

Cannabis Taxation: High Taxes & IRC Section 280e



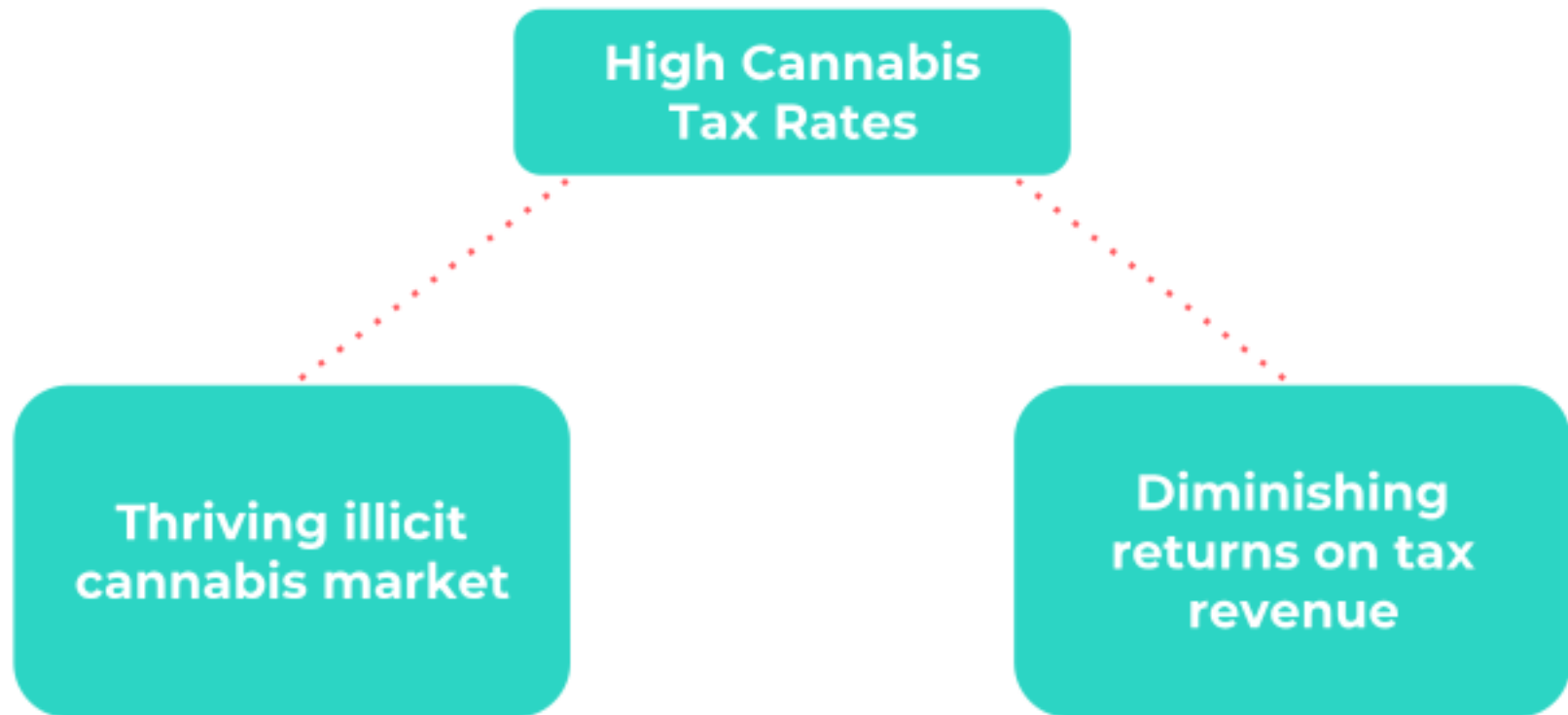
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The Harms of High Cannabis Taxes



