The Grass May Not be Greener for the Pot Business

March 3, 2015

For Immediate Release
Contact: Gigi Thompson Jarvis, CAE
202.822.6232, x119
gjarvis@naea.org

Washington, DC (March 3, 2015) — This past week the District of Columbia joined Alaska, Colorado and Oregon in legalizing recreational marijuana. Now, District residents starting “growing” businesses are in the same strange situation as other states where pot is legal: it may be legal locally, but it’s still illegal federally. And thanks to Congress, a spending bill dubbed “Cromnibus” prohibits District officials from creating the regulatory system for legal sales and taxation of the drug. While the growers will be challenged to find financial institutions willing to violate federal laws by doing business with them, at least at this point they will not pay taxes on plants they cultivate.

Colorado and Washington State may have envisioned that legal recreational marijuana would become a tax jackpot, but their dreams have been dampened substantially by the rising number of residents who have gotten themselves on the medical marijuana registry rather than pay the high taxes carried by the recreational pot. The steep taxes have also resulted in a proliferating black market pot trade in those states – even though pot is legal.

“The stores here are competing with illegal pot coming in from California and Oregon that isn’t taxed,” said Melissa Longmuir, EA, of Centinel Tax Consulting, Inc. in Bellevue, WA. “State taxes are levied on every distinct individual participant in the process, from the growers to the retailers, which accounts for over half the price. If one company is producing and processing, it’s only taxed once. A lot of people who’ve been buying it illegally for years are just continuing to do so rather than pay the inflated prices that result from state taxes. ”

Washington State legislators are discussing reducing pot taxes to make recreational stores more competitive and eliminating medical dispensaries, which have been largely tolerated by law enforcement even though they aren't allowed under state law.

Other problems facing small business owners trying to sell pot is that although the legal status of medical marijuana may be changing on the state level, it remains illegal on the federal level, making it impossible for those who run medical marijuana businesses to take advantage of any of the tax deductions IRS permits other businesses. Medical marijuana producers may not deduct expenses such as the cost of goods sold and salaries. Generally, businesses that make or buy goods to sell may deduct the cost of goods sold from their gross receipts in computing business income and most businesses rely on this to reduce their taxes and keep them profitable.

The issue revolves around what is called “illegal source income” and the upshot may well be that the sellers of marijuana can’t come out ahead financially because they are being taxed on their gross income. It may seem odd that the IRS taxes money from federally illegal enterprises, but Al Capone and others wound up in jail because of it. Section 61 of the Internal Revenue Code states that all income is taxable, from whatever source derived.

Those in the marijuana business have their share of problems, but taxes are a critical issue for small businesses of every kind. On the one hand, it’s important for them to take advantage of every tax deduction available, but they need to be careful – small businesses are often audited by the IRS. A licensed tax professional can prepare a return that allows businesses to keep their tax burden to a minimum, and stay on the right side of the law. Enrolled agents (“EAs”) are licensed by the US Department of the Treasury and required to report annual continuing education to the IRS. They can also represent taxpayers in trouble before the IRS. You can find an enrolled agent in your area on the “Find an EA” directory at www.naea.org.