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Tax Management Memorandum™

Cannabis Tax and Transfer Pricing

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Transfer pricing isn't just for multinationals. Cannabis enterprises doing business solely within the United States must consider the IRS's authority to reallocate transactions and the Treasury regulations governing intercompany service rules.

WHY CANNABIS TAXPAYERS SHOULD CARE ABOUT TRANSFER PRICING

Section 482[1] gives the IRS the authority to reallocate income and deductions among commonly-controlled business in order to prevent evasion of taxes or clearly reflect the income of the businesses.

Section 482 is one of most powerful weapons the IRS has as its disposal. It has had a number of significant victories recently in increasing tax liabilities for large multinational corporations, in some cases by billions of dollars. The allocation of income between controlled parties that are subject to a higher rate of tax and those that are subject to a lower rate of tax is a recurring issue in these cases, and a recurring government position is that the lower-taxed affiliate benefits from advantages that are not consistent with the so-called ''arm's-length standard.'' However, §482 applies to domestic corporations that are commonly controlled as well.[2] For an affiliated group filing a consolidated return, there is little impact to transfer pricing adjustments for intercompany transactions. But, in the cannabis industry, consolidated returns are infrequently encountered for reasons discussed below.

Taxpayers in cannabis enterprises are subject to §280E denying all deductions and credits with respect to cannabis-touching trades or businesses. As more and more states have legalized marijuana, corporate structures in the industry have changed. Because marijuana remains a controlled substance for federal purposes, many aspects of operations have to be integrated in each single state. The industry has evolved into growing, manufacturing, and distribution/retailing activities, which tend to be conducted in separate legal entities. In this evolving landscape, there are numerous intercompany transactions.

However, cost of goods sold is considered a reduction in gross income rather than a deduction, and §280E taxpayers are allowed to reduce taxable income by allocating certain inventory-related expenses to cost of goods sold. Broadly speaking, cannabis taxpayers thus have two tax goals: (1) separate activities subject to §280E from non-§280E activities, and (2) maximize allocation of expenses to cost of goods sold calculations. Some believe that filing a consolidated return puts pressure on the separation of activities into §280E and non-§280E entities, and for this §280E is cited as one reason cannabis companies generally do

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] A leading case that demonstrates this point is *Commissioner v. First Securities Bank of Utah, N.A.*, 405 U.S. 394 (1972), in which a domestic bank referred customers seeking ''credit life insurance'' to a commonly controlled domestic insurance company, which was subject to a lower rate of tax. Under the applicable banking laws, national banks were not authorized to act as insurance agents, and the court concluded that §482 did not authorize the allocation of income that could not have been legally earned by the taxpayer at issue. For this reason, the allocation of income to the higher-taxed unit was rejected. To the extent that the sale of cannabis is legal under the applicable laws of a state, we do not believe that the principle of *First Securities Bank of Utah* would foreclose the application of §482 to two controlled parties engaged in the cannabis industry.

not file consolidated returns. It is worth noting that it is unclear that this strategy is effective against an IRS challenge that the entities are economically interdependent and the entire controlled group is subject to §280E. Whether there has been a substantial effort to track the financial results of the separate entities on an arm's length basis is another critical component in defending the separation of activities. It is for this reason that cannabis clients should develop and apply transfer pricing principles to the various operating units.

As the industry has evolved, the large number of operating units within multiple states has driven a need to centralize services in a single corporate entity. The employees of this ''serviceco'' are typically responsible for important decisions on investments and operations, and their services have significant impact on the profitability of the various operating units. The main focus of this discussion is on how the various operating units compensate the serviceco for the services that it renders. We expect that the IRS will use its broad transfer pricing authority in ways that yield the most onerous result under §280E.

As a final note, as cannabis companies are increasingly engaged in foreign operations, traditional ''international'' transfer pricing considerations will become relevant. To the extent that servicecos are rendering services to foreign affiliates, the same transfer pricing logic will also apply in this context.

