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Proposition 64 Legalizes Marijuana in California but the War on Drugs Continues

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Introduction

Though the possession and sale of marijuana remain illegal under federal law, there are a few states that will allow legal dispensaries to purchase and sell marijuana to the public. One particular state, California, allows the sale of medical marijuana and has recently approved Proposition 64 (Prop 64). The state's Legislative Analyst's Office estimates that state and local revenues generated through state-legal sales of marijuana will potentially increase by over \$1 billion annually as a result of the passage of Prop 64.¹ The revenue would be from state excise taxes generated by the growth and sales of cannabis, individuals switching from illegal marijuana purchases to legal purchases from marijuana dispensaries, and an expected increase in the demand for cannabis products.² With passage of Prop 64 back in November 2016 and state's full legalization (beyond medicinal) of marijuana use in 2018, the state of California will have additional ways to collect tax revenue from the sales of cannabis. However, these changes require adjustments from local governments, marijuana dispensaries, and tax practitioners working with marijuana businesses. Despite of the changes in the state's tax law, the marijuana industry is encountering problems because the US Federal government still considers the possession of the drug to be illegal. This article will analyze the proposed tax changes from Prop 64, its effects on the state and local tax levels, current tax issues from the City of San Jose, problems encountered by marijuana dispensaries, and concerns for tax practitioners who serve this industry.

State Tax Laws Imposed by Prop 64

The sales for all marijuana products in California are subject to the state's sales and use tax regulations plus potentially any additional taxes enforced by the city where the seller has dispensaries. In the November 2016 election Prop 64 was approved by a popular vote of 57.13%.³ As a result of the proposition's passage, marijuana will be legal under state law for recreational use effective on January 1, 2018. With this new proposition taking place tax laws will change in order for the state and local governments to collect additional revenues in the form of taxes on cannabis products. While Prop 64 was still on the ballot, the State Board of Equalization issued a Special Notice regarding how the retail and cultivation sales of marijuana will be taxed.⁴ Changes to California's sales and use tax regulations include the following:

- Effective November 9, 2016, certain sales of medical marijuana are considered tax-exempt for sales/use tax purposes. This sales and use tax exemption applies to the retail sale of cannabis products sold as a prescription. Cannabis products that the patient may purchase are dried marijuana leaf or flower products, edible medical cannabis products, or topical creams. Patients with a prescription and also a valid Medical Marijuana Identification Card (MMIC)⁵ are allowed to choose what type of cannabis products to use within the limits of how much cannabis the dispensary will sell them per visit.

¹ See 2016 LAO summary at: <http://www.lao.ca.gov/BallotAnalysis/Proposition?number=64&year=2016>

² *Ibid*

³ Ballotpedia. (2016). *California Proposition 64, Marijuana Legalization*. Retrieved February 5, 2017 from [https://ballotpedia.org/California_Proposition_64,_Marijuana_Legalization_\(2016\)](https://ballotpedia.org/California_Proposition_64,_Marijuana_Legalization_(2016))

⁴ Board of Equalization. (10/2016). *Information About Proposition 64 for Sellers of Marijuana* <https://www.boe.ca.gov/pdf/1481.pdf>

⁵ Medical Marijuana Identification Card Program. <https://www.cdph.ca.gov/programs/MMP/Pages/default.aspx>

- Effective January 1, 2018, a 15 percent state excise tax applies to all retail sales of cannabis products including marijuana purchased on prescription.

According to California's current sales and use tax regulations, prescriptions are exempt from sales tax.⁶ As such, this special 15 percent excise tax allows the state to collect tax revenue from the gross sales of cannabis despite the general prohibition against sales tax against traditional prescription drugs. In addition, the following state tax on cultivators will apply:

- \$9.25 per ounce of dried marijuana flowers
- \$2.75 per ounce of dried marijuana leaves

Compared to most marijuana dispensaries, many cultivators do not have a sophisticated accounting system to record their sales. Some cultivators grow and process their crops, then deliver them to dispensaries for sale without issuing or saving sales receipts. Additionally, because the transaction is for a tangible product, the dispensary would not be able to issue an IRS Form 1099-MISC to the cultivator.⁷ Therefore, auditing a cultivator will be difficult. Ideally, adding an additional tax on cultivators will generate more revenue for the state, but the problem is the actual collection and enforcement of the tax.

The City of San Jose's Marijuana Industry Before Prop 64

There are currently 16 dispensaries allowed to legally sell medical marijuana in the City of San Jose.⁸ Although the city keeps trying to shut down any illegal dispensaries, it lacks proper resources to close all of them. Additionally, the 16 legal dispensaries are required to send reports of their daily sales to the city. The dispensaries are also required to report and pay their Marijuana Business Tax (MBT) on a monthly basis. This is conducted by requiring the dispensary to connect their point-of-sales (POS) system with the city's police department. When the dispensary reports its monthly sales, the sales are reported to the city's finance department which could communicate with the police department to verify monthly sales.

