EMORY LAW

Emory Bankruptcy Developments Journal

Volume 36
Issue 2 *The Seventeenth Annual Emory Bankruptcy Developments Journal Symposium*

Article 3

2020

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Lauren Timlin

Recommended Citation

Lauren Timlin, *Harvesting Highs but No Relief for the Lows: The Inconsistent Treatment of Marijuana Businesses by Bankruptcy and Tax Law*, 36 Emory Bankr. Dev. J. 395 (2020).
Available at: https://scholarlycommons.law.emory.edu/ebdj/vol36/iss2/3

HARVESTING HIGHS BUT NO RELIEF FOR THE LOWS: THE INCONSISTENT TREATMENT OF MARIJUANA BUSINESSES BY BANKRUPTCY AND TAX LAW

ABSTRACT

Despite marijuana's varying levels of legalization in thirty-three states, the U.S. federal government still regards marijuana cultivation and distribution as federal crimes, leading bankruptcy courts to deny marijuana businesses the benefits of bankruptcy for fear of aiding the illegal activities.

Courts have historically prioritized protecting the bankruptcy trustee from federal prosecution over allowing creditors and debtors access to the intended benefits of the Bankruptcy Code. Court interpretations of the Controlled Substances Act and what constitutes illegal activity continue derailing marijuana businesses' attempts at repaying creditors through bankruptcy.

While Congress remains stubborn in recognizing marijuana businesses as legitimate sources of income for bankruptcy purposes, it has not hesitated in recognizing that very same income as taxable under the Internal Revenue Code.

This Comment argues that courts should change their approaches to bankruptcy for marijuana businesses and ultimately proposes a hybrid solution involving bankruptcy and tax laws as avenues for relief for the debtor, creditor, and trustee in marijuana bankruptcy cases.

INTRODUCTION

The United States Bankruptcy Code (Code) exists to provide financial relief for debtors and protection to creditors who made failed investments. Despite this overarching purpose and the growing legality of marijuana on a state level, bankruptcy law as it currently exists does not allow individuals involved in the marijuana industry to take advantage of the protections of bankruptcy. This Comment will focus on how bankruptcy law's treatment of the marijuana industry as an illegal business endeavor prevents marijuana growers and dispensaries from benefiting from bankruptcy relief through chapter 11, 12 and 13 filings. More specifically, this Comment will argue that bankruptcy should be an avenue of relief for marijuana debtors facing financial distress by looking at (*i*) the background of bankruptcy for marijuana businesses, (*ii*) how court interpretations of federal laws inhibit these businesses opportunities for financial relief, and (*iii*) the inconsistent treatment of marijuana business income as taxable by the IRS yet inadequate to fund repayments to creditors in bankruptcy. This Comment will then propose a solution to these issues by allowing bankruptcy estate trustees to transfer to creditors tax deductions accumulated by these businesses as payment of debts, preventing trustees from exposing themselves to federal liability that would stem from distributing federally illegal assets.

Consider the hypothetical of retired Colorado resident, Buddy Kushner, who upon researching Colorado's laws regulating the marijuana industry, decides to dedicate his savings and time in retirement to cultivating cannabis to sell at his own marijuana dispensary. As a law-abiding citizen, Buddy first acquires the requisite permits and licenses necessary to legally register and operate his business under Colorado law.

Before Buddy's business becomes profitable, Buddy reaches a dangerously low point in his savings after buying a small building and all the equipment needed to grow and process the raw cannabis. In need of more capital, Buddy reaches out to friends and family for loans in exchange for an interest in his business and rents out the extra office in the building he purchased.

Colorado's high taxes on marijuana businesses and the federal government's income taxes, coupled with Buddy's inexperience as a marijuana business owner leaves Buddy overwhelmed with expenses. He decides to file for bankruptcy just two years after opening. Buddy merely wants bankruptcy protections so he can organize his finances enough to pay back creditors, while still maintaining enough of his 401(k) to maintain his modest lifestyle. However, when Buddy files his chapter 11 bankruptcy petition and plan for repaying his friends and family, the bankruptcy court denies confirmation of his plan, stating Buddy had filed in bad faith because any profits from his marijuana business are considered by federal laws as illegally obtained funds.

Buddy argues that he should be able to pay creditors back with the rental income he had been collecting from his tenant and his business's meager profits. He argues these funds are not illegal under federal law because the federal government had been collecting income taxes from both sources of income each year, and he kept meticulous records to prove it. His records include detailed expense reports that track all production and materials costs, as well as which loans funded such expenses.

The court denies Buddy bankruptcy relief, leaving him with legal fees that take away from the few funds he had to distribute to his creditors. His friends and family have to fight one another over who is repaid from Buddy's small pool of assets. Buddy cannot understand how the federal government collected taxes on his business's profits, his personal rental income, and his shareholder's dividends, yet deemed those incomes unacceptable for repaying creditors through a payment plan in bankruptcy.

Many marijuana businesses have found themselves in similar positions to Buddy.[1] Courts have denied conversion of a bankruptcy debtors' chapter 7 case to chapter 11 because the debtors' state-legal marijuana business was illegal under federal law, leading to what one court viewed as the debtors' failure to propose a confirmable plan in good faith as required by the Code.[2] Courts have also disallowed a chapter 11 debtor from using rental income to fund its payment plan because one of its building's tenants was a marijuana dispensary.[3] Tax courts have reinforced taxation of these incomes by relying on section 61 of the Internal Revenue Code (IRC), stating that both business and rental incomes derived from legal and illegal sources are considered incomes subject to federal income taxations.[4] Courts have gone a step further by enforcing taxation of a marijuana business's shareholders for both income derived as dividends from their pro rata shares of the business and the wages they had earned by working for the S corporation.[5]

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[1] *See generally In re* Arenas, 535 B.R. 845, 847 (B.A.P. 10th Cir. 2015); Arm Ventures, LLC, 564 B.R. 77, 83–84 (Bankr. S.D. Fla. 2017); Loughman v. Comm'r, No. 21464-15, 2018 Tax Ct. Memo LEXIS 85, at 5–7 (T.C. June 18, 2018).

[2] *In re Arenas*, 535 B.R. at 847.

[3] *Arm Ventures, LLC*, 564 B.R. at 83–84.

[4] 26 U.S.C. § 61 (2018); Peyton v. Comm'r, No. 16468-98, 2003 Tax Ct. Memo LEXIS 351, at *9 (T.C. May 22, 2003).

[5] Loughman, 2018 Tax Ct. Memo LEXIS 85, at *7–8.

Following a brief background on bankruptcy law and its interaction with the marijuana industry in Part I of this Comment, Part II will argue how if not for courts' narrow interpretations of federal laws, marijuana businesses and farmers qualify for relief under chapters 11 and 12 of the Code. The Code's inclusion of these chapters suggests it intended bankruptcy to be an option available to all debtors who satisfy the criteria. Part III will outline how the inconsistencies between what bankruptcy and tax laws consider "income" display Congress's arbitrary agenda in treating the marijuana industry differently from other business ventures. Congress' treatment of income from marijuana businesses as illegal drug money simultaneously denies confirmation of debtors' plans to repay creditors with such income and contradicts its recognition of incomes from these businesses through the IRS's taxation of incomes gained from marijuana dealings.

Considering the possibility that Congress and the courts will be reluctant to alter their approaches to the marijuana industry, Part IV of this Comment proposes a solution that involves permitting bankruptcy trustees to repay creditors by transferring tax deductions accumulated by the marijuana businesses. By transferring tax deductions, bankruptcy trustees can avoid violating federal laws that prohibit distributing to creditors marijuana-related assets deemed illegal substances and properties under federal law.

I. BACKGROUND

Though not a constitutionally guaranteed right, bankruptcy law exists to provide relief to both debtors and creditors when the risks of investments fail to pan out as planned. By definition, a debtor is incapable of repaying creditors all financial obligations.[6] Thus, a debtor's insolvency initiates a zero-sum game among creditors to make claims on the debtor's property before other creditors do in accordance with federal law's "first in time, first in right" rule of priority.[7]

Bankruptcy laws permit individuals and businesses overwhelmed by debt to reorganize their financial obligations and the assets to pay those obligations, all while avoiding creditors' competitive attempts to collect their shares first.[8] To prevent creditors from scrambling for relief, bankruptcy laws facilitate an organized distribution of debtors' available assets, allowing the debtor to move

6 *See* 11 U.S.C. §§ 101(5), (12), (13) (2019).
7 United States v. Bell Credit Union, 860 F.2d 365, 369 (10th Cir. 1988).
8 Grogan v. Garner, 498 U.S. 279, 283 (1991).

forward with their "fresh start" by substantially limiting the debts owed to creditors.[9]

The notion that bankruptcy law exists to give debtors filing in good faith a chance at a financial "fresh start" strongly supports the idea that the government is somewhat sympathetic to debtors in financial ruin, as well as creditors whose investments went south.[10] The concern that creditors driven by their own interests will push out other creditors to increase their chances of being paid back in full is addressed by bankruptcy law's pausing of both debtor and creditor action towards the debtor's property with an automatic stay.[11] The automatic stay protects property of the estate and certain properties of the debtor from being claimed by creditors or certain other third-party lenders who might take collections into their own hands.[12] Bankruptcy offers solutions to these concerns that optimize the debtor's options for paying back debts while protecting creditors who made failed investments.

Debtors can file for bankruptcy in any of the chapters for which they qualify, but this Comment will focus on chapter 11 for marijuana dispensaries and chapter 12 for marijuana farmers. Each chapter in the Code presents its own requirements of who can be a debtor and methods of providing relief to qualified debtors.[13] For example, chapters 11 and 12 permit debtors to retain and potentially keep using the assets they currently own, provided they propose payment plans to repay creditors with future income.[14] Obtaining plan approval from the court presents incredible challenges for marijuana debtors due to current court interpretations of both bankruptcy and federal drug laws.[15]

A. Bankruptcy and Its Unavailability to Marijuana Debtors

The optimistic rationale for bankruptcy law providing financial fresh starts to overwhelmed debtors does not extend to marijuana-related debtors because courts widely deny bankruptcy relief to marijuana cultivators and dispensaries.[16]

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9 *Grogan*, 498 U.S. at 283 (emphasizing the Court's consideration of the Bankruptcy Code's "fresh start" policy).

10 *Grogan*, 498 U.S. at 286–87.

11 11 U.S.C. § 362(a) (2019); Shaw v. Ehrlich, 294 B.R. 260, 267 (W.D. Va. 2003).

12 § 362(a).

13 11 U.S.C. §§ 1129, 1225 (2019).

14 *See* §§ 1129, 1225.

15 *In re* Arenas, 535 B.R. 845, 847 (B.A.P. 10th Cir. 2015); *In re* Rent-Rite Super Kegs W. Ltd., 484 B.R. 799, 802–05 (Bankr. D. Colo. 2012); Vivienne Cheng, Comment, *Medical Marijuana Dispensaries in Chapter 11 Bankruptcy*, 30 EMORY BANKR. DEV. J. 105, 110 (2013).

16 *In re Arenas*, 535 B.R. at 847; *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 802–05; Cheng, *supra* note 15, at 110.

