

State-Regulated Cannabis Can Thrive Without Section 280E

By **Andrew Kline and Sammy Markland** (May 14, 2024, 4:51 PM EDT)

On April 30, it was reported that the U.S. Drug Enforcement Administration will be reclassifying marijuana as a Schedule III-controlled substance.[1]

The timing of this decision could not be more critical. Without action, the future of the highly regulated intrastate state-legal marijuana marketplace would likely have been in jeopardy — and public health would have suffered the consequences.

Competition from the unregulated illicit marijuana market and the unregulated intoxicating hemp-derived marketplace has proven quite formidable, particularly given that both industries are selling untested intoxicating products in interstate commerce without having to contend with compliance costs or tax liabilities.

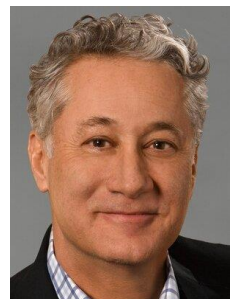
While the state-legal marketplace protects consumers through regulations requiring strict packaging and labeling standards, testing protocols, dosage limits and age verification, the intoxicating hemp industry and illicit market both operate without any such guardrails.

For the state-legal industry, a lack of access to capital markets, payment processing and traditional banking services from Federal Deposit Insurance Corp.-insured institutions has also been a significant obstacle to growth and profitability. This well-regulated intrastate industry needs a shot in the arm.

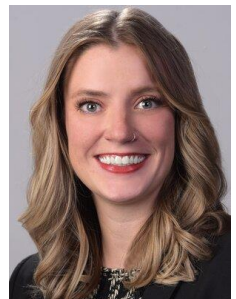
While state regulators and attorneys general weigh how to address the lack of regulation of intoxicating hemp products, and Congress decides whether the Secure and Fair Enforcement Regulation Banking Act will be a legislative priority leading up to the 2024 election, there is only one path for the state-regulated cannabis industry to thrive and perhaps even survive: removing marijuana from being subjected to Section 280E of the Internal Revenue Code.[2]

Without tax relief for the state-regulated marketplace, the two competing unregulated industries are certain to take over, jeopardizing public health and safety. But there is an escape hatch within reach.

Section 280E prohibits businesses from deducting ordinary business expenses from gross income associated with the "trafficking" of Schedule I or II substances, as defined by the Controlled Substances Act.[3] The IRS has thus applied Section 280E to state-legal cannabis businesses. Typically, this has resulted in an inability for state-regulated cannabis businesses to deduct utility costs, health insurance premiums, employee salaries, marketing and advertising costs, rent and other items normally deductible as a matter of course.



Andrew Kline



Sammy Markland

As a result of these Draconian tax policies, state-regulated cannabis companies have been paying an effective federal tax rate of 70% or higher.[4] This alone has made it nearly impossible for regulated companies to survive, never mind thrive.

President Joe Biden has positioned his administration to save the day. His efforts to reschedule cannabis to Schedule III will be transformational for the highly regulated intrastate marijuana marketplace. Among other things, state-regulated marijuana businesses will be able to write off ordinary business expenditures.

Rescheduling marijuana to Schedule III will therefore remove the most significant impediment to profitability currently imposed on the state-regulated marketplace. That's a big win for public health and safety.

The illicit market pays no taxes at all, and hemp-derived delta-9 products that test below 0.3% delta-9-THC on a dry weight basis are arguably not subject to Section 280E because the industry is not trafficking in a Schedule I or Schedule II controlled substance. Providing some relief to the state-regulated marketplace is sound public policy and will serve to safeguard the well-regulated intrastate industry that protects the public health and safety of consumers.

Providing this relief will also create jobs and pump millions of new dollars into the economy — just look at the numbers.

To determine how money might be reinvested in a post-Section 280E universe, we can examine the Section 280E tax liabilities of the top five multistate operators over the past five years using publicly available data and look at prior spend in six key areas: capital expenditures, marketing and advertising, labor, professional services, research and development, and mergers and acquisitions.

The top five multistate operators have paid a combined \$2 billion in taxes between 2020 and the last 12 months.

On a per-operator basis, each of these leading companies would have saved an average of between \$51.6 million and \$126.6 million per year.[5] The numbers speak for themselves, but suffice to say that not being subject to Section 280E will make all the difference.

Not only will Section 280E relief make the state-regulated intrastate marketplace more profitable, but it also will create jobs and serve to push the illicit market and unregulated hemp intoxicants to the sidelines. What might the operators do with these savings? It is logical to infer they would reinvest capital in the aforementioned six key areas.

The data projected that if the companies had not been subject to Section 280E between 2020 and 2023, in the last 12 months, they would have, taken together, spent an additional \$4.5 billion in capital expenditures, \$2.5 billion in marketing and advertising, \$4.7 billion in labor, \$766.4 million in professional services, \$2.8 million in research and development, and \$786.4 million in mergers and acquisitions.[6]

These figures can also be extrapolated to project future spending in a post-Section 280E environment. It is estimated that in each of 2024 and 2025, the five operators, taken together, could spend: \$2.3 billion in capital expenditures; \$1.2 billion in marketing and advertising; \$2.7 billion in labor; \$504.3 million in professional services; \$2.5 million in research and development; and \$786.5 million in mergers and acquisitions.[7]

And this economic analysis would not just apply to large businesses. In fact, small businesses will find that

deductions would increase, providing a much-needed influx of capital for expenditures.

Even if the top five companies chose to spend only half of this tax savings, the results would be impactful. The stymied cannabis mergers and acquisitions activity would be reignited, employing lawyers, compliance professionals, accountants and other transaction-related professionals.

Realtors and landlords would be back in business serving the cannabis industry. Marketing, advertising and communications professionals would see their services come back to life. Jobs would be created in retail, technology, manufacturing and processing.

Companies could press their intellectual property and legal rights in a way nearly unthinkable today. And research would no longer take a back seat to keeping the proverbial lights on.

The state-legal marijuana industry owes a debt of gratitude to the Biden administration for initiating this process, and the rest of us should acknowledge that Schedule III is the only viable path to protecting public health and safety.

Andrew Kline is senior counsel and co-chairs the cannabis industry practice group at Perkins Coie LLP. He formerly served as a federal prosecutor.

Sammy Markland is a senior director at FTI Consulting.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Zeke Miller, Joshua Goodman, et al, "US drug control agency will move to reclassify marijuana in a historic shift, AP sources say," Associated Press, (April 20, 2024). <https://apnews.com/article/marijuana-biden-dea-criminal-justice-pot-f833a8dae6ceb31a8658a5d65832a3b8>.

[2] <https://www.law.cornell.edu/uscode/text/26/280E>.

[3] <https://www.dea.gov/drug-information/csa>.

[4] "What is 280E?" Marijuana Policy Project web site. <https://www.mpp.org/policy/federal/what-is-280e/>.

[5] FTI Consulting research based on publicly available market data.

[6] FTI Consulting research based on publicly available market data.

[7] FTI Consulting research based on publicly available market data.

Posted with permission from Law360 ©2024 Portfolio Media, Inc. All rights reserved.