Even for marijuana dispensaries operating illegally in San Jose,⁹ they are still required to report their sales and pay their MBT. As of February 2015, there were five marijuana dispensaries that, according to city records, owed a combined amount of over \$2.1 million dollars in MBT taxes to the City.¹⁰ One particular dispensary, MediMart, has not only chosen to operate illegally but refused to pay state sales tax as well as San Jose's MBT.

MediMart opened in 2009 as a nonprofit collective under the entity Bay Pacific Care, Inc. Around May 2012 the business discontinued paying their MBT taxes and filed tax returns indicating that taxes were not owed. The corporation's president, David Armstrong, argued marijuana is considered illegal under Federal law, and concludes that the tax associated with the sale of the products is illegal itself.¹¹ The case between the City of San Jose and MediMart is still ongoing.

⁶ California Revenue and Taxation Code, Reg 1591(b)

⁷ IRC Sect. 1.6041-1

⁸ Office of the City Manager. N.d. *Medical Marijuana in San Jose*. Message posted February 8, 2017 <http://www.sanjoseca.gov/medicalmarijuana>

⁹ The list of registered collectives in the city of San Jose can be found at: <http://www.sanjoseca.gov/index.aspx?nid=4860>

¹⁰ Kovaleski, Tony. (2015, February 15). *Some Pot Shops Owe Millions in Unpaid Marijuana Taxes*. NBC Bay Area. Retrieved February 5, 2017 from <http://www.nbcbayarea.com/investigations/San-Jose-Pot-Shops-Owe-Millions-in-Unpaid-Marijuana-Taxes-Link-Headline-Pot-Shops-Owe-Millions-in-Unpaid-Taxes-292752491.html>

¹¹ Justia US Law. N.d. City of San Jose v. MediMarts, Inc. Retrieved February 4, 2017, from <http://law.justia.com/cases/california/court-of-appeal/2016/h042481.html>

Potential Challenges Cities Encounter with the Enactment of Prop 64

Depending on where dispensaries operate, cities have the authority to impose a MBT based on the gross sales of marijuana. The MBT rate can vary from city to city. For example, San Jose currently imposes an additional ten percent tax to the state's sales tax for retail sales of marijuana products;¹² whereas, Oakland charges MBT at a rate of five percent.¹³ A matter that would add complications to the MBT tax law, is that dispensaries want to implement a delivery service. The cannabis products would be delivered using the dispensary's vehicles and are not through common carriers. The purpose of this service is to provide convenience for patients who are physically unable to pick up the drug in person.

Though it is currently illegal for dispensaries to deliver products to their customers, Prop 64 will legalize the delivery of cannabis. A potential problem with deliveries for a city is to determine which city has the right to collect the MBT. If a dispensary located in San Jose delivers cannabis products, using its company vehicle, to Oakland, the city of Oakland would be entitled to collecting the MBT. This logic stems from the Bradley-Burns Uniform Local Sales and Use Tax Regulation 1802, where local sales tax is allocated based on the location of sale.¹⁴ Therefore, the city of Oakland will collect the MBT, causing San Jose to lose the tax revenue. Additionally, Oakland charges MBT at a lower tax rate, forcing cities to compete with each other for the collection of the tax.

The enactment of Prop 64 will propose that, under the California's Sales and Use Tax Regulation 1591, MBT will no longer apply to the sales of medical marijuana after January 1, 2018. So far, the City of San Jose has not made a determination on how the MBT will be collected nor made any changes to their municipal code.

Marijuana Industry's Lack of Federal Benefits Leads to Problems for State and Local Governments

Under Federal law marijuana is considered an illegal drug. Dispensaries are not allowed to receive any expenditure deduction or credit, "if such trade of business (or the activities which comprise such trade or business) consists of trafficking in controlled substances...which is prohibited by Federal law or the law of any State."¹⁵ This includes the denial of gross income deductions related to rent, advertising, and salaries. However, taxpayers may deduct expenses that are related to the "return of capital", such as, the costs of seed, plants and any other costs that can be properly included as cost of goods sold under Federal tax law.¹⁶ A dispensary is still required to file a Federal income tax return, but unlike non-cannabis businesses, it is not allowed to deduct most ordinary and necessary business expenses, which results in the business paying higher taxes.

