

Department of Legislative Services
Maryland General Assembly
2019 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 9 (Senator Young, *et al.*)
Budget and Taxation

**Income Tax - Subtraction Modification - Expenses of Medical Cannabis Grower,
Processor, Dispensary, or Independent Testing Laboratory**

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 or a State registered independent testing laboratory 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, 2019, and applies to tax year 2019 and beyond.**

Fiscal Summary

State Effect: General fund revenues decrease by approximately \$3.1 million in FY 2020. Future year revenue decreases reflect projected increases in medical cannabis sales. General fund expenditures increase by \$77,000 in FY 2020 due to one-time implementation costs at the Comptroller's Office.

(\$ in millions)	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024
GF Revenue	(\$3.1)	(\$2.8)	(\$3.3)	(\$3.6)	(\$4.0)
GF Expenditure	\$0.1	\$0	\$0	\$0	\$0
Net Effect	(\$3.1)	(\$2.8)	(\$3.3)	(\$3.6)	(\$4.0)

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

Local Effect: Local income tax revenues decrease by approximately \$1.9 million in FY 2020 and by \$2.5 million in FY 2024. Local expenditures are not affected.

Small Business Effect: Meaningful. Small businesses that are State registered independent testing laboratories or 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.

A medical marijuana business is not allowed to deduct ordinary and necessary business expenses, which may include expenses associated with distribution, sales, administration, management, promotion, advertisement, overhead, and support. However, it is able to deduct the costs of goods sold (COGS), which are the direct costs attributable to the production of a good. 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 2019. As a result, general fund revenues will decrease by an estimated \$3.1 million in fiscal 2020. **Exhibit 1** shows the estimated impact of the bill on State and local revenues. Medical cannabis sales totaled over \$96.0 million in 2018, and cannabis sales are expected to grow

as more licenses are issued and the number of patients increases. Thus, this estimate is based on projected medical cannabis sales in Maryland being almost \$250 million in tax year 2020 and reaching over \$440 million by 2024. 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 (TTF) and Higher Education Investment Fund revenues would also decrease beginning in fiscal 2020.

Exhibit 1
State and Local Revenue Impacts
Fiscal 2020-2024

	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>
State	(\$3,067,700)	(\$2,753,100)	(\$3,303,700)	(\$3,634,100)	(\$3,997,500)
Local	(1,937,500)	(1,738,800)	(2,086,600)	(2,295,200)	(2,524,700)
Total Revenues	(\$5,005,200)	(\$4,491,900)	(\$5,390,300)	(\$5,929,300)	(\$6,522,200)

State Expenditures: The Comptroller’s Office reports that it will incur a one-time expenditure increase of \$77,000 in fiscal 2020 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.

A portion of TTF revenues are used to provide capital transportation grants to local governments. To the extent that TTF revenues decrease as a result of taxpayers claiming the subtraction modification against the corporate income tax, TTF expenditures decrease by 13.5% of the TTF revenue decrease.

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 2020. Local revenues will decrease by approximately \$1.9 million in fiscal 2020 and by \$2.5 million in fiscal 2024, 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 2020.

Small Business Effect: As of January 2019, the Maryland Medical Cannabis Commission has issued final licenses for 15 growers, 16 processors, and 71 dispensaries and has

registered 5 independent laboratories. Additionally, the commission has pre-approved licenses for 3 growers, 2 processors, and 31 dispensaries. These businesses could benefit from being able to take the subtraction modification.

Additional Information

Prior Introductions: A similar bill, SB 37 of 2018, received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. Its cross file, HB 845, received a hearing in the House Ways and Means Committee, but no further action was taken.

Cross File: None.

Information Source(s): Comptroller's Office; Maryland Department of Health; Maryland Medical Cannabis Commission; 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. Additionally, recent legislation extended legal protections to third-party vendors authorized by the commission to test, transport, or dispose of medical cannabis, medical cannabis products, and medical cannabis waste. In December 2018, the commission proposed regulations that require registration of secure transportation companies and address the shipment of products between licensees.

Controversy Over Geographic, Racial, and Ethnic Diversity

In August 2016, the commission announced the award of 15 grower and 15 processor Stage One license pre-approvals. In December 2016, the commission announced the award of 102 dispensary Stage One license pre-approvals. After the award announcements, significant controversy involved two main issues: the decision to include geographic diversity as a final factor in choosing the grower finalists and the absence of any minority-led grower among the 15 Stage One approved grower finalists.

Legislation to alter the commission and medical cannabis industry was introduced during the 2017 and 2018 sessions. Chapter 598 of 2018, an emergency bill, made a number of significant reforms including (1) requiring outreach to encourage participation in the medical cannabis industry by small, minority, and women business owners; (2) requiring the commission to promulgate emergency remedial regulations based on the results of a disparity study and delay reviewing, ranking, or evaluating license applications until the regulations are adopted; (3) raising the statutory cap on grower licenses from 15 to 22; (4) establishing a new license cap of 28 processors; and (5) requiring the commission to report to the General Assembly regarding potential rules and regulations governing marketing and advertising practices for licensees by January 1, 2019.

Pursuant to Chapter 598, in December 2018, the commission announced five grant awards to educational and business development organizations to develop medical cannabis

educational and business development training programs. The programs are designed to provide training and assistance to small, minority, and women business owners and entrepreneurs seeking to become licensed in Maryland's medical cannabis industry.

Evaluation of Disparity Study and Conclusions

The disparity study evaluated in accordance with Chapter 598 concluded that there is a compelling interest to implement remedial measures to assist minorities and women seeking to participate in the medical cannabis industry. Based on these findings, the commission submitted emergency regulations in October 2018. The regulations alter the application review process for obtaining a medical cannabis grower, processor, and dispensary license by implementing remedial measures to assist minorities and women in the medical cannabis industry. The regulations also alter the current weighted criteria used when ranking applicants for licenses to include certain race-neutral and race-conscious provisions, addressing the needs of women and minority-owned applicants.

License and Ownership Transfers

Chapter 598 of 2018 also addressed the sale or transfer of ownership for regulated medical cannabis entities. Specifically, a medical cannabis grower, processor, or dispensary license holder may only transfer ownership of a license if the licensee was physically and actively engaged in cultivating, processing, or dispensing medical cannabis for at least two years immediately preceding the sale or transfer. Regulations require licensed growers, processors, and dispensaries to (1) notify the commission of any proposed transfer of 5% or more of an ownership interest; (2) submit criminal history and audited financial information for the potential owner or transferee; (3) obtain written commission approval of the transfer; and (4) pay a transfer fee. Statute prohibits the commission from issuing more than one medical cannabis grower license to each applicant. Regulations specify that license applicants may only have an interest in one of each type of license. In February 2018, the commission issued a [bulletin](#) highlighting rules related to the sale or transfer of a medical cannabis license. The bulletin also addressed third-party management agreements, which some licensees have entered into to allow third parties to contract to operate the licensee's business without possessing an ownership stake.

Status of Medical Cannabis Implementation

As of January 9, 2019, the commission issued 15 final and 3 pre-approved grower licenses; 16 final and 2 pre-approved processor licenses; and 71 final and 31 pre-approved dispensary licenses. Additionally, the commission has registered five independent laboratories. The commission maintains a list of licensees on its [website](#). Furthermore, there were 79,427 registered patients, 54,236 certified patients, 4,890 caregivers, and

1,243 certifying providers. The commission reported that, in the first 13 months of sales, there were \$112.1 million in retail sales at medical cannabis dispensaries in the State.