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Client Alert: HHS Recommends Rescheduling Marijuana to Schedule III: Implications and Uncertainties for the Industry

Marijuana has long been classified as a Schedule I controlled substance under the Controlled Substances Act of 1970 (the “CSA”), which is defined as a substance with no accepted medical use and a high potential for abuse, despite criticism from advocates across the industry.

In August 2022, President Biden instructed the U.S. Secretary of Health and Human Services (“HHS”) to review how marijuana is scheduled under the CSA, which assigns substances regulated under federal law to one of five schedules based primarily on their potential for dependence and abuse, medical efficacy, and safety, among other factors.

HHS announced on August 29, 2023 that it had completed its review of marijuana’s Schedule I classification and recommended to the Drug Enforcement Administration (the “DEA”) that marijuana be “rescheduled” from a Schedule I substance—which includes drugs such as heroin, among several others—to a Schedule III substance under the CSA, which is defined as a substance with moderate-to-low potential for physical and psychological dependence and abuse.

Despite HHS’s recommendation, the DEA retains final decision-making authority over whether to reschedule

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marijuana as a Schedule III substance. Furthermore, even if the DEA accepts HHS's recommendation, marijuana would still be subject to strict regulatory rules at the federal level regarding its use, possession, sale, and distribution, and would remain illegal at the state level in any state jurisdiction that has not passed its own legislation to legalize marijuana.

Rescheduling marijuana under federal law could have an enormous impact on the marijuana industry while signaling a significant shift in regulatory approach by the U.S. federal government and constitute a major step toward joining the wave of legal changes already occurring at the state level. A total of 38 states and the District of Columbia have legalized marijuana for either medical or recreational purposes.

Practical Impacts for the Marijuana Industry

The immediate impact of rescheduling marijuana would be to create alignment between federal and state marijuana policies. As of the date of HHS's recommendation, 23 states and the District of Columbia currently permit marijuana to be used, possessed, sold, and distributed recreationally by adults over a certain age, while the use, possession, sale and distribution of marijuana is prohibited entirely at the federal level. In fact, many states have passed laws that mirror the CSA, and any shift in marijuana scheduling at the federal level would likely trigger a corresponding adjustment in those states. Rescheduling marijuana may also prompt a number of states to review their own marijuana laws, either to align their approach with the federal government, modernize their marijuana policies, or reflect the growing acceptance and approval of marijuana by the public.

The shift to a Schedule III substance would also reduce the potential criminal liability that participants in the marijuana industry currently face under federal law,

though certain criminal and civil penalties likely would remain even if marijuana becomes a Schedule III substance. For example, Schedule III substances (such as ketamine) may not be sold without a DEA license or used without a prescription from a licensed medical practitioner. That being said, the potential criminal penalties for offenses involving Schedule III substances are less significant under federal law compared to penalties for offenses involving Schedule I substances, so rescheduling marijuana could lead federal law enforcement officials to be less inclined to prioritize and pursue crimes solely involving marijuana.

In addition, rescheduling marijuana would likely have significant financial implications for businesses in the industry. Section 280E of the Internal Revenue Code of 1986, as amended (the “**Code**”), states that “[n]o deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business ... consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act)[.]” This means that, currently, marijuana companies (and other businesses that sell and distribute Schedule I and II substances) generally cannot deduct ordinary business expenses such as rent, insurance, employee compensation, and other similar expenses in computing their federal taxable income, which results in a much higher effective tax rate for such businesses. If marijuana is rescheduled as a Schedule III substance, however, Code Section 280E would no longer apply to companies in the marijuana industry, and such companies would be permitted to take advantage of certain federal tax deductions, credits and other benefits provided under the Code, potentially creating huge tax savings for those companies.

A number of other benefits to the marijuana industry are likely to follow HHS’s recommendation, including access to banking, financial services, and interstate trade.

Currently, many banks and financial institutions, especially those that hold federal charters and are insured by the FDIC, are unwilling to provide loans, lines of credit, bank accounts, or credit cards to businesses in the marijuana industry. The institutions that are willing to provide any support services to such businesses, which are typically state chartered banks and credit unions, usually charge significantly higher fees and interest rates, adding to the already significant expense companies in the marijuana industry face in their operation. Rescheduling marijuana, however, would be a significant step toward reducing the risk financial services providers currently face when considering whether to provide support to marijuana companies, which could lead them to be more open to changing their stance toward the industry. Opening financial services to businesses in the marijuana industry would grant them access to critically-needed financial products and services and cut their cost of doing business by a wide margin.

Lastly, rescheduling marijuana would remove many barriers associated with researching and studying the scientific and medical impacts of marijuana, and may also ease laws and rules associated with mailing and advertising marijuana, employer drug testing, and transporting marijuana across state lines, among other changes.

Unknowns and Unanswered Questions

Despite the many benefits rescheduling marijuana would have for the industry and other related businesses, there remains a great deal of uncertainty around what may come next. For example, even if HHS's recommendation is accepted by the DEA and the DEA ultimately reschedules marijuana as a Schedule III substance, marijuana will not automatically become legalized or decriminalized at the federal level. Instead, it will continue to be subject to the strict requirements of the CSA as it relates to Schedule III substances, which still

contemplates criminal and civil penalties for violations. Furthermore, no comprehensive regime has been announced for the regulation and enforcement of marijuana at the federal level, and questions persist regarding how marijuana will be labeled, tested, and stored by the U.S. Food and Drug Administration. Many financial institutions may not immediately be willing to do business with marijuana companies and instead may choose to wait for further regulatory clarity or until Congress passes legislation on this issue, if at all. Similarly, many states, municipalities, and private employers may continue to maintain prohibitions on marijuana and are under no obligation to change their approaches to marijuana despite its wider general acceptance.

Conclusion

If the DEA accepts HHS's recommendation and decides to reschedule marijuana as a Schedule III substance, this would indicate a major shift in federal policy toward marijuana and would be seen as a major win for the industry. Significant questions, risks, and uncertainties remain, and rescheduling is only the first step toward a sweeping change across the industry; even so, businesses in the marijuana industry and those industries that want to support them could begin to experience some of the benefits of rescheduling almost immediately.

For additional information, please contact Brian J. Crump, Alexis M. Dominguez, Peter D. Miles or your NGE attorney.

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