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A customer purchases cannabis at Fine Fettle's Stamford dispensary. Cannabis retailers can pay an effective tax rate of up to 80% because they're not allowed to deduct business expenses on their state or federal tax returns.

Effective tax rate on cannabis companies 'can be fatal'; proposed bill would offer relief

By Andrew Larson
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After waiting years for the sale of recreational cannabis to become legal in Connecticut and crossing a plethora of regulatory hurdles, companies that sell the product face another challenge: taxes.

The state's adult-use industry launched Jan. 10, with eight dispensaries now approved to sell marijuana to customers 21 and older. Two more dispensaries, in Torrington and Danbury, plan to debut soon.

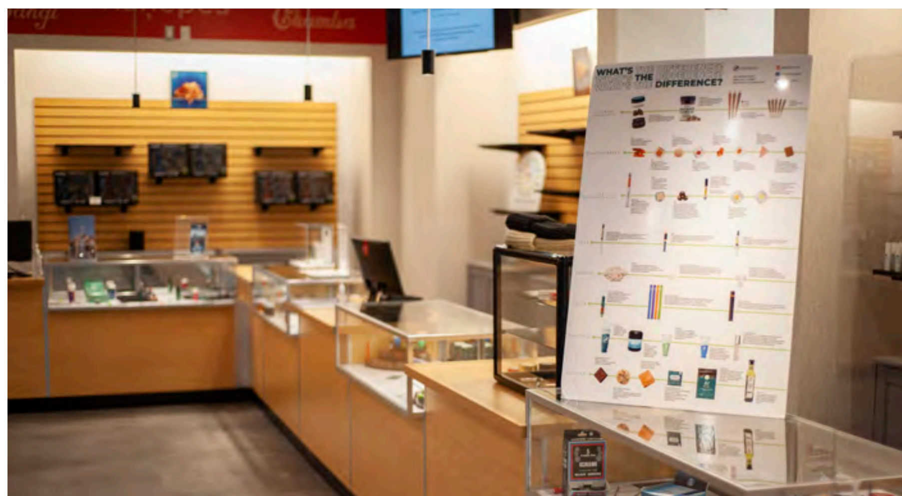
Since opening to the general public, dispensaries have seen robust sales, recording $2 million in revenues in just the first eight days. But while adult-use sales open up a lucrative new market, a large proportion of companies' revenues will go to the government.

Cannabis retailers' effective tax rate can be as high as 80%, said **Sarah Westby, co-chair of Hartford-based law firm Shipman & Goodwin's cannabis industry practice.**

Sarah Westby

That's largely because marijuana companies are unable to deduct their business expenses — such as rent and employee salaries — from their state and federal taxes due to cannabis still being illegal at the federal level.

"Their taxable revenue is much higher than it would be if they were able to deduct these expenses," Westby said. "And so they end up paying an effective tax rate of up to 70%, or even 80%, which can be fatal to many businesses."



Fine Fettle's Stamford dispensary.

In comparison, the federal corporate tax rate is much lower at 21%.

At least one state lawmaker is trying to aid the industry. **House Majority Leader Jason Rojas** (D-East Hartford) has proposed a bill (HB 5413) that would allow cannabis companies to deduct business expenses on their state taxes.

Deduction limits

Normally, companies can deduct "ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business," under Section 162(a) of the Internal Revenue Code.

But companies engaged in the trafficking of "illegal" drugs are prohibited from deducting typical business expenses.

Cannabis remains classified as an illegal Schedule I controlled substance under the federal Comprehensive Drug Abuse Prevention and Control Act of 1970.

The only business expenses that cannabis companies may deduct are the costs of goods. For cannabis cultivators, that means they can deduct the costs of growing marijuana, such as fertilizer and the salaries of employees who cultivate the crops, said **Robert Lickwar, a partner in national accounting firm UHY LLP's Farmington office.**

Robert Lickwar

"But if you are a retailer, your deduction is going to be limited only to what you pay for the item that you're eventually going to resell, so your facility costs like your rent and the employees running the cash register and selling the product aren't going to be deductible expenses," Lickwar said.

Cannabis retailers are unable to deduct about 45% of the business expenses allowable under federal law, he said, because they are technically selling an illegal product.

But they may be able to reduce their effective tax rate by organizing as a C-corp entity, Lickwar said.

Leveling the playing field

While there has been talk of changing the legal status of cannabis at the federal level, a move that President Joe Biden has said he supports, there are not currently any proposals to do so.

Meanwhile, 37 states have enacted laws legalizing cannabis for medical use, and 19 allow recreational sales.

Some states have "decoupled" from the federal prohibition, allowing cannabis companies to deduct business expenses from their state taxes, Lickwar said. But Connecticut is not one of them, so the federal law applies.

House Majority Leader Rojas said his proposed legislation would level the playing field for cannabis companies so they can deduct their expenses the same way as other Connecticut companies.

Also, it remains difficult for cannabis companies to obtain financing, as many banks won't lend to the industry unless the drug is legalized federally. That challenge, coupled with other barriers to entering the market, can put smaller cannabis companies at a disadvantage, Rojas said.

"Everyone I've met says it's an incredibly challenging business to get into, particularly because of the capital costs that are needed, but also the regulatory environment is very complicated as well because you are dealing with a controlled substance that is still illegal at the federal level," Rojas said. "... Anything that can be done to help reduce the cost of doing business, I think is to the benefit of the state, if we want to see this marketplace actually succeed."

Westby said allowing cannabis companies to deduct their business expenses will help smaller players compete.

"I think it's really hard for a business to survive without that ability," Westby said. "And the businesses that can survive are mostly the large multistate operators. That type of tax scheme really squeezes out the small individual mom-and-pop businesses, the startup businesses and a lot of the social equity businesses that the state is trying to create."

