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Re: New York Proposed Cannabis Taxation

As analyzed and discussed below, the current proposed tax rates for New York's adult use cannabis may result in a revenue shortfall of greater than 50% based on the FY2020 Budget Projections.<sup>1</sup>

#### I. Background

Every state that has legalized cannabis has done so under two main types of taxation regimes, gross receipts tax and a weight-based tax. The cultivation taxes imposed by certain states should be carefully analyzed to determine their effect on the cannabis market. States with weight-based taxes include, Maine with a cultivation tax of \$335 per pound, Alaska with a cultivation tax of \$50 per ounce, and California with cultivation taxes of \$9.25 per ounce of flower and \$2.75 per ounce of trim.

What a weight-based 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. Additionally, extraordinarily high tax rates encourage both producers and consumers to grow and purchase higher potency products. In Washington, prior to 2015, the excise tax rates were in excess of 75%, which encouraged higher potency products. Upon the reduction of taxes to a 37% retail excise tax in Washington, studies found "a significant decrease in the potency of marijuana purchased by consumers, as measured by the concentration of the psychoactive chemical tetrahydrocannabinol ("THC")...."<sup>2</sup>

A tax that is more in the form of a traditional sales tax may make the most sense as it does not differentiate between products and is instead a function of price. Moreover, studies have shown that a retail level tax "have proven the most workable form of taxation" and other forms "have faced practical implementation difficulties."<sup>3</sup> The most recent information from New Jersey is that they are considering the nation's lowest tax of 10% on cannabis. Colorado has a 15% sales tax on recreational cannabis which started as a combined 12.9% sales tax that increased to 15% on July 1, 2017.<sup>4</sup> Colorado's current 15%

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<sup>1</sup> <https://www.budget.ny.gov/pubs/archive/fy20/exec/artvii/revenue-artvii-ms.pdf>

<sup>2</sup> [http://faculty.washington.edu/ceweber/HMW\\_marijuanatax.pdf](http://faculty.washington.edu/ceweber/HMW_marijuanatax.pdf)

<sup>3</sup> <https://taxfoundation.org/marijuana-taxes-lessons-colorado-washington/>

<sup>4</sup> <https://www.colorado.gov/pacific/revenue/colorado-marijuana-tax-data>

sales tax is in addition to a 15% state retail excise tax on cannabis sales. The combined 30% tax rate has generated over \$266 million in tax revenue in 2018.<sup>5</sup>

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 30% sales tax rate. Unlicensed growers are growing cannabis for sale in other non-legal states, in search of higher profits.<sup>6</sup> 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. Studies suggest that a target rate between 10% and 25% may be most successful and reducing the illicit market.<sup>7</sup>

California’s cannabis taxes can amount to over 40%, including wholesale taxes, which has caused nearly 20% of consumers to purchase cannabis from the illicit market. Studies have shown that a 5% reduction in taxes could move nearly a quarter of purchases made on the illicit market to legal purchases.<sup>8</sup>

In light of other states’ experiences, New York may be in a rare position to attempt to insulate itself from the continued growth of the illicit market. New York can impose a tax rate no more than 30% in total, keeping it in line with other states, or even lower the tax rate below other states to attempt to create a market that effectively prices the illicit market out of competition.

## II. Current Tax Rates

As a comparison, states that have legalized cannabis for adult use have the following tax rates<sup>9</sup>:

State	Retail	Wholesale	Population (21 and over)	Recreational Revenue (2018)	Per Capita Revenue of 21 and over
California	9.25% Sales Tax 15% Excise Tax Up to 10% Local Tax <b>Total: 34.25%</b>	\$9.25 per ounce of flowers \$2.75 per ounce of leaves	30,892,866 <sup>10</sup>	\$236,000,000 (estimate) <sup>11</sup>	\$7.63
Colorado	15% State Tax <b>Total (possible): 15%</b>	15% Excise Tax	3,014,312 <sup>12</sup>	\$266,529,637 <sup>13</sup>	\$88
Maine	10% Sales Tax <b>Total: 10%</b>	\$335 per pound of flower \$94 per pound of leaves \$1.50 per immature	1,131,622 <sup>14</sup>	NA	NA

