Cashing in on Cannabis
Current Issues in Financing, Operations, Banking, and Regulations in the Cannabis Industry, and a Comparative Analysis of the U.S. and Canadian Landscapes

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Materials Summary Abstract

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The laws impacting cannabis and marijuana-related businesses have been an evolving landscape in both the U.S. and Canada. There are also a number of inconsistencies between U.S. Federal and State laws that make it increasingly difficult for stakeholders in the cannabis business to determine what is legal. 29 states plus the District of Columbia have legalized marijuana for medical purposes, six states have legalized marijuana for recreational use and Maine and Massachusetts have approved legalization measures that have not yet taken effect.

Under the Controlled Substances Act (the “CSA”), federal Law prohibits the manufacture, possession, or use of marijuana for any purpose, including medical purposes. The Money Laundering Control Act also prohibits knowingly conducting a financial transaction that involves the proceeds of unlawful activity, which includes violations of narcotics laws. However, there is an exclusion from violation of the CSA where the underlying activity is not an offense in the foreign country.

The landscape in the U.S. has changed very recently with the passage of the Agriculture Improvement Act of 2018 (also called the Farm Bill). The Farm Bill makes “industrial hemp” exempt from the Controlled Substances Action, which is the law prohibiting the manufacture, distribution and dispensing of marijuana for any purpose even in states where recreational or medical marijuana sales are legal. The Farm Bill also allows for interstate sales of hemp products. There are also efforts in certain states, namely Oregon, to allow Oregon-grown cannabis to be sold across state lines. Because of this confusing and contradictory environment in the U.S., there are genuine issues around whether marijuana-related businesses can access services of financial institutions such as obtaining loans, opening bank accounts, accepting credit and debit cards and using electronic payroll services.
In contrast, Canada became the first major world economy to legalize recreational marijuana in October, 2018. The Cannabis Act and accompanying regulation establish a licensing regime governing cultivation, processing, testing, drug products and research. There are strict rules governing operations of cannabis businesses. Each province in Canada creates their own regulatory regime around cannabis. Certain provinces permit privately owned stores and online sales (Saskatchewan and Manitoba), some permit privately owned stores with publicly managed online sales (Alberta, Ontario), others allow both private and publicly owned stores (British Columbia, Newfoundland, Yukon and Nunavut) and the largest subset permits only publicly owned stores (Quebec, New Brunswick, Nova Scotia, Prince Edward Island and Northwest Territories).

Financial institutions in the U.S. are grappling to obtain a clear understanding of what activities they may undertake vis-à-vis marijuana-related businesses. The central question is, what kind of activity by a financial institution would constitute a violation of the CSA and the Money Laundering Control Act? Based on the exclusion from the CSA discussed above, many financial institutions have been able to get comfortable with providing financial services to a marijuana-related company located a jurisdiction where marijuana is legal where their operations are solely in that country. There are also questions without clear answers around what types of products and services a financial institution can provide a company that derives revenue from a marijuana-related business and how far down the chain of suppliers to and service companies for marijuana-related businesses also may be prohibited from dealing with financial institutions. For example, will a financial institution bank a state or municipality that derives revenue from marijuana-related businesses? Or an accountant who does taxes of a marijuana-related businesses. Even where it is permissible, financial institutions often must also deal with certain ethical or reputational risk issues given the U.S. Federal law prohibition and the prohibition under laws around the world.

Businesses in the U.S. and Canada have very varied experiences in starting up and operating marijuana-related business, however, generally there are far less rules and regulations on marijuana-related businesses in Canada. The barriers for marijuana-related business in the U.S. range from obtaining bank loans and other investments to start their business, whether they may lease property and whether, in what ways they are able to bank their business and how the tax laws impact their business. State-legal marijuana-related businesses are generally denied access to most banks and financial institutions and this will continue unless there is a change in U.S. law. Additionally, Section 280E of the IRC prohibits a deduction from taxes for amounts paid in carrying on a business that constitutes trafficking in a controlled business. However, if such taxpayer is engaged in another trade or business is not subject to Section 280E.
Companies in Canada are certainly accessing the financial markets. Canopy Growth Corporation, the world’s largest legal cannabis company by market share and also publicly traded on the New York Stock Exchange, recently closed the second syndicated financing of a cannabis company. Cannabis businesses have grown at record speed as an industry in Canada – Canopy Growth Corporation grew from 700 to 2,700 employees in less than a year. Canopy Growth Corporation also exports overseas and recently obtained a license to produce hemp in New York State so they are certainly moving toward international operations.
Cashing in on Cannabis:

CURRENT ISSUES IN FINANCING, OPERATIONS, BANKING, AND REGULATIONS IN THE CANNABIS INDUSTRY, AND A COMPARATIVE ANALYSIS OF THE U.S. AND CANADIAN LANDSCAPES

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U.S. Laws Relevant to Cannabis Businesses

Sharon Cohen Levin, WilmerHale
Overview of the U.S. Legal Regime

- Forty-six states and the District of Columbia have legalized some form of medical marijuana.
- Ten states and the District of Columbia have legalized both medical and recreational use of marijuana.
- However, the manufacture, distribution, and dispensing of marijuana for any purpose continues to be a violation of the federal Controlled Substances Act, 21 U.S.C. § 801 et seq., (“CSA”), even in states where recreational or medical marijuana sales are legal.
State Laws
More than 20% of Americans live in a State where it is legal to use marijuana for recreational purposes.
Marijuana – Current Landscape: State Law

• Beginning in 2008, states began to legalize the cultivation, distribution and use of marijuana for medical purposes.
• In December 2012, Washington became the first state to legalize the cultivation, distribution and use of marijuana for recreational purposes.
• Today, this is the status of state law relating to marijuana:
  ➢ **Recreational** - 10 States (and 1 jurisdiction) have legalized the cultivation, distribution and use of marijuana for recreational purposes: Alaska, California, Colorado, Maine, Massachusetts, Michigan, Nevada, Oregon, Vermont and Washington. The District of Columbia has legalized the use for recreational purposes, but not the cultivation or sale of marijuana.
Marijuana – Current Landscape: State Law (cont.)

- **Limited Medical** - 13 States permit limited medical use of marijuana: Alabama, Georgia, Indiana, Iowa, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee, Texas, Virginia, Wisconsin, and Wyoming.

- **Prohibited** - 4 States do not permit any use of marijuana: Idaho, Kansas, Nebraska, and South Dakota.
Federal Law
The Controlled Substances Act

- Marijuana-Related businesses that “manufacture, distribute, dispense, or possess with intent to manufacture, distribute or dispense” marijuana violate the CSA, 21 U.S.C. § 841(a)(1)
The Controlled Substances Act

- The CSA also criminalizes a conspiracy to violate the U.S. narcotics laws.
- U.S. law also criminalizes aiding and abetting a violation of the CSA. To commit a violation of the aiding and abetting statute a defendant must actively participate in a criminal venture with full knowledge of the circumstances of the charged offense.
- The CSA generally only applies domestically – unless there is an intent to distribute the controlled substance in the U.S.
The Money Laundering Control Act

- **18 U.S.C. § 1956(a)(1)** – it is a crime to knowingly conduct a financial transaction that involves the proceeds of a specified unlawful activity (“SUA”) with one of the four specific intents, including:
  - Intent to promote a SUA
  - Intent to engage in tax evasion or tax fraud
  - Intent to conceal or disguise the nature, location, source, ownership or control of the proceeds of a SUA
  - Intent to avoid transaction reporting requirements

- **18 U.S.C. § 1956(a)(2)(A)** – crime to transport, transmit, or transfer internationally funds for the purpose of promoting the SUA.

- **18 U.S.C. § 1957** – crime to knowingly conduct a monetary transaction with proceeds of a SUA in an amount greater than $10,000.
The Money Laundering Control Act

- SUA includes more than 200 state and federal offenses.
- There are three broad categories of narcotics-related offenses that constitute SUAs:
  - Violations of the CSA
  - Violations of state narcotics law (if a controlled substance under the CSA)
  - Foreign narcotics offenses
- **Foreign Narcotics Offenses** – Must be a criminal offense in the foreign country. No violation of the money laundering laws where the marijuana-related business (“MRB”) operates entirely outside the U.S. – unless there is an intent to import/export or distribute marijuana in the U.S.
The Money Laundering Control Act

- **Knowledge** – the government must show that the defendant has knowledge that the funds were derived from unlawful activity.
- **Knowledge includes willful blindness** – turning a blind eye or deliberately avoiding confirming a high probability of wrongdoing and who can almost be said to have actually known the critical facts.
The Money Laundering Control Act

- **Intent to Promote** – undertaking a financial transaction for the purpose of facilitating, helping to bring about, or contributing to the continued prosperity of the SUA.