TRANSACTIONS SUBJECT TO TRANSFER PRICING REALLOCATION

The cost of goods sold of a cannabis taxpayer may be determined in a related party sale, because the retailer is supplied by the manufacturer, who is supplied by the grower. The cost at which these goods are transferred is subject to scrutiny under §482. Thus, the intercompany transfer price becomes the cost of goods sold to each successive purchaser. As noted above, a part of the organization of cannabis companies is frequently one or more subsidiaries rendering services (a ''serviceco'') to the operating subsidiaries. Services are subject to a separate set of rules under §482. This article will focus on the special rules for pricing intercompany services. A related issue outside the scope of this article is that transfer pricing also has consequences for state and local tax regimes using other methods to allocate income and expenses. It should also be noted that a broader range of services is subject to capitalization by cannabis-touching entities that are engaged in growing and manufacturing activities as opposed to retail activities.

If services are rendered to a §280E entity at too low a price, the IRS could employ a transfer pricing reallocation to increase the fees paid for the services. If the service fees cannot be capitalized by the payor, there will be an increased disallowed deduction matched by increased taxable income to the recipient.

Conversely, if services are rendered to a §280E entity at too high a price, the IRS could employ transfer pricing analysis to assert that the service provider is actually profiting from trafficking in cannabis and is therefore subject to §280E disallowance of deductions.

INTERCOMPANY SERVICE RULES

Turning now to the regulations that govern intercompany services, Reg. §1.482-9(l) is a good starting point because it defines what constitutes a ''controlled services transaction.'' This term:

> includes any activity . . . by one member of a group of controlled taxpayers (the renderer) that results in a benefit . . . to one of more members of the controlled group (the recipient(s)).
>
> An activity:
>
> Includes the performance of functions, assumptions of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances.
>
> A benefit exists if:
>
> The activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so. An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same activity on either a fixed or contingent payment basis, or if the recipient would otherwise have performed for itself the same activity or a similar activity.

It is not a complex series of questions that needs to be considered. Is there an intercompany activity? Is the activity beneficial to the service recipient? How much would a third-party have paid to get that benefit? Stated differently, what exactly does the management in the serviceco do, and does management possess knowledge that could be sold?

Happily, there are some straightforward answers to these questions. The industry is one that involves very significant and non-obvious risks, and these risks may

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vary from state to state, each state being a separate and unique market. Figuring out what to do and what to not do in the face of a changing business environment is clearly beneficial to a service recipient, and given the risk of a business failure, an arm's-length service provider with an established record could command significant fees.

The drafters have also steered the discussion to knowledge, particularly ''knowledge of and ability to take advantage of particularly advantageous situations or circumstances'' under, Reg. §1.482-9(l)(1). The legalization of cannabis by a state is, it would be argued, a ''particularly advantageous situation'' because a legal market that never previously existed is created at the stroke of a pen, and knowing how to take advantage of this opportunity fits squarely within the definition of an activity.

TRANSFER PRICING METHODS

Following on from those basic definitional provisions is the list of acceptable methods. Practice in the area consists to a great extent of choosing the method that yields the optimal result (which in the present case is the one that optimizes capitalized costs) and defending why it is the right choice, in the case of preferred methods, or why it is the wrong choice, in the case of the not-preferred. The list of possibilities is as follows:[3]

> **(1)** The services cost method, described in paragraph (b) of this section;
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> **(2)** The comparable uncontrolled services price method, described in paragraph (c) of this section;
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> **(3)** The gross services margin method, described in paragraph (d) of this section;
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> **(4)** The cost of services plus method, described in paragraph (e) of this section;
>
> **(5)** The comparable profits method, described in Section §1.482-5 and in paragraph (f) of this section;
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> **(6)** The profit split method, described in Section §1.482-6 and in paragraph (g) of this section; and
>
> **(7)** Unspecified methods, described in paragraph (h) of this section.

Services Cost Method

From a ''280E optimization'' perspective, the recovery of costs of the service provider is directionally positive to the extent that it converts potentially disallowed deductions into capitalized costs that are beyond the scope of disallowance. But given the focus on knowledge and advantageous circumstances, it would be better to see that the capitalization was capturing the premium value of the services rendered. In this regard, the services cost method does not capture any premium value.