Courts claim that regardless of state laws legalizing marijuana for medicinal or recreational use, both kinds of marijuana usage remain illegal under federal law, and because the Code is federal law, all marijuana-related activity is equivalent to a federal crime.[17]

The power dynamic between bankruptcy being federal law and marijuana being legal under state law leads bankruptcy courts to treat all marijuana-related activities as federal crimes.[18] Under the Code, any debtor whose business constitutes a federal crime is not permitted to utilize bankruptcy, which precludes marijuana businesses from seeking bankruptcy relief for their debts under the Code and using their assets or income to pay back creditors.[19] This preclusion prevents marijuana debtors from realizing the value of their assets when creditors come seeking debt repayment.[20]

In addition to helping pay off debts to creditors, bankruptcy would limit the amount and type of debts owed to creditors by controlling the ultimate pool of resources available for distribution by the trustee.[21] When trustees engage in the distribution of marijuana assets, they are technically violating federal laws against dealing illegally obtained goods.[22] Due to concerns about subjecting bankruptcy trustees to federal prosecution, courts will usually prevent marijuana debtors from proceeding into the bankruptcy process by dismissing their cases for "lack of good faith" or filing in bad faith.[23] This Comment will later address courts' varying interpretations of the good and bad faith provisions of the Code and the determining factors courts consider.

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[17] 21 U.S.C. §§ 801, 841(a)(1), 856(a) (2018); *In re Arenas*, 535 B.R. at 847; *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 802–05; Cheng, *supra* note 15, at 110.

[18] 21 U.S.C. §§ 841(a)(1), 856(a) (2018); *In re Arenas*, 535 B.R. at 847; *In re* Johnson, 532 B.R. 53, 59 (Bankr. W.D. Mich. 2015); *Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r*, 128 T.C. 173, 180–81 (2007).

[19] *In re Arenas*, 535 B.R. at 847–48; *In re Johnson*, 532 B.R. at 59; *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 802–05.

[20] *See In re Johnson*, 532 B.R. at 59.

[21] *See* 11 U.S.C. §§ 362(a), (b) (2019); 11 U.S.C § 541(a) (2019).

[22] *In re Arenas*, 535 B.R. at 847–48; *In re Johnson*, 532 B.R. at 59; *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 802, 810; Cheng, *supra* note 15, at 110.

[23] 11 U.S.C. § 1129(a)(3) (2019); 11 U.S.C. § 1225(a)(3) (2019); *In re Arenas*, 535 B.R. at 849–50; *In re Johnson*, 532 B.R. at 59; *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 802, 809; Cheng, *supra* note 15, at 109–10.

B. Preemption: The Budding Conflicts Between Federal and State Laws

The U.S. Constitution's Supremacy Clause declares that federal laws will preempt and void conflicting state laws.[24] Marijuana's exclusion from the benefits of bankruptcy for both debtors and creditors amounts to more than just another case of federal preemption, though. In fact, it is not an issue of federal preemption at all because marijuana's legality in several states allows marijuana businesses to function legally under state laws.[25]

The relationship between federal and state laws on marijuana has been described by legislative attorney Todd Garvey in his CRS Report for Congress:

> [T]he relationship between the federal ban on marijuana and state medical marijuana exemptions must be considered in the context of two distinct sovereigns, each enacting separate and independent criminal regimes with separate and independent enforcement mechanisms, in which certain conduct may be prohibited under one sovereign and not the other. Although state and federal marijuana laws may be "logically inconsistent," a decision not to criminalize—or even to expressly decriminalize—conduct for purposes of the law within one sphere does nothing to alter the legality of that same conduct in the other sphere.[26]

The coexistence of federal and state laws—despite radically different approaches to subjects like marijuana legality—puts businesses hoping to capitalize on state laws in dangerous positions.

The overarching preemption doctrine generally disallows states from enacting laws that conflict with federal laws; however, courts have not allowed the Controlled Substances Act (CSA)—a federal mandate that makes marijuana illegal under federal law—to displace state laws that have made marijuana sale and usage legal.[27] Congress went so far as to include section 903 in the CSA, which effectively limits the scope of the CSA only to state laws that create a "positive conflict" with federal law.[28] Positive conflicts consist of state laws that compel citizens to behave in violation of federal laws.[29] The conflict of federal and state laws on marijuana does not fall into the "positive conflict" category

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24 U.S. CONST. art. VI, cl. 2; *See, e.g.*, Wickard v. Filburn, 317 U.S. 111, 124 (1942).

25 *See* TODD GARVEY, CONG. RESEARCH SERV., R42398, MEDICAL MARIJUANA: THE SUPREMACY CLAUSE, FEDERALISM, AND THE INTERPLAY BETWEEN STATE AND FEDERAL LAWS 8 (2012).

26 *Id.*

27 *Id.*; Jeremy Berke & Skye Gould, *This Map Shows Every State That Has Legalized Marijuana*, BUS. INSIDER (Jan. 1, 2020), https://www.businessinsider.com/legal-marijuana-states-2018-1.

28 21 U.S.C. § 903 (2018).

29 GARVEY, *supra* note 25, at 9.

because state laws are merely creating exemptions for marijuana businesses from state prosecution as opposed to compelling citizens of the state to participate in federally illegal activities.[30]

The Court has categorized preemption into three classes: express, conflict, and field.[31] Express preemption occurs when a federal statute's language expressly states the extent to which relevant state laws will be superseded by the federal statute.[32] On the other hand, the implied preemptions of conflict and field occur when Congress did not explicitly state the federal statute's effect on state laws, but there exists reason to believe Congress intended the federal law to control.[33] More specifically, conflict preemption occurs when it is impossible for a citizen to comply with both federal and state regulations or a state law directly frustrates the purpose of a federal law; field preemption arises when a state law compels citizens to act in violation of a federal law.[34]

That being said, a general presumption against preemption exists because the exercise of police powers has historically been reserved to the states.[35] This presumption has applied to state medical marijuana laws due to their enactment through traditional state police powers to regulate drugs and medical practices, as well as define what activities constitute criminal conduct.[36]

There have been instances when the federal government has maneuvered around this presumption against preemption, and the *Gonzales v. Raich* Court raised the question of whether federal bans on marijuana cultivation and possession set forth in the CSA preempted state laws permitting such activities.[37] In fact, the CSA's section 903 limitation established Congress's intent not to preempt state laws on marijuana legality unless a positive conflict exists between the two levels of legislation.[38] No such conflict exists for laws applicable to the marijuana industry.[39] This limitation restricts the federal government's abilities to police activities forbidden in the CSA if permissive state laws provide exemptions for such activities, including the regulation of state-compliant marijuana businesses.[40]

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30 *Id.*
31 Hines v. Davidowitz, 312 U.S. 52, 67 (1941); GARVEY, *supra* note 25, at 8.
32 *See, e.g.*, Norfolk & W.R. Co. v. Am. Train Dispatchers' Ass'n, 499 U.S. 117 (1991).
33 Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947).
34 *Id.*; GARVEY, *supra* note 25, at 8–9.
35 *Rice*, 331 U.S. at 230.
36 GARVEY, *supra* note 25, at 8.
37 Gonzales v. Raich, 545 U.S. 1, 19 (2005).
38 21 U.S.C. § 903 (2018); GARVEY, *supra* note 25, at 9.
39 *See* 21 U.S.C. § 903; GARVEY, *supra* note 25, at 9.
40 *See* GARVEY, *supra* note 25, at 9.

The tentative dance of whether marijuana laws are preempted by strict federal laws begs the question as to how the federal government regulates the marijuana industry. The answer is not definitive: it does, and it does not.[41] Federal courts have held that compliance with state marijuana laws are no defense to federal criminal prosecution under the CSA, and the federal government reserves the ability to utilize its own resources to enforce federal laws.[42] Federal prosecution remains a danger for individuals and businesses operating or "facilitating" marijuana dispensaries even when they are operating according to state law.[43] But despite this ever-present warning of federal prosecution, federal officials have taken a more relaxed approach to pursuing actions against operating marijuana businesses in an effort to conserve federal resources.[44] Bankruptcy courts should adopt these federal officials' relaxed approaches when handling cases involving marijuana debtors.

1. *Liability on Third-Party Enforcers*

The federal government's unwillingness to pursue actions against marijuana companies for violating federal laws stems from the unwillingness to hold liable state officials refraining from making efforts to enforce federal laws.[45] Since any citizen possessing, producing, or distributing marijuana in light of federal sanctions is vulnerable to federal prosecution, state officials failing to prosecute state-legal marijuana businesses become liable for conspiring in those activities.[46] Seemingly aware of this liability, section 885 of the CSA provides potentially protective language that could shield state officials executing state-directed actions that violate the CSA.[47]

This protection for state officials enacting state laws might provide some guidance to courts concerned with putting bankruptcy trustees of marijuana debtors at risk of federal prosecution. It seems reasonable to assume that if state officials carrying out federally illegal state actions are protected from federal prosecution, then trustees—federally appointed officers under the Code—carrying out the federal actions of bankruptcy would be provided that same protection. A second assumption arises that even if trustees do not receive such

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41 *Id.*

42 Memorandum from Deputy Attorney Gen. David W. Ogden to selected U.S. Attorneys (Oct. 19, 2009).

43 *Id.*

44 *See id.*

45 *See id.*

46 *See* 21 U.S.C. § 846 (2018) (making it illegal to conspire to violate the CSA); 18 U.S.C. §§ 2–4, 371 (2018).

47 *See* State v. Kama, 39 P.3d 866, 868 (Or. App. 2002) (finding immunity for city police acting pursuant to a preempted state medical marijuana provision).

protection, it is possible the federal government might not even follow through with enforcing punishments on trustees in marijuana bankruptcy cases. This Comment will delve into courts' reasons for blocking marijuana companies from entering bankruptcy to avoid jeopardizing trustees when the trustees must eventually administer federally illegal assets as payment to creditors, and how the problem might be avoided.

C. How the CSA's Blunt Definitions for Marijuana Define the Industry's Opportunity for Bankruptcy

Regardless of potential preemption arguments in favor of marijuana, marijuana nevertheless remains illegal under federal law.[48] The CSA criminalizes every aspect of selling, manufacturing, distributing, and profiting from the use of "controlled substances."[49] The CSA classifies marijuana (also referred to in this Comment as "cannabis") as a Schedule I drug, deeming it as having a high potential for abuse, no currently accepted medical use treatment in the United States, and no accepted safety protocol for usage under medical supervision.[50] The CSA uses the same meaning of "trafficking" as the IRC's definition of "to traffic," which refers to the engagement in the commercial activities of buying and selling regularly.[51]

In the tax court case, *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r* (*CHAMPS*), a medical marijuana dispensary that also provided healthcare services unrelated to their marijuana production was precluded from claiming any business expenses stemming from their marijuana operations, because those expenses furthered the illegal trafficking of drugs.[52] The *CHAMPS* court wrote that a party's supplying of even medical marijuana to consumers was within the CSA's definition of "trafficking" because the business regularly bought and sold the marijuana, the selling occurring when the party distributed the marijuana to consumers in exchange for part of a membership fee.[53] The *CHAMPS* court also held that the CSA's application overrode California's state medical marijuana laws.[54]

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[48] 21 U.S.C. § 801, 812 (2018).

[49] 21 U.S.C. §§ 801, 812, 841(a)(1), 856(a) (2018).

[50] 21 U.S.C. § 812(b)(1) (2018).

[51] *See* Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r, 128 T.C. 173, 182 (2007) (citing Webster's Third New International Dictionary).

[52] *Californians Helping to Alleviate Med. Problems, Inc.*, 128 T.C. at 173–83.

[53] *Id.* at 182.

[54] *See Californians Helping to Alleviate Med. Problems, Inc.*, 128 T.C. at 183, n.5; Gonzales v. Raich, 545 U.S. 1, 27 (2005).

