

State Taxation of Cannabis: Interplay With Federal Taxation, Recent Cases and State Initiatives

WEDNESDAY, MAY 20, 2020, 1:00-2:50 pm Eastern

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State Taxation of Cannabis

May 20, 2020

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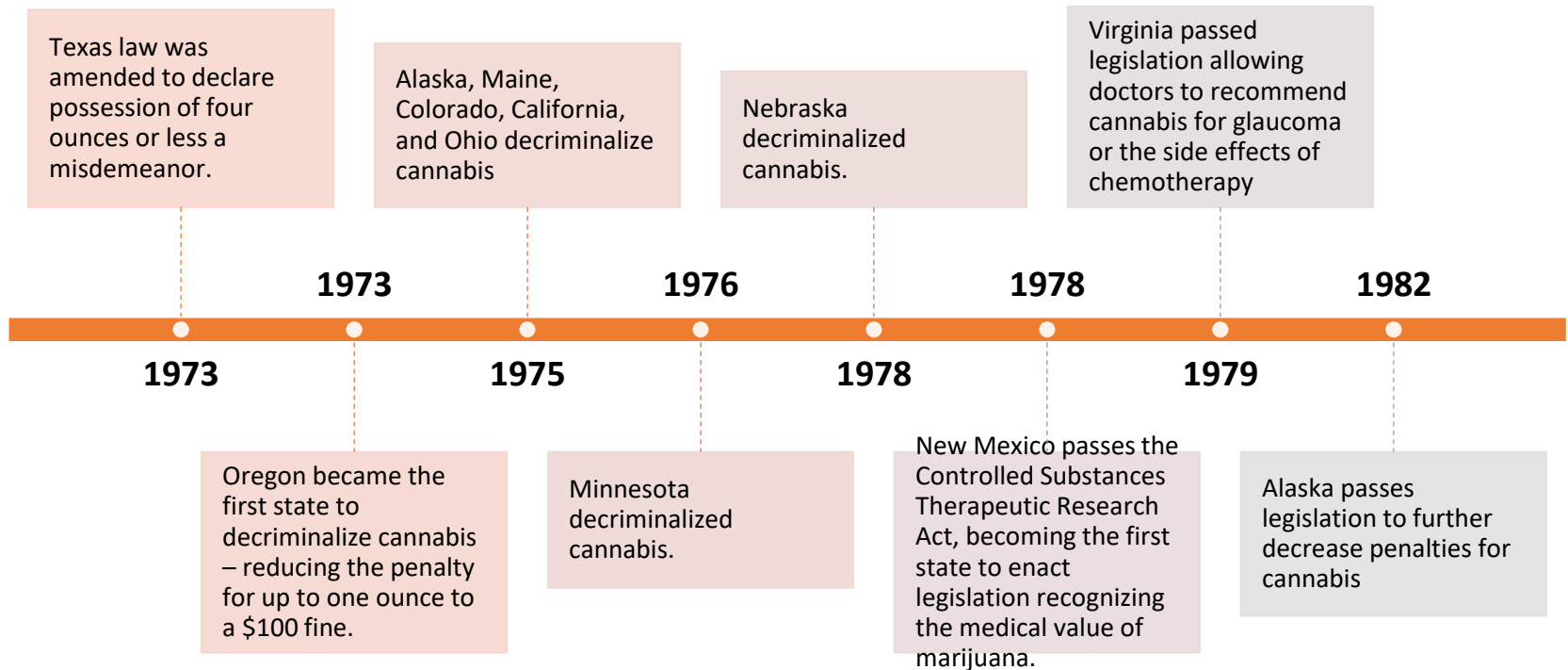
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State Taxation of Cannabis

Interplay With
Federal Taxation,
Recent Cases and
State Initiatives

Mitigating Sales,
Growers, and Excise
Taxes

Decriminalization Begins



1996: The Compassionate Use Act(CUA)



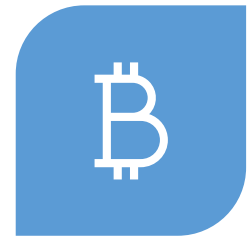
THE CUA LEGALIZED THE SALE
OF MEDICAL MARIJUANA IN
CALIFORNIA



CUA DID NOT ADDRESS THE
TAX TREATMENT OF MEDICAL
MARIJUANA



THE 2003 CUA GUIDELINES DID
NOT ADDRESS THE TAXATION
OF MARIJUANA



CALIFORNIA REVENUE AND
TAXATION CODE DID NOT
CARVE OUT ANY EXCEPTIONS
FOR MEDICAL MARIJUANA

2003:Medical Marijuana Program Act (MMPA)

