

Oregon State Legislature
Joint Committee On Implementing Measure 91
Statement of Pat Oglesby
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Mesdames Chairs and Members of the Committee:

Thank you for inviting me to speak to you. I'm delighted to do so. My name is Pat Oglesby. I'm a North Carolina lawyer, and the founder of a nonprofit tax policy organization, the Center for New Revenue, www.newrevenue.org. I served as a staff lawyer for the tax-writing committees of the U.S. Congress for eight years -- six years for the bipartisan, bicameral Joint Congressional Committee on Taxation (serving under Co-Chair Packwood of Oregon part of the time), and two years as Chief Tax Counsel of the U.S. Senate Finance Committee (serving under Chair Bentsen of Texas). I am one of eight co-authors of recent RAND Report, "Considering Marijuana Legalization: Insights for Vermont and Other Jurisdictions," "http://www.rand.org/pubs/research_reports/RR864.html, Chapter 5 of which covers revenue, and of a technical tax supplement to that Report, "Supplemental Thoughts About Revenue from Marijuana in Vermont," <http://ssrn.com/abstract=2551029>. If you are interested in marijuana tax policy, I recommend starting with Chapter 5 of the Report itself.

I helped drafters of Measure 91 informally over the phone in thinking about marijuana taxes. I was glad to see that Section 33(3) of Measure 91 collects tax of \$35 an ounce for flowers and \$10 an ounce for leaves from the producer of marijuana, "at the time of the first sale." I understand from Mr. Crawford that during some of your visits into the marketplace, you heard that some growers don't want to be the ones paying the tax. (Nobody does.)

While my understanding is that you would like me to address the collection point for the tax, I provide some background about marijuana taxes generally. That's because the collection point is the tail on the dog of a marijuana tax.

In thinking about marijuana taxes, you might consider a hierarchy of issues, ranked in importance like **heart, artery, and capillary**.

The heart is the money the state collects. The artery is the method the state uses to collect, that is, the tax base, like weight, or price -- or ancillary bases like square feet of indoor canopy, or purchased electricity. The capillary is the collection point -- the place where the check is written.

I. The Heart -- the Money

The privilege to sell marijuana is worth lots of money. So the state can charge a lot for it. Maybe. But probably not at first.

What's gone wrong in Washington, I think, is that **taxes are too high at first**. At first, the legal marijuana industry will be struggling and the black market will be strong. The same thing is happening in Colorado, where the black market and the medical marijuana market are both untaxed. So the state can't collect very much tax at first.

But maybe you can collect **more over time**. That's what would happen in a bill introduced this month in the Massachusetts House, with 12 cosponsors, <http://www.repdaverogers.com/wp-content/uploads/2015/01/An-Act-to-regulate-and-tax-the-cannabis-industry.pdf>. That bill taxes bud at \$10 an ounce in year 1, \$20 an ounce in year 2, \$35 an ounce in year 3, and \$50 after that.

The idea is that the legal market will get past supply shortages, and start-up costs, and will be able to move out the learning curve and become more efficient. The **black market** won't benefit if it's still hiding in the shadows and sneaking around – that is, if commercially viable black market operators are shut down.

So a critical step is to **keep taxes low** enough at first to beat the black market. Everything else is kind of secondary.

II. The Artery – The Tax Base

Taxing by price means taxes are high when they should be low, and low when they should be high.

The first two states taxed by price, but in every state since then, **every serious proposal taxes by weight** – like Measure 91. Here's a partial list, of seven states, including Oregon but not Massachusetts: http://www.huffingtonpost.com/pat-oglesby/marijuana-tax-measurement_b_5324705.html. (Colorado tried to tax producers by price, failed, and switched to weight. Discussion appears below.) The main taxes on **alcohol and tobacco** are by volume and weight.

For marijuana, there's a **crucial reason not to tax by price**: A percentage-based tax fluctuates with prices. It is highest at the worst time, before efficiencies and economies of scale bring dollar prices down -- when legal operators are just starting out, when supply shortages push prices up. That start-up phase is just when industry needs taxes to be lowest -- to fight a price war with bootleggers who won't give up easily.

Once the industry matures and doesn't need so much help, price-based taxes go *haywire*. As pre-tax prices go down, price-based taxes automatically go down instead of up. Those **automatic tax cuts** mean state collections go down.

Lower revenue is just part of the problem. Automatic tax cuts that come with a price base **irritate key constituencies**: the federal government, which is keeping a cautious eye on the marijuana business now, and may take a harsher look come 2017; and opponents of legalization generally, like parents, who have no interest in cheap marijuana prices.

