Cannabis Tax Proposal

I. Background

States legalizing cannabis have experimented with various taxation regimes, including flat and weight-based taxes. However, a pattern appears to be emerging, indicating that a lower rate of tax returns higher per capita tax revenue and fosters a robust and thriving market while simultaneously discouraging the illicit market.

Both the type and amount of taxes should be designed to prevent business and consumers from operating in the gray and illicit markets. Cultivation taxes are imposed by some states and should be carefully considered. Maine has a cultivation tax of $335/lb, Alaska has $50/oz, and California has $9.25/oz. What the cultivation tax does not consider is the potency, and therefore value, of the crop. Some consumers, or medical users, may prefer less potent versions of the product. Therefore, weight may not be the best metric for a cultivation tax. Cannabis is a plant that can vary widely in its composition among species. Using weight to determine the tax rate may limit growers to certain biochemical makeups and limit production potential.

Colorado uses a 15% excise tax in addition to a quasi-weight-based tax using the average market rate ("AMR") to come up with a tax that is between 20 – 30%. The AMR was implemented due to Colorado's initial requirement for vertical integration, causing related-party transaction issues.[1] In order to calculate the tax using the AMR, the weight of the marijuana sold or transferred must be multiplied by the average market rate and the result must be multiplied by 15%. For example, if the average market rate for trim is $499 per pound and a cultivation facility sells 15 pounds of trim to an affiliated party, the cultivation facility must multiply the 15 pounds of trim sold times $499 per pound to calculate the total $7,485 average market rate for the sale. The excise tax is 15% of the $7,485 calculated average market rate for the sale, or a total of $1,123 tax due.[2] Colorado's AMR considers weight but is not a straight weight-based tax similar to those states listed above and New York's proposed tax.

Colorado has a 15% sales tax on recreational cannabis that started as a 12.9% sales tax that increased to 15% on July 1, 2017.[3] The current 15% sales tax is in addition to a 15% state retail excise tax on cannabis sales (based on AMR in related party transactions). The combined tax rate has generated over $302 million in 2019.[4]

Though, as shown below, Colorado is generating the most tax revenue per capita of those 21 and over, the illicit market continues to grow due, at least in part, to a combined 20 – 30% tax rate (varied by AMR). Unlicensed growers are growing cannabis for sale in other non-legal states, in search of higher profits.[5] A 30% sales tax may lead consumers to seek illicit market products as those products are not taxed. This hurts both the state as well as legitimate businesses.

---

1 https://newrevenue.org/2016/02/09/colorado-taxes-by-weight/
2 https://www.colorado.gov/pacific/sites/default/files/Excise23.pdf
3 https://www.colorado.gov/pacific/revenue/colorado-marijuana-tax-data
4 *Id.*
5 https://www.cbc.ca/news/world/colorado-marijuana-black-market-1.4647198

Jason W. Klimek, Esq.
jklimek@boylancode.com

California's cannabis taxes are in excess of 40%, including wholesale taxes, which has caused nearly 20% of consumers to purchase cannabis from the illicit market. Studies have shown that a reduction of 5% in taxes could move nearly a quarter of purchases made on the illicit market to legal purchases.[6] High taxes are shouldering the majority of the blame in California, where illicit market sellers outnumber regulated businesses by nearly 3-to-1.[7]

New York may be in a rare position to attempt to insulate itself from the continued growth of the illicit market. New York must impose a tax rate no more than 30% in total, keeping it in line with other states or even lowering the tax rate below other states to attempt to create a market that effectively prices the illicit market out of competition. New York must consider the fact that Massachusetts tax rate is 20% and many Massachusetts dispensaries see 50% of their sales coming from New York residents.[8] Legalization in New York that results in higher retail prices will not stem the flow of New York buyers to Massachusetts.