Just like any business model in a sales-based industry, marijuana businesses must buy and sell marijuana as a core function of their operations, whether they deal in medical or recreational marijuana or both.[55] The extremely broad definition of "trafficking" as it relates to dealings in drugs sets marijuana businesses up for failure in terms of violating the strict definitions set forth by federal laws.[56] Participants in the marijuana industry engage in this kind of trafficking the second a grower sells to a retailer or a retailer opens its doors to customers to purchase any marijuana product. The definition and application of this term does not consider the possibility that the trafficking could be legal within a state's borders.[57] This broad definition is consistent with courts' attempts to adhere to Congress's policy against dealings in illegal drugs, despite any allowance of possession under state law.[58]

1. *Court Interpretations of the Good Faith Requirement for Proposing a Confirmable Plan*

The CSA's classification of marijuana as a Schedule I drug prevents marijuana debtors from filing for bankruptcy in "good faith," because any "unlawful or deceitful" conduct, or conduct resulting in an unreasonable, prejudicial delay of distribution to creditors constitutes cause for courts to dismiss the case.[59] Courts interpret marijuana's classification as a controlled substance under the CSA to mean any conduct relating to the drug equates unlawful activity, so when a debtor proposes a payment or reorganization plan involving marijuana, the court deems such proposals as unreasonable prejudicial delays that constitute bad faith filings deserving dismissal.[60]

While "bad faith" is not explicitly included in the Code's list of causes for dismissal, courts have frequently held that a debtor's lack of good faith in filing a petition establishes sufficient cause for dismissal.[61] The implied "good faith" filing requirement narrowly focuses on the debtor's conduct in arranging a liquidation or repayment plan under their selected chapter of the Code, and the

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[55] *See* Brooke Edwards Staggs, *10 Steps to Starting a Marijuana Business in California*, THE CANNIFORNIAN (Dec. 11, 2017), http://www.thecannifornian.com/cannabis-business/10-steps-starting-marijuana-business-california/.

[56] *See In re* Arenas, 535 B.R. 845, 847 (B.A.P. 10th Cir. 2015).

[57] *Id.*

[58] *See, e.g.*, *Californians Helping to Alleviate Med. Problems, Inc.*, 128 T.C. at 182.

[59] *See* 11 U.S.C.§ 707(a)(1) (2019); 11 U.S.C. § 1325(a)(3) (2019). *See, e.g.*, *In re Arenas*, 535 B.R. at 849–53.

[60] *See, e.g.*, *In re Arenas*, 535 B.R. at 849–54.

[61] Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 828 (9th Cir. 1994).

debtor's success in getting that plan confirmed by the court.[62] Despite the good faith requirement's general principle, the specificity of its language varies depending on the Code section applicable to the debtor's case.[63]

Just like its bad faith counterpart, "good faith" is not defined in the Code, leaving courts to interpret both terms' meanings.[64] Courts have interpreted section 1307, subsection (c) as giving courts discretion to consider a lack of good faith in the case to be a cause for denying confirmation of a debtor's proposed payment plan.[65] One factor courts often find as cause for dismissal is an unreasonable delay by the debtor that is prejudicial to creditors.[66] In the past, courts have considered a debtor's inability to have a plan confirmed as such an unreasonable and prejudicial delay warranting dismissal.[67] Courts consider failures to propose a plan or to have that plan confirmed for this reason as bad faith attempts to abuse the bankruptcy system.[68]

a. Component of the Good Faith Requirement

When evaluating a plan proposal's good faith, courts ask whether the plan was "legally and economically feasible."[69] The "legally" feasible component aims to make certain that the debtor intends his or her reorganization to pay back creditors, rather than deter or frustrate their collection efforts.[70] Courts generally look for three fact patterns that imply a debtor's lack of good faith: the first being that the debtor only has one asset, usually real estate; the second is the debtor exploiting bankruptcy's protections to strategically use a certain bankruptcy right or power; the third is the use of bankruptcy to obtain a certain tactical advantage in litigation.[71]

How the court applies the good faith standard impacts the debtor's chances of dismissal or getting his or her plan confirmed.[72] Plan confirmation is crucial to a debtor's attempt at filing under chapters 11, 12, and 13 of the Code because

[62] *See* 11 U.S.C. §§ 707(a), 1129(a), 1307(c) (2019) (listing the requirements of a debtor filing for bankruptcy in each respective chapter of the Code).

[63] *See* Cheng, *supra* note 15, at 110.

[64] *See In re Marsch*, 36 F.3d at 828; Cheng, *supra* note 15, at 108–09.

[65] *See, e.g.*, *In re Arenas*, 535 B.R. at 850; 11 U.S.C. § 707(a) (2019); 11 U.S.C. § 1325(a)(3) (2019).

[66] 11 U.S.C. § 1307(c)(1) (2019); *In re Arenas*, 535 B.R. at 850.

[67] *See* 11 U.S.C. § 1112 (2019); Arm Ventures, LLC, 564 B.R. 77, 82 (Bankr. S.D. Fla. 2017); *In re Arenas*, 535 B.R. at 850.

[68] 11 U.S.C. § 1307(c) (2019).

[69] *In re* Strug-Division, LLC, 375 B.R. 445, 449 (Bankr. N.D. Ill. 2007); *In re Marsch*, 36 F.3d at 828.

[70] *See In re Strug-Division, LLC*, 375 B.R. at 449.

[71] *See* Carolin Corp. v. Miller, 886 F.2d 693, 699–700 (4th Cir. 1989).

[72] *See* 11 U.S.C. §§ 706, 1307(c) (2019); *In re Arenas*, 535 B.R. at 845, 849–53.

if the debtor cannot get plans for repayment confirmed, the debtor's case will be dismissed.[73] A case's dismissal pushes the case out of bankruptcy, in turn denying the debtor relief through discharges or automatic stays, as well as throwing creditors back into the common pool problem of "first in time first in right" when trying to collect the debts owed to them.[74]

In fact, section 1129(a)(3) does not evaluate a plan's legal feasibility based on the legality of its specific terms, but instead on the legality of how the bankruptcy petitioner proposed the plan.[75] The "good faith" standard of 1129(a)(3) is a narrowly focused test of a debtor's honest intentions when he or she formulated, proposed, and confirmed the payment plan.[76] Section 1129(a)(11) of the Code proposes a feasibility standard that measures a plan's reasonable chance of success, meaning "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization."[77] This Comment does not suggest all marijuana businesses meet these standards, but that these standards should fairly be applied to such businesses instead of courts assuming these debtors are filing in bad faith solely because of the nature of their businesses.[78]

b. The CSA's Impact on the Good Faith Requirement and the Bankruptcy Estate

When courts reference the CSA's prohibition of marijuana to deny confirmation of payment plans funded by profits from an ongoing federally deemed criminal activity, they often emphasize that if these plans were to be confirmed, they would require the trustee of the estate—or the debtor, depending on which chapter the debtor filed into—to administer and distribute funds derived from violations of federal law.[79] Forcing trustees to fulfill their obligations in a plan requiring execution through unlawful means puts the trustee in danger of federal prosecution.[80] In these situations that jeopardize estate trustees, the court has found cause for dismissal for filing in bad faith.[81]

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[73] 11 U.S.C. § 706, § 1307(c) (2019). *See, e.g.*, *In re Arenas*, 535 B.R. at 849–53; Arm Ventures, LLC, 564 B.R. 77, 84 (Bankr. S.D. Fla. 2017).

[74] *See, e.g.*, U.S. v. Bell Credit Union, 860 F.2d 365, 369 (10th Cir. 1988).

[75] Cheng, *supra* note 15, at 145.

[76] 11 COLLIER ON BANKRUPTCY P 1112.04 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010); Cheng, *supra* note 15, at 110.

[77] 11 U.S.C. § 1129(a)(11) (2019).

[78] *See In re* Arenas, 535 B.R. 845, 852–53 (B.A.P. 10th Cir. 2015); *Arm Ventures, LLC*, 564 B.R. at 84.

[79] *In re Arenas*, 535 B.R. at 851.

[80] *Id.* at 854.

[81] *Id.* at 850–51.

Courts have elaborated that even if a debtor's payment plan consisted of payments from an "untainted" source, the continuation of the marijuana business would require the court, the trustee, and the debtor in possession of the estate's property to violate federal law by distributing illegal estate property.[82] This concern for bankruptcy law administrators plays a major part in courts' refusals to allow marijuana cases to proceed into the bankruptcy process out of fear that allowing exceptions to federal laws will further undermine the restrictive effects of the federal laws against drugs and other contraband.[83]

Despite the court's persistence on the irrelevance of segregated payment plan funds, this issue did not arise in *CHAMPS* when the marijuana business was allowed to separate its business costs of operating its healthcare services from its costs of operating its marijuana business, for the purpose of determining tax deductions for business expenses.[84] The seemingly minor inconsistency of a marijuana business's separation of payment plan funds is a mere preview of the greater conflicting applications between bankruptcy and tax law that will be explored later in this Comment.

The CSA also prohibits the bankruptcy system from being used as an instrument in the "ongoing commission of a crime," meaning any attempts for marijuana businesses to reorganize under chapter 11 of the Code that would permit or require a continuance of illegal activity may not be confirmed.[85] The same prohibition applies for chapter 12 and chapter 13 filings because of the "good faith" requirement of having a plan confirmed.[86] The good faith requirement ends up establishing a standard for de facto failure of marijuana businesses attempting to file for bankruptcy under these chapters.[87]

2. *Court Applications of Bankruptcy Laws Remain Hazy and Inconsistent*

There have been instances, though, when the courts have acknowledged that despite a marijuana business's technical illegality, there could be traces of good

[82] *Arm Ventures, LLC*, 564 B.R. at 84; *In re Arenas*, 535 B.R. at 852; *In re* Johnson, 532 B.R. 53, 56–57 (Bankr. W.D. Mich. 2015).

[83] *See Arm Ventures, LLC*, 564 B.R. at 84; *In re Arenas*, 535 B.R. at 852; *In re Johnson*, 532 B.R. at 56–57.

[84] *See* 26 C.F.R. § 1.183-1 (2019); *Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r*, 128 T.C. 173, 183 (2007) (accepting the marijuana business's characterization of two or more business activities as separate undertakings unless the characterization is artificial or unreasonable).

[85] Clifford J. White III & John Sheahan, *Why Marijuana Assets May Not Be Administered in Bankruptcy*, U.S. DEP'T OF JUSTICE 1, 2 (2017), https://www.justice.gov/ust/file/abi_201712.pdf/download.

[86] 11 U.S.C. § 1307(c) (2019).

[87] 11 U.S.C. §§ 1225(a)(3), 1325(a)(3) (2019); *In re Arenas*, 535 B.R. at 847; *In re* McGinnis, 453 B.R. 770, 772 (Bankr. D. Or. 2011).

faith in their filing.[88] In *In re Johnson*, the court admitted to the debtor's good faith despite his federally illegal activities in a state that had legalized medical marijuana.[89] The court justified this allowance by evaluating the case with the totality of the circumstances approach, emphasizing the debtor's dire need for bankruptcy relief, his age and state of health, and the candor of his testimony during creditor meetings.[90] The court refrained from dismissing the debtor's case, but instead enjoined the continuance of his marijuana business, at least while his case was pending.[91] Here, the court evaluated the totality of the circumstances to permit the debtor's bankruptcy relief through chapter 13 only on the condition that he abandon his entire marijuana business activities and all related assets.[92]

Bankruptcy courts have shown sympathy similar to that of *In re Johnson* with a marijuana debtor on a different occasion. In *In re Arenas*, the Bankruptcy Appellate Panel gave three reasons why a case should not be dismissed by using its own variation of the totality of the circumstances approach.[93] With this slightly different application, the court evaluated the debtor's good faith on a case-by-case basis, considering whether the debtor stated his debts and expenses accurately, whether he has made any fraudulent misrepresentations to mislead the bankruptcy court, or whether he has unfairly manipulated the Code.[94]

Courts should broaden their interpretations of the good and bad faith standards to focus more on the facts of each debtor's case to account for the possibility that the debtor was acting in good faith under state law, and that entering bankruptcy is not something a business owner considers when he or she starts operating. When determining whether a debtor's intentions for filing bankruptcy are good or bad, courts should consider a debtor's compliance with state laws regarding their marijuana operations and federal laws regarding other aspects of their business. Courts should not solely focus on the business's general purpose of manufacturing and selling a federally illegal drug. With this reasonable expansion of court interpretations, courts can facilitate bankruptcy's overarching purpose of attaining the best possible outcomes for both debtors and creditors.

