

Podcast: Tax and Banking Implications of Rescheduling Marijuana

September 28, 2023

In late August, the U.S. Department of Health and Human Services announced that it would recommend moving marijuana from Schedule I to Schedule III of the Controlled Substances Act. In this episode, corporate cannabis attorney Daniel Shortt moderates a discussion with tax attorney Douglas Charnas and financial services regulatory attorney Aaron Kouhought about what impacts rescheduling marijuana could have – or not – on state-legal, medical, and adult-use marijuana programs, especially when it comes to taxes and banking.

Daniel Shortt: Hello, my name is Daniel Shortt, and I'm an Associate out of the Seattle office with a focus on corporate work specifically in the cannabis industry. Today I'll be joined by Douglas Charnas, a Member from our Washington, DC office with more than three decades of experience in tax law, including several years as an attorney at the Internal Revenue Service, including a role as Acting Assistant to the Chief Counsel. I'm also joined by Aaron Kouhought, a Member and Chief Privacy Officer out of our Cleveland office, focused on consumer financial service compliance with over 15 years' experience as in-house and outside counsel to banks, FinTechs, and various financial institutions.

Major news broke on August 30th, 2023 when the U.S. Department of Health and Human Services (HHS) announced that it would recommend moving marijuana from Schedule I to Schedule III of the Controlled Substances Act. This was in response to a directive from Joe Biden in October, 2022, instructing HHS and the US Attorney General to reevaluate marijuana status as a Schedule 1 substance.

Schedule I substances are seen to have no medical use and a high potential for abuse. In addition to marijuana, substances like heroin and methamphetamine are placed in Schedule I. Schedule III is a less restrictive schedule, and it includes things like steroids, Tylenol with codeine and Ketamine. If marijuana is moved to Schedule III, then there will be the ability to develop marijuana-based pharmaceutical drugs and patients will be able to access marijuana drugs with a prescription. This has caused major shockwaves through the marijuana industry. It is a massive move in the history of U.S. Drug policy and it will have many, many various impacts on the industry.

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One major breakthrough is how this will impact how marijuana businesses are taxed. And with that, I'd like to turn this over to Douglas Charnas to discuss what's going to happen if in fact marijuana is rescheduled to Schedule III. How's that going to impact the tax framework, Doug?

Douglas Charnas: The tax implications are going to be significant and they'll be beneficial to the marijuana industry. Section 280E is the 800-pound gorilla for marijuana businesses. It provides that no deduction or credit is allowable for any amount paid or incurred in carrying on any trade or business, if the trade or business consists of trafficking in controlled substances within the meaning of Schedule I and Schedule II of the Controlled Substances Act, which is prohibited by federal law or the law of any state in which such trade or businesses conducted. And as Daniel said, marijuana is a Schedule I controlled substance. Congress enacted Section 280E because case law held that a drug trafficker could deduct his ordinary and necessary business expenses incurred in connection with his illegal business. Congress didn't like that. Deductions from gross income are a matter of legislative grace. What that means is you can reduce gross income only by deductions that Congress permits.

There is no constitutional right to deductions, but deductions are different from the cost of goods sold. Although there is no constitutional right to deductions, the 16th Amendment only allows Congress to tax income without apportionment among the states. So the question is, what is income for purposes of the 16th Amendment? Gross receipts from a business activity is not income for purposes of the 16th Amendment. To arrive at income, gross receipts must be reduced by costs directly incurred to produce the gross income or the gross receipts, rather. These costs are referred to as costs of goods sold. Cost of goods sold is not a deduction within the meaning of the Internal Revenue Code, but it is a subtraction from gross receipts in determining a taxpayer's gross income. When Congress enacted Section 280E, it noted in committee reports that Section 280E does not disallow gross receipts to be reduced by the cost of goods sold. To do so might create a constitutional issue.

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When a marijuana business incurs a cost, the question is whether the cost is a deduction or a cost of goods sold. If it is a deduction, Section 280E disallows the deduction. If the cost is a cost of goods sold, that cost can be subtracted from gross receipts. This creates an incentive to treat costs as cost of goods sold rather than a deduction. And this raises contention between marijuana businesses and the Internal Revenue Service. Section

280E affects retail marijuana stores more than marijuana producers. For a retailer, the cost of goods sold includes the cost of the inventory plus transportation costs and other costs incurred in acquiring the inventory. Deductions for items such as rent, payroll, insurance, premium utilities, business mileage and equipment maintenance and repair are disallowed. This disallowance of deductions substantially increases the tax burden for these businesses.