- Mere evidence of promotion is not enough. Courts have found intent to promote where a defendant is actively involved in the underlying crime and the monetary transaction was executed for the purpose of enabling further activity.
Asset Forfeiture Laws

- Federal Asset Forfeiture laws authorize the government to seek civil or criminal forfeiture of proceeds of narcotics trafficking, property that facilitates narcotics trafficking, and/or property involved in money laundering.
- 21 U.S.C. §§ 853, 881 – funds that are proceeds of violations of the U.S. narcotics laws or property that facilitates narcotics trafficking can be subject to civil and/or criminal forfeiture.
- 18 U.S.C. §§ 981, 982 – the funds involved in the money laundering transactions or traceable to them can be subject to civil and/or criminal forfeiture.
Asset Forfeiture Laws

• How to defend against a civil forfeiture?

- A financial institution or financial business would have to establish that it was an “innocent owner,” *i.e.*, that it engaged in the transaction without knowledge of the illegal conduct or, upon learning of the illegal conduct, that it did all that could be reasonably expected under the circumstances to terminate the illegal use of the property.

- A reasonable risk-based AML program can help establish innocent ownership – even if the activity occurred despite the controls of the program.
Canadian Laws Relevant to Cannabis Businesses

A. Chandimal Nicholas
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Chuck Rich
Cannabis Act [Federal legislation]

Cannabis Act legalizes cannabis in Canada
Allows adults to purchase dried or fresh cannabis and cannabis oils from retailers with provincial licenses
Allows possession up to 30 grams
Allows growth of up to four cannabis plants
Edibles are not yet legal on a commercial scale (ETA Oct 2019) but individuals may make edible products at home without using organic solvents.
Each province and territory of Canada has the ability to:

- Increase the minimum age to greater than 18
- Lower the possession limit
- Further regulate home growing
- Restrict areas of use

Each province and territory of Canada also regulates the retail sale of cannabis.
Federal Regulations

Cannabis Act and Regulations establishes licensing regime

- Cultivation (Standard, micro-cultivation, industrial hemp and nursery)
- Processing (standard and micro processing)
- Testing
- Drug Products
- Research
Restrictions

Licensees must comply with numerous regulations
Strict rules for the buildings used for operation both for
controlling environment and security
Key employees required (Responsible Person in Charge,
Quality Assurance Person, Head of Security and a Master
Grower if one has a cultivation licence)
Security checks for key employees and individuals who
exert control over licensee (including officers and directors
of corporation that is the licensee and corporation that is a
parent to the licensee, if applicable)
Strict packaging, labelling, marketing and promotional rules
Packaging and Promotion Restrictions

Cannabis shall not be promoted or sold in packages or labels that:

- give reasonable grounds to believe they could be appealing to **young people** (sections 17(1)(b), 26(a), and 27(1)(a))
- contain a “**testimonial or endorsement**” or that depicts a person, character or animal, whether real or fictional (sections 17(1)(c) and (d), 26(c), and 27(c))
- are associated with “a way of life” including **glamour**, **recreation**, excitement, vitality and risk (sections 17(1)(e), 26(d), and 27(d))

Promotion through sponsorship of events or buildings is prohibited. Placing a brand element on a non-cannabis article (i.e. swag) for promotion is permitted but only if it is not appealing to young people or is not associated with a “way of life”
Provinces create their own regulatory regime

Includes:

- Privately owned stores and online sales – Saskatchewan and Manitoba
- Privately owned stores with publically managed online sales – Alberta, Ontario
- Both private and publically owned stores – British Columbia, Newfoundland, Yukon and Nunavut
- Publically owned stores – Quebec, New Brunswick, Nova Scotia, Prince Edward Island and Northwest Territories

Each province and territory has rolled out sales on varying timelines
Canadian Laws Relevant to Cannabis Businesses

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Starting a Cannabis Business
Financing for and Investment in Cannabis Businesses
Operating a Cannabis Business, including regulatory issues impacting cannabis businesses
Ethical Issues
QUESTIONS?
Developments in the Marijuana Industry and the Implications for Financial Institutions

The myriad—and conflicting—state, federal and international laws governing the burgeoning marijuana industry have created a complicated legal landscape for financial institutions. In the United States, most states have legalized some form of marijuana use, but the manufacture, sale and distribution of marijuana nevertheless remains illegal under federal law. As a result, in providing financial products and services to US marijuana-related businesses (MRBs), a financial institution could risk violating the Controlled Substances Act (CSA), 21 U.S.C. § 841. Moreover, engaging in or facilitating transactions that contain proceeds from US marijuana sales could create liability under the money laundering laws.

