NJCPA

TO: Honorable Members of the New Jersey Legislature
FR: Ralph Albert Thomas, CEO and Executive Director
DT: February 13, 2019

RE: NJ Tax Law Should Decouple from Internal Revenue Code 280(E) to Ensure Viable Cannabis industry

While the New Jersey Society of Certified Public Accountants (NJCPA) does not have a position on whether adult use cannabis should be legalized, if it is enacted it is critically important that NJ decouple from Internal Revenue Code Section 280(E). The attached proposed changes to NJ law would decouple NJ from Federal §280(E) for gross income tax and corporate income tax calculations. This would allow cannabis business owners to deduct ordinary and necessary expenses in the same manner as their non-cannabis counterparts.

The Federal provisions contained in §280(E) present an immense challenge to the cash flow of cannabis operations in the United States. Cannabis business owners do not receive a tax benefit for any of their operating expenses due to cannabis' status as a federally controlled substance.

Deduction provisions under the tax code are, in part, designed to encourage business and to incentivize spending behaviors. By removing this incentive from the business landscape for cannabis enterprises, they derive no benefit from this principle and are operating at a dramatic disadvantage. This deters them from reinvesting the funds and growing the business. In addition, these businesses are forced to retain cash to satisfy their Federal tax liabilities which could be three times higher than a typical business tax bill. This inequitable concept will either inadvertently encourage noncompliance, stifle the growth of cannabis operations, or will prevent these businesses from success in the industry. This outcome is not consistent with the long-term goal of sustainable tax revenues.

Many of the states that have legalized cannabis have decoupled from 280E. Of the ten states with a regulated, adult-use market, two have specifically decoupled completely, one has specifically decoupled corporations, and two have no state tax at the business level thus decoupling by default. Of those, the most advanced and developed markets are those which specifically decoupled, Colorado and Oregon.

The unjust burden of Federal tax law on the cannabis industry creates a tremendous barrier to market entry. Consequently, early-stage, small businesses with an increased need for cash will struggle to survive as they compete with established operators, who will be able to squeeze margins to create high capital requirements and limit new market participants.

If NJ does not decouple from 280E, it sends the message that existing operations may consume the entirety of the market share cultivated within our State. We are hopeful for the development of a market that is ripe with diversity in operators' backgrounds, expertise, and level of experience. We therefore support the promotion, rather than the deterrence, of start-up business in New Jersey by decoupling from 280E.

In addition to the attached proposed revisions to NJ statutes, you'll also find a position paper released by the National Cannabis Industry Association addressing the 280E issue.

If you have any questions, please don't hesitate to contact our Government Relations Vice President Jeffrey Kaszerman at 973 226 4494, X210 or jkaszerman@njcpa.org.

Enclosures

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NJ Rev Stat 54A:5-1

New Jersey Gross Income Defined. New Jersey gross income shall consist of the following categories of income:

a. Salaries, wages, tips, fees, commissions, bonuses, and other remuneration received for services rendered whether in cash or in property, and amounts paid or distributed, or deemed paid or distributed, out of a medical savings account that are not excluded from gross income pursuant to section 5 of P.L.1997, c.414 (C.54A:6-27).

b. Net profits from business. The net income from the operation of a business, profession or other activity after provision for all costs and expenses incurred in the conduct thereof, determined either on a cash or accrual basis in accordance with the method of accounting allowed for federal income tax purposes but without deduction of the amount of:

(1) taxes based on income;

(2) a civil, civil administrative, or criminal penalty or fine, including a penalty or fine under an administrative consent order, assessed and collected for a violation of a State or federal environmental law, an administrative consent order, or an environmental ordinance or resolution of a local governmental entity, and any interest earned on the penalty or fine, and any economic benefits having accrued to the violator as a result of a violation, which benefits are assessed and recovered in a civil, civil administrative, or criminal action, or pursuant to an administrative consent order. The provisions of this paragraph shall not apply to a penalty or fine assessed or collected for a violation of a State or federal environmental law, or local environmental ordinance or resolution, if the penalty or fine was for a violation that resulted from fire, riot, sabotage, flood, storm event, natural cause, or other act of God beyond the reasonable control of the violator, or caused by an act or omission of a person who was outside the reasonable control of the violator; and

(3) <u>and without limitation as set forth in in determining federal taxable income pursuant to section 280(e) of the federal Internal Revenue Code.</u>

NJ Rev Stat 54:10A-4

k. "Entire net income" shall mean total net income from all sources, whether within or without the United States, and shall include the gain derived from the employment of capital or labor, or from both combined, as well as profit gained through a sale or conversion of capital assets.

