July 2020

WHAT YOU NEED TO KNOW ABOUT

Cannabis Business Taxes

PRO POINTS

- **Cannabis sales are on the rise, but state-regulated** marijuana businesses often face federal tax rates upwards of 70 percent due to tax code provision 280E.

- **Cannabis businesses can deduct Cost of Goods Sold,** but aren't allowed to make normal business deductions. The tax code ends up hurting retailers more than cultivators.

- **The high tax burden for marijuana businesses are** passed on to consumers, making it difficult for licensed cannabis businesses to compete with the illicit market.

- **Advocates are trying to change the provision in** Congress and through the courts, but it's unlikely relief is coming any time soon for the industry.

HOW WE GOT HERE

The U.S. cannabis industry has always existed in a strange state of limbo: heavily regulated by the states, but deemed unlawful by the federal government. One of the many contradictions that cannabis businesses face in this environment is a big federal tax bill thanks to a provision of the tax code called Section 280E.

Even though marijuana businesses violate federal drug laws, they're still obligated to pay federal taxes because the tax code doesn't differentiate between legal and illegal sources of income. In the '70s, an enterprising drug dealer sought deductions for his expenses in selling cocaine. Much to the dismay of the IRS, a tax court ruled in his favor in 1981, allowing the man to deduct his business expenses. In response, Congress enacted 280E the following year, prohibiting typical tax deductions for businesses "trafficking in controlled substances."

That was nearly 15 years before California became the first state to legalize medical marijuana. Now, 32 other states have joined its ranks. Eleven states and D.C. have also legalized adult-use marijuana. Cannabis sales are on track to surpass $15 billion this year, but it can still be hard to make much money in the cannabis industry, where businesses can face an effective federal tax rate upwards of 70 percent (compared with about 30 percent for other industries).

Cannabis businesses are allowed to deduct Cost of Goods Sold (COGS), which refers to the direct costs of producing the items sold. But COGS does not include operating expenses like rent, marketing, and payroll, which is why cannabis retailers are generally hit harder by 280E compared to cannabis cultivators. The industry's struggles with 280E have prompted some creative accounting aimed at maximizing COGS deductions and interesting business structures where companies try to spin off non-cannabis-related activities as a separate business.

From 2018 to 2025, cannabis businesses are expected to pay an average of $1.53 billion more a year in federal taxes thanks to 280E, according to cannabis data analytics firm New Frontier.

Even though cannabis companies are paying higher effective tax rates, the federal government could bring in more tax revenue if the industry were federally legal, including increased federal payroll taxes. The U.S. illicit marijuana market is estimated to be worth upwards of $60 billion in 2020, according to New Frontier. Federal legalization would also likely set an excise tax on the product similar to alcohol or tobacco.

Even if illicit marijuana made up 25 percent of cannabis sales, the federal government would generate an average of $22 billion a year in cannabis industry tax revenue from 2018 to 2025, according to New Frontier.

THE IMPACT

The higher effective tax rate on cannabis businesses presents challenges for the industry and governments alike.

The IRS struggles to keep tabs on transactions in a cash-intensive industry with limited access to banking. The agency has even set up special cash-counting rooms at tax time in states that have legalized marijuana. In March, a Treasury Inspector General report found a high rate of noncompliance with 280E in California, Oregon and Washington. The report recommended that the IRS develop a comprehensive approach to tracking 280E compliance.

State and local governments often set hefty excise and sales taxes on cannabis businesses that already face a sizable federal tax bill. The combined local, state and federal tax burden makes it difficult for legal cannabis businesses to compete with the illicit market because their products are much more expensive.

Federal tax revenues with and without federal legalization of cannabis

The federal government would earn less revenue from each individual cannabis retail business if cannabis was federally legal and not subject to section 280E of the federal tax code — which does not allow these companies to deduct business expenses. But federal legalization would generate significantly more revenue for the federal government from the increased number of cannabis businesses operating in the legal market nationally.

