Issues for Companies in the Cannabis and Hemp Industry to Consider When Sponsoring Qualified Retirement Plans

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An Article discussing how cannabis and hemp companies can legally sponsor, and employees of cannabis and hemp companies can participate in, qualified retirement plans.

There are approximately 300,000 employees in the legal cannabis industry. The Internal Revenue Code (Code) and the Employee Retirement Income Security Act of 1974 (ERISA) generally permit employees of cannabis and hemp companies to participate in, qualified retirement plans (similar to employees of non-cannabis and non-hemp companies). While many cannabis and hemp companies want to provide their employees with retirement benefits (such as access to a 401(k) plan), it is the retirement industry service providers who have been reluctant. Almost all types of service providers are afraid to help these companies establish 401(k) and other deferred compensation plans, including: financial advisors; broker dealers; third party administrators; record keepers; and custodians.

This Article discusses how cannabis and hemp companies can legally sponsor, and employees of those companies can legally participate in, qualified retirement plans, including:

- The current state of the law, including the Controlled Substances Act (CSA) and the Agricultural Improvement Act of 2018 (the 2018 Farm Bill).
- Whether cannabis and hemp companies can sponsor a 401(k) plan.
- Whether cannabis and hemp companies can participate in a 401(k) plan under the controlled group rules.
- Whether cannabis and hemp companies can participate in a multiple employer plan (MEP).
- Service provider issues for cannabis and hemp companies.

LEGALITY OF CANNABIS AND HEMP PRODUCTS

The main obstacle to implementing a retirement plan for companies in the cannabis and hemp industry is the retirement plan service providers' nervousness about dealing with a drug trafficker. At the federal level, the two main laws that regulate the cannabis industry are:

- The CSA (see Controlled Substances Act).
- The 2018 Farm Bill. (see 2018 Farm Bill).

CONTROLLED SUBSTANCES ACT

The CSA considers cannabis and derivative products with a THC concentration over 0.3 percent a Schedule I substance at the federal level. This means that cannabis and cannabis products exceeding this threshold are illegal to grow, possess, or sell. This includes medical marijuana.

There is a conflict between federal classification under the CSA, which criminalizes all marijuana-related activities, and state marijuana laws, some of which:

- Recognize and protect the cultivation, sale, possession, and use of medical marijuana.
- Have legalized marijuana for recreational purposes for people 21 and older.
- Have decriminalized the cultivation, possession, and sale of marijuana.

Marijuana's status as a Schedule I substance at the federal level has significant ramifications for cannabis policy at the state level.

2018 FARM BILL

The 2018 Farm Bill makes hemp legal to grow, possess, and sell if it does not exceed a maximum threshold of 0.3 percent THC. The bill essentially alters the definition of marijuana to exclude the cannabis plant's buds, leaves, and germinating seeds (and products extracted from them, such as CBD) if their THC content falls below a threshold of 0.3 percent (see Practice Note, CBD: Overview (W-019-9686)). These products are now termed hemp or industrial hemp.

Hemp, as newly defined, has come off Schedule I of the CSA, making it an ordinary agricultural commodity, while cannabis remains on Schedule I.

401(K) PLANS FOR HEMP COMPANIES

In removing hemp from the CSA, the 2018 Farm Bill makes it possible for a hemp company to sponsor a 401(k) plan under the Code or ERISA. Because hemp companies are no longer committing the

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federal crime of trafficking, they may take normal business deductions and are generally treated like any other company by retirement plan service providers.

FEDERAL TAX TREATMENT OF EXPENSES RELATED TO CANNABIS

The 16th Amendment to the Constitution gives sweeping authority for Congress to tax all income from whatever source derived, including income from illegal activities (26 U.S.C § 61(a) and *James v. United States*, 366 U.S. 213 (1961)). Even if income is derived from an illegal product or activity (for example, cannabis), Congress has the authority to tax it.

BUSINESS EXPENSES

A typical business deducts ordinary and necessary expenses it pays or incurs during a taxable year in carrying on a trade or business. Code Section 280E (26 U.S.C. § 280E) (Section 280E) forbids businesses that traffic Schedule I or II substances (as defined by the CSA) from deducting otherwise ordinary business expenses from gross income.

Because cannabis is on Schedule I of the CSA, companies that traffic cannabis cannot deduct the associated ordinary business expenses from gross income under 280E.