For the purpose of this act, the amount of a taxpayer's entire net income shall be deemed prima facie to be equal in amount to the taxable income, before net operating loss deduction and special deductions, which the taxpayer is required to report, or, if the taxpayer is classified as a partnership for federal tax purposes, would otherwise be required to report, to the United States Treasury Department for the purpose of computing its federal income tax, provided however, that in the determination of such entire net income,

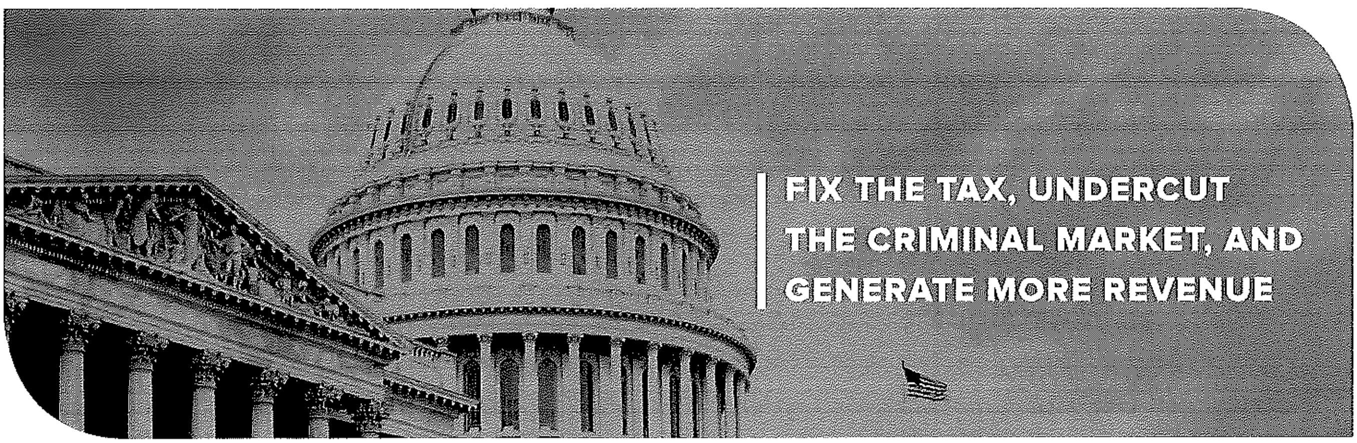
(17) <u>for a licensed cannabis establishment there shall be allowed as a deduction from entire net income of all ordinary and necessary expenses paid or incurred during the taxable year in carrying out the establishments trade or business.</u>

Learn more about NCIA's Policy Council
TheCannabisIndustry.org/PolicyCouncil

National Cannabis Industry Association
TheCannabisIndustry.org

IRC Section 280E:

An Unjust Burden on State-Legal Cannabis Businesses



Section 280E of the Internal Revenue Code (IRC) prohibits businesses engaged in the trafficking of Schedule I or Schedule II controlled substances in contravention of state or federal law from deducting normal business expenses, such as payroll and rent, from gross income. Section 280E was originally intended to penalize criminal market operators, but because cannabis remains a Schedule I controlled substance, it now applies to licensed cannabis businesses that operate in compliance with state laws and regulations. This amounts to a major financial burden for legitimate cannabis businesses, though the degree of impact varies by type of operation and business structure, among other factors. Cannabis businesses operating in states that align their tax codes with the IRC are at a particular disadvantage as they are also unable to deduct normal business expenses from their state taxes.

The language of Section 280E is as follows:

"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."