Established a voluntary statewide identification card system;

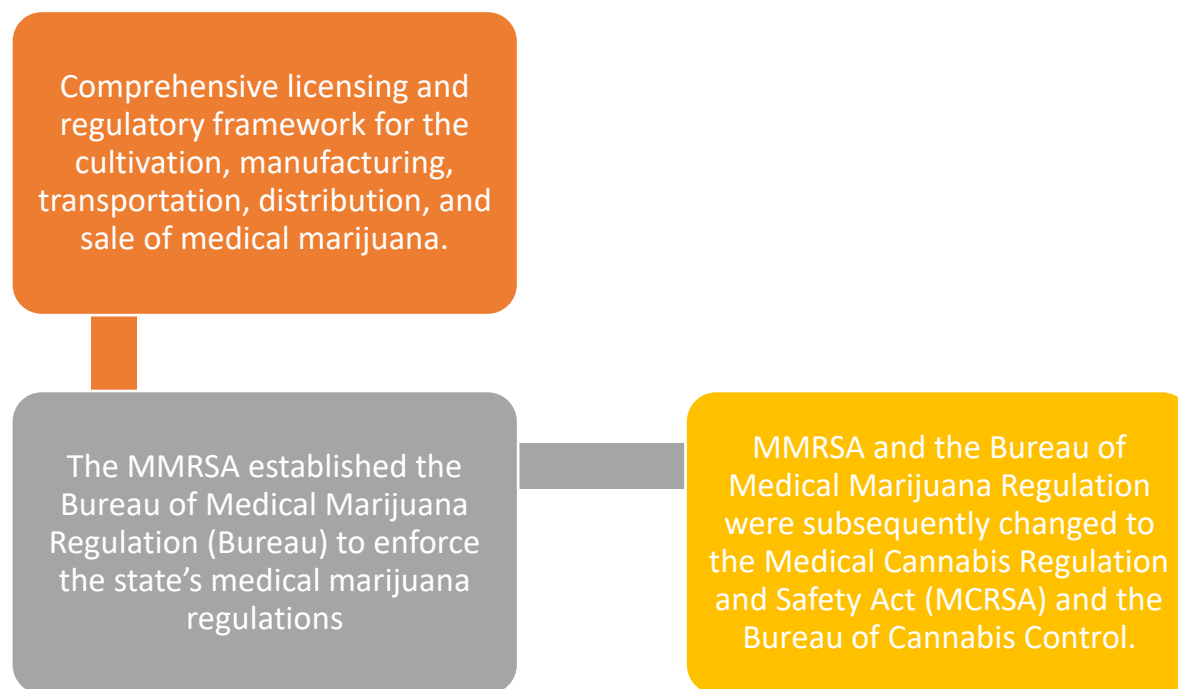
Set limits on the amount of medical marijuana each cardholder could possess;

Laid out rules for the cultivation of medical marijuana by collectives and cooperatives.

Did not address taxation of marijuana



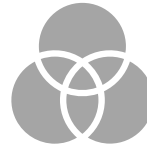
2015: The Medical Marijuana Regulation and Safety Act (MMRSA)



2016: Prop 64 Adult Use of Marijuana Act (AUMA)



On November 8, 2016, California voters approved Prop 64:



Business and Professions Code (BPC),
Marijuana Regulation and Safety
(MRS), establishes nonmedical
marijuana regulatory and licensing
provisions,



Added Part 14.5, Marijuana Tax, to
Division 2 of the Revenue and
Taxation Code (RTC) (commencing
with RTC section 34010).

California Taxation of Cannabis Under Proposition 64



New state tax on growing Both medical and nonmedical.



\$9.25 per ounce (\$9.65 as of 2020) of dried cannabis flowers
\$2.75 per ounce of dried cannabis leaves

