

Farm Bill Gives Cannabis Companies Room To Grow

By Elaine Carey and Alexander Arnote (February 5, 2019, 3:13 PM EST)

Producers of hemp — cannabis with less than 0.3 percent tetrahydrocannabinol, or THC[1] — received some good news on Dec. 20, 2018, when the Agriculture Improvement Act of 2018,[2] commonly known as the Farm Bill, was signed into law, allowing legal hemp cultivation in America.[3] Provided the crop is produced consistently with the Farm Bill’s provisions, it is removed from regulation under the Controlled Substances Act, or CSA. The market for hemp and hemp-derived products containing cannabidiol, or CBD, is expected to hit \$22 billion by 2022, according to a report by Brightfield Group.



Elaine Carey

After the 2018 midterm elections, recreational marijuana is now legal in 10 states and Washington D.C.,[4] and medical marijuana is legal in 33 states,[5] Washington, D.C., Guam and Puerto Rico. Yet, cannabis with levels of THC, the psychoactive component of the plant, above the 0.3 percent threshold is still classified as a Schedule I substance and subject to federal drug agency enforcement. This situation has resulted in a Kafkaesque maze of conflicting state and federal regulations, especially around taxes.



Alexander Arnote

Financial and Tax Benefits for Hemp Growers

The U.S. legal marijuana market size[6] was estimated at \$8.5 billion in 2017 and is expected to grow to \$23.4 billion by 2022. However, the Internal Revenue Service treats state-legal cannabis companies as no different than illegal drug traffickers. Internal Revenue Code Section 280E, which was enacted to prevent criminals from deducting expenses related to illegal drug trafficking, bars state-legal cannabis companies from nearly all tax credits and deductions that most businesses enjoy.[7]

Prior to the Farm Bill’s passage, financial institutions had been reluctant to establish relationships with hemp-related businesses. The crop was in the CSA’s definition of “marijuana” and the Feb. 14, 2014, guidance from the U.S. Department of the Treasury Financial Crimes Enforcement Network,[8] making heavily regulated banks skittish about delving into this line of business. However, after hemp deregulation, they may now turn a new leaf and embrace the industry. And cannabis companies need to understand the implications and potential of diversifying into hemp production.

Perhaps the biggest tax-related impact the Farm Bill has on hemp businesses is that producers are no longer subject to Section 280E, which has two major implications for cannabis businesses:

- Taxable income of a cannabis-industry business is calculated by deducting only cost of goods sold — the direct cost of materials and labor — from the company's gross income. The businesses cannot deduct many common operating expenses like payroll, rent, electricity, advertising, etc., which account for a substantial portion of the costs of running a business. Cannabis businesses are not even allowed to deduct the expenses that are required for them to remain compliant.
- Cannabis business profits are taxed at a rate of 70 percent or higher versus the corporate tax of 21 percent. In the context of Section 280E, cannabis businesses face many hurdles. At times, the federal tax burden of a cannabis business may exceed profits, leaving the business running at a loss or, in the worst case, insolvent.[9]

The 2018 Farm Bill sets up a process to repeal Section 7606 of the 2014 Farm Bill that had previously restricted the cultivation of hemp to state departments of agriculture or institutions of higher learning, opening the door for commercial farmers to grow hemp and exempting it from the application of Section 280E. However, the process gives the secretary of the U.S. Department of Agriculture a year to submit an industrial hemp report to Congress. Once the secretary establishes an agricultural plan for hemp, it will be another 12 months before Section 7606 restrictions are lifted.[10]

Once commercial hemp farming begins, if the business complies with the Farm Bill's definition of hemp, the hemp business may deduct costs under Section 471 and related regulations. These include:

- Direct material costs,
- Direct labor costs,
- Utilities,
- Maintenance,
- Rent (real estate and equipment) and
- Quality control.

The following indirect costs may be included in the cost of goods sold, depending upon the treatment for financial statement purposes:

- Taxes necessary for production,
- Depreciation,
- Employee benefits,
- Factory costs, and
- Administrative insurance.

Hemp farms using the cash accounting method can now expand rapidly and virtually income tax-free by reinvesting earnings into the deductible expenses. That is, of course, until its average gross receipts exceed \$25 million per year.

Inventory Tracking Not Needed

Farms with less than \$25 million in gross annual receipts over the past three years also no longer need to track inventory under the Farm Bill. If a farm has not sold the year's harvest prior to year end, it still can deduct all its production costs. Previously, growing a controlled substance is deemed manufacturing and requires surplus inventory to be added to taxable income.

Bonus Depreciation and Section 179

Eligible new equipment purchases enjoy immediate 100 percent bonus depreciation until Jan. 1, 2024. The Farm Bill extends that deduction to certain used property as well.

In addition to bonus depreciation, Section 179 provides for the full immediate equipment purchase deduction and has generous dollar limits up to \$1 million. Section 179 is available for single-purpose horticultural structures and can be immediately deducted in 2018 (with several limitations and thresholds).

Banking and Borrowing Access Increased

Most businesses take the ability to bank for granted. Without the ability to bank, businesses are at risk of theft and record keeping can be very cumbersome. Hemp farms with a solid business plan and history of earnings should theoretically now have access to borrowing. This can allow a business to expand with little capital and can greatly increase the return on investment, if done effectively.

As the act goes into effect and federal regulators weigh in on it, banks will need to consider whether they are willing to lend against the legal hemp crop as they would against any other agricultural product. In addition, they must examine how they can ensure that the crop against which they are lending has a legally acceptable THC level.