By forcing businesses – or individuals in the case of sole proprietors and partnerships – to pay taxes not only on their net profits, but also on a significant portion of their business expenses, the effective tax rate on these companies is often in excess of 70%. At times, the federal tax burden for cannabis businesses actually exceeds net profits.

A simplified model comparing the federal tax burden faced by a cannabis business and a similarly situated non-cannabis business is provided in **Table 1** for illustrative purposes.

The unfortunate result is that entities that complete the arduous state licensing process, comply with stringent state regulations, and pay a variety of taxes imposed at each level of government are at an economic disadvantage relative to the criminal market operators for whom 280E was truly intended. The unfair treatment of cannabis businesses under Section 280E has been recognized by U.S. Treasury Secretary Steve Mnuchin, who, when asked about the financial hurdles faced by state-authorized cannabis businesses, responded that he will *"work with Congress and the President to determine which provisions of the tax code should be retained, revised, or eliminated to ensure that all individuals and businesses compete on a level playing field."*[1]

Upon initial consideration, it is common for congressional staffers and Members to assume that exempting state-legal cannabis businesses from Section 280E would result in lost revenue for the federal government. Over the long term, that does not seem to be the case. The remainder of this document provides insight and analysis from Judy Xanthopoulos, a former staffer for the Joint Committee on Taxation, who concludes that reforming Section 280E would likely result in a net increase in federal tax receipts over 10 years.

Table 1:

Illustration of Cannabis vs. Non-Cannabis Business Federal Tax Burden

	CANNABIS BUSINESS	NON-CANNABIS BUSINESS
Gross Revenue	**$1,000,000**	**$1,000,000**
Cost of Goods Sold	**$650,000**	**$650,000**
Gross Income	**$350,000**	**$350,000**
Deductible Business Expenses	**$0**	**$200,000**
Taxable Income	**$350,000**	**$150,000**
Tax Due (30% Rate)	**$105,000**	**$45,000**
Effective Tax Rate	**70%**	**30%**

Revenue Effects of Section 280E

Formal revenue estimates often do not capture the real world effects of legislative changes. This is the case with respect to modifying Section 280E to allow legal adult-use marijuana businesses to deduct their regular business expenses.

A standard assumption in revenue estimates is that increasing deductible business expenses will decrease tax revenues. By the same logic, one would assume that prohibiting certain business deductions would increase revenues. However, preventing businesses from claiming ordinary business expenses – allowed to any other business entity – creates an economic disadvantage. This disadvantage results from higher costs relative to businesses not subject to 280E, and ultimately will translate to lower growth, business failure, or turnover in these newly formed legal markets.

The legal cannabis market presents a distinctive situation, because of the existing and well-established criminal market. While many businesses organize as a state-legal entity and comply with tax laws, the existence of 280E creates an incentive for many individuals to remain in the criminal market and avoid paying taxes entirely.

The move toward the formal economy is evident in states like Colorado, Oregon, and Washington, where state-licensed cannabis sales to all adults are legal. The level of DEA suppression activity shows that much of the cultivation and sales of marijuana shifted toward the state-legal market. **(See, Chart 1.)** Without allowing businesses to deduct their normal expenses, however, the criminal market will continue to fill the vacuum created by the legal market's inability to expand.

Proposals to modify section 280E (for businesses engaged in state-legal cannabis activities) would generate revenue through expanded business operations (growth in existing state-legal companies), new business formation, as well as improving noncompliance (criminal market businesses entering the legal market).

Traditional revenue estimates of 280E will only include the current level of state-approved cannabis activity. Yet even in these limited states, it is likely that a portion of the market is not captured because of the existing criminal market.

Generally, most cannabis companies with an integrated business model are paying a 75 to 80 percent effective tax rate. These effective tax rates are approximately twice the rate facing other businesses not subject to Section 280E. This creates an incentive for businesses to remain in the criminal market. Given the penalty imposed by the different effective rates, it is reasonable to assume that modifying Section 280E will improve compliance.

