

Cannabis Tax Relief Is Here — But IRS Risk Is Just Beginning

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For years, cannabis operators have functioned under a fundamentally distorted tax regime. Section 280E denied deductions that every other business takes for granted, forcing companies to pay tax on something closer to gross income than net profit.

That framework has now changed, at least for a significant portion of the industry.

The federal government's decision to reschedule state-licensed medical cannabis to Schedule III removes the § 280E limitation and allows qualifying businesses to deduct ordinary and necessary expenses under § 162.

The headline is clear: tax relief is here.

But the more important reality is this: the industry is transitioning from a regime of disallowance to a regime of interpretation, and that is where risk lives.

A Structural Shift, Not Just a Tax Cut

The removal of § 280E does more than reduce tax liability. It fundamentally changes how cannabis businesses are analyzed for tax purposes.

For the first time, medical operators must think like every other taxpayer. They must evaluate what constitutes an ordinary and necessary expense, how costs are allocated across lines of business, and whether those positions are sustainable under IRS examination.

This normalization introduces flexibility but also subjectivity. And subjectivity is where disputes begin.

For operators with both medical and recreational activities, the issue is even more pronounced. Because recreational cannabis remains a Schedule I substance, § 280E still applies to that portion of the business.

That creates an immediate need to develop defensible allocation methodologies between revenue streams, personnel, facilities, and shared overhead. These are not merely accounting questions, they are positions that will ultimately be tested.

Timing, Transition, and Retroactivity

Another layer of complexity lies in how the change is implemented.

Treasury and the IRS have signaled that § 280E relief may apply to the entire taxable year that includes the effective date of

rescheduling.

If that approach holds, it creates a significant opportunity, but also risk. Businesses may take positions that maximize deductions across the full year, while the IRS may later challenge how those positions were calculated or documented.

There is also the open question of retroactive relief. The possibility that prior years could be revisited raises strategic considerations around amended returns, refund claims, and statute of limitations issues. These decisions are not purely mechanical. They require a view of how the IRS is likely to respond.

R&D Credits: A New Frontier for Cannabis Tax Strategy

Perhaps the most underappreciated implication of rescheduling is access to the research and development credit under § 41.

Cannabis businesses, particularly those engaged in cultivation, extraction, and product development, often perform activities that meet the technical requirements for qualified research. These include developing new strains, improving yield and consistency, refining extraction processes, and designing new delivery methods.

Historically, many operators either avoided claiming the credit or took a conservative approach due to the overlay of § 280E and the lack of clear precedent in the industry. That restraint is likely to disappear quickly.

The financial upside is real. Properly documented R&D credits can offset a meaningful portion of federal tax liability, and in some cases provide payroll tax offsets for earlier-stage businesses.

But this is not low-risk territory. R&D credits are already an area of heightened IRS scrutiny, and the agency has become increasingly aggressive in challenging claims that lack contemporaneous documentation or rely on overly broad characterizations of qualifying activities.

Cannabis businesses entering this space will be doing so under two compounding factors: new eligibility, and a tendency toward aggressive positioning. That combination is precisely what draws enforcement attention.

The Inevitable Second Phase: IRS Scrutiny

Tax law changes of this magnitude do not settle quietly. They move in phases.

The first phase is what we are seeing now: rapid adoption of favorable positions. The second phase is where the IRS responds, often several years later, once patterns emerge and guidance is issued.

That is when the real issues surface. The IRS will examine whether allocation methodologies between medical and recreational operations are reasonable, whether deductions claimed under § 162 are adequately substantiated, whether R&D credits meet the technical and documentation requirements, and whether positions taken during the transition period were overly aggressive.

By the time these questions are asked, the financial stakes are often significant, and the factual record is already fixed.

Why This Requires a Different Approach

Most tax planning focuses on maximizing current benefit. In this environment, that is only part of the equation.

The more important question is whether the positions being taken today will hold up under examination, appeals, or litigation. That requires thinking not just like an advisor, but like the IRS and, when necessary, like a litigator.

Having spent nearly a decade inside the IRS Office of Chief Counsel and now representing clients in complex tax disputes, I have seen how these cases are developed from the government's side.

That perspective informs of a different approach. It means building allocation methodologies that are not just reasonable but defensible, structuring R&D credit claims with audit in mind from the outset, identifying positions that are likely to become enforcement targets, and preparing for disputes before they arise rather than reacting after the fact.

In a transition like this, the strongest position is not the most aggressive one. It is the one that can survive scrutiny.

The Bottom Line

The rescheduling of medical cannabis is a turning point. It brings long-awaited tax relief and opens the door to planning opportunities that were previously unavailable.

But it also moves the industry into a more complex and contested tax environment, one where interpretation, documentation, and defensibility matter as much as the underlying benefit.

The businesses that come out ahead will not simply be the ones that claim the most. They will be the ones who approach this moment with a clear understanding of how those claims will be evaluated when it matters most.

If you are navigating these issues, the question is not just whether you are taking advantage of the opportunity. It is whether you are positioned to defend it.