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88 *See In re Johnson*, 532 B.R. at 59.

89 *Id.*

90 *Id.* at 57 n.8.

91 *Id.* at 59.

92 *Id.* at 58.

93 *Id.*; *In re* Arenas, 535 B.R. 845, 852–53 (B.A.P. 10th Cir. 2015).

94 *In re Arenas*, 535 B.R. at 851–52.

D. *Courts' Concerns about Marijuana Assets Putting Bankruptcy Trustees at Risk of Federal Prosecution*

Courts have noted that any plan for liquidation, reorganization, or payment that calls for the trustee to administer to the estate and distribute to creditors these marijuana assets or proceeds of such assets are actions equating federal offenses.[95]

These federal restrictions put immense pressure on bankruptcy estate trustees who have the responsibility of administering the debtor's assets to the estate and then distributing the value of those assets to creditors.[96] One of the most frequent causes for dismissal is the court's concern about putting bankruptcy trustees in compromising positions.[97] If courts were to confirm plans funded by marijuana profits, they would be compelling the trustee to traffic federally illicit goods.[98] These illicit goods are comprised of anything used to promote and further the production, buying, and selling of the federally banned marijuana.[99] This categorization as illicit goods makes a marijuana farmer's or dispensary's entire inventory and equipment subject to seizure by federal authorities both inside and outside the bankruptcy process.[100]

Trustees and other potential fiduciaries of the estate are not required, and in fact, are prohibited from administering a debtor's assets to the estate if doing so violates federal criminal laws.[101] If the trustees were to administer any marijuana-related assets, they would be in direct violation of such federal criminal law.[102] Trustees in marijuana cases are forbidden from administering assets such as farming and production equipment, storage facilities, the marijuana plants themselves, and even vehicles used to transport the

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95 *See In re Arenas*, 535 B.R. at 851; *In re Johnson*, 532 B.R. at 56–57; *Arm Ventures, LLC*, 564 B.R. 77, 85 (Bankr. S.D. Fla. 2017).

96 *See* 11 U.S.C. § 704 (2019).

97 *See In re Arenas*, 535 B.R. at 852; *In re Johnson*, 532 B.R. at 56–57; *Arm Ventures, LLC*, 564 B.R. at 84–86.

98 *See In re Arenas*, 535 B.R. at 852; *In re Johnson*, 532 B.R. at 56–57; *Arm Ventures, LLC*, 564 B.R. at 84–86.

99 *See* 26 U.S.C. 280E (2018); *Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r*, 128 T.C. 173, 182 (2007).

100 *See generally* Gonzales v. Raich, 545 U.S. 1, 19–20, 27 (2005); *In re Johnson*, 532 B.R. at 56–57.

101 *In re Arenas*, 585 B.R. at 852; *see generally* 21 U.S.C. §§ 841(a)(1), 856(a) (2018).

102 *In re Arenas*, 585 B.R. at 852; *see generally* 21 U.S.C. §§ 841(a)(1), 856(a) (2018); *Arm Ventures, LLC*, 564 B.R. at 84–86.

marijuana.[103] Federal law ends up excluding from the estate assets of substantial value.[104]

1. *How Court Protections Hinder the Trustee's Duty to the Estate*

Upon the request of a party in interest in the case and after notice and a hearing, the court can order the trustee to abandon the marijuana assets if they cannot be administered; however, it is often the case that the estate would be of little value to pay back creditors in the case of such abandonment because of the immense values invested in and produced by some of these assets.[105]

The *In re Johnson* bankruptcy court permitted the debtor to continue through bankruptcy on the condition that he abandon and cease all use of his property that was involved in the cultivation, possession, or transfer of marijuana, as well as destroy all marijuana plants, byproducts, or other substances derived from the plants within his possession.[106]

The court in *In re Arenas* considered the possibility of abandonment as leaving no value for creditors, granting debtors a discharge and allowing them to retain their marijuana assets, all while protecting the debtors from further collection activities.[107] Although the *In re Arenas* court did not directly address this exact issue, it provided reasoning for preventing marijuana debtors from entering the bankruptcy system because it would lead to an inequitable result.[108]

Administering valuable marijuana assets puts trustees in a compromising position, but abandonment of these assets also conflicts with the trustee's duties to the estate.[109] The Code explains who is qualified to be a trustee and the duties the position entails, including to "collect and reduce to money the property of the estate . . . as is compatible with the best interests of parties in interest. . . ."[110] This provision raises the question as to whose interests are prioritized when valuable assets are excluded from the pool of resources with which creditors will be repaid. By abandoning valuable assets from the estate, the trustee is not completely acting in the best interests of the parties in interest, such as the debtor

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[103] *See generally In re Arenas*, 535 B.R. at 852; *In re Johnson*, 532 B.R. at 56–57; *Arm Ventures, LLC*, 564 B.R. at 84–86.

[104] *See generally In re Arenas*, 535 B.R. at 852; *In re Johnson*, 532 B.R. at 56–57; *Arm Ventures, LLC*, 564 B.R. at 84–86.

[105] *See* 11 U.S.C. § 554(b) (2019).

[106] *In re Johnson*, 532 B.R. at 59–60.

[107] *In re Arenas*, 535 B.R. at 854; *see* 11 U.S.C. §§ 554, 727 (2019).

[108] *See In re Arenas*, 535 B.R. at 854.

[109] *See generally* 11 U.S.C. § 704 (2019).

[110] 11 U.S.C. § 704(a)(1) (2019).

and creditor. Of course, when the court has ordered such abandonment, the burden no longer lies on the trustee to strive for the best interests of the creditors by violating both federal law and court orders.[111]

Cases such as *In re Johnson* suggest that the court prioritizes the trustee's potential culpability more than the administration of a debtor's bankruptcy case.[112] The *In re Johnson* court justified its decision with the logic that the trustees fulfillment of its duties would unavoidably further the debtor's federally criminal activities and that the "pervasive benefits of bankruptcy" should not be used to advance such enterprises.[113]

Both courts and Congress should reconsider the applicability of penal consequences for bankruptcy trustees obligated with carrying out the best interests of the estate just as they have for state officials who end up violating federal laws to enforce their own state laws.[114] Both governmental bodies should grant some protection to trustees attempting to administer federal bankruptcy laws to debtors otherwise compliant with state and non-bankruptcy laws.

Congress's and the courts' discretion to prioritize federal interests, combined with the IRS's a la carte income tax treatment of marijuana enterprises discussed later in this Comment, suggest that courts might be taking too much liberty when handling marijuana bankruptcy cases, leading to inconsistencies and misapplications of federal laws.

E. Precluding Bankruptcy Relief for Marijuana Debtors Extends the CSA Beyond Its Legislative Scope

The difficulty marijuana businesses face entering bankruptcy raises the fundamental question of whether there should be any relief for federally illegal businesses. Answering this question involves comparing the bankruptcy system to other statutory regimes that apply regardless of an activity's legality. For instance, money regimes such as the IRC treat illegality as irrelevant. The Internal Revenue Service (IRS) taxes both legal and illegal income and relies on other federal statutes such as the CSA to regulate the legality of drug transactions.

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111 *See generally id.*

112 *In re* Johnson, 532 B.R. 53, 57 (Bankr. W.D. Mich. 2015).

113 *In re Johnson*, 532 B.R. at 57.

114 *See* State v. Karma, 39 P.3d 866, 867–68 (Or. Ct. App. 2002) (finding immunity for city police acting pursuant to a preempted state medical marijuana provision).

The federal government should separate bankruptcy's goals from those of the CSA because the CSA's goals are adequately served just by enforcing the CSA and should allow state governments to decide how strict or lenient to be on enforcing such drug laws in accordance with the country's system of federalism and dual sovereignty. To deny the marijuana industry bankruptcy relief is an incorrect way of enforcing the CSA that does not account for the developing opinions of the subject matter or each case's specific facts. Precluding marijuana debtors from bankruptcy relief inflicts double punishment on both debtors and creditors already suffering from their financial shortcomings, thus employing the Code for an unintended purpose.

Using the bankruptcy system as a penal code opens multiple levels of actors to punishment stemming from a marijuana business's illegality. Disallowing bankruptcy relief to marijuana debtors punishes not only capital investment creditors, but also third-party service providers. Denying bankruptcy could affect anyone from a dispensary's building contractor to a food caterer for company parties that were paid on credit. Bankruptcy seeks to protect the interests of these parties and many more.

II. How Marijuana Farmers and Dispensaries Could (and Should) Qualify for Bankruptcy Relief

As discussed in Part I, if not for federal and court-imposed roadblocks to relief, marijuana businesses would otherwise qualify for bankruptcy, and creditors would not walk away empty-handed.[115] It is important to proactively examine how debtors in the marijuana industry would use the bankruptcy chapters to seek relief if Congress or the bankruptcy courts responded to the growing trend of marijuana decriminalization by making bankruptcy available to such debtors.

How a debtor moves through and exits the bankruptcy process depends on the chapter under which he or she files for relief. It would be in a marijuana business's best interest to file for relief under chapters 11 or 12 because they allow the debtor to remain in possession of prebankruptcy assets and to pay back debts with future income earned, as opposed to chapter 7 where a debtor's prebankruptcy property would be liquidated, and the proceeds of such property distributed to creditors.[116]

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115 *In re Johnson*, 532 B.R. at 57.

116 11 U.S.C. §§ 726, 1222, 1322 (2019).

Different bankruptcy chapters likely apply to different players in the marijuana industry. As such, this Comment distinguishes between marijuana growers and dispensaries when analyzing their different avenues for bankruptcy relief. This Comment will focus on marijuana growers as manufacturers, and dispensaries as both retail sellers and producers if they conduct on-site conversions of the marijuana from a smokable plant to another form of consumption. It is not uncommon for a marijuana grower to double as its own retailer, directly using and converting its raw materials into consumable final products.[117] This Comment will also consider both manufacturers and dispensaries as property owners for bankruptcy and income tax purposes.

A. *Marijuana Farmers Filing Under Chapter 12*

Marijuana growers could pursue bankruptcy relief through chapter 12, which is available to "family farmers" that have regular annual income sufficiently stable and regular to enable the family farmer to make payments under a chapter 12 plan.[118] Chapter 12 is designed to accommodate the economic realities a family farmer faces by allowing these farmers to bypass the expensive barriers they would encounter in a chapter 11 or 13 bankruptcy filing.[119] Filing into chapter 12 is a good option for smaller-scale marijuana growers who are just entering the relatively immature market because it is more streamlined and less expensive than chapter 11, and is better suited for smaller corporate entities.[120] Congress intended chapter 12 as an alternative to chapters 11 and 13 for these kinds of debtors in the bankruptcy system.[121]

Chapter 12 provides advantages over chapter 13 for growers in that chapter 12 is designed for debtors with regular income who have larger debts than individual wage earners in a chapter 13 case may have.[122] In a practical sense, chapter 12 debtors are almost guaranteed to have a substantial portion of their income dedicated to the purchase and maintenance of farming equipment and products, increasing the possibility of their debts being greater than those of a chapter 13 individual debtor.

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[117] THC CO., *About Us* (last visited Jan. 25, 2019), https://www.hollingsworthcannabis.com/aboutus/; *see generally* Californians Helping to Alleviate Med. Problems v. Comm'r, 128 T.C. 173, 181–82 (2007).

[118] 11 U.S.C. §§ 1222, 101(18), 109(f) (2019).