Removing marijuana from Schedule I would eliminate the burden imposed by Section 280E at the federal level and state level for those states where marijuana is legal. This assumes it's moved to Schedule III and not Schedule II. Section 280E would continue to apply at the federal level for states where marijuana remains illegal. For those states where marijuana medical is permitted, but recreational medical is illegal, you would expect that Section 280E would not disallow deductions for medical marijuana. But this needs to be clarified, if, or course, marijuana is rescheduled.

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Marijuana businesses should consider filing amended tax returns for any tax return that has not been closed by the statute of limitations. And they would do this to claim deductions that are disallowed by 280E. I say this because we do not know what the effective date will be for removing marijuana from Schedule I, and of course, presumably not moved to Schedule II. If the effective date is retroactive, filing amended tax returns will keep the statute of limitations from closing on the taxable year, and this will give taxpayers an opportunity to reclaim those deductions by filing amended returns.

Daniel Shortt: Thanks, Douglas, for breaking that down. It does seem like out of all the impacts that rescheduling could have, it, it's going to be most felt in this tax context because the high effective tax rate that has hit many of these state-legal marijuana business businesses has made it very difficult to operate. It's been one of the largest issues whenever I go to conferences and I'm talking with folks in the industry, the conversation always turns to taxes and 280E. So I really appreciate you breaking down how this would impact. But I want to note something here. The reason why rescheduling would have such a profound impact on taxes is because the text of 280E actually focuses on Schedule I and Schedule II substances. So this is a direct impact that rescheduling would have on the letter of the law. The reason why rescheduling would have such a profound impact on taxes is because the text of 280E actually focuses on Schedule I and Schedule II substances. So this is a direct impact that rescheduling would have on the letter of the law.

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Now, I want to turn the discussion over to Aaron, but before I do that, I want to contextualize this, that the many laws that are impacted by the difference between state law and federal law with regards to how marijuana is treated. That is to say that it's not as if rescheduling cannabis is going to get rid of all the issues that the industry has faced.

And with that in mind, Aaron, if marijuana is rescheduled from Schedule I to Schedule III, how is that going to impact the industry's ability to obtain financial services, which sometimes can be as simple as trying to find an actual bank to open up a business bank account?

Aaron Kouhoup: Yeah, no, I think it's a good question, and the answer is that the jury's probably still out. You and I had a fascinating conversation the other day that I think would be worth redoing for everybody because it's a lot of information I don't think people know about. I had asked you, in typical lawyer fashion, answering questions with a question: if Schedule III are the types of drugs I can obtain legally with a prescription, I can bank that, right? I mean, I can bank prescription medication, it's legal, I have a prescription for it. It's scheduled within that world. And so I asked very naively, well, if we're in a medical marijuana state and I have a prescription, then am I in that same world as normal prescription drugs? And your answer, from a legality of cannabis and how the prescription in a medical marijuana state works, surprised me. Do you want to go through what that means if you're in a medical state?

Daniel Shortt: Yeah. So first of all, it's really important to note that medical marijuana at the state level is not prescribed. Prescriptions are governed by federal law, including controlled Substance Act and regulated by the DEA and the FDA. If you're in a state with legal medical marijuana, you still need to go to the doctor or healthcare provider and obtain a recommendation. So from a consumer perspective, it may seem very similar to obtaining a prescription, but it's not. It's a recommendation that's governed by state law. You then take whatever authorization is provided, whether that's a card or some kind of note, these vary from state to state. And then you go to a dispensary and you obtain your medical marijuana. This is different than any other drug.

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Let's use another example, right? If you're going to a doctor and you get a prescription for Tylenol with codeine, it's not as if you go to the Tylenol with codeine dispensary. You go to the pharmacy and you get your Tylenol codeine just like you would any other prescription drug, right? That's really what the difference is here, is that

that Tylenol with codeine, it is not manufactured and formulated pursuant to a tightly regulated state-specific program. It comes out of the tightly regulated federal program overseen by the FDA and the DEA, right? And other various federal agencies involved in the Controlled Substances Act and the healthcare industry, right? So that's a very, very different framework. And even though marijuana will now move to Schedule III pending DEA approval, that is not going to convert these medical marijuana operators to more traditional FDA, DEA approved drug manufacturers.

