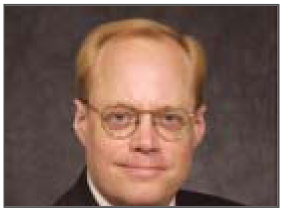
Forbes



Robert W. Wood

THE TAX LAWYER

TAXES 5/11/2015

Feds Propose 50% Marijuana Tax---As A Tax Cut

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. 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 more states legalize it, the cash hauls 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 say that Colorado's marijuana money is going up in smoke.

Still, that isn't bad for the first year. Colorado was first to regulate marijuana production and sale, so other governments are watching. Colorado also collected sales tax on medical marijuana and various fees, for a total of about $76 million. The taxes are significant, but not all the sales are going through legal channels. Perhaps it was silly to think they would.

Avenues for cheaper prices in the illegal and medical markets can trump legal recreational sales where tax revenues are highest. That makes perfect sense, and is calling for a re-examination of tax rates and enforcement. In Colorado, legalization has surprised both supporters and critics, with a mixture of good and bad.

Washington state became the second to legalize recreational marijuana. Oregon and Alaska have followed. With four recreational victories, activists are pushing legalization in other states, including California. The tax tally is likely to keep growing, if not always as predicted.

In Colorado, there is a 2.9% sales tax and a 10% marijuana sales tax. Plus, there is a 15% excise tax on the average market rate of retail marijuana. It adds up to 27.9%. But with all those taxes, many smokers buy illegally. An estimated 40% of purchases in Colorado are not through legal channels. There is also a growing relationship between the 2.9% medical marijuana tax and the 27% recreational variety.

Some patients may be reselling 2.9% medical stock. Meanwhile, the Colorado tax on marijuana has been upheld despite claims that paying it amounts to self-incrimination that violates the Fifth

Amendment. Amazingly, though, for even legal marijuana businesses, the federal tax problems remain huge.

Indeed, as the New York Times notes, Legal Marijuana Faces Another Federal Hurdle: Taxes. Federal law still trumps state law. Even legal medical marijuana businesses have big federal income tax problems: tax evasion if they don't report, and a considerably smaller risk of criminal prosecution if they do.

More imminent, though, is the risk of being bankrupted by their IRS tax bill. Let's return to the question whether marijuana businesses should pay tax on their net or gross profits. The tax code says the latter. That because 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% 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 issued guidance about how taxpayers "trafficking in a Schedule I or Schedule II controlled substances"—yes, the IRS means Marijuana dealers–can determine their cost of goods sold. 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.

The IRS guidance (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 § 280E. It prohibits deductions, but not for cost of goods sold.

Most businesses don't *want* to capitalize costs, since claiming an immediate deduction is easier and faster. In the case of marijuana businesses, the incentive is 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 don't deduct wages, rents, or repair expenses attributable to general business activities or marketing activities that are *not* part of cost of goods sold.

2013's proposed Marijuana Tax Equity Act would end the federal prohibition on marijuana and allow it to be taxed–at a whopping 50%. The bill would impose a 50% 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 be an improvement. More recently, Rep. Jared Polis (D-Co.) and Rep. Earl

Blumenauer (D-Or.) have suggested a phased 10% rate here, ramping up to 25% in five years.

For alerts to future tax articles, follow me on Forbes.com. Email me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.