[119] *Chapter 12 Eligibility in Bankruptcy*, FEDERAL JUDICIARY: ADMINISTRATIVE OFFICE OF THE U.S. COURTS (2019), http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-12-bankruptcy-basics.

[120] *Id.*

[121] *Id.*

[122] *Id.*

Chapter 12 allows debtors of the required character to establish payment plans that will provide payments to creditors over three to five years and are funded by the farmer's regular annual income that has the potential to be seasonal in nature.[123] The plans are typically for three years unless the court approves of a longer plan period "for cause," and a payment plan can never extend past five years.[124] Two categories of family farmers are permitted to file under this chapter: individual filers and legal entities.[125]

The second category of chapter 12 filers are legal entities such as corporations and partnerships.[126] Similar to the requirements for individual family farmers, corporations and partnerships filing as a "family farmer" must meet certain criteria.[127] The entity must have more than eighty percent of its asset value relating to the farming operation, and any corporate stock cannot be traded on the public market.[128]

Whether an individual or a legal entity, all chapter 12 debtors are required to provide a plan through which all or a substantial portion of future earnings or income will be allocated in deferred cash payments to pay priority claimholders in full within the designated period.[129]

Depending on whether they meet the debt restrictions, marijuana growers fit into the categories set forth in chapter 12 because the production of cannabis plants qualifies as the "raising of crops" that involves the Code's requisite manipulation of the land, as well as the hefty investments in farming equipment and operations.[130] The chance marijuana growers meet these criteria is promising considering it has typically been smaller-scale, individually or

[123] 11 U.S.C. § 1222(c) (2019). (These payments could be affected by seasonality).

[124] *Id.*

[125] 11 U.S.C. §§ 101(17)(B), 101(18)(A)(i) (2019) (Individuals in chapter 12 include a debtor and his or her spouse engaged in a farming operation with aggregate debts no greater than $4,153,150.00, no less than fifty percent of which are noncontingent, liquidated debts arising from the costs of operating the farm, and more than fifty percent gross income for the taxable year prior to the year of filing coming from the farming operation.).

[126] 11 U.S.C. § 101(18)(B) (2019).

[127] *Id.* (A legal entity filing under chapter 12 needs more than fifty percent of its outstanding stock or equity held by the one family or relatives of that family conducting the farming, and its aggregate debts must not exceed $4,153,150.00, with at least fifty percent of its aggregate noncontingent, liquidated debts, on the date of the case filing, arising from its farming operation.).

[128] *Id.*

[129] *Id.*; 11 U.S.C. § 1222(a)(1), (2) (2019); 11 U.S.C. § 1222(c) (2019); *see* J. David Aiken, *Chapter 12 Family Farmer Bankruptcy*, 28 UNIV. OF NEBRASKA, LINCOLN FACULTY PUBLICATIONS: AGRICULTURAL ECONOMICS, 632, 671–93 (1987).

[130] 11 U.S.C. § 101(21) (2019) (The Code defines a "farming operation" for chapter 12 debtors as the "tillage of the soil, dairy farming, ranching, production or raising of crops, poultry, or livestock, and production of poultry or livestock products . . . .").

family-owned marijuana cultivating operations that have filed for bankruptcy relief.[131]

As more states move to legalize the cannabis crop's production on a state level, smaller-scale farming operations, such as those owned and operated by the Code's "family farmer" demographic, have had trouble keeping up with the manufacturing demands of the growing market.[132] As larger growing operations flood into the now-legal cannabis industry, the bigger players' access to capital and more modern equipment allows them to produce more at lower marginal costs and charge lower retail prices to consumers.[133] In August of 2014, a legal gram of cannabis in Washington was priced at $35.67; but by late 2017, the retail price had declined to $7.45 per gram and a mere $2.50 per gram wholesale.[134] When faced with such price fluctuations, smaller-scale "family farmer" operations are generally inadequately funded compared to bigger operations and thus incapable of keeping pace with the higher production demands while still earning a profit.[135]

Quick and drastic shifts in pricing and consumer demands in the marijuana industry increase family farmers' needs for bankruptcy relief, just as it would for a similarly situated business in a different field operating legally under state law. The Code's specific inclusion of chapter 12 for debtors with the profile of a family marijuana farmer suggests the drafters intended the Code to help debtors of that kind by focusing on debt profiles and general farming activities, rather than the conflicts between state and federal laws. Chapter 12 displays the Code's acknowledgment that family farmer debtors need the Code and its benefits since the Code specifically mentions them to ensure they have bankruptcy options. Marijuana growers meeting the chapter 12 debtor criteria should be permitted to benefit from the Code's explicit special treatment of family farmer debtors.

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131 *In re* Arenas, 535 B.R. 845, 847–48 (B.A.P. 10th Cir. 2015); *In re* Johnson, 532 B.R. 53, 58 (Bankr. W.D. Mich. 2015).

132 Lester Black, *Legal Weed Isn't the Boon Small Businesses Thought It Would Be*, FIVETHIRTYEIGHT (Dec. 29, 2017, 4:20 AM), https://fivethirtyeight.com/features/legal-weed-isnt-the-boon-small-businesses-thought-it-would-be/.

133 Scott Rodd, *As Smaller Marijuana Businesses Get Squeezed, State Revenue Takes a Hit*, PEWTRUSTS (June 21, 2018), https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2018/06/21/as-smaller-marijuana-businesses-get-squeezed-state-revenue-takes-a-hit.

134 *Id.*

135 Black, *supra* note 132.

B. Marijuana Dispensaries Filing Under Chapter 11

On the other hand, marijuana dispensaries that do not engage in cannabis cultivation would be better off filing under chapter 11 because it permits debtors to retain their prepetition assets and pay creditors back with future earnings without having to meet the requirements of a chapter 12 debtor.[136]

In a normal chapter 11 proceeding, the debtor would retain estate property for the continuance of business unless the court ordered otherwise, and if the court does so, the debtor may use estate property with the court's permission only to the extent of what is needed for the debtor's business, as set forth by section 362 of the Code.[137]

Included in the *In re Johnson* debtor's abandoned assets were his residence, truck, all horticultural equipment, fertilizer, and any other property, directly or indirectly connected with the "possession, cultivation, sale, distribution, or other transfer of marijuana," regardless of any permissive state law.[138] The debtor was also forced to abandon any and all marijuana plants and their byproducts from the estate, or else have his case dismissed.[139]

The abandonment of a marijuana debtor's assets raises the question as to whether abandoning assets of such value constitutes a disservice to the estate that could otherwise consist of such assets. The estate is composed of property that can be tangible property or a debtor's future earnings depending on if the debtor filed in chapter 7 or 11, respectively.[140] Property of the estate acts as a pool of monetary values to be distributed to creditors.[141] Allowing marijuana debtors to move through the bankruptcy process would prevent creditors and bankruptcy estates from losing out on any valuable assets the debtor can use to repay debts.

Current application of bankruptcy laws disallows any businesses engaged in the production or sale of marijuana from using income gained from such activities to pay off debts.[142] Paying creditors back with future income instead of prepetition assets would allow marijuana debtors to retain all the

[136] 11 U.S.C. § 1322(a)(1) (2019).
[137] 11 U.S.C. §§ 363(b)–(c), 1304 (2019); *In re* Johnson, 532 B.R. 53, 58 (Bankr. W.D. Mich. 2015).
[138] *In re Johnson*, 532 B.R. at 59.
[139] *Id.*
[140] 11 U.S.C. §§ 541, 1115 (2019).
[141] *See* 11 U.S.C. § 541 (2019).
[142] *In re* Arenas, 535 B.R. 845, 850 (B.A.P. 10th Cir. 2015); *In re Johnson*, 532 B.R. at 56–57 (Bankr. W.D. Mich. 2015); Arm Ventures, LLC, 564 B.R. 77, 85 (Bankr. S.D. Fla. 2017).

infrastructure and product in which they had already made sizable investments.[143]

Just as in chapter 12, chapter 11 debtors must have regular annual income sufficient to pay priority claimholders in full via deferred cash payments.[144] Section 101(30) defines an individual with "regular income" as a person with income sufficiently stable and regular to enable that person to make payments under a chapter 11 bankruptcy plan.[145] This regular income requirement goes further to say that the income needs to be sufficient enough to fund both the plan's payments and the debtor's living expenses over the course of the plan.[146] If permitted to maintain possession and usage of their marijuana-related assets, marijuana dispensaries filing under chapter 11 could continue operating to generate income at whatever pace necessary to repay creditors.

III. THE DISJOINTED TREATMENT OF INCOME BY BANKRUPTCY AND TAX LAW

As mentioned before, bankruptcy relief is not a constitutionally guaranteed right.[147] For the most part, bankruptcy relief has been denied to marijuana debtors rather consistently; however, the treatments of these businesses in both bankruptcy and tax law proves inconsistent.[148] Inconsistencies appear through denials of filings under chapters 11 and 12 for lack of good faith and a regular stream of income, while federal tax laws consider these same incomes worthy of taxation.[149] Additionally, marijuana businesses are not permitted to claim tax deductions for business expenses they have accumulated the way other businesses can.[150] Pursuant to section 280E of the IRC, neither tax deductions nor credits are allowed for any expenses paid or incurred in the pursuit of any trade or business that involves trafficking substances deemed controlled by the CSA.[151]

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[143] 11 U.S.C. § 1306(b) (2019).

[144] 11 U.S.C. § 1322(a)(2) (2019).

[145] 11 U.S.C. § 101(30) (2019) (defining "regular income" for a chapter 13 bankruptcy filing, excluding stockbrokers or commodity brokers from the individuals who could qualify).

[146] *In re Arenas*, 535 B.R. at 850 n.20.

[147] U.S. v. Kras, 409 U.S. 434, 446 (1973).

[148] *See* Loughman v. Comm'r, No. 21464-15, 2018 Tax Ct. Memo LEXIS 85, at *1 (T.C. June 18, 2018); Peyton v. Comm'r, No. 16468-98, 2003 Tax Ct. Memo LEXIS 351, at *1 (T.C. May 22, 2003).

[149] 26 U.S.C. § 61(a)(2) (2018).

[150] 26 U.S.C. § 280E (2018); Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r, 128 T.C. 173, 182 (2007).

[151] 26 U.S.C. § 280E (2018).

Section 61 of the IRC defines what kinds of income are subject to taxation.[152] Gross income for purposes of calculating taxable income is defined as "all income from whatever source derived."[153] Nowhere in section 61 does the IRC differentiate between legal and illegal sources of income, nor does it explicitly label legal income as the only kind subject to taxation.[154] In fact, it has been established that any income earned through illegal activities is taxable as regular income.[155] The kinds of legal and illegal incomes that marijuana businesses pay taxes on but are prohibited from paying creditors back with include income derived from business, compensation for services, dividends, rental income, and dealings in property.[156] Despite the inconsistent treatment, the IRS continues taxing marijuana income under federal income tax law, and federal bankruptcy law continues denying debtors and creditors relief by means of that very same income.[157] Courts have offered no explanation as to why the federal government may benefit from the federally illegal funds, but the debtors and creditors who generated the income are prohibited from benefitting from bankruptcy law's recognition of the income.[158]

Income gained through dealings in marijuana has been disallowed by courts' interpretations of federal bankruptcy laws, while remaining subject to taxation under federal income tax laws.[159] In *Peyton v. Commissioner*, the petitioner was punished for not reporting illegal income from drug sales in his federal income taxes.[160] In *Loughman v. Commissioner*, shareholders of a marijuana entity registered as an S corporation were required to include in their gross incomes both their pro rata shares of the business's income as well as the separate wages they were paid for rendering services to the business, pursuant to section 1366 of the IRC.[161] Section 1366 (b) of the IRC specifies that income from holding shares in a company is to be treated as though it were income directly from the

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152 26 U.S.C. § 61 (2018).

