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Expert Analysis

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Excise tax or regulatory fee? A warning for bankruptcy practitioners and cannabis clients

Katherine Devanney of Cole Schotz PC discusses a recent New Mexico bankruptcy court decision that could have important implications for insolvent cannabis businesses.

In *In re Sandia Tobacco Mfrs, Inc.*, 2018 WL 4964295 (Bankr. D.N.M. Oct. 12, 2018), the Bankruptcy Court for the District of New Mexico recently held that certain outstanding "assessments" arising under the Fair and Equitable Tobacco Reform Act of 2004, 7 U.S.C. §§ 518-519(a), and its accompanying regulations were excise taxes entitled to priority under Section 507(a)(8)(E) of the Bankruptcy Code.

While this may seem like a narrow issue and holding, *Sandia* raises an important question for insolvent marijuana businesses seeking the protections of the Bankruptcy Code: are the various taxes, fees, or "assessments" levied by the government through its regulation of the industry properly considered nonpriority "regulatory fees" or, as in *Sandia*, priority tax claims? The distinction can be critical.

The Supreme Court has held, and *Sandia* confirms, that courts must look beyond the label applied in the statute and conduct a "functional analysis" of the assessment to determine whether a debt is a tax. *Sandia*, 2018 WL 4964295, at *7 (citing *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 221 (1996)).

Thus, the precedential value of any decision would be limited to the specific statute under consideration, paving the way for a plethora of priority challenges as states develop and refine their laws and regulations governing the marijuana industry.

Under the widely (though not universally) accepted *Chateaugay/Lorber* test applied in *Sandia*, a debt will be treated as a tax — and thus entitled to priority treatment — if the debt is: (1) an involuntary pecuniary burden; (2) imposed by, or under authority of the legislature; (3) for public purposes, including the purposes of defraying expenses of government or undertakings authorized by it; and (4) under the police or taxing power of the state. *Sandia*, 2018 WL 4964295, at *6.

While a governmental unit — particularly one with a multi-million dollar claim — is likely to argue the presence of all of these elements, the third factor may yield the most interesting (and likely determinative) judicial analysis, as state legislatures can enact marijuana regulations to accomplish any one of a host of diverse purposes, only some of which may be "public purposes."

Though the bankruptcy court in *Sandia* acknowledged that this element is "most often in dispute and the most difficult to apply," *Sandia*, 2018 WL 4964295, at *9, courts have provided at least some guidance as to what types of purposes qualify.

First, the public purpose must not be punitive. *CF&I Fabricators*, 518 U.S. 213, at 224. Second, the analysis must focus on the legislature's "principal purpose or purposes in imposing the assessment even if there are other incidental purposes." *Sandia*, 2018 WL 4964295, at *9.

Nevertheless, given the evolving status of cannabis law and the lack of uniformity among states (not to mention the absence of federal regulations), bankruptcy professionals advising clients in the cannabis industry would be wise to carefully review their clients' governmental claims to determine whether any "regulatory" or "licensing" fees may be subject to priority status.

Likewise, debtors' counsel should also be prepared for regulatory agencies pushing the limits of a "tax" to obtain priority status for debts that are more properly characterized as regulatory fees.

At least for the foreseeable future, this analysis will require an examination not only of the statute or regulation giving rise to the debt, but also its legislative history. The warning from *Sandia* is clear: get the analysis wrong and your reorganization could, quite literally, go up in smoke.

Footnotes

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