



## Research

# Federal Taxation of Cannabis: A Primer

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### Executive Summary

- The manufacture, distribution, and possession of cannabis is illegal under federal law, which categorizes it as a Schedule 1 controlled substance.
- This prohibition stands in contrast to the 18 states that have “legalized” recreational cannabis use and the 37 states that have enacted laws regulating cannabis use for medical reasons.
- This legal “gap” raises a number of challenges for policymakers and market participants, particularly with respect to taxation.
- Federal law requires that taxpayers must report income from illegal sources – including cannabis sales (whether state sanctioned or not) – raising numerous tax compliance and design issues.

### Introduction

A visitor to any one of the 18 states that have “legalized” recreational cannabis (marijuana) use could be forgiven for concluding that such conduct in those states is in fact legal. From the standpoint of federal law, however, the manufacture, distribution, and possession of cannabis remains a federal crime under the Controlled Substances Act (CSA). Under federal law, cannabis is a Schedule 1 controlled substance, and anyone involved in its distribution is, all else equal, a drug dealer subject to severe criminal penalties. Curiously, federal law also requires these cannabis businesses to pay federal taxes on their income even though that income is illicit money as far as federal law is concerned.

As states and localities continue to legalize cannabis use and businesses, federal law appears increasingly discordant, raising a number of practical challenges for federal and subnational policymakers. While there has been increasing attention and interest in this issue on Capitol Hill, in the near term the federal tax treatment of cannabis-related business remains fraught with risks.

### The Controlled Substances Act

In 1970, Congress passed, and President Nixon signed, the Comprehensive Drug Abuse Prevention and Control Act. The act repealed the prevailing federal drug laws and established a new legal regime regulating the manufacture, distribution, and possession of certain controlled substances. Title II of that law contained the CSA, which set forth a graduated ranking, or schedule, of regulated substances based on their potential for abuse and medical utility.<sup>[1]</sup> The CSA established five schedules for classifying controlled substances – which under the act can include prescription drugs, illicit drugs, plants, or any chemical or substance that is identified as meeting the criteria set forth under the CSA. Controlled substances with the highest potential for abuse and the least medical utility are classified as Schedule 1 controlled substances and are subject to the highest restrictions. With some highly regulated exceptions, the manufacture, distribution, and possession of Schedule 1 controlled substances is illegal and invites severe criminal penalties.<sup>[2]</sup> A survey of Schedule 1 controlled

substances finds some usual suspects such as heroin, LSD, and MDMA (ecstasy), but not, for example, cocaine or methamphetamine, which are listed as Schedule 2 controlled substances because, notwithstanding their high potential for abuse, they have currently accepted medical uses. Cannabis, by contrast, is assessed as having a high potential for abuse and no currently accepted medical uses and is therefore a Schedule 1 controlled substance under federal law.

And yet, 18 states, two territories, and the District of Columbia have, for the purposes of subnational law, “legalized” small amounts of cannabis (marijuana) for adult recreational use.[3] Further, notwithstanding the determination of the Drug Enforcement Administration (DEA), which is required to defer to the Department of Health and Human Services’ assessment that cannabis has no acceptable medical utility, 37 states and four territories have enacted laws allowing for the medical use of cannabis products.[4] The majority of U.S. states have therefore, in one form or another, defied federal law with respect to cannabis use and distribution in their respective jurisdictions. This paradox has introduced a number of complications for policymakers and market participants, including and especially with respect to taxation.[5]

### **Federal Taxation of Income from Trafficking in Controlled Substances**

Federal law requires that U.S. residents pay taxes on their income – it does not recognize income as more or less deserving of taxation owing to its source. Indeed, even income from illicit sources is subject to taxation, as the notorious bootlegger Al Capone discovered. Despite fame as a murderous gangster, the head of the Chicago “Outfit” was ultimately convicted of three felony counts of tax evasion and two misdemeanors for failure to file a tax return.[6] Indeed, a careful review of Internal Revenue Service (IRS) [Publication 17](#), the guide for completing tax returns for individuals, reveals that it is as candid as it is humorous. The form helpfully clarifies for individuals that “income from illegal activities, such as money from dealing illegal drugs, must be included in your income on Schedule 1 (Form 1040), line 8, or on Schedule C (Form 1040) if from your self-employment activity.” And should anyone want to get creative, for example, about their income from loan-sharking (“usurious interest”), illegal bribes and kickbacks, or stolen property, do know that the IRS has already thought of that – all must be included on a 1040. There is, however, an exception for stolen property *if* the taxpayer/thief returns the property within the year it was stolen.

