PERSPECTIVE

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Big Loss For Marijuana In Ruling On Taxes

By Robert W. Wood

Should marijuana businesses pay tax on gross profits or net profits? It sounds like a silly question. After all, virtually every business in every country pays tax on net profits, after expenses. Even famously high California business taxes are based on net revenues.

But the topsy-turvy rules for marijuana seem to defy logic. And taxes are clearly a big topic these days. Many have suggested that legalizing marijuana would mean huge tax revenues. As California voters and legislators consider legalization, revenue could be on their minds too.

As more states legalize it, the cash hauls from both medical and recreational marijuana look ever more alluring. In Colorado, the governor's office estimated that it would collect $100 million in taxes from the first year of recreational marijuana. In the end, Colorado's 2014 tax haul for recreational marijuana was $44 million, causing some to complain.

Of course, $44 million is nothing to sneeze at, particularly for the first year. Colorado was first to regulate marijuana production and sale, so other state governments are watching. Colorado also collected sales tax on medical marijuana and various fees, for a total of about $76 million.

Plainly, not all Colorado sales are going through legal channels. In Washington state, regulators say the state collected *$65 million in first-year taxes* from recreational marijuana sales in just 12 months. That was on cannabis sales of over $260 million from June 2014 to June 2015.

Now, in another blow to the budding industry, the Internal Revenue Service convinced the 9th U.S. Circuit Court of Appeals that a legal San Francisco dispensary called the Vapor Room cannot deduct its business expenses. In effect, the business must pay federal and state tax on 100 percent of its gross income. The case, *Olive v. Commissioner*, 13-70510 (July 9, 2015), came to the 9th Circuit on appeal from the U.S. Tax Court.

Martin Olive sold medical marijuana at the Vapor Room, where he used vaporizers so patients did not have to smoke. However, with only one business, Section 280E precluded Olive's deductions. Indeed, although good record-keeping has been a key fact in many marijuana tax cases, even good records won't make vaporizers or drug paraphernalia deductible.

The 9th Circuit upheld the Tax Court ruling that Section 280E prevents the legal medical marijuana dispensary from deducting ordinary or necessary business expenses. Under federal tax law, the Vapor Room is a "trade or business ... consist[ing] of trafficking in controlled substances ... prohibited by Federal law." This tax issue for marijuana businesses — even legal ones — has been well publicized.

Indeed, the New York Times has suggested that the tax problems are huge, as legal marijuana faces another federal hurdle: taxes. See Jack Healy, "Legal Marijuana Faces Another Federal Hurdle: Taxes," New York Times (May 10, 2015), p. A17. Federal law still trumps state law. Even legal medical marijuana businesses have big federal income tax problems: tax evasion if they fail to report, and the risk of criminal prosecution if they do.

For many, a bigger fear than prosecution is the risk of being bankrupted by their IRS tax bill. Regardless of whether marijuana businesses *should* pay tax on their net or gross profits, the tax code says the latter. Section 280E of the tax code denies even legal dispensaries tax deductions because marijuana remains a federal controlled substance.

The IRS says it has no choice but to enforce the tax code. One answer is for dispensaries to deduct expenses from other businesses distinct from dispensing marijuana. If a dispensary sells marijuana and is in the separate business of care-giving, the care-giving expenses are deductible.

If only 10 percent of the premises is used to dispense marijuana, most of the rent is deductible. Good record-keeping is essential, but there is only so far one can go. Recently, the IRS Office of Chief Counsel issued guidance about how taxpayers "trafficking in a Schedule I or Schedule II controlled substances" — and this would include legal medical marijuana dealers — can determine their cost of goods sold. *See* IRS ILM 201504011 (Jan. 23, 2015).

After all, you have to report your profit, but how do you do that? If you buy goods for $10 and resell them for $20, your profit is $10. Your cost of goods sold is $10. ILM 201504011 is complex, but tries to answer how dealers can determine cost of goods sold, as well as whether the IRS auditing a dealer can make them change.

There is considerable tax history in the IRS missive. The IRS is clear that you can deduct only what the tax law allows you to deduct. The trouble started in 1982, when Congress enacted Section 280E. It prohibits business expense deductions, but at least it does not prohibit claiming the cost of goods sold.

Most businesses do not want to capitalize costs. Claiming an immediate deduction is easier and faster. In the case of marijuana businesses, the incentive appears to be the reverse. So the IRS says it is policing the line between the costs that are part of selling the drugs and others.

Sure, deduct wages, rents and repair expenses attributable to production activities. They are part of the cost of goods sold. But do not deduct wages, rents or repair expenses attributable to general business activities or marketing activities that are not part of cost of goods sold. Once again, there is considerable nuance associated with the tax rules for marijuana businesses. Getting it wrong can be expensive.

Meantime, there are still discussions about heaping on federal taxes. 2013's proposed Marijuana Tax Equity Act (H.R.501) would have ended the federal prohibition on marijuana and allow it to be taxed — at a whopping 50 percent. The bill would have imposed a 50 percent excise tax on cannabis sales, plus an annual occupational tax on workers in the field of legal marijuana.

Incredibly, though, with what currently amounts to a tax on gross revenues with deductions being disallowed by Section 280E, perhaps it would have been an improvement. More recently, Rep. Jared Polis (D-Co.) and Rep. Earl Blumenauer (D-Or.) have suggested a phased 10 percent rate, ramping up to 25 percent in five years. *See* Marijuana Tax Revenue Act of 2015 (H.R. 1014).

As for the Vapor Room, the inability to deduct expenses is a big blow. Many businesses have finessed the tax issue with other businesses that are complimentary. But until the tax code is changed, the tension over taxes and tax reporting for many of these businesses will be palpable.

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