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In this article, Rowe examines how section 199A may provide some tax relief to cannabis business owners, and he discusses remaining obstacles.

Thirty-three states, as well as the District of Columbia, Guam, and Puerto Rico, have legalized the sale of marijuana[1] and the national trends favor expanding legalization.[2] Many experts predict exponential growth for the legal cannabis industry in the coming years, as well as the creation of hundreds of thousands of jobs.[3] Despite legalization and the economic opportunities it creates, cannabis businesses face a tremendous obstacle to success and growth in the form of the federal tax code. The fact that marijuana is legal at the state level, but remains illegal under federal law, creates an inherent tension for cannabis businesses, and federal tax treatment of these businesses exemplifies this tension. While cannabis businesses may be operating legally under the laws of their home state, marijuana's illegality under federal law has a punitive tax effect because of section 280E. There are specific policy proposals that would eliminate this punitive effect for state-legal cannabis businesses.[4] However, until these proposals are adopted, or marijuana is legalized for federal purposes, the tension remains with dramatic effect.

Section 280E, enacted through the 1982 Tax Equity and Fiscal Responsibility Act,[5] disallows a tax deduction for amounts paid or incurred in a trade or business that consists of the sale of a controlled substance.[6] Although it may be legal under state law, marijuana is still a Schedule I controlled substance under the federal Controlled Substances Act.[7] As a result, sellers of state-legalized marijuana fall squarely within the purview of section 280E, which states that:

> 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

[1] *See* "State Medical Marijuana Laws," National Conference of State Legislatures (Jan. 23, 2019). The terms "marijuana" and "cannabis" are used interchangeably in this article to refer to all products and compounds derived from the cannabis plant, including cannabidiol, that are classified as Schedule I controlled substances under federal law.

[2] *See, e.g.*, Lisa N. Sacco et al., "The Marijuana Policy Gap and the Path Forward," Congressional Research Service, R44782 (2017) (finding an increase in support for marijuana legalization nationwide, going from 12 percent in 1969 to 60 percent in 2016); and Pew Research Center release, "Modest Rise in Percentage Favoring General Legalization" (Apr. 1, 2010) (finding 73 percent support for medical marijuana).

[3] *See, e.g.*, Matt Ferner, "Legal Marijuana Is the Fastest-Growing Industry in the U.S.: Report," *Huffington Post*, Jan. 26, 2015 (referencing an industry report by The ArcView Group, a marijuana industry investment and research firm); and Debra Borchardt, "Marijuana Industry Projected to Create More Jobs Than Manufacturing by 2020," *Forbes*, Feb. 22, 2017 (referencing a report by New Frontier Data).

[4] *See, e.g.*, Daniel Rowe, "Harmonizing Federal Tax Law and the State Legalization of Marijuana," 51 *Loy. L.A. L. Rev.* 291 (2018) (recommending the amendment of section 280E to exempt specific activities regarding state-legalized marijuana sales). *See also* Carrie E. Keller, comment, "The Implications of I.R.C. 280E in Denying Ordinary and Necessary Business Expense Deductions to Drug Traffickers," 47 *St. Louis U. L.J.* 157 (2003) (recommending the omission of section 280E from the IRC entirely).

[5] P.L. 97-248, 96 Stat. 324 (1982).

[6] Section 280E (2012).

[7] *See* Controlled Substances Act, 21 U.S.C. section 812 (2012).

> 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 is conducted.[8]

While the application of section 280E imposes a significant tax burden on cannabis businesses by taxing their gross income,[9] owners of cannabis businesses that are operating in passthrough form (partnerships and S corporations) or as sole proprietorships may be able to find some relief in the newly enacted section 199A deduction for qualified business income (QBI). (The section 199A regulations use the term relevant passthrough entities (RPEs) to describe some partnerships, S corporations, trusts, and estates.[10] RPE in this article refers to all partnerships, S corporations, and sole proprietorships.) However, cannabis business owners must overcome multiple hurdles before they can use the section 199A deduction. These hurdles include the application of section 280E itself, the specified service trade or business (SSTB) classification, and the wage and property basis limitations of section 199A. As this article explains, the second and third hurdles do not come into play when the cannabis passthrough owner's taxable income is below a specific level. The second hurdle arises for medical marijuana sellers, but not for sellers of non-medical (recreational) marijuana. Finally, the third hurdle may be insurmountable for pure retailers, while businesses that produce marijuana may be able to overcome it to some degree.