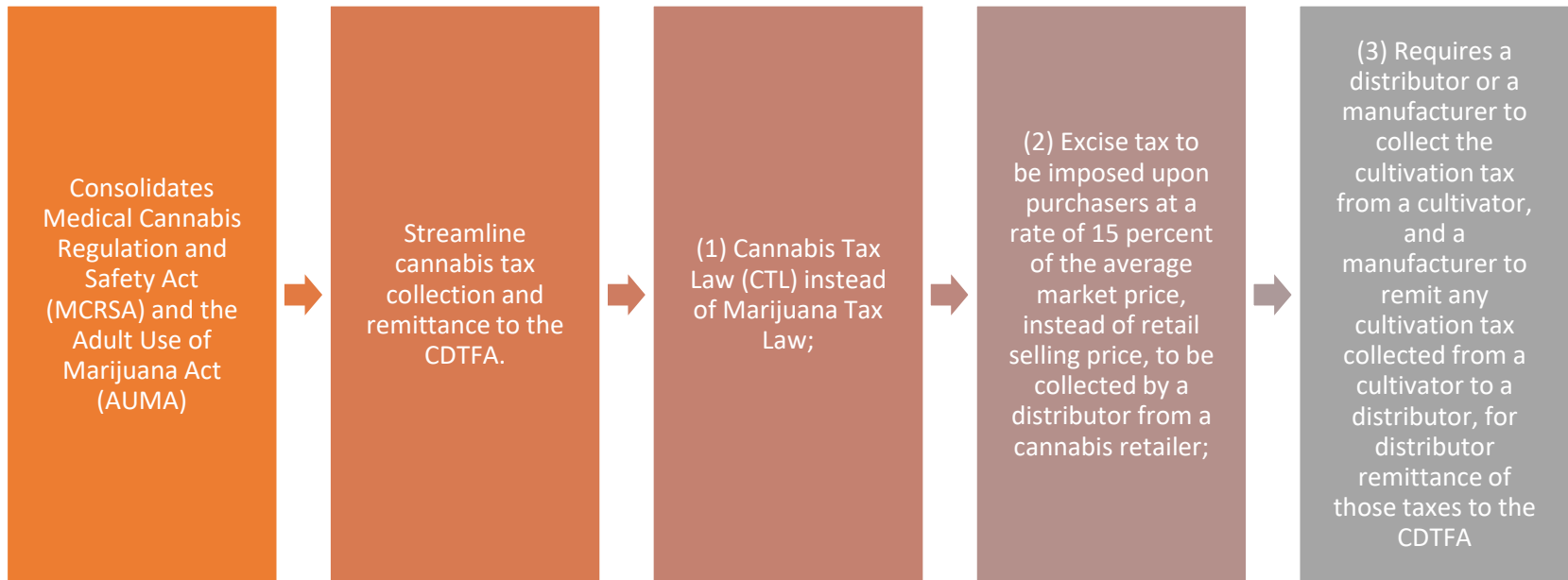


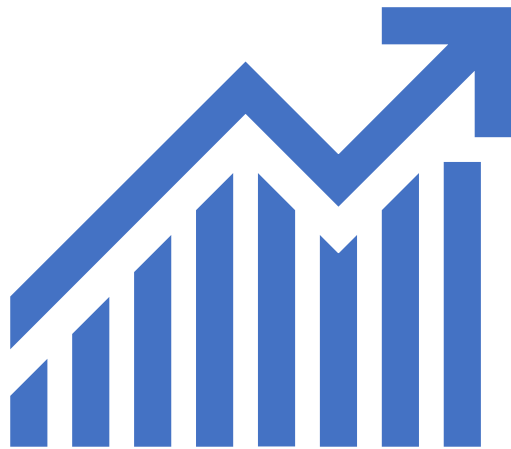
New state retail excise tax Both medical and nonmedical.
15 percent of retail price



Existing state and local sales tax Nonmedical only. Rates vary across the state but average around 8 percent

2017: The Medicinal and Adult-Use Cannabis Regulation and Safety Act (MAUCRSA) SB 94





California Cannabis Income Tax Prior to 2018

Medicinal cannabis businesses operated as nonprofit cooperatives or collectives prior to 2018.

The California Department of Justice published guidelines that stated businesses may operate as statutory cooperatives (incorporated) or as a collective (either incorporated or unincorporated).

Cannabis businesses are not eligible for California franchise and income tax exemption.

Some medicinal cannabis businesses formally incorporate as nonprofit mutual benefit corporations or nonprofit cooperatives, they do not meet the requirements for income tax exemption described in IRC Section 501(c) or California R&TC Section 23701.

Incorporated cooperatives, incorporated collectives, and unincorporated collectives must report income by filing an annual tax return. These entities generally file a Form 100, California Corporation Franchise or Income Tax Return.

Current California Income Taxation of Cannabis

Most businesses may deduct cost of goods sold, and ordinary and necessary business expenses on their California returns.

These taxpayers include:

Sole proprietorships (including farmers), Partnerships, Limited Liability Companies (LLC), Disregarded Entities (Single Member LLCs) Corporation, S Corporations Corporations, (including co-ops and collectives)

They are able to operate on a for-profit or not-for-profit basis.

They are not eligible for California franchise and income tax exemption, as they do not meet the requirements as described in Internal Revenue Code (IRC) Section 501(c) or California Revenue and Taxation Code (R&TC) Section 23701.



