

Hidden Tax Dangers in Cannabis Outsourcing Arrangements

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Outsourcing arrangements are viewed by some in the cannabis community as a way to not be deemed a “trafficker,” and thus able to avoid the harsh prohibition on business expense deductions under tax code Section 280E. CPAs Rachel Wright, Simon Menkes, and Abraham Finberg of AB FinWright LLP and attorney Andrew Gradman warn the meanings of “traffic” and “produce” in an outsourcing context are still too imprecise to rely on an outsourcing arrangement to avoid 280E.

As cannabis becomes mainstream, we are seeing more of what we call outsourcing arrangements—that is, contracts where one entity (LicenseCo) pays another entity (OutsourceCo) to help run its business. There are many good reasons to do this. Maybe someone owns land, which is licensed and zoned for cultivation, but has no clue how to cultivate it. Or they may prefer to have another company act as the employer, to shift liability under state and federal employment law. Some tasks are best done by a specialist who does nothing else.

In this article, we focus on arrangements in which OutsourceCo takes responsibility for the conduct of LicenseCo’s entire business. In some sectors, this is becoming the norm. For example, under “Farm Service Management Arrangements,” the landowner only nominally owns the product, to comply with state licensing laws. Otherwise, he or she outsources all operations and plays a passive role. Also, we focus only on activities, which would clearly qualify as both trafficking and as production had LicenseCo undertaken them alone. Under tax code Section 280E, “traffickers” may not claim current tax deductions for their expenses; nevertheless, under Section 471, they may reduce future income by these amounts, to the extent allocable to the “production” of inventory.

Our concern is that when OutsourceCo is brought into the equation, this could cause LicenseCo to lose its status as a producer, and/or could cause OutsourceCo to become a trafficker but not a producer. If so, the outsourcing arrangement will trigger hefty taxes for that party.

The Meaning of ‘Produce’

This idea—that an outsourcing arrangement might affect a party’s status as “trafficker” and “producer” in different ways—is possible because, in the cases involving outsourcing, the courts apply different tests.

In the context of outsourcing arrangements, the term “produce” is based on control over the manufacturing process. See *Patients Mutual Assistance Collective Corp. (d.b.a. Harborside Health Center) v. Commissioner (Harborside)* (adopting the definition in *Suzy’s Zoo v. Commissioner*. In *Suzy’s Zoo*, the U.S. Court of Appeals for the Ninth Circuit held that a greeting card company was a producer, and not a “small reseller” (a pre-TCJA concept) where it hired an outside company to print its cards. The court explained that “production” turns on “ownership” as defined for tax purposes, and that tax ownership depends not upon state-law title but instead upon “the degree of control ... exercise[d] over the manufacturing process.”

Applying the same test, the Tax Court in *Harborside* reached the opposite result, and held that Harborside was not a producer, where it “had complete discretion over whether to purchase what bud growers brought in, paid growers only if it bought their bud, and at times rejected the ‘vast majority’ of its growers’ bud.” The court also noted that Harborside “thought growers could do whatever they wanted with the rejected bud. ... Harborside merely sold or gave members clones that it had bought from nurseries and bought back bud if and when it wanted. In between these two steps it had no ownership interest in the marijuana plants.”

These cases raise two concerns. First, under what circumstances might LicenseCo cease to be a producer? Second, under what circumstances might OutsourceCo be a producer? As summarized in *Harborside*, the critical factors are (1) degree of control exercised over the manufacturing process, and (2) retention of the exclusive right to sell the finished product.

In a Farm Service Management Arrangement, we get mixed results: that is, LicenseCo retains minimal control over the manufacturing process, yet it retains the exclusive right to sell. Thus, it is unclear which entity will qualify as a producer. In fact, it is not obvious that either will qualify.

The Meaning of ‘Traffic’

By contrast, the definition of “traffic” (in outsourcing arrangements) was addressed in *Alternative Health Care Advocates v. Commissioner*. There, the dispensary (Alternative) paid a related company (Wellness) to employ personnel, maintain bank accounts, and pay expenses. In the court’s view, “Alternative acted only through Wellness.” The “only difference” between the companies was that Alternative “had title to the marijuana.” Wellness employees were “directly involved in” the provision of marijuana to Alternative’s patient-members; they “were engaged in the purchase and sale of marijuana (albeit on behalf of Alternative); that was Wellness’ primary business.”

Wellness argued that it could not be a trafficker unless it “had title to the marijuana its employees were purchasing and selling.” The court disagreed, noting that nothing in the law “limits application to sales on one’s own behalf rather than on behalf of another.” More generally, Wellness also argued that it wasn’t a trafficker because, as a management services company, it “did not itself engage in the purchase and sale of marijuana.” The court also rejected this argument. Something in this relationship led it to conclude that, if the combined Alternative-Wellness unit was a trafficker (which it was, since it engaged in “buying and selling [cannabis] regularly”), then Wellness alone would be a trafficker.

What is that something? It is not clear. If the problem lay in the court's observation that "Alternative acted only through Wellness," and that there was no "difference" between the companies, this might be cured by splitting Wellness into several smaller companies. However, if the problem was that Wellness employees were "directly involved in" providing marijuana, then we would need to go further and ask what "direct involvement" means. (Is this limited to cannabis-touching, or does it extend to accounting, sales, and legal work?) Finally, how important was the Court's observation that this was Wellness's "primary business?" Could this be cured if Wellness provided similar services to mostly non-cannabis clients?

A Trafficker but not a Producer

Based on these rules, there might be cases where neither company is a producer; cases where both companies are traffickers; and (most terrifying of all) cases where one or both parties qualifies as a trafficker but not as a producer. This last scenario could arise in a Farm Services Management Arrangement, whose hallmark is the separation of power to buy and sell (which is relevant to both trafficking and production) from control over the manufacturing process (which is only relevant to production).

Our advice must be imprecise, because the meanings of "traffic" and "produce" in an outsourcing context are still imprecise. Until this is clarified, we recommend that in a Farm Services Management Arrangement, the LicenseCo should contrive to retain more control over the manufacturing process, in order to protect its status as a producer. The arrangement might provide that LicenseCo owns all property, employs all personnel, etc. OutsourceCo merely provides a manager.

Conversely, to mitigate the risk that OutsourceCo will be treated as a trafficker, the work undertaken by OutsourceCo might be broken up among several contracting entities—such as separate contractors for payroll, transportation, management, farm labor, etc. By breaking up these functions, we prevent there from being a single company which is LicenseCo's alter ego, thus making it harder to label any one of these OutsourceCos as a trafficker. In addition, those contractors might seek to engage in substantial non-cannabis work.

We realize that these changes could be onerous. Still, we recommend caution. The stakes of getting Section 280E wrong are even more onerous.

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