CPA Practice Advisor

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By Samantha Schafer, CPA.

Thinking that only dispensaries have to worry about taxes to their cannabusiness? Think again. Entrepreneurs, processors, and cultivators in the cannabis industry may be subject to taxation, and it's important for them to understand the

IRC Sec. 280 E sets the guidelines for cannabusiness' taxation. The most critical part of the guidance states, "No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business consists of trafficking in controlled substances which is prohibited by Federal law or the law of any State in which such trade or business is conducted." So, what does that mean for cannabusiness owners? Do they have to pay tax on all gross revenue? Yes and no. Inventory creates an advantageous situation for categorizing a number of business costs as Cost of Goods Sold (COGS). This provides an opportunity for these entrepreneurs to benefit from tax deductions under IRC Sec. 471.

Know What Qualifies as COGS

Another way to think of COGS is to basically assess the cost of products necessary for the operation of business. For cannabusiness owners, that can mean the cost of clones and seeds, the cost of flower and trim, and the cost to produce cannabis products like pre-rolls and gummies for consumers. IRC Sec. 147 ensured that these critical costs incurred by cannabusinesses be classified as deductibles for income tax purposes.

However, this means that these entrepreneurs must be diligent in their cost accounting or risk leaving deductions on the table – or worse – taking wrongful deductions that can have consequences for your business. That's why if cost accounting wasn't a major priority for these owners prior to IRC Sec. 471, it's critical that it is now. If the IRS finds that an erroneous deductions were made, they can enforce a penalty where cannabusiness owners may be required to pay up to 20% of the excessive amount claimed.

Be Mindful of Cash Business Implications

Due to the nature of the industry, it's common for cannabusinesses to conduct their transactions for the most part in cash. However, just because there is no digital record of the transaction doesn't mean you can avoid declaring the income when tax

cash payment options at some of their Taxpayer Assistance Centers if the business is unbanked.

Work with a Qualified Accountant in Cannabis

Once you have cleared arguably the biggest hurdle to entering the cannabis industry – getting your license – your next order of business should be to secure an accountant or CPA with experience in the cannabis industry. These professionals can help you set up your books and determine record keeping best practices, while guiding you through how to properly classify your expenses for accuracy.

Making sure your COGS are accurate is the best way to ensure your tax liability is accurate as well, and working with a seasoned accounting professional can give you that peace of mind. Additionally, accounting partners can help assist you through the filing process and how to make quarterly estimated tax payments if you choose to fulfill your tax obligations throughout the year.

Cannabusiness tax liabilities are much more nuanced than those of other businesses. Understanding the factors impacting filing can make all the difference in ensuring you receive a maximized refund and avoid costly penalties.

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