AB 37 NON-CONFORMITY WITH FEDERAL INCOME TAX LAW

In 2019 California enacts AB 37(Section 17209 of the California Revenue and Taxation Code)

California Non-Conformity with IRC Section 280E:

For each taxable year beginning on or after January 1, 2020, and before January 1, 2025, Section 280E of the Internal Revenue Code, relating to expenditures in connection with the illegal sale of drugs, shall not apply to the carrying on of any trade or business that is commercial cannabis activity by a licensee.

Internal Revenue Code § 280E: Expenditures In Connection With The Illegal Sale Of Drugs

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 (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.



Marijuana as a Schedule 1 drug

The federal government has classified marijuana as a Schedule 1 drug according to the Controlled Substances Act (CSA), P.L. 91-513, the same classification as heroin.

This classification means that it is perceived to have no medicinal value and a high potential for abuse.

Cocaine and methamphetamine are classified under the CSA as Schedule 2 drugs, which is a less restrictive category

Federal Taxation of Gross Profit



For federal income tax purposes, marijuana businesses pay income taxes on their gross profit instead of their net income



Income generated from trafficking in marijuana, must be reported for federal tax purposes.



For those who choose to report the income deductions are minimal and, therefore, their tax bills are quite high

Calculation of gross profit includes a deduction for COGS

The IRS has issued guidance to provide that the COGS, historically, is not considered an expense but rather a component of gross income.

All other deductions normally allowed in a for-profit business are specifically excluded by Sec. 280E.

Utilities, wages, rent, taxes, and repairs are all non-deductible for federal income tax purposes

Example: Federal Income Taxation of Cannabis

During year one, a Cannabis business buys products for \$100,000 and resells them for \$200,000. The business pays rent of \$20,000 and wages of \$30,000.

The business is required to report a \$100,000 profit for federal income tax purposes.

Only the COGS of \$100,000 is deducted from gross income

No other deductions, such as rent or wages are allowed for federal income tax purposes

Example: California Income Taxation of Cannabis



During year one, a Cannabis business buys products for \$100,000 and resells them for \$200,000. The business pays rent of \$20,000 and wages of \$30,000.



The business is required to report a \$50,000 profit



In addition to the COGS of \$100,000 other operating expenses such as rent and wages are allowed for California income tax purposes

What is legitimately included in COGS ?



The complexity comes in determining any deduction that could be attributable to general business activities or marketing activities would be difficult to establish as being part of COGS.



However, sometimes the line between what is or is not COGS is not so easy to discern.

Californians
Helping to
Alleviate
Med.
Problems,
Inc., (2007)
128 TC 173
("CHAMP")

CHAMP provides services California pursuant to Compassionate Use Act of '96 (CCUA)

IRS disallowed all of CHAMP's deductions under Code Sec. 280E

The Tax Court held that marijuana is a schedule I controlled substance for this purpose, even if it's medical marijuana recommended by a physician as appropriate to benefit the user's health.

Calculating Cost of Goods Sold

IRC Sec. 471 regs have different rules for resellers and producers.

Resellers must use as their COGS the price they pay for inventory plus any transportation or other necessary charges incurred in acquiring possession of the goods

Producers must include in COGS both the direct and indirect costs of creating their inventory. (Reg § 1.471-3(c), Reg § 1.471-11)

Producers have to capitalize the cost of raw materials, expenditures for direct labor, and indirect production costs incident to, and necessary for, the production of the particular article, including an appropriate portion of management expenses. (Reg § 1.471-3(c)).



Harborside Health Center

Harborside Health Center
(Harborside) business activities:

The sales of marijuana and
products containing marijuana.

Harborside also purchased its
marijuana flowers (buds) from its
patient-growers with some of
these growers promising to sell
what they cultivated back to
Harborside.

The sales of products with no
marijuana, including branded
clothing, hemp bags, books
about marijuana, and marijuana
paraphernalia such as rolling
papers, pipes, and lighters.

Therapeutic services:
A portion of each marijuana sale
included free holistic services.

