



Tax Strategies for Entrepreneurial Firms to Minimize the Impact of Section 280E

JOHN F. MCARDLE, DOUGLAS G. CHENE, ALICE J. DE KONING

While the cannabis industry is rapidly growing at the state level, cannabis remains illegal at the Federal level.

Introduction

The current dichotomy between Federal and State law with regard to the legal sale of cannabis products has created an uneven playing field for entrepreneurial firms that seek to operate cannabis-related businesses. The cultivation and sale of cannabis is legal in some form in a majority of U.S. states, yet cannabis remains a prohibited and controlled substance at the Federal level. As a result, firms are unable to engage in traditional banking relationships; have difficulty obtaining financing, insurance, and other professional advisory services; and are unable to avail themselves of common tax accounting strategies that are available to other businesses that produce agri-

cultural products or sell consumer goods. Several states have introduced bills to “decouple” from Federal law, thereby allowing cannabis businesses to benefit from these common tax accounting strategies. At the Federal level, however, entities that produce or sell cannabis products are at a competitive disadvantage to non-cannabis businesses.

This paper first describes the scope of the U.S. market for cannabis products and describes the specific legal issues that preclude firms in this sector from using common tax accounting strategies to minimize tax liability. We then discuss two typical scenarios for a cannabis startup, a production operation and a retail sales operation. We describe the typical guidance provided

John F. McArdle is an Associate Professor at Salem State University. Douglas G. Chene is a Professor at Salem State University. Alice J. de Koning is a Teaching Professor at the University of Calgary.

by accounting and tax firms who seek to advise clients in this industry, and present two hypothetical business structures for an entrepreneurial firm in this space. We assess how federal courts have evaluated these types of arrangements and offer some guidance on how typical pitfalls in these arrangements might be avoided. Finally, we close with some observations about how regulation and entrepreneurial strategy interrelate, consider the public policy implications of cognitive dissonance at the federal and state levels, and offer a comparative perspective on regulating this industry in an international context.

Statement of the Problem

Thirty-seven states have legalized the sale of medical cannabis, and twenty-one have also legalized the sale of cannabis products in an adult-use recreational market. Cannabis is big business. 2022 industry revenues are estimated to be \$22.6 billion for cannabis producers, and that revenue is estimated to grow at an annualized 14.6% by 2027.² On the retail side, 2022 revenues were reportedly \$31 billion, estimated to annually grow 14.9% by 2027.³

However, while the cannabis industry is rapidly growing at the state level, cannabis remains illegal at the Federal level. Cannabis is a Schedule I controlled substance under the Controlled Substances Act (CSA), and the production, distribution, and possession of cannabis is illegal.⁴ Internal Revenue Code (IRC) § 280E disallows deductions or credits for any amount paid or incurred in carrying on any trade or business that consists of illegally trafficking in a Schedule I or II controlled substance within the meaning of the CSA.⁵ Because trafficking cannabis remains illegal under the CSA, § 280E applies to businesses that sell cannabis, even if they operate in states that have legalized cannabis.⁶ As a result, § 280E prohibits these businesses from claiming most deductions or credits for expenses related to the sale or trafficking of cannabis.⁷ The only exception to § 280E's prohibition on expense deduction is the ability of firms to reduce their gross receipts by properly calculating the costs of goods sold (COGS) under IRC § 471.⁸

Reportedly, there is wide noncompliance with the provisions of § 280E,

in large part due to a lack of guidance from the Internal Revenue Service.⁹ A 2020 Treasury Inspector General for Tax Administration (TIGTA) report concluded that 59% of returns sampled from three states that had legalized cannabis likely had § 280E adjustments, and recommended that the IRS develop a comprehensive compliance approach for the cannabis industry.¹⁰ To date, that has not occurred.

In the absence of adequate IRS guidance regarding the structure and operations of firms engaged in cannabis production or sales, a number of accounting and law firms, as well as some industry associations, have recommended various approaches to organizing the activities of businesses in this industry. This has created some significant potential for risk, as federal law is largely unsettled with respect to many of these arrangements. The national taxpayer advocate has estimated that cannabis businesses may face tax liabilities that are five times greater than businesses not subject to § 280E.¹¹

The Current Landscape

Overview of the industry, and two typical entrepreneur/startup scenarios. The value chain for cannabis products in the United States has three major components: producers, retailers, and ancillary services. Within the cannabis sector, producers (growers) and retailers (dispensaries) are major players in the value chain that directly deal with cannabis, and thus are vulnerable to excessive tax burdens given the restrictions of § 280E. Understanding the operating, investing, and financing cash flows typical to each type of enterprise can help identify and segregate costs, and allow for the development of tax strategies. We acknowledge that there are other businesses within the value chain that may be vulnerable to high tax burdens, such as seed stock producers and wholesalers, but discussing the producers and retailers will suffice for illuminating typical challenges faced by cannabis businesses.

Cannabis production is a capital and labor intensive business. Producers typically grow cannabis in highly controlled, indoor environments, or on large outdoor farms in areas where climate is relatively

stable during the growing season.¹² A typical seed-to-harvest cycle is 20-24 weeks.¹³ Producers invest in lighting systems, ventilation, filters, watering, and other systems, often with automated control systems. One of the challenges of growing cannabis is that the plant is vulnerable to mold and infestations, and the risk of loss of a crop for producers can be quite high. To deal with these challenges, producers invest in sophisticated systems, have learned to build compartmentalized grow rooms to limit crop damage, and employ sophisticated monitoring equipment.¹⁴ The construction costs and energy usage of these facilities are considerable.¹⁵ The exact growing process and staff needs depend on the producers' operations strategy, but regardless of the degree of automation, considerable expertise and direct human oversight are needed to ensure healthy plants with good harvests.¹⁶ At harvest, staff collect and process the buds, deal with the plant waste, dry and cure, package, and store the product. Depending on the company, the packaging could be bulk or individual use packaging. Some producers also extract cannabis oils, which is a separate process. In addition, producers have quality control processes, marketing and sales, and other functional roles. A critical aspect of the whole operation is the need for extensive security for the premises, operations and staff, as strong black-market demand for cannabis is an incentive for criminal activity.