Thus, despite being engaged in earning income from activities made illegal under the CSA, otherwise lawful cannabis distributors must still file timely and accurate tax returns and pay all applicable taxes. There was a time when federal tax law was truly blind to income from drug sales. In a 1981 U.S. Tax Court Opinion, the court held that a taxpayer who “was self-employed in the trade or business of selling amphetamines, cocaine, and marijuana” was entitled to claim travel, rent, packaging costs, and other similar costs as expenses deductible against his otherwise taxable income from being a drug dealer.[7] But among the many provisions included in the 1982 Tax Equity and Fiscal Responsibility Act of 1982, a major Reagan-era tax increase, Congress added section 280E to the tax code, which denies taxpayers trafficking in substances on Schedules 1 or 2 of the CSA from being able to claim deductions and credits for federal tax purposes.[8] Today, otherwise lawful cannabis distributors cannot claim typically deductible expenses such as employee salaries, rent, or utilities. These businesses are similarly denied any tax credits to which they may otherwise be entitled. These businesses may deduct the cost of the goods sold – essentially the cost of the actual cannabis sold or produced, adjusted for inventory – but effectively nothing else.[9]

The lawful cannabis industry faces numerous regulatory hurdles that makes even good-faith compliance with the law a challenge. For example, even though cannabis dispensaries cannot deduct employee wages against their taxes, they nevertheless must comply with minimum-wage laws. While these businesses must pay taxes, they are largely unbanked due to regulatory hurdles that prevent such businesses from accessing banking and

other financial services. [10] Without bank accounts, these businesses must make tax payments in person, in cash, at regional IRS offices. Indeed, former Secretary Mnuchin testified in 2020 that the IRS had to construct cash rooms to accommodate these payments.[11]

## Proposals

The DEA can administratively delist cannabis as a Schedule 1 controlled substance, but a number of parameters and restrictions make that unlikely, even under a permissive administration.[12] Ultimately, only Congress can amend the CSA itself to remove, or otherwise reform the treatment of cannabis under federal law. There have been several legislative proposals to reform the federal treatment of cannabis, including with respect to taxation considered in Congress in recent years. With respect to taxation narrowly, the federal tax treatment of cannabis is such that it is already nominally taxed at the federal level. “Normalizing” the federal tax treatment of cannabis could be as simple as repealing the application of section 280E to otherwise lawful cannabis dispensaries. That would amount to a \$5 billion federal *tax cut* for cannabis businesses, according to a 2017 estimate.[13] This estimate, however, is relative to a baseline in which the sale of cannabis is illegal at the federal level – the assumed level of income from cannabis is potentially understated. A more permissive federal tax posture may increase taxable income through higher compliance.[14]

Among the most significant development in federal cannabis policy since perhaps the enactment of the CSA occurred in December of 2020, when the House of Representatives passed, [H.R. 3884](#), the Marijuana Opportunity Reinvestment and Expungement (MORE) Act. The MORE Act delists cannabis from the CSA and eliminates any associated criminal penalties from federal law. The act further expunges criminal records of individuals convicted of federal cannabis offences and requires resentencing of certain federal prisoners. According to the Congressional Budget Office, these changes would reduce time-served for existing and future inmates by a combined 73,000 years.[15]

With respect to taxation, delisting cannabis from the CSA would render 280E inapplicable to cannabis businesses, meaning these taxpayers would be eligible for any and all applicable tax deductions and credits. The act would impose an excise tax, beginning at 5 percent and gradually increasing to 8 percent, on cannabis products as well as an occupational tax on certain cannabis-related businesses. Net of the revenue losses associated with exempting cannabis businesses from 280E, the new taxes would raise a combined \$13.7 billion over the next decade.[16] The legislation would also, however, incur new spending liabilities of \$6.3 billion, for a net deficit decrease of just over \$7 billion over the budget window. While the Senate did not act on the MORE Act before the end of the 116<sup>th</sup> Congress, House Judiciary Chairman Nadler reintroduced the MORE Act for the 117<sup>th</sup> Congress on May 28, 2021.

