as pens, non-branded and branded clothing, books, paraphernalia, community outreach services, therapeutic services, and brand development from sales of cannabis and products containing cannabis also proved unsuccessful when cannabis and cannabis product sales represented 98.7% of the taxpayer's revenue during the years at issue.[21] In *Harborside*, the Tax Court determined that ''selling marijuana and products containing marijuana was [the taxpayer's] primary purpose,'' as was clearly the case in *Olive* and *Canna Care*. These cases are to be contrasted with *CHAMP* in which the caregiving services were determined to be the taxpayer's primary purpose and ''substantially different'' and ''separate and apart'' from the sale of cannabis.[22]

Whether multiple activities are separate trades or businesses or only one is a question of fact.[23] The determination depends on the ''degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together. . ., and the similarity of the various undertakings.''[24] In *Harborside*, the Tax Court determined that the activities the taxpayer identified as separate lines of business (non-cannabis product sales, therapeutic services, and branding) were not separate business activities but rather ''entwined'' with its primary business activity: the sale of cannabis and cannabis derived products.[25]

Viewing *CHAMP* from the perspective of the Tax Court's more recent cannabis cases, it is apparent that avoiding the §280E prohibition on deduction of business expenses requires any non-cannabis related business to be sufficiently independent of the cannabis business to merit operation on its own. While the non-cannabis business activity need not necessarily be profitable, it must have a profit motive.[26] While *CHAMP* demonstrates organizational independence is not a necessity, it clearly becomes a way of separating the non-cannabis business activity and reinforcing its independence. Thus, separation of facilities, personnel, finances, management, and any other functions necessary for the business to be viable independently of the taxpayer's cannabis business (including rendering services to unrelated, non-cannabis businesses) supports the taxpayer's claim that the non-cannabis activity is a separate line of business and therefore not subject to the prohibitions of §280E. Segmentation of separate business activities conducted through separate entities clearly delineates the revenues and costs associated with each line of business. This is clearly easier for a larger, more well-established business than for a start-up whose revenues may not support the redundancy required by such segmentation. If the non-cannabis business activity is substantial, shared employees and facilities may not be problematic.[27]

The distinction between cannabis and non-cannabis business has taken on greater significance. The 2018 Farm Bill decriminalizes ''hemp'' defined as ''cannabis sativa L. . . with a delta-9 tetrahydrocannabinol concentration of not more than 0.3 percent on a dry

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[17] 128 T.C. 173 (2007).

[18] *See* 128 T.C. at 185; *Patients Mut. Assistance Collective Corp. d.b.a. Harborside Health Ctr. v. Commissioner*, 151 T.C. No. 11 at 19 (Nov. 29, 2018).

[19] *See* , *e.g., Olive v. Commissioner*, 139 T.C., 1942 (2012), *aff'd,* 392 F.3d 1146 (9th Cir. 2015); *Canna Care, Inc. v. Commissioner*, T.C. Memo 2015-206, *aff'd*, 694 F. App'x 570 (9th Cir. 2017); *Harborside*, above, at 42 (2018).

[20] *Canna Care, Inc. v. Commissioner*, T.C. Memo 2015-206 at 13. Final regulations under §199A also combine activities incident to others. *See* Reg. §1.199A-4(c).

[21] *Harborside*, 151 T.C. No. 11 at 41.

[22] 128 T.C. at 183.

[23] 151 T.C. No. 11 at 38.

[24] *Id.*, quoting *Olive*, 139 T.C. at 41.

[25] 151 T.C. No. 11 at 47.

[26] 151 T.C. No. 11 at 44. *Accord* §183.

[27] *See CHAMP*, 128 T.C. at 183–84.

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weight basis.''[28] Hemp production and sale should easily lend itself to satisfying the separation from cannabis production and sale necessary to avoid the limitations of §280E. Hemp production and sale can yield sufficient revenue to justify the cost of separate facilities, personnel, management, and operations necessary to break the interdependence that has frustrated taxpayer attempts in the post-*CHAMP* case law to successfully delineate separate lines of business. Reinforcing that separation by conducting business through separate entities (which compels separate books and accounting) should eliminate concerns about application of §280E to deny deduction of ordinary and necessary business expenses.[29] This will clearly require producers and sellers (particularly retail dispensaries) to rethink the relationship between cannabis and non-cannabis businesses.