As the description of producers' operations makes clear, production requires significant capital to invest in the construction of the production building and equipment. An investment in a new operation requires considerable front-end capital. In addition, working capital is needed to fund operations, as the growing cycle takes 3-5 months. The expenses of the staff and utilities in the growing facilities may be counted as cost of goods sold, but marketing and security, for example, would not be included in COGS.¹⁷ With equity investments, ROI on the investments are considerably diminished if costs cannot be deducted. Fewer expense deductions plus higher tax payments would result in lower profits, and thus lower returns and slower growth of book value of the company. Using debt financing is equally challenging. First,

EXHIBIT 1

Single Entity Comparison with Non-Cannabis Business

	Tomato Farm (non-cannabis business)	Cannabis Facility (cannabis business)
Revenue	\$4,000,000	\$4,000,000
Cost of Goods Sold	\$1,150,000	\$1,150,000
Gross Income	\$2,850,000	\$2,850,000
Deductible Business Expenses (including annual debt service)	\$1,350,000	(disallowed)
§179 Deductible Expenses	\$900,000	(disallowed)
Net Operating Income Before Taxes	\$600,000	\$600,000
Net Taxable Income	\$600,000	\$2,850,000
Combined Federal (21%) and State (8%) Tax Rates	29%	29%
Tax Owed	\$174,000	\$826,500
Post-Tax Net Cash Flow	\$461,500	(\$226,500)

producers do not have access to banking institutions and other normal sources of debt financing and thus risk higher interest rates in nonconventional markets, and second, the interest payments are not deductible.

An alternative producer model is outdoor cultivation, which is generally limited to certain regions. One advantage of outdoor cultivation is that it generally entails significantly lower capital costs – buildings and equipment are needed only for processing and storing the cannabis buds. Outdoor fields generally do not need expensive systems for lighting, ventilation, and security. In fact, the most extreme security needs are largely limited to harvest and processing, when the risk of criminal activity are highest. Studies indicate that the cost of production in outside facilities is considerably cheaper.¹⁸ In addition, most of the expenses are variable and can be classified as COGS. These producers have less of a tax burden, although they may have more risk of theft and adverse weather conditions.

For retailers, the tax challenges are markedly different. Access to capital can be critical for retailers, not just to fund store operations and purchase saleable products, but they may also need a cash float to handle transactions, as credit arrangements may not be feasible due to Federal law.¹⁹ Similar to producers, tax deductions available to

retail shops are limited, and as a result the tax burden for a retail cannabis shop is higher than it would be for other retail sector businesses. The amount of deductible COGS is limited to the price paid to producers or wholesalers for the cannabis products.²⁰ A retail store, however, entails renting retail space, building out the interior, installing fixtures, signage, utilities, point of sale systems, sales assistants, and all the other details that are part of any retail operation. These expenses are not deductible for a cannabis retail entity.²¹ Further, unlike most retail stores, a cannabis dispensary requires additional security and secure storage, including a place to store the cannabis stock and to store the cash. In some cases, the concerns for securing cash can be a major issue, because Federal law effectively restricts access to the banking system, limiting options for cannabis retail businesses to safeguard cash.²²

Given these challenges, it can be difficult for an entrepreneur looking to open a cannabis retail entity to attract suitable startup capital, or to establish cashflow sufficient to cover operating expenses. The challenge for a retailer is to generate a good enough ROI to attract equity investments, or retain large enough earnings after tax to cover interest expenses. The current legal and regulatory landscape precludes the use of tax-advantaged strategies typically employed by a non-

cannabis retailer. Accordingly, professional advisors have developed guidance and strategies for entity structure, with mixed results.

Typical Guidance proposed by CPA, law, and other advisory firms. While there are risks to firms associated with this industry due to a broad application of § 280E, there is also great potential reward given the growth within this sector. CPA firms, law firms, and industry associations often provide guidance to entrepreneurial cannabis start-ups on how to organize their activities in a tax-efficient manner. Typically, these firms cite a number of hurdles faced by cannabis businesses and provide a general discussion of options that these businesses might use to reduce their federal tax burden. As noted above, the investment in starting up a cannabis business requires considerable capital, both initially for the acquisition of assets, construction and other capital costs as well as working capital to pay operating costs before the business is fully operational. In the United States, cannabis businesses are considered illegal activities, so these costs are disallowable expenses under the tax code. The combination of significant capital and operating costs, and the relatively high tax burden resulting from the disallowance of many startup and operating costs for a cannabis business, create a narrow path for an entrepreneur to tread when attempting to

EXHIBIT 2

Multiple Entity Comparison Cannabis Business

	Rental LLC (non-cannabis business)	Operating Entity (cannabis business)
Revenue	\$1,000,000	\$4,000,000
Cost of Goods Sold	0	\$1,150,000
COGS (Production Related Rent Expense)	0	850,000
Gross Income	\$1,000,000	\$2,000,000
Deductible Business Expenses (including annual debt service)	\$1,000,000	\$0
§179 Deductible Expenses	\$900,000	\$0
Net Taxable Income (Loss)	(\$900,000)	\$2,000,000
Combined Federal (21%) and State (8%) Tax Rates	29%	29%
Tax Owed (Sheltered)	(\$261,000)	\$580,000
Post-Tax Net Income (Loss)	(\$246,500)	\$1,420,000

make their business financially viable while remaining compliant with a number of statutory tax provisions. This section summarizes the Federal tax landscape regarding the issues that cannabis businesses face to remain in compliance with the Internal Revenue Code.

