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Legal Cannabis Dispensary Taxation: A Textbook Case of Punishing Law-Abiding Businesses Through the Tax Code

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Abstract: *Section 280E of the Internal Revenue Code (IRC) creates a gross receipts tax situation for legal cannabis dispensary small businesses. This is due to an accident of history and a perversion of Congressional intent. ATR supports fixing this mistake. H.R. 2240, the "Small Business Tax Equity Act of 2013" does so. ATR urges all Congressmen to support this common-sense legislation.*

What's the issue? Under tax law, legal cannabis dispensaries are unable to claim the ordinary and necessary business expense deductions that any other legal business can claim.

Why does the tax code discriminate against the cannabis dispensary industry like this? As a longstanding matter of tax law, all income derived from whatever source is taxable. Criminal prosecutors have long used this rule to assess taxes and penalties on organized criminals.

In the 1981 tax court case *Edmonson v. Commissioner* (T.C. Memo 1981-623), a criminal facing a tax assessment for ill-gotten gains asserted his right under tax law to deduct "ordinary and necessary" expenses against this income. The court ruled that if a tax liability is asserted by the government, the taxpayer does get to deduct his business expenses, even in the context of a criminal proceeding. The person in question went on to deduct telephone, automobile, and other business expenses.

Congress retaliated. In 1982, part of the TEFRA tax increase (P.L. 92-248) created a new Section 280E of the code. It reads:

> "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."

The clear intent of Congress at the time was to prevent street dealers from avoiding a heavy tax liability by claiming expenses as if they were running legitimate businesses.

What does this have to do with cannabis dispensaries? Under the Controlled Substances Act, cannabis (a.k.a. marijuana) is a Schedule I substance. Thus, income from the sale of cannabis is taxable as income, but ordinary and necessary business expenses are not deductible against that income for the determination of taxable profit.

What about states that have legalized cannabis dispensaries? Since 1996, 20 states and the District of Columbia have legalized medical use of cannabis, with many of those states establishing state licensed dispensaries. Last November, voters in Colorado and Washington State made the cultivation and sale of cannabis to all individuals 21 years of age or older legal through state licensed stores.

When the cultivation and sale of cannabis has been regulated, legitimate businesses have been created in response. Colorado, for example, has approximately 5000 employees working in this legal industry. But the fact that a cannabis dispensary is legal under state law does not change the Schedule 1 status of the product.

What tax penalties do legal cannabis dispensaries face in these states? Like any other business, cannabis dispensaries must pay taxes on all business revenues. Unlike other businesses, however, this industry cannot deduct ordinary and necessary business expenses to arrive at a true taxable business profit. In essence, they pay a gross receipts tax instead of an income tax.

What type of ordinary and necessary expenses are denied to this industry under Sec. 280E of the code? Expenses include but are not limited to:

- Wages and salaries
- Commissions and payments to contractors
- Health and other insurance premiums
- Pension plans
- Equipment for the business such as computers and furniture
- Rent and home office expenses
- Marketing and advertising costs
- Travel and lodging expenses
- Automobile expenses
- Business meals and entertainment
- Interest paid on business loans
- State and local taxes and fees
- Legal and other professional expenses
- Repair and maintenance
- Telephone, internet, and other utility costs

To use a very simple example, let's say two nearly identical businesses each have $500,000 in business revenue. Each business is allowed to deduct the cost of goods sold ($250,000), but only the first business can also deduct ordinary and necessary business expenses. The first business can deduct $150,000 of ordinary and necessary business expenses, but the second business cannot because it's restricted by Sec. 280E. Assume a 35% tax rate for each business:

	Normal business	Sec. 280E Business
Revenue	$500,000	$500,000
Cost of goods sold	$250,000	$250,000
Ordinary and necessary	$150,000	$0
Real World Profit	$100,000	$100.000
Taxable Profit	$100,000	$250,000
Tax (35%)	$35,000	$87,500
Avg. Eff. Tax Rate	35%	87.5%

The second business faces a tax bill $52,500 greater and an average effective tax rate much higher than the first. The only reason is that this business cannot deduct the same expenses as any other business. This creates a huge disincentive for the second business to hire more workers, increase wages, provide additional benefits, or invest in things like infrastructure improvements.

Can't the IRS just waive Sec. 280E? Unfortunately, no. In a letter to Congressman Pete Stark on December 16, 2010, the IRS told the Congressman the following: "Because neither section 280E nor the Controlled Substances Act makes exception for medically necessary marijuana, we lack the authority to publish the guidance that you request. The result you seek would require the Congress to amend either the Internal Revenue Code or the Controlled Substances Act."

Is there a bill to fix this tax law quirk? H.R. 2240, the "Small Business Tax Equity Act of 2013," has been introduced by Cong. Earl Blumenauer (D-Ore.). His bill amends Sec. 280E of the IRC to add the following language: "unless such trade or business consists of marijuana sales conducted in compliance with State law." In other words, if a state legalizes cannabis, the businesses which act in accordance with state law will be treated like any other businesses.

Why is H.R. 2240 good tax policy? It's a basic principle of tax policy that the tax code should not pick winners and losers. There aren't many clearer examples of this principle being violated than this Sec. 280E issue. Under no reasonable scenario should a perfectly-legal business, organized under state law, be denied the same ordinary and necessary business expenses as any other business.

Another basic tax principle is that gross receipts taxes are unfair. They only measure one side of the profit equation—revenues—and take no account of the expenses which were incurred to garner those revenues. Two very different businesses profit-wise could have identical business receipts in the door. No tax policy expert—left, right, or center—believes that gross receipts taxes are good public policy. Section 280E imposes a *de facto* gross receipts tax on this industry.

Finally, the intent of Congress is important in tax law. In 1982, Congress wanted to send a message to kingpin drug dealers by enacting Section 280E. More than three decades later, a newly legal business sector finds itself punished in a way Congress never intended. This inequity in tax law must be corrected in order for Congress to clarify its true intent in the matter.

What about conservative opposition to illegal narcotics? That's not at issue here. By definition, these businesses are operating in states where their product is no longer illegal. Changing Section 280E in this way thus has nothing to do with any narcotics that remain illegal under federal and state law. Congress never intended for legal businesses to face unfair and punitive treatment at the hands of the tax code. Moreover, there is a countervailing conservative value of limiting the size and scope of government. Section 280E raises tens of millions in taxes from a fledgling industry which is immediately being spent in Washington.

What's the revenue score? The Joint Committee on Taxation has not evaluated this proposal. However, relative to the broader U.S. economy, the cannabis dispensary industry is very small and exists in a minority of states for the moment. It is very likely that a score would produce negligible revenue effects. If anything, H.R. 2240 is a very modest tax cut for small businesses.