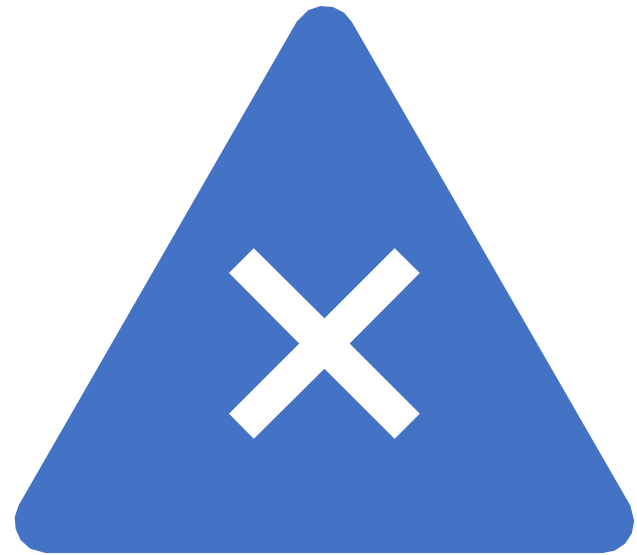
Branding activities:
Part of a "unified business
enterprise" with its activities
that did make money during the
years at issue.

Harborside's IRS Audit

IRS determined that Harborside's sole trade or business was trafficking in a controlled substance and that Code Sec. 280E prevented it from deducting business expenses.

IRS also determined that Harborside had to calculate COGS using the Code Sec. 471 regs for resellers.

Harborside argued that Code Sec. 280E didn't apply to it, that it was a producer, and that a dismissed civil-forfeiture action precluded a deficiency action.



Harborside in Tax Court

The Court determined that Harborside was engaged in only one trade or business, which was trafficking in a controlled substance.

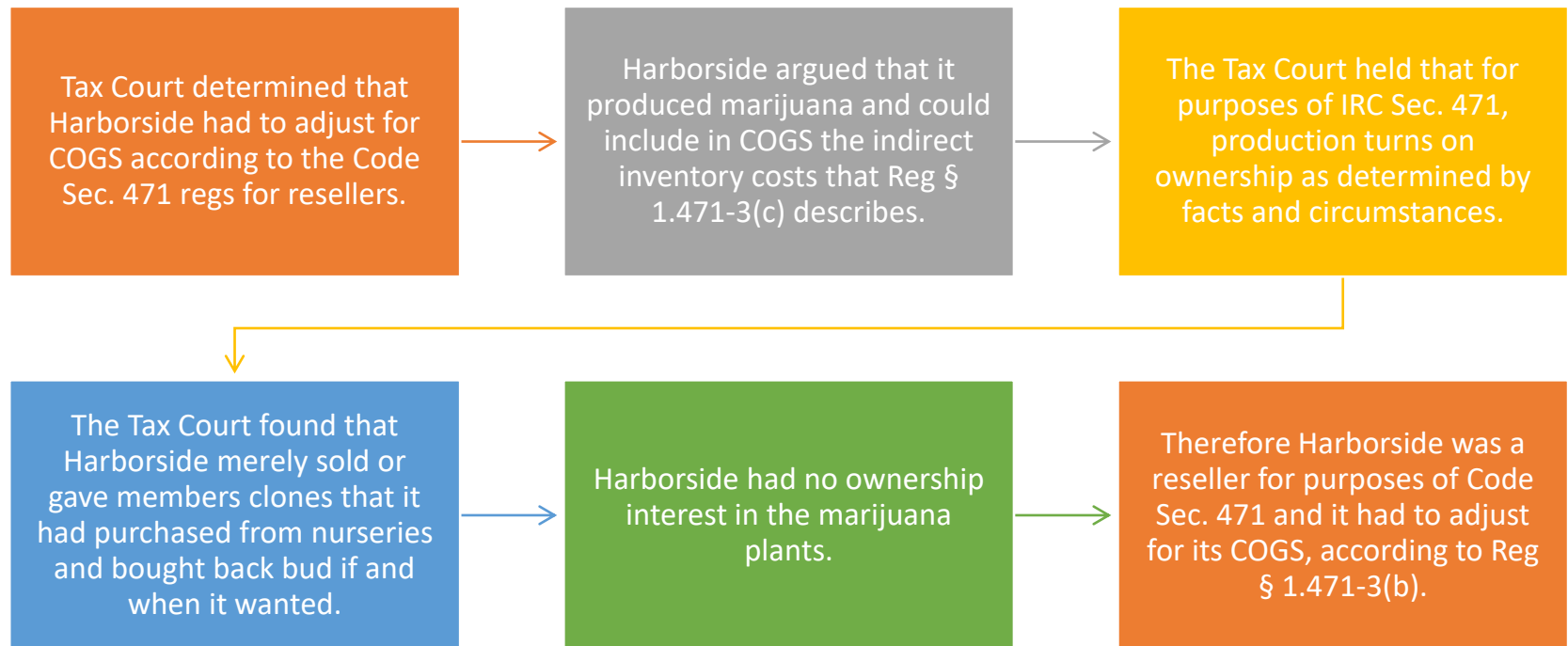
Marijuana sales accounted for over 99.5% of its revenue.

