Income tax challenges for medical marijuana businesses in Oklahoma

Jessica N. Cory represents businesses and individuals in a wide range of transactional matters, with an emphasis on tax planning.

In this article, Oklahoma City Attorney Jessica N. Cory explores the conflict between federal and state law as it pertains to Oklahoma medical marijuana businesses.

What is the primary federal tax issue for Oklahoma medical marijuana businesses?

Jessica Cory, attorney with Phillips Murrah law firm answers: The primary tax issue for Oklahoma medical marijuana businesses stems from the conflicting treatment of the marijuana industry under federal and state law. Although the approval of State Question 788 last summer legalized the use, growth and sale of medical marijuana for state purposes, marijuana remains an illegal drug under the federal Controlled Substances Act. Special tax provisions apply to penalize anything deemed illegal drug trafficking under federal law, including licensed medical marijuana businesses.

What are the specific federal tax burdens a medical marijuana business will face?

Internal Revenue Code Section 280E represents the biggest tax challenge for medical marijuana businesses. Generally, the Internal Revenue Code allows a taxpayer to take a deduction for all “ordinary and necessary” business expenses paid or incurred during the taxable year. Congress has created an exception to this rule in certain instances, however.

One such exception is Code Section 280E, which prohibits a taxpayer engaged in the business of “trafficking in controlled substances” from taking a deduction for ordinary business expenses. Because the federal Controlled Substances Act defines marijuana as a Schedule I drug, Code Section 280E severely limits the types of deductions available to a medical marijuana business.

Although Code Section 280E prevents a marijuana business from taking normal business deductions, it does not bar a business from offsetting its gross receipts with its cost of goods sold (“COGS”). This means a business can at least reduce its potential taxable income by its direct costs of production. However, the Internal Revenue Code has issued guidance strictly limiting the types of costs a taxpayer engaging in a marijuana business can allocate to COGS, to prevent an end-run around Code Section 280E.

Case law supports this narrower interpretation of COGS for the marijuana industry, including prohibiting resellers of marijuana from including any indirect costs – costs other than the price paid for inventory plus any transportation or other necessary acquisition costs – in COGS.

Is there anything marijuana business owners can do to minimize their federal tax burden?

Yes, a tax professional can help marijuana businesses develop strategies for minimizing the impact of Code Section 280E. For example, a tax adviser can help a business differentiate between COGS and business deductions to take full advantage of the COGS offset allowed under federal law. In addition, a tax professional may be able to help a company structure its business to separate out its different activities to avoid having Code Section 280E apply too broadly. It is also essential for marijuana businesses to keep careful records, particularly if the business also engages in additional activities unrelated to growing, processing or selling marijuana.

Has there been any effort in Congress to fix the disparity in treatment under federal and state law?

Members of Congress have repeatedly introduced legislation to exempt marijuana businesses lawfully operating under state law from the parameters of Section 280E. For example, the Strengthening the Tenth Amendment through Entrusting States ("STATES") Act, which would amend the Controlled Substances Act to protect people operating within the bounds of state cannabis laws, was recently reintroduced. Unfortunately, despite bipartisan support and the backing of several 2020 presidential candidates, the odds are not in favor of passage at this time.

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