



Cannabis industry in regulatory crosshairs

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The legal cannabis industry has expanded prodigiously over the last decade and, as of 2020, a majority of states now allow the sale of cannabis for both medical and recreational uses. What was once primarily an underground enterprise is now an open, multi-billion-dollar industry, with sales expected to nearly double by 2025.

However, despite the increasing acceptance of legal cannabis at the state level, and skyrocketing sales, problems related to taxation remain. For example, while legal cannabis businesses are obligated to pay federal income taxes, cannabis itself remains a Schedule I Controlled Substance. This presents a number of issues, both with payment processing (cannabis businesses still rely heavily on cash as they generally cannot accept credit cards or rely on the traditional banking system) and taxation (a perception of underreporting and a lack of governmental guidance for full compliance). Legislative efforts aimed at ameliorating certain cannabis-related business challenges, such as the Secure and Fair Enforcement (“SAFE”) Banking Act,¹ have as of yet not generated sufficient political support to become law.

In pertinent part, under Internal Revenue Code (“I.R.C”) Section 61, businesses, including those in the cannabis industry, are obligated to report all income, regardless of source or legality. Yet, I.R.C. Section 280E prohibits deductions and credits “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.” This includes cannabis, which is still classified as a Schedule I substance. As a result, legal cannabis businesses are obligated to report all income related to their state-legal enterprise, but are not allowed to deduct the expenses incurred thereby. Since the IRS has not published guidance for cannabis businesses, many such companies, at some risk, continue to take Section 280E-prohibited adjustments, including common costs associated with marketing, advertising, distribution, and interest.

The rapid growth of the cannabis industry, a general perception of cannabis industry noncompliance and underreporting, and the tension between IRC 61 and 280E led the Treasury Inspector General for Tax Administration (“TIGTA”) to recently conduct an audit to “evaluate the IRS’s examination and education approach to certain cash-based industries with an emphasis on legal cannabis operations.” Reviewing random samples of 2016 federal tax filings for cannabis businesses in California, Oregon, and Washington, TIGTA found that the IRS had likely missed out on roughly \$50 million in tax revenue due to noncompliance with I.R.C. 280E by legal cannabis

businesses in those three states alone. Yet TIGTA also noted that the IRS “has provided little guidance associated with I.R.C. § 280E” and that “[n]o references to cannabis businesses can be found in IRS publications.” As part of its investigation and report, TIGTA issued six specific recommendations to the IRS aimed at ramping up compliance and enforcement in the legal cannabis industry. Those recommendations and the IRS’s response to each are summarized below:

Recommendation 1

The IRS “should develop a comprehensive compliance approach... for this industry and leverage State marijuana business lists to identify noncompliant taxpayers.”

Response

The IRS “will use data analytics to identify the size and scope of non-compliant taxpayers” and “will determine whether additional compliance activities are necessary...”

Recommendation 2

The IRS should ensure that examiners use specific codes to better track marijuana business examinations.

Response

The IRS “will provide guidance to examiners to apply the appropriate code(s) to cases to track marijuana examinations.”

Recommendation 3

The IRS “should develop guidance specific to the marijuana industry... and document and publicize it... to improve awareness of the tax filing requirements for taxpayers in this industry, such as the application of I.R.C. § 280E.”

Response

The IRS already has “a comprehensive audit technique guide (ATG) for cash intensive businesses... available on IRS.gov” and “will provide additional information for cash intensive businesses... as needed.”

Recommendation 4

The IRS should develop and distribute “specific guidance” for “taxpayers that report Schedule I related activities on Federal [t]ax [r]eturns.”

Response

IRS “resources at present are focused on priority guidance in response to TCJA [the Tax Cuts and Jobs Act of 2017] and reducing regulatory burdens in response to [a 2017 executive order]” but would “consider developing and issuing guidance” as recommended once these other items were resolved.

Recommendation 5

The IRS “should leverage publicly available State tax information and expand use of Fed/State agreements to identify nonfilers and unreported income in the marijuana industry.”

Response

The IRS will “review the publicly available State tax information and Fed/State agreements to determine whether and how they could be legally, systematically, effectively, and efficiently used in compliance activities.”

Recommendation 6

The IRS “should increase educational outreach towards unbanked taxpayers making cash deposits regarding the unbanked relief policies available.”

Response

The IRS will “expand the penalty relief information currently available on IRS.gov to educate unbanked taxpayers about the penalty relief policies applicable to them.”

In sum, the TIGTA report shines a spotlight on the unique issues related to the legal cannabis industry and urges the IRS to increase its efforts, both preemptively, through general guidance and publications targeted at the cannabis industry, and reactively, through enhanced application of state tax data and federal/state agreements. Critically, the IRS does not dispute these issues or the idea of actively pursuing lost tax revenue associated with systemic underreporting throughout the cannabis industry, but also does not commit to any cannabis-specific guidance.

Takeaways

Expect a significant increase in IRS civil and criminal enforcement efforts focused on the legal cannabis industry

The message coming from the TIGTA report is very clear: the government, and the IRS in particular, has the cannabis industry in its crosshairs and it is fair to assume that the message of the industry’s underreporting of the taxes it owes will quickly spread to all of the IRS field offices across the country. In turn, this will undoubtedly result in significantly ramped up enforcement efforts, both on the civil and criminal sides, likely without any warning or additional guidance to legal cannabis businesses. The spectre of increased subpoenas and audits looms large.

Take this opportunity to get your taxes in order

Legal cannabis businesses that are not already doing so must immediately comply with I.R.C. 280E and not take credits or deductions for prohibited business expenses. Those businesses that have been taking such deductions must prepare for audits and enforcement actions by compiling tax and business records now, as the lack of guidance or notice specific to the cannabis industry regarding compliance with I.R.C. 280E will not serve as a defense to IRS actions. It also goes without saying that legal cannabis businesses in receipt of IRS subpoenas or action letters should immediately consult with legal counsel.

Consult with legal counsel now!

Given the rise of the legal cannabis industry, the growing billions in revenue, and the likelihood that the number of states legalizing cannabis will only increase, it is understandable that the Treasury is intent on recovering what it perceives to be lost revenue. In light of the potential for ruinous IRS actions, legal cannabis businesses should consult with legal counsel familiar with the complexities of current cannabis legislation, tax law, and remedial measures available as soon as possible.

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¹The SAFE Banking Act seeks to “increase public safety by ensuring access to financial services to cannabis-related legitimate businesses and service providers and reducing the amount of cash at such businesses.” In particular, the SAFE Banking Act would prevent federal banking regulators from taking certain actions in states that have legalized cannabis, including terminating deposit insurance for or imposing restrictions upon banking institutions that provide financial services to cannabis-related businesses.