MARIJUANA TAXATION: NAVIGATING THE HIDDEN TAX OF IRC SECTION 280E

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Legal Adult-use cannabis is taxed at multiple levels. New York, for example, imposes taxes on the THC content of cannabis products ranging from $.005/mg of THC for flower to $.03/mg of THC for edibles, and 13% state and local sales taxes.

But a hidden tax lurks for cannabis entrepreneurs: the effect of IRC Section 280E, which restricts the deductions and credits available to cannabis businesses.

Generally, IRC Section 162(a) allows a taxpayer to deduct from the calculation of taxable income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including (1) . . . salaries . . .; (2) traveling expenses . . . ; and (3) rentals . . . ."

These deductions, however, are expressly disallowed under Code Section 280E, enacted in response to a tax court case[1] which allowed deductions to a trafficker of amphetamines, cocaine, and cannabis.

Section 280E states:

> *No 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 (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.*

Cannabis, of course, is a Schedule I controlled substance under the Controlled Substances Act, meaning that in the eyes of the federal government there is no currently accepted medical use and a high potential for abuse, regardless of its legality under state law.

The Senate report accompanying the enactment of Section 280E, however, specifically said that Section 280E's prohibition on deductions and credits did not affect the adjustment to gross receipts with respect to effective costs of goods sold,[2] commonly referred to as "COGS," which leads to the paradoxical result that one can expense the cost of cannabis or other Schedule I or II substances, but ordinary business overhead expenses – deductible in virtually any other business context – are not here.

Section 280E creates a major economic disincentive for many cannabis businesses. Imagine the following simplified scenario:

[1] *Edmonson v. Commissioner*, 42 T.C.M. 1533 (T.C. 1981).

[2] S. Rep. No. 97-494, at 309 (1982).

A store that sells widgets has revenues of $1 million. The cost of the widgets is $500,000, and rent, utilities, salaries, and other operating expenses amount to $350,000. Federal income taxes would be calculated as follows:

Revenue:	$1,000,000.00
COGS:	- $500,000.00
Admin and Overhead:	- $350,000.00
Taxable Income:	$150,000.00
Taxes in 24% bracket:	**$30,021.00**

Now, consider an otherwise identical store that sells cannabis, where the administration and overhead expenses are disallowed:

Revenue:	$1,000,000.00
COGS:	- $500,000.00
Taxable Income	$500,000.00
Taxes in 35% bracket:	**$149,544.25**

It's quite a hit to the bottom line! Moreover, in most states the amount of taxable income for state tax purposes is a percentage of federal taxable income, although some states, including New York, do permit the disallowed deductions for state income tax purposes for cannabis businesses.[3]

Unfortunately, despite sporadic attempts in Congress to legalize cannabis, there is little prospect of Section 208E being repealed in the near to medium term.

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There are two basic strategies to lessen the effects of Section 280E.

1. The first is to try to encompass as many expenses within the definition of COGS as possible, something that may be easier for some cannabis businesses than others.

Schedule C of IRS Form 1040 sets forth the method of calculating COGS:

Inventory at the beginning of the year (including total cost of raw materials, works in progress, finished goods, and materials and supplies used in manufacturing)
\+ Purchases (including the costs of raw materials or parts purchased for manufacture into a finished product), less cost of items withdrawn for personal use
\+ Cost of labor, direct and indirect, spent in fabricating the raw materials into a finished, saleable product (other than amounts paid to the taxpayer)
\+ Materials and supplies, such as hardware and chemicals used in the manufacturing process

[3]NY Tax Law §§ 208 (9)(a)(23) and 612(c)(46).

+ Other costs, such as containers and packaging, transportation, and factory overhead (rent, heat, light, power, insurance, depreciation, taxes, maintenance, labor and supervision) that are direct and necessary to the manufacturing process
- Inventory at the end of the year
= COGS[4]

Thus, a cannabis cultivator can deduct most of the expenses of cultivation; similarly, a processor could likely deduct its costs. A dispensary, on the other hand, can only deduct the cost of inventory acquired and the costs associated with the acquisition of the product, not overhead such as store rent, salespeople, and most other expenses. Consumption lounges may be able to avail themselves of the second option, below. Microbusinesses, though, are a bit of a hybrid, able to deduct costs associated with the manufacture and distribution of cannabis, but likely not the overhead associated with any retail activities, except as noted below.

2. The second basic strategy is to establish a separate entity to capture the costs that can't be deducted under Section 280E, but with important constraints.

By setting up a second entity, one can possibly deduct other necessary and ordinary expenses associated with activities that are legal under federal law, including payroll, rent, promotion, sale, support, administration, and management; this can possibly result in lower taxes than if the activities were combined in one entity. The catch is that the second company must be a legitimate stand-alone company, with real purpose and revenue separate and apart from the cannabis business, and not just be ancillary to the federally illegal activities.

