What is 280E?

Conflicting state and federal laws have created huge tax implications for individuals who grow, process, and sell marijuana. Federal income taxes are calculated for nearly all businesses by taking the total income during the year (gross income), and subtracting business expenses that took place in order to make that income during the year. This is called the “taxable income.” Tax that the business pays is calculated based on the taxable income figure, which can be greatly affected by the allowable business expenses that are subtracted from that year’s total income. The corporate tax rate is 21%, and small businesses often pay less.

With state-legal cannabis businesses, owners cannot make use of these tax breaks, and they end up paying taxes on their gross income, rather than an adjusted amount like other businesses. These tax rates often end up being 70% or higher, making it exceptionally costly to own a cannabis business.

This tax which hits the cannabis industry so hard is due to 26 U.S. Code § 280E, which is simply referred to as “280E.” Section 280E of the Internal Revenue Code prohibits businesses from deducting otherwise established business expenses from gross income associated with the “trafficking” of Schedule I or II substances, as defined by the Controlled Substances Act. Section 280E has been applied to state-legal cannabis businesses, as cannabis is still declared a Schedule I substance. This applies to all businesses that partake in the cultivation, sale, or processing of the cannabis plant, for medical or recreational use.

How did we get here?

Courts in the 1980s found that it was possible for illicit drug dealers to unfairly use the tax code to utilize business tax benefits. Congress sought to reverse a Tax Court decision in the 1981 case of Edmondson v. Commissioner when a Tax Court allowed an amphetamine, cocaine, and cannabis trafficker to deduct ‘ordinary’ and ‘necessary’ business expenses related to an illicit drug business (rent, packaging, telephone and automobile expenses, and a small scale). Congress moved to close that loophole that made this possible and passed 26 U.S. Code § 280E, which provides clear guidance for the IRS:

> No deduction or credit shall be allowed… on any trade or business if such trade or business… consists of trafficking in controlled substances… which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

In the decades since the introduction of 280E, two out of every three states in the U.S. adopted programs to license and regulate cannabis-related businesses, with revenues topping $7 billion in total revenue since legalization began in 2012.

Federal law, however, has not been updated.

State-legal cannabis businesses are allowed to deduct the Cost of Goods Sold (COGS) from their

taxes, which includes the costs and expenses directly related to the production of goods. Due to the nature of their businesses and expenses, this tends to help cultivators more than retailers. Legal retail operators can usually claim deductions for the following direct costs under COGS: invoices for products, freight, labor (related directly to production), packaging, lab testing, security, shake and trim, tinctures, and transportation associated with buying cannabis products and legal shipping costs. Other costs may also be deductible depending on individual business models. Indirect expenses such as website design, charitable contributions, meals and entertainment, franchise fees, banking service charges, advertising, and marketing are never deductible for legal cannabis retailers under Section 280E. As mentioned, retail outlets, where many smaller cannabis businesses get started, are hit the hardest because cultivators, which tend to be bigger companies, can lower their tax burden more than their retail counterparts by declaring the cost of goods sold during taxes. The net result is that everyone is paying far more than they should, with smaller businesses paying the highest tax rates.

There have been efforts to amend the 280E tax provision in the past, but they failed to gain support in Congress. Many consider state-licensed marijuana businesses to be operating illegally and do not believe companies should be granted any particular consideration.

Discussions around 280E often turn to the need for broader reform (full legalization), or otherwise rescheduling or rescheduling marijuana so that it is no longer listed as a Schedule I controlled substance, and therefore no longer subject to 280E limitations at all.

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