

Department of Legislative Services
 Maryland General Assembly
 2022 Session

FISCAL AND POLICY NOTE
 First Reader

House Bill 351 (Delegate Wilkins)

Ways and Means and Health and
 Government Operations

**Income Tax - Subtraction Modification - Expenses of Medical Cannabis Grower,
 Processor, Dispensary, or Independent Testing Laboratory**

This bill creates a subtraction modification against the State individual and corporate income tax for the amount of ordinary and necessary expenses, including a reasonable allowance for salaries or compensation, paid or incurred during the taxable year in carrying on a trade or business as a State licensed medical cannabis grower, processor, or dispensary or a State registered independent testing laboratory. The subtraction modification may be claimed if the deduction for ordinary and necessary expenses is disallowed under Section 280E of the Internal Revenue Code (IRC). **The bill takes effect July 1, 2022, and applies to tax year 2022 and beyond.**

Fiscal Summary

State Effect: General fund, Transportation Trust Fund (TTF), and Higher Education Investment Fund (HEIF) revenues decrease by approximately \$6.4 million in FY 2023, reflecting the impact of about one and one-half tax years. Future year revenue decreases reflect annualization and the projected increase in taxable deductions. General fund expenditures at the Comptroller’s Office increase by \$120,000, and TTF expenditures decrease by \$78,300 in FY 2023.

(\$ in millions)	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
GF Revenue	(\$5.6)	(\$4.1)	(\$4.6)	(\$5.0)	(\$5.5)
SF Revenue	(\$0.8)	(\$0.6)	(\$0.7)	(\$0.7)	(\$0.8)
GF Expenditure	\$0.1	\$0	\$0	\$0	\$0
SF Expenditure	(\$0.1)	(\$0.1)	\$0.0	(\$0.1)	(\$0.1)
Net Effect	(\$6.4)	(\$4.7)	(\$5.2)	(\$5.7)	(\$6.3)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate increase; (-) = indeterminate decrease

Local Effect: Local income tax revenues and local highway user revenues decrease by approximately \$1.6 million in FY 2023 and by \$1.5 million in FY 2027. Local expenditures are not affected.

Small Business Effect: Meaningful.

Analysis

Current Law: No similar State subtraction modification or tax credit exists.

Generally, income from any source is presumptively taxable by the federal government, even if such income is generated from illegal activity. Thus, though a marijuana business is illegal under federal law, it must still pay federal income tax on its taxable income. Businesses may generally deduct ordinary and necessary business expenses on their federal income tax return, which typically results in a lower federal and State income tax liability. However, a marijuana business is prohibited from deducting ordinary and necessary business expenses, because IRC § 280E states that no expenses incurred in connection with the trafficking of controlled substances, or illegal drugs, may be deducted for federal income tax purposes. Section 280E also disallows other deductions and certain tax credits.

A medical marijuana business is not allowed to deduct ordinary and necessary business expenses, which may include expenses associated with distribution, sales, administration, management, promotion, advertisement, overhead, and support. However, a business may deduct the costs of goods sold, which are the direct costs attributable to the production of a good.

Federal legislation has been introduced in the U.S. Congress in recent years to amend the IRC to exempt a trade or business that conducts marijuana sales in compliance with state law from the prohibition against allowing business-related tax credits or deductions for expenditures in connection with trafficking in controlled substances. In addition, several states have “decoupled” from federal income tax law and allow a marijuana business to deduct for state income tax purposes ordinary and necessary business expenses.

Natalie M. LaPrade Medical Cannabis Commission

The Natalie M. LaPrade Medical Cannabis Commission is responsible for implementation of the State’s medical cannabis program, which is intended to make medical cannabis available to qualifying patients in a safe and effective manner. Medical cannabis sales have increased from \$96 million in calendar 2018 to about \$565 million in calendar 2021.

State Revenues: Subtraction modifications may be claimed beginning in tax year 2022. It is assumed that the proposed changes impact withholdings and estimated payments. As a result, general fund revenues decrease by an estimated \$5.6 million, TTF revenues decrease by \$0.6 million, and HEIF revenues decrease by \$0.2 million in fiscal 2023. **Exhibit 1** shows the estimated fiscal impact of the bill on State and local revenues.