While 280E restricts cannabis companies from the same deductions that non-cannabis businesses take, cannabis companies may take a cost of goods sold (COGS) adjustment, which allows subtraction of the COGS from gross income (the subtraction from gross income lowers the resulting income subject to income tax).

The authority for this deduction can be found in:

- Treas. Reg. Section 1.61-3(a), which defines gross income as total sales less COGS. The Tax Court has previously held that COGS is an adjustment to gross income and not a deduction (*Rodriguez v. Comm'r*, 97 T.C.M. (CCH) 1090 (2009)).
- IRS Chief Counsel Advisory 201504011 (Jan 23, 2015) (CCA 201504011), which clarified that although a cannabis company cannot claim deductions for trafficking marijuana, it may take a COGS adjustment for indirect production-related business expenses (production-related business expenses). Non-tax practitioners consider the COGS adjustment as giving a similar effect as a tax deduction and sometimes refer to a cannabis producer's right to a COGS adjustment as a "deduction".

  Because the IRS distinguishes between a cannabis producer and a cannabis reseller, companies should consult CCA 201504011 for proper COGS treatment.

While outside the scope of this Article, cannabis taxpayers should work with accountants who are experts in absorption accounting required by 280E, so that they allocate the largest allowable amount under the law to COGS.

DEDUCTION FOR RETIREMENT PLAN COSTS

Code Section 263A (26 U.S.C. § 263A) determines how a taxpayer may take deductions when that taxpayer produces inventory. The taxpayer must determine whether the item is indirectly attributable to its inventory and whether (and how) it must be capitalized. Treas. Reg. Section 1.263A-1(e)(3)(ii) provides examples of indirect costs that must be capitalized. These examples include:

- Indirect labor costs.
- Officers' compensation.
- Pension and other related costs.
- Employee benefit expenses.

Treas. Reg. Section 1.263A-1(e)(3)(ii)(C) provides that pension and other related costs include contributions paid to or made under any stock bonus, pension, profit-sharing, or annuity plan or other plan deferring the receipt of compensation whether the plan qualifies under Code Section 401(a) (26 U.S.C. § 401(a)) or not.

While a detailed discussion of these rules is outside of the scope of this Article, Code Section 263A and its underlying Treasury Regulation therefore provide the authority for a cannabis company to deduct production-related expenses and pension costs (including employee deferral and employer matching contributions related to a 401(k) plan) when it has inventory that is deemed to be sold.

(See Business Expenses and Practice Note, Contributions to a Defined Contribution Plan: Overview (0-608-6785).)

401(K) PLANS FOR CANNABIS COMPANIES

Even though there is authority for cannabis companies to establish 401(k) plans, retirement plan industry service providers are blocking them. Many service providers have taken a business stance that they will not work with these companies due to the stigma attached to drug trafficking.

There is no prohibition under the Code for a cannabis or hemp company in sponsoring a 401(k) plan. Service providers should not have concern in allowing a hemp company to sponsor a 401(k) plan with the passage of the 2018 Farm Bill.

There are two additional ways that service providers can offer 401(k) plans legally to cannabis companies under:

- The controlled group and affiliated service group rules (see Cannabis and Hemp Companies Participating in a 401(k) Plan Under the Controlled Group Rules).
- MEP rules (see Multiple Employer Retirement Plans).

CANNABIS COMPANIES PARTICIPATING IN A 401(K) PLAN UNDER THE CONTROLLED GROUP RULES

If a service provider understands that hemp is no longer federally illegal and allows a hemp company to sponsor and adopt a 401(k) plan, then the controlled group and affiliated service group rules under the Code permit (and can require) employees of a cannabis company to participate in that hemp company's 401(k) plan.

The controlled group rules identify when two or more corporations and certain other groups of related trades or businesses are treated as if they are one employer under ERISA and the Code. When the sponsor of a qualified retirement plan is a member of a controlled group, all employers of the group must be treated as a single employer to determine if the plan satisfies the requirements of the Code.

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For each plan sponsored by a controlled group member, the plan qualification requirements must be satisfied for all employees and the plans of all members of the controlled group (see Practice Note, Controlled Group and Affiliated Service Group Rules (3-522-4866)). Included in these rules are nondiscrimination tests, including tests to determine if enough employees are allowed to participate in the 401(k) plan. In a controlled group, the tests extend to all employees across the entire controlled group of companies that are deemed the single employer.