Federal tax law does not differentiate between income derived from legal and illegal sources, a business's gross income includes all income from whatever source derived, including income derived from business.²³ The code provides that term "taxable income" means gross income minus the deductions allowed by [26 USC § 63].²⁴ Thus, all income from this business activity needs to be included in the entity's Federal tax return as income. It is long-settled that income from businesses that are deemed illegal under federal law is still subject to taxation.²⁵ Generally, businesses are permitted to adjust their income by deducting expenses which are "ordinary and necessary" under § 162(a), state and local taxes under § 164, business losses under § 165, and depreciation under § 167.²⁶ However, as a result of § 280E, cannabis businesses are unable to avail themselves of these deductions.

§ 280E disallows the deduction of most operating and capital expenses associated with illegal activities that would normally be allowed under § 162(a), 164, 165, and 167.²⁷ The IRS has consistently applied § 280E to cannabis busi-

nesses, and courts have consistently found the IRS position to be proper.²⁸

While cannabis businesses are unable to deduct most of their operating and capital expenses, an exception to the disallowance of expenses is the cost of goods sold. Cost of goods sold includes "expenditures necessary to acquire, construct or extract a physical product which is to be sold."²⁹ Cost of goods sold is considered an exclusion from gross income and not a deduction.³⁰ Businesses are allowed to deduct the cost of goods sold under § 471.

The extent to which cannabis businesses can deduct expenses related to their cost of goods sold varies between producers and retailers. Producers are in a more advantageous position because they may be able to qualify more operating costs under the umbrella of cost of goods sold. Producers are allowed to include indirect production costs, including wages, rents, repairs, utilities, and maintenance expenses as inventoriable costs that are transferred to the cost of goods sold when sales are made.³¹ In addition, advice from the IRS Office of Chief Counsel stated that book depreciation deductions and state taxes under § 164, among others, may be deducted if GAAP financial statements were issued by the entity.³² Retailers must use the inventory valuation rules of Reg § 1.471-3(b). This means that a retailer can only include the invoice price of goods purchased, less trade or

other discounts, plus transportation of the goods to the site of the business and "other necessary charges incurred in acquiring possession of the goods."³³

This single entity approach still leaves many costs non-deductible for federal tax purposes under § 280E. For example, acquisition, construction, and capital costs related to the investment in these businesses are disallowable expenses. Typically, a business would be able to deduct these types of costs under § 1245 for expenses related to the acquisition of personal property, § 1250 for expenses related to the acquisition of real property, and use § 1231 to achieve more favorable tax treatment on the disposition of property used in their business. § 1231 allows businesses to deduct losses from the disposition of property held for more than one year as ordinary losses that can be deducted from ordinary income rather than capital losses. The inability to deduct initial investment costs such as buildout costs for tangible property under § 1245 and real property under § 1250 to maximize the ability to front-load deductions when beginning the business can be substantial, thus raising the financial hurdles to profitability compared to non-cannabis businesses. Therefore, strategically organizing a new venture to maximize opportunities under the tax code is very important.

A Hypothetical Scenario. Consider a single-entity example that shows the impact of § 280E on a cannabis business compared to a tomato farming business. Jerry and Phil want to open a cannabis production business. They have elected to organize their business as a C corporation, since they have other income streams that put them in a higher tax bracket. In addition, they want to limit their liability and to make the business attractive to investors.

The business will grow, harvest, and refine cannabis products. Typically, the seed to harvest production cycle for a cannabis plant is 19-24 weeks. They plan to grow product in an indoor facility, both so that they can maximize the production capacity of each harvest and control all aspects of the growing cycle, and so that they can have staggered production cycles.

They have a commitment from a private investor to loan them \$7,000,000 to finance site acquisition, construction, and equipment-related costs. The loan has a 10-year term at a rate of 12.5%. In order to hedge against risk, the private lender stipulates that the loan will be a recourse liability, and that interest-only payments will be made during the first five years of the loan. Annual debt service on the loan will be \$875,000.

They anticipate that their gross annual revenues will be \$4 million per year, and

that their cost of goods sold will be \$1,150,000 per year. They estimate deductible business expenses (including the debt service costs to acquire and renovate an existing warehouse building for production of cannabis products) to be \$1,350,000 per year. They further estimate that the venture's equipment costs in year one (that would normally be eligible for § 179 expense deduction) will total \$900,000.

Jerry has some experience running an indoor hydroponic tomato farm and was surprised to learn that the tax treatment of his proposed cannabis business would result in higher tax costs due to § 280E and, as a result, lower net income. Their accountant, Bob, developed a simple comparative chart to explain § 280E's impact on taxes and profits. See Exhibit 1.

In an attempt to maximize the deductibility of capital and operating expenses related to operating a cannabis venture, professional firms and industry associations often advise their clients to structure the business as two separate legal entities, one that operates the cannabis business, and another that owns and manages the real estate, or (in some instances) performs non-cannabis related operations. If structured properly through the use of two distinct legal entities that arrange contracts in an arms-length transaction, a cannabis entrepreneur might be able to deduct a significant

amount of capital and operating expenses. In this type of arrangement, the non-cannabis business would assume all costs related to acquisition, construction, and management of the real estate, and the cannabis business would then rent the real estate, most likely using a gross lease arrangement.

Generally, commercial leases are structured as either triple-net leases or as gross leases.³⁴ In a triple-net agreement, the costs for maintenance, taxes, and insurance are passed on to the tenant (lessee) as an additional cost. In a gross lease, the tenant pays rent for the use and occupancy of the space, and the landlord assumes the cost for all other expenses, including maintenance, taxes, and insurance. The structure of the rental agreement provides additional tax savings opportunities. If the lease arrangement is a gross lease in which the lessor retains responsibility for the expense for capital and operating costs, the real estate entity is able to take accelerated depreciation deductions.³⁵ While the operating entity would still not be able to deduct its rent under § 280E, the real estate entity would be able to take advantage of depreciation deductions related to capital improvements, and might also shift some operating expenses that could be properly attributed to the real estate entity.

