Impact of Tax Reform on Cannabis Businesses

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On December 22, 2017 President Trump signed into law what is commonly referred to as the “Tax Cuts and Jobs Act” (TCJA). The TCJA makes dramatic changes to federal income taxes and is likely to have downstream impacts in states with an income tax.

Cannabis industry participants should be interested in the following items:

1. The TCJA did not modify section 280E. Cannabis businesses that “traffic” cannabis are generally subject to federal income tax on their gross profit — gross income less cost of goods sold.

2. The highest marginal tax rate for C corporations dropped from 35 percent to 21 percent, and the TCJA eliminates the corporate alternative minimum tax.

3. A new special deduction under section 199A is available to certain sole proprietorships, partnerships and S corporations.

4. Marginal tax rates for individuals are generally lower. However, the TCJA eliminates or limits a number of deductions.

How Does the New Deduction Under Section 199A Work?

It is complicated. For a more detailed discussion of the new provision, please refer to our articles here and here.

The new provision generally provides a deduction equal to 20 percent of qualified business income (QBI). The deduction is available to all individual taxpayers below specified income limits — $157,000 for individual filers and $315,000 for joint filers. Once a taxpayer’s income exceeds those limits, several limitations start to apply.

The first limitation is that the relevant pass-through income cannot be from a specified service trade or business. This limitation is unlikely to affect cannabis businesses. However, certain sophisticated structures utilizing management companies may need additional analysis.

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1 In order to comply with Senate rules for the bill to qualify as a budget reconciliation bill, the short title “Tax Cut and Jobs Act” was actually deleted from the final bill but the name, or at least the acronym, seems to have lingered in local parlance.
The second limitation is calculated using the pass through business’s W-2 wages or W-2 wages plus the unadjusted tax basis of qualified property. QBI is limited to the lesser of (a) 20 percent of the taxpayer’s QBI with respect to a qualified trade or business or (b) the greater of (i) 50 percent of the W-2 wages with respect to the qualified trade or business or (ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted tax basis in qualified assets. Confused yet?

What Is the Impact to C Corporations?

Cannabis companies operating as C corporations are subject to IRC 280E if their trade or business consists of trafficking in Schedule I or II controlled substances. As noted above, the TCJA did not modify IRC 280E. However, C corporations, including those trafficking cannabis, benefit from the reduced 21 percent tax rate so the adverse consequences of 280E is reduced.

For example, in 2017 a cannabis C corporation with $1 million in gross revenue, $500,000 in cost of goods sold, and $200,000 in other expenses has federal taxable income of $500,000 ($1 million less $500,000 of COGS). IRC 280E denies a deduction for the $200,000 of trade or business expenses. The 2017 federal income tax liability is $175,000.2 Assuming the same fact pattern for a cannabis C corporation in 2018, the corporation’s 2018 federal income tax liability is $10,000 — a tax savings of $ 70,000!

What Should Cannabis Businesses Do in Light of the TCJA?

Cannabis C corporations subject to IRC 280E cost disallowance are better off under the new law because paying federal income tax on 21 percent of non-deductible costs is better than paying tax on 35 percent of those same costs. Cannabis companies structured as a pass-through for tax purposes may benefit from the new IRC 199A deduction. So what should you do with your cannabis business?

Unfortunately, the TCJA did not simplify the tax code or enable most taxpayers to prepare business tax returns on something the size of a postcard. There is no one size fits all tax answer for every cannabis business. C corporations may work for a business that intends to bootstrap the business by reinvesting all earnings. A similarly situated business may want to distribute all available cash flow from operations to the owners. In this case, a C corporation might not be the best tax answer and a pass-through preferred. However, that conclusion will depend on factors including the business’s total W-2 wages and the individual taxpayer’s income from non-cannabis sources. We recommend cannabis businesses consult with their tax advisor to determine if their current structure is efficient or if it makes sense to restructure.

2 Note this example ignores the prior corporate marginal tax rates in IRC 11(b) that imposed marginal rates from 15 percent to 35 percent. In fact, the liability should be $170,000 when using the relevant IRS tax tables.