Now, to go back to the question about banking, right? If you have a pharmaceutical drug company that's now researching and developing marijuana-based drugs, then that is legal, that has been legalized, but the rescheduling would not legalize these state-level programs. We talked about medical marijuana, but the same is also true for recreational. If you live in a state with adult use or recreational cannabis, it's not as if you need to go to a pharmacy to obtain cannabis. You go to a licensed retail store or dispensary. So there's still going to be the issue with federal law.

If you have a pharmaceutical drug company that's now researching and developing marijuana-based drugs, then that is legal, that has been legalized, but the rescheduling would not legalize these state-level programs. We talked about medical marijuana, but the same is also true for recreational.

And kind of turning it back to you, Aaron, with your expertise and your knowledge in the financial services industry, I think you said earlier the jury is still out. What kind of considerations, what kind of things would we look at? I mean, this is the move from Schedule I to Schedule III is going to reduce risks, I think in a lot of ways, because it's a less restrictive substance. But given the fact that these state-legal marijuana businesses are not operating in full compliance with federal law, are still essentially legal operators, do you think that that's going to move the needle at all in terms of the financial services available?

Aaron Kouhoup: Honestly, no. And that's where my question to you the other day and why I thought that explanation you just gave is really valuable for anybody who wants to get into this from a banking perspective. If you broke it out between medical and recreational, just hypothetically. And if rescheduling to a Schedule III did what you said it doesn't do, right? If it made it like a normal prescription type drug where I go out and I get it like I would Tylenol with codeine, then I think there could be a significant impact for at least medical usage, right? Because now you're treating it from banking perspective like you would a prescription medication. And I think that, as I said earlier, there really is not that same overarching restriction of, I can't bank something that is federally illegal as a general rule, right?

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I mean, obviously if I'm a federal bank or if I'm a state bank that's subject to FDIC insurance, there's this tension that's always been out there. We've talked about it on other podcasts before where the government has kind of said, look, it's not legal. FinCEN has said, file SARS, follow BSA, follow seven principles, and we're going to allow it. But they've never really said it was okay, right? They've just said, we're making a policy decision to not enforce. And other federal agencies like NACHA have done the same thing. If you do it following FinCEN guidance, then okay, we're not saying it's legal. We're just saying that we're not going to enforce against you if you were to use the ACH network or if you were to bank it.

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A reclassification, if it did what I thought it did, and you set me straight, I think, would've impacted that medical classification. On the recreational perspective, I think it becomes exactly the same. Right? The risk really doesn't shift from a legal perspective. Now, where I think it does have a big impact is perhaps around reputational risk, around some of the soft risks that make a bank say, I do, I am comfortable in my risk decision. I'm following the rules, FinCEN, and my federal regulators understand it. I've told them that I'm doing it, and I've taken the risk to engage. I think that, when I was at banks, I used to say all the time when this came up. I was in Maine, it was one of the earlier states with medical, when I was talking to bankers, internally or out at state conferences, part of the perception problem is that when you classify cannabis in the same realm as heroin and other Schedule I drugs, it's going to impact the way in which the bank's reputational risk might lie.

Now, you're talking about what a consumer feels like is a normal prescription medication, to your point earlier, right? It might not be from a legal perspective, but it feels that way. So the perception, I think the risk perception kind of changes there, even though the legal reality remains the same, which is that I am running the risk that it's still not been legalized, regardless of the schedule that it is in. It's still illegal. And you still have that problem that unless it becomes legal on the federal level, or something like the SAFE Act passes, where you're able to allow the banks to bank state-legal, if one of those two things don't happen, you still have the tension where you have an illegal substance regardless of classification, and a state-legal regime.

And I do think that the reclassification can affect that risk tolerance, even though it doesn't really change anything from a pure legal perspective. The tension is just that you have a state-legal substance and a federally illegal concept.

