Legalized Recreational Marijuana and the Black-Market Challenge: Early Lessons for Future Pot Laws

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Section I: Introduction

“Legalization is sexy, implementation is not,” observed Todd Arkley, a Washington-based accountant who advises legal marijuana businesses on tax issues.¹ State policymakers, who face the significant challenge of creating a whole new legal marijuana market after voters in four states and the District of Columbia have now passed voter initiatives to legalize marijuana for recreational use, might have similar feelings. But the way that the recreational marijuana market is taxed and regulated in these states not only affects the price and characteristics of the product sold, it could determine the political success of one of the most closely watched experiments in some of the United States’ “laboratories of democracy.”

In the states that have legalized marijuana, voters backing marijuana legalization initiatives expressed a desire to replace the black market with a legal structure that taxes and regulates its sale, meaning that the new recreational market must effectively compete on price with the black market while still providing promised revenue to the states. Therefore, the way in which recreational marijuana is taxed will largely determine if these competing goals are met. Economists at the RAND Corporation believe that as production is scaled up, “[t]he pretax retail price of marijuana will substantially decline, likely by more than 80 percent.”² As a result, the “price that consumers face will depend heavily on taxes, the structure of the regulatory regime, and how taxes and regulations are

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enforced.” Therefore voters, lawmakers, and regulators face the challenging prospect of implementing just the right balance of regulation and taxation that allows for legal marijuana to be sold at a competitive price and satisfies the goal of generating revenue.

Complicating matters further, some states must do more than compete with the black market. Many states already have established medical marijuana programs that are popular among recreational users as well as legitimate medical patients, sometimes referred to as the “gray market.” If a medical marijuana market is already established, widely accessible, and dispensary sales are taxed at a substantially lower rate than recreational sales, there may be little incentive for these consumers to migrate from the medical market to the recreational market. While pre-existing medical marijuana markets improve on many of the worst features of the black market, Colorado and Washington are experiencing the undesirable outcome of having a loosely regulated medical market alongside a highly regulated and more expensive recreational market. In addition to the recreational businesses losing a large share of the market to medical businesses, states miss out on much-needed tax revenue if medical marijuana programs are too lax and allow recreational users to avoid taxes.

For jurisdictions that have recently legalized marijuana such as Alaska and Oregon, and also those that are considering a tax and regulate approach to recreational marijuana in the near future, the experience in Colorado and Washington provides early lessons in establishing a new legal market to compete with the existing black and gray markets. While the laws, regulations, and markets with respect to legal marijuana are rapidly changing and the black market, because of its very nature, is difficult to analyze,

\(^3\) Id.
there are some clear recommendations that can be made. First, states should consider taxing marijuana by weight rather than “ad valorem,” or based on price. Second, states should impose taxes that start out low, when recreational marijuana is likely to be expensive, and gradually increase over time as production costs fall. Third, states should attempt to structure taxes on recreational marijuana in a manner that allows business to make maximum deductions on federal taxes, a problem largely unforeseen by legalization activists. Lastly, states with pre-existing medical marijuana programs must find ways to ensure that only sick individuals benefit from tax-advantages.

Section II: A Regulated Marijuana Market Must Compete Effectively With the Black Market

One of most compelling reasons for policymakers to set up a regulated recreational marijuana market, as opposed to the potential alternatives of simply replacing criminal penalties with civil fines or making marijuana legal to possess without providing consumers a place to purchase the drug, is to reduce crime and violence associated with underground markets. The Marijuana Policy Project, a national organization that played a major role in the campaigns to legalize marijuana in Colorado and Washington, argues:

Marijuana is a significant source of income for individuals and groups involved in other criminal activities. For example, much of the violence escalating on the Mexican border revolves around the actions of Mexican drug cartels fighting over profits from marijuana sales. In fact, former U.S. Drug Czar John Walters told the Associated Press in 2008 that marijuana is the biggest source of income for these ruthless narcoterrorist organizations. Whether they are large-scale drug cartels or small-town street gangs, the vast supply and demand surrounding marijuana will ensure they have a constant stream of profits to subsidize other illegal activities. Regulating marijuana like alcohol would eliminate this income source and, in turn, eliminate the
violence and turf battles associated with the illegal marijuana market.⁴