PLANNING IN RESPONSE TO U.S. TAX CONSIDERATIONS: BONG RIPS AND TAX TIPS

Separate business entities allow separate entity choices.[30] Cannabis resellers and producers are not able to deduct business expenses other than those associated with cost of goods sold computed in the manner directed by Treasury regulations under §471. Conducting cannabis business through an entity subject to the lowest possible rate of taxation cushions the loss of deductions in computing income subject to tax. Under current revenue laws, C corporations are taxed at a flat 21% federal rate. In contrast, owners of pass-through entities are subject to federal income tax rates which may be as high as 37%. For the same reason that business expenses made non-deductible by §280E are best paid by a C corporation because of the lower rate to which its income is subject, other non-deductible expenses will also best be paid by this entity (for example, life insurance on officers and directors through split-dollar funding arrangements).

While certain business activities may be so aligned with the sale of cannabis as to be difficult to segment into a separate line of business under the ''incidental'' test emerging from the Tax Court's cannabis cases (consider paraphernalia sales), other activities by their very nature are imminently distinguishable (for example, rental of tangible real or personal property). Corporations have always been horrific tax choices for ownership of real estate. In addition to all the customary reasons for keeping assets (tangible or intangible) out of an operating business and keeping real estate out of a corporation, if the owners of the cannabis business also own real estate used in the production or sale of the cannabis, that real estate is best owned through a separate entity to remove any risk that §280E would prevent full utilization of costs associated with the real estate being currently deductible. Even with respect to costs which go into the computation of goods sold (such as property taxes), the timing of the deduction (the year paid or year the inventory is sold) merits ownership of the real estate through a separate entity. Thus, the cannabis business pays rent to the entity owning the real property at which the product is grown, warehoused, or sold. Since the rent will not be deductible by the cannabis company, this structure creates a risk of double taxation. However, to the extent the real estate entity has sufficient deductible expenses (such as depreciation, interest, property taxes, maintenance, and repairs) to allow rent paid by the cannabis business to be fully sheltered from taxation, a double tax is avoided. If the rental income is fully sheltered by expenses the effective tax rate on the cannabis profit is 21%. If not fully sheltered, payment to a pass-through entity owning the real estate may increase the federal rate of tax to as much as 50.23%. Modeling is critical in this exercise (consistent with the post-2017 TCJA[31] world).

Absent some circumstances by which income earned by the non-cannabis entity from services provided to the cannabis entity is fully sheltered from tax, little tax advantage is to be gained by engaging a related non-cannabis business to provide services to the cannabis business, even if the non-cannabis business is organized as a pass-through qualifying for the 20% deduction for qualified business income under §199A.[32] The cannabis entity is prohibited from deducting rent, royalties paid for use of intellectual property, and other expenses for services such as transportation, accounting, security that might be provided by a non-cannabis business entity. Consequently, the combined rate of tax paid on the revenues of both entities will still be at a relatively high federal rate of 44.384% when the non-cannabis entity is organized as a pass-through whose owners are exposed to the highest marginal federal income tax bracket.

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[28] Agriculture Improvement Act of 2018 (Pub .L. No. 115-334), §10113.

[29] It appears to be the position of IRS and Treasury that separate businesses cannot exist in the same entity unless each activity is eligible to use a different method of accounting. *See* Preamble to T.D. 9847, 84 Fed. Reg. 2952 at 2956 (Feb. 8, 2019) (§199A regulations) (''The Treasury Department and the IRS also believe that multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business under §1.446-1(d).'').

[30] Any structuring to minimize U.S. taxation must be fully cognizant of the character of the foreign investor (as an individual or entity organized under foreign law) and home country revenue laws affecting repatriation of the U.S. investment returns.

[31] Tax Cuts and Jobs Act, Pub. L. No. 115-97 (Dec. 22, 2017).

[32] Foreign owners of pass-through entities are not denied the benefit of the 20% deduction for qualified business income under §199A.

