COMMENTARY

Legal and Economic Impacts of Cannabis Rescheduling

Opinions vary on how rescheduling could impact existing state medical and adult-use regulatory schemes, but industry participants seem to agree that such a move would foster industry growth, reduce criminalization, and expand access to cannabis products.

May 06, 2024 at 09:13 AM

Special Sections

By Peter S. Murphy and Zachary R. Kobrin | May 06, 2024 at 09:13 AM

On April 30, the U.S. Department of Justice (DOJ) issued a statement confirming its intent to reschedule cannabis from Schedule I to Schedule III under the 1970 Controlled Substances Act (CSA). Rescheduling cannabis from Schedule I to Schedule III represents a historic shift in federal policy with wide-ranging legal, regulatory, economic and health care implications. DOJ's action comes seven months after the formal recommendation by the U.S. Department of Health and Human Services (HHS) to the U.S. Drug Enforcement Agency (DEA) that cannabis be removed from Schedule I.

Opinions vary on how rescheduling could impact existing state medical and adult-use regulatory schemes, but industry participants seem to agree that such a move would foster industry growth, reduce criminalization, and expand access to cannabis products.

A Fundamental Shift in Perspective

Rescheduling represents a fundamental change in the federal government's attitude toward cannabis.

Schedule I drugs are deemed to have no medical use and a high potential for abuse. See 21 U.S.C. Section 812. For over 50 years, cannabis has remained listed among the world's most dangerous drugs trapped by a bureaucratic process impervious to the opinion of the majority of U.S. doctors and to a growing body of scientific minds. Consider, cocaine and synthetic opioids (e.g., Fentanyl), which according to the Centers for Disease Control and Prevention are responsible for hundreds of deaths per day, are listed in Schedule II and considered less dangerous than cannabis.

Thus, the reclassification of cannabis to Schedule III is a substantial (if not long overdue) admission by the DEA that cannabis has medicinal value—an opinion shared by nearly 90% of the U.S. population—and that the likelihood of abuse is not as high as drugs like cocaine and fentanyl.

What Happens Next?

Cannabis will not be rescheduled overnight.

First, the DOJ's proposal needs to be approved by the White House Office of Management and Budget (OMB) and work its way through the rulemaking process; including a public comment period that could last 30-60 days. Following the public comment period the rule could be challenged (which is very possible) in court. Only after a final review by an

administrative judge will the agency publish its final rule which would not go into effect for at least another 30 days after that. Many feel the administration would like to have rescheduling fully implemented by the November election. While this is possible, it is not certain.

Impact on State Medical and Adult-Use Cannabis Legalization

In the months leading up to the DOJ's statement, there has been a flurry of analysis, speculation, and even some panic from those who believe rescheduling could spell the end of state-legal medical and adult-use cannabis programs.

Moving cannabis to Schedule III would place a glaring spotlight on the contradiction between state and federal cannabis laws and regulations. Moreover, reclassification without the federal government (either administratively or through Congress) implementing other legal reforms would not bring the state-legal cannabis industry into compliance with federal controlled substances laws. Absent accompanying policy reforms, the manufacture, distribution, and possession of adult use marijuana would still be illegal under federal law.

Given the need for additional reforms, some fear that reclassification is just the prelude to a broader federal crackdown on state-level legalization—or alternatively—the "pharmaceuticalization" of cannabis across the country.

These fears are based on the following chain of logic: Unlike Schedule I, substances in Schedule III have an accepted medical use and are dispensed by prescription. The Food and Drug Administration (FDA) must approve prescription drugs. All medical cannabis products will thus become subject to FDA approval and only available by prescription from FDA-approved manufacturers. This would result in the shuttering of contradictory (illegal) state cannabis programs.

This worst-case scenario overlooks two important points: First, cannabis has been federally illegal since 1937, and despite prohibition, state-legal programs have spread to a majority of the states and nearly 75% of the U.S. population. For the last 10 years, the federal government has contorted itself through piecemeal legislation and ad hoc agency guidance to reassure the states that a federal crackdown is not coming unless legalization implicates a more pressing priority—e.g., money laundering, organized crime/cartels, and keeping guns and drugs from children. And second, even if there was an appetite to change course and upend state-legal cannabis programs in favor of a single federal alternative, there are insufficient resources to pull it off.