153 26 U.S.C. § 61(a) (2018).

154 26 U.S.C. § 61 (2018).

155 26 U.S.C. § 61(a) (2018); 26 C.F.R. § 1.61-14(a); James v. United States, 366 U.S. 213, 218 (1961).

156 26 U.S.C. § 61(a)(1)–(3), (5), (7) (2018); Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955).

157 *See* Loughman v. Comm'r, No. 21464-15, 2018 Tax Ct. Memo LEXIS 85, at *1 (T.C. June 18, 2018); Peyton v. Comm'r, No. 16468-98, 2003 Tax Ct. Memo LEXIS 351, at *1 (T.C. May 22, 2003).

158 *See* 26 U.S.C. § 1366(a)–(c) (2018); Peyton, 2003 Tax Ct. Memo LEXIS 351, at *1; Loughman, 2018 Tax Ct. Memo LEXIS 85, at *1.

159 *See* 26 U.S.C. § 280E (2018); *In re* Arenas, 535 B.R. 845, 850 (B.A.P. 10th Cir. 2015); *In re* Johnson, 532 B.R. 53, 56–57 (Bankr. W.D. Mich. 2015); Arm Ventures, LLC, 564 B.R. 77, 85 (Bankr. S.D. Fla. 2017); Loughman, 2018 Tax Ct. Memo LEXIS 85, at *1; Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r, 128 T.C. 173, 182 (2007).

160 Peyton, 2003 Tax Ct. Memo LEXIS 351, at *2.

161 26 U.S.C. § 1366(a)–(c) (2018); Loughman, 2018 Tax Ct. Memo LEXIS 85, at *9.

source from which the corporation realized or incurred the income.[162] Section 1366 suggests the IRS considered and accepted the fact that the shareholders' incomes are acceptable as taxable income despite being derived from a federally illegal source such as marijuana sales.[163]

A. Federal Tax and Bankruptcy Law's Mistreatment of Rental Income

Regarding income from dealings in property, bankruptcy law disallows debtors from using rental income or income from the sale of real estate to pay back creditors if there had been marijuana trafficking of any kind on the premises.[164] Section 856(a) of the CSA explicitly makes illegal knowingly leasing, renting, using, or maintaining any place for the purpose of manufacturing, distributing, or using any controlled substance.[165] Because of marijuana's inclusion in the CSA's list of controlled substances, section 856 applies to any property owner who either owns or rents premises to the marijuana operation.[166] Such property owners include family farmers who own the acreage upon which they conduct their marijuana farming operations.[167] This exclusion of rental income from being used to fund repayment to creditors once again diminishes the value of the estate available to creditors and undermines the overarching purpose of bankruptcy law to organize debtor assets in a way that optimizes the estate's ability to repay creditors, and a debtor's chances for a fresh start.[168]

Because of these prohibitions, bankruptcy debtors are prevented from using property that has already been heavily invested in—both with internal and external funding—to pay back debts.[169] Section 856 of the CSA explicitly prohibits property owners from knowingly and intentionally renting, leasing, profiting from, or making available for use any place to be used for the manufacture, storage, distribution, or use of a controlled substance, regardless of whether compensation was received.[170] Section 856 interacts with bankruptcy

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[162] 26 U.S.C. § 1366(b) (2018).

[163] 26 U.S.C. § 1366(a)–(c) (2018); Loughman, 2018 Tax Ct. Memo LEXIS 85, at *9; Olive v. Comm'r, 139 T.C. 19, 39 (2012).

[164] 21 U.S.C. § 856(a) (2018); *In re Arenas*, 535 B.R. at 847–48.

[165] 21 U.S.C. § 856(a) (2018).

[166] *Id.*

[167] 21 U.S.C. § 841(a)(1) (2018).

[168] *See* Grogan v. Garner, 498 U.S. 279, 286–87 (1991).

[169] *In re Arenas*, 535 B.R. 845; Arm Ventures, LLC, 564 B.R. 77, 84 (Bankr. S.D. Fla. 2017); *In re* Johnson, 532 B.R. 53, 56 (Bankr. W.D. Mich 2015); *In re* Rent-Rite Super Kegs W. Ltd., 484 B.R. 799, 809 (Bankr. D. Colo. 2012).

[170] 21 U.S.C. § 856(a)(2) (2018).

by excluding from the bankruptcy estate any real property or buildings that the debtor intends to use to repay creditors because the properties, and any profits derived from such properties, were involved in ongoing criminal violations of federal law.[171]

In *In re Rent-Rite Super Kegs*, the court dismissed a landlord-debtor's chapter 11 bankruptcy case when a debtor executed a promissory note by giving the bank the deed of trust on a warehouse the debtor owned, the leasing of which the debtor derived a quarter of his income.[172] That promissory note was then used to secure a creditor's claim, who requested the bankruptcy court dismiss the debtor's attempts to reorganize under chapter 11 because of the debtor's unlawful leasing to tenants who grew marijuana.[173] It did not matter that the debtor was not directly involved in the marijuana production—legal under Colorado law—because the CSA criminalizes indirectly profiting from a controlled substance.[174] The court held the landlord-debtor responsible for the nature of his tenants' business, subsequently punishing the landlord for his tenants' state-legal operations by denying the landlord the benefits of bankruptcy.[175]

The bankruptcy court in *In re Rent-Rite Super Kegs* openly considered the conflicts between Colorado state law and the CSA, contemplating whether the CSA would override such explicitly permissive state laws.[176] This court went on to explain that the discrepancies in federal and state laws regarding marijuana legality were not issues of federal preemption because Colorado state laws would not be affected by federal enforcement of the CSA, but rather just the application of federal bankruptcy laws would be impacted.[177] The *Rent-Rite* court reasoned that this interplay between federal and state law demanded a denial of bankruptcy relief to the landlord-debtor.[178]

Despite its reasoning, this court admitted that such broad application of section 856, known as the "crack house statute" because it was intended to control crack houses, may be too harsh when applied to this landlord-debtor's conduct.[179] The broad application of section 856 effectively undermines the

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171 *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 803–04.
172 *Id.* at 802.
173 *Id.* at 804.
174 *Id.*
175 *Id.*
176 *Id.*
177 *Id.* at 805.
178 *Id.*
179 *Id.* at 803, n.3.

structure of the Code when establishing which assets of value can be administered to the estate and distributed to creditors for a worthwhile outcome in a bankruptcy case by excluding significant sources of a marijuana debtor's income and value.

The *Rent-Rite* court ultimately disallowed the administration of the warehouse and other personal property stored within it—totaling $3.8 million in value—to the bankruptcy estate. The court dismissed the case for cause because the debtor was knowingly renting space to parties growing marijuana.[180] This decision to dismiss for cause is reinforced by the causes set forth in section 1112 of the Code.[181]

The court also reasoned it had to weigh the consequences of the debtor's criminal conduct on the chapter 7 trustee's ability to administer the chapter 7 estate.[182] *Rent-Rite* did not involve any trustee action to abandon the warehouse—which would have led to conversion from chapter 11 to 7—but the court nonetheless speculated that if a trustee were to administer the warehouse, then the estate's major asset would essentially be a crime scene.[183] Regardless of which chapter the debtor filed under, the trustee in *Rent-Rite* would have been obligated to administer the building to the bankruptcy estate, as well as any proceeds, rents, or profits from such property because section 541 of the Code includes such property as property of the estate.[184] Once again, the CSA's criminalization of any such profiting from the use or manufacture of a controlled substance, such as marijuana, significantly frustrates the successful administration of a bankruptcy case for a debtor, even when that debtor is only distantly connected to a marijuana operation.[185]

Even though federal laws and their applications completely exclude profits from properties once they have been associated with marijuana dealings of any kind, the federal government still imposes federal income taxes on this very same income.[186] As mentioned before in the *Peyton* memo, since the IRC does not distinguish between legal and illegal incomes, a taxpayer is liable for taxes on income from all sources, including income illegally derived from the commission of criminal activities.[187] This blending of incomes from both legal

180 11 U.S.C. § 1112(b)(4) (2019); *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 810.

181 *Id.*

182 *Id.* at 804.

183 *Id.*

184 11 U.S.C. § 541(a)(6) (2019).

185 21 U.S.C. §§ 841(a)(1), 856(a) (2018).

186 26 U.S.C. § 61 (2018).

187 *Id.*; Peyton v. Comm'r, No. 16468-98, 2003 Tax Ct. Memo LEXIS 351, at *1 (T.C. May 22, 2003).

and illegal sources does not occur anywhere in the Code.[188] This inconsistency skews towards allowing the government to benefit from marijuana income, but not the innocent third parties to which the money should be allocated.[189]

Any administration of federally illegal assets, such as cannabis plants, related production equipment, or income from marijuana-related operations, to the bankruptcy estate or to creditors puts the trustee at risk of federal prosecution.[190] For these concerns, the *Rent-Rite* court decided such properties be forfeited in accordance with the CSA.[191] The court further expressed that the facts of *Rent-Rite* and concerns for the bankruptcy trustee outweighed concerns for the best interests of the creditors and the estate, and thus disallowed any contemplation of whether a dismissal or conversion would be in the best interests of the creditors and the estate.[192] Thus, the *Rent-Rite* court effectively prioritized the trustee's interests over those of the debtor, creditors, and the estate.[193]

If not for courts' concerns about trustees violating federal laws, it would seem to be in the best interests of both creditors and debtors to administer such valuable pieces of property to the estate, thus providing funding for the estate's distribution to creditors owed payment.[194] These categorizations as taxable income raise the question of what justifies the unfavorable treatment of a marijuana debtor's income under bankruptcy law enough to disallow that same income from being used to repay creditors in a chapter 11 or 12 bankruptcy case.[195]

B. Tax Law's Denial of Tax Deductions Earned by Marijuana Businesses

In addition to the inconsistent treatment towards marijuana business's incomes, marijuana's status as a Schedule I drug also denies businesses in the industry the benefit of deducting business expenses from their taxable income.[196] Section 162 of the IRC dictates that deductions are permitted for all ordinary and necessary expenses paid or incurred in carrying on any trade or business,

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188 *See generally* 11 U.S.C. (2019).

189 *See* Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r, 128 T.C. 173, 181–82 (2007).

190 *In re* Rent-Rite Super Kegs W. Ltd., 484 B.R. 799, 810 (Bankr. D. Colo. 2012).

191 *Id.* at 804.

192 11 U.S.C. 707(a) (2019); *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 810–11.

193 *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 810–11.

194 11 U.S.C. §§ 1129(a), 1329(a) (2019).

195 *In re* Arenas, 535 B.R. 845 (10th Cir. B.A.P. 2015); Arm Ventures, LLC, 564 B.R. 77, 84 (Bankr. S.D. Fla. 2017); *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 804; Peyton v. Comm'r, No. 16468-98, 2003 Tax Ct. Memo LEXIS 351, at *1 (T.C. May 22, 2003).

196 26 U.S.C. § 280E (2018); 11 U.S.C. §§ 1225(a)(3), 1325(a)(3) (2019); *In re Arenas*, 535 B.R. at 847; Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r, 128 T.C. 173, 182 (2007).

including things such as salaries for personal services rendered or rental payments made for purposes of the trade or business.[197] The problem here is that expenses incurred in the course of a federally illegal business are not considered ordinary and necessary expenses.[198] The ordinary and necessary business expense deductions that are available to other businesses via section 261 of the IRC are denied to marijuana businesses by section 280E.[199] The IRC's selective application of which incomes and expenses marijuana businesses can benefit from suggests an unjustified special treatment towards marijuana businesses that negatively impacts the industry on both a federal and state level. This Comment will discuss how courts can mitigate the industry's adverse special treatment not only by broadening their interpretations of crucial terminology as discussed earlier, but also by introducing more creative solutions for marijuana debtors to optimize the resources available to the bankruptcy estate.