For a hemp company that sponsors a 401(k) plan and that has a cannabis company in its controlled group, this means that the Code likely requires that the cannabis company employees participate in the hemp company's existing 401(k) plan.

Controlled Group Example for Cannabis and Hemp Companies

A hypothetical example can demonstrate the effects of a controlled group for a hemp and cannabis company. For example, assume that:

- There is a Canadian parent company called CanadaParent with two wholly owned US subsidiaries called HempCo and CannabisCo.
- HempCo and CannabisCo are part of the same controlled group under the Code and are brother-sister corporations.
- HempCo sponsors its own HempCo 401(k) plan and fails the annual coverage test under Code Section 410(b) (see Practice Note, Requirements for Qualified Retirement Plans: Coverage Requirements (3-506-6895)).

Under the controlled group rules, CannabisCo and HempCo are deemed to be a single employer and the Code likely requires that CannabisCo's employees participate in HempCo's 401(k) plan. If CannabisCo's employees are not allowed to participate (and do not participate in their own nondiscriminatory 401(k) plan), then HempCo violates many provisions of ERISA and the Code. Under these rules, CannabisCo's employees likely participate in the HempCo 401(k) plan to ensure that the HempCo 401(k) plan passes nondiscrimination testing.

If the CannabisCo employees are not allowed to participate in the HempCo plan, and the HempCo plan fails nondiscrimination testing, the IRS could deny otherwise legitimate tax benefits to HempCo, including:

- Disallowing deductions on the corporate tax return of HempCo.
- Requiring income tax on the amount of HempCo employee deferrals to the HempCo 401(k) plan.
- Disallowing the tax deferred growth on the earnings of accounts of HempCo 401(k) plan participants.
- Prohibiting HempCo 401(k) participants from rolling over their money in a tax-free distribution.

Similar organizational structures in other industries could be of concern for nondiscrimination testing purposes, including a non-cannabis company sponsoring a 401(k) plan that owns a significant percentage or has enough common ownership in the stock of a cannabis company (that does not have its own 401(k) plan). This scenario also would likely violate the nondiscrimination rules.

Fiduciary Duties

The violation of the controlled group rules may also be a fiduciary breach under ERISA. Under ERISA, fiduciaries must act according to applicable plan documents if the documents are consistent with ERISA (29 U.S.C. § 1104(a)(1)(D)). This means that fiduciaries must follow the terms of the plan documents and review the plan documents to determine that they comply with ERISA. (See Practice Note, ERISA Fiduciary Duties: Overview (5-504-0060).)

The failure to permit CannabisCo employees to participate in the HempCo 401(k) plan could be a fiduciary breach and improper administration of the 401(k) plan document.

MULTIPLE EMPLOYER RETIREMENT PLANS

A MEP is a qualified plan that is:

- Not maintained under a CBA.
- Maintained by two or more employers that are not members of the same controlled group, trade or businesses under common control, or members of the same affiliated service group.

A MEP can be considered a single plan under the Code and ERISA, thereby reducing the administrative burdens and fiduciary risk involved when an employer sponsors its own plan. Participation in a MEP is often attractive to small employers.

MEPs have received attention following a 2018 directive from the Trump administration to increase small-employer access to MEPs. The DOL responded with final regulations clarifying the definition of employer for defined contribution MEPs.

In December 2019, the SECURE Act became law and makes significant changes to MEPs by amending ERISA to allow unrelated employers to participate in a MEP called a "pooled employer plan" that meets certain requirements (see Pooled Employer Plans Under SECURE Act).

For more information on MEPs, see Practice Note, Multiple Employer Retirement Plans (MEPs) (W-021-7154).

Pooled Employer Plans Under SECURE Act

Under existing law, the group sponsoring a MEP must have a particularly close economic or representational nexus to the employers and employees participating in the plan to be considered a single plan.

The SECURE Act provides that a MEP that meets the requirements of a "pooled employer plan" is treated as a single plan, even though the employers have no connection other than participating in the plan (effective for plan years beginning after December 31, 2020) (Pub. L. No. 116-91, Division O, Section 101(b) (amending ERISA § 3(2)).

