Federal Rules on Income Taxation of New Mexico's Medical Cannabis Industry

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Federal Income Taxation Primer: the Constitutional Tax Base

- The upper limit of the federal income tax base is "gross income."
  - The 16th Amendment to the US Constitution authorizes Congress to "incomes" regardless of their source and without the need to allocate that income among the states.
  - The US Supreme Court has ruled that "income," for purposes of the 16th Amendment, means "gross income" not "gross receipts."
  - Income does not include the return of capital.

Federal Income Taxation Primer: the Constitutional Tax Base

- "Gross receipts" must be reduced by the "cost of goods sold" (COGS) to derive "gross income:" the constitutional tax base.
  - For producers or resellers of products, the "return of capital" is reflected in COGS.
  - COGS generally means the expenditures necessary to acquire, construct, produce, or extract a physical product.
  - Even if the activity generating the income is illegal at the federal level (i.e. medical cannabis), *the IRS generally allows COGS to reduce "gross receipts" to avoid constitutional issues.*

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Federal Income Taxation Primer: the Statutory Tax Base

- The IRC is effectively a tax on “net income,” not “gross income.”
  - Congress has elected to impose federal income tax on “net income.”
  - Ordinary trade or business expenses are deducted from “gross income” to derive the tax base.
    - Ordinary trade or business expenses –
      - Depreciation, wages, utilities, advertising, legal, etc.
  - Because Congress has set a statutory tax base smaller than constitutionally permissible, these “deductions” are a matter of legislative grace.

Origins of IRC § 280E

- 1981 US Tax Court case involving an illegal drug trafficker.
- Held that because IRC does not distinguish between legal and illegal income, the taxpayer was entitled to both:
  - Reduce “gross receipts” by COGS to derive “gross income;” AND
  - Deduct ordinary trade or business expenses (rent, packaging, weighing equipment, telephone service) to derive “net income” like every other taxpayer engaged in lawful business activities.
    - *Edmondson v. Comm’r*, T.C. Mem, 1981-623.
- Congress immediately responded by enacting IRC § 280E in 1982.

IRC § 280E

- *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.

Effect of 280E on Federal Taxable Income

Herbal Supplement Business

Gross Receipts

- Minus COGS (constitutional)
- Minus ordinary trade or business deductions (statutory)

Federal Taxable Income ("net income")

NM Medical Cannabis Business

Gross Receipts

- Minus COGS (constitutional)

Federal Taxable Income ("net income")

- Statutory ordinary trade or business deductions disallowed by 280E.

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The Effect of 280E on New Mexico Income Taxes

- PIT and CIT "piggyback" the IRC.
- New Mexico uses Federal Taxable Income to calculate New Mexico income tax.
  - § 7-2A-2(C) (starting point for calculating NM CIT is federal taxable income as defined in the IRC).
  - § 7-2-2(A) & (B) (starting point for calculating NM PIT is adjusted gross income/federal taxable income).
- For a medical cannabis business (lawful in NM, but not federally) the NM tax base is higher because it includes 280E-disallowed ordinary trade or business expenses.

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Decoupling from IRC 280E: Leveling the Playing Field

- SB 228 (2018)
  - Amends the definition of “base income” in the PIT and CIT programs.
  - Under SB 228 and for businesses that lawfully operate under NM law, base income *excludes* an amount equal to any expenditure that is eligible to be claimed as a federal income tax deduction but that is disallowed by IRC 280E.

Policy Reasons for Decoupling

- Tax Policy Reasons:
  - Revenue Adequacy: negative but minimal effect on GF revenues. FIR SB 228.
  - Efficiency: Prevents interference with economy, especially considering the effect of IRC 280E on federal income taxes.
  - Equity: treats lawful businesses the same.
  - Simplicity: typical calculation done by all businesses.
  - Accountability:
    - There will need to be a line on PIT/CIT forms to effectuate the decoupling;
    - Prevents over-capitalizing to COGS.

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Legal Reasons for Decoupling

- Potential Equal Protection violation.
  - Rational basis for 280E at the federal level does not apply in NM.
    - The activity is legal in NM.
  - Treating lawful businesses differently without firm legal rationale.

Questions