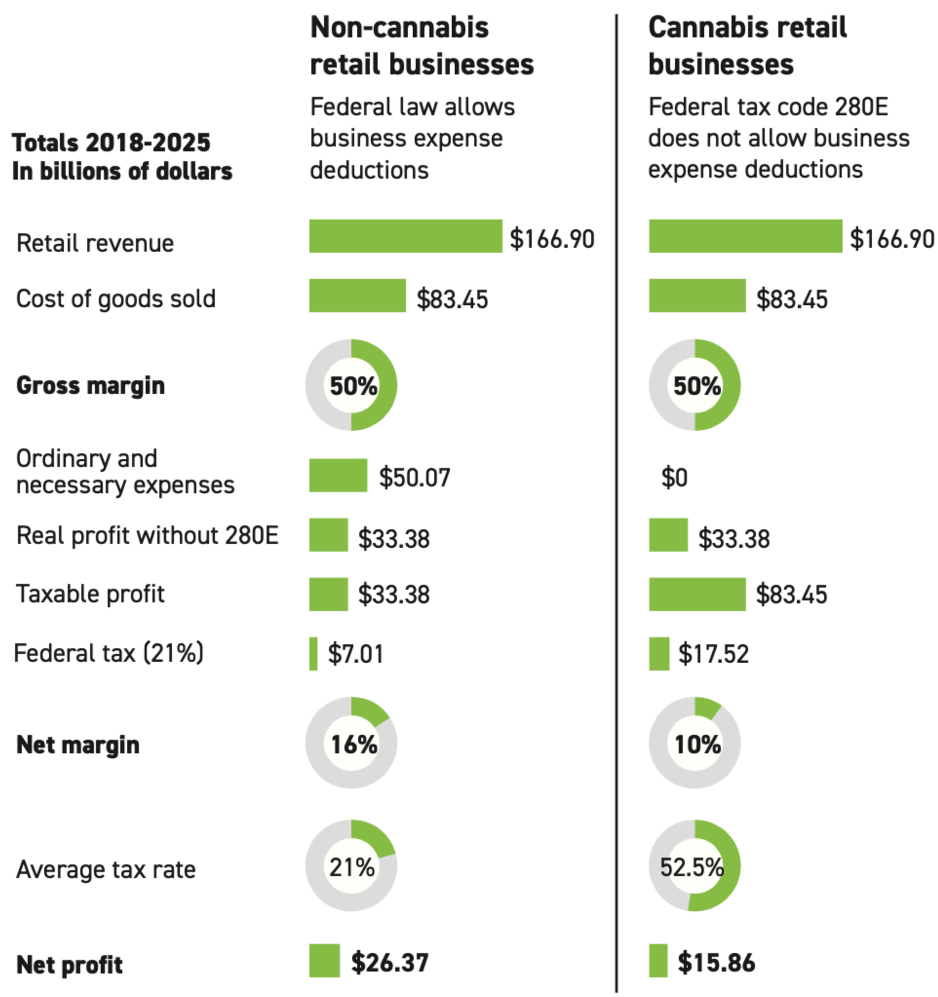
Totals 2018-2025 **In billions of dollars**	**Projected taxes if cannabis were federally legal** Assuming that 75 percent of all U.S. consumer demand is met by the legal market	**Current taxes, with cannabis federally illegal** Reflects only states where legal; no assumptions for state legalization in 2020 to 2025	***More revenue generated if cannabis was federally legal and not subject to 280E***
TOTAL BUSINESS REVENUE	$737.12	$250.36	**$486.76**
Federal business tax revenues	$30.96	$22.78	**$8.18**
Federal payroll withholdings	$71.10	$24.15	**$46.95**
Federal sales tax revenues	$73.71	$0	**$73.71**
TOTAL FEDERAL TAX REVENUES	$175.77	$46.93	**$128.84**

Source: New Frontier Data 2019 report "Cannabis in the U.S. Economy"

While 280E impacts cannabis businesses across the sector, the burden can be particularly acute for a retailer starting up in a newly legal state. The tax code often leaves them further in the red in their initial years of business when they face a hefty tax bill, even if their companies lost money that year. Entrepreneurs say this hampers their ability to grow their workforce and invest in their businesses.

How federal tax code 280E impacts U.S. retail businesses

Most businesses in the U.S. economy pay less than 30 percent in federal taxes, according to New Frontier Data. Because cannabis is illegal under federal law, cannabis businesses are taxed as much as 70 percent or more because section 280E of the federal tax code does not allow the companies to deduct business expenses. As a result, cannabis may be the most taxed industry in the U.S. economy. Here is an example of how section 280E wouldn't alter a non-cannabis retail business' net profit but would affect the profits of a cannabis retail business.



Source: New Frontier Data 2019 report "Cannabis in the U.S. Economy"

WHAT'S NEXT

Sen. Ron Wyden (D-Ore.) and Rep. Earl Blumenauer (D-Ore.) have introduced legislation in both chambers of Congress that would exempt state-regulated cannabis businesses from 280E. But it's unlikely the proposal will advance this year and its chances in the next Congress will largely depend on how the November elections go. Federal marijuana legalization would also solve the business's tax problems, but the chances of that happening soon are even more remote.

WHAT'S NEXT

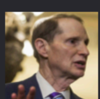
Cannabis businesses have tried (and failed) to challenge 280E in court. But there are two cases moving forward, which argue that 280E is unconstitutional. It will take years before any of those cases could potentially be heard by the Supreme Court, if they do at all — and most tax experts think their chances of success are remote.

For now, both businesses and investors operate under the assumption that 280E isn't going anywhere soon. Cannabis businesses' 280E compliance is "fertile ground" for IRS audits, said Thomas Ostrander of the law firm Duane Morris, so they should keep careful records.

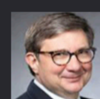
POWER PLAYERS

Rep. Earl Blumenauer (D-Ore.)
The lawmaker has been at the forefront of cannabis issues in Congress, co-founding the Congressional Cannabis Caucus and introducing a bill to exempt state-legal marijuana businesses from 280E.

Michael J. Desmond, Chief Counsel of the IRS
The office of the chief counsel for the Internal Revenue Service released a memo in 2015, outlining a strict interpretation of 280E. Tax courts have generally ruled unfavorably in legal challenges over the provision by cannabis companies.



Sen. Ron Wyden (D-Ore.)
Wyden is the Senate sponsor of a bill to allow state-regulated cannabis companies to take business deductions. Like Blumenauer, he represents Oregon and has introduced multiple bills seeking federal marijuana reform.



James Mann, Tax Attorney
Mann is representing Harborside Health in a case arguing the unconstitutionality of the tax code provision, perhaps the most high-profile court challenge to 280E. If successful, the case would have widespread implications for the cannabis industry.