INTERNAL REVENUE CODE SECTION 280E:
CREATING AN IMPOSSIBLE SITUATION FOR LEGITIMATE BUSINESSES

What is Section 280E?

Section 280E of the Internal Revenue Code forbids businesses from deducting otherwise ordinary business expenses from gross income associated with the "trafficking" of Schedule I or II substances, as defined by the Controlled Substances Act. The IRS has subsequently applied Section 280E to state-legal cannabis businesses, since cannabis is still a Schedule I substance.

A throwback from the Reagan Administration, Section 280E originated from a 1981 court case in which a convicted cocaine trafficker asserted his right under federal tax law to deduct ordinary business expenses. In 1982, Congress created 280E to prevent other drug dealers from following suit. It states that no deductions should be allowed on any amount "in carrying on any trade or business if such trade or business consists of trafficking in controlled substances."

With 23 states and the District of Columbia now allowing some form of legal marijuana, 280E is applied to state-regulated cannabis businesses more often than it is to the types of illegal drug dealers that the provision was intended to penalize.

How does Section 280E hurt state-legal cannabis businesses?

Federal income taxes are based on a fairly simple formula: start with gross income, subtract business expenses to calculate taxable income, and then pay taxes on this amount. Owners of regular businesses often derive profits from these business deductions.

Cannabis businesses, however, pay taxes on gross income. These businesses often pay tax rates that are 70% or higher. As John Davis, owner of the Northwest Patient Resource Center in Seattle, WA states, "I'm taxed on nearly double the amount that my business actually makes."

"I'm taxed on nearly double the amount that my business actually makes."

– John Davis, Northwest Patient Resource Center

Below is a simplified model that illustrates the tax structure for cannabis businesses compared to a normal businesses. In this scenario, the normal business's taxable income is $150,000, while the cannabis business is taxed on $350,000, despite having the same costs and expenses.

	Non-Cannabis Business	Cannabis Business
Gross Revenue	$1,000,000	$1,000,000
Cost of Goods Sold	$650,000	$650,000
Gross Income	$350,000	$350,000
Deductible Business Expenses	$200,000	$0
Taxable Income	$150,000	$350,000
Tax (30%)	$45,000	$105,000
Effective Tax Rate	30%	70%

The taxation problem facing cannabis businesses just got worse.

"There are a lot of businesses that are going to get absolutely creamed."

– Jim Marty, Bridge West CPAs

In January 2015, the Internal Revenue Service issued an internal memorandum that opined on how state-legal cannabis businesses should compute federal income taxes. Drafted by the IRS Chief Counsel, the memo rejects many of the tax deductions that these businesses have traditionally made. The memo challenges tax strategies that allow these businesses to stay afloat, and imposes a strict interpretation of Section 280E of the Internal Revenue Code. Without even the meager deductions state-legal cannabis businesses were previously allowed to take, these businesses face a bleak financial future. This deeply affects their ability to reinvest profits back into their local communities and fulfill the will of state voters, legislatures, and regulatory bodies that have mandated that cannabis be dispensed through legal storefronts.

Jim Marty, a CPA with Colorado's Bridge West CPAs, says that many marijuana businesses are going to struggle under the new rules. "There are a lot of businesses that are going to get absolutely creamed," he says.

What types of business expenses are scrutinized under 280E?

- Employee salaries
- Utility costs such as electricity, internet and telephone service
- Health insurance premiums
- Marketing and advertising costs
- Repairs and maintenance
- Rental fees for facilities
- Routine repair and maintenance
- Payments to contractors

State-legal cannabis businesses are allowed to deduct the Cost of Goods Sold (COGS) on their taxes. Also, since 2007, cannabis businesses have made deductions on their non-cannabis business activities. Most importantly, however, cannabis businesses have also followed guidance from section 263A of the IRC, which allows businesses to capitalize on indirect costs — such as administrative and inventory costs, as well as the amount paid in state excise taxes — and deduct them under COGS.

Depending on the business, these indirect costs can be sizable. The strategy of including these costs in COGS is oftentimes what allows cannabis businesses to collect meager profits.

What deductions are now likely to be challenged?

- General and administrative costs (bookkeeping, legal expenses, technology costs)
- State excise taxes
- Storage of cannabis
- Purchasing cannabis
- Depreciation of cannabis

How did these deductions benefit cannabis businesses?

Attached below are three documents that illustrate how 280E has applied to typical cannabis businesses both before and after the tightening of IRS rules.