<sup>5</sup> *Id.*

<sup>6</sup> <https://www.cbc.ca/news/world/colorado-marijuana-black-market-1.4647198>

<sup>7</sup> <https://taxfoundation.org/marijuana-taxes-lessons-colorado-washington/>

<sup>8</sup> [https://mjbizdaily.com/wp-content/uploads/2018/08/High-Cost-of-Illegal-Cannabis\\_FINAL\\_.pdf](https://mjbizdaily.com/wp-content/uploads/2018/08/High-Cost-of-Illegal-Cannabis_FINAL_.pdf)

<sup>9</sup> <https://www.leafly.com/news/industry/marijuana-tax-rates-by-state>

<sup>10</sup> <https://suburbanstats.org/population/how-many-people-live-in-california>

<sup>11</sup> <https://www.sacbee.com/news/politics-government/capitol-alert/article225185310.html>

<sup>12</sup> <https://www.infoplease.com/us/comprehensive-census-data-state/demographic-statistics-33>

<sup>13</sup> <https://www.colorado.gov/pacific/revenue/colorado-marijuana-tax-data>

<sup>14</sup> <https://suburbanstats.org/population/how-many-people-live-in-maine>

		plant \$0.30 per seed			
Massachusetts	6.25% State Tax 10.75% Retail Tax 3% Local Tax <b>Total: 20%</b>	NA	4,587,935 <sup>15</sup>	NA	NA
Nevada	10% Excise Tax Up to 8% Local Tax <b>Total: 18%</b>	15% Excise Tax	1,411,378 <sup>16</sup>	\$69,400,000 (estimate through June 2019) <sup>17</sup>	\$49
Oregon	17% State Tax 3% Optional Local Tax <b>Total (possible): 20%</b>	NA	2,429,348 <sup>18</sup>	\$82,203,729 (fiscal year 2018) <sup>19</sup>	\$34
Washington	37% Excise Tax <b>Total: 37%</b>	NA	5,650,485 <sup>20</sup>	\$319,000,000 <sup>21</sup>	\$56

III. Analysis

The above table shows a probable correlation between tax rate and revenue per capita of those 21 and older. Colorado’s 15% retail tax along with a flat 15% excise tax on the wholesale side resulted in the highest tax revenue out of any adult use state. However, Colorado also has one of the most mature adult use markets. Conversely, California’s retail tax and weight based excise tax and Washington’s 37% retail tax resulted in significantly lower tax revenues per capita of those 21 and over. However, it is important to note that there are many factors that influence the revenue collected by a state and taxation is merely one factor.

Upon legalized sales in Washington in 2014, taxes were imposed at a 25% rate on producers, then again on processors, and then 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 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).<sup>22, 23</sup>

Similarly, the cumulative 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 the substantially increased prices associated with legal purchases. The revenue shortfall of \$101 million in California has prompted the legislature to reduce the retail excise tax from 15% to 11% and suspend all cultivation taxes until 2022. The legislature’s rationale is that States with lower tax rates have seen continued tax revenue growth

<sup>15</sup> <https://www.infoplease.com/us/comprehensive-census-data-state/demographic-statistics-149>  
<sup>16</sup> <https://www.infoplease.com/us/comprehensive-census-data-state/demographic-statistics-217>  
<sup>17</sup> <https://www.reviewjournal.com/news/pot-news/nevada-marijuana-tax-revenues-top-31m-from-july-to-october-1562785/>  
<sup>18</sup> <https://www.infoplease.com/us/comprehensive-census-data-state/demographic-statistics-245>  
<sup>19</sup> <https://www.oregon.gov/DOR/programs/gov-research/Documents/Financial-reporting-receipts-public.pdf>  
<sup>20</sup> <https://suburbanstats.org/population/how-many-people-live-in-washington>  
<sup>21</sup> <https://www.tre.wa.gov/portfolio-item/washington-state-marijuana-revenues-and-health/>  
<sup>22</sup> <https://www.gleamlaw.com/wa-state-mj-tax/>  
<sup>23</sup> [https://taxfoundation.org/marijuana-taxes-lessons-colorado-washington/#\\_ftnref27](https://taxfoundation.org/marijuana-taxes-lessons-colorado-washington/#_ftnref27)

