

ANALYSIS OF AMENDED BILL

Author: Gipson Analyst: Janet Jennings Bill Number: AB 567
 See Legislative
 Related Bills: History Telephone: 845-3495 Amended Date: September 4, 2015
 Attorney: Bruce Langston Sponsor _____

SUBJECT:	Medical Cannabis Tax Amnesty
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SUMMARY

This bill would require the Franchise Tax Board (FTB), the Board of Equalization, and the Employment Development Department to conduct a tax penalty amnesty program for medical cannabis-related businesses.

This analysis only addresses the provisions of the bill that would affect the FTB’s programs and operations.

RECOMMENDATION

No position.

Summary of Amendments

The September 4, 2015, amendments removed provisions of the bill relating to property taxation, and replaced them with the provisions discussed in this analysis. This is the department’s first analysis of the bill.

REASON FOR THE BILL

The reason for the bill is to encourage medical marijuana dispensaries to come forward and begin to comply with the state’s tax laws.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2017, and would be specifically operative during the period beginning April 1, 2016, through September 30, 2016, or during a timeframe ending no later than December 31, 2016. The program would apply to tax liabilities for taxable years beginning before January 1, 2014.

FEDERAL LAW

Under [Internal Revenue Code \(IRC\) section 280E](#), no deduction or credit is 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.

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The Controlled Substance Act that was adopted in 1970 lists marijuana as a schedule 1 controlled substance.

Therefore, a business that sells marijuana, even if for medical reasons, cannot deduct necessary and ordinary business expenses like a normal business, but is required to pay federal income taxes on their earnings at the federal level. However, a deduction for cost of goods sold is allowed.

STATE LAW

The treatment of income and expenses from the sale of marijuana under state law differs depending on whether the sale/expenses fall under the Personal Income Tax Law (individuals, partnerships) vs. Corporation Tax Law (including statutory cooperatives).

Personal Income Tax Treatment

California conforms to IRC section 280E.¹ Therefore, California follows federal treatment with respect to personal income tax treatment of medical marijuana dispensaries.

State law² provides that no deductions (including deductions for cost of goods sold) are be allowed to any taxpayer on any of his or her gross income directly derived from illegal activities, but only if the taxpayer was determined to be engaged in criminal profiteering, as defined in Section 186.2 of the Penal Code or in an act or omission of criminal activity enumerated in Revenue and Taxation Code(R&TC) section 17282(a). Those activities include drug trafficking. For this limitation to apply, current law expressly provides that a taxpayer must be found to be engaged in these activities through a final determination in a criminal proceeding, or a proceeding in which the state, county, city or other political subdivision was a party.

Corporate Income Tax Treatment

For corporations, including statutory cooperatives, California has stand-alone law; the automatic denial of deductions under IRC sec. 280E does not apply as it does for personal income tax. An entity taxed as a corporation under Corporation Tax Law involved in the medical marijuana activity is allowed to deduct its necessary and ordinary business expenses³ and cost of goods sold⁴ assuming the entity has adequate records to substantiate these items.

However, state law⁵ provides that no deductions (including deductions for cost of goods sold) are allowed to any taxpayer on any of his or her gross income directly derived from illegal activities, but only if the taxpayer was determined to be engaged in criminal profiteering, as defined in Section 186.2 of the Penal Code or in an act or omission of criminal activity enumerated in R&TC section

¹ R&TC section [17201\(c\)](#).

² R&TC section [17282](#).

³ R&TC section [24343](#).

⁴ R&TC section [24271](#).

⁵ R&TC section [24436.1](#).

24436.1(a). Those activities include drug trafficking. For this limitation to apply, current law expressly provides that a taxpayer must be found to be engaged in these activities through a final determination in a criminal proceeding, or a proceeding in which the state, county, city or other political subdivision was a party.

THIS BILL

This bill would require the FTB to develop and administer a tax-penalty amnesty (amnesty) program for qualified taxpayers.