Chart 1:

DEA Seizure of Cultivated Plants in Colorado, Oregon, and Washington, Compared to Total Plants Seized in the US, 2011-2015

Source: DEA, Final Domestic Cannabis Eradication/ Supression Program Statistical Report, various years

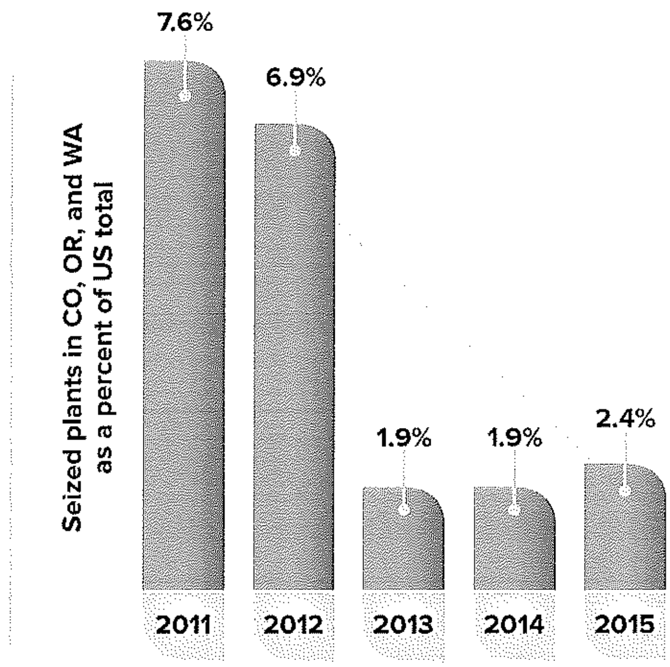


Table 2:

Estimated Total Legal Market Value, by States with Legal Medical or All-Adult Use Markets (in millions of dollars)

Source: Estimates prepared by J. Xanthopoulos, PhD for the National Cannabis Industry Association. These fully-developed estimates rely on Colorado parameters for per capita use among the adult population. Each state's propensity to purchase cannabis reflects the current patterns of cannabis consumption based on data from SAMHSA[2]. These estimates rely on current consumption behavior prior to legalization in these states, as well as Colorado's experience since legalization.[3]

State	Market	2016	2020	2025	[illegible]
Alaska	ADULT	228.7	321.7	320.6	320.3
Arizona	MED	169.4	258.3	277.3	296.1
Arkansas	MED	53.8	75.0	73.3	71.0
California	ADULT	9,158.2	12,969.6	12,937.9	12,923.2
Colorado	ADULT	1,337.7	1,881.0	1,862.2	1,843.6
Connecticut	MED	99.5	135.8	128.9	121.8
Delaware	MED	26.1	36.7	36.0	34.9
Wash, DC	MED	20.7	26.0	23.3	21.1
Florida	MED	480.5	717.1	756.2	794.1
Georgia	MED	187.2	267.9	268.0	265.7
Hawaii	MED	36.2	49.6	48.5	47.2
Illinois	MED	293.1	399.6	382.2	364.5
Louisiana	MED	89.6	122.6	118.2	113.0
Maine	ADULT	347.4	477.3	456.1	432.9
Maryland	MED	126.0	176.9	174.0	171.0
Massachusetts	ADULT	1,759.4	2,409.8	2,307.7	2,198.4
Michigan	MED	293.9	401.4	381.4	361.1
Minnesota	MED	132.2	185.3	181.5	177.5
Montana	MED	32.5	45.0	43.6	41.8
Nevada	ADULT	716.7	1,088.8	1,150.7	1,203.7
New Hampshire	MED	43.0	60.6	59.7	58.6
New Jersey	MED	189.9	262.5	253.9	244.6
New Mexico	MED	57.0	78.8	76.2	72.6
New York	MED	539.0	728.0	688.4	649.3
North Dakota	MED	12.4	16.6	15.6	14.5
Ohio	MED	293.9	398.0	376.7	354.9
Oklahoma	MED	73.8	101.6	98.6	95.3
Oregon	ADULT	1,191.5	1,703.1	1,714.0	1,726.7
Pennsylvania	MED	287.1	389.3	369.1	348.6
RhodeIsland	MED	45.5	62.1	58.9	55.6
Vermont	MED	27.2	37.6	36.2	34.8
Washington	ADULT	1,807.3	2,602.2	2,643.9	2,697.9
TOTAL ESTIMATED MARKET		$20,156.4	$28,485.8	$28,318.7	[illegible]