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Assuming sufficient separation from the cannabis activity exists to avoid the taint of §280E, the entity through which the non-cannabis activity is conducted may be organized as a sister corporation to the cannabis corporation under the common control of a U.S. parent corporation. In this scenario, although the entity through which the non-cannabis activity is conducted is also organized as a C corporation, any losses from the non-cannabis activity could be applied to offset the income of the cannabis corporation through a consolidated return.[33] The disadvantage of C corporations has always been the second layer of tax incurred when the after-tax revenues of the C corporation are distributed to its stockholders. Distributions of qualified dividend to the shareholders (foreign or domestic) will be taxable at rates of 15% or 20%.[34] If the potential for after-tax profits has not been fully eliminated by application of §280E or by arm's-length payments to related parties, any remaining profits can be made available to the shareholders of the C corporation by loans in lieu of dividends. Those loans would, of course, be subject to arm's-length requirements and personal holding company and accumulated earnings considerations which severely limit the utility of this strategy as profits and investments accumulate inside the corporations. However, in a low interest rate environment the opportunity for a modest tax deferral on reasonable terms exists. Section 163(h)'s disallowance of deductions on personal interest and limitations on deductions of investment and business interest, respectively, under §163(d) and §163(j), should also be considered in this context.

Although §280E compels the cannabis business to be organized as a C corporation, the non-cannabis business has no such constraint. The income of the entity through which the non-cannabis activity is conducted will likely be subject to a lower rate of tax if organized as a pass-through whose income qualifies for the 20% deduction under §199A. A pass-through entity also allows the owners to derive a tax benefit from losses experienced by the non-cannabis business. Under prior law, if foreign ownership of a pass-through entity was desired, taxation under subchapter K was the only option. However, with the advent of changes to §1361(c)(2)(B)(v), non-resident aliens can be shareholders of S corporations if the shares are owned through an electing small business trust (ESBT) described in §1361(e).[35] In the case of a foreign investor, a pass-through entity organized as an S corporation is infinitely preferable inasmuch as gain on sale of the stock of a corporation engaged in a U.S. trade or business escapes U.S. taxation. In contrast, gain on sale of an interest in a partnership engaged in a U.S. trade or business is subject to U.S. taxation under newly enacted §864(c)(8).[36] However, unless the foreign investor can somehow exit by sale of her beneficial interest in the ESBT, gain on sale of the S corporation stock will be fully subject to U.S. tax.

CONCLUSION: LET ME BE BLUNT

Maximizing the cost of goods sold and choice of a U.S. business entity taxed at a relatively low rate of 21% are the best opportunities for domestic and foreign investors in cannabis businesses to minimize exposure to U.S. income taxation. Fortunately for the foreign investor resident in a jurisdiction with which the United States has a tax treaty, a favorable withholding rate on dividends paid by the U.S. business entity produces a result with an acceptable rate of U.S. taxation. The lack of deduction for interest means foreign investment structured as debt has the same after-tax cost to the cannabis company as equity. However, for the foreign investor, interest is subject to a lower rate of withholding under many U.S. tax treaties.[37] Organization of the cannabis enterprise as a corporate entity also provides favorable U.S. tax treatment on exit by the foreign investor. To the extent investment extends to non-cannabis activities, the low rate of entity tax provided by a C corporation and lack of tax on exit may prove more favorable than ownership of the non-cannabis business through a pass-through entity despite the relief provided by §199A.

"We shall, by and by, want a world of hemp more for our own consumption."

—John Adams, President of the United States (1797–1801)

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[33] Query: Would single-member LLCs owned by a C corporation provide sufficient separation to avoid application of §280E to the non-cannabis disregarded entity?

[34] Such dividend distributions may also be subject to the tax on net investment income imposed by §1411(a)(1).

[35] Pub. L. No. 115-97, §13541(a). See generally Reg. §1.1441-7(a)(1) and §1.1441-5T(b)(2)(iii) with regard to withholding by domestic trusts on distributions to foreign beneficiaries.

[36] *See* §1446(f) with regard to withholding on sales of partnership interests by foreign persons.

[37] *See, e.g.,* Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital, art. XI(1).

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