Harvard economist Jeffrey Miron, who has studied the relationship between drug and alcohol prohibition and violence, reasons that black markets are likely to cause increased violence because participants often lack a mechanism, such as the civil justice system, for dispute resolution.⁵ Further, under prohibition, private arrangements established by market participants to resolve disputes are harder to maintain.⁶ Another consequence of prohibition, according to Miron, is increased “disputes between the government and market participants” that “are more likely to be resolved with violence.”⁷ Miron concludes “that drug and alcohol prohibition have substantially raised the homicide rate in the U.S. over much of the past 100 years.”⁸

In all four states that established a legal market for marijuana from 2012 through 2014, voters clearly intended to reduce or eliminate the role of the black market and the perceived social ills associated with it. Colorado and Alaska’s new laws both state: “Legitimate, taxpaying business people, and not criminal actors, will conduct sales of marijuana.”⁹ Washington’s Initiative 502 made clear its intent to take “marijuana out of the hands of illegal drug organizations and brings it under a tightly regulated, state-

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⁵ Jeffrey A. Miron, Violence and the U.S. Prohibitions of Drugs and Alcohol, 1 Am. L. & Econ, Rev, 78, 81 (1999).
⁶ Id. at 83.
⁷ Id.
⁸ Id. at 78.
⁹ COLO. CONST. art. XVIII, § 16(1)(b)(IV); Alaska Stat. Ann. § 17.38.010(b)(2) (West, Westlaw through 2014 2nd Reg. Sess.).
licensed system similar to that for controlling hard alcohol.”¹⁰ Oregon’s ballot initiative stated the intent of the new law was to “[p]revent revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels.”¹¹ A watershed New York Times editorial series advocating for the legalization of marijuana echoed this goal arguing “a well-regulated system should undermine and eventually eliminate the black market for marijuana, which has done great damage to society.”¹²

In addition to curbing violence associated with the black market, states have also found the promise of additional revenue from taxing marijuana to be an attractive way to supplement state revenue. If legalization were implemented on a national scale, one estimate is that governments would earn “$6.2 billion annually if marijuana were taxed at rates comparable to those on alcohol and tobacco.”¹³ In addition, Miron estimated in a 2005 report that legalizing marijuana would “save $7.7 billion per year in government expenditure on enforcement of prohibition.”

However, according a RAND report commissioned by Vermont that studied the implications of marijuana legalization, state governments will likely need to look past taxes solely as a “revenue-raising devices” and consider the “collateral consequences” that “could outweigh revenue in importance.”¹⁴ One of the major challenges for

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¹¹ Control Regulation, and Taxation of Marijuana and Industrial Hemp Act, 2015 Or. Laws Ballot Measure 91 §1 (West).
policymakers, especially in the context of the regulated-market approach embraced by Colorado and Washington, is to set tax rates at what drug-policy analyst Mark Kleiman calls the “Goldilocks point,” high enough to discourage “excessive consumption and out-of-state exports” but low enough to compete with illicit black market dealers. The “task is complicated by the possibility that increasing firm size and technological innovation will drive production costs for basic product forms down dramatically over time.”

Since marijuana remains illegal under the Controlled Substances Act (CSA), another motive for states to incentivize the optimal price point in the recreational market is that doing so may be necessary to ward off unwanted federal intervention in the states’ marijuana businesses. The Department of Justice issued guidance to federal prosecutors instructing them to prioritize enforcement if black market activities surface as a result. Specifically the guidance prioritizes “[p]reventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels…[p]reventing violence and the use of firearms in the cultivation and distribution of marijuana,” and “[p]reventing the diversion of marijuana from states where it is legal under state law in some form to other states.” As Kleiman noted, if taxes are set too high, the effect on price could boost black market activities and related violence inside of the state. But if taxes are set too low, the

16 CAULKINS ET AL., supra note 14, at 75.
18 Id.
price could incentive diversion of legally grown marijuana to neighboring states. Both of these outcomes could invite increased federal enforcement of the CSA.