But there's another set of reasons: **Pricing can be phony**. And when taxpayers get to play games, you can expect games to be played. Washington is dealing with the beautiful \$30

bong that comes with a “free” eighth ounce of marijuana. What about the \$99 bus tour with free product supplied? What about the employee discount? What about the employee who is paid a salary of 5 grams per hour of a special strain that nobody else can get – and whose value can hardly be guessed? What about “gifts” to landlords, or shareholders, or friends? What about sampling that the owner does just to make sure the product is OK? If you are looking for simplicity, taxing a percentage of price is not the way to go. It sets up a situation where lots of transactions need to be checked – if you are serious about collecting tax.

A weight base encourages potency, and it requires a system to measure product, but that challenge should not be more than the State of Oregon can handle. Once the system is up and running, **people can agree** about how much a package weighs. There’s no litigation, no appeals dragging on for years.

For completeness, here’s the **technical story of how Colorado’s price base failed**. In Colorado, an “excise tax is imposed on the first sale or transfer from a retail marijuana cultivation facility.” <https://www.colorado.gov/pacific/sites/default/files/Excise23.pdf>. There, the tax is “[c]alculated by pounds sold or transferred,” with “weight in pounds rounded to 4th decimal point” separately for bud (flower) and trim (leaves). <https://www.colorado.gov/pacific/sites/default/files/RetailMarijuanaReturnFilingOverviewOct2014.pdf>. Colorado’s weight-based tax exists because a price-based tax failed. Colorado’s Constitution calls for a 15-percent excise tax on that first sale or transfer, but that tax failed because a percentage of price was meaningless in the case of a vertically integrated company that has no separate producer. Having moved away from a price base, the Colorado tax collection system does not seem to be at the top of the list of the state’s problems with marijuana legalization.

III. The Capillary – The Collection Point

A. In General

It’s natural that growers are not delighted to be handling marijuana taxes for the state. Paying tax is not only about the money; there are regulatory burdens and paperwork hassles. Any business would like to be free of those burdens and hassles (not to mention paying the money). But growers could point out several specific **problems with collection from growers**. Growers would have to separate medical marijuana from recreational early in the supply chain, as they sell product. At some point, some business would have to do that, but early separation may lead to supply imbalances one way or the other. Unless testing for pesticides, mold, and so on takes place at the grower level, a refund mechanism for marijuana that fails testing would be needed. And growers might prefer the option of having the task of separating flowers from leaves, to be weighed and taxed separately, take place later in the supply chain.

Any tax structure is likely to distort the market to some extent. Taxes are a drag on commerce, and the collection process is part of that drag. But the **market may evolve** in unexpected ways in reaction to any tax structure. For instance, the task of separating flowers from leaves may turn out to be done in some cases by mobile service providers, working for a fee rather than taking title to product.

A policy goal of making growing marijuana relatively burden-free may have undesirable consequences. A large number of growers can create a glut and an especially steep price collapse, as is foreshadowed in the Washington State **grower-level glut**, “an economic nightmare” for growers. <http://www.theguardian.com/us-news/2015/jan/16/seattle-marijuana-struggle-sell-big-harvest-floods-market>. The same squeeze on growers took place in the cured tobacco market before the New Deal’s imposition of quotas.

But growers might suggest simply transferring the burden of paying tax to the **retailer**.

The decision about where to collect tax involves balancing a number of factors. Probably the most important factor is **preventing tax evasion**, that is, preventing untaxed product from reaching consumers.

A principle of excise taxation is: **Collect early**. As early as you can. The main advantage of collecting early in the supply chain is that it can allow you to have a pretty effective system. If you don’t collect early, you allow leakage – untaxed marijuana leaving the legal supply chain and evading tax. So, for instance, a retail level tax doesn’t get collected from an employee pilfering product, or the thief breaking into a store or high-jacking a truck, or a shoplifter.

Product can get **diverted** out of the tax system unless tax is collected early. And it will be to the state’s advantage to have an idea of the amount of product in the pipeline from inception of the supply chain.

An example of early collection is the **Oregon tax on cigarettes**. The first Oregon buyer in the supply chain pays tax and puts stamps on the product. “By law, each pack of cigarettes sold in the state must have an Oregon tax stamp. Licensed cigarette distributors purchase these tax stamps from the Oregon Department of Revenue.”

<http://www.oregon.gov/dor/tob/pages/index.aspx>

A model of taxing the first producer – like the grower, for marijuana – is the **federal liquor tax**. Liquor bears federal tax as it leaves the distillery. And then everyone knows that that liquor is tax-paid. Liquor bottles have to have tamper-evident closures, and a computer auditing system has replaced tax stamps.