Further complicating matters, Canada became the first major world economy to legalize recreational marijuana in October 2018. Because the US narcotics laws generally do not apply to activity that is legal abroad, providing financial products and services to Canadian MRBs would not violate the CSA or implicate the US money laundering laws. However, that is not the case in many European countries. The European Union recently passed a law expanding the extraterritorial scope of member countries’ money laundering laws with respect to certain narcotics-related offenses. These laws could now criminalize the transfer of funds from activity that is legal in the foreign country (e.g., marijuana sales in Canada) if that activity would be illegal in the home country.

Below we discuss the fragmented legal and regulatory landscape governing the marijuana industry as well as notable recent developments and their implications for global financial institutions.

The US Narcotics Laws

In the United States, 46 states have legalized marijuana for medical and/or recreational use in some form. Medical marijuana is used to control seizures, ease glaucoma and combat the loss of appetite caused by chemotherapy, among other treatments. Notwithstanding these developments, the manufacture, sale and distribution of marijuana for any purpose continues to be a violation of the CSA even in states that have legalized its use at the state level. As a result, businesses that manufacture, sell or distribute marijuana in the United States are generally operating in violation of federal law.

The federal government, however, has issued directives that create uncertainty regarding the likelihood of marijuana-related prosecutions. Department of Justice (DOJ) officials in the Obama Administration had issued several memoranda, known as the “Cole memoranda,” deprioritizing federal criminal prosecutions involving state-regulated marijuana businesses based
on a set of eight priority factors. On January 4, 2018, former Attorney General Jefferson Sessions rescinded that guidance and instructed federal prosecutors to determine “which marijuana activities to prosecute” based on the “well-established principles that govern all federal prosecutions.” Practically, this means that federal marijuana enforcement priorities will be determined by individual United States Attorneys’ Offices. Although Attorney General Sessions’ memorandum did not alter the status of marijuana under federal law—marijuana commerce remained illegal even after the Cole memoranda were issued—the rescission of the Cole memoranda increased the risk of prosecution for marijuana-related commerce. Attorney General nominee William Barr has not yet decided whether he would formally reinstate the Cole memoranda if he is confirmed, but he has announced that he “do[es] not intend to go after parties who have complied with state law in reliance on the Cole memorandum.” The risk of prosecution with respect to medical marijuana is much lower because Congress has limited DOJ’s ability to use federal funds to enforce the CSA with respect to state-legalized medical marijuana businesses through the Rohrabacher-Blumenauer Amendment.

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The 2018 Farm Bill, Industrial Hemp and CBD

Industrial hemp and products derived from hemp, such as cannabidiol (CBD), create yet another source of uncertainty. In December, Congress passed and the president signed the long-awaited 2018 Farm Bill, which removes industrial hemp from the CSA’s definition of marijuana and expands legal cultivation of industrial hemp.\(^5\) CBD and other extracts derived from industrial hemp are no longer Schedule 1 drugs under the CSA.

The cultivation of industrial hemp and the manufacture and sale of CBD products, however, are still subject to state laws and regulations as well as Food and Drug Administration (FDA) regulation. Although some states had legalized hemp and CBD prior to the 2018 Farm Bill, industrial hemp and CBD products remain illegal (at least for now) at the state level in many states. Other states regulate CBD as a form of medical marijuana and allow its use by patients with prescriptions. And it remains to be seen how state regulation of industrial hemp and CBD may change in response to the 2018 Farm Bill.

Additionally, the FDA’s approach to regulating CBD is not yet clear. The FDA has indicated that it may regulate CBD as a pharmaceutical drug (subject to the FDA drug-approval process) rather than as a dietary supplement.\(^6\) And the FDA recently approved a childhood epilepsy drug, Epidiolex, whose active ingredient is CBD. The FDA has also issued warning letters addressed to CBD manufacturers and retailers who claim unproven health benefits from CBD, but it has not yet brought enforcement actions against CBD manufacturers.