Brief Overview of Section 199A

Section 199A was added by the Tax Cuts and Jobs Act.[11] Congress's intent was to reduce the federal tax burden on non-corporate businesses[12] by providing a deduction of up to 20 percent of passthrough income for qualified business owners.[13] Under section 199A, an individual taxpayer may deduct the lesser of their combined QBI amount or 20 percent of the excess of their taxable income over their net capital gain for the tax year.[14] A taxpayer's QBI amount is the sum of 20 percent of the aggregate amount of real estate investment trust dividends and qualified publicly traded partnership income plus the sum of the lesser of:

1. 20 percent of the taxpayer's QBI; or
2. the greater of:
   a. 50 percent of the W-2 wages; or
   b. the sum of 25 percent of the W2 wages plus 2.5 percent of the unadjusted basis immediately after acquisition (UBIA) of all qualified property for each trade or business in which the taxpayer has an ownership interest.[15]

QBI is the net amount of income, gain, deduction, and loss effectively connected with the conduct of a trade or business in the United States that is not an SSTB or the trade or business of performing services as an employee.[16] An SSTB, which does not qualify for the section 199A deduction, is defined by reference to section 1202(e)(3)(A), but modified as follows:

> any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the skill or reputation of one or more of its employees or owners, or which involves

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[8] Section 280E.

[9] Reg. section 1.61-3 defines "gross income derived from business" as the total sales, less the cost of goods sold (COGS). While section 280E prevents the deduction of ordinary and necessary business expenses, it does not disallow a deduction for COGS. The legislative history of section 280E indicates that COGS was left unaffected to avoid "possible challenges" to section 280E on constitutional grounds. S. Rep. No. 97-494, at 309 (1982).

[10] Reg. section 1.199A-1(b)(10).

[11] P.L. 115-97, 131 Stat. 2054 (2017).

[12] Joint Committee on Taxation, "General Explanation of Public Law No. 115-97," JCS-1-18, at 20 (Dec. 2018).

[13] Section 199A.

[14] Section 199A(a).

[15] Section 199A(b).

[16] Section 199A(c).

the performance of services that consist of investing and investment management, trading, or dealing in securities.[17]

In other words, for a passthrough business to generate a section 199A deduction for its owner, it must generate non-SSTB income and have sufficient W-2 wages or wages plus UBIA to support the deduction amount. It is important to note, however, that the SSTB restriction and the W-2 wage/UBIA limitation do not apply if the taxpayer has taxable income below the following threshold amounts (adjusted annually for inflation):

1. $157,500 for single, married filing separately, head of household, and qualifying widow(er); or
2. $315,000 for married filing jointly.[18]

There are also phase-in/phaseout rules for taxpayers with taxable income above the previous thresholds but below:

1. $207,500 for single, married filing separately, head of household, and qualifying widow(er); or
2. $415,000 for married filing jointly.[19]

The phase-in/out amounts are also adjusted for inflation.[20]

With this general framework of the section 199A mechanics in place, the remainder of this article focuses on the availability of the section 199A deduction for taxpayers reporting passthrough income from cannabis businesses. The article looks at the specific provisions of sections 280E and 199A that may restrict or limit the owners of cannabis RPEs from using the 20 percent deduction. Whether they can take advantage of section 199A is a significant issue for cannabis RPE owners because of the tremendous tax burden imposed by section 280E. The ability to deduct 20 percent of business income could soften the impact of section 280E's expense disallowance, reducing the top federal marginal rate on passthrough income from a cannabis business from 37 percent to 29.6 percent.[21] This article considers whether the statutory language of section 280E in general prevents a deduction under section 199A, whether the sale of cannabis and cannabis-related products constitutes an SSTB under section 199A, how the W-2 wage and UBIA limitations of section 199A affect cannabis businesses, and how the aggregation of RPEs could benefit cannabis business owners.

There are distinct categories of cannabis business owners that may be affected differently by each hurdle. Owners with taxable income below the thresholds will be concerned only with whether section 280E itself prohibits a section 199A deduction. Those owners will not need to determine whether their business is an SSTB or if it has sufficient W-2 wages or UBIA to support a deduction. Owners with income above the thresholds will be concerned with all three hurdles, but some may be in better situations than others to take advantage of section 199A. This is described in more detail throughout the article, but in general those owners who also own related non-cannabis businesses or owners who have a combination of retail and production activities may be better situated to qualify for a section 199A deduction than owners of strictly retail cannabis businesses.

Hurdle 1: Section 280E Itself

The first issue is whether the plain language of section 280E itself prohibits a potential section 199A deduction for taxpayers receiving passthrough income from a cannabis business. The answer to this question should be no. Section 280E explicitly prohibits *deductions* or credits for businesses selling federally illegal drugs,[22] and section 199A is an allowance of a *deduction*.[23] However, section 280E disallows deductions *for expenditures* — amounts paid or incurred in carrying on a trade or business involving drug trafficking.[24] Section 199A, on the other hand, is a below-the-line deduction taken by an individual

[17] Section 199A(d)(2).