Figure 1 is a 1065 tax filing from 2013 from a medical cannabis business in Denver, Colorado. Gross receipts totaled $776,772, and thanks to some strong work by a CPA, the business was able to deduct $435,819 in Cost of Goods Sold, leaving a gross income of $340,953. The business had an additional $153,806 in deductions that any other business would be able to take, but were disallowed under 280E. Since the business was allowed deductions on Cost of Goods Sold, it paid taxes on $340,953 instead of on $776,772. Its effective tax rate was still 55% of its final earnings, but the business owner was able to invest the remaining cash back into the business.

Without these deductions, what does a final tax bill look like for a state-authorized cannabis business?

Figure 2 is a 1065 tax filing from 2014 from a medical cannabis dispensary in Seattle, Washington. The business followed the new, even stricter 280E rules in its filing. As the documents show, gross income from this business totaled $154,469 for 2014, and the business had $101,100 in expenses. If this business were a regular business, it would be taxed on its earnings, which were $53,369. In order to comply with 280E, however, the business was unable to take these deductions, and instead it paid taxes on $154,469. The business' tax payment totaled $46,340, which equates to 87% of its true earnings. The business owner had only $7,029 to either invest back into his business or keep as profit.

What's the worst-case scenario for a business under 280E?

Figure 3 is a 1065 and Statement of Activities and Changes In Net Assets from a medical marijuana dispensary in Arizona. The business produced $876,420 in gross receipts and was permitted to deduct $319,386 in Cost of Goods Sold, but could take no deductions for its other expenses. The business, thus, was taxed on its gross income, which was $557,034.

Like many startup businesses, however, the dispensary had significant first-year expenses, which totaled $867,863. These operating expenses were non-deductible under 280E. So while the business actually lost a total $310,829 for the year, its tax bill was still $189,781. Despite bringing in $876,420, the business ended up more than half a million dollars in the red.

Mitch Woolheiser, owner of Northern Lights Cannabis in Edgewater, Colorado, said he's "hoarding cash" in preparation for his tax payment. "I can't give my employees raises. I can't put money back into my business. Instead I've been hoarding cash in anticipation of what the IRS is going to take," Woolheiser says.

"I can't give my employees raises. I can't put money back into my business. Instead I've been hoarding cash in anticipation of what the IRS is going to take."

– Mitch Woolheiser, Northern Lights Cannabis

How many state economies are affected by 280E?

Section 280E affects all businesses that engage in the cultivation, sale, or processing of the cannabis plant. This includes cultivators, medical dispensaries, marijuana retail stores, and infused product manufacturers, as well as concentrates and cannabis oil manufacturers.

Cannabis is now legal in some form in 23 U.S. states as well as the District of Columbia, with Oregon and Alaska joining Colorado and Washington as states with laws regulating marijuana sales to adults over 21. Several other states are expected to enact similar laws regulating marijuana in 2016.

What impact does this have on the cannabis industry and states attempting to regulate marijuana?

> ***"Section 280E de-incentivizes people from filing tax returns. It penalizes people who are trying to be transparent and operate within the law."***
>
> ***– Henry Wykowski, Henry G. Wykowski & Associates***

Cannabis entrepreneurs *want* to pay federal and state taxes. Maintaining a strong working relationship with the IRS legitimizes these businesses and, in turn, the entire cannabis industry. But the current taxation climate has convinced some cannabis entrepreneurs to either ignore 280E on their tax filings, or forego paying taxes altogether. These businesses would rather gamble on the IRS overlooking their filing than see their revenues evaporate due to 280E.

As Henry Wykowski, a California attorney who works with marijuana clients on tax issues, states, "Section 280E de-incentivizes people from filing tax returns. It penalizes people who are trying to be transparent and operate within the law."

We believe the most recent IRS memo will force even more cannabis businesses to sidestep the IRS. This will undoubtedly lead to long and expensive audits, as well as lawsuits that will challenge the IRS memo and 280E as a whole.

How can this problem be resolved?

The National Cannabis Industry Association believes that the best fix to the situation is to remove marijuana from the Controlled Substances Act. However, The Small Business Tax Equity Act – companion Senate and House legislation introduced in the 114th Congress by Sen. Ron Wyden (D-OR) and Rep. Earl Blumenauer (D-OR) – would more narrowly address the unfair impact 280E has on states with regulated cannabis markets without necessitating a sweeping shift in U.S. marijuana policy.

> ***"The intent of the law was to go after criminals, not law-abiding job creators. Congress needs to step up and clarify that this provision has become a case study in unintended consequences."***
>
> ***– Grover Norquist, Americans for Tax Reform***

The legislation – S. 987 and H.R. 1855 – would exempt cannabis businesses acting in compliance with state law from the 280E provision, thereby allowing them to take the ordinary business deductions afforded to all other legal businesses.