Some examples: In the so-called *CHAMP* case,[5] the tax court ruled that Section 280E did not preclude the deduction of expenses for the non-drug-related business of the taxpayer. In that case the organization, which distributed medical marijuana, also offered counseling and caregiving services to its members. The court held that the organization operated with a dual purpose, and that the latter services constituted a trade or business separate from that of trafficking in a controlled substance: the organization offered extensive counseling services in the form of support groups for members with a variety of illnesses, social services to low-income members, one-on-one counseling, social activities, instruction, online computer access, and encouraged its members to participate in political activities. The court said that one pertinent factor in determining whether the two sets of activities constituted separate trades or businesses is the degree of "economic interrelationship" between the two. The court accepted the testimony of the organization's executive director, who said that its primary function was the provision of counseling services and only secondarily as a place for seriously ill patients to access their medicine. The court cited a Supreme Court case for the proposition that "the mere fact than an expenditure bears a remote relation to an illegal act makes it non-deductible."[6]

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[4] IRS Pub. 334 (2021) and Pub. 535 (2021). The foregoing applies to businesses with average annual gross receipts for the prior three years of less than $25 million; otherwise, the taxpayer must use the accrual method of accounting and certain expenses must be capitalized with the cost recovered through depreciation, amortization, or depletion. Pub. 535 and IRC §§ 471, 448(c).

[5] *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner of Internal Revenue*, 128 T.C. 173 (2007).

[6] *Commissioner v. Heininger*, 320 U.S. 467, 474 (1943).

However, in another set of cases, culminating in *Olive v. Commissioner*,[7] the 9th Circuit held that the test for determining whether an activity constitutes a trade or business is "whether the activity was entered into with the dominant hope and intent of realizing a profit."[8] In that case, a California medical marijuana dispensary, in addition to selling cannabis, provided its customers with a lounge in which to consume the product; games, books, and art supplies; yoga, movies, and massage therapy; and complimentary snacks, among other things, all at no extra charge. The court held that the only activity that generated revenue was the sale of marijuana, and hence the costs of the other activities were not deductible. The court then provided the following example, which is instructive:

> Bookstore A sells books. It also provides some complimentary amenities: Patrons can sit in comfortable seating areas while considering whether to buy a book; they can drink coffee or tea and eat cookies, all of which the bookstore offers at no charge; they can obtain advice from the staff about new authors, book clubs, community events, and the like; they can bring their children to a weekend story time or an after-school reading circle. The "trade or business" of Bookstore A "consists of" selling books. Its many amenities do not alter that conclusion; presumably, the owner hopes to attract buyers of books by creating an alluring atmosphere. By contrast, Bookstore B sells books but also sells coffee and pastries, which customers can consume in a café-like seating area. Bookstore B has two "trade[s] or business[es]," one of which "consists of" selling books and the other of which "consists of" selling food and beverages.[9]

There are myriad conclusions to be drawn from these cases. First, if segregating cannabis activities from other activities by using separate entities, the second entity must carry on a "business or trade" which seeks to make a profit and is independent of the cannabis activity; selling branded T-shirts or other merchandise (such as pipes, bongs, etc.) in a dispensary setting may not be sufficient to pass the test, depending on whether such sales yield a profit, meaning after the deduction of expenses. The case for an independent "business or trade" is stronger when the non-cannabis business is pre-existing; thus a "head shop" that adds the dispensing of marijuana may possibly be eligible to deduct the expenses of the head shop activities, capturing some of the costs for rent, heat, etc., that are common to both sets of businesses. While the *CHAMP* and *Olive* cases don't involve separate entities for the two sets of businesses, it may well be easier to show the distinction by grouping the cannabis-related activities under one entity, and the other activities under another.

A consumption lounge that integrates a café where food and beverages are sold may be in a stronger position to claim two separate "trades or businesses," depending on the profitability of the latter, in line with the bookstore analogy above.

A distributor, however, is more limited, but has the first option available, namely deducting COGS which would include transportation costs. To the extent that other products are

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[7] 792 F.3d 1146 (9th Cir. 2015).

[8] Quoting *United States v. Am. Bar Endowment*, 477 U.S. 105, 110n. (1986) (internal citations omitted).

[9] 792 F.3d at 1150.

distributed as well, these cases suggest that common costs of administration could be recovered to the extent they are ordinary and necessary to the operation of the non-cannabis portion of the business.

As noted above, a microbusiness is in a peculiar situation: on the one hand, it is a producer of goods, for which the COGS deduction should be available; on the other hand, it is a retailer with a more limited set of options. To the extent the microbusiness only sells cannabis, it is likely that overhead associated with the retail portion of the business would not be deductible unless there is another profit-making business for which common expenses can be deducted.

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Both of these popular routes for dealing with the strictures of Section 280E depend on the particular facts of the case; there is no "bright line" rule or safe harbor. Given the dramatic effect Section 280E can have on the overall profitability of the enterprise and the high risk of audit for a cannabis business, it is important for any cannabis-related business to consult with attorneys and accountants who are familiar with these issues.

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