IV. TRUSTEES SHOULD BE PERMITTED TO USE TAX DEDUCTIONS AND CREDITS TO REPAY CREDITORS WHILE AVOIDING FEDERAL PROSECUTION

As seen above, marijuana businesses face an uphill battle waiting for Congress and the judiciary to provide them a place in the bankruptcy system. This Comment proposes a workaround solution that would aid debtors in the system as it exists today until courts change their interpretations of the Code or relax their trustee concerns, or until Congress takes legislative action.

Despite the many obstacles to relief, marijuana farmers and dispensaries might be able to pay creditors if they were able to utilize the tax deductions for which they qualified, and then transfer those deductions to creditors as payments for debts. Allowing this transfer of tax deductions could provide both lenders and borrowers with some form of relief without requiring trustees to violate federal law by administering illegal substances and properties to a bankruptcy estate, thus essentially selling those illegal assets back to creditors.

There is a general rule that one taxpayer cannot claim the tax deductions of another taxpayer; however, the federal government's creation of exceptions for the marijuana industry to other general rules make flexibility seem more of a possibility, particularly when the tax and bankruptcy codes have been amended frequently.[200] Because bankruptcy courts handling marijuana cases prioritize the

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197 26 U.S.C. § 162(a) (2018).

198 26 U.S.C. § 280E (2018); *Californians Helping to Alleviate Med. Problems*, 128 T.C. at 182.

199 26 U.S.C. §§ 261, 280E (2018); *Californians Helping to Alleviate Med. Problems*, 128 T.C. at 182.

200 *See In re Arenas*, 535 B.R.; *Arm Ventures, LLC*, 564 B.R. at 84; *In re Rent-Rite Super Kegs W. Ltd.*, 484 B.R. at 804; *Californians Helping to Alleviate Med. Problems*, 128 T.C. at 182; *Peyton v. Comm'r*, No.

trustee's well-being when handling marijuana-related assets, both Congress and courts should explore the potential of the monetization of tax deductions and credits in the amount of loans made by creditors to bankruptcy debtors to avoid the issue of bankruptcy trustees dealing in federally illegal assets entirely. This Comment proposes that even if courts stuck to the general rule of disallowing deduction transfers, allowing creditors to claim a marijuana debtor's costs of goods sold "deductions" could be another possibility of relief for both marijuana debtors and creditors.[201]

A. *The Availability of Costs of Goods Sold "Deductions"*

Contrary to its greater scheme of seemingly discriminatory tax treatment, section 280E of the IRC does not prohibit marijuana businesses from deducting inventoriable costs from a business's annual ordinary income.[202] These inventoriable costs, otherwise known as cost of goods sold (COGS), are not deductions under section 162(a) of the IRC, and thus are not prohibited from being claimed under section 280E.[203] Businesses classifying expenses as inventoriable costs must wait until the inventory item is sold to claim the deduction from that inventory expense.[204] Marijuana farmers and dispensaries could have large COGS considering the sizable initial investments in inventories and their catering to a continuously growing consumer base.[205] The allowance of COGS recordation could allow marijuana businesses to include otherwise excluded business expenses into the business's COGS, and in turn, use them to offset the marijuana business's gross receipts from drug sales.[206]

Californians Helping to Alleviate Medical Problems (*CHAMPS*) demonstrates the COGS concept not by the tax court's division of the

16468-98, 2003 Tax Ct. Memo LEXIS 351, at *1. *See generally* Andrew Beattie, *A Concise History in U.S. Tax Law*, INVESTOPEDIA (Apr. 2, 2010), https://www.investopedia.com/articles/tax/10/concise-history-tax-changes.asp; FED. JUD. CTR., THE EVOLUTION OF U.S. BANKRUPTCY LAW (2019); CORP. FIN. INST., U.S. BANKRUPTCY CODE: TITLE 11 OF THE UNITED STATES CODE (2019).

[201] 26 U.S.C. §§ 162(a), 280E (2018); (The term "deductions" is in quotes because COGS expenses are not "deductions" within the meaning of the IRC yet are still subtracted from a business's gross receipts when calculating annual gross profit).

[202] 26 U.S.C. § 280E (2018); *Californians Helping to Alleviate Med. Problems*, 128 T.C. at 182.

[203] 26 U.S.C. §§ 162(a), 280E (2018).

[204] Richard L. Russell Jr., *IRC Section 162 and Deductible Business Expenses for Marijuana Dispensaries: The Taxation of Breaking Bad*, THE CPA JOURNAL, (Oct. 27, 2017), https://www.cpajournal.com/2017/10/27/irc-section-162-deductible-business-expenses-marijuana-dispensaries/.

[205] Matej Mikulic, *Current and Projected Legal Cannabis Market Value in the United States in 2016 and 2025 (in Billion U.S. Dollars)*, Statista (Sept. 2, 2019), https://www.statista.com/statistics/765671/value-of-the-us-cannabis-market-current-and-future/.

[206] 26 U.S.C. § 280E (2018). *Californians Helping to Alleviate Med. Problems*, 128 T.C. at 182.

dispensary's expenses between marijuana and non-marijuana related service expenses, but rather by the court's discussion that the dispensary was able to declare COGS expenses for both the marijuana and healthcare services inventoriable costs.[207] When explaining its allowance of deductions for COGS expenses, the *CHAMPS* court referenced a Senate Finance Committee report that reiterated the public policy against drug dealing that resulted in section 280E. The report went on to say that section 280E does not apply to COGS deductions, thus not precluding COGS adjustments to a marijuana business's gross receipts.[208] The *CHAMPS* court agreed with the report, stating the legislative history displayed Congress's intent to deny regular deductions to drug trafficking businesses, but not to all of a taxpayer's business expenses solely because the taxpayer engaged in trafficking a controlled substance, such as marijuana.[209]

Treasury Regulation 1.471-11 addresses the inventories of manufacturers by stating that businesses can subtract from their incomes COGS that were incurred through production costs incident to or necessary for the production or manufacture of operations or processes.[210] These costs include both direct production costs and fixed and variable indirect production costs.[211] The direct production costs can result from either direct material or direct labor expenses. Direct material expenses are the costs from materials that get consumed in the ordinary course of manufacturing of a product, and direct labor expenses include things such as compensation, overtime pay, and payroll taxes.[212] Indirect production costs include all costs incident to and necessary for production or manufacturing operations that do not fall into the direct production cost category.[213] Accordingly, marijuana farmers and dispensaries are not prevented from offsetting their gross revenues with inventoriable and production costs that qualify as COGS expenses.[214]

Marijuana growers can meet these production requirements because their farms are producing and manufacturing cannabis crops.[215] Dispensaries, on the other hand, might not always have the production operations necessary for optimizing their COGS benefits. For marijuana dispensary businesses to really

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207 *Californians Helping to Alleviate Med. Problems*, 128 T.C. at 182.
208 *Id.* at 181–82.
209 *Id*.
210 26 CFR § 1.471-11 (1993).
211 § 1.471-11(b)(2)(i).
212 §§ 1.471-11, 1.471-3.
213 § 1.471-11(b)(3)(i).
214 *See* Californians Helping to Alleviate Med. Problems v. Comm'r, 128 T.C. 173, 182 (2007).
215 26 CFR 1.471-11(b)(2)(i) (1993).

capitalize on the potential benefits from COGS deductions, they should include in business operations some type of production or manufacturing function, such as processes that convert the cannabis plants to a consumable form.[216]

It is possible for a marijuana grower to control the conversion of its products as well their distribution. The Hollingsworth Cannabis Company (THC Co.) is a family-oriented cannabis farm based in Washington state and organized as a limited liability company that is owned and operated by brother and sister Raft and Joy Hollingsworth.[217] THC Co. employs multiple generations of the Hollingsworth family, with members' roles ranging from farming and processing to quality control and sales.[218] Since THC Co.'s genesis in 2013, the Hollingsworth family has expanded the farm's business activities from cannabis production to material processing and conversion of raw cannabis into a variety of consumable forms, to then distributing those finished products to consumers.[219] THC Co. is a perfect example of a relatively small operation that would qualify for COGS deductions because of its control of the different levels of the supply chain.

Though the benefits of claiming COGS expenses are greater for marijuana-producing businesses, retailers can still allocate some of their operating costs to inventory costs.[220] However, even if a marijuana retailer does not conduct on-site material conversions or productions like THC Co., it can still allocate to its inventory costs expenses from the necessary transportation and acquisition of the cannabis or cannabis products.[221] Dispensaries can also allocate to inventory costs, the price payed to the supplier for the cannabis, sales costs, and costs from storing the cannabis.[222]

The benefits from claiming COGS deductions could offer courts and marijuana debtors in bankruptcy creative solutions to satisfy creditors that otherwise would walk away with nothing.

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216 26 CFR § 1.471-11 (1993).

217 Brian MacIver, *How the Hollingsworth Cannabis Company Found Its Place in Washington's Marketplace*, CANNABIS BUS. TIMES (May 10, 2019), https://www.cannabisbusinesstimes.com/article/the-company-you-keep/.

218 *Id.*

219 *Id.*

220 Farrell Fritz, P.C., *Cannabis, Business Expenses, and the Code*, JDSUPRA (June 25, 2018), https://www.jdsupra.com/legalnews/cannabis-business-expenses-and-the-code-33616/.

221 *Id.*

222 *Id.*

B. The Transferability and Monetization of Tax Deductions and Credits

The concept of paying back debts with transfers of deductions from taxable income can be compared to the transfer and monetization of both federal and state tax credits. Both the federal government and state governments allot to certain taxpayers and taxpaying businesses tax credits when such taxpayers engage in behaviors the government wants to promote.[223] When transferring tax credits, a company with a low tax burden uses the portion of the credit it had generated, then sells whatever is left over to a company with a higher tax burden.[224] Tax credit transfers allow companies to benefit from any leftover value in the credits, which in turn allows the selling company to continue funding its valued behaviors, and simultaneously supports the buying companies financial efforts to engage in similar creditable practices.[225]

A receipt of a tax credit by a taxpayer is not considered an accession to that taxpayer's wealth which would be treated as a gain subject to taxation; rather, these tax credits are regarded as reductions in tax liability.[226] Additionally, deductions are not considered accessions to wealth either, otherwise the deduction would serve no purpose when used to offset income because it would instead increase the amount of wealth subject to tax.[227] Thus, it would logically follow that any tax credits or deductions resulting from dealings in marijuana that could potentially be used to repay bankruptcy debts via transfers to creditors would not be considered profiting or gaining from the use of controlled substances under the CSA or bankruptcy law.[228]

1. The Policies Behind Tax Credit Transferability

State governments will often offer transferable state tax credits to stimulate economic growth by drawing in new businesses, creating jobs, and encouraging investment.[229] The program started with the Federal Low Income Housing Program that granted housing developers tax credits to allow them to undertake significantly less debt.[230] Similar to businesses just starting out in the marijuana

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223 *See* Jennifer A. Zimmerman, *The Transferability and Monetization of State Tax Credits*, 25 J. OF MULTISTATE TAXATION AND INCENTIVES 1 (2015).

224 *Id.*

225 *See id.*

226 *Id.*

227 IRS, DEDUCTING BUSINESS EXPENSES, (2018), https://www.irs.gov/businesses/small-businesses-self-employed/deducting-business-expenses.

228 21 U.S.C. § 841(a)(1) (2018); *In re* Arenas, 535 B.R. 845, 847 (10th Cir. B.A.P. 2015).