The bill would provide the following definitions:

- “Amnesty period” means the period during which the tax penalty amnesty program is conducted.
- A “qualified taxpayer” means a taxpayer with unreported income from a medical cannabis-related business that is subject to taxes administered by the FTB.
- A “medical cannabis-related business” means a person that engages in the sale of cannabis for medical purposes to qualified patients or the primary caregivers of qualified patients pursuant to the Compassionate Use Act of 1996, or the Medical Marijuana Program.⁶

A qualified taxpayer would be required during the amnesty period to file an application for tax penalty amnesty and, within 60 days after the conclusion of the amnesty period, do all of the following:

- File completed tax returns for all years for which the qualified taxpayer has not previously filed a tax return and file completed amended return for all years for which the qualified taxpayer underreported the qualified taxpayer’s income.
- Pay in full any taxes and interest due or any taxes and interest proposed to be assessed for each taxable year for which amnesty is requested; or applies for an installment payment agreement. With respect to installment payment agreements, the FTB would be allowed to enter into an installment payment agreement that includes interest on the outstanding amount due. Failure by the qualified taxpayer to fully comply with the terms of an installment payment agreement would render the waiver of penalties and fees null and void, unless the FTB determines that the failure was due to reasonable cause and not due to willful neglect; and, in the case of any such failure, the total amount of tax, interest, fees and all penalties would become immediately due and payable.

The amnesty application would be in the form and manner specified by the FTB, but in no case would a mere payment of any taxes and interest due with respect to the amnesty be deemed to constitute an acceptable amnesty application.

⁶ Beginning on January 1, 2004, the Medical Marijuana Program Act sets possession guidelines for cardholders, and recognizes a qualified right to "collective and cooperative cultivation" of medical marijuana.

Upon the conclusion of the amnesty period, the FTB would be allowed to propose a deficiency assessment upon any return filed during the amnesty period, impose penalties and fines, or initiate criminal action with respect to the difference between the amount shown on that return and the correct amount of tax. This action would not invalidate any waivers previously granted under the amnesty program.

All revenues from the proposed amnesty would be deposited into the Personal Income Tax Fund⁷ or Bank and Corporation Fund⁸, as applicable.

For any qualified taxpayer that meets the amnesty requirements discussed above, both of the following would apply:

- The FTB would waive all unpaid penalties and fees imposed for each taxable year for which tax penalty amnesty is allowed, but only to the extent of the amount of any penalty or fee that is owed as a result of previous nonreporting or underreporting of tax liabilities or nonpayment of any taxes previously assessed.
- No criminal action could be brought against the qualified taxpayer for each taxable year for which tax penalty amnesty is allowed for the nonreporting or underreporting of tax liabilities or the nonpayment of any taxes previously assessed or proposed to be assessed.

Tax amnesty would not apply to violations, as of the first day of the amnesty period, either of the following apply:

- The qualified taxpayer is on notice of a criminal investigation by a complaint having been filed against the qualified taxpayer or by written notice having been mailed to the qualified taxpayer.
- A court proceeding had already been initiated.

No refund or credit would be granted with respect to any penalty or fee paid with respect to a taxable year prior to the time the qualified taxpayer makes a request for tax penalty amnesty. In addition, a qualified taxpayer could not file a claim for refund or credit for any amounts paid in connection with the tax penalty amnesty program.

⁷ R&TC section [19602](#).

⁸ R&TC section [19604](#).

Regardless of any other law, a licensing authority would be required to revoke or refuse to issue, reinstate, or renew a state or local license⁹ of a qualified taxpayer that is eligible to participate in the amnesty program but does not participate in the amnesty program, and that either fails to file returns with the FTB or reports a gross understatement of tax.¹⁰ Revocation or refusal to issue, reinstate, or renew a state or local license would not be effective unless the licensing agency, at least 60 days before the date of revocation or refusal, mails a notice to the qualified taxpayer that indicates that the license would be refused or revoked by that date.

The FTB would be allowed to issue forms, instructions, notices, rules, or guidelines, and take any other necessary actions needed to implement the amnesty program, specifically including any forms, instructions, notices, rules, or guidelines that specify the form and manner of any acceptable form of the amnesty application.