In his endorsement of The Small Business Tax Equity Act, Americans for Tax Reform President Grover Norquist said, "The intent of the law was to go after criminals, not law abiding job creators. Congress needs to step up and clarify that this provision has become a case study in unintended consequences."

This sensible solution would bring this outdated provision of the tax code into the modern era and allow cannabis businesses to operate in accordance with the will of state voters and legislative bodies who have mandated that these businesses work within a legitimate, above-ground environment. Amending 280E will also allow businesses in the emerging cannabis industry to better invest in their local communities by hiring additional employees and offering more competitive salaries rather than sending inordinate amounts of revenue into the federal tax coffers.

National Cannabis Industry Association, April 2015

ACKNOWLEDGMENTS

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Matthew Walstatter, Pure Green Cannabis
Mitch and Eva Woolheiser, Northern Lights
Henry Wykowski, Henry G. Wykowski and Associates
Luigi Zamarra, Luigi CPA

Figure 1

Form **1065**

Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2013, or tax year beginning ____________, 2013, ending ____________, 20 ____ .

► Information about Form 1065 and its separate instructions is at *www.irs.gov/form1065*.

OMB No. 1545-0099

2013

A Principal business activity: [redacted]

Name of partnership: [redacted]

D Employer identification number: [redacted]

B Principal product or service: [redacted]

Type or Print

Number, street, and room or suite number. If a P.O. box, see the instructions. [redacted]

E Date business started: [redacted]

C Business code number: [redacted]

City or town, state or province, country, and ZIP or foreign postal code: [redacted] [redacted] [redacted]

F Total assets (see instrs) $ 260,244.

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return (6) ☐ Technical termination — also check (1) or (2)

H Check accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ►

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ► 2

J Check if Schedules C and M-3 are attached ☐

Caution. *Include **only** trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.*

	Line	Description				Amount	
INCOME	1 a	Gross receipts or sales	1 a	776,772.			
	b	Returns and allowances	1 b				
	c	Balance. Subtract line 1b from line 1a			1 c	776,772.	Gross
	2	Cost of goods sold (attach Form 1125-A)			2	435,819.	COGS
	3	Gross profit. Subtract line 2 from line 1c			3	340,953.	Taxable Profit
	4	Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)			4		
	5	Net farm profit (loss) (attach Schedule F (Form 1040))			5		
	6	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			6		
	7	Other income (loss) (attach statement)			7		
	8	**Total income (loss).** Combine lines 3 through 7			8	340,953.	
DEDUCTIONS (SEE INSTRS FOR LIMITATIONS)	9	Salaries and wages (other than to partners) (less employment credits)			9	85,004.	
	10	Guaranteed payments to partners			10		
	11	Repairs and maintenance			11	6,638.	
	12	Bad debts			12		
	13	Rent			13	8,325.	
	14	Taxes and licenses			14		
	15	Interest			15		
	16a	Depreciation (if required, attach Form 4562)	16a	8,287.			
	b	Less depreciation reported on Form 1125-A and elsewhere on return	16b	0.	16c	8,287.	
	17	Depletion **(Do not deduct oil and gas depletion.)**			17		
	18	Retirement plans, etc.			18		
	19	Employee benefit programs			19		
	20	Other deductions (attach statement) *. STMT			20	-108,254.	
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21	0.	
	22	**Ordinary business income (loss).** Subtract line 21 from line 8			22	340,953.	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member manager) is based on all information of which preparer has any knowledge.

► Signature of general partner or limited liability company member manager ► Date

May the IRS discuss this return with the preparer shown below (see instrs)? ☒ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☒ if self-employed	PTIN
Jordan Cornelius	Jordan Cornelius	12/31/14		[redacted]

Firm's name ► Cornelius CPAs — Firm's EIN ► [redacted]

Firm's address ► 10200 E Girard Ave, Ste A-105, Denver CO 80231 — Phone no. (303) 625-4077

Figure 1

Form 1065
Page 1, Line 20

Other Deductions Worksheet

► Keep for your records

2013

Name as Shown on Return	Employer Identification No.
[redacted]	[redacted]