This guidance is often offered by a number of firms to highlight the value they

NOTES

- ¹ National Conference of State Legislatures, "State Medical Marijuana Laws," <https://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx>. (Feb. 1, 2023).
- ² Brigitte Thomas, "U.S. Specialized Industry Report OD4141, Medical & Recreational Marijuana Growing," IBISWorld, January 2023.
- ³ Brigitte Thomas, "U.S. Specialized Industry Report OD4142, Medical & Recreational Marijuana Stores," IBISWorld, September 2022.
- ⁴ 21 U.S.C. § 812(c).
- ⁵ 26 U.S.C. § 280E.
- ⁶ *United States v. Oakland Cannabis Buyers' Co-op.*, 532 U.S. 483 (2001).
- ⁷ *N. California Small Bus. Assistants Inc. v. Commissioner*, 153 T.C. 65 (2019).
- ⁸ 21 U.S.C. § 471. See also Chief Counsel Advice 2015-04011 (Dec. 10, 2014).
- ⁹ Milan N. Ball, "The Application of Internal Revenue Code Section 280E to Marijuana Businesses: Selected Legal Issues," Congressional Research Service (CRS) Reports and Issue Briefs (2021) R46709.
- ¹⁰ Dep't Of Treas., Treasury Inspector General For Tax Admin., 2020-30-017, "The Growth Of The Marijuana Industry Warrants Increased Tax Com-

- pliance Efforts And Additional Guidance" (2020). <https://www.treasury.gov/tigta/auditreports/2020reports/202030017fr.pdf>.
- ¹¹ National Taxpayer Advocate, NTA Blog: "Despite Operating Legally in Many States, Marijuana-Related Businesses Face Significant Federal Income Tax Law Challenges," May 10, 2022. Available at: <https://www.taxpayeradvocate.irs.gov/news/nta-blog-despite-operating-legally-in-many-states-marijuana-related-businesses-face-significant-federal-income-tax-law-challenges/>
- ¹² Sam Wilson, Hekia Bodwitch, Jennifer Carah, Kent Daane, Christy Getz, Theodore Grantham, & Van Butsic, "First known survey of cannabis production practices in California," 73 *Cal. Agriculture* 3 (2019), 119-127.
- ¹³ The average production cycle for a cannabis plant to develop from seed to harvest is about 18 weeks. After harvest, there is a drying process that generally takes 2 weeks, followed by a grading, testing, and quality control period that can add an additional 2 weeks. Cannabis products are then either packaged for sale or put through an extraction process. The entire period from seeding to sale can take as long as 24 weeks. For a detailed overview of the commercial production process, see Armina Ligaya, "The life cycle of

- a cannabis plant, from seed to store," Canadian Press, Dec. 26, 2018. <https://business.financialpost.com/pmn/commodities-business-pmn/agriculture-commodities-business-pmn/the-life-cycle-of-a-cannabis-plant-from-seed-to-store>
- ¹⁴ Evan Mills, "The carbon footprint of indoor Cannabis Production," 46 *Energy Policy* 58 (2012).
- ¹⁵ Evan Mills & Scott Zeramby, "Energy Use by the Indoor Cannabis Industry: Inconvenient Truths for Producers, Consumers, and Policy Makers," in *The Routledge Handbook of Post-Prohibition Cannabis Research*, 243-265. (Routledge, 2021).
- ¹⁶ Eirik Hammersvik, Sveinung Sandberg, & Willy Pedersen, "Why small-scale cannabis growers stay small: Five mechanisms that prevent small-scale growers from going large scale," 23 *Intl. J. of Drug Policy* 6 (2012): 458-464.
- ¹⁷ *Californians Helping to Alleviate Medical Problems, Inc., v. Commissioner*, 128 T.C. 173 (2007).
- ¹⁸ See also Chief Counsel Advice 2015-04011 (Dec. 10, 2014).
- ¹⁹ Jonathan P. Caulkins, "Estimated cost of production for legalized cannabis" (RAND Drug Policy Research Centre: Santa Monica, CA 2010).
- ²⁰ C.C.A. 2015-04011 (Dec. 10, 2014).
- ²¹ 26 U.S.C. § 280E

might provide their clients by conducting a cost-segregation study, a necessary step to maximizing the arrangement. A cost segregation study begins with the process of identifying personal property assets that are grouped with real property assets and then reallocating those personal property assets for federal tax reporting purposes. The study treats the purchase of real estate as more than the acquisition of land and a building. The primary goal of a cost segregation study is to help a client maximize their depreciation deduction by examining all assets purchased and assuring they are classified so that they can be depreciated over the shortest useful life allowed by the IRS, as established in either the general depreciation system³⁶ or in the alternate depreciation system.³⁷

As a general rule, a building is depreciated over a 39-year life and classified as real property by the IRS.³⁸ However, a cost segregation study allows many parts of the building and its fixtures to be classified as personal property, which has a shorter useful life, and thus can be depreciated over shorter periods of time. As a result, the costs for assets in the building classified in this way can result in much larger depreciation deductions. For example, carpeting, vinyl wall and floor coverings, accordion doors and partitions, kitchen hoods and exhaust systems, among many other assets that might be in the building, qualify as 5-

or 7-year personal property. Further, they can classify certain land improvements as part of the real property as 15-year property.³⁹ For a cannabis entrepreneur, eligible property might include irrigation and hydroponic systems, lighting and electrical components, or security equipment. The study begins with an engineering report of all of the components of the building and then an accountant can segregate the various assets between the real property and the personal property, and allocate the purchase price accordingly, resulting in a much higher annual depreciation deduction and significant tax savings.