The US Money Laundering Laws

The risk of providing products or services to marijuana-related businesses is not limited to narcotics laws. The US money laundering laws make it a crime to conduct a financial transaction with proceeds of “specified unlawful activity,” provided that a defendant has the requisite knowledge and/or intent. See 18 U.S.C. §§ 1956, 1957. It is also a crime to transport, transmit or transfer funds internationally for the purpose of promoting a specified unlawful activity even if the funds are derived from a legitimate source. See 18 U.S.C. § 1956(a)(2).

As relevant in the context of marijuana commerce, federal, state and foreign narcotics offenses constitute specified unlawful activity. As a result, if an entity engages in a financial

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\(^6\) See, e.g., US Food and Drug Administration, FDA and Marijuana: Questions and Answers, https://www.fda.gov/newsevents/publichealthfocus/ucm421168.htm#enforcement_action (last visited Feb. 5, 2019) (Q. “Can products that contain THC or cannabidiol (CBD) be sold as dietary supplements? A. No. Based on available evidence, FDA has concluded that THC and CBD products are excluded from the dietary supplement definition under sections 201(ff)(3)(B)(i) and (ii) of the FD&C Act, respectively.”).
transaction knowing that the property involved represents the proceeds of some unlawful activity (e.g., US marijuana sales or foreign marijuana sales in other countries where marijuana remains illegal) and intends to promote the carrying on of unlawful activity, it may violate the US money laundering laws. If a transaction exceeds $10,000, intent to promote the underlying activity is not required. See 18 U.S.C. § 1957. The government need only establish that the entity knowingly engaged in a monetary transaction in property derived from specified unlawful activity with a value greater than $10,000.

Implications for Financial Institutions in the United States

The complicated legal status of marijuana in the United States has potentially serious implications for financial institutions. A financial institution that provides products or services directly to a US MRB could be viewed as conspiring to violate or aiding and abetting a violation of the CSA because such services promote or facilitate the US MRB’s business. The potential money laundering risk arises where the financial institution receives or transfers funds from a US MRB that it knows are derived from the sale of marijuana. The money laundering risk is greater for transactions that exceed $10,000 because specific intent to promote the underlying criminal activity is not required; the government need only prove that the transaction contained crime proceeds and that the financial institution had knowledge or was willfully blind to that fact.

The money laundering risk is not limited to direct transactions with US MRBs. There may also be risk in providing products and/or services to businesses that support US MRBs, such as companies that manufacture fertilizer and packaging materials or even provide accounting or legal services. Businesses that support US MRBs may engage in transactions with funds that contain proceeds from US marijuana sales (i.e., crime proceeds), and the receipt or transfer of such funds by a financial institution could expose a financial institution to liability under the US money laundering laws. The risk of providing products or services to such supporting businesses is lower than for providing products and services directly to US MRBs, but financial institutions can further mitigate their risk by obtaining representations and warranties from supporting businesses to ensure that they are not transacting with crime proceeds.7

The risk also differs based on the products or services provided (e.g., consumer banking services, initial public offerings, secondary-market trading, and research and analysis). Products and services that are material (i.e., necessary) to a US MRB’s business create a greater risk that a financial institution could be viewed as aiding and abetting or conspiring to violate the CSA or promoting illegal marijuana sales in violation of the US money laundering laws. Activities that are further attenuated from the underlying marijuana sales—e.g., secondary-market trading of

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7 Medical marijuana-related businesses present an even lower risk of prosecution given the Rohrabacher-Blumenauer Amendment.
securities—make it less likely that a financial institution would have the requisite knowledge and/or intent to violate US narcotics or money laundering laws.

In fact, regulatory guidance suggests that financial institutions may provide certain banking services related to marijuana-related business. In 2014, the US Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) issued guidance based on the Cole memoranda that was designed to help banks reconcile the tension between state and federal narcotics laws. The FinCEN guidance created a three-tiered suspicious activity report filing system for marijuana-related activity. Notably, the FinCEN guidance does not prohibit financial institutions from providing banking services to state-licensed MRBs. Rather, FinCEN issued the “guidance [to] clarif[y] how financial institutions can provide services to marijuana-related businesses consistent with their BSA obligations.”\(^8\) FinCEN has not revised the guidance following the repeal of the Cole memoranda.

