

Massachusetts Marijuana Facility Operators Face Tax Challenges

Description

As the prospect of legalized recreational marijuana nears for Commonwealth residents, some serious attention needs to be given to the unique issues Massachusetts-based marijuana businesses will face in the coming years and months. On top of strict regulations, legislative uncertainty, and limited access to banking, taxpayers in this industry must contend with some unique federal and state tax challenges.

Federal Issues and Open Questions

The biggest area of complexity for marijuana businesses comes in simply computing net federal taxable income. Since 1982, Section 280E of the Internal Revenue Code has prohibited taxpayers from being able to deduct ordinary and necessary business expenses related to trafficking controlled substances. Although the sale of both medical and recreational marijuana is now legal from the perspective of Massachusetts law, marijuana is still considered a Schedule I controlled substance under federal law, meaning Section 280E potentially applies to all businesses – including nonprofits – that touch marijuana products.

Because Section 280E can disqualify a large portion of a taxpayer's business expenses from being deductible, the income tax rate for marijuana businesses with high overhead costs can easily top 100% of economic net income without careful management. The effective tax rate could be even higher in situations where interest and penalties are owed.

The IRS has made compliance with Section 280E especially complicated for legal marijuana businesses because it has refused to issue official guidance on issues like the definition of "trafficking" or the treatment of commonly-controlled enterprises. As a result, extra attention is required in considering how to structure marijuana businesses from a choice of entity perspective.

Fortunately, the effects of Section 280E can be at least partially mitigated. For starters, Section 280E permits taxpayers with multiple business lines to deduct ordinary and necessary expenses that are appropriately allocable to these lines. For added protection, multiple business lines should ideally be segregated using separate legal entities and separate payroll systems.

Section 280E also permits a deduction for a taxpayer's "costs of goods sold," although there are open questions as to how that figure should be computed. Currently, the IRS has confusingly instructed marijuana businesses to comply with Section 280E by applying 1980's-era rules to calculate costs of goods sold. Some industry observers have understandably called the rationale underlying this guidance into question. Consequently, the allocation of expenses to costs of goods sold is likely to remain a significant area of uncertainty as well as a point of IRS audit emphasis.

In light of the potential for Section 280E to wreak havoc on a marijuana business's profit margins, taxpayers in this industry need to carefully manage their cost structures and implement a clear and consistent methodology for making expense allocations.

Massachusetts State Tax Considerations

In Massachusetts, the legislature continues to tinker with the regulation of marijuana. Governor Baker signed a compromise bill H. 3818 on July 28, 2017 revising numerous aspects of the Question 4 legislation that was approved by voters last November. A summary of the major provisions of the revised law can be found here [Massachusetts Lawmakers Send Revised Marijuana Bill to Governor Baker](#)

The compromise bill changes the rate of tax on retail sales of recreational marijuana to consist of a 10.75% state excise tax and the state's 6.25% sales tax. A city or town can also elect to impose a 3% local sales tax on retail marijuana shops, potentially bringing the total tax burden on gross sales up to 20%. Although the new rates are a significant increase from the 12% combined excise and sales tax rate initially approved by voters last November, they are still the second lowest in the country and are lower than some legislators had hoped. Rates as high as 28% were reportedly proposed at one point during the legislative session, as was a separate tax to be levied on wholesale transactions. These provisions were ultimately rejected. The new tax rates are effective immediately, although legal recreational sales will not begin in Massachusetts until July of 2018. No taxes are imposed on medical marijuana sales.

There are also some questions as to how marijuana businesses should compute their Massachusetts state income tax liability. Massachusetts state taxable income generally starts with federal income tax liability, meaning that expenses disallowed by Section 280E should conceptually be disallowed in Massachusetts. However, the federal policy underlying the expense disallowance found in Section 280E is no longer consistent with Massachusetts law.

Right now, there is no provision in the Massachusetts General Laws that decouples the computation of Massachusetts state taxable income from federal law with respect to the limitations imposed by Section 280E. However, other states that have embraced legalized marijuana sales have given taxpayers relief in this area. It remains to be seen if the Massachusetts legislature will provide a similar benefit for businesses in this industry, but this adjustment would go a long way in cutting the excessive income tax exposure that Section 280E can create.

As federal and state law continues to develop in this area, we will be sure to keep you posted on the tax implications.

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