As applied in practice for an entrepreneur seeking to create a dual-entity structure for a cannabis-related business, if the entrepreneur can legitimately allocate expenses to the non-cannabis business, and then classify those capital expenditures as “tangible personal property” under § 1245 rather than “tangible real property” under § 1250, they would be able to accelerate the depreciation recovery on as short as a 5-year, rather than a 39-year, schedule.⁴⁰ It is important for the entrepreneur to accumulate detailed documentation on all of the asset acquisitions. An accounting firm can take this documentation and perform a cost-segregation study to examine all property transactions in detail and maximize accelerated depreciation deductions

for the real estate entity. An additional benefit of this type of study is that it allows for the maximum use of the § 179 deduction. Essentially, by providing a substantial current-year deduction, § 179 allows a taxpayer to treat the total cost of assets classified as personal property as an expense rather than capitalize it in the taxable year in which the property is placed in service. This can add up to \$1.08 million in depreciation deductions in a given year depending on the amount of eligible § 179 property placed in service and the entity’s taxable income before the § 179 deduction.⁴¹

This type of dual-entity structure allows entrepreneurs to maximize the deductibility of costs and reduce their financial hurdles at the start-up of their businesses. Both entities must take care to maintain detailed records of these costs in order to have appropriate substantiation in the event that their tax return deductions are challenged by the IRS. Under this structure, the real estate entity must charge market-rate rents to avoid running afoul of § 482, which requires transactions to be arms-length in nature.⁴² Additionally, they should avoid commingling assets, staff, or other components of the businesses.

In addition, if there is interlocking ownership of the two entities they must match income and deductions as required by § 267, which covers related-party transactions. This applies if one of the entities is an accrual basis taxpayer and the other is a cash basis taxpayer. Assume the real estate entity is using the accrual basis and the operating entity is using the cash basis. In this scenario, the operating entity cannot take a deduction it paid to the real estate entity until the real estate entity takes that payment into income.⁴³ To comply with § 168, the depreciation deductions must be claimed by the real estate entity. There may be other deductions that the real estate entity can take that would not be deductible to the operating entity, such as charitable contributions under § 170.

Returning to Jerry and Phil, recall under the single-entity approach above that their cannabis business has a net profit of \$2,023,500 in the first year. So, their accountant Bob recommended that they consider structuring the business as two separate entities – a real estate

NOTES

²² Colleen M. Baker, “Entrepreneurial Regulatory Legal Strategy: The Case of Cannabis,” 57 Am. Bus. L.J. 4 (2020).

²³ 26 U.S.C. § 61(a)(2).

²⁴ 26 U.S.C. § 63(a).

²⁵ *United States v. Sullivan*, 274 U.S. 259 (1927); *James v. United States*, 366 U.S. 213, 218 (1961).

²⁶ *Welch v. Helvering*, 290 U.S. 111 (1933).

²⁷ 26 U.S.C. §§ 162(a), 164, 165, & 167.

²⁸ See, for illustration, *Olive v. Commissioner*, 792 F.3d 1146 (9th Cir. 2015); *Feinberg v. Commissioner*, 916 F.3d 1330 (10th Cir. 2019); *Beck v. Commissioner*, T.C. Memo. 2015-149.

²⁹ *Reading v. Commissioner*, 70 T.C. 730, 733 (1978, *aff’d*, 614 F.2d 159 (8th Cir. 1980)).

³⁰ *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

³¹ Reg. § 1.471-3(c).

³² C.C.A. 2015-04011, (Dec. 10, 2014).

³³ Reg. § 1.471-3(b).

³⁴ For a good overview of these approaches, see Joseph D. Quinn, & Kenneth J. Smith, “The Ridgely house venture: Triple net commercial lease/purchase case,” 15 Issues in Accounting Educ. 3 (2000).

³⁵ Soled, Jay A., & Charles E. Falk, “Cost Segregation Applied,” 198 Journal of Accountancy 28 (2004). See also Peter Smith, “Tax Depreciation,” in *Strategic Management of Built Facilities*, 159-170 (Routledge, 2013).

³⁶ 26 U.S.C. § 168(a).

³⁷ 26 U.S.C. § 168(g). Notably, cannabis producers engaged in farming operations might have to use the alternate depreciation system.

³⁸ 26 U.S.C. § 168(c).

³⁹ Rev. Proc. 87-56.

⁴⁰ 26 U.S.C. § 168(e)(3)(b).

⁴¹ 26 U.S.C. § 179.

⁴² 26 U.S.C. § 482.

⁴³ 26 U.S.C. § 267.

⁴⁴ 26 U.S.C. § 162(a).

⁴⁵ 26 U.S.C. § 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) that are prohibited

holding company that would acquire, renovate, and manage the facility; and a separate business that would be responsible for all aspects of cannabis production. Doing so, Bob reasoned, would allow the partners to shift much of the currently nondeductible expenses of the single-entity cannabis business under Exhibit 1, including the § 179 expenses, to the real estate holding company.

Exhibit 2 shows the tax impact on the business using this multi-entity approach. Recall from Exhibit 1 that they have a commitment from a private investor to loan them \$7,000,000 to finance site acquisition, construction, and equipment-related costs. The loan has a 10-year term at a rate of 12.5%. In order to hedge against risk, the private lender stipulates that the loan will be a recourse liability, and that interest-only payments will be made during the first five years of the loan. Annual debt service on the loan will be \$875,000.

