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Cannabis Under Federal Law – Separating Businesses Is Key for §280E

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TRAFFICKING A CONTROLLED SUBSTANCE

While many states now permit legal medicinal or adult use commercial cannabis activity, cannabis remains classified as Schedule I controlled substance under the Controlled Substances Act (CSA).

This classification (1) transforms a ''plant-touching'' cannabis business compliant under state law into a criminal enterprise ''trafficking in a controlled substance'' under federal law, (2) treats otherwise compliant business owners and operators as ''drug dealers'' pandering drugs deemed equivalent to cocaine and heroin, and (3) subjects such businesses to §280E.[1]

Section 280E penalizes traffickers of Schedule I or II drugs by disallowing the deduction of ''ordinary and necessary'' business expenses (aka ''below the line deductions''), after reducing gross receipts by cost of goods sold (or ''COGS''), essentially resulting in federal income tax liability calculated based on gross income, not net income.

In this environment, seemingly simple business decisions like choice of entity, accounting methods, and ownership structure are critical for purposes of risk management. If a cannabis business is not structured carefully and thoughtfully from a tax perspective, the effect of §280E's disallowance of deductions can easily result in effective tax rates and tax bills equaling or exceeding the economic profits of the business, often leaving the business operating in the red.

Worse still, for partnerships, §280E exposes upper-tier owners to crushing federal tax liabilities flowing through from their plant touching cannabis partnerships.

Meanwhile, the IRS has issued little guidance on §280E, taxpayer compliance rates are proving low, enforcement of §280E has been slow and inconsistent, and the IRS is said to be at least three years behind in its audit programs, all of which means the IRS is barely getting started auditing cannabis licensees, and we taxpayers have yet to see how extensive and deep those audit trails will reach following ''plant-touching'' dollars.

SECTION 280E

Section 280E provides:

> **No deduction or credit shall be allowed for** any amount paid or incurred during the taxable year in carrying on **any trade or business** if such trade or business (or the activities which comprise such trade or business) **[that] 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. (emphasis added)

Section 280E was enacted in 1982 in response to the 1981 Tax Court decision in *Edmondson v. Com-*

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

missioner,[2] in which the Tax Court concluded that drug dealer Jeffrey Edmondson was permitted to deduct certain below-the-line expenses (such as home office deduction, auto mileage expenses, telephone, etc.) in calculating the income tax liability of his drug dealing business for the 1974 tax year.

In a typical overreaction to the outcome of a logical process, Congress found this allowance of "ordinary and necessary" business deductions to a "business" illegal by law to be outrageous and against public policy, and enacted §280E in 1982 to reverse the *Edmondson* holding by disallowing ordinary and necessary expenses to those trafficking in Schedule I and II drugs.[3]

Unfortunately, the "public policy" principles that triggered the scheduling of cannabis as a controlled substance has not continued to evolve with the public's attitudes and growing acceptance of cannabis for medicinal or adult use.

So what is a cannabis pioneer to do in navigating such treacherous terrain?

The short answer is to proceed with caution, and do not try this at home. The issues and risks at play are highly technical and often counter-intuitive, and require knowledgeable professional guidance.

Ownership and operations should be structured and established with care and deliberation, toward the objectives of optimizing cash flow and tax efficiencies, minimizing the likelihood of future regulatory risks arising, and strengthening chances of surviving scrutiny when they inevitably do.

To that end, this article briefly highlights certain rules, tools, and techniques to keep in mind for cannabis operations, including establishing multiple separate trades or businesses, and an overview of COGS, inventoriable costs, and cost segregation.

MULTIPLE TRADES OR BUSINESSES

Primary and Secondary Trades or Businesses

Cannabis licensees operating more than one license type or licensed location would be wise to conduct each activity and location as a separate trade or business.

Similarly, cannabis businesses disproportionately impacted by §280E might want to seriously consider establishing a separate primary trade or business that is either nonplant touching or a more COGS intensive plant touching business (like a small retail shop in the same building as a cannabis manufacturing or cultivation facility operated by the same licensee).

This approach could reduce the effect of §280E by permitting deductions for certain ordinary and necessary business expenses that might otherwise be disallowed to a trade or business more heavily impacted by §280E.