With respect to taxes, RAND concluded that “[i]t is unlikely that any plan will get marijuana revenue right at first, and the market is likely to evolve and prove tumultuous beyond anyone’s ability to predict.”\textsuperscript{19} In any case, policymakers in states that have not yet legalized marijuana have the advantage of studying the markets in Colorado and Washington to apply lessons learned in those states to their own.

\textbf{Section III: Current Status of Marijuana Markets in Closely Watched Jurisdictions}

This section summarizes the current issues of marijuana law and policy in Colorado, Washington, Oregon, Alaska, Washington D.C., and California with regard to the taxation of marijuana markets, challenges faced by policymakers, and policy changes being considered and implemented.

\textbf{Colorado}

Colorado voters approved Amendment 64 in 2012, which legalized marijuana and instructing the state government to set up a tax and regulate system.\textsuperscript{20} Pursuant to the initiative, the next important policy decision was determining the rate at which to tax marijuana. The Amendment instructed the Colorado state General Assembly to “enact an excise tax to be levied upon marijuana sold or otherwise transferred by a marijuana cultivation facility to a marijuana product manufacturing facility or to a retail marijuana store at a rate not to exceed fifteen percent.”\textsuperscript{21} In accordance, the Colorado legislature

\textsuperscript{19} CAULKINS ET AL., \textit{supra} note 14, at 100.


\textsuperscript{21} COLO. CONST. art. XVIII, § 16(5)(d).
passed legislation, subject to voter approval through a subsequent statewide referendum, imposing the maximum-allowed 15% excise tax in addition to a 10% “special sales tax.”

The marijuana tax legislation was presented to voters in 2013 as Proposition AA and spurred a statewide debate on the effect of the tax rates on the marijuana economy.23 A spokesman for the Committee for Responsible Regulation, a campaign supporting the passage of Proposition AA, argued that the “convenience of buying marijuana, and paying this amount of tax on marijuana, will still outweigh any benefits consumers might think there would be in trying to get it from the black market.”24 In addition to the convenience of purchasing marijuana in stores, the campaign cited the "the comfort in knowing exactly the potency and the quality."25

Opponents warned that the high taxes would drive recreational users to the black market. One of the arguments presented against the taxes in the state voter guide stated:

> The new state taxes created by the measure may be so high that they undercut one of the intended purposes of Amendment 64, which is to encourage consumers to purchase marijuana from licensed stores rather than the from the underground market...By overtaxing a product that is readily available in the underground market, the

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25 *Id.*
measure may limit sales from licensed stores and keep consumers in the underground market.”

The Colorado chapter of the National Organization for the Reform of Marijuana Laws (NORML) called the 25% tax rate for marijuana “excessive” and warned that such a high tax rate, along with the decision by some communities to block the licensure of retail outlets, “has the potential effect to keep a black market for marijuana alive in Colorado.”

With proponents of Proposition AA promising $67 million of additional revenue for the state, with the first $40 million from excise taxes “earmarked for public-school construction,” Colorado voters overwhelmingly passed the 25% tax rate in late 2013, two months before legal marijuana sales began in Colorado on January 1, 2014, setting the overall tax rate at 27.9% after factoring in the state’s 2.9% traditional sales tax. The tax rate on medical marijuana is only subject to the 2.9% sales tax.

Studies of the marijuana market in Colorado show that converting consumers from the black markets and medical marijuana “gray” market to the legal recreational market remains a challenge. The Colorado Department of Revenue estimated in mid-

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28 Research Publ’n No. 626-1, supra note 26, at 24.


30 Marijuana Taxes | Quick Answers, supra note 29.
2014 that the total demand, including the recreational, medical, and black market, for marijuana among 21-year-old adults and older to be 130.3 metric tons (approximately 287,262 pounds) in 2014.\(^{31}\) A follow up report indicates that legal sales - medical and recreational - totaled 148,000 pounds of flowering marijuana in 2014,\(^{32}\) meeting just over half of the estimated total demand. The majority of the legal marijuana sold was medical at 109,578 pounds versus 38,660 pounds of recreational.\(^{33}\)

In mid-2014, the Colorado Department of Revenue determined:

…that conversions from medical to retail consumption is relatively low. Instead, retail supply of marijuana is growing, while medical marijuana is relatively constant. This may indicate that medical consumers would rather pay the medical registration fees as opposed to the higher tax rates, or that there are currently relatively few retail outlets compared to medical centers. Therefore, the retail demand is derived primarily from out-of-state visitors and from consumers who previously purchased from the Colorado black and gray markets.\(^{34}\)

The Colorado Marijuana Enforcement Division noted that by the end of 2014 retail marijuana sales were beginning to close the gap with medical but sales but still “only accounted for 26% of the total flowering marijuana sold at both Medical Centers and Retail Stores in the aggregate for the preceding twelve months.”\(^{35}\) An estimate by the


\(^{33}\) Id. at 19.

\(^{34}\) MARKET SIZE AND DEMAND FOR MARIJUANA IN COLORADO DEMAND, supra note 31, at 3.

\(^{35}\) ANNUAL UPDATE, supra note 32, at 18.
Marijuana Policy Group estimated in October 2014 that the state’s retail stores satisfied only approximately 18% of the Colorado’s total market demand, including medical and the black market.\textsuperscript{36} Barbara Brohl of the Colorado Marijuana Enforcement Division believes that “[o]ne of the reasons that there has been less movement from medical marijuana to recreational marijuana than expected is because of the lower taxes.”\textsuperscript{37}

Colorado Governor Hickenlooper signed two bills that aim to address the problems that the medical and black markets pose to the recreational markets. Senate Bill 14 enacted on May 18\textsuperscript{th}, 2015 will increase oversight on large medical marijuana cultivators to prevent diversion to the black market and directs the state health agency to reform physician guidelines for medical marijuana recommendations.\textsuperscript{38} In an effort to combat black market dealers who are undercutting recreational sales, Hickenlooper signed a bill on June 4, 2015 that would permanently lower the recreational sales tax from 10% to 8% beginning in July 2017.\textsuperscript{39}

Washington

Similar to Colorado, Washington voters also passed an initiative to legalize, tax, and regulate marijuana in 2012. The initiative instructed the state’s Liquor Control Board to develop rules to implement retail marijuana sales. The Board was charged with determining “the maximum number of retail outlets that may be licensed in each county” and also maximum quantities that marijuana producers, processors, and retailers are allowed have on their premises at one time. With respect to the maximum number of marijuana retail outlets allowed in each county, in determining that number, the Board must consider whether not only population and safety issues, but whether there will be an adequate supply of “licensed sources of useable marijuana and marijuana-infused products to discourage purchases from the illegal market.” Similarly, when determining maximum quantities of marijuana allowed for producers, processors, and retailers, the state liquor control board was instructed to consider “[t]he provision of adequate access to licensed sources of marijuana…to discourage purchases from the illegal market” as well as “[e]conomies of scale, and their impact on licensees’ ability to both comply with regulatory requirements and undercut illegal market prices.”

Initiative 502 levied a 25% excise tax on each transfer in the supply chain, wholesale sales between producers and processors, wholesale sales between processors

\[\text{Jonathan Martin, } \text{Voters Agree to Legalize Pot, Seattle Times, Nov. 6, 2012, }
\text{http://blogs.seattletimes.com/politicsnorthwest/2012/11/06/marijuana-legalization-takes-commanding-lead/}.\]

\[\text{Initiative Measure 502, 2013 Wash. Sess. Laws 29.}\]

\[\text{Id. at 39; Id. at 42.}\]

\[\text{Id. at 40.}\]

\[\text{Id.}\]
and retailers, and on retail sales. After state and locals taxes are included, Moody’s Investors Service found that the effective tax rate on marijuana sales equaled 44%. Again the state’s Liquor Control Board is required to “regularly review the tax levels…and make recommendations to the legislature as appropriate regarding adjustments that further the goal of discouraging use while undercutting illegal market prices.” It’s unknown whether these specific mandates, built into the law to consider the effect of policies on the black market will reach the desired outcome without creating a regulatory environment that the industry feels is too burdensome.

