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If You Want a Natural Medicine Company, Start Tax Planning Now

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A recent bill passed by Colorado voters allows for the establishment of a regulated market for plant-derived psychoactive substances. Potential owners of natural medicine companies should understand how Section 280E of the tax code may affect their businesses, says Holland & Hart's Jennifer Benda.

On Nov. 8, Colorado voters passed the Natural Medicine Act of 2022, which opens the door to establishing a regulated market for psilocybin and psilocyn in Colorado. The bill also creates regulated markets for DMT, mescaline, and other plant-derived psychoactive substances. Entrepreneurs and advocates will no doubt be rushing to work with regulators over the next 18 months to establish a strict regimen for cultivation and sale of natural medicines, as well as regulation of healing centers.

The bill contemplates a system where licensed healing centers can acquire, possess, cultivate, manufacture, deliver, transfer, transport, supply, sell, or dispense natural medicine. The centers would also be able to provide medicine for natural medicine services, conduct administration sessions, or provide natural medicine services. The bill would require the Department of Regulatory Agencies to begin accepting license applications by Sept. 30, 2024.

Before seeking a license, potential business owners should consider how to structure their new business and how to tackle the onerous tax structure caused by the federal-state drug law disconnect. While the bill provides a broad outline that has the potential for multiple business models, the model selected by licensees will have significant tax implications that impact profitability. Potential licensees need to understand Internal Revenue Code Section 280E, the cases interpreting Section 280E, and must diligently prepare a sophisticated business plan.

Why Section 280E Matters

Section 280E is a product of the War on Drugs. Congress took note after a 1981 Tax Court ruling authorized an amphetamine, cocaine, and marijuana dealer to deduct ordinary and necessary trade or business expenses such as a scale, packaging, auto miles, travel expenses, telephone charges, and rent.

In 1982, Congress passed Section 280, which provides: “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 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 trade or business is conducted.” The legislative history provides: “To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective cost of goods sold is not affected by this provision of the bill.”

Because Section 280E disallows deductions other than cost of goods sold, a business selling natural medicines that are Schedule I or II controlled substances will be stuck with this provision and its drain on profitability. Those looking to enter the natural medicine and psychedelics industry should team up with the cannabis industry and persuade state legislators to carve out state legal businesses selling Schedule I or II controlled substances from Section 280E.

Structuring Your Business

Barring the (unlikely) repeal of Section 280E, natural medicine businesses must plan for its impact. A huge factor in determining the effects of Section 280E is how the business is structured in terms of the products and/or services it intends to provide. Some questions to consider include whether the business will only produce and/or sell natural medicines, whether it will also provide administration sessions or natural medicine services, or whether it will only provide administration sessions or natural medicine services.

There is one pivotal court case involving state-legal medical marijuana that provides guidance to these operational decisions. In *Californians Helping to Alleviate Medical Problems Inc. v. Commissioner*, the Tax Court ruled that a community center offering a wide variety of services had two separate trades or businesses: providing caregiving services and selling medical marijuana. This allowed the taxpayer to bifurcate its taxable income and apply Section 280E to disallow only deductions related to the sale of medical marijuana.

Critical facts allowed CHAMP to separate its operations into more than one trade or businesses. Its primary purpose was to provide caregiving services to members, which were described by the court as extensive and included regular support group sessions. It provided low-income members meals and hygiene products, as well as one-on-one counseling services, social events, field trips, and yoga classes, among other benefits. In addition, only 10% of the facility was dedicated to the sale of medical marijuana, and 18 of 25 employees were not involved in the sale of

medical marijuana.

This case can provide direction to businesses operating under the Natural Medicine Act that decide to provide services such as administration sessions or offer other natural medicine services in addition to the sale of natural medicines. Businesses will need to consider whether structures should combine or segregate the healing center services from the business of cultivating and/or selling natural medicines.

Separating lines of businesses will require more than establishing separate legal entities. To carve out activities from Section 280E, a business will need to demonstrate distinct profit motives and establish separate organizational and economic activities to show the separate entities are not a unified business enterprise.

If Subject to Section 280E, Plan for It

While it may seem that being first in line for a natural medicine license would reap the largest profits, many first adopters in the cannabis industry learned too late the deleterious financial results of Section 280E that caused the demise of many businesses. Because sophisticated business advisers avoided working with the marijuana industry for many of the initial years, license holders did the best they could to continue operating on very slim margins with little, if any, outside capital.

For better results, natural medicine licensees should factor Section 280E into business modeling from the beginning. Work with your accountants and advisers to consider various business structures, and realistically model cash expenses and pricing so you start off with the proper funding and investor expectations, to avoid being put out of business by unpaid tax liabilities.

Great opportunities await those who are prepared for the economic risk involved in establishing a natural medicine company and are willing to become politically involved in changing the tax laws so their business can be taxed just like any other.

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