Despite the fact that it is legal to operate a marijuana dispensary under Federal law, California recognizes a dispensary as a potential legal business. The state has a stand-alone law that allows marijuana dispensaries to deduct expenses, such as, rent, advertising, salaries and other ordinary and necessary expenses on their state tax returns so long as the business is operated as a corporation.¹⁷ Deductions for any necessary business expenses and cost of goods sold may be deducted on a California corporate tax return as long as they are considered necessary for operating

¹² San Jose Municipal Code 4.66.250(A)

¹³ City of Oakland. N.d. *City of Oakland Business Tax Classification & Rate Schedule*: <http://www2.oaklandnet.com/w/OAK024875>

¹⁴ Article 19. Bradley Burns-Burns Uniform Local Sales and Use Taxes, Reg. 1802(d)

¹⁵ IRC §280E

¹⁶ AICPA, COCPA, and Washington Society of Certified Public Accountants. (2016). *An Issue Brief on State Marijuana Laws and the CPA Profession*. <http://www.aicpa.org/Advocacy/State/DownloadableDocuments/MarijuanaCPAsIssueBrief.pdf>

¹⁷ Calif. Rev. and Tax Sect. 24343 and 24271. Also see: Franchise Tax Board. (2016 April 12). *Medical Marijuana – State and Federal Income Tax Law*. Message posted to https://www.ftb.ca.gov/businesses/Medical_Marijuana/Income_Tax_Law.shtml#_ftn4

the business under IRC 162.¹⁸ However, if the dispensary is *not* operated as a corporation (for example, as a sole proprietorship), California does follow the Federal tax rules as it relates to the non-deductibility of all expenses (except for cost of goods sold). Therefore, dispensaries need to consider the differences between California tax laws and Federal tax laws when they decide what form of business entity to operate from and they should save all expense documentation for tax purposes. It is not uncommon for dispensaries to be more concerned with Federal tax laws than state laws. Since dispensaries are denied most federal deductions, they believe that they do not need to save records related to their business. The lack of records from these particular dispensaries makes it incredibly difficult for the state and city authorities to audit these businesses.

Another problem facing both the industry and tax authorities is that there are various Federal laws that may potentially make it illegal for banks and credit unions from accepting any money related to sales of cannabis products as well as providing traditional banking services such as credit card and check processing. As a result, dispensaries are effectively forced to receive payments from customers and pay state and local taxes in cash.¹⁹ However, small community banks may be allowed to work with marijuana dispensaries but will need to comply with the US Treasury and Justice Department to monitor their client's activities. Standards from the US Treasury and Justice Department require these financial institutions to monitor red-flag activities.²⁰ These red flags require that the banks must monitor the following activities from dispensaries:

- Rapid movement of cash deposits followed by immediate withdrawals.
- Commingling of business funds with the officers' or owners' personal accounts.
- Deposits from third parties that are not related to the business.
- Ensure the dispensaries financial statements are consistent with their banking activities.

The standards from the US Treasury and Justice Department also require financial institutions to focus heavily on revenue deposited from marijuana dispensaries. Financial institutions need to compare revenues deposited from the dispensary with other dispensaries in the area. Specifically, the US Treasury and Justice Department list the following activities that local financial institutions need to check:

- Cash deposits from the dispensaries and ensuring income received from the sale of cannabis products are consistent with the tax figures they are reporting to state and local governments.
- Business revenue to ensure that the dispensary is not receiving unexpected substantial amounts of revenue in contrast to their competitors.
- The revenue is only from the sale of state-legal cannabis products but not any other illegal drugs or activities.

These stringent regulations may create too many challenges for small community banks and make the cost of working with marijuana dispensary clients higher than the benefits banks can receive. These often deter such banks from wanting to work with marijuana dispensaries and ultimately results in them denying them as clients, thereby forcing the dispensaries to operate without a bank and store large amounts of cash in their business which is vulnerable to theft.

A business that operates without a bank tends to be a business without records. A lack of records will make it difficult for state and cities to audit a dispensary. Bank statements provide third party data

¹⁸ California Revenue and Taxation Code – RTC 24343

¹⁹ Quinton, Sophie. (2016 March 22). *Why Marijuana Businesses Still Can't Get Bank Accounts*. Retrieved February 3, 2017 from <http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2016/03/22/why-marijuana-businesses-still-cant-get-bank-accounts>

²⁰ Department of the Treasury Financial Crimes Enforcement Network. (2014 February 14). *BSA Expectations Regarding Marijuana-Related Businesses*. Retrieved February 8, 2017 from <https://www.fincen.gov/sites/default/files/shared/FIN-2014-G001.pdf>

that help verify gross sales and thus confirming that the dispensary has paid the correct amount of taxes owed. When dispensaries only have records from their point of sale / cash register system, this creates a problem in that POS records generated by the marijuana business can be easily manipulated by the business.