Legal recreational marijuana sales have had a shaky debut in Washington. When sales began during the summer of 2014, consumers faced sky-high prices and supply shortages. By January 2015, prices dropped substantially as more marijuana was produced, but black market prices were still about 50% cheaper than in recreational shops. A report released by the Washington Department of Revenue on January 30, 2015 found that black-market “marijuana sells for between $9 and 12 per gram” while “[s]tate-regulated recreational marijuana sells for $25 to $40 per gram.”

Another major impediment for the retail market in Washington is the pre-existing medical marijuana market described by Seattle Times editors as “much larger” and

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45 Id. at 52.
47 Initiative 501, supra note 10, at 53.
49 Id.
“wildly unregulated” compared to the recreational market.\textsuperscript{51} In contrast to other states’ medical marijuana programs, Washington does not require patients or physicians to register with the state, nor does the state have an exact count of how many medical dispensaries operate.\textsuperscript{52} The state licensed 334 recreational stores statewide but “about 300 dispensaries operate” inside of Seattle alone.\textsuperscript{53} In addition, sales of medical marijuana are only subject to state and local taxes, making the price substantially lower than recreational pot.\textsuperscript{54} According to Moody’s Analyst Andrea Unsworth, “[t]he tax structure in Washington State is likely to be a major deterrent for consumers who do not see the value in obtaining the product from a storefront as opposed to a medical dispensary.”\textsuperscript{55}

In 2015, Washington took steps to level the playing field between the recreational marijuana market and the medical and illegal markets. In a significant move to reform the medical marijuana market and merge it with the recreational system, Governor Inslee signed legislation on April 24\textsuperscript{th}, 2015, that will eliminate large unregulated medical dispensaries, establish voluntary patient registries, and temper unregulated medical marijuana production.\textsuperscript{56} The legislation will also subject medical marijuana products to

\textsuperscript{53} Id.
\textsuperscript{54} Id.
\textsuperscript{55} Moody’s Investors Service, \textit{supra} note 45.
the same stringent testing and labeling requirements that exist for recreational marijuana.\textsuperscript{57}

The legislature is also moving towards reforming the way recreational marijuana is taxed. Finding that the “implementation of [Initiative 502] has established a clearly disadvantaged regulated legal market with respect to prices and the ability to compete with the unregulated medical dispensary market and the illicit market,” the Washington State House of Representative passed legislation on April 10\textsuperscript{th}, 2015 to reform the tax treatment of retail marijuana.\textsuperscript{58} The legislation “intends to reform the current tax structure for the regulated legal marijuana system to create price parity with the large medical and illicit markets with the specific objective of increasing the market share of the legal and highly regulated marijuana market.”\textsuperscript{59} House Bill would replace the three separate 25\% excise tax levies on production, processing, and retail with one excise tax of 30\% on the retail sale only,\textsuperscript{60} which would have the likely effect of lowering input costs for producers and processors, eventually bringing down the overall price. A competing bill passed by the Senate would put in place the same reformed tax structure but set the rate slightly higher at 37\%.\textsuperscript{61}

\textbf{Oregon}

Oregon voters approved the legalization of recreational marijuana on November 4, 2014, following the footsteps of Colorado and neighboring Washington.\textsuperscript{62} In a letter to

\begin{itemize}
\item \textsuperscript{57} \textit{Id.}
\item \textsuperscript{58} H. B. 2136, 2015 Reg. Sess., 64th Leg. (Wa. 2015).
\item \textsuperscript{59} \textit{Id.}
\item \textsuperscript{60} \textit{Id.}
\item \textsuperscript{61} S.B. 6062, 2015 Reg. Sess., 64th Leg. (Wa. 2015).
\item \textsuperscript{62} Noelle Crombie, \textit{Recreational Marijuana Passes in Oregon: Oregon Election Results 2014}, OREGONIAN, Nov. 4, 2014,
\end{itemize}
the Oregon legislature, the state Liquor Control Commission, which will be responsible for marijuana regulation, warned that “[t]here are several economic challenges to the success of a well-regulated commercial market for recreational marijuana.” The letter states that the “continued independent status of the medical program is a market force that limits the ability of the recreational system in terms of sales and potential revenue production” because “at some level the systems will directly compete for customers.” The Commission estimates “the recreational system will begin with a potential of 20 percent market penetration of current Oregon marijuana consumption.” In order to be successful, the “recreational system will have to prove its superiority in terms of security, quality, convenience and price to overcome the illegal market, home grow provisions of Ballot Measure 91, and a medical system largely free of regulations and associated costs that will be present in the recreational system.”

