

# **Taxing the Cannabis Industry: State and Local Tax Implications**

by Tram Le and Judy Vorndran

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In this installment of Spreading SALTvation, Le and Vorndran examine state and local tax implications and risks for businesses in the cannabis industry, addressing sales tax exemptions and interstate commerce issues.

Tax laws change rapidly. Please consult with a qualified tax professional to discuss specifics of your situation and the applicability of the information presented.

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The emerging cannabis industry is evolving quickly with rapidly changing laws and regulations. Most states have recently either legalized medical or recreational marijuana<sup>1</sup> to offset budget deficits, support economic recovery with job creation, and generate millions in sales on a product that remains illegal under federal law.<sup>2</sup>

California was the first state in the 1990s to legalize medical marijuana.<sup>3</sup> Several states followed with similar initiatives focused on medical marijuana. Legalized medical marijuana created a path to legalizing marijuana for recreational use, beginning with Colorado and Washington in 2012<sup>4</sup> and followed by Oregon and Alaska in 2014.<sup>5</sup> Today, over three-quarters of states have passed legislation to legalize the sale and use of cannabis and cannabis products (with some states legalizing products with low THC, high cannabidiol products) for medical and recreational purposes,<sup>6</sup> leaving only a handful of states where cannabis is entirely illegal and prohibited.

As the cannabis industry grows and moves toward greater mainstream acceptance, states are taxing and tightly regulating the use and sale of cannabis and cannabis products. This activity has created complex state tax implications for businesses in the cannabis ecosystem, including distributors who procure, sell, or transport

<sup>1</sup> The terms cannabis and marijuana are referred to interchangeably and reference both cannabis plants and products containing THC levels above 0.3 percent. Under the Agricultural Act of 2014, cannabis with a dry weight THC level at or below 0.3 percent is considered hemp, while cannabis with THC levels above 0.3 percent is classified as marijuana.

<sup>2</sup> See 21 U.S.C. sections 841, 844.

<sup>3</sup> California Proposition 215 (1996).

<sup>4</sup> Colorado Amendment 64 (2012) and Washington Initiative 502 (2012).

<sup>5</sup> Oregon Measure 91 (2014) and Alaska Ballot Measure 2 (2014).

<sup>6</sup> National Conference of State Legislatures, "State Medical Marijuana Laws" (June 23, 2021).

cannabis; licensed retailers; cultivators/growers; processors; and manufacturers.

### State Taxation of Cannabis Industry

State and local governments apply varying rules and rates in taxing cannabis and business activities involved in growing, cultivating, manufacturing, testing, distributing, and selling cannabis.

From a state income tax perspective, cannabis businesses and owners must understand whether the applicable state laws conform to IRC provisions. For federal tax purposes, section 280E prohibits taxpayers from deducting trade or business expenses incurred in the trafficking of controlled substances. Because cannabis is considered a controlled substance under federal law, businesses are not allowed to deduct business expenses for state income tax purposes when a state's law conforms to the IRC.

However, Colorado and Oregon allow cannabis businesses to deduct expenses that otherwise would be nondeductible under section 280E, thus decoupling from IRC treatment and creating additional complexity in preparing returns.<sup>7</sup> In California, conformity to the IRC applies at the individual income tax level but does not conform for state corporate franchise tax purposes.<sup>8</sup> Because of the difference in conformity rules, cannabis businesses filing a corporate tax return in California may be able to deduct business expenses, while individuals who are sole proprietors and filing partnership returns may not deduct business expenses under section 280E.

As for sales tax, some states impose tax on the transaction sale of marijuana products. Others levy a cannabis excise tax that may be based on the percentage of price, weight, or THC potency levels. Washington imposes a 37 percent excise tax on recreational retail sales of marijuana but does not impose an excise tax on medical marijuana.<sup>9</sup>

Colorado imposes sales tax on the sale of medical and recreational marijuana and marijuana products regardless of the form in

which the products are sold. Colorado also provides an exemption for patients that are registered and issued a card with the state health department, which adds an additional layer of compliance to ensure that proper documentation is collected.<sup>10</sup>

Additional Colorado taxes may apply at the local level, which, when layered on state taxes, adds up quickly. Colorado's home-rule jurisdictions have largely opted to apply local sales taxes of their own if they allow cannabis businesses in their boundaries. In Denver, medical and recreational marijuana is subject to the general sales tax rate of 4.31 percent. A special cannabis-related tax of 5.5 percent is added for retail and recreational marijuana sales for a combined sales tax rate of 9.81 percent.<sup>11</sup>