Depending on the industry structure, early collection of tax may have downsides. It may involve a significant number of taxpayers; the cost of early reporting may be marked up and passed along; and early reporting does not solve all problems. For instance, if wholesalers, processors, or retailers can find a way to incorporate non-tax-paid marijuana into products and disguise it as tax-paid, tax is evaded. Since tax would have been collected early, those illegal products would evade tax, inappropriately. That is, without thorough **tracking and tracing**, non-tax paid products of illegal growers could be mixed in with legal, tax-paid product. Tracking and tracing will likely be needed in any system. So with seed-to-sale tracking, perhaps bud and trim that have borne tax at the grower level could be sealed in non-consumer packages noting their weight, weight that is reported to the state before transportation begins – and probably after it ends. Receipts and bills of lading could accompany transported tax-paid product. To prove the chain of custody in Colorado, Radio Frequency Identification Tags accompany tax-paid product from the grower to the

intermediate buyer.

B. Products from concentrates

In any event, postponing collection not only violates the collect-early principle, it wouldn't work easily for, say, **edibles**. Edibles, tinctures, e-cigarette cartridges and the like typically involve concentration of raw plant material, often leaves as opposed to bud. By the time products like edibles are sold, the bud and trim that the statute taxes can't be measured in them. So a weight-based tax on these products at retail does not work.

To shift the collection burden from the grower, here's an idea that makes me very nervous: Scrapping the whole weight-based tax and bringing in a new price-based tax – because you don't like the collection point. So if the collection point is the tail on the dog of a marijuana tax, and you really can't stand the tail on the dog you've got, you may deliberately choose to **swap out the dog because you don't like its tail**, but that's not tweaking. It's putting the capillary in charge of the heart. I would urge you to keep the weight base.

But here is a modest, two-pronged tweak to the tax base that might accommodate all taxes being collected at retail. Call it bifurcation, or parallel tracks, or dual collection. This option, listed in the RAND Report for Vermont, has two parts, and could conceivably work with a retail collection point. The first part is: Tax could be collected **at retail on plant matter by weight**. Current taxes of \$35 for flowers and \$10 for leaves would be collected at retail. Most retail sales of unprocessed plant matter would probably be sales of flowers.

The second part is: Tax could be collected **at retail on concentrates and products by THC content**. My understanding from folks in the industry is that concentrates are homogeneous enough to yield replicable THC test results – as replicable as liquor, taxed by the federal government by proof, that is, alcohol content. And I understand that a batch of THC could be accurately traced through into products, such as cookies. Indeed, best practice might require labeling of amount of THC in edibles and the like. This tax option would not require testing of edibles or products: The tax would apply to the amount of THC actually infused into the product at processing, but would be collected only at retail, on the basis of a label indicating that amount of THC. See <http://newrevenue.org/2013/05/01/bifurcating-the-tax-base-for-marijuana/>.

WARNING: This system would require a brand new determination -- of a numerical dollar-and-cent tax rate for each milligram of THC. What rate of tax per milligram of THC, for instance, would correspond to a tax of \$10 per ounce of trim? The appropriate **tax rate for each milligram of THC** is a question for scientists and technologists, so I offer no suggestion. (And, to repeat, it depends on the scientific measurement working accurately. This system could take some time to set up.)

Any **tax break for medical marijuana** could then be delivered at the retail level. That addresses perhaps the strongest objection to a grower-level tax: the situation where growers would have to designate product as medical or recreational, when they don't know which market will need product more. I do not address or endorse a permanent tax break for medical marijuana; I just note that this two-pronged tweak would allow the delivery of the

tax break at the retail level.

This option of collecting these taxes at retail does not come from the RAND Report, and it makes me nervous, because I like the principle of early collection. But it yields ground at the capillary level, while **protecting the artery level and the heart**. So it should not be rejected out of hand, I believe.

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I want to stress one final technicality. It involves interaction of the state excise tax with an arcane provision of federal income tax law, Tax Code Section **280E**. The state might want to examine the statute to see that it allows marijuana businesses to include excise taxes in “cost of goods sold” so as to make them federally deductible to the extent possible under Section 280E. Not being able to deduct excise taxes would add to their burden.

In modern commerce, taxes may be complex and **complicated** because they need to be. As the industry structure develops, I would urge you to keep consulting with industry, with the executive branch, and with stakeholders, to advance the goal of a system that collects tax without unduly burdening taxpayers and the state.

Marijuana taxation may prove completely different from taxing alcohol and tobacco. Marijuana is much more valuable by weight and volume than either. Raw marijuana is valuable in commerce, whereas raw tobacco and grapes and corn are not. So standard models may not apply. We all have a lot to learn.

Thank you for the opportunity to testify before you today. I would be happy to try to answer any questions.