Buffalo Law Journal
EST. 1929

Operational issues for medical marijuana producers

By Kenneth Manning and Benjamin Farber | Guest Columnist
Jul 29, 2015, 9:00am EDT

As news stories about the rise of legal marijuana businesses continue apace in the national media, New York State moved closer toward permitted marijuana use for medicinal purposes under the state's Compassionate Care Act (Article 33, Title 5-A of the New York Public Health Law).

Medical Cannabis
ALAIN_STUDIO

In early June, we learned that 43 groups submitted applications in the hopes of receiving one of the five licenses to be granted by the state Department of Health to grow and sell medical marijuana in New York. Though the five groups that ultimately receive the licenses from the DOH may be perceived as "hitting the jackpot," they will nonetheless be confronted with a unique set of challenges in light of the current legal framework for businesses in the medical marijuana industry.

Many of these challenges stem from the fact that marijuana continues to be included as a Schedule I drug under the Controlled Substances Act (21 U.S.C. §§ 801 904 (2015)). The result is that the operation of a medical marijuana business may be permitted under state law, but it is considered to be trafficking in a controlled substance under federal law. In this article, we identify a series of issues under federal law that registered organizations under New York's medical marijuana program will have to contend with given the current federal legal landscape.

In August 2013, the U.S. DOJ Office of the Deputy Attorney General issued guidance (informally known as the Cole Memo) to U.S. Attorneys regarding the DOJ's approach to enforcement of the Controlled Substances Act as it relates to marijuana usage in view of legalization of marijuana usage under state law. Essentially, the Cole Memo provides that DOJ enforcement with respect to marijuana production, sales and consumption in states where it is legally permitted will be limited to instances where certain priority areas are implicated such as distribution to minors, distribution of sales revenue to criminal enterprises and firearms usage in connection with the cultivation and distribution of marijuana.

While the Cole Memo provides some general information regarding deployment of federal prosecutorial resources with respect to marijuana enforcement, practitioners should consider it simply as non-binding guidance and medical marijuana businesses should be counseled that federal prosecutors are nonetheless capable of bringing enforcement actions against medical marijuana businesses for violations under the Controlled Substances Act.

In February 2014, DOJ issued supplemental guidance regarding marijuana-related financial crimes. While this guidance acknowledged that financial transactions involving proceeds from marijuana-related activity can form the basis of prosecution under various federal statutes, it reiterated the general policy of the Cole Memo — that federal prosecution should be pursued in a manner consistent with certain identified priority areas.

In coordination with that guidance, the Financial Crimes Enforcement Network of the U.S. Department of Treasury (FinCen) issued a memo that provided general information for financial institutions seeking to provide services to state-licensed medical marijuana businesses. The FinCen memo provides that, among other things, financial institutions that elect to provide financial services to medical marijuana businesses are required to file suspicious activity reports, with FinCen describing the services provided to such businesses.

Given the reporting obligations that financial institutions must make in connection with serving medical marijuana businesses and the potential for prosecution under federal law, many financial institutions are reluctant to have medical marijuana businesses as clients. Consequently, medical marijuana businesses are left to conduct transactions exclusively in cash, without the aid of banks, payroll services or any other financial service providers.

The inability to engage in bank transactions or maintain accounts with depository institutions inevitably means that medical marijuana businesses remain targets for theft, given their need to maintain large sums of cash on hand to pay vendors and employees in the ordinary course of business.

Another significant challenge arising from marijuana's status as a Schedule I drug is the limitation on the permitted use of federal tax deductions by medical marijuana businesses. Under Section 280E of the Internal Revenue Code (I.R.C. § 280E), "no deduction or credit [is] allowed for any amount paid or incurred ... in carrying on any trade or business if such trade or business ... 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."

Section 280E was enacted by Congress in 1982 in order to reverse the holding in a prior U.S. Tax Court case where that court allowed an illegal business to recover the cost of amphetamines, cocaine and marijuana (i.e., the goods sold by the illegal business) and allowed the taxpayer to claim business deductions with respect to that illegal business. (See Edmondson v. Comm'r, T.C. Memo 1981-623 (1981), superseded by statute, I.R.C. § 280E, as recognized in Californians Helping to Alleviate Medical Problems Inc. v. Comm'r, 128 T.C. 173 (2007)).

Since the enactment of Section 280E, the Tax Court has issued case rulings relating to medical marijuana businesses that have provided some guidance on the scope of application of Section 280E. (See, e.g., Californians Helping to Alleviate Medical Problems Inc. v. Comm'r, 128 T.C. 173 (2007); Olive v. Comm'r 139 T.C. 19 (2012), aff'd, No. 13-70510, 2015 WL 4113811 (9th Cir. July 9, 2015)).

Further, the Internal Revenue Service's Office of Chief Counsel has provided guidance on the treatment of cost of goods sold for federal tax purposes by businesses that sell medical marijuana. (See IRS Chief Couns. Mem. 201504011 (Dec. 10, 2014)).

Though current federal law presents a thicket of issues for medical marijuana businesses, efforts have been undertaken in Congress to address these matters. For example, the House of Representatives recently passed the fiscal year 2015 Commerce, Justice, Science and Related Agencies appropriations bill that included the reauthorization of the Rohrabacher-Farr amendment, which blocks the DOJ from using funds to undermine medical marijuana programs that are legal under state law.

Additionally, the Compassionate Access, Research Expansion and Respect States (CARERS) Act of 2015 bill was introduced in the U.S. Senate earlier this year (S. 683, 114th Cong. (2015)). If enacted, the CARERS Act would limit control and enforcement provisions under the Controlled Substances Act as it relates to medical marijuana in states where production, sale and consumption is permitted.

The legislation would also transfer marijuana from Schedule I to Schedule II of the Controlled Substances Act and limit the actions that could be taken by federal banking regulators and federal prosecutors with respect to depository institutions that provide financial services to legitimate marijuana businesses. Though these legislative initiatives show promise, there is still work to be done to address these (and other) federal issues for operators of medical marijuana businesses.

Kenneth Manning and Benjamin Farber are partners at Phillips Lytle LLP: kmanning@phillipslytle.com, bfarber@phillipslytle.com.