

Department of Legislative Services
Maryland General Assembly
2020 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 146 (Senators Young and Feldman)
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, 2020, and applies to tax year 2020 and beyond.**

Fiscal Summary

State Effect: General fund, Transportation Trust Fund (TTF), and Higher Education Investment Fund (HEIF) revenues decrease by approximately \$5.0 million in FY 2021. Future year revenue decreases reflect projected increases in medical cannabis sales. General fund expenditures for the Comptroller's Office increase by \$118,000 and TTF expenditures decrease by \$73,700 in FY 2021.

(\$ in millions)	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
GF Revenue	(\$4.2)	(\$3.3)	(\$3.5)	(\$3.6)	(\$3.7)
SF Revenue	(\$0.8)	(\$0.6)	(\$0.6)	(\$0.7)	(\$0.7)
GF Expenditure	\$0.1	\$0	\$0	\$0	\$0
SF Expenditure	(\$0.1)	(\$0.1)	(\$0.1)	(\$0.1)	\$0.0
Net Effect	(\$5.0)	(\$3.9)	(\$4.1)	(\$4.2)	(\$4.3)

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

Local Effect: Local income tax revenues decrease by approximately \$787,000 in FY 2021 and by \$682,000 in FY 2025. Local highway user revenues decrease by \$73,700 in FY 2021 and by \$45,400 in FY 2025. Local expenditures are not affected.

Small Business Effect: Meaningful.

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 challenged the applicability of IRC § 280E due to the activity being allowed under state statutes. The U.S. Tax Court held in *Olive v. Commissioner*, 139 TC 19, 38, (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.

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, there are legal protections for third-party vendors authorized by the commission to test, transport, or dispose of medical cannabis, medical cannabis products, and medical cannabis waste.

Status of Medical Cannabis Implementation

Statute limits the number of grower and processor licenses the commission can issue, and regulations establish a limit on the number of dispensary licenses. Specifically, the commission can issue 22 grower, 28 processor, and 102 dispensary licenses. As of January 2020, the commission had issued 17 final grower licenses; 18 final processor licenses; and 85 final dispensary licenses. Additionally, the commission had registered six independent laboratories. The commission maintains a list of licensees on its [website](#). Furthermore, there were 37,363 registered patients, 88,594 certified patients, 8,003 caregivers, and 1,705 certifying providers. The commission reported that between December 2018 and December 2019 there were \$268.3 million in retail sales at medical cannabis dispensaries in the State.

State Revenues: Subtraction modifications may be claimed beginning in tax year 2020. As a result, general fund revenues decrease by an estimated \$4.2 million, TTF revenues decrease by \$0.5 million, and HEIF revenues decrease by \$0.2 million in fiscal 2021. **Exhibit 1** shows the estimated fiscal impact of the bill on State and local governments.

Medical cannabis sales totaled over \$96.0 million in 2018 and \$252.2 million in 2019. Sales are expected to continue to grow as more licenses are issued and the number of patients increases. Thus, this estimate projects Maryland medical cannabis sales of approximately \$390 million in tax year 2021 and almost \$460 million by 2025. 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 some taxpayers do not have sufficient tax liability, revenue losses will be less. Most medical cannabis license holders are limited liability corporations, thus they generally may elect to be classified as a corporation or a partnership. This estimate assumes that one-quarter of all subtraction modifications are deducted against the personal income tax, with the remaining amount deducted against the corporate income tax.

Exhibit 1
State and Local Revenues
Fiscal 2021-2025

	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>
<u>State Revenues</u>					
General Fund	(\$4,214,000)	(\$3,319,000)	(\$3,511,000)	(\$3,582,000)	(\$3,654,000)
HEIF	(224,000)	(177,000)	(187,000)	(191,000)	(194,000)
TTF	(546,000)	(430,000)	(455,000)	(464,000)	(473,000)
Total	(\$4,984,000)	(\$3,926,000)	(\$4,153,000)	(\$4,237,000)	(\$4,321,000)
<u>Local Revenues</u>					
Income Tax	(\$787,000)	(\$620,000)	(\$656,000)	(\$669,000)	(\$682,000)
LHUR	(73,700)	(58,100)	(61,400)	(62,600)	(45,400)
Total	(\$860,700)	(\$678,100)	(\$717,400)	(\$731,600)	(\$727,400)

HEIF: Higher Education Investment Fund
LHUR: local highway user revenue
TTF: Transportation Trust Fund

Source: Department of Legislative Services

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of \$118,000 in fiscal 2021 to add the subtraction modification to the personal and corporate income tax returns. This includes data processing changes to the income tax return processing and imaging systems and system testing. Otherwise, the Comptroller's Office can likely administer the subtraction modification with existing resources. However, to the extent taxpayers claim a significant number of subtraction modifications and have complex ownership arrangements, the Comptroller's Office advises it may incur additional costs in order to hire a revenue examiner.

A portion of TTF revenues are used to provide capital transportation grants to local governments. Thus, any decrease in TTF revenues from corporate tax revenues results in a 13.5% decrease in TTF expenditures to local governments (9.6% beginning in fiscal 2025). Accordingly, TTF expenditures decrease by \$73,700 in fiscal 2021 and by \$45,400 in fiscal 2025, as shown in Exhibit 1. TTF revenues also fund the State capital program; thus, a decrease in TTF revenues decreases expenditures for the State capital program.

Local Revenues: Local income tax revenues decrease by about 3% of the total net State subtraction modifications claimed against the personal income tax. Local revenues will decrease by approximately \$787,000 in fiscal 2021 and by \$682,000 in fiscal 2025, as shown in Exhibit 1. Additionally, local governments receive a portion of corporate income tax revenues as local highway user revenues through capital transportation grants. Under this bill, local highway user revenues decrease by approximately \$73,700 in fiscal 2021 and by \$45,400 in fiscal 2025 as a result of deductions taken against the corporate income tax.

Small Business Effect: Small businesses that are State registered independent testing laboratories or State licensed medical cannabis growers, processors, or dispensaries benefit from the subtraction modification. The benefit will depend on their tax liability and the amount of ordinary and necessary expenses disallowed under IRC Section 280E.

Additional Information

Prior Introductions: SB 9 of 2019 and SB 37 of 2018 received a hearing in the Senate Budget and Taxation Committee but no further action was taken. The cross files, HB 568 of 2019 and HB 845 of 2018, received a hearing in the House Ways and Means Committee, but no further action was taken.

Designated Cross File: None.

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

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