Fortunately, Reg. §1.482-9(b) limits the availability of services cost method to ''covered services.'' The rule of Reg. §1.482-9(b)(5) makes it clear that a service cannot constitute a ''covered service'' if it involves ''key competitive advantages, core capabilities, or fundamental risks of success or failure in one of more trades or business of the controlled group.''

The notion that serviceco management possesses special knowledge about an industry runs squarely into this rule of exclusion, so it follows that this method is not a correct method.

Comparable Uncontrolled Services Price Method

Because the cannabis industry is not widely served by established management consulting firms, there is not a great deal to draw on in terms of comparable uncontrolled transactions. This may evolve as time goes by, but at present the lack of data seems to present an insurmountable challenge to the application of this method.

In terms of §280E optimization, comparable market transactions covering the same services are obviously the best indicator of value. But until the market value is more clearly established, this method is theoretically sound, but not really administrable in practice.

Gross Services Margin Method

As the drafters note at Reg. §1.482-9(d), ''this method ordinarily is used in cases where a controlled taxpayer performs services or functions in connection with an uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer.'' For a vertically integrated cannabis corporation, the only uncontrolled sales are typically at the consumer level. In the world of §280E, one would want to create as much space as possible between the management consultant and a specific retail sale as possible. As the examples reveal, this method fits particularly well in a commission agent context.

The serviceco in our fact pattern is emphatically not involved in selling the products.

Cost of Services Plus Method

From a practical perspective, the cost plus method rules the world. Adding a 10% to 20% premium to the

[3] Reg. §1.482-9(a)(1)-§1.482-9(a)(7).

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cost of service is as simple a solution as one could hope for. In many cases, a 10%–20% mark-up on the cost of services does capture significant value. But the key question remains as to whether a greater rate of return is warranted based on the value of the particular services in question.

Reg. §1.482-9(e)(1) provides that the method ''is ordinarily used in cases where the controlled service renderer provides the same or similar services to both controlled and uncontrolled parties.'' This leads to the question of which serviceco in the industry provides services to any uncontrolled party, and in cannabis, they are not great in number.

That regulation, Reg. §1.482-9(e)(1), continues to note that the method ''is ordinarily not used in cases where the controlled services transaction involves a contingent-payment arrangement.'' For those who think that cost plus is not capturing the true premium value of the services rendered by the serviceco, having some contingent consideration for the services would seem like a prudent choice.

Comparable Profits Method

This is the first item on the list that takes the reader out of the services regulations, back to the generally applicable methods.[4] (This is probably where the cannabis industry wants to be because the method is looking to ''objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.'' Although there are bound to be a number of points to debate, high-end consulting firms generate high rates of return, and choosing which high-end consulting firm one is most like is the kind of conversation that is likely to yield the optimal result.

Profit Split Method

Here again we are taken back to other generally applicable methods, in this case Reg. §1.482-6. This method involves the allocation of income to ''routine contributions'' of the controlled parties and then allocates the residual profits based on their respective ''nonroutine contributions.'' While we do not rule out the possibility that this method could apply in the cannabis industry, it depends on the value of the intangible property provided, for example, brand licensing and proprietary production methods. It therefore may be that analogizing the serviceco to various high-end consulting firms seems like a more productive path.

Unspecified Methods

These are not regularly encountered in practice. Given the relative novelty of the cannabis industry in the economy, it would probably not be wise to pursue relatively novel methods of transfer pricing. Thus, we think that the better choice would be stick to an analogy that is readily understood, like high end consulting, and seek to breathe life into the analogy.

CONCLUSION

We believe that there is a strong case to be made that the services rendered by the serviceco in the typical cannabis firm are analogous to the services rendered by high-end consulting firms. Moreover, we believe that, in certain circumstances, a strong case can be made that the cost of consulting services should be a capitalized cost to the person bearing the expense. If both of these things are true, there is a significant opportunity for controlled groups to mitigate the adverse impact of §280E disallowance through a careful analysis of the way in which intercompany services are transfer priced.

[4] Reg. §1.482-5.

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