Further, medical cannabis is often taxed differently than recreational cannabis. In Illinois, a 1 percent state sales tax applies to medical cannabis, while recreational use cannabis is subject to a 6.25 percent tax. Local municipalities may impose additional sales tax up to 3 percent. As for excise tax, rates are based on the THC concentration level. Cannabis-infused products such as food and beverages are subject to a 20 percent excise tax. Other products with 35 percent THC or less are subject to a 10 percent excise tax, while products containing more than 35 percent THC are subject to a 25 percent excise tax. Illinois further imposes cannabis cultivation privilege tax on both medical cannabis at a rate of 7 percent of the sales price per ounce and recreational cannabis at a rate of 7 percent of the gross receipts from the sale by a cannabis cultivator or grower.<sup>12</sup>

California has a 15 percent cannabis excise tax based on the average market price of cannabis and cannabis products sold in a retail sale and a cultivation tax on harvested cannabis based on weight and category (i.e., cannabis flowers, leaves, and fresh cannabis plants). California imposes a retail sales tax of 7.25 percent, plus up to 1 percent in an automatic local sales tax. Local

<sup>7</sup> Colo. Rev. Stat. sections 39-22-104(4)(r), 39-22-304(3)(m) and Or. Rev. Stat. section 316.680(i).

<sup>8</sup> California Assembly Bill 37 (2019).

<sup>9</sup> Washington State Liquor and Cannabis Board, "FAQs on Taxes."

<sup>10</sup> Colorado Department of Revenue, "Sales 93: Sales Tax on Marijuana" (July 2017).

<sup>11</sup> City and County of Denver, Colorado, Tax Guide, "Topic No. 95: Marijuana — Medical and Retail" (2019).

<sup>12</sup> Illinois Department of Revenue, "Cannabis Tax Frequently Asked Questions."

governments may impose additional taxes up to 15 percent. For medical marijuana, California provides a sales tax exemption.<sup>13</sup>

In Utah, only medical marijuana is legal, but sales are exempt entirely from sales tax.<sup>14</sup>

### Sales Tax Exemptions for Cannabis

Like other businesses, cannabis growers, cultivators, manufacturers, distributors, and retailers pay sales and use tax on purchases of goods used in their businesses unless an exemption applies. For cannabis growers and cultivators, purchases may include essential equipment and materials such as specialized lighting, fertilizers, soils, and software needed to run operations. Manufacturers generally purchase items such as equipment and machinery to produce, store, and package products such as gummies, brownies, and oils. For these cannabis businesses, purchases that qualify for a statutory agricultural or manufacturing or a resale exemption are not subject to sales tax.

Less clear cut are rules for taxing cannabis businesses engaged in agriculture and manufacturing activities. In situations in which cannabis cultivators or growers consider themselves farmers, as opposed to manufacturers, their activities may not fall within statutory exemptions, unlike food-producing farmers. The ambiguity of state positions leaves a cannabis grower on their own to determine whether they are a farmer as defined by state law.

Although cannabis operations can mimic farming or manufacturing, only a few states have taken a position on whether a cannabis business is a farmer or manufacturer. In states where a cultivator may be considered a manufacturer or farmer for sales and use tax purposes, purchases of some materials and equipment may be exempt when they are used directly in the manufacturing process or are considered a component of cannabis products produced for sale.

Among the states addressing exemptions, Washington passed a law that states that marijuana producers are not considered farmers,

and marijuana is not an agricultural product.<sup>15</sup> In Arkansas, a legal counsel opinion determined that marijuana cultivation does not qualify because marijuana is not “food, fiber or timber, sod, or a nurseryman product.”<sup>16</sup> Alternatively, Oklahoma has published a regulation stating that marijuana growers will qualify for the agricultural exemption.<sup>17</sup> California has issued tax publications stating that marijuana cultivators qualify as farmers.<sup>18</sup>

In states such as North Carolina and West Virginia, there is a conspicuous absence of guidance addressing whether marijuana is an agricultural product for the purpose of the exemption for commercial production of agricultural products. Generally, marijuana may qualify for the farmer exemption if all other requirements are met. By definition, North Carolina law states that a qualifying farmer includes a business that grows crops.<sup>19</sup> No laws, rules, or guidance have been published in the state indicating that marijuana should be treated differently from other crops. Absent guidance or rules in North Carolina, marijuana would likely be considered a crop and would qualify for an agricultural exemption when grown for sale.

West Virginia is another state that has not released laws, rules, or guidance taking the position that marijuana should be treated differently from other agricultural products. However, the state exempts the “commercial production of an agricultural product.” An agricultural product is defined to include “any . . . plant or animal production activity” and any related farm practices.<sup>20</sup> Since marijuana is a plant, it likely qualifies when grown for sale, and the exemption would apply to purchases of materials such as soil and nutrients used to produce cannabis products.

When agricultural exemptions are expansive and cover many products, such as North

<sup>15</sup> Wash. Code Rev. section 82.04.213(1).

