Tax Court Confirms That Cannabis Businesses Cannot Take Advantage of Certain Tax Breaks Other Businesses Use

Description

One of the most frustrating issues facing the USâ€™s burgeoning cannabis industry has been the inequitable tax treatment that cannabis businesses face as compared to other industries. The IRSâ€™s guidance for one section of the tax code â€“ Section 280E â€“ has particularly frustrated the cannabis industry. Section 280E generally bars businesses â€œtraffickingâ€• in controlled substances from taking deductions and credits. Specifically, Section 280E appears to bar tax deductions for businesses trafficking in a Schedule I or II controlled substances, even if those substances are legal on the state level.

And with cannabis now legal in dozens of statesâ€”and numerous other states still actively considering legalization of recreational cannabisâ€”accountants and attorneys have long urged the IRS to clarify how broad the 280E restriction is when it comes to businesses legally operating under state law.

Further guidance on 280E has not been part of the recent iterations of the IRSâ€™s list of top guidance objectives. Indeed, IRS marijuana rules have largely been pushed off the agencyâ€™s radar as it has prioritized pandemic issues and other projects over the last year. As a general matter, state-legal cannabis businesses subject to Section 280E can reduce the amount of their revenues that get hit with taxes by the cost of their inventories, or â€œcost of goods sold.â€• But what constitutes the proper measure of â€œcost of goods soldâ€• in the context of cannabis operations has been disputed. There is little guidance by the IRS on what the â€œcost of goods soldâ€• is for cannabis operations, and so the question has been left open to interpretation. For cultivators, cost of goods is fairly simple: cost of the seed, the labor to cultivate (including the ownerâ€™s salary if the owner was involved in the production), rent, and so forth. For a dispensary, those costs are more difficult to delineate. But in any event, the Section 280E prohibition on the use of a variety of tax deductions other than â€œcost of goods soldâ€• by cannabis operations continues to be disputed.

Now, in InÂ *San Jose Wellness v. Commissioner*Â (Docket Nos. 12313-15, 12353-15, and 15714-18), the U.S. Tax Court has weighed in on the applicability of 280E to state-legal cannabis operations thatÂ *also*Â sell other goods. According to that decision, a California medical marijuana business cannot use certain business tax breaks because of the 280E restriction.

San Jose Wellnessâ€”a medical marijuana dispensary that also sold T-shirts, pipes, and offered acupuncture servicesâ€”sought charitable contribution and depreciation deductions on several years of tax returns. The IRS issued several deficiency notices to the dispensary between 2015 and 2018, disallowing $11.9 million in deductions and determining that the business owed a deficiency of $4 million and $181,423 in penalties.

The Tax Court disallowed the application of those tax breaks, siding with the IRS in an opinion that consolidated several cases, citing Section 280E. Selling other merchandise didnâ€™t exempt San Jose Wellness from the restriction, the court said. â€œThe requirements of section 280E are clear, and the hypotheticals posited by SJW are not relevant to these cases,â€• said Judge Emin Toro in his opinion.

It remains possible, or even likely, that a case related to Section 280E (and the IRSâ€™s interpretation thereof) will reach the U.S. Supreme Court soon. A Colorado dispensary has already filed a petition to do so, but the Court has not yet scheduled a conference to consider the dispensaryâ€™s petition.

Until that happens, or until Congress addresses the inclusion of cannabis as a Schedule I drug (and therefore

subject to Section 280E), cannabis businesses should consider whether to separate non-cannabis operations into separate legal entities, to take advantage of the beneficial tax treatment that non-cannabis businesses can obtain. And one should always keep in mind that attorneys or accountants with experience dealing with cannabis matters may be able to assist in setting up your operations to best protect your business, given the current state of the law.

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