A special Oregon-state legislative committee charged with implementing Measure 91 is, according to Senator Ginny Burdick, attempting to “work out a system that allows medical marijuana to continue ‘but add a layer of accountability and a layer of tracking so we can make sure the medical marijuana is getting to dispensaries and patients and not

64 Id.
65 Id.
66 Id.
to the black market and is not going to end up competing with the recreational market like it did in Washington and to some degree in Colorado.**67

Oregon’s voters proposed taking a different approach to taxing recreational marijuana from that of Colorado and Washington. They eschewed an “ad valorem” excise tax based on percentage of sale and instead opted for a tax based on weight levied on producers at $35 per ounce for flowers, $10 per ounce for leaves, and $5 for each immature plant.68 However, despite the statement of a key state senator co-chairing the Joint Committee on Implementing Measure 91 favoring “very low” tax rates at the start of legal marijuana sales due to concerns about black market competition,69 the Oregon legislature is poised to replace the voter-approved weight-based tax with a 20% sales tax.70

While the legalization of marijuana in Oregon is set to take effect on July 1, 2015, recreational sales are not expected to begin until 2016. However, the state’s top Republican state senator proposed allowing recreational sales to begin sales early at medical marijuana dispensaries out of concern “that the state needs to move quicker to

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69 OREGONIAN, supra note 66.
provide an alternative to the black market once marijuana becomes legal on July 1.”71 The Oregon legislature may vote a measure that allows recreational users to buy marijuana at medical retailers beginning in October 2015.72

Alaska

Alaskan lawmakers and policymakers are working to implement Measure 2 passed in November 2014, which mandates the state government to develop and issue regulations for a recreational market during a nine-month period that began on February 24, 2015.73 The state legislature passed a bill on April 19th that would create a specialized Marijuana Control Board to implement legalization.74 Similar to the taxation system established by Oregon, Alaska will levy a weight-based $50 per ounce excise tax on the sale or transfer of marijuana from a cultivation facility to a retail store or product manufacturing facility as opposed to the “ad-valorem” taxes levied by Colorado and Washington.75

An economic study of the Alaskan marijuana market conducted by the Marijuana Policy Group, the same firm that produces economic studies for the Colorado government, estimates that 22.4% percent of the state’s overall demand will be provided

72 OREGONIAN, supra note 70.
73 Alaska Alcohol Beverage Control Board, Marijuana Initiative FAQs, (accessed May 1, 2015), http://commerce.state.ak.us/dnn/abc/resources/MarijuanaInitiativeFAQs.aspx.
by the new legal market during the first year.\textsuperscript{76} If retail prices decrease from $14 per gram to $8 per gram by 2020, analysts expect the recreational share of the market to increase to 75%.\textsuperscript{77} However, “[i]f retail prices increase significantly, then most heavy users will avoid this supply mode and buy marijuana from black or grey market sources as possible.”\textsuperscript{78} The number of people initially participating in the retail market in Alaska is expected to be higher than Colorado because “Alaska does not have a deep network of pre-existing medical dispensaries.”\textsuperscript{79}

\textbf{Washington D.C.}

In contrast to the four state jurisdictions that legalized marijuana, the District of Columbia’s Initiative 71 passed on November 4, 2014 did not establish a regulated market for marijuana due to local rules that do not “allow ballot measures to impact the city’s budget.”\textsuperscript{80} Initiative 71 legalizes the use and possession of marijuana and allows residents to grow up to six plants in their homes.\textsuperscript{81} DC activists and politicians that supported the legalization initiative expected the DC Council to pass a more comprehensive tax and regulate bill that would establish a functioning legal market.\textsuperscript{82}