This bill would exempt the FTB's standards, criteria, procedures, determinations, rules, notices, or guidelines from the requirements of the Administrative Procedure Act.

The FTB would be required to conduct a public outreach program and adequately publicize the amnesty program in order to maximize public awareness and make qualified taxpayers aware of the amnesty program. The FTB would be required to coordinate to the highest degree possible its publicity efforts and other actions taken in implementing the amnesty program.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

A licensing authority would need to know if a qualified taxpayer fails to file returns with the FTB or reports a gross understatement of tax. The bill lacks the specific authority necessary for the FTB to disclose confidential tax information to a "licensing authority." In addition, the licensing authority provision lacks a process for protesting a proposed licensing sanction, which could lead to due process disputes or litigation with taxpayers.

The bill lacks some provisions historically included in amnesty programs such as including a specific date for installment agreements from the amnesty program to be paid in full or a provision that would allow additional time for the processing of returns before an overpayment would accrue interest.

⁹ A state or local license would include a license issued for any activity of cannabis-related businesses or a California drivers' license.

¹⁰ A gross understatement of tax would mean a deficiency that is in excess of 25 percent of the amount of tax reported on a qualified taxpayer's return.

The bill contains terms and definitions that would be unclear and inconsistent with terminology generally used for income and franchise tax purposes. For example, the bill uses the term “person” in places where the more appropriate term would be “taxpayer.” And, the bill would define a “qualified taxpayer” to mean a taxpayer with “unreported” income; however, the bill would also provide for a state or local license to be revoked, or be refused to be issued, reinstated, or renewed, for “underreporting” of income. Thus, if a cooperative underreports income, they would not meet the definition of a qualified taxpayer if some income was reported.

TECHNICAL CONSIDERATIONS

Department staff has identified the following technical considerations. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

- The operative date should be updated to apply to the period beginning April 1, 2017, through September 30, 2017, or during a timeframe ending no later than December 31, 2017.
- For consistency the term "medical" should appear before "cannabis-related business" throughout the bill.
- The bill’s provision that requires a licensing authority to revoke, refuse to issue, reinstate or renew a state or local license would be added to the Revenue and Taxation Code. The authority would be better placed in the Vehicle and Business and Professions Codes that regulate these actions.

LEGISLATIVE HISTORY

AB 243 (Wood, Chapter 688, Statutes of 2015) among other things, authorized specified state agencies to promulgate regulations or standards relating to medical marijuana and its cultivation.

AB 266 (Bonta, Chapter 689, Statutes of 2015) among other things, enacted the Medical Marijuana Regulation and Safety Act for the licensure and regulation of medical marijuana business and establishment of the Bureau of Medical Marijuana Regulation, under the supervision and control of the Director of Consumer Affairs.

SB 643 (McGuire, Chapter 719, Statutes of 2015) among other things, granted the Department of Consumer Affairs sole authority to establish and administer the licensing of entities operating a medical marijuana business.

SB 1100 (Senate Budget Committee, Chapter 226, Statutes of 2004), among other things, established a general tax penalty amnesty program for individuals and corporations.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. A review of these states' laws found that four of these states have enacted medical marijuana statutes: Michigan in 2008, Massachusetts in 2013, and Illinois, Minnesota, and New York in 2014. None of the states reviewed was found to have conducted a tax penalty amnesty similar to the one proposed by this bill.

FISCAL IMPACT

This bill would impact the department's printing, processing and programming, and education and outreach costs. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Department staff is unable to determine the economic impact for this bill until the operative date has been amended.

SUPPORT/OPPOSITION¹¹

Support: None on file.

Opposition: None on file.

ARGUMENTS

Proponents: Some could argue that this bill would encourage medical marijuana cooperatives to comply with the state's tax laws.

Opponents: Some could argue an additional amnesty specific to the cannabis business may create cynicism among law-abiding taxpayers who will see tax debtors benefiting from recurring noncompliance and encourage noncompliance as taxpayers wait for the next amnesty.

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¹¹ No support or opposition has been recorded as related to the September 4, 2015, amendments.