On July 14, Senate Majority Leader Schumer released a [discussion draft](#) of the Cannabis Administration and Opportunity Act (CAOA), which, among other provisions, would delist cannabis from the CSA, establish federal regulatory regimes for the legal cannabis sales and distribution, and impose a federal excise tax of 10 percent for the first full year after enactment, gradually increasing by five percentage points per year until reaching 25 percent in the fourth year post-enactment. For the first four years, the tax would be based on price, while in year five and thereafter, the tax would be levied on a per-ounce rate in the case of cannabis flower, or a per-milligram of THC rate in the case of any cannabis extract.

The introduction of a federal excise tax on cannabis would add it to the current short list of consumer products subject to a specific tax. Most federal excise tax revenues come from sales of motor fuel, airline tickets, tobacco, alcohol, and health-related goods and services. In 2019, those amounted to about \$100 billion in federal revenues.

The design and structure of these taxes varies considerably.<sup>[17]</sup> For consumables such as alcohol and tobacco, the taxes are levied as a fixed dollar amount per volume, with various rates that apply to specific products. While prices for these products vary considerably, for comparison, based on estimated average prices, effective tax rates can be derived for comparison. For example, the federal excise tax on a pack of cigarettes is \$1.01. According to estimates, the average national price of a pack of cigarettes is \$7.22.<sup>[18]</sup> Accordingly the effective federal excise tax for cigarettes is 13.99 percent. Based on other estimated prices, the effective tax rates for federal excise on beer, wine and liquor are approximately 1.2 percent, 1.5 percent, and 7.9 percent.<sup>[19]</sup> The MORE Act would therefore impose a federal cannabis excise tax that would exceed existing federal excise taxes on beer, wine, and liquor (once fully implemented), but less than federal tobacco taxes. The 25 percent rate in the CAO, on the other hand, would ultimately tax cannabis more highly than beer, wine, liquor, and cigarettes.

### **Recognized Impacts of Federal Excise Taxes**

At the federal level, excise taxes make up a relatively small share of revenues, comprising just 2.5 percent of federal receipts in FY2020. Excise taxation therefore tends to reflect very specific products and businesses, often singled out for additional taxation. Accordingly, these are tax policies that have very narrow bases (compared to general income and consumption taxes) essentially by design. This narrow scope reflects the substantial evolution of the size and scope of the federal government. Indeed, the very first tax imposed by the United States was a whiskey tax in 1791. Three years later, the tax inspired a revolt in western Pennsylvania.<sup>[20]</sup> Excise taxation in the United States survived and, combined with tariffs and other duties, comprised the bulk of U.S. revenue collection well into to the 20<sup>th</sup> century. As the federal government grew in scope and scale, however, broad-based taxes supplanted excise taxes as a major source of federal revenue, such that the United States is the least reliant on excise taxes compared to other Organisation for Economic Co-operation and Development nations.<sup>[21]</sup>