(see: Colorado’s more than 7% tax revenue growth from 2017 to 2018<sup>24</sup>). Democratic Assemblyman Rob Bonta, sponsor of California’s bill to reduce cannabis taxes, stated, “Lowering a tax rate to bring in more money might sound counterintuitive, but as they found in Washington state, if you drop the tax, more people will buy more legally so revenue will go up.”<sup>25</sup>

If New York were to follow California’s model of high taxes out of the gate (New York’s proposed taxes could be over 20% higher than California’s current tax rates) followed by lower taxes after revenues fail to meet expectations, New York runs the risk of small businesses being 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 future taxes. The smaller businesses will not be able to sustain high taxes and low profit margins and will not be able to push the ultimate cost to the end consumer in the form of higher retail prices as they would be undercut by larger businesses with bigger profit margins or dealers in the illicit market. The result would be a New York market in which large businesses and the illicit market thrive after small businesses failed due to overly burdensome taxes; in complete contravention to one of the main purposes of legalizing cannabis in New York.

An example of the various tax rates and their effects on retail prices is shown below. The assumptions on wholesale and retail prices are based on market averages in Colorado and growing yields are based on average yield statistics.

<b>Assumptions</b>	<b>Amounts</b>
Square Footage	7,000
Harvests Per Year	6
Annual Total Flower Yield (Grams)	1,680,000
Annual Total Trim Yield (Grams)	1,680,000
Total Yield (Grams)	3,360,000
Flower Cost Per Gram (Wholesale)	\$1.93
Trim Cost Per Gram (Wholesale)	\$0.88
Flower Cost Per Gram (Retail)	\$7.14
Wholesale Revenue	\$4,727,400.00
Retail Revenue	\$12,000,000.00

<sup>24</sup> <https://www.colorado.gov/pacific/revenue/colorado-marijuana-tax-data>

<sup>25</sup> <https://www.sfchronicle.com/bayarea/philmatier/article/California-craving-more-tax-revenue-from-13582251.php>

Colorado	Percentage	Taxes Collected	Price at Retail Incl. Tax	Illicit Price	Price Difference
Excise	15%	\$709,110.00			
Retail	15%	\$1,800,000.00			
Total Tax Revenue		\$2,509,110.00			
Effective Tax Rate		30%			
Gram			\$9.29	\$9.00	3%
Ounce			\$260.00	\$252.00	3%

  

California	Percentage	Weight Tax (per gram)	Taxes Collected	Price at Retail Incl. Tax	Illicit Price	Price Difference
Trim		\$0.10	\$165,000.00			
Flower		\$0.33	\$555,000.00			
Excise	15%		\$1,800,000.00			
Sales Tax	10%		\$1,200,000.00			
Total Tax Revenue			\$3,720,000.00			
Effective Tax Rate			40%			
Gram				\$10.02	\$9.00	11%
Ounce				\$280.46	\$252.00	11%

  

New York CRTA	Percentage	Weight Tax (per gram)	Taxes Collected	Price at Retail Incl. Tax	Illicit Price	Price Difference
Trim		\$0.25	\$420,000.00			
Flower		\$1.00	\$1,680,000.00			
Excise	22%		\$1,040,028.00			
Total Tax Revenue			\$3,140,028.00			
Effective Tax Rate			66%			
Gram				\$11.89	\$9.00	32%
Ounce				\$332.84	\$252.00	32%

  