[18] Section 199A(b)(3)(B) and section 199A(d)(3).

[19] *Id.*

[20] Section 199A(e)(2).

[21] The top marginal tax rate for individuals for tax year 2018 is 37 percent, per section 1 (37 percent x (1 - 0.2) = 29.6 percent).

[22] Section 280E.

[23] Section 199A(a).

[24] Section 280E.

on her personal return based on her share of QBI.[25] QBI is determined at the passthrough level after deducting allowable ordinary and necessary business expenses from revenue, but the section 199A deduction is determined at the passthrough owner level based on the owner's share of passthrough *income*.

So while section 280E may operate to disallow business expenses when determining a cannabis passthrough's QBI, section 280E would not further disallow that passthrough's owner the ability to take a section 199A deduction on their share of income. This is because section 280E disallows a deduction for amounts *paid or incurred* but the section 199A deduction is taken based on amounts reported as income. Therefore, cannabis RPE owners should be able to overcome the first hurdle.

Also, because all its ordinary and necessary business expenses are disallowed in determining federal taxable income, the cannabis business would have a higher QBI than a similarly situated business that is not subject to section 280E (a non-280E business). Consider the example in Table 1 of a non-280E business (alcohol producer) compared with a marijuana producer. This example assumes that the other deductions are ordinary and necessary business expenses, fully deductible absent section 280E:

Table 1. Comparison of Potential QBI for Non-280E Business vs. Cannabis Business

	Alcohol Producer	Marijuana Producer
Gross receipts	$1,000,000	$1,000,000
Cost of goods sold	($500,000)	($500,000)
Gross profit	$500,000	$500,000
Other deductions:		
Salaries	($200,000)	($200,000)
Utilities	($50,000)	($50,000)
Rent	($100,000)	($100,000)
Advertising	($80,000)	($80,000)
Total other deductions	($430,000)	($430,000)
Allowable other deductions	($430,000)	—
Taxable income/ potential QBI	$70,000	$500,000

The application of section 280E leaves the marijuana producer with significantly higher QBI, which could result in a higher section 199A deduction to mitigate the punitive effect of section 280E. The example in Table 2 illustrates this mitigation; however, it does not consider the W-2 wage and UBIA limitations on the section 199A deduction imposed by section 199A(b)(2)(B) and reg. section 1.199A-2, which are discussed later.

Although section 280E does not outright prohibit the ability of a cannabis business owner to take a deduction under section 199A, there are still additional hurdles for taxpayers with taxable income above the $157,500 and $315,000 thresholds to overcome. These hurdles include determining whether the relevant cannabis business is an SSTB and determining whether the business has sufficient levels of W-2 wages or UBIA to support a deduction of 20 percent of QBI.

Hurdle 2: Medical Sales and the SSTB Classification

As mentioned, section 199A and the regulations thereunder provide that, other than for taxpayers with taxable income below specific thresholds, QBI deriving from an SSTB is not eligible for the 20 percent deduction.[26] Cannabis-related businesses come in many forms. Some strictly grow or cultivate cannabis, while others sell cannabis as retailers. A business might sell only non-cannabis merchandise such as pipes, papers, and other paraphernalia or may sell a combination of cannabis and non-cannabis

[25] Section 199A(f)(1)(A).

[26] Section 199A(c) and reg. section 1.199A-5(a)(2). Taxpayers with taxable income below the thresholds of section 199A(b)(3)(B) and (d)(3) do not need to concern themselves with whether their QBI comes from an SSTB. The QBI is eligible for the 20 percent deduction either way.

Table 2. Illustration of the Potential Tax Benefit of Section 199A for a Marijuana Business

	Alcohol Producer	Marijuana Producer	
	With Section 199A	Without Section 199A	With Section 199A
Gross receipts	$2,000,000	$2,000,000	$2,000,000
Cost of goods sold	($1,000,000)	($1,000,000)	($1,000,000)
Gross profit (GP)	$1,000,000	$1,000,000	$1,000,000
Other deductions:			
Salaries	($400,000)	($400,000)	($400,000)
Utilities	($100,000)	($100,000)	($100,000)
Rent	($200,000)	($200,000)	($200,000)
Advertising	($160,000)	($160,000)	($160,000)
Total other deductions (OD)	($860,000)	($860,000)	($860,000)
Allowable other deductions (AOD)	($860,000)	—	—
Net income (GP less OD)	$140,000	$140,000	$140,000
Taxable income/potential QBI (GP less AOD)	$140,000	$1,000,000	1,000,000
Tentative section 199A deduction[a]	($28,000)	—	($200,000)
Taxable income after section 199A deduction	$112,000	$1,000,000	$800,000
Tax due at top marginal rate (37 percent)	$41,440	$370,000	$296,000
Tax as a percentage of net income	29.60%	264.29%	211.43%

[a]Notwithstanding the application of section 199A(b)(2)(B) and reg. section 1.199A-2.

products. Businesses frequently conduct multiple activities through a single entity or location.

