E-BOOK

# The Cannabis Industry's Biggest Financial Hurdle: 280E

If you've done any financial work in the cannabis industry, you might know about 280E. In a nutshell, 280E is a federal tax code preventing state-legal cannabis companies from deducting most business expenses that other industries write off.

For the purposes of this discussion, cannabis refers to plants with a high-THC content or marijuana. Hemp, also considered cannabis, is not directly included in this discussion, as hemp businesses are not subject to the same 280E tax rules as cannabis businesses.

The rules of 280E require that high-THC cannabis businesses pay taxes on a higher proportion of their income than other businesses. Current Internal Revenue Code (IRC) guidelines allow state-legal cannabis operations to deduct only the cost of goods sold (COGS) from their taxes. This gives businesses in the industry an opportunity to claim some, but not all, of the expenses associated with bringing cannabis products to market.

Not all businesses are subject to tax code 280E. Ancillary businesses, like cannabis staffing firms, for example, are not subject to 280E even though they work directly with cannabis companies. For those bringing cannabis products to market, successfully navigating accounting issues hinges on working with the right people and resources. This includes working closely with a specialized cannabis accountant to meet the industry's unique needs.

## Basics of 280E

Cannabis is a controlled substance in the United States, and legal businesses must navigate 280E to stay tax compliant. Not all cannabis businesses are subject to 280E, as we mentioned above. If you're an ancillary business or a business that deals only in hemp and CBD, you're exempt from this tax code.

The 280E tax code impacts state-legal medical and recreational cannabis businesses. However, if you're a state-legal medical or recreational dispensary, a cultivator, or any other flower-touching participant in the supply chain, you must navigate this tax code to remain compliant.

## Who is affected?

| Affects | Does not affect |
|---|---|
| Cultivation companies | CBD & hemp companies |
| Manufacturing companies | Cannabis accounting firms |
| Dispensaries | Cannabis-focused software companies |
| Cannabis transportation companies, delivery services | CPG companies, like vape manufacturers, who don't distribute cannabis |
| Any business directly handling cannabis | Other non-plant-touching businesses |

A simple rule of thumb: If you are a high-THC cannabis plant-touching business, 280E affects you.

American cannabis businesses are working toward ways to simplify compliance:

- Removing cannabis from the Schedule I Substances list (de-scheduling), similar to industrial hemp's 2018 removal
- Federal legalization, resulting in potentially different outcomes than just simple de-scheduling
- Reworking 280E's language to exclude state-legal cannabis

## Calculating taxes with 280E

Cannabis businesses don't get to include many regularly tax-deductible expenses in their formula. Therefore, their taxable revenue is their gross margin (total revenue minus COGS).

If you're subject to 280E, you can't claim traditional business expenses on your taxes. State-legal cannabis businesses can only deduct expenses from one category—COGS. In this case, COGS refers only to the costs directly associated with producing cannabis, such as the invoice price you paid for that cannabis to sell in your dispensary.

Non-cannabis businesses, like a grocery store, can claim business expenses outside of the COGS. For example, the electricity bill on the store's sales floor, the cost of salaries for salespeople, and marketing activities. A dispensary, however, cannot claim its light bill, because it's not directly related to the production of cannabis. Different people will tell you COGS means different things, but for the most part it is straightforward. Note that, within the industry, cannabis cultivators have more opportunities to claim COGS than other operations.

### Federally legal businesses

**Gross margin - Other tax-deductible expenses = Taxable revenue**

### Cannabis businesses

**Gross margin = Taxable revenue**

Cannabis businesses take a large majority of the tax-deductible business expenses out of the equation, so they are left paying taxes on their gross margin. This often creates an effective tax rate of 70% or more.

## What cannabis business can and can't claim

| Expense | Claim |
|---|---|
| Invoice price for cannabis (before any sort of trade or discounted rate) | ✓ |
| Electric bills in inventory (not sales) | ✓ |
| Dispensary staff's salary | ✗ |
| Rent | ✗ |
| Display cases* | ✗ |
| Insurance* | ✗ |
| Any service fees* (like plumbers) | ✗ |
| Additional fees* | ✗ |

*Excluding cultivation facilities

## Taxes and multiple entities

The adjacent chart shows what cannabis businesses can and can't claim under 280E. Just determining the expenses that are subject to 280E, however, is not enough. Companies also need to ensure that 280E compliance practices are consistent and well documented in the event of an audit.

Many cannabis companies operate multiple entities, particularly if they hold multiple licenses. It is important for each entity to allocate its 280E expenses appropriately and to be able to look at tax liabilities across multiple entities.

With careful accounting, cannabis businesses can reduce their tax burden if they accurately and consistently allocate appropriate expenses.

While businesses subject to 280E may never have the freedom to deduct business expenses that non-cannabis businesses have, a lot can be done to reduce liability in the short run.

## Cannabis as part of a separate business focus

A caregiving organization focused on helping disabled individuals, that also offers the purchase of legal medical cannabis, is not subject to 280E. When the primary business activities are caregiving and not medical cannabis distribution, the business is only subject to 280E regulations on cannabis-related activities. If a company distributes both cannabis and hemp for medical use, they are only subject to 280E for the cannabis portion of the business, because hemp businesses aren't under 280E's purview.

### Californians Helping to Alleviate Medical Problems (CHAMP)

CHAMP provided caregiving services to disabled people, and that included a limited amount of medical cannabis. The organization also provided hygiene supplies, support groups, services and events for low-income individuals, counseling services, social events and outings, and technology accessibility. In 2007, CHAMP argued that their primary services were caregiving, not distributing medical cannabis. The court agreed and the organization didn't have to follow 280E guidelines for other areas of their business.

### Follow-up cases

In 2012 in another case, a California medicinal shop was able to present CHAMP's model in front of the tax court and win their case.

A separate 2012 case yielded a different outcome. The Vapor Room tried to argue that while it was a medical cannabis consumption lounge, that is not all it did. Although medical cannabis was the sole source of revenue for the California store and patrons could consume cannabis inside, it had a community-center like feel, with chairs, tables, games, and free food, plus they had services like massages, yoga, and movies. Therefore, the company argued against deducting only COGS according to 280E guidelines. Because these other services were free and being a community center was not their primary service, the court ruled the Vapor Room had to operate with 280E in mind in all aspects of their business.

### The precedent

Through these cases, a precedent has been set: if cannabis is a company's primary line of revenue, though they may offer other add-on services, they must adhere to 280E guidelines. On the other hand, if the company is a caregiving organization first and foremost where cannabis sales are an add-on, 280E only applies to expenses relating to cannabis. In that case, it's critical you maintain adequate recordkeeping. Ideally, you'd separate your cannabis records from non-cannabis records to further clarify the distinction between the two businesses.

The rules of 280E present significant hurdles for cannabis businesses, but they are not impossible to cross. Complying with 280E can make accounting more complex and increase effective tax rates for cannabis businesses. For those who are up to the challenge, 280E can be overcome with the use of the right accounting solutions to ensure compliance and automated practices for allocation that are defensible in the event of an audit. Solid accounting, alongside savvy approaches to differentiating products, managing expenses, and pricing, can help legal cannabis businesses achieve and grow their competitive advantage.

For more information about flexible accounting solutions that can help keep your business 280E compliant and profitable:

Contact us at 877-437-7765 or visit [sageintacct.com.](sageintacct.com)