Banks have been struggling with that since the inception of all of this, and it comes down to risk tolerance. And I do think that the reclassification can affect that risk tolerance, even though it doesn't really change anything from a purely legal perspective. The tension is just that you have a state-legal substance and a federally illegal concept. Unless you are a non-interstate bank that is operating just as an in-state bank in a state-legal aspect, you are governed by the federal prohibition. You are violating federal law. The tension is just that it's an illegal substance on the federal level, and I can't bank it, except for if I want to rely on an agency's promise that they won't enforce what is existing law, right? It's a promise to not enforce, not a green light to do something. So a new agency head could reverse it in six minutes, right? No, we ARE going to enforce it. And now you have a framework, you have a banking system, you have a program that you're making a lot of money off of, you have a lot of resources dug into, and you're shutting it down. Because all they're saying is, we're not going to enforce the law in the book, they never changed the law. They never, never said, you're allowed to bank it. They just said, we're not going to enforce existing law.

That tension is what needs to be resolved, right? And so that reputational risk, that soft risk, I think was higher. The reclassification may impact what you're willing to take on for risk, because it is more like that prescription drug. It's an acknowledgement by the federal government that this is a different universe of drug than when it was up in [Schedule I]. So, you know, I think it certainly would factor into your risk tolerance, and factor into your considerations, even though from a purely legal perspective, to your point, whether it's recreational or not. It's still illegal on the federal level, and you still have that overarching tension of not being able to engage in banking activities that are illegal on the federal side. So we still need to solve that tension either through legislative action or, you know, something needs to happen to solve that tension. But I do think that it's a consideration in thinking about it from the risk perspective, because it has, for lack of a better word, softened the perception, if it's been reclassified down.

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Daniel Shortt: I think that's a really important point as well when we talk about the perception, right? Because let's say that we were having this conversation not based on rescheduling, right? If it hadn't occurred, and this was more just a general discussion about the developments in the relationship between marijuana businesses and financial services. I think if you look at that over time, marijuana businesses have increased their access to financial services. And that's not because there's been a scheduling change. It's, I think, because there's been a cultural shift, right? We don't think about marijuana the same way that we used to think about it. Many, many, many states have legalized in some form or another, and that perception is key with a lot of these third party vendors and service providers. That includes lawyers, accountants, bankers, a whole host of different professionals.

So to the extent that this is a beacon showing that we're getting closer and closer to some form of real federal

legalization, or at least we're getting further and further away from risk of criminal prosecution, even though it still exists, I think that it's really relevant to look at that perception as well. Because, you know, we're lawyers, we focus on the letter of the law, but we also have to take into account that a lot of this really is perception based. And if individuals making decisions at banks or other financial service providers, if they're viewing this industry as less risky, then that could potentially increase the services available to marijuana businesses. Even if it doesn't make the full change in law that, you know, we as lawyers would like to see before we advise clients as to entering into this space.

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I want to wrap up with a couple of points here. One, this is not a done deal. I really want to reiterate the fact that this process is not just based on the HHS recommendation. The Controlled Substance Act governs how different substances are scheduled, how they move schedules, how they're removed from the Controlled Substances Act altogether. And that does require approval from the Department of Justice by way of the DEA. And if you look at the DEA's history, it has been reluctant to say the least, to reschedule marijuana. They've never had a directive though, from the president of the United States to evaluate scheduling. So I do think that the DEA will follow the recommendation, but until that happens, marijuana remains a Schedule I substance, and it does not change. The taxes don't change. Financial service access doesn't change. Nothing changes.

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The other point I'd like to make is that no one knows exactly how this is going to work. There are a lot of unknowns with this, and although we have a history of federal and state-level drug policy, there's no guarantee other than the tax impact, which again, that's based on the text of 280E.

There's no guarantee that rescheduling is going to be good or bad for the industry. There's concerns that this could lead to some crackdown on state legal state-legal marijuana businesses. Personally, I don't think that that would happen. I think it would be incredibly unpopular for any presidential administration to shut down these state legal state-legal programs. But again, no one can actually know. And if someone tells you that they know definitively what's going to happen with rescheduling, I would take that with a significant grain of salt. And unless there's anything else that Douglas or Aaron would like to add, I think that that concludes our podcast for today.

Douglas Charnas: Well, from the tax perspective, this would be huge and I think it would be a very welcome thing. But as you say, it's not a done deal and nobody's counting on it yet.

Daniel Shortt: Alright, thank you everyone for joining us.

Aaron Kouhopt: Thank you.

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