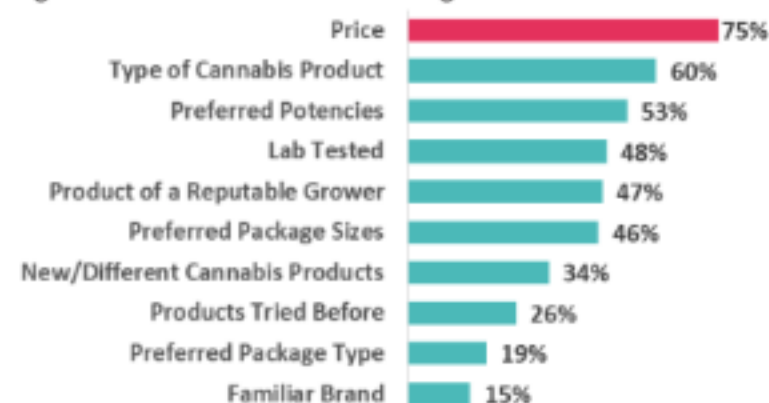
High tax rates strengthen the unregulated market by:

- Incentivizing consumers to seek out lower prices in the unregulated market
- Deterring existing cannabis operators from entering the legal market

Consumers are price sensitive.

- **Deloitte Analysis:** the typical Canadian consumer is only willing to pay a 9% premium for regulated cannabis
- **RAND/Washington survey:** if the price of legal cannabis sold for \$4 more per gram than the illicit market, legal sales would make up less than half of the total market

Figure 1. Considerations for Purchasing Decisions



Source: Deloitte. *A Society in Transition, an Industry Ready to Bloom*. 2018.

- **California's excessively high cannabis tax rates:**
 - Make it nearly impossible to operate a viable cannabis business
 - Support a thriving unregulated market
- **California cannabis taxes (before 7/22)**
 - 15.0% retail excise tax
 - Weight-based cultivation tax
 - 7.25% state sales tax
 - Local excise tax(es)
 - .15% - 3.0% local sales tax
- **In July 2022, Governor Newsom signed a bill eliminating the cultivation tax, hoping to bring much-needed relief to the legal industry**

United News | High Noon

In California, the world's largest legal weed market is going up in smoke

California pot companies warn of impending industry collapse

Leading California cannabis companies are warning Gov. Gavin Newsom that the state's legal marijuana industry is on the verge of collapse

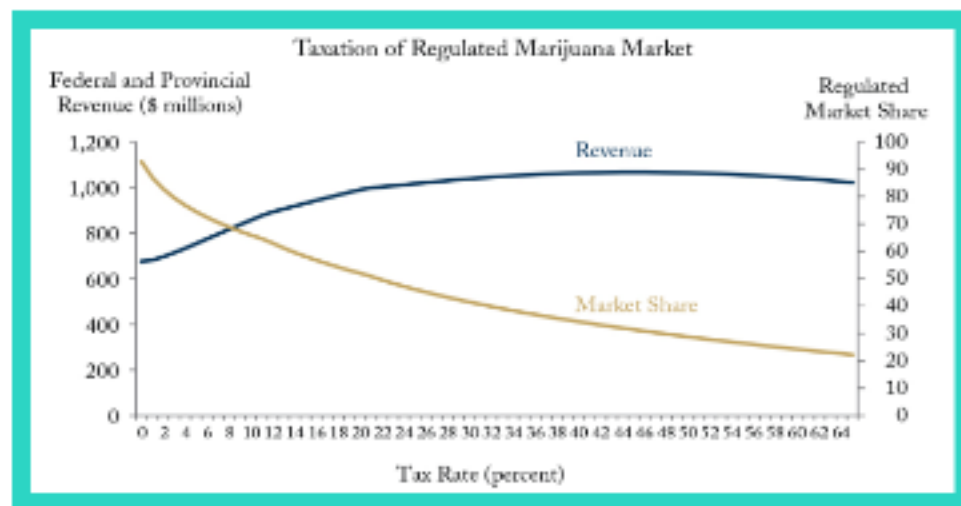
Forbes

California Eliminates Cannabis Cultivation Tax

High tax rates lead to diminishing returns on tax revenue

- If the price of cannabis is too high, potential tax revenue will be diverted to the illicit market or neighboring markets with lower tax rates

