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Finally, Good News from the IRS: Cannabis Operators Could Be Eligible for the Qualified Business Income Deduction

Insight — February 15, 2023

If you didn't attend the American Bar Association's Section of Taxation meeting last week, you may have missed that IRS Counsel confirmed they will not automatically challenge a Section 199A qualified business income deduction claimed by a cannabis business owner.

What is Section 199A of the Internal Revenue Code? This provision replaced the Section 199 domestic production activities deduction that existed prior to the 2018 Tax Cuts and Jobs Act. Simply put, it provides many owners of sole proprietorships, partnerships, S corporations, and some trusts and estates, a deduction of income from a qualified trade or business on their personal tax return, thereby reducing an individual's tax liability. While subject to certain limitations, it equals 20% of "Qualified Business Income" from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate.

Why is this IRS concession important to cannabis business operators?

First, the IRS hasn't provided much public guidance to cannabis businesses or business owners on the many issues that arise in applying the punitive Internal Revenue Code Section 280E or other more nuanced tax issues like the qualifying for the Employee Retention Credit. Until now, there has been uncertainty among tax preparers as to whether cannabis owners could claim a deduction of income from a qualified trade or business on their individual income tax returns. **Any** public guidance provided by the IRS assists cannabis business operators and their respective advisors and tax preparers avoid uncertainty and surprises when the inevitable IRS audit occurs, so this recent development is significant.

Second, the ability of cannabis operators to deduct a portion of income flowing through on their individual income tax returns will potentially reduce the operator's individual tax liabilities. However, for taxpayers with incomes above certain thresholds, the Section 199A deduction is limited to 50% of W-2 wages or 25% of W-2 wages plus 2.5% of unadjusted basis in all qualified property.

For cannabis operators this means cultivators and manufacturers will benefit from the IRS's good news more than retail businesses or vertically

integrated cannabis companies because Section 280E does not limit the costs that are deductible for the cultivation and manufacturing sides of the business in the same way that impacts the retail side of a business.

If you have pass-through income from a cannabis operation, what should you do as a result of this development? Call your tax return preparer and confirm you have claimed Section 199A for prior tax years. If you have not, file amended returns before the statute of limitations expires. Then, work with your tax return preparer to budget your 2023 estimated taxes with a Section 199A deduction included in the estimates.

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