

ANALYSIS OF AMENDED BILL

Author: Wood, et al. Analyst: Jessica Deitchman Bill Number: AB 420
Related Bills: See Legislative History Telephone: 845-6310 Amended Date: June 13, 2017
Attorney: Bruce Langston Sponsor: _____

SUBJECT: Personal Income Tax Deduction Related to Commercial Cannabis or Marijuana 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 or marijuana activity.

RECOMMENDATION – NO POSITION**Summary of Amendments**

The June 13, 2017, amendments removed the provisions related to medical cannabis and marijuana advertisements and license number disclosure 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 create taxpayer equality among taxpayers subject to the Corporation Tax Law (CTL) and the PITL by allowing taxpayers subject to the PITL to deduct their ordinary and necessary business expenses related to legal commercial cannabis or marijuana activities.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2017.

FEDERAL LAW

Generally, current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business, unless specifically excluded by statute.

Additionally, taxpayers can deduct their cost of goods sold (inventory costs, and labor) from their total income for all trades or businesses.

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](#), prohibited by Federal law or the law of any State in which such trade or business is conducted.

The Controlled Substances Act adopted in 1970 lists marijuana as a schedule I controlled substance.

Therefore, a taxpayer engaged in the trade or business of marijuana sales, regardless of the buyer's medical or recreational purpose, computes their taxable income as gross receipts less the cost of the marijuana sold.

STATE LAW

The treatment of income and expenses from the sale of marijuana under state law differs depending on whether the taxpayer is subject to the PITL or the CTL.

Under the "Adult Use of Marijuana Act"¹ (AUMA), beginning January 1, 2018, all entity types are eligible to receive a license and operate a trade or business that is described as commercial cannabis activities.

Personal Income Tax Treatment

Generally under the PITL, state law² follows federal tax treatment (under IRC section 280E³) that disallows deductions (including deductions for cost of goods sold) 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 specified 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, 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 the medical marijuana activity may deduct ordinary and necessary business expenses⁴ and cost of goods sold,⁵ assuming the entity has adequate records to substantiate these items.

¹ Proposition 64, November 9, 2016.

² R&TC section [17282](#).

³ R&TC section [17201\(c\)](#).

⁴ R&TC section [24343](#).

⁵ R&TC section [24271](#).

However, state law⁶ 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 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 allow taxpayers subject to the PITL to deduct ordinary and necessary business expenses related to a trade or business that is commercial cannabis activity, as defined in subdivision (j) of Section 19300.5 of the Business and Professions Code, or commercial marijuana activity, as defined in subdivision (d) of Section 26001 of the Business and Professions Code, or both.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concern. Department staff is available to work with the author's office to resolve this and other concerns that may be identified.

This bill would be operative for taxable years beginning on or after January 1, 2017. However, California's AUMA is not expected to be operative until January 1, 2018. It is recommended the bill be amended to not disallow these deductions for taxable years beginning on or after January 1, 2018.

LEGISLATIVE HISTORY

Research of California legislation found no legislation similar to the provisions of this bill.

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.

⁶ R&TC section [24436.1](#).

ECONOMIC IMPACT

Revenue Estimate

This bill, as amended June 13, 2017, would have a revenue impact on the general fund, but the amount is unknown.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This bill would become operative on January 1, 2017. However, this estimate assumes the impact would occur after January 1, 2018, when the AUMA becomes operative.

Absent the availability of FTB 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 article⁷ indicated that the retail cannabis 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, 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 \$12 million per \$1 billion in PITL retail sales.

POLICY CONCERNS

This bill would require a taxpayer who files under the PITL to have a license, as specified, under the Business and Professions Code. However, a taxpayer who files under existing CTL is not required to be licensed under AUMA in the Business and Professions Code. Therefore, this bill would treat taxpayers differently based on their business status.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

⁷ University of California Agricultural Issues Center (2017), Economic Costs and Benefits of Proposed Regulations for the Implementation of the Medical Cannabis Regulation and Safety Act (MCRSA). Prepared for the Bureau of Marijuana Control.

ARGUMENTS

Proponents: Some may argue that this bill would create equitable treatment among similarly situated taxpayers by allowing taxpayers subject to the PITL to deduct ordinary and necessary business expenses related to commercial cannabis or marijuana activities.

Opponents: Some may argue that those taxpayers subject to the PITL should be excluded from deducting sales relating to the sale of any drugs because it is illegal at the federal level.

LEGISLATIVE STAFF CONTACT

Jessica Deitchman
Legislative Analyst, FTB
(916) 845-6310

jessica.deitchman@ftb.ca.gov

Jame Eiserman
Revenue Manager, FTB
(916) 845-7484

jame.eiserman@ftb.ca.gov

Diane Deatherage
Legislative Director, FTB
(916) 845-6333

diane.deatherage@ftb.ca.gov