Excessive tax rates result in diminishing returns for tax revenue generation



C.D. Howe Institute
Analysis: Legal market
share dips below 50%
once net effective tax
rates exceed 20%

IRC 280E

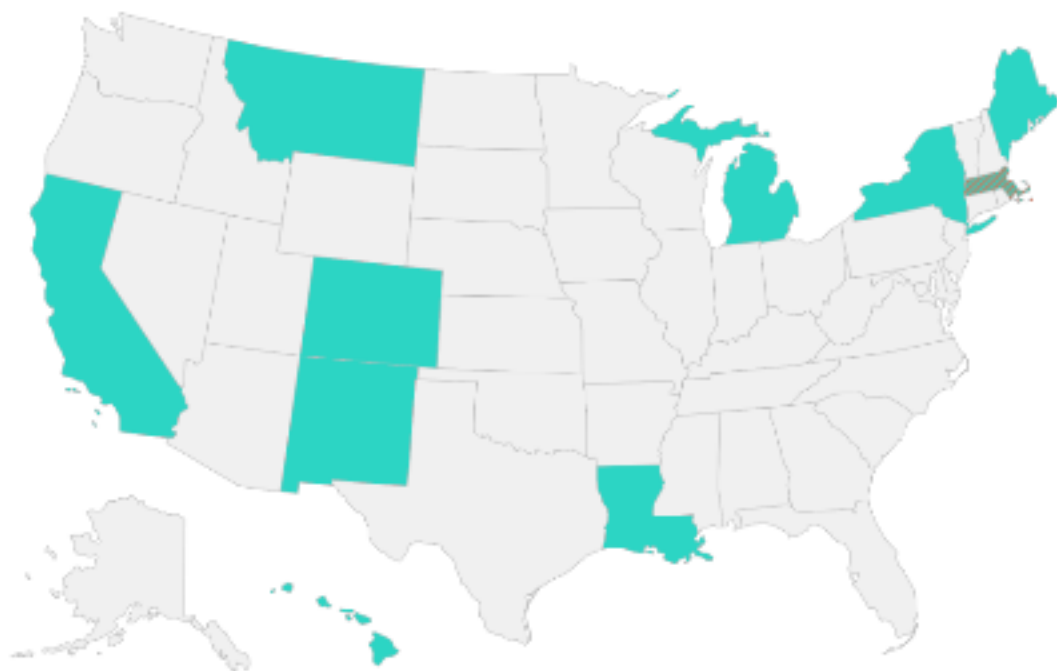


- **Section 280E of the IRS' Internal Revenue Code (IRC)**
 - Prohibits those trafficking Schedule I and Schedule II substances from deducting typical business expenses and claiming tax credits when paying federal income tax
- **Cannabis is currently classified as a Schedule I substance, meaning that all cannabis businesses are subject to Section 280E restrictions**
 - Cannabis operators pay taxes on gross profit instead of net income
 - Cannot deduct ordinary and necessary expenses, only COGS

Impact on legal cannabis industry:

- Significantly exacerbates the tax burden of legal cannabis businesses
- Cannabis businesses pay substantially higher federal income taxes compared to non-cannabis businesses
- In some cases, cannabis businesses pay federal income tax rates of up to 70%

	Non-Cannabis Business	Cannabis Business
Revenue	\$1,000,000	\$1,000,000
Cost of Goods Sold	<u>-\$500,000</u>	<u>-\$500,000</u>
Gross Profit	\$500,000	\$500,000
Rent	-\$100,000	\$100,000
Utilities	-\$100,000	\$100,000
Insurance	-\$50,000	\$50,000
Maintenance	-\$50,000	\$50,000
Taxable Income	\$200,000	\$500,000
Tax Liability @ 25%	\$50,000	\$125,000
Income After Taxes & Expenses	\$150,000	\$75,000



280E Tax Exemption for State Taxes

- **Many states align their tax codes with IRC Section 280E**
 - Cannabis businesses in these states cannot deduct ordinary and necessary business expenses when paying state income tax as well
- **A handful of states have passed laws decoupling from Section 280E with respect to cannabis**

Thank You!

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