This estimate assumes ordinary business expenses are 20% of sales and that one-half of taxpayers have sufficient tax liability to benefit from the subtraction modification. To the extent that additional taxpayers do not have sufficient tax liability, revenue losses will be less than estimated. The estimate also assumes that (1) one-half of all subtraction modification amounts are deducted against the personal income tax, with the remaining amounts deducted against the corporate income tax and (2) future amounts subtracted increase by 10% annually.

Exhibit 1
State and Local Revenues
Fiscal 2023-2027

	<u>FY 2023</u>	<u>FY 2024</u>	<u>FY 2025</u>	<u>FY 2026</u>	<u>FY 2027</u>
State Revenues					
General Fund	(\$5,564,000)	(\$4,146,000)	(\$4,560,000)	(\$5,016,000)	(\$5,518,000)
HEIF	(238,000)	(178,000)	(195,000)	(215,000)	(236,000)
TTF	(580,000)	(432,000)	(475,000)	(523,000)	(575,000)
Total	(\$6,382,000)	(\$4,756,000)	(\$5,230,000)	(\$5,754,000)	(\$6,329,000)
Local Revenues					
Income Tax	(\$1,493,000)	(\$1,113,000)	(\$1,224,000)	(\$1,346,000)	(\$1,481,000)
LHUR	(78,300)	(58,300)	(45,600)	(50,200)	(55,200)
Total	(\$1,571,300)	(\$1,171,300)	(\$1,269,600)	(\$1,396,200)	(\$1,536,200)

HEIF: Higher Education Investment Fund

LHUR: local highway user revenue

TTF: Transportation Trust Fund

State Expenditures: The Comptroller’s Office reports that it will incur a one-time expenditure increase of \$120,000 in fiscal 2023 to add the subtraction modification to the personal and corporate income tax returns. This includes data processing changes to the income tax return processing and imaging systems and system testing.

A portion of TTF revenues is used to provide capital transportation grants to local governments. Thus, any decrease in TTF revenues from corporate income tax

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revenues results in a 13.5% decrease in TTF expenditures to local governments (9.6% beginning in fiscal 2025). Accordingly, TTF expenditures decrease by \$78,300 in fiscal 2023 and by \$55,200 in fiscal 2027, as shown in Exhibit 1. TTF revenues also fund the State capital program; thus, a decrease in TTF revenues decreases expenditures for the State capital program.

Local Revenues: Local income tax revenues decrease by about 3% of the total net State subtraction modifications claimed against the personal income tax. Local income tax revenues will decrease by approximately \$1.5 million in fiscal 2023 and by \$1.5 million in fiscal 2027, as shown in Exhibit 1. Additionally, local governments receive a portion of corporate income tax revenues as local highway user revenues through capital transportation grants. Under this bill, local highway user revenues decrease by approximately \$78,300 in fiscal 2023 and by \$55,200 in fiscal 2027 as a result of deductions taken against the corporate income tax.

Small Business Effect: Small businesses that are State registered independent testing laboratories or State licensed medical cannabis growers, processors, or dispensaries would benefit from the subtraction modification. The magnitude of the benefit will depend on their tax liability and the amount of ordinary and necessary expenses disallowed under IRC Section 280E.

Additional Information

Prior Introductions: SB 900 of 2021, SB 146 of 2020, and SB 9 of 2019 received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. The cross files, HB 217, HB 1210, and HB 568, received a hearing in the House Ways and Means Committee, but no further action was taken.

Designated Cross File: SB 333 (Senator Young) - Budget and Taxation.

Information Source(s): Comptroller's Office; Maryland Department of Health; Maryland Medical Cannabis Commission; CCH Intelliconnect; the Maryland Bar Journal; Department of Legislative Services

Fiscal Note History: First Reader - January 31, 2022
fnu2/jrb

Analysis by: Robert J. Rehrmann

Direct Inquiries to:
(410) 946-5510
(301) 970-5510