280E Update and “loophole”

It is well known that the cannabis industry faces extreme challenges when dealing with the IRS. This was further confirmed by a report recently released by the Treasury Inspector General for Tax Administration (TIGTA) on March 30, 2020. The report details the findings and recommendations resulting from of a study conducted on marijuana industry tax returns for the 2016 tax year. What they found was a high rate of noncompliance resulting in hundreds of millions of dollars in lost tax revenue. These findings are concerning for an industry still seeking legitimacy, however, the report also uncovered what many in the industry are calling a loophole in the tax code.

What is TIGTA and why should I care?

Before diving into the details of the report, it’s important to understand the role that TIGTA plays. The agency was established in 1999 to provide independent oversight and serve as an Inspector General for matters relating to the IRS. Their mission is to promote the fair administration of the Federal tax system and work to ensure that the IRS is held accountable for the trillions of dollars in tax revenue it collects each year. Their impartial role within the Treasury means their findings should be given serious consideration by both business owners and tax professionals.

There will be more IRS audits of cannabis companies

The report highlights the struggles that cannabis companies face, specifically in dealing with Section 280E. In their study of cannabis companies operating in California, Oregon, and Washington, TIGTA found that 59% of taxpayers were not fully compliant with 280E. In 2016 alone, they estimated that these businesses underpaid their federal tax liabilities by $48.5 million. Projected forward five years, the agency calculated $242.6 million in unpaid taxes from marijuana businesses. These figures also don’t account for the explosive growth in the industry over the past four years, so the actual numbers are likely much, much higher. This serves to underscore the fact that cannabis audits are extremely profitable for the IRS. In fact, half of the recommendations that TIGTA made to the IRS in their report involved ways that the IRS could enhance their audit efforts and increase revenue collection.

Don’t call it a loophole

There is no avoiding Section 280E. Taxpayers have challenged the legitimacy of this infamous code section, with some challenges even making it as far as the Supreme Court. However, as it stands, there is no legal way to avoid the far-reaching effects of 280E. But what if there was a way to mitigate those effects while still adhering to the rules? In its report, TIGTA brought to light an unforeseen interpretation of a provision included in the 2017 Tax Cuts and Jobs Act (TCJA) that may do just that.

In order to understand how this change impacts taxpayers, some background on Section 280E is required. Section 280E states that no deduction or credit shall be allowed for any amount paid or incurred in carrying on any trade or business that consists of trafficking in controlled substances. In anticipation of potential challenges to the constitutionality of this law, congress did allow taxpayers subject to this provision to deduct their cost of goods sold (COGS) in determining taxable income. Said differently, the only deduction allowed for companies operating in the marijuana industry is their cost of goods sold.

The computation of cost of goods sold is complicated and operators in this space do everything they can to maximize this deduction. Section 471 of the Code and the regulations thereunder go to great lengths describing what costs can and cannot be included in inventory, and thus, COGS. Even still, there is a level of ambiguity that makes compliance difficult and time consuming. This new change to Section 471 by the TCJA was aimed at helping small businesses by eliminating the burden of accounting for inventory and allowing taxpayers that meet certain criteria to treat inventory in accordance with their own internal accounting procedures. For the cannabis industry, the implications are significant. Rather than go through the detailed process of tracking inventoriable costs and losing the rest to the void of 280E, companies can potentially adopt an accounting policy that treats all costs as COGS and receive a deduction for these expenditures on their tax returns. In doing so, companies can circumvent the effects of 280E while maintaining compliance with the law. For an industry that often sees effective tax rates north of 80%, this interpretation of the Code would level the playing field with more traditional industries and bring much needed relief in the form of a reduced tax bill.

In order to qualify, companies need to meet the criteria for certain small businesses outlined in Section 471(c). The two primary hurdles are the gross receipts test and the applicable financial statement (AFS) exception. To meet the gross receipts test, taxpayers and their affiliates must have average annual gross receipts under $25 million (indexed for inflation) for the three previous years. Taxpayers with an AFS (meaning any audited or reviewed financial statement) will not qualify for this treatment.

When TIGTA detailed this finding in their report, they recommended that the IRS develop specific guidance on how this particular application of the Code might be interpreted. The IRS disagreed, citing other administrative priorities. It's worth noting that this was the only recommendation that the IRS disagreed with out of the six included in the report. With the IRS staying silent, taxpayers and their advisors are left to debate the risks of wading into uncharted waters.

About the authors:

Simon Dufour and Jeff Elkins lead the cannabis practice for Hall & Company which has been serving the cannabis industry since 2014. They teach continued professional education to CPAs and attorneys on 280E and banking, taught the Cannabis Business 101 course at the NCIA conference, were on the first ever ACG OC Cannabis Panel, are Founding Members of The Cannabis Society Virtual Conference, presenters for various Webinars, and have been guests on several cannabis related podcasts.