II. Current Tax Rates

As a comparison, states that have legalized cannabis for adult use have the following tax rates[9]:

State	**Retail**	**Wholesale**	**Population (21 and over)**	**Recreational Tax Revenue** *(2018)*	**Per Capita Revenue of 21 and over**
Alaska	NA	$50 per ounce of flower $15 per ounce of leaves $25 per ounce immature/abnormal flower $1 per clone	470,085[10]	$10,800,000[11]	$23
California	9.25% Sales Tax 15% Excise Tax Up to 10% Local Tax **Total: 34.25%**	$9.25 per ounce of flower $2.75 per ounce of leaves	30,892,866[12]	$345,000,000 (estimate)[13]	$11
Colorado	15% State Tax Up to 10% Local Tax **Total (possible): 25%**	15% Excise Tax (multiplied by AMR)	3,014,312[14]	$302,458,426[15]	$100

6 https://mjbizdaily.com/wp-content/uploads/2018/08/High-Cost-of-Illegal-Cannabis_FINAL_.pdf
7 https://www.sfchronicle.com/opinion/openforum/article/High-cannabis-taxes-keep-black-market-alive-in-14065408.php
8 https://yonkerstimes.com/new-yorkers-flocking-to-mass-to-buy-pot/
9 https://www.leafly.com/news/industry/marijuana-tax-rates-by-state
10 https://suburbanstats.org/population/how-many-people-live-in-alaska
11 https://www.upi.com/Top_News/US/2019/06/14/States-reap-tax-rewards-from-legalized-marijuana-sales/7721560462729/
12 https://suburbanstats.org/population/how-many-people-live-in-california
13 https://www.upi.com/Top_News/US/2019/06/14/States-reap-tax-rewards-from-legalized-marijuana-sales/7721560462729/
14 https://www.infoplease.com/us/comprehensive-census-data-state/demographic-statistics-33
15 https://www.colorado.gov/pacific/revenue/colorado-marijuana-tax-data

Jason W. Klimek, Esq.
jklimek@boylancode.com

Maine	10 % Sales Tax **Total: 10%**	$335 per pound of flower $94 per pound of leaves $1.50 per immature plant $0.30 per seed	1,131,622[16]	NA	NA
Massachusetts	6.25% State Tax 10.75% Retail Tax 3% Local Tax **Total: 20%**	NA	4,587,935[17]	NA	NA
Nevada	10% Excise Tax Up to 8% Local Tax **Total: 18%**	15% Excise Tax	1,411,378[18]	$69,800,000[19]	$49
Oregon	17% State Tax 3% Optional Local Tax **Total (possible): 20%**	NA	2,429,348[20]	$82,203,729[21]	$33
Washington	6.5% State Tax 37% Excise Tax **Total: 43.5%**	NA	5,650,485[22]	$319,000,000[23]	$56

III. Analysis

The above table shows a probable correlation between tax rate and revenue per capita of those 21 and older. A 15% retail tax along with a 15% excise tax, based on AMR, on the wholesale side resulted in the highest tax revenue out of any adult use state. However, that Colorado also has one of the most mature adult use markets. Conversely, California's over 34% retail tax and weight-based excise tax resulted in significantly lower tax revenues per capita of those 21 and over. It is important to note that there are many factors that influence the revenue collected by a state and taxation is a single factor.

Upon legalized sales in Washington in 2014, taxes were imposed at a 25% rate on producers, 25% again processors, and then 25% again at retail. This resulted in non-deductible taxes for cannabis businesses, leading to higher retail prices and lower tax revenue than projected. In 2015, Washington collapsed its tax rates to a single 37% retail tax that was not counted as income for federal tax purposes. The

16 https://suburbanstats.org/population/how-many-people-live-in-maine
17 https://www.infoplease.com/us/comprehensive-census-data-state/demographic-statistics-149
18 https://www.infoplease.com/us/comprehensive-census-data-state/demographic-statistics-217
19 https://www.upi.com/Top_News/US/2019/06/14/States-reap-tax-rewards-from-legalized-marijuana-sales/7721560462729/
20 https://www.infoplease.com/us/comprehensive-census-data-state/demographic-statistics-245
21 https://www.oregon.gov/DOR/programs/gov-research/Documents/Financial-reporting-receipts-public.pdf
22 https://suburbanstats.org/population/how-many-people-live-in-washington
23 https://dor.wa.gov/about/statistics-reports/recreational-and-medical-marijuana-taxes

Jason W. Klimek, Esq.
jklimek@boylancode.com

lowering of the excise tax rate caused Washington to beat its tax revenue projections by more than 200%, resulting in tax revenue in 2017 of $315 million (compared to its $120 million projection).[24,25]

Cumulatively, the tax rate in California can be as high as 45% which has caused significant numbers of consumers to turn to the illicit market in order to avoid substantially increased prices associated with legal purchases. "California's legal cannabis sales totaled $2.5 billion in 2018, about $500 million less than in 2017."[26] Further, California has lowered is cannabis tax revenue projections for 2019 and 2020 by $67 million and $155 million, respectively.[27]