\textsuperscript{76} \textsc{Marijuana Policy Group}, \textit{supra} note 36.
\textsuperscript{77} \textit{Id}.
\textsuperscript{78} \textit{Id}.
\textsuperscript{79} \textit{Id}.
\textsuperscript{82} Aaron C. Davis, \textit{D.C. Council Backs Down on Marijuana Hearing After Attorney General Warning}, \textsc{Wash. Post}, Feb. 9, 2015, http://www.washingtonpost.com/local/dc-
But instead, Congress, which has the power to specify how the District of Columbia spends money, effectively blocked the city from spending any funds to establish a tax and regulate system that would have created a legal market to compete with the black market.83

In the RAND Corporation’s report to Vermont on marijuana policy, it discussed the how the “home-grow” model of marijuana that DC adopted in the near-term, based on the language of Amendment 71, could affect the black market. It found that:

Although home growing could help siphon some demand away from the black market, it might not ever win a large market share. Black-market marijuana could be just too cheap and available for the opportunity to grow one’s own to appeal to many customers. Grow-your-own plus sharing (also known as grow and give) offers little opportunity for the government to generate revenue and provides less scope for enforcing product quality and labeling standards; however, regulations are indeed a possibility (see Chapter Six for further discussion). There is also some risk of enabling illegal commercial production, particularly if the limits on home production are set too high. Enterprising entrepreneurs could distribute production across friends’ houses, with each house staying below the threshold limit, and aggregate the production into (illegal) wholesale quantities only when it was time to harvest the marijuana and ship it to market.84

In an interview with the Washington Post, one DC-based black-market marijuana dealer labeled the city’s legalizations effort the “dealer-protection act of 2015.”85

83 Id.
84 CAULKINS ET AL., supra note 14, at 58.
While Congress has effectively boosted the black market in Washington, DC by preventing the city from establishing a recreational market alongside of legalization, more people are taking advantage of the city’s small medical marijuana market. In July 2014, the D.C. council redefined the medical conditions qualifying patients for medical marijuana from a restrictive list of serious condition to “any condition for which treatment with medical marijuana would be beneficial, as determined by the patient’s physician.” As a result, the number of people seeking a doctor’s approval to buy medical marijuana from dispensaries has tripled to 2,700 since the legislation was passed. However, there is a shortage of supply for the marijuana patient community that is keeping the price per ounce at around $550 compared to a $350 street price. The supply shortage of medical marijuana is attributable to current regulations limiting suppliers to the three approved dispensaries growing 1,000 plants.

California

California is discussed in this section because it is often cited as one of the next states most likely to legalize marijuana in 2016 election, and its actions will be highly

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88 *A D.C. Doctor Makes Medical Marijuana a Specialty*, supra note 83.
89 Id.
influential for other states.91 One of the biggest challenges for policymakers will be confronting the state’s loosely regulated medical marijuana market, which the state’s Blue Ribbon Commission on Marijuana Policy acknowledged as “a quasi-legal recreational market.”92 In California, the “medical system is among the least restrictive in terms of qualifying medical conditions.”93 In the event that medical marijuana will be subject to lower taxes than recreational, “people who are not sick should be discouraged from seeking medical access to marijuana for the purpose of avoiding paying taxes.”94 The report also notes the unique challenge in California because “a very large number of people” are “accustomed to recreational use at medical prices.”95 A new recreational system may not function unless the state finds a way to attract those who purchase from the medical market.96

Section IV: Four Early Lessons Learned from Colorado and Washington

If eliminating the black market is one of the primary policy goals of the growing legalization movement, there are several lessons that can be learned from the experience in Colorado and Washington about methods to tax recreational marijuana as well as addressing a potentially competing medical marijuana market.

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93 Id. at 12.
94 Id.
95 Id.
96 Id.
States Should Avoid Price-Based Taxes Adopted by Colorado and Washington Because of the Potential for a Price Collapse.

Arguably, implementing a price-based tax for recreational marijuana was a major mistake by Colorado and Washington. In considering how to tax the production and sale of marijuana, states should now choose a weight-based tax over a price-based tax because of the likely price fluctuations that will take place as the new recreational market is established. While both approaches have advantages and disadvantages, the price-based tax is most problematic for a new industry trying to beat the black market.