They anticipate that their gross annual revenues will be \$4 million per year, and that their cost of goods sold will be \$1,150,000 per year. They estimate deductible business expenses (including the debt service costs to acquire and renovate an existing warehouse building for production of cannabis products) to be \$1,350,000 per year. They further estimate that the venture's equipment costs in year one (that would normally be eligible for § 179 expense deduction) will total \$900,000.

In Exhibit 2, Jerry and Phil create an LLC in which they put the real estate assets. They deduct the loan to finance the real estate and charge the operating entity a \$1 million annual facility and equipment triple net lease payment, of which 85% is directly attributable to production and therefore falls under COGS. Further, let's assume the operating entity makes a timely S election so that the income passes through to the individual stockholders of the corporation that operates the cannabis business. The \$6,000,000 loan, intended for site acquisition and construction costs, will be assumed by the real estate LLC in order to maximize tax savings.

Using a single-entity approach (Exhibit 1), the tax bill for the cannabis entity was \$826,500, resulting in a negative cash flow of \$226,500. Using a dual-entity approach allows the venture to maximize tax savings, which allows the venture to realize positive cash flow, freeing that cash for investment, distribution, and expansion. Additionally, the real estate holding company, an LLC, is able to harvest a \$246,500 tax loss which can be passed through to the owners to offset profits distributed to them by the cannabis entity, an S corporation.

The \$900,000 of Section 179 expense of the Rental LLC is a result of the ability in the cost segregation study to classify components of the facility as 5- and 7-year personal property and thus these costs are eligible for immediate expensing

under this section of the tax code. Further, note that this amount was paid out of the \$6,000,000 loan used to buy the site and build the facility.

What the courts have said about these types of arrangements

For most businesses, the tax code allows businesses to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.⁴⁴ However, for cannabis businesses, § 280E disallows ordinary and necessary expense deductions, providing that only those expenses related to the cost of goods sold may be deducted.⁴⁵ Generally, federal courts have not looked favorably on attempts by cannabis businesses to deduct non-COGS expenses. As a result, advisory firms have increasingly provided guidance for firms in this industry to perform cost segregation studies and establish a dual entity structure.

It has long been settled that more than one business can operate in the same physical space, and even by the same ownership and management team.⁴⁶ For entities engaged in the production or sale of cannabis products, the degree to which the firms are separated, and the robustness and legitimacy of the income-generating activity of the non-cannabis business, seem to be the decisive factor in how courts view these arrangements.⁴⁷ A series of recent court cases provide context. *Californians Helping to Alleviate Medical Problems "CHAMP"* (taxpayer had two businesses, one that dis-

NOTES

by federal law or the law of any state in which such trade or business is conducted."

⁴⁶ *Alverson v. Commissioner*, 35 B.T.A. 482, 488 (1937). "The statute is not so restricted as to confine deductions to a single business or principal business of the taxpayer. A taxpayer may carry on more than one trade or business at the same time."

⁴⁷ Lisa Sacco, Cong. Research Serv. R44782, "The Evolution of Marijuana as a Controlled Substance and the Federal-State Policy Gap" (2022).

⁴⁸ *Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007).

⁴⁹ *Olive v. Commissioner*, 792 F.3d 1146 (9th Cir. 2015).

⁵⁰ *Alternative Health Care Advocates v. Commissioner*, 151 TC 225, 236-40 (2018).

⁵¹ *Patients Mutual Assistance Collective Corporation d.b.a. Harborside Health Center v. Commissioner*, 151 T.C. 176 (2018).

⁵² *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1199 (10th Cir. 2018), cert. denied, 139 S. Ct. 2745 (2019).

⁵³ New Jersey has the highest corporate income tax rate at 11.5%. See Janelle Fritts, "State Corporate Income Tax Rates and Brackets for 2023," Tax Foundation (2023) <https://taxfoundation.org/publications/state-corporate-income-tax-rates-and-brackets/>

⁵⁴ Ruth Mason, "Federalism and the taxing power," 99 Cal. L. Rev. 975 (2011): 975-1035. See also Eric Zolt, "Deterrence Via Taxation: A Critical Analysis of Tax Penalty Provisions," 37 UCLA L. Rev. 343 (1989).

⁵⁵ J. Comm. on Taxation, JCX-37-08, A Reconsideration of Tax Expenditure Analysis 45 (2008).

⁵⁶ Safe Banking Act of 2021, H.R. 1996/S 910 117th Cong. (2021).

⁵⁷ MORE Act, H.R. 3617, 117th Cong. (2021); Cannabis Administration and Opportunity Act, S 4591, 117th Cong. (2022).

⁵⁸ Marijuana 1-to-3 Act of 2021, H.R. 365, 117th Cong. (2021).

⁵⁹ The Small and Homestead Independent Producers Act of 2022, H.R. 8825, 117th Cong. (2022).

⁶⁰ For an excellent overview of proposed legislation in the 117th Congress, see Joanna Lampe Cong. Research Serv. R45948, "The Controlled Substances Act (CSA): A Legal Overview for the 118th Congress" (2023).

⁶¹ *Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007), at 183, citing *Collins v. Commissioner*, T.C. Memo 1990-57.

⁶² Reg § 1.183-1(d)(1).

⁶³ *Alternative Health Care Advocates v. Commissioner*, 151 T.C. 225, 236-40 (2018).

⁶⁴ *Id.*, at 237.

⁶⁵ *Id.*, at 238-239.

⁶⁶ *Alverson v. Commissioner*, 35 B.T.A. 482, 488 (1937).

