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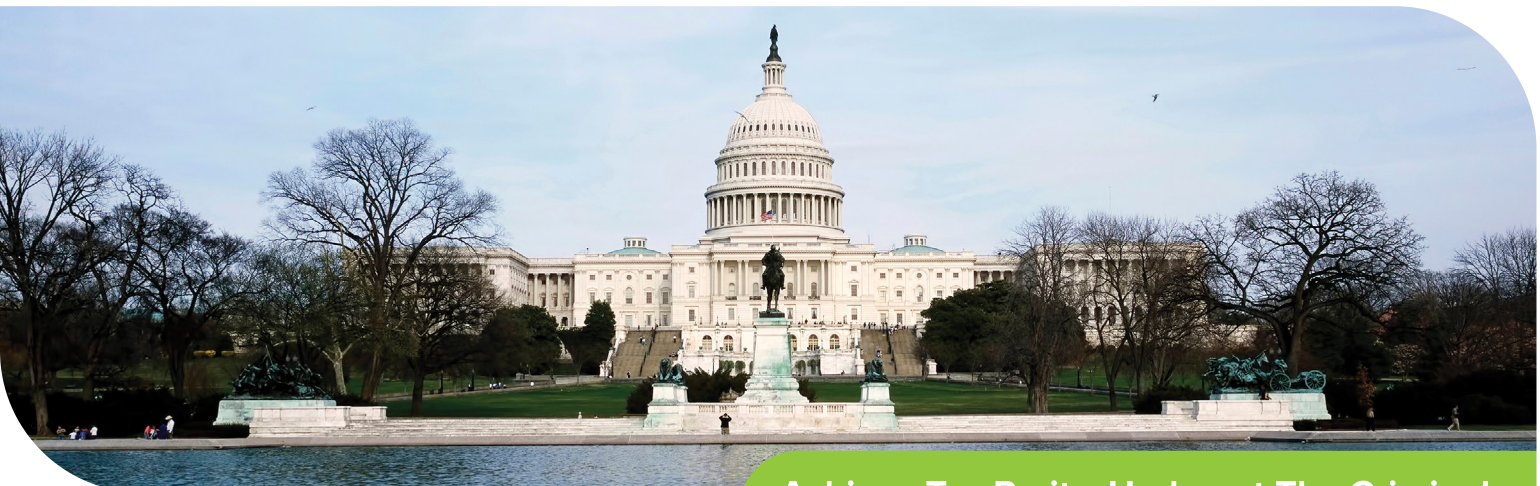
National Cannabis Industry Association
TheCannabisIndustry.org

IRC Section 280E:

An Unjust Burden on State-Legal Cannabis Businesses



Achieve Tax Parity, Undercut The Criminal Market, And Generate More Revenue

The Language of Section 280E is as Follows:

"*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.*"

Internal Revenue Code Section 280E

Section 280E of the Internal Revenue Code (IRC) prohibits businesses engaged in the trafficking of Schedule I or Schedule II controlled substances in contravention of state or federal law from deducting normal business expenses, such as payroll and rent, from gross income. Section 280E was originally intended to penalize illicit market operators, but because cannabis remains a Schedule I controlled substance, it now applies to licensed adult-use and medical cannabis businesses that operate in compliance with the laws and regulations on the books in dozens of states. This amounts to a major financial burden for legitimate cannabis businesses, though the degree of impact varies by type of operation and business structure, among other factors. Most states with legal cannabis and tax codes aligned with the IRC have excluded 280E to provide parity in the state code but the state-licensed businesses continue to be at a disadvantage due to the outdated federal tax provision.

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By forcing businesses – or individuals in the case of sole proprietors and partnerships – to pay taxes not only on their net profits, but also on a significant portion of their business expenses, the effective tax rate on these companies is often in excess of 70%. At times, the federal tax burden for cannabis businesses actually exceeds net profits.

A simplified model comparing the federal tax burden faced by a cannabis business and a similarly situated non-cannabis business is provided in Table 1 for illustrative purposes.

The unfortunate result is that entities that complete the arduous state licensing process, comply with stringent state regulations, and pay a variety of taxes imposed at each level of government are at an economic disadvantage relative to the illicit market operators for whom 280E was truly intended. Upon initial consideration, it is common for congressional staffers and Members to assume that exempting state-legal cannabis businesses from Section 280E would result in lost revenue for the federal government. Over the long term, that does not seem to be the case.

The remainder of this document provides insight and analysis from Whitney Economics, a leading market research firm focused on the cannabis industry.

Table 1:

Illustration of Cannabis vs. Non-Cannabis Business Federal Tax Burden

	CANNABIS BUSINESS	NON-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	$0	$200,000
Taxable Income	$350,000	$150,000
Tax Due (30% Rate)	$105,000	$45,000
Effective Tax Rate	70%	30%

Revenue Effects of Section 280E

Formal revenue estimates often do not capture the real world effects of legislative changes. This is the case with respect to modifying Section 280E to allow legal adult-use marijuana businesses to deduct their regular business expenses.

A standard assumption in revenue estimates is that increasing deductible business expenses will decrease tax revenues. By the same logic, one would assume that prohibiting certain business deductions would increase revenues. However, preventing businesses from claiming ordinary business expenses – allowed to any other business entity – creates an economic disadvantage. This disadvantage results from higher costs relative to businesses not subject to 280E, and ultimately will translate to lower growth, business failure, or turnover in these newly formed legal markets.

The legal cannabis market presents a distinctive situation, because of the existing and well-established illicit market. While many businesses organize as a state-legal entity and comply with tax laws, the existence of 280E creates an incentive for many individuals to remain in the illicit market and avoid paying taxes entirely.

