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Cannabis Companies and the 280E Tax: Is Rescheduling the Key?

Will Cannabis Companies Finally Achieve Tax Fairness Without Waiting for Rescheduling? Legal Arguments Suggest Possible Immediate Relief From IRS Rule 280E

The cannabis industry has long faced one of its most significant challenges: the Internal Revenue Service's (IRS) Rule 280E, which denies cannabis businesses the ability to deduct ordinary business expenses. This loophole in tax law has often resulted in astronomical tax liabilities, forcing companies to pay taxes that can reach near the full gross income of their operations. However, many industry observers are now wondering if the ongoing federal rescheduling process could be the key to resolving this issue. While many have assumed the change in cannabis' classification would be required for cannabis companies to finally receive tax fairness, new legal arguments suggest that the industry could achieve tax relief even before the rescheduling process is finalized.

Understanding IRS Rule 280E and Its Impact on Cannabis Businesses

IRS Rule 280E has long been a thorn in the side of cannabis operators. Originally intended to target illegal drug dealers, 280E prevents any business trafficking in controlled substances (as defined in Schedule I and II of the Controlled Substances Act) from deducting expenses typically allowable for other businesses. For cannabis operators, this means they are denied deductions for everyday expenses like payroll, rent, utilities, and marketing costs.

For years, cannabis businesses have struggled under this regime. Without the ability to deduct common expenses, companies often find themselves paying taxes on the entirety of their revenue. In the absence of deductions, cannabis businesses effectively face an inflated tax burden, leaving many to struggle with massive tax debts.

However, there is an important nuance in the tax code worth noting: 280E does not directly address the official scheduling of a substance, but rather its definition as a controlled substance according to the Schedule I and II criteria. This distinction opens the door for a unique argument—if cannabis no longer meets the legal definition of a Schedule I or II substance, it might no longer fall under the purview of 280E, regardless of its formal classification.

The Federal Rescheduling Process and Its Potential Impact on Tax Laws

In recent years, the federal government has begun taking steps toward reclassifying cannabis as a less dangerous substance under the Controlled Substances Act (CSA). In August 2023, the U.S. Department of Health and Human Services (HHS), based on input from the Food and Drug Administration (FDA) and the National Institute on Drug Abuse (NIDA), recommended that cannabis be moved from Schedule I to

Schedule III. This move came after a formal review process, which concluded that cannabis no longer met the criteria for Schedule I classification. Specifically, cannabis was found to have a lower potential for abuse than Schedule I substances, an accepted medical use, and a moderate risk of dependence—characteristics of Schedule III substances.

The Justice Department's Office of Legal Counsel (OLC) also weighed in on the rescheduling process in 2024, asserting that cannabis should be evaluated under a more reasonable standard for medical use. While there is still some ambiguity about whether the rescheduling process will be completed quickly, it is clear that government agencies no longer view cannabis as a Schedule I substance under the CSA.

The Key Question: Does 280E Still Apply Before Rescheduling Is Finalized?

The official rescheduling process for cannabis is still underway, but does that mean cannabis companies must continue to operate under the burdensome 280E tax regime until the final paperwork is completed? According to many legal experts, the answer may be no. The language of 280E does not rely solely on the formal classification of cannabis as a Schedule I drug. Rather, it ties the prohibition of tax deductions to the meaning of Schedule I and II substances. In this case, cannabis' removal from Schedule I, even before the final rescheduling is legally official, could be enough to argue that 280E should no longer apply.

This argument has been bolstered by a memo from the IRS in 2024, which asserted that cannabis businesses should not expect tax relief until the official rescheduling process is completed. However, many experts believe this stance overlooks the key language of 280E, which links tax treatment to the "meaning" of Schedule I status, not just the formal designation. As such, cannabis businesses may have a legitimate case for challenging the application of 280E right now—before the final rescheduling rule is passed.

The Internal Revenue Code Section 471(c) Strategy: A Potential Solution for Smaller Operators

Cannabis businesses have not been entirely without options to mitigate the impact of 280E. One solution that has gained traction in recent years is the Internal Revenue Code Section 471(c), which was enacted under the Tax Cuts and Jobs Act of 2018. This provision allows small businesses with less than $29 million in gross receipts to use inventory accounting methods to classify a broader range of expenses, including rent and payroll, as inventory-related costs. By capitalizing these expenses as part of the cost of goods sold, cannabis businesses can deduct them even under the constraints of 280E.

Despite regulatory pushback from the IRS, which initially sought to limit the applicability of Section 471(c) to cannabis companies, many tax professionals continue to use it as a defensible strategy. While there is still some regulatory ambiguity regarding its use in the cannabis sector, IRS enforcement has been minimal, and the strategy remains a viable option for smaller cannabis businesses to reduce their tax liabilities.

The IRS Response: Why the Agency Continues to Enforce 280E Strictly

In 2024, IRS made its stance clear: cannabis companies will not be entitled to refunds for taxes paid under 280E, regardless of the ongoing rescheduling process. The IRS maintained that the current classification of cannabis as a Schedule I substance requires 280E to remain in effect. This stance has been criticized by legal experts, who argue that the IRS is elevating the formal bureaucratic process over the substance of the law. According to experts, if cannabis no longer meets the definition of a Schedule I drug, then it should no longer be subject to the restrictions of 280E.

Despite this pushback, the IRS has made it clear that it intends to enforce 280E as long as cannabis is officially classified as a Schedule I substance. However, it is worth noting that cannabis businesses may be

able to challenge this position, especially in light of the growing consensus among government agencies that cannabis should no longer be classified as a Schedule I substance.

Can Cannabis Companies Secure Tax Fairness Without Waiting for Rescheduling?

While the formal rescheduling process for cannabis may still take time to finalize, cannabis businesses and their tax professionals have several avenues available to mitigate the impact of 280E. Legal experts argue that the time may be right for companies to challenge the continued applicability of 280E, even before the rescheduling process is officially completed.

For small businesses, strategies like Section 471(c) may offer some immediate relief. However, cannabis businesses must continue to monitor the rescheduling process closely and be prepared to defend their positions as legal precedents and IRS guidance continue to evolve.

Ultimately, while the rescheduling of cannabis is likely to be the key to unlocking tax fairness for the industry, there are already pathways available for cannabis companies to mitigate the impact of 280E—and, in some cases, achieve tax relief even before the rescheduling process is finalized.

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