1	Accounting			1		
2	Advertising			2	33,915.	
3	Amortization			3		
4	Automobile and truck expense			4	285.	
5	Bank charges			5	433.	
6	Cleaning			6		
7	Commissions			7		
8	Computer services and supplies			8	1,814.	
9	Credit and collection costs			9		
10	Delivery and freight			10		
11	Discounts			11		
12	Dues and subscriptions			12		
13	Equipment rent			13	3,763.	
14	Gifts			14		
15	Insurance			15	1,933.	
16	Janitorial			16		
17	Laundry and cleaning			17		
18	Legal and professional			18		
19 a	Meals and entertainment, subject to 50% limit	19 a				
b	Meals and entertainment, subject to 80% limit	b				
c	Meals and entertainment, allowed at 100%	c	447.			
d	Less disallowed	d				
e	Meals and entertainment, net			19 e	447.	
20	Miscellaneous			20		
21	Office expense			21		
22	Outside services			22	3,833.	
23	Parking fees and tolls			23		
24	Permits and fees			24		
25	Postage			25	98.	
26	Printing			26		
27	Security			27		
28	Supplies			28	13,195.	
29	Telephone			29	4,497.	
30	Tools			30		
31	Training/continuing education			31		
32	Travel			32		
33	Uniforms			33		
34	Utilities			34	1,014.	
35	Other (itemize):			35		
	PROFESSIONAL SERVICES				6,565.	
	SOFTWARE					
	CASH SHORT/OVER				764.	
	MERCHANT ACCOUNT FEES				12,181.	
	263A ADJUSTMENT TO COGS				-39,185.	
	280E NON-DEDUCTIBLE EXPENSES				-153,806.	Non-Deductible
35	Total			35	-108,254.	

ptpw6101.SCR 06/05/12

Figure 2

[redacted]
SEATTLE, WA 98126
206-588-2841

March 27, 2015

[redacted]

RE:
[redacted]
Schedule K-1 from Partnership's 2014 Return of Income

Dear [redacted]

Enclosed is your 2014 Schedule K-1 (Form 1065) Partner's Share of Income, Deductions, Credits, Etc. from [redacted]. This information reflects the amounts you need to complete your income tax return. The amounts shown are your distributive share of partnership tax items to be reported on your tax return, and may not correspond to actual distributions you have received during the year. This information is included in the Partnership's 2014 Federal Return of Partnership Income that was filed with the Internal Revenue Service.

This is the final year that [redacted] will file a Return of Partnership Income. As a result, this will be the last Schedule K-1 (Form 1065) you will receive from the partnership.

If you have any questions concerning this information, please contact us immediately.

Sincerely,

[redacted]

Enclosure(s)

Figure 2

651113

[X] Final K-1 [ ] Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2014**

Department of the Treasury Internal Revenue Service

For calendar year 2014, or tax year beginning ____________, 2014 ending ____________, ______

Partner's Share of Income, Deductions, Credits, etc.

► See separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number

[redacted]

B Partnership's name, address, city, state, and ZIP code

[redacted]

Seattle, WA 98126

C IRS Center where partnership filed return

e-file

D [ ] Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number

[redacted]

F Partner's name, address, city, state, and ZIP code

[redacted]

Bellevue, WA 98004

G [X] General partner or LLC member-manager [ ] Limited partner or other LLC member

H [X] Domestic partner [ ] Foreign partner

I1 What type of entity is this partner? Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here [ ]

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	51 %	51 %
Loss	51 %	51 %
Capital	51 %	51 %

K Partner's share of liabilities at year end:

Nonrecourse	$
Qualified nonrecourse financing	$
Recourse	$ 11,988.

L Partner's capital account analysis:

Beginning capital account	$ 39,213.
Capital contributed during the year	$
Current year increase (decrease)	$ 73,273.
Withdrawals & distributions	$
Ending capital account	$ 112,486.

[X] Tax basis [ ] GAAP [ ] Section 704(b) book [ ] Other (explain)

M Did the partner contribute property with a built-in gain or loss?

[ ] Yes [X] No

If 'Yes', attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	101,100.	15	Credits	
2	Net rental real estate income (loss)				
3	Other net rental income (loss)		16	Foreign transactions	
4	Guaranteed payments	53,369.			
5	Interest income	2.			
6a	Ordinary dividends				
6b	Qualified dividends				
7	Royalties				
8	Net short-term capital gain (loss)				
9a	Net long-term capital gain (loss)		17	Alternative minimum tax (AMT) items	
			A		-283.
9b	Collectibles (28%) gain (loss)				
9c	Unrecaptured section 1250 gain				
10	Net section 1231 gain (loss)		18	Tax-exempt income and nondeductible expenses	
11	Other income (loss)		C		21,734.
			19	Distributions	
12	Section 179 deduction	5,434.			
13	Other deductions		20	Other information	
A		661.			
			A		2.
14	Self-employment earnings (loss)				
A		154,469.			