While some marijuana retailers are able to sell to recreational users under the laws of their home states, other retailers are restricted to sales for medical use. The federal statute and regulations provide that a business performing services "in the field of health" shall be considered an SSTB. The question that arises is whether those businesses selling marijuana for medical use shall be considered to be "in the field of health" for purposes of section 199A. Based on Treasury guidance, including the preamble to the final section 199A regulations, the answer appears to be no.

The final regulations do not specifically address sales of medical marijuana, but of the specific health professions they do discuss, pharmacists and pharmaceutical sales are most comparable to medical marijuana retailers. The regulations state that services performed in the health field include "the provision of *medical services* by individuals such as physicians, pharmacists . . . and other similar healthcare professionals performing services in their capacity as such."[27] However, the "performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient."[28] The regulations state that "the performance of services in the field of health

[27]Reg. section 1.199A-5(b)(2)(B)(ii) (emphasis added).

[28]*Id.*

does not include . . . manufacture and/or sales of pharmaceuticals or medical devices."[29] For a marijuana dispensary that sells medical marijuana or devices or supplies for consuming it, considering the dispensary analogous to a pharmacy results in non-SSTB treatment for that sales activity.

It is possible that the dispensary employees also provide advice or consultations to customers. Would that be akin to the provision of medical services by a pharmacist, and thus within the realm of an SSTB? Again, the answer appears to be no, but it is not entirely clear. Continuing with the pharmacist analogy, the preamble to the regulations state, "The Treasury Department and the IRS agree that the sale of pharmaceuticals and medical devices by a retail pharmacy is not by itself a trade or business performing services in the field of health."[30] However, some services provided directly by a pharmacist may fall under the definition of an SSTB. The distinction between an SSTB and non-SSTB pharmacist appears to hinge on whether the pharmacist is providing direct medical treatment (such as inoculations) or medical consultations, as opposed to simply retail sales.[31]

Providing advice on selecting a medical marijuana product should not fall under the scope of medical services. It would be difficult for the federal government to argue that medical marijuana, while not recognized as part of a legal health field because of the Controlled Substances Act and disallowed as a medical expense for itemized deduction purposes,[32] is nevertheless a recognized health field for purposes of section 199A. In fact, Schedule I controlled substances are defined by the federal government as drugs "with no currently accepted medical use in treatment in the United States."[33]

By analogy to a pharmacy, the sale of medical marijuana products alone should not constitute the provision of services in the field of health, and based on federal law, advice or consultations on which medical marijuana to buy would also fall outside the realm of medical services. However, to the extent a dispensary employs medical doctors who diagnose medical conditions and prescribe cannabis as a treatment, the medical doctors' services may fall within the field of health definition and be considered an SSTB. But in most cases, the retail sales and nonmedical consultation services of most cannabis businesses should not be considered SSTB activity under section 199A.

However, there are cases in which cannabis businesses will separate their activities into distinct business lines, perhaps including the provision of caregiving services, to mitigate the application of section 280E.[34] In those cases it is possible that a separated trade or business may be considered an SSTB, depending on the type of health services it is providing, while the business of actually selling the cannabis is not an SSTB. The regulations provide for a de minimis rule for a business that performs both SSTB and non-SSTB activities.[35] Under that rule, a business is not considered to be an SSTB if less than 10 percent of its gross receipts are attributable to the performance of services in one of the specified fields of section 199A(d)(2), which include health and consulting.[36] The 10 percent threshold is reduced to 5 percent for businesses with gross receipts exceeding $25 million.[37] Thus, even if a cannabis business is deemed to be providing some degree of medical services, if it falls within the scope of the de minimis rule, then the entire business will be treated as a non-SSTB. If the business does not fall under the de minimis rule but can demonstrate that the medical activity is a separate and distinct trade or business (which would likely be essential for avoiding section 280E as well) the portion of activity relating to the actual marijuana sales can still be treated as non-

[29] *Id.*

[30] Preamble to section 199A regulations, at section VI.A.2.

[31] *Id.*

[32] *See* IRS Publication 502.

[33] Controlled Substances Act, 21 U.S.C. section 812(b)(1)(B) (2012).

[34] *See, e.g.*, *Californians Helping to Alleviate Medical Problems Inc. (CHAMP) v. Commissioner*, 128 T.C. 173 (2007).

[35] Reg. section 1.199A-5(c)(1).

[36] *Id.*

[37] *Id.*

SSTB.[38] In other words, the de minimis threshold is not an all-or-nothing test.

