

Timing Guidance Tops Cannabis Advisers' Rescheduling Wish List

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By Wesley Elmore

A final rule on marijuana reclassification is likely still months away, but cannabis advisers already have ideas for the type of guidance they hope to see from the IRS.

"There's going to be a huge need for tax guidance," said Michael Rosenblum, co-chair of Thompson Coburn LLP's cannabis practice. "Some of this can literally make or break the company or save hundreds of millions in taxes, so it's very important stuff."

The Justice Department and the Drug Enforcement Administration on May 16 [released](#) a proposed rule to reschedule marijuana under the Controlled Substance Act, moving it from Schedule I to the less restrictive Schedule III. Following its [publication](#) in the *Federal Register* May 21, the rule is now subject to public comment and hearing requests before potential finalization — a process that might not wrap up until late this year or even next year.

The effective date of the final rule, and what it means for the availability of deductions for cannabis businesses, will be the biggest issue needing IRS guidance, advisers agreed. That's because the move to Schedule III will mean that cannabis businesses are no longer subject to [section 280E](#), which prohibits businesses that traffic in Schedule I or Schedule II substances from deducting their expenses.

The big question for cannabis businesses, then, is whether [section 280E](#) will no longer apply from the date the final rule is published, or whether that inapplicability will be retroactive for the entire year in which the rule is published.

"We'd just like to see confirmation or clarification on whether the effective date of the DEA's eventual final rule means 280E no longer applies for the entire tax year in which the rule becomes final or if deductions/credits must be bifurcated between nondeductible and deductible based on timing," explained Kat Allen of Henry G. Wykowski and Associates.

With some cannabis operators facing effective tax rates estimated to be as high as 70 percent, the final decision on timing could be worth billions of dollars. Whitney Economics, a cannabis research firm, [estimated in 2023](#) that cannabis businesses paid \$1.8 billion in excess taxes in 2022 because of [section 280E](#) and would pay \$2.1 billion extra in 2023.

Roadmap Needed

IRS Commissioner Daniel Werfel [told a House panel](#) May 7 that his agency won't wait in the run-up to rescheduling but will work with the cannabis industry to address its guidance needs. However, he

didn't tip his hand on where the IRS might come down on the questions raised by practitioners.

"I think everybody's kind of curious to see how things will play out — if rescheduling occurs, and particularly to see whether there's any retroactive component to it," said Rosenblum.

Jennifer Benda of Holland & Hart LLP said she believes that unless Congress acts to say otherwise, "the IRS position will be that [section 280E](#) no longer applies as of the date that marijuana is no longer a Schedule I or II substance."

"Because that will most likely be a random date in the middle of a tax year, without any guidance, taxpayers will be left to their own devices in determining how to determine the income for the period when [section 280E](#) applies and when it does not," Benda continued.

That would create a headache not just for taxpayers but also for the IRS, said Michael D. Harlow of CohnReznick LLP.

For example, if rescheduling were to happen halfway through the year and it was not made retroactive to the beginning of the year, it would "be very difficult for the IRS to manage tax filings where 280E is applied for the first half of the year and not for the second half of the year," Harlow said.

"I don't know how the IRS is going to handle that, but we're going to need some guidance relatively quickly," Harlow added.

Benda agreed. "IRS guidance on this topic would provide taxpayers a roadmap for successfully preparing their tax returns for the year of rescheduling and could help minimize disputes between the IRS and cannabis companies on this issue," she said.

Depreciation and Other Issues

The effective date of any final rescheduling rule and the applicability of [section 280E](#) will affect cannabis businesses' planning decisions in other ways, according to Allen. For example, based on the IRS's position on the issue, a company might want to delay triggering a loss under [section 165\(f\)](#) or acquiring depreciable property.

"The IRS also may want to issue industry guidance for depreciable property where depreciation or amortization deductions have not been allowed or allowable," Allen said. She gave the example of intellectual property purchased five years ago that becomes amortizable under [section 197](#) and noted that the taxpayer would seem to get only the remaining 10 years of deductions under the code.

Harlow similarly argued that rescheduling will raise complicated questions around tax provisions like bonus depreciation and the research and development credit.

"You are going to have situations where you would have eligible fixed assets that were placed in service prior to rescheduling but will still be used by the business on an ongoing basis. So is that

asset now bonus eligible?” Harlow said. “Or when calculating your base spend for R&D expenses, if those were incurred prior to rescheduling, is that taken into consideration?”

There’s also the question whether a business that has been using straight-line depreciation for the useful life of an asset can file an accounting method change request to catch up on bonus depreciation once [section 280E](#) no longer applies, Harlow added. “I don’t think so because when the asset was placed in service, 280E was the law of the land. But I’m sure that’ll be something people will want clarity on,” he said.

Cannabis businesses’ inventory methods could also be ripe for guidance, according to Benda. “Because [section 280E](#) has encouraged the use of expansive inventory methods, the IRS could also provide guidance or a window for the industry to change inventory methods, if they determine it might be beneficial to do so,” she said.

Looking Back

Both Harlow and Rosenblum said that even if rescheduling moves forward and [section 280E](#) becomes inapplicable to cannabis businesses, there will still be some with large prior-year tax balances related to [section 280E](#).

“One question is whether the IRS would potentially go back even further than the beginning of this calendar year” to provide [section 280E](#) relief, said Rosenblum. “I don’t think that’s likely, but that would be even better obviously,” he said.

Harlow agreed that some [section 280E](#) relief for prior years would be great, arguing that forgoing that relief could lead to inequities in the industry.

Harlow noted that some large cannabis operators have already filed amended returns claiming [section 280E](#) refunds, with at least one reportedly receiving large refunds based on those returns. He described a potential post-rescheduling environment in which some cannabis operators take the position that [section 280E](#) shouldn’t have applied in earlier years and amend their returns to claim refunds. They may then get refunds or successfully litigate with the IRS over the issue. Meanwhile, other — likely smaller — cannabis operators won’t do that and will still be on the hook for prior-year taxes.

With those smaller operators more likely to go out of business because of their tax debts, the situation “doesn’t seem very equitable,” Harlow said.

Attorneys speaking on a May 22 webinar sponsored by the US Cannabis Council [said that](#) whether to file refund claims for prior years depends on a business’s facts and circumstances, as well as its risk tolerance. In a September 2023 alert on its website, Duane Morris LLP [advised businesses](#) to file protective claims for refunds before the statute of limitations for filing a refund claim expires.

Harlow wondered whether, even if [section 280E](#) relief isn’t explicitly made retroactive, the IRS would still go after those prior-year taxes after rescheduling. “Is the IRS really going to continue to actively

pursue audits under 280E and collect those prior-year balances? Nobody knows," he said. "But it seems really hard for the IRS to continue to fight that fight after rescheduling."