



## **Analysis of Original Bill**

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Sponsor:

Bill Number: AB 1863

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Related Bills: See Legislative  
History

**Subject:** Personal Income Tax Deduction Related to Commercial Cannabis Activities

### **Summary**

This bill would, under the Personal Income Tax Law (PITL), repeal the prohibition on deducting ordinary and necessary business expenses attributable to commercial cannabis activity.

**Recommendation – No position.**

### **Reason for the Bill**

The reason for the bill is to create taxpayer equality among taxpayers subject to the Corporation Tax Law (CTL) and the PITL by allowing those taxpayers subject to the PITL to deduct their ordinary and necessary business expenses related to licensed commercial cannabis activities.

### **Effective/Operative Date**

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2019.

### **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](#)) that is prohibited by federal law or the law of any state in which such trade or business is conducted.

The Controlled Substances Act as adopted in 1970 lists cannabis as a schedule 1 controlled substance.

Therefore, a business that sells cannabis is barred from deducting what would otherwise be ordinary and necessary business expenses and may only deduct costs of goods sold in determining taxable income.

## State Law

The treatment of income and ordinary and necessary business expenses from the commercial cannabis activities under state law differs depending on whether the taxpayer is subject to the PITL or CTL.

### Personal Income Tax Treatment

California's PITL conforms to IRC section 280E.<sup>1</sup> Therefore, California follows federal treatment with respect to personal income tax treatment of cannabis sales.

State law<sup>2</sup> 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 any illegal activity, 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). Any such activity includes drug trafficking. For this limitation to apply, current law expressly provides that a taxpayer must be found to be engaged in such activity through a final determination in a criminal proceeding, or a proceeding in which the state, county, city and county, city or other political subdivision was a party.

### Corporate Franchise and Income Tax Treatment

For corporations, including statutory cooperatives, California has stand-alone law; the automatic denial of deductions under IRC section 280E does not apply as it does for personal income tax. An entity taxed as a corporation under the CTL that is involved in commercial cannabis activities is allowed to deduct its necessary and ordinary business expenses<sup>3</sup> and cost of goods sold,<sup>4</sup> assuming the entity has adequate records to substantiate these items.

However, state law<sup>5</sup> 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 any illegal activity, 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 24436.1(a). Any such activity includes drug trafficking. For this limitation to apply, current law expressly provides that a taxpayer must be found to be engaged in such activity through a final determination in a criminal proceeding, or a proceeding in which the state, county, city and county, city or other political subdivision was a party.

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<sup>1</sup> R&TC section [17201\(c\)](#).

<sup>2</sup> R&TC section [17282](#).

<sup>3</sup> R&TC section [24343](#).

<sup>4</sup> R&TC section [24271](#).

<sup>5</sup> R&TC section [24436.1](#).

## **This Bill**

This bill would allow taxpayers subject to the PITL to deduct ordinary and necessary business expenses related to a trade or business that is a commercial cannabis activity, as defined in Division 10 of the Business and Professions Code.

## **Implementation Considerations**

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

## **Legislative History**

AB 420 (Wood, et. al. 2017/2018) is substantially similar to this bill. AB 420 is currently in the Senate Committee on Appropriations.

## **Other States' Information**

Review of *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws found no comparable deduction. These states were selected and reviewed due to their similarities to California's economy, business entity types, and tax laws.

## **Fiscal Impact**

This bill would not significantly impact the department's costs.

## **Economic Impact**

### Revenue Estimate

This bill as introduced on January 11, 2018, would have a revenue impact on the general fund, but the amount is unknown.

## **Revenue Discussion**

Absent the availability of Franchise Tax Board data, the department identified a review article issued by University of California Agricultural Issues Centers (AIC) that examined six different studies on the cannabis market and its potential market size. The AIC review article indicated that the commercial cannabis activities market could be valued between \$4 and \$11 billion in California.

Although, the form of business ownership for tax years beginning on or after January 1, 2019, is unknown, for purposes of this estimate, it is assumed that these entities would operate under the PITL, e.g., a sole proprietorship or partnership. Using income and expense data in the AIC report, it is assumed that ordinary and necessary business expenses would be approximately 20 percent of sales. As a result, every \$1 billion in retail market sales would result in an estimated additional \$200 million in deductions claimed resulting in an estimated revenue loss of \$13 million per \$1 billion in PITL retail sales.

## **Support/Opposition**

Support: None provided.

Opposition: None provided.

## **Arguments**

Proponents: Some may argue that this bill would encourage transparency in the state's cannabis industry by providing equitable tax treatment under the PITL and CTL to taxpayers engaged in a legal activity in this state.

Opponents: Some may argue that activities defined as illegal by the federal government should be ineligible for any state tax benefits, including the deduction for ordinary and necessary business expenses.

## **Policy Concerns**

This bill would be operative for taxable years beginning on or after January 1, 2019. However, California's Adult-Use Marijuana Act became operative as of January 1, 2018. To allow those business that began in 2018, to deduct their expenses, the author may wish to amend the bill to be operative to tax returns due on and after January 1, 2018.

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