The regulations also provide that "services performed in the field of consulting" are considered SSTBs.[39] The definition of consulting is quite broad, including "counsel to clients to assist the client in achieving goals and solving problems."[40] Based on this definition, myriad activities could be consulting, including providing advice on selecting a specific cannabis product for a specific medical condition. However, it is unlikely that such an activity would truly be viewed as an SSTB using the consulting umbrella. Typically, dispensaries are not charging separately for consulting services, and they are provided in direct connection to the sale of goods. The regulations provide that consulting does not include "services embedded in, or ancillary to, the sale of goods" for an otherwise non-SSTB.[41] Also, if there is no separate payment received for the services, then they do not constitute an SSTB.[42] Finally, even if the dispensary charges separately for consulting services, it may be able use the de minimis rule to remain treated as a non-SSTB overall. Most cannabis RPEs will be able to overcome the second hurdle.

Hurdle 3: The W-2 Wage and UBIA Limitations

Perhaps the most significant hurdle for a cannabis business to overcome in determining whether its income may generate a section 199A deduction is the W-2 wage and UBIA limitations imposed by section 199A(b)(2). To support the 20 percent deduction, the business must have sufficient W-2 wages or basis in its qualified property or be properly aggregated with another business or businesses that have sufficient wages or property basis.[43] For example, if a business generates $50,000 of QBI for its owner, the potential section 199A deduction is $10,000 ($50,000 x 20 percent). However, the amount that will be considered for the deduction is the *lesser of* (1) the $10,000 or (2) the greater of either (i) 50 percent of the business's W-2 wages or (ii) 25 percent of its wages plus 2.5 percent of the UBIA of its depreciable property.[44] To support the $10,000 deduction, the business must have either $20,000 of W-2 wages or some combination of wages and property that, when multiplied by 25 percent and 2.5 percent respectively, equals or exceeds $10,000. (Again, it should be noted that taxpayers with taxable income below the thresholds of section 199A(b)(3)(B) and (d)(3) do not need to overcome this third hurdle. Those taxpayers will be eligible for the 20 percent deduction regardless of W-2 wages or UBIA. This third hurdle applies to taxpayers with taxable income over the threshold amounts.)

The major issue facing an RPE that is subject to section 280E is whether it actually has any wages or property that *qualify* for the section 199A(b)(2) limitations. For purposes of the wage limitation, W-2 wages do not include any amounts that are not properly allocable to QBI.[45] The regulations clarify that "properly allocable to QBI" means that the wage expense must be taken into account in computing the RPE's QBI.[46] By operation of section 280E, wage expense — other than the portion properly attributable to the cost of goods sold (COGS) — is not taken into account in determining QBI because it is not a deductible business expense. So in Table 2, the $400,000 of wages will not provide any support for the section 199A deduction. Unless the business has sufficient wages in its COGS or has sufficient UBIA to support the deduction (or can be aggregated with other RPEs), the significant QBI created by the lack of ordinary and necessary business deductions will not translate into a tangible benefit to the business owners.

Here the distinction between a cannabis producer and a cannabis retailer is significant. COGS for a retailer consists of the amount paid for inventory plus "transportation or other necessary

[38] *See* reg. section 1.199A-5(c)(1)(iii)(B), which provides an example of a separate trade or business within a single limited liability company. It is not clear what specifically would constitute a separate trade or business within a single passthrough for purposes of section 199A, but it appears that at a minimum there should be separate books and records and separate employees for each trade or business.

[39] Reg. section 1.199A-5(b)(2)(B)(vii).

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] Section 199A(b)(2)(B). Rules for aggregation are discussed *infra*.

[44] Section 199A(b)(2)(B).

[45] Section 199A(b)(4)(B).

[46] Reg. section 1.199A-2(b)(4).

charges incurred in acquiring" the inventory.[47] This COGS calculation would not include labor costs, and as a result, the pure retailer would not have any deductible W-2 wages. Without deductible W-2 wages, the retailer's QBI will not result in a section 199A deduction (absent sufficient UBIA or aggregation with other RPEs, as discussed later). COGS for a producer, on the other hand, include the cost of raw materials, direct labor, and indirect production costs incurred in producing marijuana. For example, a producer's or grower's COGS would include direct materials, such as seeds or the marijuana itself, and direct labor to plant, harvest, mix, or bake the cannabis product. Therefore, the producer will most likely have W-2 wages within its COGS. Those wages, which are taken into account in computing QBI since they run through COGS, can be used to satisfy the section 199A(b)(2) wage limitation. Therefore, to the extent a cannabis RPE can either demonstrate that it conducts a separate and distinct business that is not subject to section 280E (and has its own W-2 wages or UBIA) or that it is a producer or has production activity, the RPE's owners may be able to overcome this third hurdle of the W-2 wage/UBIA limitation.