As the composition of federal revenue evolved to more broad-based taxes, however, excise taxation has occupied a narrower lane in federal policymaking. These taxes have come to serve variously as dedicated user-fees, controlling externalities, or as instruments of social change. A classic example of a user-fee model is the \$0.184 federal excise tax on motor fuels, better known as the “gas tax.” This tax substantially funds federal highway expenditures (and transit projects) and is borne by purchasers of gasoline – a proxy, if imperfect, for road use. Excise taxes can also be structured to tax externalities. Arthur Pigou proposed in 1920 the application of excise taxes at rates equal to the marginal external damage of a given activity. These Pigouvian taxes are nominally designed to shift the cost that a given activity imposes on society onto the activity generating the cost on society – the externality. In the United States., polluter taxes and excise taxes on consumer products that pose environmental damage are examples of these taxes in practices. The goal, however, is to efficiently shift the cost from society onto to locus of the externality-producing activity or actor. Other excise taxes are, at least in part, designed to discourage the activity altogether. For example, taxes on tobacco products have increased as public policy has increasingly discouraged tobacco use.<sup>[22]</sup> Note that the structure of an excise tax designed to discourage a particular behavior, all else equal, would be ill suited as an excise tax designed to provide a stable revenue stream, and vice versa. This is a function of the relative elasticity of the tax on the given activity. <sup>[23]</sup> This disproportionate impact is a key consideration that can again be in tension with other parameters of the tax policy.

## Conclusion

While federal and state governments remain somewhat in limbo on the overarching question of legalization and associated taxation, the practicalities of how much and how effectively these products are taxed have policy implications for governments, local economies, consumers, and even complementary industries. While the current tax regime surrounding cannabis products is inconsistent and in need of review, the question of federal marijuana legalization must naturally take many considerations beyond tax practicalities into account. Since major congressional action on federal cannabis policy and taxation is unlikely in the near term, however, states and localities will continue to serve as the policy laboratories on the cannabis front.

[1] 21 U.S.C. §§ 801-904

[2] See <https://www.americanactionforum.org/weekly-checkup/the-drawbacks-of-the-drug-scheduling-regime/> for additional background on scheduling controlled substances under the CSA

[3] <https://www.ncsl.org/research/civil-and-criminal-justice/marijuana-overview.aspx>

[4] <https://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx>; see <https://www.dea.gov/press-releases/2016/08/11/dea-announces-actions-related-marijuana-and-industrial-hemp> for more on DEA's rationale for continuing to list cannabis as a Schedule 1 controlled substance.

[5] For further background on issues that arise from the policy gap between federal and subnational laws regarding cannabis, see: <https://crsreports.congress.gov/product/pdf/R/R44782>

[6] [https://www.archives.gov/exhibits/american\\_originals/capone.html#:~:text=After%20nearly%209%20hours%20of,in%20](https://www.archives.gov/exhibits/american_originals/capone.html#:~:text=After%20nearly%209%20hours%20of,in%20)

[7] <https://www.leagle.com/decision/1981157542mqtcml53311221>

[8] 26 U.S. Code § 280E

[9] See also: <https://crsreports.congress.gov/product/pdf/R/R44056/3>

[10] <https://www.americanactionforum.org/insight/marijuana-banking-a-primer/>; for

[11] <https://appropriations.house.gov/events/hearings/departments-of-the-treasury-budget-request-for-fy2021>; see also <https://taxfoundation.org/marijuana-dispensary-settles-case-after-irs-suggests-it-engage-money-laundering/> for a particularly absurd example of federal and state legal discordance.

[12] <https://crsreports.congress.gov/product/pdf/IN/IN11204>

[13] <https://newtax.files.wordpress.com/2018/12/370531229-Senator-Gardner-280E-Score-12-04-2017.pdf>

[14] <https://taxfoundation.org/recreational-marijuana-tax/#Revenue>

[15] <https://www.cbo.gov/publication/56882>

[16] <https://www.cbo.gov/system/files/2020-12/hr3884.pdf>

[17] <https://www.ttb.gov/tax-audit/tax-and-fee-rates>

[18] <https://www.tobaccofreekids.org/assets/factsheets/0202.pdf>

[19] **Author's calculations**

[20] <https://history.house.gov/Historical-Highlights/1700s/The-1791-Excise-Whiskey-Tax/>

[21] <https://www.bus.umich.edu/otpr/WP2007-2.pdf>

[22]

<https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3228562/#:~:text=Most%20studies%20found%20that%20raising,perso>

[23] <https://taxfoundation.org/federal-excise-taxes-proper-role/>