What is §280e?

And How to Reduce your Tax Liability

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What is §280e?

26 U.S. Code § 280E - Expenditures in connection with the illegal sale of drugs

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.

https://www.law.cornell.edu/uscode/text/26/280E

What does this mean?

Schedule I Drugs include Marijuana and Psilocybin.

§280e is only one sentence long but means that any trade or business trafficking in a Schedule I or II substance CANNOT deduct ordinary business expenses. Businesses will pay tax on their Gross Profit, not Net Profit.

A trade or business applies to all entities under the same ownership umbrella, so setting up multiple entities just to “beat” §280e does NOT work.

- The Alternative Health Care Advocates Tax Court case is an excellent example of why this does not work.
  https://www.dopecfo.com/blog/lessons-in-compliance-from-4-notorious-cannabis-court-cases

Gross Profit = Revenues less Cost of Goods Sold (COGS)

- COGS is the only allowable legal deduction under this tax code.

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Federal Income Tax Example

Marijuana/Psilocybin businesses are subject to §280e, which means these businesses are taxed on Gross Profit vs. Net Income.

There are many more restrictions when applying the tax code for these businesses.

- Section 263a Inventory capitalization is not allowed
- Section 179 Bonus depreciation is not allowed
- Section 199a Qualified business income is not allowed
- R&D tax credits are not allowed
- As well as many more nuances

To reduce your tax liability, you can maximize the allowable legal deductions for the cost of goods sold (COGS) under proper and consistent **GAAP-level cost accounting** (see IRC §471 next).

	Normal Business 12/31/2022	Under 280e 12/31/2022
Revenue	$ 500,000	$ 500,000
COGS	$ (250,000)	$ (250,000)
Gross Profit (Loss)	**$ 250,000**	**$ 250,000**
Labor	$ 50,000	$ 50,000
Rent	$ 50,000	$ 50,000
Insurance	$ 3,000	$ 3,000
Marketing & Advertising	$ 15,000	$ 15,000
Utilities	$ 6,000	$ 6,000
Repairs and Maintenance	$ 8,000	$ 8,000
Travel	$ 4,500	$ 4,500
Other General & Admin Costs	$ 5,000	$ 5,000
Loss on Sale of Assets	$ 1,500	$ 1,500
Operating Costs	**$ 143,000**	**$ 143,000**
EBITDA	**$ 107,000**	**$ 107,000**
Depreciation Expense	$ 6,000	$ 6,000
Interest Expense	$ 13,000	$ 13,000
Earnings before Tax (EBT)	**$ 88,000**	**$ 88,000**
Tax Expense (21% corp rate)	$ 18,480	$ 52,500
Net Income (Loss)	**$ 69,520**	**$ 35,500**
Effective tax rate	**21.0%**	**59.7%**

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How to “Beat” §280e

Simple. You can’t beat §280e.

- You will face the Federal Tax Court if you attempt one or more of these avoidance tactics.
  - Setting up multiple-entity structures when the only purpose is to avoid §280e
  - Incorrectly allocating costs to COGS to reduce Gross Profit
  - Over-allocating expenses to non-canna divisions so they can be deducted
  - Trying to find a tax loophole will backfire.

Are we S.O.L.? No!

- You can reduce your tax liability by utilizing full absorption cost accounting via§471.
- Proper “GAAP” level cost accounting under §471 is required, and most non-canna accountants do not do this correctly.
- Avoid the risk of fines, penalties, loss of licensure, and more because of poor accounting. There is a high probability that the IRS will audit businesses subject to §280e.

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What is §471?

26 U.S. Code § 471 - General rule for inventories

Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the **best accounting practice** in the trade or business and as **most clearly reflecting the income**.

Seed-to-Sale cost accounting is **CRITICAL**, as this is the only method allowable to do Cannabis tax correctly.

- §471-2: Valuation of inventories. Generally, the lower of cost or market (LCM).
- §471-3: Retailers/Dispensaries.
- §471-11: For Cultivators, Processors, & Manufacturers. Many more allowable costs in this category.
  - Accrual and absorption costing are required in monthly accounting procedures
  - All direct costs, plus the determination of three types of indirect costs:
    - Costs that must be included
    - Costs that can never be included (i.e. advertising), and
    - Costs that can be included if they are consistent with the taxpayer's recurring financials and in accordance with GAAP

https://www.law.cornell.edu/uscode/text/26/471
https://www.law.cornell.edu/cfr/text/26/1.471-3
https://www.law.cornell.edu/cfr/text/26/1.471-2
https://www.law.cornell.edu/cfr/text/26/1.471-11

Cannabis Tax Strategies

Structure your business correctly.