Moreover, some states have encouraged the financial services industry to provide banking services to state-authorized MRBs. For example, New York Governor Andrew Cuomo directed the New York State Department of Financial Services to encourage New York state-chartered banks and credit unions to provide banking services to New York’s medical marijuana and hemp businesses.\(^9\) Several members of Congress have introduced legislation to enable state-licensed US MRBs to engage in relationships with banks and other financial institutions,\(^10\) and many have advocated for US MRBs to have access to the banking system.\(^11\)

### Canada Legalizes Recreational Marijuana

Canadian MRBs, however, do not pose these same risks under US law. Canada legalized recreational marijuana on October 17, 2018, becoming the world’s largest marketplace for legal marijuana. Each of Canada’s provinces and territories is responsible for establishing its own rules governing how marijuana may be sold and where it may be consumed, but as a general matter, individuals 18 years and older may now consume marijuana, possess up to 30 grams of


marijuana in public and grow up to four marijuana plants at home. Some provinces, such as British Columbia, have elected to operate government-run marijuana stores while others have granted licenses to private distributors.

Because the manufacture, distribution and sale of marijuana in Canada is now legal, MRBs that operate exclusively in Canada with no nexus to the United States are no longer engaged in specified unlawful activity—a predicate offense—under the US money laundering laws. Accordingly, providing the same products and services that could implicate the US narcotics or money laundering laws if provided to a US MRB would not violate US law if provided to a Canadian MRB. That is not necessarily the case under European law.

European Countries Expand the Scope of Their Money Laundering Laws

On October 23, 2018, the European Parliament and the European Council signed the Directive on Countering Money Laundering by Criminal Law (the Directive), which broadens the scope of extraterritorial activity that may serve as a predicate for a money laundering offense in European Union (EU) member countries. Currently, the laws of some EU member countries, such as Germany, provide that extraterritorial activity is generally not a basis for a money laundering conviction unless the activity is illegal both in the country where the activity takes place and in the EU member country. These laws apply what is known as the “double criminality criterion,” meaning that the activity has to be a crime in both relevant countries to constitute a predicate offense. The Directive prohibits EU member countries from applying the double criminality criterion in cases of illicit trafficking in narcotic drugs and psychotropic substances (including the cultivation of cannabis). The elimination of the double criminality criterion means that proceeds from legal marijuana sales in Canada, which would be illegal if they occurred in the EU member country, could provide the basis for a money laundering conviction in the EU. EU member countries will be required to implement the Directive by December 3, 2020.

The United Kingdom’s money laundering law similarly provides that persons or institutions that receive payments derived from legal marijuana sales abroad commit a criminal offense, provided that they know or suspect the funds were derived from the sale of marijuana. In the United Kingdom, it is illegal to possess, grow or sell marijuana, and the Proceeds of Crime Act (POCA) defines “criminal property” by reference to whether the predicate activity is lawful in the United Kingdom (not where the activity occurred). Although there is a statutory exemption to POCA for certain predicate acts that are legal where they occurred, that exemption

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does not apply to marijuana possession, cultivation or sales given the prison sentences permissible for such crimes.

As explained above, because the manufacture, distribution and sale of marijuana in Canada is now legal, MRBs that operate exclusively in Canada with no nexus to the United States are not acting in violation of the US narcotics or money laundering laws. Providing products and services to Canadian MRBs could, however, provide the predicate for a money laundering violation in European Union member countries.

Summary

In sum, the risk of violating the US narcotics or money laundering laws by providing products or services to businesses involved in marijuana commerce depends on a number of factors, including (but not limited to):

- Whether the business is engaged in the manufacture, sale, or distribution of recreational or medical marijuana in the United States;
- Whether a foreign business operates in or has a nexus to the United States or operates solely in a jurisdiction where marijuana is legal, such as Canada; and
- Whether the business provides products or services to MRBs and/or receives funds that may be derived from US marijuana sales.

Financial institutions should be aware of and develop policies and procedures to mitigate these risks. Because different jurisdictions take different approaches to criminalizing activities involving MRBs, financial institutions should centralize risk-management decision making around marijuana-related issues with a knowledgeable group of legal, compliance and risk management personnel.

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The legal landscape for the cannabis industry continues to shift in significant ways. Recent changes in federal law now make some types of cannabis exempt from the restrictions of the federal Controlled Substances Act. There are other efforts to attempt to allow Oregon-grown cannabis to be sold across state lines. While these regulatory developments are occurring, court decisions continue to impact the tax treatment of businesses in this industry.