For example, in the case *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*,[4] (*CHAMP*), *CHAMP* successfully took the position that its primary trade or business was the provision of caregiving services to the terminally ill, and its secondary trade or business was the supply of medical cannabis to its members.

SEPARATE TRADES OR BUSINESSES

Whether an activity is a separate trade or business is a question of fact that depends on the totality of the circumstances and the degree of economic interrelationship between the two undertakings.

To be respected as truly separate and distinct, each trade or business should be operated as a separate business. While considered on a case by case basis, there are certain steps taxpayers can take to improve the likelihood of surviving scrutiny. For example, each business should:

(a) Prepare and maintain separate P&Ls, financial statements, comprehensive books and records, separate employee time clocks and HR records, separate insurance policies or insurance coverage, and if possible, a separately defined premises or allocation of square footage, and clearly defined areas with different signage.

(b) Maintain separate job functions/titles with written job descriptions, and policies treating each business as a separate employer, like clocking in or out of one business before switching to the other, and separate calculations of time worked for break purposes.

(c) Establish a clearly defined and consistently applied methodology for shared expenses (like a "Tenant's Share" of common area maintenance charges in multi-tenant buildings).

Although this analysis is open to interpretation of the facts, below are listed some of the questions that courts have considered in making these determinations:

(1) How does the revenue from each trade or business compare?

[2] T.C. Memo 1981-623.

[3] Tax Equity and Fiscal Responsibility of 1982, Pub. L. No. 97-248, Part II, Subtit. I, §351.

[4] 128 T.C. 173 (2007).

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(2) Are the undertakings conducted at the same place?

(3) Were the undertakings formed as separate activities?

(4) Does one undertaking benefit from the other?

(5) Does the taxpayer use one undertaking to advertise the other?

(6) To what degree do the undertakings share management?

(7) To what degree does the management oversee the assets of both undertakings?

(8) Do the taxpayers use the same accountant for the undertakings?

(9) To what degree do the undertakings share books and records?

And, specifically for cannabis determinations:

(10) What is the primary purpose of each trade or business?

(11) Are the additional services and activities incidental to the provision of cannabis?

(12) Or, is the provision of cannabis ancillary to the primary line of business?

Organizational Structure

Although administratively more burdensome, separate trades and businesses are generally easier to establish and defend if owned and conducted by different entities that abide corporate formalities and transact business at arm's length as though unrelated.

INVENTORY & COGS FOR SCHEDULE I & II DRUGS

For businesses subject to §280E, the calculation and substantiation of COGS are crucial to determine income tax liability.

In CCA 201504011, the IRS indicated a taxpayer ''trafficking in Schedule I or Schedule II drugs'' determines COGS by using the applicable inventory-costing regulations under §471 as they existed when §280E was enacted in 1982.

At that time, ''inventoriable cost'' meant a cost capitalized to inventories under §471 (as those regulations existed before the enactment of §263A). In other words, the ''full-absorption'' method of computing COGS under the pre-1987 §471 rules, which takes into account both direct and indirect production costs.

In other words, the taxpayer will capitalize inventoriable costs when incurred, and will remove these costs from inventory when units of merchandise are sold.

The specific regulations are Reg. §1.471-3(b) for ''resellers'' of property, and Reg. §1.471-3(c) and Reg. §1.471-11 for ''producers'' of property, as explained below.

''Inventoriable Costs'' for Retailers

For resellers of cannabis like dispensaries, inventoriable costs can be taken into account in COGS only to the extent they are strictly related to the acquisition of cannabis and cannabis products for resale, and the storage and handling of inventory for sale. The disallowance of below the line deductions and the limited availability of costs includible in COGS means that retailers are among the hardest hit by the effects of §280E.

For a reseller of cannabis, inventoriable costs generally are limited to (a) the invoice price of the cannabis or cannabis product, *less* (b) any trade or other discounts, *plus* (c) acquisition costs (including the cost of travel to purchase cannabis, transportation and shipping costs of the cannabis, and other necessary charges required to take possession of the inventory).

