

Hashing Out the Details of Marijuana Tax Law

When your client is excited about the prospect of starting a new marijuana business, it's likely considered a real "buzz-kill" to bring up complicated tax laws. But to avoid costly mistakes in penalties or overpayments, that is exactly what you need to do. Setting up and running a business that is legal at a state level but illegal at a federal level has unique complications when it comes to federal taxes. Add to that the complexity of understanding the many variations of state laws, and tax planning becomes a key step that should be executed early in your client's business planning process ... and with the guidance of a tax professional like you.

The Federal Tax Hit

To be clear, at the federal level the sale of marijuana, or any schedule I or II controlled substance, is still illegal, regardless of state laws. In a bit of contradictory logic, the federal tax law views income from the sale of marijuana as taxable income like any other legal business, but does not allow a marijuana business the same benefits from tax deductions as a legal business. This is because of a 1982 law passed by Congress that bans deductions and tax credits for illegal trafficking of drugs. U.S. tax code section 280E states:

"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."

To avoid constitutional challenges, Congress added an exclusion for cost of goods sold, meaning expenses that fall under the definition of cost of goods sold can still be deducted.

For marijuana resellers, 280E is an expensive piece of tax code. It means resellers can only deduct the cost of getting the marijuana (purchase price and transport to the point of resale). All other standard deductions for the costs of doing business—wages, rent, vehicles, advertising, etc.—are not allowed.

For producers of marijuana, the impact is less significant given a greater percentage of their expenses fall under the "cost of goods sold" umbrella.

How to Minimize the Federal Tax Hit

For resellers who are planning to resell marijuana in addition to other services—care services, counseling, selling other legal merchandise, etc.—there may be an option to minimize the impact of 280E. Careful structuring and accounting of two separate businesses—one that sells marijuana and must abide by 280E, and one that conducts the "legal" portion of the business—can allow a business to continue to recognize standard deductions for the legal portion of the business.

In the 2007 ruling on *Californians Helping to Alleviate Medical Problems, Inc. (CHAMPS) v. Commissioner*, the judge agreed that CHAMPS could separate the legal work they were doing to provide counseling and support services to

their members from the sale of marijuana to their members; and, that only those expenses associated with the sale of marijuana were subject to 280E and could not be deducted.

While *CHAMP v. Commissioner* provides precedent for splitting the legal and illegal portions of a business to limit the impact of 280E, there are other cases where this approach was denied by the courts. It's important to understand upfront what's required for activities to be considered reasonably separate and ensure the business structure and accounting is executed accordingly. Again, tax planning needs to be considered early and often ... and with the help of a tax professional.

Now, Let's Look at State Tax Laws

As of year-end 2018, there were only 17 states where marijuana was still fully illegal. The other 33 states vary from legalizing marijuana only for medical purposes to full legalization. As the laws regarding legalization vary by state, so do the tax requirements.

While you would expect that any states legalizing the sale of marijuana would apply their standard sales tax, some apply additional sales tax rates above the standard rates. In Washington, for example, the sale of marijuana is charged a 37 percent sales tax rate in addition to the standard sales tax. In Oregon, where there is no sales tax on general goods, marijuana sales are charged 17 percent sales tax.

In addition to higher sales tax rates, marijuana businesses are being subjected to a number of other state taxes. Some states are levying excise taxes on producers, cultivation taxes on cultivators and different types of licensing and reporting requirements for marijuana businesses. Since marijuana taxes differ greatly by state it would be impossible to cover all of them here. But suffice it to say, there is enough complication and variation that working with your client to ensure they understand the specific tax and licensing requirements of their state is key to ensuring accurate business planning.

Summing It Up

Starting a marijuana business can be a fun and lucrative venture. Unfortunately, there is no way around the messy business of taxes and tax law. Working jointly (my last pun, I promise) with your client each step of the way, from building the business plan to setting up the business to preparing for tax time, is key to making sure the full value of the opportunity is realized.

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