Its other activities were neither economically separate nor substantially different.

As that single trade or business — the sale of marijuana — was trafficking in a controlled substance under federal law, Harborside couldn't deduct any of its related expenses.

The sale of non-marijuana-containing products had a "close and inseparable organizational and economic relationship" with, and was "incident to," Harborside's primary business of selling marijuana.

Harborside's IRC Section 471 Analysis



Northern California Small Business Assistants Inc., (“Northern California”),



TAX COURT HOLDS THAT IRC SECTION 280E IS NOT A PENALTY PROVISION AND THEREFORE DOES NOT VIOLATE THE PROHIBITION ON EXCESSIVE FINES UNDER THE EIGHTH AMENDMENT OF THE U.S. CONSTITUTION.



THE IRS HAD PREVIOUSLY DETERMINED THAT NORTHERN CALIFORNIA SBA IS SUBJECT TO THE LIMITATIONS OF SECTION 280E

“Northern California” Arguments

Northern California argued that IRC Section 280E violated the Eighth Amendment’s prohibition on excessive fines by imposing a penalty through a tax on the company’s gross receipts.

The Excessive Fines Clause guards against abuses of the government’s right to punish.

The court held that the section doesn’t violate the constitution because it isn’t a penalty provision.

Northern California argued that the IRS should apply the section more narrowly even if it were constitutional, so that it blocks business deductions that are ordinary and necessary under tax code Section 162 but not deductions from other tax code sections

Judge David Gustafson wrote a partial dissent, saying he believed the section unconstitutionally exceeds the power Congress has under the Sixteenth Amendment to impose an income tax

Judge Elizabeth Copeland wrote a partial dissent of her own, insisting that Section 280E is a penalty and urging further analysis of whether it violates the Eighth Amendment

Choice of Entity for Cannabis Business

Prior to Prop 64 California state law required California Cannabis Businesses to operate on a not-for-profit basis

Non-profit mutual benefit corporations became pervasive, with a smattering of other non-profit entity types.

In 2018, with the passage of Prop 64 California Cannabis businesses converted to For-Profit Entities

C Corporation Tax Consequences

Double taxation: C corporations are subject to income tax at the entity level & dividend distributions are taxable to shareholders.

Under the TCJA, that corporate rate was reduced to a flat 21% from 35%

For example, a C corporation that earns \$1,000,000 will pay tax of \$210,000

When that corporation pays dividends, that same money is taxed again to the shareholder at the shareholder's individual rate, typically 37% (\$370,000), so the total tax on the profits is 58% or \$580,000

A partnership or S corporation results in less overall tax to the owners 37% or \$370,000

Therefore, it matters very much how much the company will distribute to shareholders each year.

Raising Money From Professional Investors

A C Corporation is the typical choice for companies that will raise funds, because of its ability to issue preferred stock to professional investors

Different classes of preferred stock for different equity investment rounds

Ability to issue equity incentives to employees

LLC Structure

Appropriate structure if:

You do not anticipate that the business will require significant outside funding

Small number of capital partners

Ease of establishment, maintenance and amendment

LLCs are set up by and managed through an Operating Agreement

A contract between the LLC Members

An Operating Agreement can be easily modified to allow the business to have fewer moving parts that require meetings and maintenance

LLCs pass profits and losses pass through directly to the members

LLC Tax Consequences

Taxation as an LLC will be more favorable if:

The individual owners' tax brackets are below 37%

The owners qualify for the 20% deduction QBI deduction for flow-through income under IRC section 199A

The business plan emphasizes distributing cash to investors over reinvesting cash into the business (growth).

California Sales and Excise Taxation

State Retail Excise: There is a 15% marijuana excise tax on retail marijuana sales.

Sales Tax: The sales tax is 7.25% and up depending on local options and applies to retail marijuana sales.

Local Excise: Local jurisdictions have the power to assess fees and taxes on marijuana sales.

Wholesale Tax: When growers and processors sell their product to a customer, such as a dispensary, and the customer provides the grower or processor with a valid and timely resale certificate, the sale is not subject to sales tax.

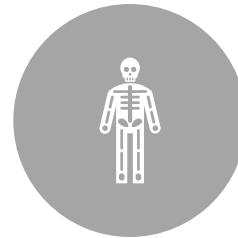
Cultivator Tax: There is a \$9.25 per dry-weight ounce tax on marijuana flowers and a \$2.75 per dry-weight ounce tax on marijuana leaves and applies to both medical and retail.