The W-2 wage and UBIA determinations are made for each separate trade or business of the RPE,[48] so proper separation into non-280E activities or producer activities can be signification for section 199A purposes. To be sure, the amount of W-2 wages either within COGS or attributed to the non-280E activity must still be at a level that is sufficient to support the section 199A deduction (again, absent aggregation with another RPE). It is important to note that a cannabis business may not circumvent section 280E's disallowance provision by capitalizing labor and other expenses into inventory through the uniform capitalization (UNICAP) rules of section 263A.[49] If COGS contains amounts that were capitalized under the UNICAP rules but would have otherwise been disallowed (for example, 50 percent of meals, fines, and penalties, or costs subject to section 280E), then those amounts remain disallowed. Section 263A is a timing provision, used to determine when an expense can be deducted.[50] It cannot be used to change the character of an expense from deductible to nondeductible.[51] Therefore, section 263A will not provide a workaround for providing deductible W-2 wages to be considered for the section 199A(b)(2) limitation.[52]

It is not clear whether section 280E directly affects the UBIA limitation, although, as discussed later, UBIA alone may not offer much solace to cannabis business owners hoping to take advantage of the section 199A deduction. UBIA requires "qualified property," which is defined by the IRC and regulations as "tangible property of a character subject to the allowance for depreciation under section 167(a)" that is used in the production of QBI.[53] Section 280E may disallow depreciation expense[54] if the property subject to depreciation is used in a business for which section 280E applies, and the depreciation expense cannot be properly classified as part of COGS. However, it does not appear that the property be required to actually produce tax

[47] Reg. section 1.471-3(b).

[48] Reg. section 1.199A-2(a)(2), (3).

[49] *See* ILM 201504011. *See also* section 263A(a)(2) (any "cost which . . . could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph"); *Patients Mutual Collective Corp. v. Commissioner*, 151 T.C. 11, 117 (2018); and *Alternative Health Care Advocates v. Commissioner*, 151 T.C. 13, 138 (2018).

[50] ILM 201504011.

[51] *Id.*

[52] *See* Rowe, *supra* note 4, for a comprehensive discussion of the UNICAP rules as applied to marijuana businesses.

[53] Section 199A(b)(6)(A) and reg. section 1.199A-2(c). Qualified property must also be "held by, and available for use in, the trade or business. . . at the close of the taxable year" and its depreciable period must not have ended before the close of the tax year. *Id.*

[54] *See, e.g.*, *Alterman v. Commissioner*, T.C. Memo. 2018-83 ("This conclusion holds even for depreciation" when determining that the taxpayer was not entitled to business expense deductions because of section 280E.).

depreciation[55] in order to be considered UBIA, but rather the property should simply be "of a character" that is subject to section 167. Such property is that which is used in a trade or business or held for the production of income.[56] A cannabis RPE's fixed assets should meet this definition, provided they are used in producing QBI, whether the associated depreciation expenses are actually allowed in determining taxable income.[57]

However, because the amount of UBIA that may support a section 199A deduction is limited to 2.5 percent, its availability will likely have little benefit for cannabis RPEs. For example, to support the $200,000 deduction in Table 2, without qualified W-2 wages, a cannabis RPE would need at least $8 million of UBIA. And having $1 million of UBIA would support a deduction of only $25,000. Thus most cannabis RPEs will look toward W-2 wages to support the potential section 199A deduction. As discussed, having sufficient qualified W-2 wages is a difficult task for retailers. Their best hopes lie in identifying qualified non-280E trades or businesses that they are conducting or aggregating the 280E QBI with non-280E QBI that has qualified W-2 wages or UBIA.

Conducting Separate Trades or Businesses

Cannabis businesses often want to establish that they are conducting separate and distinct trades or businesses to mitigate the detrimental tax effects of section 280E. If they can establish that they have a separate business that is not considered trafficking of a controlled substance, even if it is conducted within the same legal entity, the expenses properly allocated to that non-280E business may be deductible.[58] Likewise, if a cannabis RPE can establish separate non-trafficking trades or businesses for purposes of section 199A, it may be able to use the wages of the separate business line to support a section 199A deduction under the aggregation rules discussed later. Alternatively, if it can establish that it is conducting production activities, even if it is also a retailer, it can use the COGS wages from the production activity to support a section 199A deduction (perhaps aggregating the production and retail activities to optimize the deduction under the principles of aggregation discussed later). So the motivation behind separating trades or business for purposes of section 280E becomes even more significant regarding a potential section 199A deduction.

