HB 845

Department of Legislative Services

Maryland General Assembly
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FISCAL AND POLICY NOTE
First Reader

House Bill 845 (Delegate Queen, *et al.*)

Ways and Means and Health and Government Operations

Income Tax – Subtraction Modification – Expenses of Medical Cannabis Grower, Processor, or Dispensary

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This bill creates a subtraction modification against the State individual and corporate income tax for the amount of ordinary and necessary expenses, including a reasonable allowance for salaries or compensation, paid or incurred during the taxable year in carrying on a trade or business as a State licensed medical cannabis grower, processor, or dispensary if the deduction for ordinary and necessary expenses is disallowed under Section 280E of the Internal Revenue Code (IRC). **The bill takes effect July 1, 2018, and applies to tax year 2018 and beyond.**

Fiscal Summary

State Effect: General fund revenues decrease by approximately $646,000 in FY 2019. Future year revenue decreases reflect projected increases in medical cannabis sales. General fund expenditures increase by $139,000 in FY 2019 due to one-time implementation costs at the Comptroller's Office.

($ in millions)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
GF Revenue	($0.6)	($1.0)	($1.9)	($3.2)	($3.9)
GF Expenditure	$0.1	$0	$0	$0	$0
Net Effect	($0.8)	($1.0)	($1.9)	($3.2)	($3.9)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate increase; (-) = indeterminate decrease

Local Effect: Local income tax revenues decrease by approximately $408,000 in FY 2019 and by $2.5 million in FY 2023. Local expenditures are not affected.

Small Business Effect: Meaningful. Small businesses that are State licensed medical cannabis growers, processors, or dispensaries benefit from the subtraction modification.

Analysis

Current Law: No similar State subtraction modification or tax credit exists.

Generally, income from any source is presumptively taxable by the federal government, even if such income is generated from illegal activity. Thus, though a marijuana business is illegal under federal law, it must still pay federal income tax on its taxable income. Businesses may generally deduct business expenses as ordinary and necessary business expenses on their federal income tax return, which typically results in a lower federal and State income tax liability. However, a marijuana business is prohibited from deducting ordinary and necessary business expenses because IRC § 280E states that no expenses incurred in connection with the trafficking of controlled substances, or illegal drugs, may be deducted for federal income tax purposes.

While a medical marijuana business is not allowed to deduct ordinary and necessary business expenses, it is able to deduct the costs of goods sold (COGS), which are the direct costs attributable to the production of a good, including the cost of materials and direct labor. COGS typically account for between 70% and 85% of the expenses related to the operation of a medical marijuana retail facility, and COGS for cannabis growers and cannabis production facilities tend to make up an even greater percentage.

Background: Taxpayers have attempted to argue the inapplicability of IRC § 280E due to the activity being allowed under state statutes. The Tax Court held in *M. Olive*, 139 TC 19, 38, Dec. 59,146 (2012): "The dispensing of medical marijuana, while legal in California (among other States), is illegal under federal law. Congress in section 280E has set an illegality under federal law as one trigger to preclude a taxpayer from deducting expenses incurred in a medical marijuana dispensary business. This is true even if the business is legal under state law."

Federal legislation has been introduced in Congress in recent years to amend the IRC to exempt a trade or business that conducts marijuana sales in compliance with state law from the prohibition against allowing business-related tax credits or deductions for expenditures in connection with trafficking in controlled substances.

See the **Medical Cannabis Appendix** for information on Maryland's medical cannabis program.

State Revenues: Subtraction modifications may be claimed beginning in tax year 2018. As a result, general fund revenues will decrease by an estimated $646,000 in fiscal 2019. **Exhibit 1** shows the estimated impact of the bill on State and local revenues. There is no historical data on the size of the medical cannabis market in Maryland since medical cannabis in the State was not available for sale until December 2017. Thus, this estimate is based on projected medical cannabis sales in Maryland being $34 million in tax year 2018 and reaching over $400 million by 2023. This estimate also assumes ordinary business expenses are 20% of sales and that a taxpayer has sufficient tax liability to benefit from the subtraction modification. To the extent that a taxpayer does not have sufficient tax liability to benefit from taking the subtraction modification, revenue losses will be less. Most of the pre-approved license holders are limited liability corporations, so it is assumed that taxpayers will claim the subtraction modification against the individual income tax. However, to the extent that the taxpayers are corporations, Transportation Trust Fund and Higher Education Investment Fund revenues would also decrease beginning in fiscal 2019.

Exhibit 1
State and Local Revenue Impacts
Fiscal 2019-2023

	2019	2020	2021	2022	2023
State	($646,000)	($969,000)	($1,938,000)	($3,192,000)	($3,947,250)
Local	(408,000)	(612,000)	(1,224,000)	(2,016,000)	(2,493,000)
Total Revenues	**($1,054,000)**	**($1,581,000)**	**($3,162,000)**	**($5,208,000)**	**($6,440,250)**

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $139,000 in fiscal 2019 to add the subtraction modification to the personal and corporate income tax returns. This includes data processing changes to the SMART income tax return processing and imaging systems and system testing.

Local Revenues: Local income tax revenues decrease by about 3% of the total net State subtraction modifications claimed against the personal income tax beginning in fiscal 2019. Local revenues will decrease by approximately $408,000 in fiscal 2019 and by $2.5 million in fiscal 2023, as shown in Exhibit 1. To the extent that subtraction modifications are claimed against the corporate income tax, local highway user revenues decrease beginning in fiscal 2019.

Small Business Effect: The Maryland Medical Cannabis Commission has issued 15 pre-approvals to companies to grow medical cannabis, 15 pre-approvals to companies to process medical cannabis, and 102 pre-approvals to companies to dispense medical cannabis. As of December 2017, final licenses have been issued for 14 growers, 12 processors, and 22 dispensaries by year-end 2017. These businesses could benefit from being able to take the subtraction modification.

