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## Clearing the Air about Marijuana in Qualified Opportunity Zones

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### INTRODUCTION

The 2017 tax act (Pub. L. No. 115-97) created the new concept of qualified opportunity zones (QOZ), which are low-income census tracts in which certain investments by qualified opportunity funds (QOFs) are provided tax benefits.<sup>1</sup> A QOF's lower-tier subsidiary generally should not have a trade or business listed in §144(c)(6)(B), which includes any golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises (some practitioners refer to such businesses as "sin businesses," but this article uses the non-judgmental and less anti-golf term of "excluded business.")<sup>2</sup>

As noted by the author in a prior discussion of various QOZ requirements,<sup>3</sup> §144(c)(6)(B) was enacted by the Tax Reform Act of 1986 and has not been revised to reflect recent entrepreneurship developments, such as a marijuana dispensation facility or vaping facility.<sup>4</sup> However, some practitioners have questioned the extent that QOFs can be involved in marijuana businesses.

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<sup>1</sup> §1400Z-1, §1400Z-2. All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

<sup>2</sup> §1400Z-2(d)(3)(A)(iii); Prop. Reg. §1.1400Z-2(d)-1(d)(6).

<sup>3</sup> Libin Zhang, *Qualified Opportunity Zones: Hot Tubs and Other Hot Topics*, 160 Tax Notes 769, 775 n. 11 (August 6, 2018).

<sup>4</sup> See also Amy Lee Rosen, *Proposed Opportunity Zone Regs Hazy on Marijuana Projects*, Law360 (Feb. 12, 2019).

### EXCLUDED BUSINESSES

The history of excluded businesses is intertwined with the history of tax-exempt bonds. Private parties generally cannot use tax-exempt bonds to acquire a significant amount of land, with limited exceptions for cases such as environmental preservation, small loans to first-time farmers, airports, and other infrastructure improvements.<sup>5</sup>

The Tax Reform Act of 1986 created a new type of tax-exempt bond, the qualified redevelopment bond, for which the proceeds can be used to acquire and rehabilitate real properties in certain blighted areas, including land.<sup>6</sup> In order to ensure that qualified redevelopment bonds are targeted incentives, Congress enacted two provisions to limit the use of the bond proceeds.

Section 144(c)(6)(B) provides that no portion of qualified redevelopment bond proceeds can be used to provide (including the provision of land for) any of the excluded businesses. The prohibitions of this §144(c)(6)(B) were later incorporated by reference into other tax incentive programs, such as the §45D new markets tax credit (NMTC), the §1397C empowerment zone incentives, and most recently the QOZ provisions.

In addition, §144(c)(6)(A) provides that no more than 25% of qualified redevelopment bond proceeds can be used to provide a longer and overlapping older list of businesses, such as retail food and beverage services, automobile sales or service, tennis club, skating facility, racquet sports facility, airplane, sky-box, and health club facility.<sup>7</sup> The QOZ provisions do not incorporate the separate prohibitions of §144(c)(6)(A), which should be welcome news to QOZ car dealerships and airplane owners.

Based on the statutory interpretation doctrine of *expressio unius est exclusio alterius*, items not listed in §144(c)(6)(B) should not be considered excluded

<sup>5</sup> §147.

<sup>6</sup> §144(c).

<sup>7</sup> See §144(a)(8), §147(e).

businesses. In *Iselin v. United States*,<sup>8</sup> Congress subjected specific categories of ticket sales to taxation but failed to cover another category, and the Supreme Court declined to expand the list after noting: “The particularization and detail with which the scope of each provision, the amount of the tax thereby imposed, and the incidence of the tax, were specified, preclude an extension of any provision by implication to any other subject. The statute was evidently drawn with care. Its language is plain and unambiguous. What the Government asks is not a construction of a statute, but, in effect, an enlargement of it by the court, so that what was omitted, presumably by inadvertence, may be included within its scope. To supply omissions transcends the judicial function.”

Furthermore, §144(c)(6)(B) does not prohibit cigarette, cigar, and cigarillo facilities, which are the closest analogues to marijuana facilities.

Some commentators have stirred the pot by suggesting that a marijuana business may be covered by the excluded businesses’ last category, as a store the principal business of which is selling alcoholic beverages for consumption off premises.<sup>9</sup> While your author is not as familiar with the extent that marijuana and alcohol are customarily mixed and then consumed off premises, it seems that the prohibition should not apply to products that do not contain alcohol in liquid form. It is possible that some commentators were focused on the growing use of ethanol as a solvent in the extraction process for concentrated cannabinoids and terpenes. However, due to ethanol’s hydroxyl group causing polarity in a water solution, it tends to co-extract chlorophyll and requires some ongoing research in improving taste and coloration, in contrast to other solvents like supercritical CO<sub>2</sub> and butane. In any case the remaining ethanol is generally removed from the final, oil-based concentrate using either a rotary evaporator or vacuum distillation.

Even if the alcohol-based exclusion is extended in a chemically implausible fashion to products that contain mostly tetrahydrocannabinol (THC) and other lipids, the exclusion should apply only to liquids and not to other states of matter, such as marijuana in an aerosol preparation or within a gelatin-based solid (also known as “gummies”).