What was earned

*See attached statement for a

Amount taxed on… 30% is $46,340.07 Amount to live on would be $7,029.00

FOR IRS USE ONLY

BAA For Paperwork Reduction Act Notice, see Instructions for Form 1065. Schedule K-1 (Form 1065) 2014

Partner 1 PTPA0312L 11/28/14

Figure 3

Form **1120** Department of the Treasury Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2013 or tax year beginning ________________, ending ________________

▶ Information about Form 1120 and its separate instructions is at *www.irs.gov/form1120.*

OMB No. 1545-0123

2013

A Check if:
1a Consolidated return (attach Form 851) . . ☐
b Life/nonlife consolidated return . . . . . ☐
2 Personal holding co. (attach Sch. PH) . . . ☐
3 Personal service corp. (see instructions) . . . ☐
4 Schedule M-3 attached ☐

TYPE OR PRINT

Name

Foreign country name Foreign province/state/county Foreign postal code

B Employer identification number

C Date incorporated

D Total assets (see instructions)
$ 1,406,508

E Check if: (1) ☒ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

	Line	Description			Line	Amount
Income	1a	Gross receipts or sales	1a	876,420		
	b	Returns and allowance	1b			
	c	Balance. Subtract line 1b from line 1a			1c	876,420
	2	Cost of goods sold (attach Form 1125-A)			2	319,386
	3	Gross profit. Subtract line 2 from line 1c			3	557,034
	4	Dividends (Schedule C, line 19)			4	
	5	Interest			5	
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	
	10	Other income (see instructions—attach statement)			10	
	11	**Total income.** Add lines 3 through 10 ▶			11	557,034
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E) ▶			12	
	13	Salaries and wages (less employment credits)			13	
	14	Repairs and maintenance			14	
	15	Bad debts			15	
	16	Rents			16	
	17	Taxes and licenses			17	
	18	Interest			18	
	19	Charitable contributions			19	
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			20	
	21	Depletion			21	
	22	Advertising			22	
	23	Pension, profit-sharing, etc., plans			23	
	24	Employee benefit programs			24	
	25	Domestic production activities deduction (attach Form 8903)			25	
	26	Other deductions (attach statement)			26	
	27	**Total deductions.** Add lines 12 through 26 ▶			27	0
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	557,034
	29a	Net operating loss deduction (see instructions)	29a			
	b	Special deductions (Schedule C, line 20)	29b			
	c	Add lines 29a and 29b			29c	0
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28 (see instructions)			30	557,034
	31	Total tax (Schedule J, Part I, line 11)			31	189,392
	32	Total payments and refundable credits (Schedule J, Part II, line 21)			32	0
	33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐			33	
	34	**Amount owed.** If line 32 is smaller than the total of lines 31 and 33, enter amount owed			34	189,392
	35	**Overpayment.** If line 32 is larger than the total of lines 31 and 33, enter amount overpaid			35	0
	36	Enter amount from line 35 you want: **Credited to 2014 estimated tax** ▶		Refunded ▶	36	0

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Sign Here ▶ Signature of officer Date ▶ Title

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☒ No

Paid Preparer Use Only

Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN

Firm's EIN ▶

Phone no.

State AZ ZIP code

Figure 3

STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS
December 31, 2013

NET SALES	$ 876,420	Gross
COST OF SALES	319,386	COGS
GROSS PROFIT	557,034	Taxable Income
OPERATING EXPENSES		
Consulting	442,331	
Contract labor	417,204	
Occupancy	102,343	
Depreciation	73,147	
Interest expense	34,637	
Advertising and promotion	32,253	
Management fees (See Note 5)	29,263	
Computer and internet	10,592	
Utilities	9,886	
License and permits	7,739	
Insurance	6,885	
Repairs and maintenance	4,522	
Bank fees	3,985	
Telephone	3,760	
Office supplies	3,441	
Research and development	855	
Travel	557	
Security	448	
Meals and entertainment	299	
Printing	107	
Allocation to inventory	(316,391)	
Total Operating Expenses	867,863	Non-Deductible
INCOME BEFORE INCOME TAXES	(310,829)	
PROVISION FOR INCOME TAXES	(189,781)	Taxes Paid
(Decrease) in Net Assets	(500,610)	Total loss
NET ASSETS, BEGINNING OF YEAR	(337,418)	
NET ASSETS, END OF YEAR	$ (838,028)	