- Sometimes, forming a multi-entity system will promote efficiency – especially for verticals and businesses with non-canna divisions.
- It helps your cannabis accountant maximize allowable deductions for each entity properly.

Correctly implement §471 to reduce taxes and audit risk.

- Don't be the next Harborside.
- Incorrectly applying tax strategies to avoid §280e will result in penalties, fines, and potential loss of license.

Properly segment your non-canna divisions.

- Refer to Olive v. Commissioner tax case https://harvardlawreview.org/2016/03/olive-v-commissioner/
- Non-marijuana businesses must be profitable (on their own), sustainable, and have separate books.

Use vertical integration to minimize tax liabilities.

- Best to control the supply chain, share overhead, and take advantage of economies of scale.
- Correct intercompany accounting, consolidations, eliminations, and market transfer pricing are needed.

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Do’s and Don'ts

DO’s:

- DO have a canna-specific chart of accounts.
- DO utilize custom cost accounting templates for 471 and monthly GAAP cost accounting.
- DO utilize operational templates to track raw materials, WIP, and finished goods.
- DO have organized accounting books and records.
- DO complete monthly GAAP accruals – once a quarter or at year-end is NOT GAAP compliant.
- DO follow current cannabis accounting & tax court cases.
- DO maintain a permanent audit trail and a perpetual data room.

DON’Ts:

- DON’T over-allocate expenses into COGS or non-canna divisions.
- DON’T use Section 263a for Schedule I entities.
- DON’T attempt cost accounting without proper training and tools. You may cause more harm than good.
- DON’T assume all stages of a vertical are treated the same.
  - Each stage (cultivation, processor, manufacturer, retail, etc.) has different rules for COGS so that an audit is not triggered.

IRS Audit Triggers

The IRS will look for evidence that you owe additional taxes to the government:

- ALL companies subject to §280e are at high risk of an IRS audit because of the complicated tax regulations.
- Cash-based companies (due to banking restrictions) often provide increased opportunities for illegal activities.
  - Any cash transactions ≥$10k are required to be reported to the IRS.
- Poor bookkeeping, recordkeeping, inventory management, and cash discrepancies are guaranteed ways to draw the attention of the IRS.
- Ensure you are reporting ALL income.
- Mismatch between vendor-reported income and the 1099 reports you filed.
- Improper deductions compared to the IRS benchmarks for the industry.
- Business relationships (i.e. partnerships, vendors, investments) with other companies currently being audited.
- Misallocation of expenses to non-canna divisions or entities.
- Commingling personal and business funds (or separate entity funds).
- Questionable financing or ownership agreements.
- Unpaid employment taxes or late/unfiled income tax returns.
- Consecutive net losses (3+ years).

IRS

Department of the Treasury
Internal Revenue Service

What to Do if Your Business is Audited

Don’t Panic!:

- Do NOT ignore the letter – contact a tax professional immediately.
- Don’t provide more information than what is requested.
  - This could open a can of worms that you don’t want to be opened.
- Keep all original documents for reference.
- All correspondence with the IRS should be in writing.
- Don’t mislead the IRS examiner – this will only hurt your chance of surviving the audit.
- Follow the three P’s – prepared, polite, & professional – when dealing with the IRS.
- Do not respond to the IRS questions or information requests with aggression – they are only doing their job.
- If you believe the IRS is making an unreasonable or unfair request, consult your tax attorney to intervene.

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Additional Reading

- https://www.thetaxadviser.com/issues/2015/jul/houser-jul15.html
- https://www.hchlawyers.com/blog/2022/may/cannabis-tax-audit-red-flags-that-attract-irs-at/
- https://www.dopecfo.com/blog/tax-strategies-for-cannabis-companies
- https://www.greenmarketreport.com/tax-court-rules-against-harborside-in-280e-case/

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Erica Sloan is a dynamic and detail-focused Cannabis Accounting professional with 15+ years of success as a trusted advisor in her field. She is well-versed in policy creation, complex tax regulations and compliance, budget development, financial management best practices, internal controls, strategic planning, CFO services, and more.

Erica is an MBA alumni of East Carolina University. She lives on a small farm in the Shenandoah Valley with her veteran husband, her 3 children, and many animals. As a long-time advocate for cannabis, hemp, and CBD, she enjoys helping CEO's address the many unique financial challenges of the industry and offers exceptional value to help businesses reach their goals.

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Much of what we do in the cannabis industry is in a “grey area,” with little or no federal guidance or guidance from the IRS or the tax code.