New York MRTA	Percentage	Weight Tax (per gram)	Taxes Collected	Price at Retail Incl. Tax	Illicit Price	Price Difference
Trim		\$0.10	\$168,000.00			
Flower		\$0.62	\$1,041,600.00			
Excise	15%		\$709,110.00			
Local Tax	2%		\$240,000.00			
Total Tax Revenue			\$2,158,710.00			
Effective Tax Rate			46%			
Gram				\$10.40	\$9.00	16%
Ounce				\$291.33	\$252.00	16%

As can be clearly seen above, the CRTA's proposed tax rate would be in excess of a 60% effective rate and would result in prices of legal cannabis exceeding illicit market prices by over 30%. Even the MRTA's lower tax rate would result in an effective tax rate in excess of 45%. Given California's \$101 million tax revenue shortfall from its average tax rate in excess of 40%, and a mere 11% over illicit market prices, 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 state legal cannabis businesses) the deduction of all business expenses, except cost of goods sold ("COGS"), resulting in lower profit margins and higher retail pricing. Tacking on rates as high as 45%, as we've seen in California (and higher rates proposed by New York legislation) will lead to an immediate increase in retail pricing that far exceeds the illicit market as cannabis companies seek to protect what little profit margin exists.

In particular, 280E disproportionately affects dispensaries, as COGS for dispensaries are extremely limited and exclude the largest costs, labor and location/utilities. Dispensaries have the lowest barrier to entry and will likely be a vector into the adult-use market for those with without large investment

dollars behind them. Therefore, dispensaries will have the lowest profit margins of any cannabis industry segment and New York must ensure that excessive tax rates do not squeeze retail margins further as dispensaries attempt to compete with illicit market prices.

#### IV. Suggested Taxation Regime

New York would be advised to adopt a taxation regime similar to Colorado's in order to avoid increasing illicit market sales. Section 280E is unlikely to change for the next two to four years and therefore, a lower New York State tax rate accounts for the economic reality that the federal tax law denies deductions to all expenses except COGS. It is also imperative that any adult use law in New York contain language to decouple the New York tax code from 280E for cannabis business purposes to ensure that legal cannabis businesses can deduct ordinary and necessary expenses for state tax purposes.

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 tax professionals to render advice to reduce effective tax rates through exotic and complex business structures.

Further, it is imperative New York include language to exempt adult-use cannabis from Article 28 of the New York State Tax Law requiring all purchases of physical goods, except those exempted under Art. 28, Part 3 of the Tax Law, incur a sales and compensating use tax. The proposed laws do not address sales tax and the potential increase to consumer prices by 8% or more. Currently, medical cannabis is exempt from sales and use tax under the blanket exemption for medical supplies and related items. Failure to exempt adult-use cannabis from sales and use tax will result in exacerbating the problems associated with high excise tax rates as discussed above.

Additionally, it would be advisable that New York refrain from imposing an excise tax at the production and wholesale levels. Instead of imposing a weight based or flat tax on producers and processors, the excise tax should instead be borne by consumers, as it has been in Washington since 2015. The tax revenue to New York would be indistinguishable but this would allow businesses to simplify their tax accounting and help alleviate some of the pressure caused by 280E. The placement of the excise tax could be reversed upon a change in federal law allowing for ordinary and necessary business deductions for cannabis companies. Upon a change in federal law, the ability to allocate such excise tax between retail and wholesale gives the State a mechanism, similar to the federal government's ability to control interest rates through the Fed, to encourage or discourage production capacity and pricing without the need to consistently adjust license numbers or production capacity.

Lastly, instead of modeling our tax rates on California's (lower) rates that have resulted in a \$101 million shortfall, which have stifled legal businesses and threatened an emerging industry, and ultimately has led to a planned reduction in retail tax rates and elimination of cultivation taxes, it is proposed that New York adopt rates similar to Colorado's which have proven efficacy to facilitate legal sales, sustain increased tax revenue growth year-over-year and support a thriving market. Upon a change in federal tax law, New York would have the ability to increase its tax rates and maintain price equilibrium as companies will be allowed to deduct their ordinary and necessary business expenses.