However, recent case law has not been kind to cannabis businesses that have attempted to establish separate non-280E trades or businesses. Despite the success of Californians Helping to Alleviate Medical Problems Inc. in Tax Court in 2007, subsequent cases have held that marijuana businesses failed to establish separate non-280E activities. In *Olive*,[59] the taxpayer's activities of hosting yoga classes and other services were deemed incidental to its primary business of selling marijuana, so that all its expenses fell within the scope of section 280E.[60] Similarly, in *Alterman*,[61] the taxpayer contended that it had a separate business of selling non-marijuana merchandise for which business expenses should be allowed, but the court disagreed.[62] The court, citing *CHAMP*, reasoned that "whether selling non-marijuana merchandise was a separate business from selling marijuana merchandise is an issue of fact that depends on, among other

[55] This appears to be true at least in the context of property held by a partnership, as the preamble to the section 199A regulations contemplates allocating UBIA between partners when there is qualified property with no tax deprecation. Presumably the test for qualified property is not whether it actually produces tax depreciation, but whether it is "of a character" that would. *See* preamble at 27-28.

[56] Section 167(a).

[57] Whether depreciation expense disallowed by application of section 280E should nevertheless be considered "allowable" for determining the adjusted basis of the associated asset is beyond the scope of this article.

[58] *See CHAMP*, 128 T.C. 173 (The court held that the taxpayer was engaged in two trades or businesses, one of selling marijuana and one of caregiving services. The caregiving services were deemed substantial, and not merely incidental to the sale of marijuana, thus expenses allocated to the caregiving services were not disallowed under section 280E. Although the taxpayer did not maintain separate books and records to track the specific expenses regarding the caregiving services, the court apportioned the expenses based on relative number of employees and square footage of the facilities dedicated to each separate business line.). *Id.* at 184-185.

[59] *Olive v. Commissioner*, 139 T.C. 19 (2012).

[60] *Id.* at 42-43.

[61] *Alterman v. Commissioner*, T.C. Memo. 2018-83.

[62] *Id.* at 26.

Table 3. Basic Aggregation Example

	QBI	20 Percent of QBI	W-2 Wages	50 Percent of W-2 Wages	Potential Section 199A Deduction[b]
Marijuana retailer	$1,000,000	$200,000	—	—	—
Marijuana producer	$20,000	$4,000	$410,000[a]	$205,000	$4,000
Total potential section 199A deduction without aggregation			$4,000	—	—
Aggregated businesses	$1,020,000	$204,000	$410,000	$205,000	$204,000

[a]W-2 wages properly included in COGS.

[b]The lesser of 20 percent of QBI or 50 percent of W-2 wages.

things, the degree of economic interrelationship between the two activities."[63] The *Alterman* court looked at the relative revenue received from the marijuana and non-marijuana sales, along with the fact that the non-marijuana products (for example, pipes) complemented the marijuana products, in concluding that the taxpayer was truly engaged in only one business, which was selling marijuana.[64]

In another recent case, Harborside Health Center attempted to establish that not only was it engaged in separate trades or businesses that were outside the scope of section 280E, but also that it should be able to compute a portion of its COGS using the rules for a producer rather than a retailer.[65] The court ruled against the taxpayer on both matters, and in analyzing the existence of separate businesses, it placed great emphasis on relative revenue, the time spent by employees in various activities, and the facility space dedicated to each activity.[66] These cases illustrate that establishing a separate non-280E trade or business when a company derives substantial revenue from the sale of cannabis relies heavily on the facts and circumstances. *CHAMP* provides an example of "good facts" while the facts in cases such as *Olive* fall on the other end of the spectrum.

Also, the section 199A regulations provide insight into how a taxpayer may establish separate trades or businesses. Reg. section 1.199A-5(c)(1)(iii)(B) implies that maintaining separate books and records, as well as having separate employees dedicated strictly to each business line, may be sufficient to establish separate trades or businesses. However, the preamble to the section 199A regulations makes frequent reference to section 446(d) and the regulations thereunder for determining whether a taxpayer is engaged in multiple trades or businesses.[67] The section 446(d) guidance requires "a complete and separate set of books and records" for each trade or business.[68] Additional steps that a taxpayer could take are: conducting the businesses through separate legal entities (including multiple single-member limited liability companies); maintaining separate bank accounts and financing facilities; having dedicated floor or facility space, or even separate locations, for each business; having different customers for each business; and having separate management for each business. Although the *CHAMP* court apportioned expenses between marijuana and non-marijuana businesses in the absence of separate books and records,[69] taxpayers would be wise to avoid such a situation and should, at a bare minimum, keep separate financials for each trade or business.

However, much like the tension that exists between federal and state cannabis laws, there is also a tension in the goals of a cannabis RPE owner for purposes of section 280E versus section

[63]*Id.*

[64]*Id.* at 26-27.

[65]*Patients Mutual*, 151 T.C. 11.

[66]*Id.* at 112-115.

[67]*See* preamble to section 199A regulations at 20-21.