<sup>16</sup> Ark. Revenue Legal Counsel Op. No. 20190102 (Dept. of Fin. & Admin. Apr. 2, 2019).

<sup>17</sup> Okla. Admin. Code section 710:65-19-216.

<sup>18</sup> California Department of Tax and Fee Administration, “Tax Guide for Cannabis Businesses — Cultivators.”

<sup>19</sup> N.C. Gen. Stat. section 105-164.13E.

<sup>20</sup> W.Va. Code section 110-15-2(2.16), 11-15-9 (a)(8).

<sup>13</sup> California Department of Tax and Fee Administration, “Tax Guide for Cannabis Businesses — Getting Started.”

<sup>14</sup> H.B. 3001 Utah Medical Cannabis Act.

Carolina's general inclusion of crops, medical marijuana likely meets the state's definition. Unless a state has passed a law to specifically exclude marijuana growers or producers, as in Washington or where exemptions are narrower and more limited to items like food and fiber, marijuana businesses would not likely be entitled to the exemption.

In states that are silent on the issue of exemptions, businesses selling to the cannabis industry and operating in these states must look to existing laws and rules — or request guidance directly from the state — to help make the determination of whether an exemption applies. In many of these situations, a tax decision must be made based on little to no clear-cut guidance, which puts cannabis businesses at risk of over- or under-collecting sales tax.

### Interstate Commerce Complications in Regulating Cannabis

States are closely regulating the cannabis ecosystem through state health departments or newly created state agencies. New Jersey's Cannabis Regulatory Commission is charged with regulating and implementing strict guidelines from sourcing seeds to planting, processing, manufacturing, and tracking and reporting retail sales of cannabis and cannabis products.

There are also state-specific licensure requirements for businesses that implement cannabis operations. Some states, such as Florida, require vertical integration to regulate the seeding, production, manufacturing, and retail sale of marijuana.<sup>21</sup> This creates complexities and difficulties for businesses to enter the market. Multistate businesses operating in a state that requires vertical integration and another state that disallows it will create complications that could require the businesses to change their operations and create workarounds to comply with the regulatory landscape in each state.

States have generally prohibited the import and export of cannabis and cannabis products because of the federal ban on cannabis. As such, businesses are not allowed to produce, sell, and

transport cannabis across state lines; states restrict cannabis that is produced in the state from being sold outside the state. Also, states have restricted licensure exclusively to in-state residents,<sup>22</sup> meaning out-of-state businesses and nonresidents are not allowed to own or operate facilities in the local production, possession, and sale of marijuana. Operations may be banned and zoned in some areas to limit retail operations with another layer of regulations from local municipalities.

Under the dormant commerce clause, states are prohibited from placing undue burden on or discriminating against interstate commerce. Notably, the prohibition on marijuana sales across state lines and residency requirements place restrictions on interstate commerce in the cannabis industry. These restrictions are generally unconstitutional unless a state can show that the undue burden or discrimination against out-of-state businesses is necessary to serve a legitimate local purpose. However, the economic benefits — job creation and revenue generation — are unlikely a legitimate purpose.

The justification for tightly regulating cannabis operations includes reducing illegal activities and sales in states where marijuana sales are not legal. These barriers create potential undue burden on interstate commerce, discriminate against outofstate companies, and result in excessive resources and costs for multistate business operations. Although Congress recently considered legalizing marijuana at the federal level,<sup>23</sup> the federal criminalization of marijuana as a Schedule I controlled substance provides justification for states to continue to limit cannabis operations and activities to within their own borders. If legalized at the federal level, however, limitations on interstate sales of cannabis and cannabis products would be less likely to be justified.

### Significant Challenges to Come

As state legalization stretches from coast to coast, the acceptance of and demand for cannabis

<sup>22</sup>28-B Me. Rev. Stat. section 202(2)-(3); Montana Initiative No. 190; and Oklahoma H.B. 2612.

<sup>23</sup>H.R. 3884, Marijuana Opportunity, Reinvestment, and Expungement Act (MORE Act).

<sup>21</sup>Fla. Stat. section 381.986(8)(e).

products is increasing. Understanding state tax laws and their implications is important to minimize that risk and tax exposure and the application of exemptions in states that have legalized marijuana in some capacity. If the federal government removes marijuana as a Schedule I substance, there could be significant changes to state regulations, thus creating more challenges and potential opportunities for businesses operating in this industry.

As cannabis businesses try to keep up with evolving regulatory and reporting requirements, their tax responsibilities and obligations may not be prioritized. These businesses must be aware of the tax implications and risks associated with this industry and seek out a qualified tax adviser to ensure compliance with the rapidly changing state tax laws across the country. ■



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