Other costs like electricity for designated inventory areas may be includible in COGS, but the cost of electricity used in sales areas is not eligible to be deducted as COGS. To that end, a best practice recommendation is to create a designated inventory space with clearly defined square footage that is closed off from the sales floor and other areas of cannabis business retail premises, and if possible, with separately metered utilities.

''Inventoriable Costs'' for Producers – Costs of Production

The term ''producer'' should be interpreted to include cultivation, manufacturing, assembly, and similar processes where the resulting final inventory product for sale is different from the raw material used to make it as a result of the taxpayer's trade or business.

For a ''producer'' of cannabis, inventoriable costs generally include (a) direct production costs (e.g., the cost of materials used directly in production such as plants or seeds), *plus* (b) direct labor costs (e.g., the labor costs associated with planting, harvesting, cultivating, growing, trimming, packaging for pick-up, etc.), *plus* (c) what are known as ''Category 1'' indirect production costs, and if GAAP financial statements are prepared, potentially ''Category 3'' indirect production costs.

Direct Costs

''Direct production costs'' are costs which are incident and necessary for production or manufacturing

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operations or processes, and are components of the cost of either direct material or direct labor.5

''Direct material costs'' include (1) the cost of raw materials and components used directly in the production process and become an integral part of the specific product, and (2) those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product.

''Direct labor costs'' include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

''Category 1'' Indirect Costs

Below are listed Category 1 indirect production costs that must be taken into account when determining inventoriable costs, but only to the extent the costs are incident and necessary to the production or manufacturing processes:[6]

(1) Rent;

(2) Repair expenses;

(3) Maintenance;

(4) Utilities, such as heat, power and light;

(5) Indirect materials and supplies;

(6) Tools and equipment not capitalized;

(7) Costs of quality control and inspection; and

(8) Indirect labor and production, supervisory wages (basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential costs, payroll taxes, contributions to a supplemental unemployment plans, etc.), and presumably certain costs of regulatory compliance required by law, like security, the track and trace program, etc.

''Category 3'' Indirect Costs and GAAP Financial Statements

The preparation and use of GAAP financial statements makes available the inclusion of certain Category 3 indirect production costs in calculating COGS.

Below are listed examples of Category 3 indirect production costs that can be taken into account when determining inventoriable costs, but only to the extent the costs are incident and necessary to the production or manufacturing processes:[7]

(1) Depreciation and cost depletion;

(2) Costs pertaining to strikes, rework labor, scrap, and spoilage;

(3) Administrative expenses related to production;

(4) Officer salaries related to production;

(5) Insurance costs related to production (e.g., insurance on machinery and equipment);

(6) Taxes deductible under §164 (other than income taxes such as state and local excise taxes and cultivation taxes paid or accrued in connection with the disposition of property or in an income producing activity); and

(7) Pension and profit-sharing contributions representing current service costs otherwise allowable as a deduction under §404, and other employee benefits incurred on behalf of labor incident to and necessary for production.

Costs Not Included in Inventoriable Costs

Below are listed costs which are not includible in the computation of inventoriable costs for tax purposes:

(1) Marketing expenses;

(2) Advertising expenses;

(3) Selling expenses;

(4) Other distribution expenses;

(5) Interest;

(6) Research and experimental expenses (includes product development expenses);

(7) Losses under §165;

(8) Percentage depletion in excess of cost depletion;

(9) Depreciation and amortization reported for federal income tax purposes in excess of depreciation reported by the taxpayer in financial reports;

(10) Income taxes attributable to income received on the sale of inventory;

(11) Pension contributions to the extent that they represent past services cost;

(12) General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes; and

5 *See* Reg. §1.471-11(b)(2)(i).

[6] *See* Reg. §1.471-11(c)(2)(i).

[7] *See* Reg. §1.471-11(c)(2)(iii).

ISSN 8755-0628

(13) Salaries paid to officers attributable to the performance of services for the benefit of the business as a whole rather than to production or manufacturing operations or processes.