⁶⁷ Wayne Hall, Daniel Stjepanovi[cacute], Jonathan Caulkins, Michael Lynskey, Janni Leung, Gabrielle Campbell, & Louisa Degenhardt, "Public health implications of legalising the production and sale of cannabis for medicinal and recreational use," *The Lancet* 394, no. 10208 (2019): 1580-1590.

pensed medical marijuana, and one that provided caregiving services);⁴⁸ *Canna Care* (activity incident to sale of medical marijuana)⁴⁹; *Olive* (non-cannabis services were provided at no cost and therefore not income generating, precluding deduction of those expenses); *Alternative Health Care Advocates* (deductions were disallowed because non-cannabis business was only ancillary to the main operation)⁵⁰; *Harborside* (held that § 280E denies business expense deductions to any trade or business that involves trafficking in controlled substances, even if that trade or business also engages in other activities)⁵¹; *Alpenglow* (IRS has authority to investigate activity and determine if a business regularly bought and sold illegal substances).⁵²

A growing Federal-state schism. Several states have proposed and enacted legislation to allow cannabis-related businesses to deduct their ordinary and necessary business expenses on their state tax returns. This approach to explaining the scope of allowable tax deductions for cannabis-related firms, known as “decoupling” from existing federal law, is quite controversial. On the one hand, a state’s decision to decouple from § 280E can expand the range of possible tax savings for a firm operating within the industry. In a tax environment where state taxes can be as high as 11.5% percent, this can be substantial.⁵³ On the other hand, a federal court may invalidate this strategy as an encroachment of the federal government’s exercise of its powers, perhaps arguing it is a violation of the Commerce or Su-

premacy Clauses. Congress routinely uses the federal tax code as a method of achieving non-budgetary policy goals, such as protecting public health, safety, and welfare. These provisions, sometimes called “tax penalties”⁵⁴ or “negative tax subsidies,”⁵⁵ are designed as a form of indirect federal regulation.

Likelihood of action in the 118th United States Congress. While there have been proposals in the most recent 117th Congress to allow cannabis-related firms to have access to the federal banking system,⁵⁶ remove cannabis from the Controlled Substances Act,⁵⁷ move it to a less restrictive schedule,⁵⁸ or allow interstate shipment of cannabis between states that have legalized its sale,⁵⁹ none of those proposals were enacted prior to the expiration of the 117th Congress.⁶⁰ Given that the House of Representatives has shifted to the right, it is unlikely that the current landscape of federal regulations in this area will change in the short term. As such, a dual entity structure is an attractive option for many entrepreneurs.

Pitfalls and Possible Solutions

If executed poorly, the typical guidance proposed by advisory firms may leave entrepreneurs and firms exposed to significant tax liability. This section presents five common pitfalls identified in the case law and offers some possible solutions to avoid falling into them.

Structure is key. In order for a dual-entity approach to withstand scrutiny from the IRS, care must be taken to es-

tablish two clearly distinct entities. Taxpayers may be involved in more than one trade or business, and “whether the entities are separate is a question of fact that depends on the degree of economic interrelationship between the two undertakings.”⁶¹ The IRS generally accepts a taxpayer’s characterization of two or more undertakings as separate activities unless the characterization is artificial or unreasonable.⁶² An example of how the IRS views these arrangements with skepticism can be found in a 2008 case, *Alternative Health Care Advocates*.⁶³ In that case, an entrepreneur created two businesses, a cannabis retail store and an operations management company. The entrepreneur then attempted to shift expenses to the management company to maximize deductions. The arrangement was deemed to be improper, as the non-cannabis business was only ancillary to the main operation.⁶⁴

Clear firewalls are essential: A dual-entity approach must ensure that there are not interlocking owners, shared office or retail space, or other shared resources between the two entities. In *Alternative Health Care Associates*, the entities operated out of the same retail space, and the entrepreneur attempted to segregate costs between employee activity related to the cannabis business, and employee time and retail floor space related to the non-cannabis operations. This overly narrow read of § 280E was not persuasive.⁶⁵

Sustainability of the non-cannabis entity is required: Another consideration is to ensure that the real estate business is a sustainable venture on its own, so that it can reasonably be distinguished from the cannabis entity. One way to do this is to ensure that the rent received by the real estate operation is reasonable and market rate, and the entity’s income must equal or exceed the real estate entity’s operating expenses.

Contracting with more than one tenant reduces risk: Typically, this type of arrangement is more likely to be successful if the real estate entity has more than one tenant. The case law is clear that more than one business can operate in the same physical space, and even have the same ownership and management team.⁶⁶ If the real estate entity employs a gross lease approach for the tenants, the likelihood of the deductions

NOTES

⁶⁸ William C. Bunting & James M. Lammendola, “Why Localism is Bad for Business: Land Use Regulation of the Cannabis Industry,” 17 N.Y.U. J.L. & Bus. 267 (2021).

⁶⁹ Alice de Koning & John McArdle, “Implementing regulation in an emerging industry: multi-province perspective,” 55 J. of Canadian Studies 2, 362-394 (2021).

⁷⁰ Data Table, Statistics Canada. (2022). Table 36-10-0124-01 Detailed household final consumption expenditure, Canada, quarterly (x 1,000, 000) <https://doi.org/10.25318/3610012401-eng>. See also John F. McArdle & Alice de Koning, “Barriers to scale: The effect of regulations on entrepreneurial strategies in a nascent industry,” Working Paper.

⁷¹ Cannabis Act. SC 2018, C16.

⁷² Deloitte, “An industry makes its mark: The economic and social impact of Canada’s cannabis sector” (2021), [https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consumer-](https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consumer-business/ca-en-consumer-business-cannabis-annual-report-2021-AODA.pdf)

[business/ca-en-consumer-business-cannabis-annual-report-2021-AODA.pdf](https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/consumer-business/ca-en-consumer-business-cannabis-annual-report-2021-AODA.pdf).

⁷³ Adolf Lande, “The Single Convention on Narcotic Drugs,” 776 (1962). See also Kevin J. Fandl “Up in Smoke: International Treaty Obligations and Marijuana Reform in the United States,” 58 Am. Bus. L.J. 1 (2021): 163-220. <https://doi.org/10.1111/ablj.12181>.