Harborside Tax Decision Affirms IRS' Strict Interpretation of Section 280E

The successful passage of the Farm Bill notwithstanding, a recent tax case made it clear that the IRS won't change its stance on cannabis in the foreseeable future. In December 2018, a landmark U.S. Tax Court ruling (*Patients Mutual Assistance Collective Corporation d.b.a. Harborside Health Center v. Commissioner Of Internal Revenue Service*),^[11] reaffirmed the strict interpretation of Section 280E as it applies to cannabis companies, despite growing state-level legalization.^[12] California-based medical marijuana dispensary Harborside Health Center was required to repay business deductions taken between 2007 and 2012, although a separate ruling weeks later by the court found Harborside not liable for millions of dollars of accuracy-related penalties.^[13]

The court cited Harborside's timely filing of its tax returns and "keeping good books and records" as a key strength of its argument. The court's opinion stated that Harborside acted "with reasonable cause and in good faith" in its efforts to comply with the law. In the past, the court has "declined to impose accuracy-related penalties when there was no clear authority to guide taxpayers" and it would do so again in Harborside's case.

The Harborside case highlights the need for cannabis companies to design, create and maintain immaculate financial and operational processes to avoid regulatory penalties, which is not an easy proposition in an industry without access to traditional banking services and where tax laws are still evolving.

For example, some cannabis companies legally circumvent Section 280E by structuring their business into two limited liability companies. The first business directly produces and distributes Schedule I cannabis and files a tax return without deductions. The second business engages in activities that are legal under federal law, such as selling ancillary items; e.g., t-shirts, or owning and managing the building where the first business operates. The second business files a tax return claiming all ordinary deductions.

Using this approach, two separate businesses can claim more deductions and pay less tax than a single business that would be entirely subject to Section 280E. Knowing which expenses are deductible and having accurate financial records is critical to the successful implementation of this type of tax strategy.

Unanswered Questions and Potential Challenges for CBD Producers

While many have perceived the new Farm Bill as the legalization of industrial hemp and CBD, there are several unanswered questions and potential road blocks that the CBD industry will need to work through in the coming months.

- Ambiguity around “any part” — The definition of industrial hemp mentioned that no part of the plant can exceed 0.3 percent THC. While this is of low concern for traditional fiber and seed varieties, “selective sampling” of CBD varietal parts could exceed that threshold.
- U. S. Food and Drug Administration — The FDA has issued guidance that including CBD in food or supplemental products is a violation of FDA rules and potentially illegal. This may or may not apply to topical applications.
- U.S. Drug Enforcement Agency — Cannabinoids that have not been approved by the FDA are still considered Schedule I illegal drugs and this includes CBDs. This means CBD that is extracted from cannabis grown outside the specific provisions of the Farm Bill is still federally illegal.

Legal Hemp Takes a First Step into a Larger World

The Farm Bill gives newly legal hemp companies, whether owned by cannabis companies or not, unprecedented access to capital markets and banking services, including federal crop insurance, e-commerce sites and advertising platforms. With increased investment, research, cultivation and sales come additional regulations from agencies such as the FDA, which didn’t regulate hemp when it was an illegal substance, but now may increase their involvement with CBD.

Cannabis companies employing the separate LLC strategy may see low-THC hemp as an opportunity to grow the legal side of their businesses to capture more tax benefits. However, given that large players like Vertical Cos. and Charlotte’s Web Holdings Inc. already have plans to spin off their hemp assets and seek funding^[14] in early 2019 that could produce as much as \$1 billion worth of CBD, companies should carefully analyze the market before deciding to enter. The influx of large-scale hemp production will suppress crop prices, and new market entrants would have to deal with an onslaught of rapidly changing state and federal hemp regulations.

Conclusion

What the Farm Bill means for cannabis companies is that states and Native American tribes now have the authority to regulate hemp. As states begin to regulate hemp production and more states adopt sensible marijuana legislation, there may be more pressure on the IRS to address the federal tax burden on state-legal medical and recreational cannabis companies. In the meantime, cannabis companies must stay abreast of new regulations and maintain the highest level of financial control within the gray area between state and federal legality.

Elaine Carey is a managing director and Alexander Arnote is a senior director at FTI Consulting Inc.

The opinions expressed are those of the author and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general informational purposes and is not intended to be and should not be taken as legal advice.

[1] 7 U.S.C. Sec. 5940.

[2] Agriculture Improvement Act of 2018, Pub.L. 115-334 (Dec. 20, 2018).

[3] Id. § 7605(a); 10113.

[4] <http://www.ncsl.org/research/civil-and-criminal-justice/marijuana-overview.aspx>

[5] <http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx>

[6] <https://www.forbes.com/sites/thomaspellechia/2018/06/26/in-2017-beyond-u-s-enjoys-the-highest-legal-cannabis-market-share-worldwide/#7751b6ba2d20>.

[7] I.R.C. Section 280E.

[8] <https://www.fincen.gov/news/news-releases/fincen-issues-guidance-financial-institutions-marijuana-businesses>.

[9] Duncan MacEwan et al.; “Economic Impact Analysis of CalCannabis Cultivation Licensing Program Regulations”; 34 (Dec. 5, 2017).

[10] Id. § 7605(b).

[11] Patients Mutual Assistance Collective Corporation d.b.a. Harborside Health Center v. Commissioner Of Internal Revenue Service

[12] Patients Mutual Assistance Collective Corporation v. Commissioner of Internal Revenue, 151 T.C. No. 11.

[13] Patients Mutual Assistance Collective Corporation v. Commissioner of Internal Revenue, T.C. Memo. 2018-208.

[14] <https://www.bloomberg.com/news/articles/2018-12-11/hemp-companies-poised-to-list-in-u-s-as-farm-bill-goes-to-vote>