Without allowing businesses to deduct their normal expenses, however, the illicit market will continue to fill the vacuum created by the legal market's inability to expand.

Proposals to modify section 280E (for businesses engaged in state-legal cannabis activities) would generate revenue through expanded business operations (growth in existing state-legal companies), new business formation, as well as improving noncompliance (illicit market businesses entering the legal market). All of these factors would drive significant growth in jobs and state and federal income taxes.

Traditional revenue estimates of 280E will only include the current level of state-approved cannabis activity. Yet even in these limited states, it is likely that a portion of the market is not captured because of the existing illicit market.

Generally, most cannabis companies with an integrated business model are paying a 75 and 80 percent effective tax rate. These effective tax rates are approximately twice the rate facing other businesses not subject to Section 280E. This creates an incentive for businesses to remain in the illicit market. Given the penalty imposed by the different effective rates, it is reasonable to assume that modifying Section 280E will improve compliance.

The existence of an established illicit market that remains outside the current budget baseline indicates that there is an additional – ***unrecognized or unmeasured*** – revenue effect from modifying Section 280E. Bringing illicit market business into the legal market would very likely offset the revenue losses associated with modifying Section 280E.

Table 2:

Estimated Total Legal Market Value, by States with Legal Medical or All-Adult Use Markets (in millions of dollars)

State	2023	2024	2025
Alabama	7.4	52.3	105.0
Alaska	213.1	215.7	218.3
Arizona	1,619.7	2,073.6	2,406.9
Arkansas	320.9	322.8	324.7
California	5,394.9	6,629.7	7,274.0
Colorado	1,701.7	1,720.4	1,740.8
Connecticut	168.8	247.7	506.8
Delaware	65.4	104.6	135.2
District of Columbia	79.3	102.6	126.2
Florida	2,296.4	3,516.0	4,387.0
Hawaii	75.5	95.2	152.1
Illinois	2,380.2	2,979.7	2,983.9
Iowa	15.5	31.0	61.8
Louisiana	48.8	97.7	174.8
Maine	198.8	243.0	265.1
Maryland	696.0	901.9	1,110.7
Massachusetts	1,788.2	1,867.0	1,924.6
Michigan	2,515.0	2,579.7	2,740.3
Minnesota	124.4	223.6	270.1
Mississippi	4.5	13.5	31.5
Missouri	678.1	876.9	1,078.1
Montana	295.5	296.3	296.9
Nevada	933.6	954.6	1,055.9
New Hampshire	36.5	49.0	74.1
New Jersey	631.1	1,007.6	1,299.9
New Mexico	466.7	498.7	499.4
New York	237.8	445.8	742.5
North Dakota	27.5	27.4	27.3
Ohio	520.7	607.0	762.4
Oklahoma	881.0	885.1	889.4
Oregon	1,078.0	1,160.1	1,209.7
Pennsylvania	1,753.6	1,753.7	1,753.4
Rhode Island	89.6	89.6	89.5
South Dakota	4.6	9.3	20.0
Utah	165.7	168.9	172.2
Vermont	27.4	32.9	48.5
Virginia	146.0	200.7	337.0
Washington	1,465.3	1,652.6	1,797.8
West Virginia	14.2	19.8	39.7
Total	**29,167**	**34,754**	**39,134**

** No data for medical cannabis sales in Kentucky or Georgia as of press time. Source: Whitney Economics*

Revenue Effects of Section 280E *(continued)*

Table 2 (previous page) lists states that have regulated adult-use or medical cannabis sales and the estimated total sales through the state's legal system. These estimates assume relatively modest growth in the industry.

One feature of the fully-developed market estimates is that it provides a sense of the market for cannabis that is ***not captured by our legal economy***. Numerous studies confirm that the illicit market continues to exist even in states that have allowed for a regulated one. Since there are still some states that have yet to regulate adult cannabis sales, a large portion of marijuana purchases are outside the tax and regulatory system. Thus far, most states have been unable to capture this economic activity.

As states transition to legal adult-use cannabis, growth of this legal market is likely to remain strong during the budget scoring period. The estimated total market for cannabis (adult-use, medical, and illegal) is quite significant, and suggests that in the legal markets the growth will be robust (as they transition to legal sales). However, the growth that will be captured in the budget estimates is from existing illicit-market businesses – that are not recognized in the budget baseline – as they transition to legal enterprises.

The higher the tax cost specific to this industry means that it is less likely that capital investment will continue. Further, it also lowers the expectation that the legal businesses will gain market-share from the illicit market. Conversely, the lower the 280E tax burden, the more likely it is that individuals will transition from the non-filer market into the regulated and taxed market.

Reforming 280E may negatively impact federal tax revenues in the very short term but amending the code to allow state-licensed businesses to take deductions for ordinary and necessary expenses will spur growth in the legal market, creating a multiplier effect on wages and income tax revenue.

The table below shows the net gain to the economy (including payroll taxes) that could be realized if 280E is reformed. This data is based on an analysis provided by Whitney Economics.

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Table 3:

Estimated Net Economic Benefit Based on Modifying Section 280E to Exempt State-Licensed Cannabis Businesses in the Legal State Markets (in millions of dollars)

	2023-2026	2027-2030
Total Corporate Taxes (with 280E)	20,540	35,479
Total Corporate Taxes (after 280E reform)	9,480	16,375
Delta	-11,060	-19,104
Total Incremental Wages	5,732	9,901
Total Incremental Payroll Taxes	883	1,525
Total Multiplier Effect from Wages	12,038	20,793
Net Benefit to Economy	1,861	3,214