Tax Planning for Cannabis Companies

By DANIEL ROWE

Now legal in 33 states (as well the District of Colombia, Guam and Puerto Rico), cannabis has seen a rise in the percentage of Americans favoring legalization with a majority now in support of ending prohibition. As the tide of public opinion shifts, state legalization has opened up significant economic opportunities. Experts predict that the legal cannabis industry will create hundreds of thousands of jobs in the next few years, and it is widely recognized as the fastest-growing job market in the country.

Despite these positive trends, state-legal cannabis businesses still face many economic obstacles to success, including a high barrier to entry for small business owners due to complicated and costly licensing processes, high application fees and the need for professional advice to navigate the regulatory system.

Once established, businesses face further economic hurdles stemming from cannabis being a Schedule I controlled substance under the federal Controlled Substances Act. In addition to preventing access to traditional banking, this federal classification subjects state-legal cannabis businesses to a substantial tax burden created by Internal Revenue Code Section 280E.

SECTION 280E – AN OVERVIEW

In response to a Tax Court case involving a drug trafficker, Congress added Section 280E to the Internal Revenue Code in 1982 as a punitive measure against illegal drug dealing. This code section prohibits taxpayers from deducting ordinary and necessary business expenses if they are in the business of trafficking controlled substances. This causes state-legal cannabis businesses to potentially owe income tax on gross business income, even if they generate a net loss after paying normal business expenses such as payroll, rent and utilities.

The law does allow for the deduction of Cost of Goods Sold (certain inventory or production costs), but the inability to deduct other operating expenses can lead to a heavy tax burden. Section 280E was enacted long before states began legalizing cannabis, and before medical benefits and research had become well known, helping to shift public opinion. As long as cannabis is considered a Schedule I controlled substance, state-legal businesses must grapple with the economic impact of Section 280E.

MITIGATING SECTION 280E

Cannabis businesses may deduct Cost of Goods Sold in determining taxable income. Thus, proper accounting for inventory and production costs and proper classification between retail and production activities can enable these businesses to capture appropriate deductions and reduce taxable income.

While Section 280E applies to trafficking controlled substances, some cannabis companies may be engaged in other non-280E type activities, such as sales of non-cannabis merchandise or health services. By identifying and properly allocating business expenses to the non-280E activities, cannabis businesses can reduce their taxable income. Expenses attributable to the non-280E activities generally remain fully deductible.

Proper planning, such as utilizing separate entities for non-280E activities or maintaining separate payrolls or books and records, can mitigate the scope of Section 280E.

CHOICE OF BUSINESS ENTITY

The form of entity has tax implications well beyond the impact of Section 280E, but there are specific features that cannabis businesses should consider. While California tax law conforms to federal Section 280E for individuals, it does not do so for corporations. As a result, a cannabis company operating as a corporation under California law may still deduct its ordinary and necessary business expenses in determining its California taxable income. Cannabis companies operating in California must factor the value of this differing treatment into choosing their form of business entity.

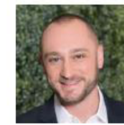
PASSTHROUGH ENTITIES

Businesses operating in passthrough form (partnerships, S corporations and even sole proprietorships) may be able to benefit, for federal tax purposes, from the newly enacted 20-percent passthrough deduction of Section 199A.

While there may be a benefit derived from Section 199A, a business formed as an S corporation may face an increased tax burden due to the requirement that it pay reasonable compensation to its shareholder-employees. This requirement could result in taxable wages for the shareholders without a corresponding wage deduction because of the 280E limitation.

Section 280E is just one of many economic hurdles facing the rapidly expanding cannabis industry, but an awareness of and proper planning for the impact of Section 280E can go a long way in improving the profitability of a cannabis enterprise. While many bills have been introduced to legalize cannabis at the federal level, until one becomes law, businesses must contend with the tax effects of Section 280E.

Because of the various impacts, it is important for cannabis businesses to partner with tax advisors with a strong understanding of this area and an awareness of developing case law so they can help ease the tax burden on emerging cannabis businesses.



Daniel Rowe, J.D., CPA, is a partner with Green Hasson Janks. He has 17 years of public accounting experience and specializes in partnership and S corporation taxation. He provides technical and strategic advice to partnerships, S corporations and their individual owners, including tax advice on restructuring and buy/sell transactions. He has authored numerous tax articles and served as an editor or adviser on tax and legal journals.

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