## FARMING

When a QOF owns a lower-tier subsidiary that is a QOZ business, this two-tier structure incorporates some existing empowerment zone requirements, such

as the §1397C(b)(2) requirement that generally at least 50% of a QOZ business’s gross income must be derived from the active conduct of a business within a QOZ.<sup>10</sup> During the early months of the QOZ regime, some have wondered and requested clarification as to whether the empowerment zone’s “qualified business” limitations were also required for a QOZ business, which would prevent a QOZ’s lower-tier subsidiary from owning residential rental property, larger farms (more than \$500,000 in owned and leased assets), or predominantly intangibles.<sup>11</sup> Such a prohibition would be consistent with the NMTC precedent, which is not allowed for such activities.<sup>12</sup>

In Revenue Ruling 2018-29, the Treasury Department provided an example of a QOF that directly acquired a factory building and converted it into residential rental property. The ruling did not involve a lower-tier subsidiary with a QOZ business, which therefore did not have to meet the §1397C(b)(2) gross income test or other requirements for a QOZ business in a two-tier structure. Nevertheless, some practitioners view the ruling as suggesting that residential rental property is an acceptable QOZ business and that the empowerment zone prohibitions were not incorporated into the QOZ business rules. Based on similar reasoning, a QOZ business should be able to own a large farm, including large marijuana farms.

## SECTION 280E AND GROSS INCOME TAXATION

Section 280E prohibits any deduction or credit for any amount paid or accrued in carrying on a trade or business that consists of trafficking in controlled substances that are prohibited by federal law or the law of any state in which such business is conducted.<sup>13</sup> Controlled substances are on schedules I or II of the Controlled Substances Act: schedule I contains substances with a high potential for abuse and no accepted medical use, such as heroin, LSD, MDMA (ecstasy), peyote, and marijuana; schedule II contains substances with a high potential for abuse but have some accepted medical use with severe restrictions, such as cocaine and methamphetamine.

<sup>10</sup> §1400Z-2(d)(3)(A); Prop. Reg. §1.1400Z-2(d)-1(d)(5).

<sup>11</sup> §1397C(d). See U.S. Conference of Mayors, Comments to the IRS for the implementation of Opportunity Zone provisions (Aug. 23, 2018); National Housing Conference, Comments re Opportunity Zone Regulations (Aug. 15, 2018).

<sup>12</sup> §45D(d)(3).

<sup>13</sup> There is some debate over whether foreign tax credits are allowed for marijuana activities in Canada and other countries that have legalized marijuana. See Amy Lee Rosen, *Cannabis Cos.’ Use of Foreign Tax Credits May Draw IRS Fire*, Law360 (Jan. 31, 2019).

<sup>8</sup> 270 U.S. 245 (1926).

<sup>9</sup> See Lydia O’Neal, *Weed Industry Sees Potential in ‘Opportunity Zone’ Breaks*, Daily Tax Report (March 13, 2009).

In *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*,<sup>14</sup> the Tax Court used the dictionary definition of “trafficking” as “to engage in commercial activity: buy and sell regularly.” In *Alternative Health Care Advocates v. Commissioner*,<sup>15</sup> a management services company was held to be trafficking in marijuana because the management services company’s employees were directly involved in the buying and selling activities, albeit on behalf of a different company that held title to the products. Similarly, a QOF that regularly buys and sells marijuana to customers would be subject to §280E.

In contrast, §280E should not apply to businesses that do not buy and sell marijuana regularly, such as law firms that advise on marijuana issues, accounting firms that prepare marijuana-related tax returns, media organizations that promote marijuana information, janitorial firms that clean marijuana workplaces, car rental operators that lease to marijuana businesses, and other supporting businesses.

For example, a QOF partnership spends \$420 to acquire a single-purpose agricultural or horticultural structure,<sup>16</sup> which was specifically designed, constructed, and used for the commercial production of plants in a Colorado QOZ.<sup>17</sup> Because the single-purpose agricultural or horticultural structure has a depreciation recovery period of 10 years,<sup>18</sup> the QOF may claim a 100% bonus depreciation deduction for its building purchase price.<sup>19</sup> The QOF must substantially improve the property, which means that the

QOF must double within 30 months the adjusted tax basis of the building, as adjusted by depreciation.<sup>20</sup>

The QOF may lease the single-purpose agricultural or horticultural structure to a separate operating business that engages in plant cultivation. The operating business, which may or may not be a QOF, may decide to plant marijuana using a nutrient film technique hydroponics system and be subject to §280E. Either way, the QOF is engaged in a rental business that is separate from any controlled substances trafficking business. The QOF should satisfy all of the QOZ requirements, including that it actively conducts its rental trade or business.<sup>21</sup>

## CONCLUSION

While the QOZ rules have their hazy areas, the excluded businesses list clearly consists of only seven activities. The definitions of some excluded businesses may have differing interpretations, such as whether they include a health spa with massage services or a whiskey distillery,<sup>22</sup> but there should be less ambiguity over a marijuana business being considered an alcohol business or otherwise part of the excluded list.

A heavier concern for marijuana businesses is §280E, which disallows all deductions for taxpayers that buy and sell marijuana products regularly. Businesses that do not directly deal with cannabis in a trafficking capacity, such as rental businesses and other supporting activities, are less likely to be subject to §280E and find their deductions go up in smoke.

<sup>14</sup> 128 T.C. 173 (2007).

<sup>15</sup> 151 T.C. No. 13 (Dec. 20, 2018).

<sup>16</sup> §168(i)(13).

<sup>17</sup> This is based on an example in Libin Zhang, *Qualified Opportunity Zones and Select Partnership Issues*, 34 Tax Mgmt. Real Est. J. No. 11 (Nov. 7, 2018).

<sup>18</sup> §168(e)(3)(D)(i).

<sup>19</sup> §168(k)(2)(A)(i)(I).

<sup>20</sup> §1400Z-2(d)(2)(D)(ii).

<sup>21</sup> See Prop. Reg. §1.1400Z-2(d)-1(d)(5)(ii)(B).

<sup>22</sup> See Brian Cugliari and George Barlow, *Subjecting Craft Breweries to the QALICB Test*, Novogradac Journal of Tax Credits Vol. VIII, Issue XI (Nov. 2017).