This is important because before the SECURE Act the members of a cannabis and hemp trade association had to have a similar geographic proximity or commonality of trade (which they do). Effective for plan years beginning after December 31, 2020, that is not the case.

(See Practice Note, Multiple Employer Retirement Plans (MEPs): Pooled Employer Plans Under SECURE Act (W-021-7154).)

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Multiple Employer Retirement Plans and Cannabis and Hemp Companies

While the DOL has not specifically commented regarding MEPs for cannabis companies, the MEP model has existed for many years. For example, MEPs exist for other industries, including:

- Wine growers.
- Real estate agents.
- Restaurant owners.

(See Practice Note, Multiple Employer Retirement Plans (MEPs) (W-021-7154).)

Under the MEP rules, an association of cannabis companies would be permitted to sponsor a 401(k) plan. For cannabis companies, this would be set up as follows:

- The entity that sponsors the plan likely is an entity, such as an association, that represents companies in the same trade of cannabis and cannabis-derived products. For example, the Cannabis Growers of America may sponsor the Cannabis Growers of America 401(k) Plan.
- The members of the association likely would be permitted to adopt the association's 401(k) plan. For example, with service providers refusing to allow their independent sponsorship of a 401(k) plan, CannabisCo and HempCo could each adopt into the Cannabis Growers of America 401(k) plan.

Under this example, the sponsor of the plan therefore is not a cannabis or hemp company, but rather a non-profit trade association that is not in the business itself of cannabis or hemp. This may be important to service providers who have previously not been comfortable in providing plan services to cannabis or hemp companies.

SERVICE PROVIDER ISSUES

Many hemp and cannabis companies are currently receiving pushback from service providers (and some cannabis companies themselves are skeptical) when trying to set up 401(k) plans. Even after hearing a sound legal analysis, service providers still may not be comfortable with offering hemp and cannabis companies a 401(k) plan, and they are still determining their tolerance for offering services to these customers.

Enforcement policies of the Department of Justice (DOJ) appear to support the conclusion that cannabis companies can sponsor a 401(k) plan, including:

- The DOJ yielding to states that have legalized cannabis as none of the 50 prosecutions by the DOJ from 2018 and 2020 to date involved any companies that were compliant with their state laws regarding cannabis.
- That as long as companies can demonstrate that they conform to their state's laws regarding legalization and that they do not present any of the eight federal concerns in a 2013 memo from Deputy Attorney General James Cole (Cole Memo), then DOJ will not pursue prosecution against these "drug traffickers" and their service providers.
- That the current Attorney General William Barr has appeared to endorse the Cole Memo. When he was asked about the federal government's role in enforcing drug trafficking laws in states that have legalized cannabis, he has noted that he favored removing the federal government interfering with states determining their own cannabis policies (rather than encouraging a conflict between federal and state laws).

  Barr's comments reflect an easing enforcement position with the "drug traffickers" who are legal under state laws (this seems consistent with the Trump Administration's view on cannabis, given its legalization of hemp under the Farm Bill).

Recent pushback from service providers includes concern regarding:

- Questioning the existence of legal authority. Service providers question how a 401(k) plan can be set up for a cannabis company under federal law (the Code and ERISA) when cannabis is not legal under other federal laws (like the Controlled Substances Act). Service providers find difficulty in accepting that under IRS and DOL rules, the law already allows 401(k) plans for cannabis companies.

  There is no type of specific ruling that any company needs to obtain to participate in a 401(k) plan. This is the case even for cannabis companies.
- Regulation from the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission (SEC). Review of FINRA and SEC investigations indicate concern over proper disclosures for individuals investing in marijuana businesses, not whether a marijuana business can sponsor a 401(k) plan under ERISA and tax laws.
- Reputation. Many service providers are making a business decision based on public perception and their risk tolerance that they do not want to provide services to the cannabis industry.
- Public acceptance. Some service providers are dipping their toes in the water and others are waiting on the sidelines to determine the public's acceptance of cannabis and hemp companies. This is similar to service providers working with tobacco companies.
- Not wanting to be the first service provider offering services to a cannabis company. Many service providers do not want to be the first service provider to provide retirement plan services to cannabis companies. Most prefer to take a "wait and see" approach to determine if the companies and their activities become more widely accepted by the general public.

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