If New York were to follow California's model of high taxes out of the gate (New York's proposed taxes would be even higher than California's initial taxes) and were then to lower the tax rates after tax revenues fail to meet expectations, New York runs the risk of small businesses unable to withstand the initial high tax period. This will lead to a business environment where only the most well-funded businesses are able to absorb and offset the taxes with an eye towards lower taxes. The smaller businesses will not be able to absorb and offset some of the taxes and will not be able to push the ultimate cost to the end consumer in the form of higher retail prices as these small businesses would be undercut by larger businesses with bigger profit margins.

An example of the CRTA's tax rates and its effect on retail prices is shown below. The assumptions on growing costs gathered from small, local farmers and publicly companies.

	CRTA
Small Farm cost per gram	$2.00
Large Farm cost per gram	$0.80
Tax Per Gram	$1.00
Markup to Distributor	100%
Distributor Markup	50%
Average Dispensary Markup	75%
State Tax	20%
Sales Tax	2%

24 https://www.gleamlaw.com/wa-state-mj-tax/
25 https://taxfoundation.org/marijuana-taxes-lessons-colorado-washington/#_ftnref27
26 https://dor.wa.gov/about/statistics-reports/recreational-and-medical-marijuana-taxes
27 https://www.npr.org/2019/08/23/753791322/california-says-its-cannabis-revenue-has-fallen-short-of-estimates-despite-gains

Jason W. Klimek, Esq.
jklimek@boylancode.com

	Taxes/Cost	Markup to distributor	Per Gram Tax	State Tax	Distributor Markup	Dispensary markup 75%	Sales Tax	1/8 Cost
CRTA/MRTA	$2.00	$4.00	$5.00	$6.00	$9.00	$15.75	$16.07	$56.23
CRTA/MRTA	$0.80	$1.60	$2.60	$3.12	$4.68	$8.19	$8.35	$29.24

The average illicit price of cannabis in states with legal cannabis (medical or recreational) was $227.[28] The CRTA's tax rates would push the retail cost of an ounce to nearly $450 for a small grower. Given California's $101 million tax revenue shortfall from its average tax rate in excess of 40%, it can be demonstrated that New York's proposed tax rate will drive legal consumers to the illicit market in search of lower prices, thereby decreasing cannabis tax revenue and undermining the goals of the legislation.

Additionally, Section 280E of the federal tax law increases the tax burden on businesses which will necessarily pass on the tax to consumers, resulting in higher pricing. Section 280E prohibits traffickers in controlled substances (all legal cannabis businesses) the deduction of all business expenses, except cost of goods sold ("COGS"). An excise tax paid by cultivators that would otherwise be a deductible business expense becomes non-deductible by virtue of Section 280E resulting in the need to increase sales price. Legal cannabis businesses can face effective tax rates in excess of 70% which results, to an extent, on taxation of revenue, not profits.[29] Tacking on an additional 45% tax, as we've seen in California (and higher rates proposed by New York) will lead to an immediate increase in retail pricing that far exceeds the illicit market as cannabis companies seek to project what little profit margin exists.

Lastly, IRS Chief Counsel Advisory, IRS CCA 201631016, requires that excise taxes be capitalized which reduces gain on the sale of property. Therefore, an excise tax, according to the CCA, is not a deductible expense for businesses, and instead must be capitalized into the cost of goods. If a cultivator is required to pay an excise tax, the cost would be difficult for the cultivator to capitalize as they are not buying a product for resale, but instead creating the product. This could result in the situation wherein a cultivator is taxed on the money used to pay the excise tax.

IV. Suggested Taxation Regime

New York would be advised to reconsider the current tax regime in favor of taxation that supports a thriving ecosystem and gives small businesses the ability to operate in a market that already has multi-billion-dollar players. Further, Section 280E is unlikely to change for the next two to four years and therefore, a lower New York State tax rate allows for the economic reality that the federal tax law denies deductions to all expenses except COGS.