The existence of an established criminal market that remains outside the current budget baseline indicates that there is an additional – unrecognized or unmeasured – revenue effect from modifying Section 280E. Bringing criminal market business into the legal market would very likely offset the revenue losses associated with modifying Section 280E. **(See Table 2 for estimates of potential growth in legal markets.)**

One feature of the fully-developed market estimates is that it provides a sense of the market for cannabis that is not captured by our legal economy. Numerous studies confirm that the criminal market exists and remains stable.[4] Since there are only a few states that allow adult use through legal markets, the majority of marijuana purchases are outside the tax and regulatory system. Thus far, most states have been unable to capture this economic activity.

As states transition to legal adult-use cannabis, growth of this legal market is likely to remain strong during the budget scoring period. The estimated total market for cannabis (adult-use, medical, and illegal) is quite significant, and suggests that in the legal markets the growth will be robust (as they transition to legal sales). However, the growth that will be captured in the budget estimates is from existing criminal-market businesses – that are not recognized in the budget baseline – as they transition to legal enterprises.

Colorado most closely resembles a fully-developed cannabis market and the estimated market-share of the legal market is approximately 86.9 percent.[5] However, capital invested in Colorado, which provided the initial growth in the legal market, was invested prior to knowing what the IRS's enforcement attitude and the associated effective tax rates would be. Now that investors are aware of the high tax cost of operating in this industry, it has made raising capital more challenging.

The higher the tax cost specific to this industry means that it is less likely that capital investment will continue. Further, it also lowers the expectation that the legal businesses will gain market-share from the criminal market. Conversely, the lower the 280E tax burden, the more likely it is that individuals will transition from the non-filer market into the regulated and taxed market.

During the budget period, it is likely that revenue losses will occur in the early years. However, as the legal markets in the existing states continue to expand, that transition from the criminal market will result in revenues beginning to eclipse the losses. In many states, the market is only beginning to emerge into the legal channels. Thus, the potential for increased Federal revenues, **as detailed in Table 3,** is significant.

Table 3: Estimated Revenue Based on Modifying Section 280E to Exempt State-Legal Cannabis Businesses, Under Various Assumptions of Growth in the Legal State Markets for Adult-Use Marijuana (in millions of dollars)

	2018-2022	2023-2027	TOTAL 2018-2027
Low Growth Assumptions	-368	266	-102
Moderate Growth Assumptions	-125	875	750
Robust Growth Assumptions	262	1,290	1,552

FOOTNOTES

1. Senate Finance Committee, January 2017. Hearing on the Nomination of Steve Mnuchin to be Secretary of the Treasury: Questions for the Record. Retrieved from: http://static.politico.com/bc/9e/81e33aa74b5980daa9ffdeb7cba9/steven-mnuchin-responses-to-senate-finance-committee.pdf
2. Source: SAMHSA, Center for Behavioral Health Statistics and Quality, National Survey on Drug Use and Health, 2010, 2011, and 2012 (2010 Data – Revised March 2012). Refer to Appendix B for a brief survey of research on the elasticity of demand for cannabis.
3. Colorado offers detailed compliance, tax, licensing, and business activity data. Given that the market progressed with annual growth rates between 37 and 45 percent, and that it continues to thrive, it offers the best perspective of a fully functioning market.
4. These estimates are consistent with investment series studies that seek to invest in legal adult-use marijuana businesses. For example, refer to Cowan and Company, New Frontier Financials, or the Rand Corporation ("How Big is the U.S. Market for Illegal Drugs," RB-9770, 2014).
5. This statement relies on market estimates that compare the current level of legal sales with the estimated total consumption of marijuana (with the current patterns of cannabis consumption based on data from SAMHSA).