Medical Tax: The state's 15% marijuana excise tax is imposed upon purchasers of all marijuana and marijuana products, including medical marijuana but medical is exempt from state sales tax.

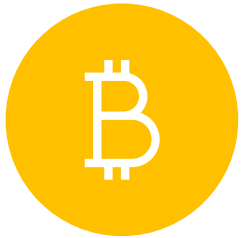
Colorado Income Taxation of Cannabis



Colorado specifically allows individuals to subtract expenses disallowed by Section 280E to determine Colorado taxable income.



See Colo. Rev. Stat. Sec. 39-22-104(4).



Colorado specifically allows corporations to subtract expenses disallowed by Section 280E to determine Colorado taxable income.



See Colo. Rev. Stat. § 39-22-304(3)(m), (n).

Hawaii Income Taxation of Cannabis



Act 230, SLH 2016 (Act 230) allows taxpayers engaged in medical marijuana businesses to deduct business expenses and claim tax credits on their income taxes.



See Haw.Rev. Stat. § 235-2.4(r).



Act 230 is effective for taxable years beginning after December 31, 2015.



Applicable to tax years beginning after December 31, 2015, Section 280E does not apply to the production and sale of medical marijuana and manufactured marijuana products by dispensaries licensed under Chapter 329D and their subcontractors. See Haw. Rev. Stat. § 235-2.4(r).

New Jersey Income Taxation of Cannabis



Section 280E should not apply. New Jersey does not conform to the Internal Revenue Code.



New Jersey taxable income starts with New Jersey gross income and is adjusted for modifications.



A taxpayer is subject to tax on the taxpayer's net profits from business.



A taxpayer's net profits from business is determined by taking into account all ordinary costs and expenses incurred in the conduct of that business. There is no state provision similar to Section 280E.

Oregon Income Taxation of Cannabis



Oregon has enacted a provision that allows individual taxpayers to subtract expenses for any federal deduction that a taxpayer would have been allowed if not for Section 280E to determine state taxable income. See O.R.S. § 316.680(1)(i).



Oregon has enacted a provision that allows corporate taxpayers to subtract expenses for any federal deduction that a taxpayer would have been allowed if not for Section 280E to determine state taxable income. See ORS § 317.763.


Pennsylvania Income Taxation of Cannabis

 For individual taxation, Pennsylvania does not conform to the Internal Revenue Code.

 Pennsylvania taxable income starts with state gross income.

 There is no provision similar to Section 280E that would disallow the expenses that Section 280E disallows.

 For corporations, Pennsylvania conforms to the Internal Revenue Code.

 The starting point is Federal taxable income. There is no provision that states Section 280E does not apply.

California Sales and Excise Taxation

State Retail Excise: There is a 15% marijuana excise tax on retail marijuana sales.

Sales Tax: The sales tax is 7.25% and up depending on local options and applies to retail marijuana sales.

Local Excise: Local jurisdictions have the power to assess fees and taxes on marijuana sales.

Wholesale Tax: When growers and processors sell their product to a customer, such as a dispensary, and the customer provides the grower or processor with a valid and timely resale certificate, the sale is not subject to sales tax.

Cultivator Tax: There is a \$9.25 per dry-weight ounce tax on marijuana flowers and a \$2.75 per dry-weight ounce tax on marijuana leaves and applies to both medical and retail.

Medical Tax: The state's 15% marijuana excise tax is imposed upon purchasers of all marijuana and marijuana products, including medical marijuana but medical is exempt from state sales tax.

Alaska Sales and Excise Taxation of Cannabis



State Retail Excise: There is no state excise on retail marijuana sales.



State Sales Tax: There is no state sales tax but local communities can impose a local sales tax, which would apply to retail marijuana purchases unless otherwise exempted.



Local Excise: Municipalities can and have imposed an additional local marijuana excise tax. .



Wholesale Tax: The excise tax is \$50 an ounce for any part of the bud and flower and \$15 an ounce for the remainder of the plant.



Cultivator Tax: Paid on wholesale sales.



Medical Tax: There are no retail sales of medical marijuana.

Colorado Sales and Excise Taxation of Cannabis

State Retail Excise: There is a 15% marijuana excise tax imposed retail sales of marijuana.

Sales Tax: Retail sales are exempt from the state's 2.9% sales tax but any applicable state administered city or county sales taxes for which an exemption has not been expressly granted by city or county resolution or ordinance applies.

Sales of retail marijuana are exempt from some, but not all special district sales taxes.