Looking to the New York Franchise Tax as a guide, New York could enact an excise tax that is based on total revenue of an organization. Basing excise tax rates on revenues ensures that New York can create a level playing field between incumbents with hundreds of millions or billions of dollars, who benefit from economies of scale, and small, locally owned cannabis companies. The excise tax would be in addition to

[28] https://www.statista.com/statistics/589821/street-and-dispensary-marijuana-price-difference-by-us-state/
[29] https://www.thedailybeast.com/feds-slap-70-tax-on-legal-marijuana-businesses

Jason W. Klimek, Esq.
jklimek@boylancode.com

a proposed sales tax of 2-4% or a rate determined by the legislature. The goal, however, would be to ensure that retail prices do not exceed illicit market prices by more than 10%.

It is suggested that New York enact several brackets and specify rates designed to bring the total incidence of excise tax across the state to less than 30%. Rates may be enacted by the legislature while the brackets may be determined by the Department of Taxation and Finance or another regulatory agency. This would allow the regulatory agency to enact policies that are somewhat equivalent to the Federal Reserve's monetary policy, enabling New York to indirectly control market pricing to reduce illicit market sales.

Further, vertically integrated companies (companies holding a combination of producer, processor, distribution, etc., or have common ownership among companies holding multiple licenses) would have their own set of higher brackets while non-integrated companies (or companies that do not have common ownership) have a lower set of brackets. This would ensure that New York does not pyramid taxes at retail, similar to VAT.

For example, vertically integrated companies or companies that have common ownership may have rates from 20% to 50%, based on revenue. Whereas, companies that are not vertically integrated or do not have common ownership have brackets from 10% to 30%, based on revenue. These rates are not suggested rates, merely examples to illustrate the concept. It is advised that an economic analysis be performed in order to understand the market effects of such rates and taxation regime.

This type of taxation would encourage larger companies to work with smaller companies in order to keep the products from larger companies at a low retail price. It would also encourage competition in the market as vertically integrated companies would be taxed at higher rates than non-integrated companies, thus incentivizing smaller, non-integrated companies as opposed to large conglomerates.

Moreover, it would be suggested that total revenue of a cannabis company would be determined considering ownership interests as well. By way of example, if a foreign cannabis company owned 20% of a New York cannabis company, 20% of the revenues of that foreign cannabis company would be added to the revenues of the New York cannabis company to determine the applicable excise tax bracket. This would ensure that ownership of companies by larger, out of state companies would not be able to escape higher taxation rates while using the revenue generated by their out-of-state activities to fund in-state activities.

It is important to note that any rates enacted by the legislature must take into account sales tax. It is suggested that cannabis be exempted from Art. 28 of the New York Tax Law and have its own cannabis sales tax rate, such that the legislature can control the total incidence of tax and ensure the total tax rate, when averaged across the industry, does not exceed 30%.

Jason W. Klimek, Esq.
jklimek@boylancode.com

Lastly, care must be given as to how the excise tax is drafted and implemented to avoid any potential § 280E issues that may cause the denial of deduction.

V. Conclusion

If New York were to enact lower tax rates until the federal tax law is updated, it would act as an investment into the cannabis ecosystem in New York. Further, it would allow small businesses, who cannot afford sophisticated planning techniques, to compete with large cannabis companies who can engage expensive legal and taxation advice to reduce effective tax rates through exotic and complicated business structures.

Additionally, instead of modeling our tax rates on California's (lower) rates that have resulted in a well over a $100 million shortfall annually and, when adjusted for population, the second lowest amount of tax revenue, ahead of only Massachusetts[30], which have stifled legal businesses and threatened an emerging industry, it is proposed that New York either adopt a flat tax at rates which have proven efficacy to facilitate legal sales, sustain increased tax revenue growth year-over-year and support a thriving market or adopt a first-in-the-nation approach to cannabis excise tax that takes into account the size of a company's revenue in determining excise tax rates.

When looking at the data across the United States, it is clear that tax rates in excess of 30% significantly harm the cannabis economy, driving people to the illicit market, consolidating the industry to only the largest players, and ultimately reducing tax revenue. New York has the unique opportunity to learn from the eleven other states that have legalized recreational cannabis and utilize the parts of laws that work and disregard the parts that do not. A data-driven approach that recognizes the information learned from other states as well as the breadth and extent of New York's illicit market (equal to or larger than California's) is necessary if New York is going to create a cannabis ecosystem that will support local, small businesses and a thriving cannabis economy.

[30] https://www.npr.org/2019/08/23/753791322/california-says-its-cannabis-revenue-has-fallen-short-of-estimates-despite-gains

Jason W. Klimek, Esq.
jklimek@boylancode.com