Additional Information

Prior Introductions: None.

Cross File: SB 37 (Senator Young) - Budget and Taxation.

Information Source(s): Comptroller's Office; Maryland Department of Health; Maryland Medical Cannabis Commission; the Maryland Bar Journal; *Baltimore Sun*; CCH Intelliconnect; Department of Legislative Services

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Appendix – Medical Cannabis

Natalie M. LaPrade Medical Cannabis Commission

The Natalie M. LaPrade Medical Cannabis Commission is responsible for implementation of the State's medical cannabis program, which is intended to make medical cannabis available to qualifying patients in a safe and effective manner. The program allows for the licensure of growers, processors, and dispensaries and the registration of their agents, as well as registration of independent testing laboratories and their agents. There is a framework to certify health care providers (including physicians, dentists, podiatrists, nurse practitioners, and nurse midwives), qualifying patients, and their caregivers to provide qualifying patients with medical cannabis legally under State law via written certification.

Medical cannabis may only be obtained from a grower or dispensary licensed by the commission, and the commission may license no more than 15 growers. However, beginning June 1, 2018, the commission may issue the number of grower licenses necessary to meet demand for medical cannabis by qualifying patients and caregivers in an affordable, accessible, secure, and efficient manner. There is no established limit on the number of processor licenses in statute or regulation, but the commission chose to limit the initial number to 15. While there is no specific restriction on the number of dispensaries in statute, regulations set a limit of 2 dispensary licenses per senatorial district or up to 94 dispensary licenses statewide.

License Application Process

The commission is required to actively seek to achieve racial, ethnic, and geographic diversity when licensing growers and to encourage such applicants who qualify as a minority business enterprise (MBE). There is no requirement for the commission to seek to achieve racial, ethnic, and geographic diversity when licensing processors, but there is such a statutory requirement for dispensaries. There is no requirement to encourage applicants who qualify as an MBE for either processor or dispensary licenses.

The commission opened applications for grower, processor, and dispensary licenses in September 2015. Towson University's Regional Economic Studies Institute (RESI) was commissioned to review grower and processor applications through a double-blind review process in which all identifying information was redacted. The scoring system authorized the commission to take into account the geographic location of the growing operation to ensure geographic diversity in the award of licenses. The scoring system did not include a consideration of race, based on a letter from the Office of the Attorney General stating that constitutional limits prohibited the consideration of race or ethnicity for licensing when there is no disparity study that indicates past discrimination in similar programs.

In August 2016, the commission announced the 15 growers and 15 processors who were awarded Stage One license pre-approvals. The evaluation procedures to be used in the award of dispensary licenses were adopted by the commission in November 2016, and the commission announced 102 dispensaries who were awarded Stage One license pre-approvals in December 2016 (this number included 10 pre-approvals issued to applicants who also received grower license pre-approvals). All of the Stage One pre-approvals awarded in 2016 have 365 days from the date of pre-approval notification to complete all necessary steps to obtain final licensure. Should an awardee fail to do so, the commission has the authority to not issue a final license.

Controversy Over Geographic, Racial, and Ethnic Diversity

Since the award announcements, there has been significant controversy surrounding two main issues: the decision to include geographic diversity as a final factor in choosing the grower finalists; and the fact that none of the 15 Stage One approved grower finalists is led by minorities.

Geographic diversity became an issue when two companies among the top 15 ranked growers did not receive pre-approval after being replaced by other companies in order to provide geographic representation throughout the State. In July 2016, a subcommittee of the commission unanimously voted to preliminarily approve the top 15 growers based on the RESI scoring, which did not include a consideration of location. Afterward, the subcommittee reversed its vote, which resulted in two lower-ranked firms being moved into the top 15 growers in order to achieve geographic diversity. The two companies that were initially included in the top 15 growers but later removed are suing the commission, claiming that the determination of how geographic diversity was to be considered was unclear to applicants. In addition, none of the top 15 growers is minority owned, which prompted a lawsuit by an African American-owned company that was denied a grower license seeking to halt the medical cannabis program until the commission takes action to ensure racial and ethnic diversity among licensed growers.

A number of bills relating to the composition of the commission and the number of grower and processor licenses, as well as licensing criteria and the approval process, were introduced during the 2017 legislative session. However, none of these bills passed.

In April 2017, Governor Lawrence J. Hogan directed the then Governor's Office of Minority Affairs to initiate a disparity study of Maryland's regulated medical cannabis industry to be conducted by the Maryland Department of Transportation (MDOT) in cooperation with the commission. According to MDOT, the study is underway, and will be completed by early 2018. Additionally, in July 2017, Governor Hogan announced nine new appointments to the commission; of these, three appointments filled vacancies, and six replaced commissioners whose terms had expired. As a result of these appointments, minority representation on the commission doubled.

The chair of the commission has stated that the commission is committed to seeking and promoting racial diversity and minority inclusion and will continue to work with the legislature to help solve these complex problems, but it does not want to further delay the program. At its October 3, 2017 meeting, the commission announced that, as a result of discussions with the Legislative Black Caucus, it intended to form a minority affairs subcommittee to help address some caucus concerns; this committee has since been formed.

Status of Medical Cannabis Implementation

As detailed in its annual report, the commission had issued final licenses for 14 growers, 12 processors, and 22 dispensaries by year-end 2017. Additionally, the commission had approved one-year provisional registrations for four independent testing laboratories. The commission maintains a list of licensees on its website, which can be found at http://mmcc.maryland.gov/Pages/industry.aspx. The first medical cannabis in the State was available for sale in late 2017, and at least seven dispensaries planned to be open for business by January 2018.