

High Taxes—Section 280E’s Effect on Marijuana Businesses

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SECTION 280E

Section 280E denies deductions and credits to marijuana businesses, even businesses that are legally operating under state law. *See e.g.*, *Californians Helping to Alleviate Med. Problems, Inc. v. Comm’r* (CHAMP), 128 T.C. 173 (2007). Section 280E reads:

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 activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I or 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.

I.R.C. § 280E. In short, if a business “traffics” in a controlled substance, it is not allowed to claim deductions or credits on its federal tax returns. I.R.C. § 280E. Although Section 280E’s constitutionality has been challenged, marijuana businesses that want to avoid an IRS audit should operate under the assumption that it is constitutional— the IRS has not lost a single Section 280E case.

“Controlled Substance”

For tax purposes, there are two types of cannabis plants: marijuana and hemp. Marijuana and hemp are legal distinctions based on a cannabis plant’s THC concentration. 7 U.S.C.A. § 1639o(1). For decades federal statute did not distinguish between marijuana and hemp—all cannabis was a Schedule I substance under the Controlled Substances Act—making both subject to Section 280E. 21 U.S.C.A. § 802(16).

The 2014 Farm Act distinguished “industrial hemp” from marijuana, defining it as cannabis with a THC concentration of not more than 0.3% by dry weight. Agricultural Act of 2014, 113 Pub. L. No. 79 § 7606(b)(2) (2014). It wasn’t until four year later, however, that the 2018 Farm Bill removed industrial hemp from the Controlled Substances Act’s definition of marijuana and permitted its cultivation under state-led agricultural pilot programs. Agriculture Improvement Act of 2018, 115 Pub. L. No. 334, §§ 2204, 12619(a).

Since the passage of the 2018 Farm Bill, if cannabis is (i) legally grown under a state-led agricultural pilot program and

(ii) has a THC concentration of not more than 0.3% by dry weight, then Section 280E does not apply. Agriculture Improvement Act of 2018, 115 Pub. L. No. 334, §§ 2204, 12619(a). If cannabis does not meet both of these requirements, however, it is considered marijuana and is subject to Section 280E.

“Trafficking”

Section 280E does not define trafficking and there are no Section 280E regulations. I.R.C. § 280E. Without statutory or regulatory guidance, the definition of “trafficking” has been left to the courts.

The Tax Court defines trafficking as “to engage in commercial activity; buy and sell regularly.” CHAMP, 128 T.C. 173, 182 (2007). The Tax Court’s definition may have limited applicability, however, as it has only heard cases involving dispensaries. Whether other plant-touching businesses that don’t buy or sell marijuana are trafficking, such as testing facilities, has not yet been decided.

Although the IRS has not released guidance defining trafficking, its preferred definition may be broader than the Tax Court’s. In *Alternative Health*, the Tax Court considered various definitions of trafficking:

- Repair expenses,
- “transport, transfer, or otherwise dispose of, to another, for purposes of commercial advantage or private financial gain, or to make, import, export, obtain control of, or possess, with intent to so transport, transfer, or otherwise dispose of.” 18 U.S.C.A. § 2320(f)(5) (on the trafficking of counterfeit goods or services).
- Maintenance,
- “[k]nowingly or willfully buy[ing], sell[ing], offer[ing] for sale, or giv[ing] away ... to any person for use.” I.R.C. § 7208(4)(B) (on the trafficking of postage stamps).
- “[t]he illegal importation, manufacture, distribution, and possession and improper use of controlled substances. ...” 21 U.S.C.A. § 801(2) (Controlled Substances Act on trafficking).

Alternative Health Care Advocates v. Comm’r (Alternative Health), 151 T.C. 225, 236–37. There is a common theme underlying each of these definitions—the transfer of legal or beneficial possession. Alvarez & Marsal, *CHAMPioning Certainty in the World of Cannabis Taxation*, PLI (Nov. 7, 2019), <https://www.pli.edu/programs/championing-certainty-in-the-world-of-cannabis-taxation>. If the IRS proffered these definitions, its position may be that any plant-touching business is subject to Section 280E.

TAX PLANNING

Because Section 280E prevents marijuana businesses from claiming any deduction or credit, it is common for businesses to have effective income tax rates of 90% or more on net income. Jackie Fountain, *Tax pitfalls of owning a marijuana business*, *The Tax Advisor* (Nov. 1, 2018), <https://www.thetaxadviser.com/issues/2018/nov/tax-pitfalls-owning-marijuana-business.html>. Marijuana businesses may even have to pay income taxes when they don’t generate a profit. *N. Cal. Small Bus. Assistants, Inc. v. Comm’r*, 153 T.C. No 4 (Oct. 23, 2019) (Gustafson, J., concurring in part, dissenting in part). Careful planning and record keeping are essential, therefore, to limiting a marijuana business’s tax liability.

