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Smart Strategies to Lessen Section 280E Impact on Cannabis

Mitigating the Impact of Section 280E: How Cannabis Businesses Are Fighting Back Against Crushing Federal Tax Burdens

Understanding the Heavy Tax Burden Placed on Legal Cannabis Operations

Cannabis businesses, though legal in many states, continue to face significant hurdles because of federal law. One of the most pressing issues is the extraordinarily high effective federal tax rate, which can easily surpass 50%. This heavy tax burden stems from Section 280E of the Internal Revenue Code — a rule that prevents companies engaged in trafficking Schedule I or II controlled substances from claiming typical business deductions or credits.

This means expenses like rent, utilities, wages, and marketing — which are fully deductible for most other businesses are not deductible for cannabis companies. As a result, many cannabis businesses pay taxes based on their gross profit, calculated as gross receipts minus the cost of goods sold (COGS). The outcome is a significantly inflated taxable income and, consequently, a higher tax bill.

The Legal Origins of Section 280E and Its Unintended Consequences for Modern Cannabis

Section 280E was originally enacted in 1982 as part of the government's war on drugs. Its purpose was to ensure that illegal drug dealers could not claim tax deductions for their criminal enterprises. However, with the legalization of cannabis at the state level, the same statute now penalizes legitimate and state-licensed cannabis businesses, effectively treating them as illicit traffickers under federal law.

The discrepancy between state legality and federal prohibition has created a complex and costly tax environment for cannabis entrepreneurs. Many legal operators are now searching for legitimate, compliant ways to mitigate Section 280E's impact and bring their tax rates closer to those of non-cannabis businesses.

Employee Stock Ownership Plans (ESOPs): A Legal Strategy with Multiple Benefits

One promising approach to reduce the burden of Section 280E involves the creation of an Employee Stock Ownership Plan (ESOP). An ESOP is a qualified retirement plan that allows employees to gain indirect ownership in their company. Because ESOPs are tax-exempt entities, they can create significant advantages in industries like cannabis that are otherwise heavily taxed.

If a cannabis business is structured as an S corporation, income normally passes through to shareholders and is taxed at their individual rates. However, when an ESOP becomes a shareholder, its portion of the company's income escapes taxation entirely because ESOPs are exempt from income tax. This structure can

effectively neutralize Section 280E’s impact for the portion of the company owned by the ESOP.

Beyond tax benefits, ESOPs also provide meaningful incentives for employees, enhancing retention, motivation, and overall company culture. By aligning employee and business interests, cannabis companies can strengthen internal stability while reducing tax liabilities.

That said, establishing an ESOP is not without challenges. The company’s existing owners must sell some or all of their equity to the ESOP. As long as any portion of the company remains under non-ESOP ownership, Section 280E will continue to apply to that share of the business. Despite the complexity, many forward-thinking cannabis entrepreneurs are exploring this structure as a powerful, dual-purpose tool for tax reduction and employee engagement.

Section 471(c): An Alternative Method for Small Cannabis Businesses

For cannabis operators that are not ready or willing to undertake an ESOP transaction, another path exists through Section 471(c) of the Internal Revenue Code. This section allows certain “small businesses” those with average annual gross receipts below $31 million over the past three years to use an alternative method of inventory accounting.

This provision enables qualifying businesses to include additional indirect costs in their calculation of cost of goods sold (COGS). While Section 280E continues to apply to the business, the reclassification of certain expenses as inventory costs means fewer deductions are disallowed. Essentially, it reduces the taxable base and results in a lower effective tax rate.

While the savings under Section 471(c) may not be as dramatic as those achieved through an ESOP, the implementation process is simpler, requires no ownership changes, and provides meaningful relief for small and mid-sized cannabis businesses seeking sustainable tax strategies.

Balancing Compliance, Strategy, and Growth in a Complicated Regulatory Landscape

The use of ESOPs and Section 471(c) represents a growing sophistication in cannabis business strategy. Rather than relying solely on advocacy for federal reform, companies are leveraging existing tax provisions to improve their financial resilience. Still, the regulatory environment remains intricate, and each business must carefully evaluate its eligibility, corporate structure, and long-term goals before adopting these approaches.

Legal experts emphasize that successful mitigation of Section 280E requires collaboration between tax professionals, corporate attorneys, and business leaders. Structuring a cannabis business correctly from the outset — or restructuring intelligently after growth — can make the difference between profitability and financial distress.

Expert Insight: Guiding Cannabis Businesses Through Tax Complexity

Industry experts such as Jason W. Klimek and Ryan E. Dunn of Harris Beach Murtha are at the forefront of advising cannabis businesses on these matters.

- Jason W. Klimek, co-leader of the firm’s Cannabis Industry Team, brings deep expertise in taxation and corporate law, helping cannabis companies navigate entity selection, regulatory compliance, and complex funding structures.
- Ryan E. Dunn, also a member of the Cannabis Industry Team, focuses on tax planning for partnerships, corporations, and S corporations, with experience across cannabis, technology, and

finance sectors.

Their combined knowledge provides a roadmap for cannabis businesses seeking legitimate, compliant methods to reduce the crushing effects of Section 280E while maintaining operational and regulatory integrity.

The Road Ahead for Cannabis Businesses Under Federal Tax Law

Until cannabis is reclassified or descheduled at the federal level, Section 280E will continue to loom large over the industry. However, strategies like ESOP implementation and 471(c) inventory accounting demonstrate that innovation within the existing legal framework can yield real relief.

As more states legalize cannabis and federal attitudes continue to evolve, tax professionals expect that businesses using these proactive strategies will be best positioned for long-term success. By combining compliance, creativity, and employee empowerment, the cannabis industry can continue to grow even under the shadow of Section 280E.

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