



Bill Analysis

Author: Jones-Sawyer, et al. Bill Number: AB 1863

Subject: Personal Income Tax Deduction Related to Commercial Cannabis Activities

Summary

This bill would, under the Personal Income Tax Law (PITL), allow the deduction of ordinary and necessary business expenses attributable to a licensee's commercial cannabis activity.

Reason for the Bill

This bill would, under the PITL, allow a licensee to deduct ordinary and necessary business expenses related to a trade or business that is a commercial cannabis activity. The bill would define "commercial cannabis activity" and "licensee" as having the same meanings as set forth in Division 10 (commencing with Section 26000) of the Business and Professions Code.

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, 2018.

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 Corporation Tax Law (CTL).

Personal Income Tax Treatment

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

State law² 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 expenses³ and cost of goods sold,⁴ 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 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.

This Bill

This bill would, under the PITL, allow a licensee to deduct ordinary and necessary business expenses related to a trade or business that is a commercial cannabis activity. The bill would define "commercial cannabis activity" and "licensee" as having the same meanings as set forth in Division 10 (commencing with Section 26000) of the Business and Professions Code.

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 244361.1.

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

This bill as amended on May 8, 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 the 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 billion and \$11 billion in California.

Although the form of business ownership for tax years beginning on or after January 1, 2018, 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.

Appointments

None.

Support/Opposition⁶

Support: California Cannabis Industry Association (Sponsor); California Asian Pacific Chamber of Commerce; Rural County Representatives of California; United Cannabis Business Association; Southern California Coalition; Drug Policy Alliance; San Francisco Chamber of Commerce; WeDrop; and CMG/Caliva.

Opposition: None provided.

Votes

Location	Date	Yes Votes	No Votes
Senate Floor	August 21, 2018	29	6
Assembly Floor	May 29, 2018	64	11

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⁶ According to the August 6, 2018, Senate Governance and Finance committee analysis.