⁷⁴ Press Release, United Nations, Office on Drugs and Crime, CND Votes on Recommendations for Cannabis and Cannabis-Related Substances. https://www.unodc.org/documents/commissions/CND/CND_Sessions/CND_63Reconvened/Press_state_ment_CND_2_December.pdf (Dec. 2, 2020).

⁷⁵ Note: We used a hypothetical 8% state income/gross receipts tax rate for this exhibit. 48 States impose either an income tax or a gross receipts tax on corporations, with rates ranging from 2.5% to 11.5%. See Jared Walszak & Janelle Fritts (2023). 2023 STATE BUSINESS TAX CLIMATE INDEX. Tax Foundation. <https://taxfoundation.org/2023-state-business-tax-climate-index/>

being disallowed will be much lower if there are multiple tenants in the space. Discuss gross lease strategy to shift costs to the real estate entity/landlord; rent to more than one entity reduces the possibility that it is considered a sham.

Performing a cost segregation study is a necessary step: A cost segregation study will provide a reasonable basis and justification for whatever tax positions the entities might take. This needs to be done by a disinterested third party (e.g., accounting firm) that can substantiate the segregating of the costs.

Strategy Implications, Public Policy, and an International Perspective

Entrepreneurs considering investment in a new entity have many competing concerns, among them risk, the likelihood of overcoming an investment hurdle rate, opportunities for asset growth, and other strategic dimensions. In the case of cannabis, the regulations that affect tax obligations raise the bar for all of these elements, requiring an entrepreneur to seek out more sophisticated advice and to design more complex legal arrangements than a typical startup farm or retail operation requires. Such entrepreneurs must work closely with professional advisors to ensure they understand their options for structuring the business and their limitations in how they operate to avoid complications due to commingling assets, operations, or ownership.

Typical new entrepreneurial ventures focus the startup strategy on creating and building operations, and issues of real estate do not arise until much later. In the case of cannabis businesses, whether producers or retailers, this focused approach may not be a wise choice. In a startup that includes acquiring real estate, the benefits of reducing tax obligations likely outweigh the costs of financing the property.

Looking further ahead, of course, if there is reform at the federal level with regard to the deductibility of cannabis-related business expenses, then these types of arrangements may become a moot point from a tax perspective. However, they may still be appropriate from

a liability perspective, as segregating the cannabis and non-cannabis elements of the enterprise may reduce the risk of legal exposure, and may additionally allow for nuanced insurance contracts.

Accountants, lawyers, insurance agents, financial planners, and other professionals who advise clients in this industry might benefit from developing a coordinated approach among a team of professionals. Doing so will provide opportunities to better serve the needs of shared clients, and leverage their expertise to acquire additional clients in a rapidly expanding industry.

The current black market for cannabis products in the United States is a significant societal problem that contributes to an overburdened criminal justice system and expands racial and ethnic inequalities. Illegal cannabis is not only a public safety threat from a crime perspective, it is also a public health issue as these products are currently unregulated.⁶⁷ And large amounts of tax revenues are foregone due to tax evasion or underreporting by individuals participating in this industry.⁶⁸

In the Canadian context, keeping profits out of the hands of criminals was a foundational principle for the legalization of recreational cannabis, as was providing a mechanism for quality control with a focus on public health and safety. Recreational cannabis products sold on the legal Canadian market are tracked in a seed-to-sale database, produced by licensed and controlled business entities, sold in government regulated retail shops.⁶⁹ The amount of cannabis sold in legal Canadian markets has overtaken the illegal market.⁷⁰

The United States has yet to adequately address these issues. It is particularly appropriate to do so at the federal level, by establishing regulations and safeguards to reduce illicit activity and harmonize the various regulatory approaches used by individual states. Doing so would reduce administrative costs and burdens on a criminal justice system, while providing opportunities for increased tax revenue.

Reforming the legal status of cannabis products would allow for the achievement of public policy goals such as protecting the health and welfare of the general public and limiting the amount

of money flowing to criminal enterprises. But reform in this area requires smart legislation and regulation that understands and reflects market realities.

While cannabis remains a scheduled narcotic on international treaties, recreational use of cannabis is now legal in some form in seven countries: Canada, Georgia, Malta, Mexico, South Africa, Thailand, and Uruguay. Cannabis is legal at both the federal and provincial level in Canada,⁷¹ accordingly, there are no concerns about entity structure in order to recapture investment costs for capitalizing a cannabis business. Under the Canadian tax code, they are treated like any other business. Canadian tax revenues from cannabis businesses are significant, estimates suggest that the cannabis industry contributed \$15.1 billion CAD in federal/provincial tax revenue between 2018-2021.⁷²

Cannabis was added to Schedule I of the Controlled Substances Act largely as a means of complying with the requirements of the 1961 Single Convention on Narcotic Drugs.⁷³ Yet in December 2020, the UN Commission for Narcotic Drugs voted to remove cannabis and cannabis-derived products from Schedule IV of the Single Convention, largely seen as a move toward moving these substances into a less restrictive class of regulated substances.⁷⁴ While cannabis remains prohibited on Schedule I of the Single Convention, increased pressure by the World Health Organization and several national governments to further declassify it may result in changes to federal legislation in the U.S.

Perhaps the Canadian regulatory model can be imported to the U.S. and adopted in the context of cannabis-related firms. Doing so would recognize the reality of a system where states are rapidly moving to allow firms to operate legitimately in a highly-regulated and monitored industry, which both improves community and public safety concerns and also provides opportunities for capturing tax on their operations. If the purpose of § 280E was to reduce criminal activity and make the world a safer place, perhaps we should recognize the reality that the world is changing and reform our regulatory framework. ●

Reproduced with permission of copyright owner. Further reproduction prohibited
without permission.