BUSINESS

Reclassifying Marijuana Could Unlock Billions in Tax Savings for Cannabis Companies

Proposed change could lift income-tax burden that wipes out most licensed marijuana retailers' earnings

By Jennifer Maloney Follow *and Richard Rubin* Follow

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Cannabis businesses are currently barred from claiming deductions on many basic business expenses.
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Many U.S. cannabis businesses could become profitable for the first time if the Biden administration follows through on its plan to reclassify marijuana as a less dangerous drug.

That is because the change could lift a heavy income-tax burden: Section 280E of the federal tax code currently bars cannabis businesses from claiming deductions on many basic business expenses. That rule often results in an effective tax rate of 70% or more, wiping out most licensed marijuana retailers' earnings.

"It's an absolute game-changer," said Boris Jordan, executive chairman of Curaleaf Holdings, which operates 145 dispensaries and 19 cultivation sites across the U.S. "It's something we've been waiting for, for the better part of 10 years."

The proposed rule could take months to complete and could be further stalled by lawsuits. The public, including state regulators and marijuana companies, would have a chance to comment and the White House would have to sign off on a final version of the rule before it could go into effect.

Marijuana is legal in some form in 40 states and the District of Columbia, but is illegal under federal law—and would remain so even if the Drug Enforcement Administration moved marijuana from Schedule I to the less-restrictive Schedule III, equivalent to prescription medications such as anabolic steroids and some combinations of acetaminophen and codeine.

Cannabis businesses would still have to contend with limited access to banking services and financing. They still wouldn't be allowed to transport marijuana across state lines. And companies that sell marijuana in the U.S. still couldn't be traded on U.S. stock exchanges. (Several Canadian operators are listed on U.S. exchanges while U.S. operators are listed on Canadian exchanges.)

Current tax rules allow cannabis businesses to deduct their cost of goods sold, so growers that put most of their resources into production don't get hit hard. PHOTO: EVA MARIE UZCATEGUI/BLOOMBERG NEWS

A national survey conducted in 2022 by Whitney Economics, a cannabis industry research firm, found that fewer than 25% of cannabis businesses were profitable. Licensed U.S. cannabis companies this year are expected to make $31.4 billion in sales and pay $2.3 billion more in federal taxes than they would under normal business tax rules, according to Whitney Economics forecasts.

For companies that have been hanging on in hope of one day making it into the black, the policy change could be transformative. Business leaders said they could use the cash to invest more in marketing, offer better benefits to employees and expand into newly opened markets such as Ohio. Industry leaders said they are also optimistic that the policy shift could reduce the stigma around cannabis, bring more investors into the sector and make federal lawmakers more open to legalizing marijuana.

Congress created Section 280E of the tax code in 1982, when Sen. Bill Armstrong (R., Colo.) tucked the provision into a larger bill as the federal War on Drugs was ramping up.

Cresco Labs CEO Charlie Bachtell, center, said the company has paid millions more in U.S. federal taxes than it would have under normal business conditions. PHOTO: DANIEL ACKER/BLOOMBERG NEWS

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The law denies many ordinary deductions and tax credits to businesses that are "trafficking in controlled substances" listed under Schedule I and II.

When marijuana was illegal at the federal and state levels, that deduction limit had a relatively small impact, and it mostly gave U.S. authorities an additional tool to go after drug dealers and impose taxes on top of criminal prosecutions. But state legalization combined with Section 280E created an odd hybrid. The cannabis industry looked like regular businesses in many respects—except for the income-tax bills.

"Draconian, I think, is putting it lightly," said Charlie Bachtell, chief executive of Cresco Labs, which has dispensaries and production facilities across eight U.S. states. For each of the past two years, Cresco has paid between $70 million and $80 million more in U.S. federal taxes than it would have under normal business conditions, he said. Despite the hefty tax bill, Cresco in the last quarter of 2023 became free cash-flow positive for the first time since it went public in 2018.

Wanda James, CEO and co-founder of Simply Pure Brands, said the tax change could lower the barriers to entry for women, people of color and veterans. PHOTO: DAVID ZALUBOWSKI/ASSOCIATED PRESS

The cannabis industry has "really been kind of stumbling its way forward because of the economic burdens of 280E," said Brian Vicente, a cannabis lawyer in Denver.

The current tax rules allow cannabis businesses to deduct their cost of goods sold, so growers that put most of their resources into production don't get hit hard. Businesses closer to the consumer get hammered by Section 280E. For instance, a retailer selling clothes or food can deduct rent, marketing and wages when calculating taxable income. But a cannabis retailer typically can't take any of those deductions.

"It's impossible to make those numbers work," said Wanda James, CEO and co-founder of Simply Pure Brands, which has a dispensary in Colorado and a new branch about to open in New Jersey. "It's just a question of how long is your runway."

James, a former Navy officer, restaurateur and political organizer, was among the first Black cannabis licensees in Colorado. She said the tax change could lower the barriers to entry for women, people of color and veterans, many of whom have struggled to keep their cannabis businesses afloat after winning state lotteries for social-equity licenses.

The tax change could also shrink the gap in profitability between legal and illegal cannabis businesses, helping licensed businesses that have struggled to compete with the black market. Unlicensed operations can sell marijuana at lower prices and pay fewer administrative and regulatory costs.

More broadly, moving cannabis to Schedule III could create an unusual tax regime. Businesses would still face significant state taxes and high costs for banking and other services. But cannabis would actually have more favorable federal tax treatment than alcohol and tobacco, which are subject to federal excise taxes on top of income taxes.

Sens. Chuck Schumer (D., N.Y.), Cory Booker (D., N.J.) and Ron Wyden (D., Ore.) are reintroducing legislation that would decriminalize marijuana and impose federal excise taxes of up to 25%.

—Liz Essley Whyte contributed to this article.

Write to Jennifer Maloney at Jennifer.Maloney@wsj.com and Richard Rubin at richard.rubin@wsj.com

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