It is more likely that rescheduling will have little negative impact on state cannabis programs in the near term and may result in broader state legalization. In more than half the states, rescheduling automatically triggers state-level rescheduling. In certain automatic trigger states, like Idaho, where cannabis is currently illegal for any use, rescheduling would open a pathway for at least medical cannabis to be legalized.

One of, if not the biggest unknowns, is what will happen at the intersection where state regulation ends and federal policy begins. Rescheduling alone will not be sufficient. There will likely be calls that the federal government should use this opportunity to open up interstate commerce for the industry. It will be important for the federal government to try and preserve the existing legal markets while regulating the safe expansion of commerce and industry within the cannabis sector.

The hope, by many, is that the federal government will learn from the issues that have arisen with the growth of the U.S. hemp industry following passage of the 2018 Farm Bill and focus on broader patient and customer safety issues and rely on the states to set and enforce medical and adult-use cannabis policy.

Rescheduling Will Provide Immediate Benefits to Cannabis Operators

Section 280E of the Internal Revenue Code (280E) (26 U.S.C.A. Section 280E) is one of the biggest burdens facing cannabis companies. 280E prohibits cannabis companies from taking tax deductions or credits from normal business expenses.

The corporate tax rate for most companies is 21%. Businesses pay these taxes based on the income they generate, and that amount is typically reduced because of allowable business expenses. The single largest expense most companies can deduct is their labor costs. To put 280E into perspective, state-legal cannabis operators do not enjoy these benefits and typically have an effective tax rate of 70%, or higher.

Currently, cannabis operators are only allowed to deduct the cost of goods sold (COGS) from their taxes. COGS includes the expenses directly associated with the production of the goods. For most operators this is a de minimis amount compared to their total operating expenses. Moving cannabis to Schedule III would end the stranglehold 280E currently has on the cannabis industry by allowing state-legal operators to deduct ordinary and necessary business expenses; just like every other business operating in the U.S. Rescheduling cannabis would have an immediate and sizeable impact on the amount of money generated by cannabis operators, how much they can spend on expansion and improvements and how they treat their workforce financially. Additionally, cannabis operators will likely see an immediate impact on state corporate taxes as well. Thus, having 280E no longer apply to state-legal cannabis operators has the potential to be one of the most important outcomes of rescheduling.

Rescheduling cannabis will also likely open the U.S. capital markets and stock exchanges (NYSE and Nasdaq) to permit the listing of “plant-touching operators” based in the United States. This will have two major effects. First, U.S.-based public cannabis companies currently forced to list on a foreign stock exchange or on the over-the counter market, will be able to uplist to the NYSE or Nasdaq and have greater access to capital. Second, it will open the possibility for other companies from the pharmaceutical, tobacco and consumer packaged goods (CPG) industries to enter the cannabis sector. Despite what some have feared, it is unlikely that big-pharma or tobacco or CPG companies will hijack the industry. The cannabis industry is too developed to be overrun. What is more likely is that rescheduling will spur M&A activity and create more financing opportunities for companies that desperately need capital.

One additional positive outcome of rescheduling that is often overshadowed by the topics above concerns medical advancements and research. Moving cannabis to Schedule III will result in expanded research opportunities, which have been stymied for decades due to cannabis Schedule I status. Currently, there has not been an adequate amount of clinical research into the efficacy of specific strains or cannabinoids as compared to traditional pharmaceutical or nutraceutical products. Rescheduling could lead to new opportunities for partnerships with universities or medical institutions and serve to further normalize the cannabis industry.

The DOJ’s change of tack is encouraging and brings the agency in line with current scientific research and attitudes toward cannabis. Since 2002—the last time proponents petitioned DEA to reschedule cannabis—the ground has shifted under the agency’s feet. The United States is now home to a multibillion-dollar cannabis industry and Americans have a fundamentally different relationship with cannabis than their parents or grandparents. But, there is still much work to be done.

Peter S. Murphy *is a partner resident in Saul Ewing’s Wilmington, Delaware office. He advises cannabis industry clients on regulatory compliance, licensing applications, and corporate transactions to support the launch and growth of their business. This includes helping clients navigate evolving cannabis regulations and develop multistate licensing, operations and branding strategies.*

Zachary R. Kobrin *is a partner resident in the firm’s Fort Lauderdale office. Kobrin is a transactional and regulatory lawyer who understands that business clients want practical advice on how to complete deals and navigate complex statutory and regulatory regimes affecting their growth and daily operations.*