Local Excise: Local jurisdictions have the power to assess fees and taxes on marijuana sales.

Wholesale Tax: A 15% excise tax is imposed on the first sale or transfer from a retail marijuana cultivation facility to a retail marijuana store, retail marijuana product manufacturing facility or to another retail marijuana cultivation facility.

Medical Tax: Medical marijuana is not subject to the 15% retail marijuana state excise tax.

Sales of medical marijuana are subject to sales tax in the same manner as other sales of tangible personal property.



Tax Differences Medical and Recreational Cannabis

Recreational Cannabis Tax

The largest tax is an excise tax.

Excise Tax is a percentage of the retail price. This 'sin' tax is for goods that are thought to be “socially harmful” or “unnecessary”.

Excise tax rates will vary from state to state from 10% excise tax to 37% in Washington state

Medical Cannabis Tax

Most states with a medical cannabis program impose some sort of sales tax on medical cannabis products.

These particular tax rates are similar to the general state or local sales tax rates, typically between 3% and 10%

Are Cannabis business owners eligible for §199A deduction ?

§199A creates fairness between C corporations (now taxed at 21%) and pass-thru entity owners taxed at up to 37% (or 29.6% after the §199A deduction)

A cannabis businesses operating as a C corporations are taxed at the flat 21% rate

§280E denies a tax deduction or credit for non-COGS expenses paid or incurred from trafficking in controlled substances

The §199A deduction is neither “paid” nor “incurred” by a taxpayer

The §199A deduction is not claimed at the entity level but on the owner’s personal tax return.

Does §280E applies only at the business level, or is it applied at the pass-thru owner’s level?

Cannabis businesses (such as dispensaries and growers) are not specifically listed as an ineligible trade or business under the final 199A regulations.

Is the pass-thru taxpayer of a cannabis business eligible for the §199A deduction ?

IRC §280E Compliant Accounting System

include for all costs that are accounted into inventory, and then ultimately into cost of goods sold.

Appropriate cost allocation methods.

Cost allocation is necessary for shared expenses.

Cultivator may have various rooms throughout their facility for different plant batches, drying or curing activities, office space, and storage.

Packaging and cold storage areas that each need to be accounted for independently

Shared expenses need to be allocated properly to each as part of 280E cost accounting.

A compliant accounting system should contain allocation procedures and thorough documentation process

State regulations also require specific accounting processes

A compliant accounting system should have a record keeping process for a complete audit trail for every transaction

Audit trail should be easy to trace and review

Chart of account structure, and customized record keeping processes

Packaging

Packaging can increase brand awareness

Packaging can enhance shelf presence

Branding and customer appeal can be increased through product packaging

Packing expenses may be includible in COGS with 280E accounting

Most other advertising expenses or customer marketing costs are not includible in COGS.



Inventory Management



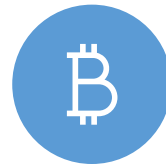
INVENTORY MANAGEMENT SOFTWARE IS CRUCIAL TO THE CANNABIS INDUSTRY



THIS SOFTWARE ALLOWS DETAILED TRACKING AND REPORTING



INVENTORY MANAGEMENT SOFTWARE ALSO OFFERS DETAILED COGS TRACKING



DETAILED TRACKING IS GREAT FOR MAKING SURE ALL COGS COSTS REMAIN TRACKED AND AVAILABLE FOR BOOKKEEPING PURPOSES



INVENTORY MANAGEMENT MAY ALSO INCLUDE STORAGE, ORDERING, AND TESTING ACTIVITIES



COSTS FOR INVENTORY MANAGEMENT OR INSPECTION MAY ALSO BE INCLUDIBLE IN COGS

(“TIGTA”) “The Growth of the Marijuana Industry Warrants Increased Tax Compliance Efforts and Additional Guidance”

Prior to the Tax Court decision in Harborside, many cannabis taxpayers took the tax return position that they could rely on the uniform capitalization rules found in section 263A to determine cost of goods sold (“COGS”).

The Tax Cuts and Jobs Act (“TCJA”) provides most taxpayers with immediate expensing of new and used property used in their trade or businesses under section 168(k).

Cannabis companies subject to section 280E are limited to reducing their gross income by any depreciation capitalized into inventory and later reducing gross receipts as COGS.

The immediate expensing available under section 179 is subject to the disallowance provisions of section 280E

Trafficking businesses are not entitled to bonus depreciation.

The IRS will challenge any aggressive section 471(c) position that includes direct and indirect costs in calculating COGS.

The IRS will likely argue cannabis taxpayers must calculate COGS by applying direct costs only and without regard to section 471 or the regulations