Costs of Goods Sold

Marijuana businesses may claim cost of goods sold (or “COGS”). *CHAMP*, 128 T.C. 173, 178 n.4. COGS is not a deduction within the meaning of Section 162, but an offset to income. *Feinberg v. Comm’r*, 114 T.C.M. (CCH) 471 (2017). To find a marijuana business’s taxable income, COGS is subtracted from the business’s gross receipts. *Feinberg v. Comm’r*, 114 T.C.M. (CCH) 471 (2017).

Generally, COGS is the cost of acquiring the inventory of a business, either through purchase or production. *Patients Mut. Assistance Collective Corp. v. Comm’r* (Harborside I), 151 T.C. 176, 205 (2018). What may be claimed as COGS, however, depends on whether a business is considered a producer or a reseller. *Patients Mut. Assistance Collective Corp.*, 151 T.C. 176 at 210.

Dispensaries are considered resellers. *Patients Mut. Assistance Collective Corp.*, 151 T.C. 176 at 210. COGS for resellers is the cost of inventory and any other cost necessarily incurred to gain possession of inventory. 26 C.F.R. § 1.417-3(b) (1982). COGS, therefore, includes the purchase price of marijuana and the freight costs of shipping marijuana to the dispensary. Marijuana that is not sold to customers, however, does not reflect the cost of goods sold. *Olive v. Comm’r*, 139 T.C. 19, 36 (2012). If a dispensary gives marijuana away for free or if marijuana is withdrawn from inventory for personal use, the underlying cost of this marijuana may not be included in COGS. *Olive*, 139 T.C. 19 at 35–36.

Producers may include direct and indirect costs that are incident to and necessary for production or manufacturing in their COGS. 26 C.F.R. § 1.471-3(c). Direct costs are direct material or labor costs. 26 C.F.R. § 1.471-11(b)(2). This includes the cost of seeds or clones and labor costs, such as wages, overtime, and payroll taxes. 26 C.F.R. § 1.471-11(b). Indirect costs are divided into two categories, those that *must* be subtracted as COGS and those that are not COGS. 26 C.F.R. § 1.471-11(c)(i)–(ii).

Indirect costs that must be subtracted as COGS include:

- Utilities,
- Rent,
- Indirect labor and production supervisory wages, and
- Indirect materials and supplies.

26 C.F.R. § 1.471-11(c)(i).

Indirect costs that are not COGS are expenses for:

- Taxes,

IRS, Publication 1544, *Reporting Cash Payments of Over \$10,000 (Received in a Trade or Business)* (2014). If the Form 8300 filing requirements are triggered, the business has 15 days to (i) file the Form 8300 and (ii) give the buyer a written statement that the business is filing the Form 8300. IRS, Publication 1544. Failure to file the form or furnish the written statement may result in civil and criminal penalties. IRS, Publication 1544.

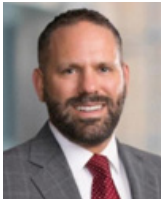
Be Audit Ready

Because marijuana businesses tend to be cash based and are subject to Section 280E, their returns are closely scrutinized by the IRS. *See e.g.*, IRS, I.R.M. 5.8.5.25.2 (2017). If, upon audit, a marijuana business cannot produce records that sufficiently substantiate its income, the tax consequences can be severe. The business’s income can be reconstructed and its claimed COGS can be denied. *See e.g.*, *Raymond Chico and Ruby Chico v. Comm’r*, 2019 T.C.M. (CCH) 123 (Sept. 16, 2019); *Olive v. Comm’r*, 139 T.C. 19, 32–36. If a dispute reaches the Tax Court and the business cannot produce sufficient financial records, the Court can make estimates “bearing heavily ... upon the taxpayer whose inexactitude is of his own making.” *Feinberg v. Comm’r*, 114 T.C.M. (CCH) 471 (Oct. 23, 2017). Hiring an experienced cannabis accountant and keeping meticulous financial records will enable a marijuana business to minimize its tax liability and be audit-ready.

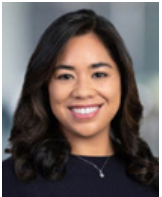
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