ACCOUNTING METHODS FOR CAPITALIZATION AND DEDUCTION OF COSTS

The capitalization and deduction of costs and expenses for purposes of COGS are governed by §471 and the uniform capitalization rules under §263A (aka ''UNICAP''), which require taxpayers to capitalize direct and indirect costs allocable to the taxpayer's property produced or acquired for resale. For purposes of the uniform capitalization rules, to ''produce'' means to construct, build, install, manufacture, develop, improve, create, raise or grow.[8]

In November 2018, the IRS issued Rev. Proc. 2018-56 and final regulations under the uniform capitalization rules of §263A[9], which redefine how certain types of costs are categorized (like changing the treatment of negative adjustments for certain costs), introducing a new simplified method of allocating inventoriable costs, and expand qualification for the simplified methods of cost accounting as a ''small business taxpayer'' (average annual gross receipt for prior three (3) years does not exceed $25 million per year (adjusted for inflation)).

The UNICAP rules permit different methodologies based on facts and circumstances to allocate capitalizable §263A costs, like the standard cost method, specific identification method, burden rate, or another reasonable allocation method; and offer alternative simplified methods to determine and allocate costs between ending inventory and COGS, adding in 2018 the then newly introduced ''modified simple production method'' to the existing simplified production method and simplified resale method. Section 263A also requires that computations be made on a tax basis, so book-to-tax differences must also be taken into account and the rules changed in the 2018 final regs.

While changes in the 2018 final regs most directly impacted manufacturers and producers, all taxpayers dealing with inventoriable costs should review their current inventory cost accounting and UNICAP methodologies for compliance purposes. There may be opportunities to improve tax efficiencies, but there could also be methodologies that are no longer be permissible under current guidance, or that may require a change in accounting method to comply with current law.

[8] §263A(g)(1); Reg. §1.263A-2(a)(1)(i).

[9] T.D. 9843, RIN 1545-BG07, 83 Fed. Reg. 58,476 (Nov. 20, 2018) (2018 final regs).

COST SEGREGATION AND ACCELERATED OR BONUS DEPRECIATION

One popular but somewhat controversial tool that could be used to improve cash flow for cannabis businesses is cost segregation.

Cost segregation ''allocates'' or ''segregates'' the component parts of assets by type or class based on useful life (depreciation recovery periods) and placed-in-service dates to more precisely compute depreciation, typically documented in a cost segregation study. The underlying incentive for cost segregation is the significant tax benefits derived from utilizing shorter recovery periods and accelerated depreciation methods for computing depreciation deductions (including bonus depreciation and §179 deduction).

Real property, also known as ''§1250 property,'' is generally eligible for straight-line depreciation over a recovery period of 39 years for non-residential property, and 27.5 years for residential property.

Building systems, equipment, furniture, and fixtures are tangible personal property referred to as ''§1245 property,'' having a shorter depreciation recovery period, and is also eligible for accelerated depreciation (i.e., double declining balance, bonus depreciation and §179 deduction).

The actual cost of each individual component should be used when available. Otherwise, if only lump sums are available, cost estimating techniques are employed to allocate costs to the individual components of property (e.g., land, land improvements, buildings, equipment, furniture and fixtures, etc.).

Cost segregation studies can be used for buildings already in service, or recently purchased, constructed, improved, or remodeled, and certain buildings recently sold (if the taxpayer is eligible to file an amended return for the year of sale).

For buildings already in service, depreciation deductions for prior years can be recomputed, and a one time catch up provision known as a §481(a) adjustment allows a current-period deduction for the difference between depreciation deducted to date and that which could have been deducted using cost segregation, instead of having to amend prior year returns.[10]

Note however, the IRS has taken the position that a change in recovery period is a change in accounting method, and requires the taxpayer complete and timely file Form 3115, *Application for Change in Accounting Method,* which itself requires careful assessment given the potential effect on accounting methods of other changes in law, like the 2018 UNICAP final regs.

[10] *See* Rev. Proc. 2002-9.

ISSN 8755-0628

For more information, see the IRS's *Cost Segregation Audit Technique Guide*.

CONCLUSION

The discrepancy between federal and state law creates significant challenges, risks, and potential pitfalls for cannabis businesses to plan around and guard against, even when operating in compliance with state law. Chief among these risks is future contingent federal tax liability upon reassessment of §280E adjustments in prior year tax returns on audit, which cannabis businesses are generally advised to expect at every level of government.

Cannabis businesses would be wise to routinely assess their §280E compliance, and promptly amend prior year tax returns to reflect reporting changes.

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