Cannabis companies under 'magnifying glass' as state hires industry auditors

HBJ PHOTO | STEVE LASCHEVER

An employee at cannabis grower CTPharma's Rocky Hill plant rolls joints for recreational sale.

By Andrew Larson
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As the state Department of Revenue Services works to ensure compliance and reduce the tax gap – the difference between taxes owed and the amount that is paid on time – **Commissioner Mark Boughton** said in an interview with the Hartford Business Journal that his agency has hired five cannabis auditors.

The new DRS examiners will not only enforce the state's tax laws, but help cannabis companies ensure they're collecting the correct amount and remitting it properly and on time — generally the month after the end of the month to which the tax applies, said **Robert Lickwar, a partner in national accounting firm UHY LLP's** Farmington office.

The pay-as-you-go model is meant to help companies avoid situations where they owe a larger-than-expected amount at the end of the tax year.

"They're hiring people number one for enforcement, but also number two, to get people through the process," Lickwar said.

The state projects $4.1 million in tax revenue from cannabis sales in fiscal 2022, with that number expected to grow to $73.4 million by fiscal 2026, according to an Office of Fiscal Analysis report.

By design, the state's cannabis tax scheme is cumbersome.

There are three taxes on retail sales:

- The state's usual 6.35% sales tax;
- A 3% sales tax dedicated to the city or town where the sale occurs;
- And a tax based on THC content that will cost about 10% to 15% of the sale price, according to the Department of Revenue Services.

The total tax on retail sales is about 20%, the same as in Massachusetts, where recreational pot legally hit the market in 2018.

"Just to deal with that administrative burden of calculating out those taxes for the consumer and then finding a way to incorporate that automatically into your point-of-sale system was certainly a challenge for retailers," said **Sarah Westby, co-chair of Hartford-based law firm Shipman & Goodwin's cannabis industry practice.**

Many companies are working with attorneys and accountants to ensure compliance.

"You have to treat your tax compliance like you treat your operational regulatory compliance, which is, you need to dot your I's and cross your T's because the industry is under a magnifying glass, especially as new states come online," said **Jeremy Shaw, a partner with national cannabis law firm Vicente Sederberg.**

PROJECTED TAX REVENUE FROM ADULT-USE CANNABIS SALES IN CT

TAX TYPE	FY 22	FY 23	FY 24	FY 25	FY 26
6.35% sales tax	$2.1M	$12.5M	$23.8M	$36.8M	$37.7M
State cannabis tax	$1.0M	$7.9M	$9.6M	$17.0M	$17.5M
Municipal cannabis tax	$1.0M	$5.9M	$11.2M	$17.4M	$18.2M
TOTAL	$4.1M	$26.3M	$44.6M	$71.2M	$73.4M

Source: Office of Fiscal Analysis

EXPERT'S CORNER

Claiming the Employee Retention Credit: How to qualify and avoid scams

By Brenden Healy

Businesses can still claim the Employee Retention Credit (ERC) if they had to temporarily or permanently close operations due to COVID-19.

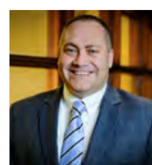
The ERC program generally allows for a three-year window for businesses to claim the credit. Therefore, businesses can claim the 2020 credit until April 15, 2024, and 2021 expenses by April 15, 2025.

ERC basics

To encourage companies and organizations to keep their employees on payroll, the ERC was enacted by the Coronavirus Aid, Relief and Economic Security (CARES) Act and signed into law in March 2020.

In 2021, the Consolidated Appropriations Act, 2021 (CAA) and the American Rescue Plan Act (ARPA) amended and extended the credit.

The ARPA amendment allows small employers that received a Paycheck Protection Program (PPP) loan to also claim the ERC.


Brenden Healy

For 2021, an employer can receive a 70% credit for the first $10,000 of qualified wages paid (i.e. $7,000) per employee in each qualifying quarter of 2021. This could be a 2021 maximum of $21,000 per employee.

This is an increase from 50% (or $5,000) per employee for all 2020. The credit generally applies to wages paid or incurred from March 13, 2020, through September 30, 2021.

Additionally, the cost of employer-paid health benefits can be included as part of employees' qualified wages.

How to qualify

In order to be eligible for the ERC, employers must have:

- Experienced a full or partial cessation of operations as a result of government-mandated restrictions on commerce, travel or group gatherings during 2020, or the first three quarters of 2021, due to COVID-19; or
- Experienced a considerable drop in gross receipts in 2020, or the first three quarters of 2021; or
- Been considered a recovery start-up business during the third or fourth quarter of 2021.

Avoiding ERC scams

The IRS is cautioning employers to be vigilant of third parties that may be encouraging them to claim the ERC when they are not eligible.

Some third-party providers, often referred to as "ERC mills," are guaranteeing businesses a refund without fully understanding the employer's circumstances.

These providers may use various means of communication, such as emails, letters, voicemails and even television advertising, to reach out to businesses. When businesses respond, these "ERC mills" may make false claims for write-offs related to the credit, which does not align with the taxpayer's eligibility and calculation of the credit.

These third parties may also neglect to inform businesses that wage deductions reported on the companies' federal income tax returns must be adjusted to account for the credit amount.

Thus, the ERC is taxable to the business, unlike PPP loan forgiveness.

Businesses should cautiously approach advertised schemes or direct solicitations that promise excessive tax savings. Incorrectly claiming the ERC may result in the credit being repaid along with penalties and interest charges.

Brenden Healy is a tax partner in the Hartford office of accounting and consulting firm Whittlesey.