229 Zimmerman, *supra* note 223, at 1.

230 *Id.* at 2–3.

industry, real estate developers need tax credits to acquire the large amounts of capital at the beginning of projects in order to finance the project to completion.[231]

Just as tax deductions are assigned to certain types of costs such as COGS, tax credits are used to incentivize certain kinds of business expenses.[232] For example, many states now offer film production tax credits for specific production costs to incentivize production companies to make large expenditures in the state offering the credit.[233] These credits can be used to offset income tax liability, sales tax liability, or a combination of the two.[234]

2. *How Tax Credit and Deduction Transferability Can Support Marijuana Debtors*

There are a variety of ways in which a business can transfer tax credits: through a regular sales transaction, offering refunds, allowing for carry-back or forward, or disproportionate allocation.[235] In a regular sales transaction, an investor buys the credit for an agreed-upon price.[236] A refundable tax credit simply refunds the unused credit to the taxpayer.[237] If the amount of the credit is larger than the tax liability owed, the holder will receive a refund for the difference.[238] The refundable tax credit method will sometimes allow a taxpayer to receive a refund even though they were not the one to incur the tax liability.[239]

The regular sales transactions for tax credits can be analogized to the loan transaction that occurs between a creditor and debtor prior to bankruptcy. A typical creditor-debtor relationship consists of a creditor loaning the debtor some form of capital in exchange for the debtor's promise to repay the creditor sometime in the future. The debtor then uses the capital loaned by the creditors to finance tax credit or deduction-generating activities. The tax credits or deductions could then be transferred back to creditors in proportion to the initial loan made plus any predetermined interest. These tax benefits can act as payment to creditors in satisfaction of the debtor's prior promise to repay.

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231 *Id.* at 1.
232 *Id*.
233 *Id.* at 4.
234 *Id.* at 5.
235 *Id.* at 4.
236 *Id.* at 7.
237 *Id.* at 5.
238 *Refundable vs. Non-Refundable Tax Credits*, IRS.COM (2020), https://www.irs.com/articles/refundable-vs-non-refundable-tax-credits.
239 Zimmerman, *supra* note 223, at 5.

Perhaps an even more suitable method for marijuana businesses to transfer tax benefits is the carry-forward method. Many times creditors are lending start-up capital to the marijuana businesses before the businesses have accumulated their COGS deductions.[240] A creditor's loaning money can be viewed as a purchase of an interest in the marijuana debtor's future COGS expenses.[241] If taxpayers cannot claim a credit or deduction for the full amount in the current tax year it is earned or incurred, they can carry it back or forward to another tax year within the applicable range set forth in the IRC.[242] This method would enable creditors to claim such deductions at the time the debtor files for bankruptcy by adjusting the creditor's appropriate tax return to account for the amount of the loan the debtor is incapable of repaying.

3. *Allowing Tax Benefit Transfers for Similarly-Situated Industries*

A more similarly situated industry to marijuana businesses than film production is the increasingly popular craft brewery market. Like marijuana companies, breweries also incur state excise taxes at various stages of their operations.[243] In response, New York has begun offering refundable tax credits to reimburse companies for investing in a brewery to cover some of the additional tax liability for the investment.[244] The New York court justified the credit by pointing out that the tax credits would be offset by the excise taxes breweries are required to pay.[245] Marijuana businesses are also responsible for paying state excise taxes, but at a higher price than breweries.[246] Breweries and other beer retailers in California are subject to both a six percent sales tax paid by the consumer, and a $0.20 on the gallon excise tax that is paid by the seller or distributor.[247] This state excise tax is levied on top of the federal excise tax incurred by merchants, which can be either $3.50 per barrel for the first 60,000 produced or up to $18 per barrel if the merchant produces over 6 million barrels.[248]

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240 *See id.*

241 *See* 11 U.S.C. § 101(5) (2019) (defining a creditor's "claim" as a right to payment that can be unliquidated, contingent, and unmatured).

242 26 U.S.C. § 39 (2018).

243 Zimmerman, *supra* note 223, at 5.

244 *Id.* at 7.

245 *Id.*

246 *California: Alcohol Excise Taxes*, SALES TAX HANDBOOK (2018) https://www.salestaxhandbook.com/california/alcohol.

247 *Id.*

248 *Id.*

Marijuana businesses are not afforded the kind of marginal step-up taxation for excise taxes that would consider the business's operation size, but rather are all taxed at the same exorbitant levels regardless of their size.[249] For example, as of January 2018, the excise tax rate on all marijuana products and derivatives in California is fifteen percent.[250]

If states continue charging marijuana businesses these high tax rates, on top of the high federal income tax rates, the states permitting marijuana businesses should allow them to trade in their tax deductions and credits like the states do for other similarly situated businesses.[251] This kind of system on the state level would allow marijuana businesses to pay back debts without ever even having to enter the bankruptcy process.

An additional advantage to transferrable credits is that the transaction does not require any form of legal relationship or liability between the buyer and seller, such as a legal partnership or proprietorship.[252] Creditors lending to marijuana businesses would not have to be concerned about their personal liability for the business's operations if the creditors were repaid in tax credits and deductions.[253] Though courts have not yet addressed this concept, it seems more equitable to afford the same protection to a bankruptcy trustee distributing these credits and deductions to creditors as repayment for his or her federally appointed duties.

CONCLUSION: HOW BANKRUPTCY LAW NEEDS TO EVOLVE

Tying these ideas back to marijuana debtors filing for bankruptcy, courts should look to tax law's case-by-case approaches when deciding to dismiss or refusing to convert a marijuana debtor's bankruptcy filings or confirmation plan proposals.[254] Just as courts in tax cases have found illegally acquired income—many times illegally acquired under both state and federal laws—as taxable for income tax purposes, bankruptcy courts should also refer to the different levels of this income's legality for debtors seeking to use it to repay creditors.[255]

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249 *Id.*

250 CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION, TAX GUIDE FOR CANNABIS BUSINESSES, (2018).

251 Zimmerman, *supra* note 223, at 5.

252 *Id.* at 1.

253 *Id.*

254 *See* James v. United States, 366 U.S. 213, 219 (1961), Collins v. Comm'r, 3 F.3d 625 (2nd Cir. 1993), Peyton v. Comm'r, No. 16468-98, 2003 Tax Ct. Memo LEXIS 351, at *1 (T.C. May 22, 2003).

255 26 U.S.C. § 61(a) (2018), *James*, 366 U.S. at 219; *Collins*, 3 F.3d, *Peyton*, No. 16468-98, 2003 Tax Ct. Memo LEXIS 351, at *1.

Deeming income from state-legal marijuana businesses as illegal for bankruptcy purposes leaves debtors helpless in the face of financial ruin, while also leaving creditors to their own devices to fight over whatever small amounts of value they can squeeze out of the debtor. Bankruptcy exists to prevent these kinds of outcomes.[256]

Bankruptcy courts need to adjust their interpretations of what constitutes a good faith filing to take into consideration the legality of a debtor's business under state laws. Debtors and creditors should not be punished by denials to bankruptcy when pursuing business opportunities made available to them by state laws. Courts handling bankruptcy cases should stop viewing properly run marijuana businesses compliant with state regulations and federal tax laws as bad faith petitioners in bankruptcy. If not for existing strict interpretations, marijuana dispensaries would qualify for bankruptcy relief via chapters 11 and 12.

Bankruptcy courts also need to start considering marijuana business's incomes as sufficiently legal to fund payment plans in bankruptcy, just as the IRS considers that same income sufficient to pay federal income taxes. The federal government's selective treatment of marijuana income and expenses for both bankruptcy and tax deduction purposes raises suspicion as to Congress's predominantly unfavorable policies towards the marijuana industry. The influence these policies have on laws that govern and significantly disadvantage the industry should change alongside society's views towards and needs for the industry.

To appease courts' concerns about jeopardizing bankruptcy trustees and debtors in possession by compelling them to carry out liquidation and distribution plans financed by illegally acquired funds, courts should narrow their applications of what constitutes bad faith filings and abuses of the bankruptcy system. By denying confirmation of payment plans financed by state legal funds because of the federal umbrella of bankruptcy law, courts are excluding assets and cash reserves of great value that could provide both creditors and debtors with the financial relief for which bankruptcy law was intended.[257]

Courts' excuse that putting bankruptcy trustees at risk of federal prosecution as a reason to disallow marijuana businesses from entering bankruptcy is undermined by the federal government's history of not pursuing state legal

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[256] *See* Grogan v. Garner, 498 U.S. 279, 283 (1991).
[257] *See id.*

marijuana businesses despite their illegality on the federal level. Though the CSA does not override state marijuana laws, state officials carrying out the laws remain vulnerable to federal repercussions. The federal government's protection of state actors should be extended to bankruptcy trustees appointed by and acting in accordance with the Code.

Additionally, courts' current treatment of property, both real and personal, in marijuana bankruptcy cases prevents debtors from liquidating valuable assets with which they could pay back creditors.[258] Just as the *CHAMPS* court separated the marijuana dispensary's incomes between income earned from marijuana sales and healthcare services, courts should separate the use of a piece of property from the inherent value of that property. This separation should especially be considered when marijuana-related activity does not affect the integrity of the land itself or the building within which a dispensary had previously operated. Excluding the value of such properties from the bankruptcy estate results in an inefficient and wasteful organization of a debtor's assets antithetical to the purposes of the Code.

If court interpretations of the Code and Congress's policy viewpoints do not change, federal courts should expand the case-by-case approaches to unique bankruptcy cases—such as ones involving marijuana debtors who get caught between the discrepancies of federal and state laws—by at least allowing creditors in bankruptcy to collect repayment in the form of the tax benefits from COGS expenses not precluded by section 280E of the IRC. It seems logical to allow creditors to claim deductions from expenses used to fund the business's assets and operations. This strategy of matching creditors' loans with the tax benefits their money helped fund is supported by the fact that legitimately licensed marijuana businesses keep meticulous financial records since states and the federal government force them to pay federal and state taxes solely in cash.[259] The recordkeeping of marijuana businesses likely will maintain its level of precision to avoid giving the IRS any more reason to target their businesses' operations.[260] Properly run marijuana businesses implement strict bookkeeping practices because the last thing a debtor in bankruptcy needs is to be accused of tax fraud.[261]

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258 *In re* Arenas, 535 B.R. 845, 847–48 (B.A.P. 10th Cir. 2015); *In re* Johnson, 532 B.R. 53, 59 (Bankr. W.D. Mich. 2015); *In re* Rent-Rite Super Kegs W. Ltd., 484 B.R. 799, 802 (Bankr. D. Colo. 2012).

259 Justin Rohrlich, *Cannabis Companies Are Paying Federal Taxes in Cash and It's Giving the IRS a Headache*, QUARTZ (Nov. 14, 2018), https://qz.com/1461947/the-irs-cant-handle-cannabis-companies-all-cash-tax-payments/.

260 *Id.*

261 *Id.*

From oils to blunts to edibles, from medicinal to recreational goods, marijuana businesses are diversifying the products and services they offer to thrive in an increasingly competitive industry. As these businesses become more legitimate and publicly accepted, they should receive the same treatment under the law as other legal business ventures. The legal climate surrounding bankruptcy for marijuana debtors needs to grow to incorporate the changing attitudes towards the industry in a way that does not leave both debtors and creditors high and dry.

LAUREN TIMLIN*

* Executive Notes and Comments Editor, *Emory Bankruptcy Developments Journal* (Vol. 36); J.D. Candidate, Emory University School of Law (2020); B.S., University of Florida. I would like to thank my faculty advisor, Professor Alexander "Sasha" Volokh, and my student advisor, Seth Webster, for their guidance and encouragement for this piece. I also want to thank the editors and staff of the *Emory Bankruptcy Developments Journal* for their diligent efforts put towards my piece and the other publications in the issue. Finally, I would like to thank my parents, James and Phyllis Timlin, as well as my friends, for their love and support.