[68]Reg. section 1.446-1(d)(2). The section 446(d) guidance is useful for cannabis businesses to consider, both for section 199A as well as section 280E purposes.

[69]*CHAMP*, 128 T.C. at 184-185.

199A. When the goal is to avoid or reduce the application of section 280E, the business owner will want to establish the existence of separate and distinct activities. But, to properly aggregate activities under section 199A, there must be a demonstrated connection or interdependence between them. This tension arises when the taxpayer seeks to aggregate cannabis and non-cannabis activities while the two have been separated for section 280E purposes. But it should not pose an issue for a taxpayer seeking to aggregate a cannabis retail business with a cannabis production business if the two businesses are both subject to section 280E.

Aggregation by Passthroughs and Individuals

If a cannabis RPE is able to sufficiently establish the existence of either non-280E trades or businesses or production activities that provide qualified W-2 wages to support a section 199A deduction, the aggregation principles of section 199A may be employed to maximize the available deduction. Similarly, if an owner of a cannabis RPE also owns other non-280E RPEs that can be properly aggregated for purposes of section 199A, the owner can use the aggregation principles to provide support for a section 199A deduction stemming from income of the cannabis RPE.

Section 199A and the regulations thereunder contain an aggregation provision, by which multiple trades or businesses can be considered as a single unit when computing QBI and the W-2 wage and UBIA limitations. To aggregate multiple trades or businesses, the following requirements must be met:

1. the same person or group of persons must own 50 percent or more of each trade or business (as determined by applying the attribution rules of sections 267(b) and 707(b)) for a majority of the tax year, including the last day;
2. the trades or businesses to be aggregated must have the same tax year;
3. none of the trades or businesses can be SSTBs; and
4. two of the following conditions must be met:
   a. the businesses provide products, property, or services that are the same or customarily offered together;
   b. the businesses share facilities or significant centralized business elements;
   c. the businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.[70]

The aggregation of multiple trades or businesses may be done at the individual taxpayer's level[71] or may be done by the RPE itself.[72] An aggregation election need not be made in the first year of eligibility, but once it is made the election is permanent.[73]

Aggregation can be beneficial for an owner of a cannabis RPE that produces QBI but does not have sufficient W-2 wages or UBIA to support the related section 199A deduction. By aggregating the cannabis RPE with another RPE that does have sufficient W-2 wages or UBIA, the owner may still be able to take advantage of a portion of, if not the full, section 199A deduction. Table 3 illustrates this concept.

By aggregating the retail and production RPEs, the taxpayer can take advantage of the fact that the producer, despite having less QBI, provides sufficient W-2 wages because of wages that are included in its COGS.

Aggregation of cannabis retail and cannabis production RPEs is feasible, as they are likely to satisfy at least two of factors in reg. section 1.199A-4(b)(1)(v). However, outside the retailer/producer context, the specific aggregation requirements under section 199A could put some taxpayers in the difficult position of trying to simultaneously argue that they have separate and distinct trades or businesses for purposes of section 280E, but yet those trades or businesses meet the aggregation requirements of the section 199A regulations (that is, they share facilities or significant business elements). The arguments that a cannabis business would want to make based on recent case law to demonstrate that it has separate non-280E activities include showing a low degree of economic relationship to the

[70] Reg. section 1.199A-4(b)(1).

[71] Reg. section 1.199A-4(b)(2)(i).

[72] Reg. section 1.199A-4(b)(2)(ii).

[73] Reg. section 1.199A-4(c)(1) and -4(c)(3).

cannabis activity, separate employees or facilities, and products that are not incidental to cannabis sales. However, to properly aggregate businesses for section 199A, the same taxpayer would argue that the activities share facilities or significant business elements, are operated in coordination with each other, or provide products that are the same or customarily offered together. Of course, these are not mutually exclusive arguments, but they are highly dependent on facts and circumstances and require careful consideration and planning.

Conclusion

Owners of cannabis RPEs that fall under the taxable income thresholds of section 199A can take advantage of the 20 percent passthrough deduction without concern for W-2 wages, UBIA, or falling within the definition of an SSTB. For all other taxpayers, there are significant hurdles to overcome before realizing some relief from the harsh tax effect of section 280E. While the aggregation provision of section 199A may provide some relief, there is an inherent tension in the goals of a cannabis RPE owner in separating activities for section 280E purposes while aggregating for section 199A purposes. Congress has various options to reduce or eliminate the harsh tax effect imposed on cannabis businesses by section 280E. These options include legalizing marijuana, rescheduling it as a Schedule III or higher controlled substance, and repealing section 280E or amending it to exclude state-legal marijuana businesses. Without some congressional relief, cannabis RPE owners will have to contend with the hurdles of section 199A in hopes of finding some reduction of their heavy federal income tax burden. ■