Tax board officials in California floated an idea of forming a state-run bank, but the bank would still need to use Federal wiring services.²¹ The problem with marijuana industries being a cash only business is that cash is difficult to trace and has restricted state and local governments' abilities to collect taxes. In the San Francisco Bay Area, it was discovered that about 35% of medical marijuana businesses paid their sales taxes, which was about \$27 million.²² Currently, states like California that have legalized the sale of marijuana are unable to find a solution to the banking issues and related tax compliance and audit issues unless the Federal government decides to remove marijuana from its list of dangerous drugs under Schedule I of the Controlled Substances Action (those that are deemed to have no medicinal benefits). If this were to happen, then under current Federal laws it would enable financial institutions to more easily provide full-scale banking services to this industry. Though Prop 64 came with the proposal that the state of California will receive additional tax revenues, the proposition did not provide an overall solution on how the state and cities will collect taxes without a proper audit trail. However, auditing cash-only businesses is not impossible, but audit results may lead to imperfect findings.

Tax Preparer Concerns

Most marijuana businesses will need to have an outside tax preparer. Before a tax practitioner accepts a dispensary as a client, an AICPA staff and volunteer generated report (with input from both the Colorado and Washington state CPA societies) recommends that CPAs should first determine how their state board defines and applies "good and moral character."²³ Though California does not have a clear definition on good and moral character, it is expected that a CPA does have and must maintain this characteristic. With the anticipation of Prop 64 being in full effect in 2018 and the lack of guidance from the California Board of Accountancy, a CPA is placed into an unknown situation. One major concern a CPA may have is that even though on a state level marijuana is legal, it is still illegal under Federal law which could possibly put the CPA's practice and license at risk.

The AICPA staff and volunteer report recommends that CPAs, before accepting a marijuana business as a client, discuss the following questions with their legal counsel:

- What is the position on my state board of accountancy on CPAs providing services to marijuana growers/distributors?
- What is the legal risk of providing services to this industry in this state?
- Will there be a risk of prosecution to a CPA or a CPA firm if they choose to provide services for businesses involved in this industry?
- What are the chances that the Drug Enforcement Administration (DEA) or Department of Justice will prosecute this business?
- How are other CPAs in my state currently offering services to the business?
- Will providing this affect malpractice insurance or personal liability insurance?
- What are that chances that a practitioner will be disciplined, sanction or lose the license by providing services to these businesses?

²¹ Cadelago, Christopher. (2015 July 31). *California tax officials float state-run bank for marijuana industry*. The Sacramento Bee. Retrieved February 10, 2017 from <http://www.sacbee.com/news/politics-government/capitol-alert/article29685532.html>

²² Ibid.

²³ See *An Issue Brief on State Marijuana Laws and the CPA Profession* (last updated on 2016 January 8) at: <http://www.aicpa.org/Advocacy/State/DownloadableDocuments/MarijuanaCPAsIssueBrief.pdf>

- What procedures and policies should be considered to ensure that the potential client understands the state laws concerning marijuana related businesses and if the client is following those rules?

The report also recommended that a CPA should consider conducting background investigations on marijuana clients to ensure that they have been complied with the law.²⁴ As for any services performed, an engagement letter should specifically state the type of services to be performed as well as the type of services will not be undertaken by the CPA. The practitioner should also require the owners and/or corporate officers of the business to sign a representation letter. This letter should be updated whenever the CPA makes any additions or changes to the firm's policy. It should also state that the client understands state law requirements and intends to fully comply and will not withhold information from the CPA.

It is also important that practitioners perform proper due diligence under Circular 230.²⁵ Records from dispensaries are composed by the taxpayers themselves and will not have a bank record to verify the sales earned. However, practitioners may rely on the information in good faith. As long as the practitioner is confident that they have not ignored any information, they can accept the client's information.²⁶ As for every client, CPAs should document the work and communication with the client. They should also seek advice from colleagues who work with marijuana businesses. However, if a practitioner or CPA believes that if accepting a marijuana business may create too much risk, they have a right to decline (and should not accept) the business as a client.

Conclusion

The marijuana industry is relatively new in the state of California. Despite the expectation of Prop 64 to raise one billion in tax revenue, there are still unsolved problems on how these potential revenues will be collected or how dispensaries can be compliant with the law. Some of the issues originate from Federal law maintaining its illegal status on marijuana. Other problems result from confusion between Federal, state, and local laws, making practitioners fear violating required codes of conduct. However, laws can change and the industries involved in the sale of cannabis may eventually find a proper place in the tax law.

²⁴Ibid.

²⁵ Circular 230 - §10.22 (31 CFR Subtitle A, Part 10)

²⁶ Circular 230 - §10.34(d)