With the passage of the Agriculture Improvement Act of 2018 (known more commonly as the farm bill) in December, the growing and processing of some forms of cannabis known in the bill as “industrial hemp” are exempt from the Controlled Substances Act. For purposes of the farm bill, industrial hemp is cannabis with less than 0.3 percent THC content. This is a substantial expansion on the provisions in the 2014 farm bill that allowed states to create pilot hemp programs. The 2018 farm bill also allows for interstate sales of hemp products. However, the new law also increases federal oversight of state industrial hemp programs requiring the USDA to approve the state’s plan to license and regulate hemp production. This means Oregon’s hemp laws and regulations, which already saw substantial changes in the past year, may see additional changes based on input from the USDA.

It is important to understand that the uses for industrial hemp go beyond the types the name might imply. The largest use of industrial hemp in Oregon is for production cannabidiol (CBD) products. CBD is a non-psychoactive cannabinoid that is believed to have a number of therapeutic qualities. CBD products that are produced in accordance with the farm bill, under applicable state and federal regulations by a licensed grower will also be exempt from the Controlled Substances Act. This provides clarity about one of the gray areas in the 2014 farm bill, though we do not yet know exactly how CBD will be addressed in USDA-approved regulations.

Something else to watch is how the Food and Drug Administration treats CBD products. The FDA recently granted approval to a CBD isolate, Epidiolex, as a drug. This raises the question as to whether other CBD products that may be regulated as drugs or, less stringently, as supplements. The 2018 farm bill leaves the decision to the FDA. It is also important to note that the Federal Food, Drug and Cosmetic Act classifies any product for human consumption with the same active-ingredient as an FDA-approved pharmaceutical “adulterated and misbranded,” causing some concern that ordinary CBD isolate produced by Oregon-licensed hemp handlers might run afoul of FDA regulations after the approval of Epidiolex. To this point, the FDA seems most concerned with medical claims made by those marketing CBD isolate other than Epidiolex, but this is another area that is worth keeping an eye on moving forward.

An ongoing challenge for cannabis businesses is Section 280E of the Internal Revenue Code. Section 280E prohibits a deduction for amounts paid in carrying on a trade or business that consists of trafficking in controlled substances listed on Schedule 1 of the Controlled Substances Act. Cannabis businesses do get to offset their taxable revenues by their cost of goods sold, but the impact of Section 280E can be particularly harsh on portions of the cannabis industry that are not involved in production and thus do not have substantial expenses related to their costs of goods sold.

As a general matter, a taxpayer who sells cannabis but is also engaged in another trade or business is not subject to Section 280E with respect to his or her other business. This led to the case of Californians Helping to Alleviate Medical Problems Inc. v. Commissioner (known as “CHAMP”), which clarified that a medical marijuana dispensary that also separately provided caregiving services substantially different from its cannabis business was able to deduct its ordinary business expenses related to the provision of caregiving services. This case has been part of the foundation for cannabis businesses having side businesses, such as paraphernalia and apparel sales, to allow them to deduct portions of rent and other expenses associated with that second line of business.

The 2018 farm bill clarifies that parties in the industrial hemp industry are not subject to 280E, but the news has not been as good for other parts of the cannabis industry. Recently, in the case of Alterman v. Commissioner, the Tax Court held that the sale of hats, shirts, and paraphernalia was not a separate trade or business primarily due to the lack of records kept for that portion of the business. In December 2018, another round of the dispute between Harborside Health Center and the IRS resulted in the Tax Court determining that the sale of clothing and paraphernalia, which amounted to 2 percent of Harborside’s revenues was “neither economically separate nor substantially different” than Harborside’s primary business of selling cannabis.

Another important point from a recent case involving an Oregon taxpayer who failed to file both personal tax returns and business tax returns is that trafficking in a controlled substance is considered a negative factor in criminal sentencing guidelines. As such, failing to file taxes while engaging in the cannabis industry can result in stiffer criminal penalties.

There is growing pressure from cannabis growers in parts of Oregon to legalize the interstate sale of medical and recreational use cannabis. However, even if legislation were to gain traction, substantial work would need to be done by legislators and regulators across the states where cannabis is legal in order to create uniform testing and labeling requirements. The easiest way to help to make this a reality will be to work through groups like the Uniform Law Commission to create model legislation, a process that will likely take years.

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