Taxation of Medical Marijuana dispensaries

As of this writing, 23 states and the District of Columbia have some form of legislation which allows the sale of marijuana for medicinal purposes. Just five years ago, the number was 14, and ten years ago the number was 9. Despite the efforts of their opponents, the medical marijuana industry is growing. The medical marijuana market was estimated at $1.7 billion in 2013. The illegal “black” market was estimated at $110 billion. There are publically traded companies that have dipped their toe in this industry: Insys Therepeutics, Inc. (NASDAQ: INSY) has a product known as Marinol which helps reduce vomiting in chemotherapy patients. We as accountants and advisors should be aware of the tax issues affecting this industry.

No Deduction Allowed for Trade or Business in Drug Trafficking

The main tax issue affecting medical marijuana dispensaries is what expenses are deductible and not deductible under Internal Revenue Code (IRC) 280E. 280E states “No deduction or credit shall be 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) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.” Since marijuana and all cannabis products are a schedule I controlled substance, medical marijuana dispensaries are clearly within the purview of IRC 280E and it would appear that they would be taxed on their gross receipts, with no deduction allowed for any expenses. However, the Senate committee report indicates that the disallowance doesn't affect the adjustment to gross receipts for cost of goods sold (S Rept No. 97-494 Vol I (PL 97-248)). Consequently, dispensaries should allocate their costs between production and costs directly related to revenue (allowable) and other costs (sales related and General and Administrative expenses) which would not be allowable under IRC 280E. The tax court has upheld this allowance of “cost of goods sold” in Olive v. Commissioner, 139 T.C. 2 (2012), and practitioners have followed this guidance. Record keeping and a consistent and logical method of allocation of costs is the key to allowance of these costs.

Two Businesses?

Another tax court case shows further allocation of costs. In California Helping to Alleviate Medical Problems, Inc. v. Commissioner (CHAMP), 128 T.C. 173 (2007), the tax court ruled that a dispensary effectively had two businesses - selling medical marijuana and giving care to patients. The director was an experienced health professional and operated the dispensary with care giving as the primary feature and dispensing of medical marijuana as a secondary feature. The court allowed the deductions related to the care giving business.

The California Difference

Although California allows for the distribution of medical marijuana under Proposition 215, the Compassionate Use Act of 1996 (CUA), the CUA and subsequent additional legislation in 2003 do not address the income tax treatment of the distribution of medical marijuana. Moreover, the California Revenue and Taxation Code does not list any exceptions for medical marijuana dispensaries. One might assume that because the sale of marijuana for medicinal purposes is legal in California under Prop 215, that California tax law ought to allow for the same deductions as any other business. However, the reality is that under the California Revenue and Tax Code (R&TC) for individuals, the distribution of medical marijuana is considered drug trafficking and under California R&TC 17282 does not even allow the deduction for Cost of Goods Sold. However, the California R&TC is different for corporations. For individuals, the California R&TC conforms to the Federal tax law, which includes IRC 280E. California R&TC for corporations does not conform to Federal tax law, and thus does not
conform to IRC 280E. So unless the corporation is found to be engaged in drug trafficking under a criminal proceeding, California corporate tax allows full deductions for all ordinary and necessary business expenses.

**How do I pay taxes electronically without a bank account?**

Many federal taxes (employment taxes and corporate income taxes among others) must be paid electronically. There is a mandatory 10% penalty on the amount paid if they are not paid electronically. Many banks do not feel comfortable doing business with medical marijuana dispensaries because they do not want to violate anti-money laundering laws or public perception. In February 2014 the U.S. Department of Justice issued a memorandum to give financial institutions more guidance in dealing with medical marijuana dispensaries. Known as the "Cole Memorandum", it outlines what financial institutions should be aware of when doing business with medical marijuana dispensaries. In particular, financial institutions can file a "MARIJUANA LIMITED" SAR (Suspicious Activities Report) which would be limited to the following information: (i) identifying information of the subject and related parties; (ii) addresses of the subject and related parties; (iii) the fact that the filing institution is filing the SAR solely because the subject is engaged in a marijuana-related business; and (iv) the fact that no additional suspicious activity has been identified. This should give some comfort that the institution is complying with the law and can service the customer.

**Is the Sale of Marijuana for Medicinal Purposes subject to Sales Tax?**

Sales tax is generally a state tax and each state has its own sales tax laws. In California all sales are taxable unless the sale qualifies for a specific exemption under the sales tax laws. The exemption that might apply to medicinal marijuana sales is the exemption for medicine.

To qualify for exemption from sales tax under Regulation 1591, the item must qualify as a medicine and the sale or use of the item must be either (1) prescribed for treatment by a medical professional authorized to prescribe medicines and dispensed by a pharmacy; (2) furnished by a physician to his or her own patients; or (3) furnished by a licensed health facility on a physician's order. Regulation 1591 defines medicine as any substance intended for use by external or internal application to the human body in the diagnosis, cure, mitigation, treatment, or prevention of a disease and which is commonly recognized as a substance intended for that use.

In 2011 the California State Board of Equalization which governs sales tax law ruled that the sale of medical marijuana by marijuana dispensaries is not exempt from sales tax like other prescribed medicines and thus is subject to sales tax.

**Summary**

The taxation of medicinal marijuana dispensaries is very different than your typical business and not what one might expect. Because of the differences with respect to California corporate taxation, the corporate structure has some definite advantages. The key to adhering to these laws is documentation and good record keeping. This is where a knowledgeable accountant is very beneficial to the success of the business.

**For More Information, Contact:**

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