Pat Oglesby, a former chief tax counsel of the Senate Finance Committee who advises states on marijuana taxation, explained in his testimony before the Oregon state legislature, “[t]axing by price means taxes are high when they should be low, and low when they should be high.” As the RAND report on marijuana legalization policy options commissioned by Vermont explains, in Colorado and Washington, a priced-based tax caused retail prices for marijuana to be “abnormally high early on” resulting in the “black market and fake medical market” retaining “market share.” After the initial phase of where it is likely that the recreational market will experience low supply and high demand accompanied by high prices for the consumer product, states should take into consideration “the likelihood that a maturing industry will achieve innovations and economies of scale” and this could cause an “after-tax price collapse.” In Washington, a version of this scenario may be playing out as shortages of marijuana have turned into

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97 TESTIMONY OF PAT OGEBSY, OR. STATE LEG. J. COMM. ON IMPLEMENTING MEASURE 91, 78th Leg. Assemb., 2 (Feb 16, 2015), available at https://olis.leg.state.or.us/liz/2015R1/Downloads/CommitteeMeetingDocument/46431.
98 CAULKINS ET AL., supra note 14, at 78
99 Id.
an oversupply and recreational prices had dropped significantly.100 In addition, very low
prices combined with a tax-based on price “can lead to taxes that are too low,”101 which
may erode revenue and invite federal scrutiny if cheap marijuana is diverted across state
lines.102 A weight-based tax will provide a stable revenue stream that does not fluctuate
with price, but may have the unintended consequence of encouraging high potency.103

Voters in the two most recent states to legalize marijuana, Oregon and Alaska, have both
elected to tax marijuana by weight,104 although Oregon’s legislature may replace the
weight-based tax with a retail price base.105

Another tax base being considered is THC potency, but as the Vermont RAND
study points out, implementation would be significantly more complex than a price or
weight-based approach and no state has tried to implement a potency tax base.106

Recreational Marijuana Taxes Should Start Low and Gradually Increase as the
Market Matures.

Another big mistake made by Colorado and Washington was levying very high
taxes on marijuana businesses at the start of legalization rather than starting taxes low and
gradually raising them once marijuana prices drop and the industry matures. The
advantage to the approach of starting taxes low is that it would avoid the problem of
initial high prices for recreational marijuana, allowing the new industry to compete with
the black and gray markets, and then provide some price stability when production costs

100 Brad Tuttle, Legal Pot Prices Keep Getting Cheaper, TIME, Apr. 22, 2015,
101 Id.
102 GUIDANCE REGARDING MARIJUANA RELATED FINANCIAL CRIMES, supra note 17.
(Memo states that preventing diversion to other states will be a high priority.)
103 CAULKINS ET AL., supra note 14, at 77
104 Oglesby, supra note 94.
105 OREGONIAN, supra note 70.
106 CAULKINS ET AL., supra note 14, at 80-84.
drop. The Vermont RAND study describes five options for legislatures to dynamically adjust taxes: 1) indexing the taxes to rise with inflation, 2) legislatively scheduled future tax-rate increases, 3) staggering the implementation of different types of taxes, 4) delegating rate-setting to the state executive branch, and 5) allowing state executive branch officials to adjust rates set by legislators.

A marijuana legalization bill introduced in Massachusetts in March 2015 recognized the problem of early high taxes and proposes slowly increasing an excise tax from $10 an ounce in the first year that would rise to $50 per ounce by the fourth year of legalization.

**States Should Structure Taxes to Help Businesses Make Deductions on Federal Taxes.**

Marijuana businesses that operate legally under state law face a major disadvantage with respect to federal taxes because of Internal Revenue Code (IRC) Section 280E, which prohibits marijuana businesses from claiming most federal tax deductions. Professor Ed Roche at University of Denver Sturm College of Law writes, “Congress enacted Section 280E in reaction to the Tax Court’s ruling in *Edmonson v. Commissioner*, in which the Tax Court allowed a taxpayer to deduct his expenses associated with selling various illegal drugs. The most egregious aspect of Section 280E may be that the federal government does not allow for a deduction of many state

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taxes resulting in an assessment on “income tax on revenue that actually accrues to the state.””

This high federal tax rate may be stunting the recreational market in its ability to compete with the black market. According to Taylor West, the deputy director of the National Cannabis Industry Association, Section 280E “results in her clients paying more than 70 percent of their profits in taxes to the federal government.” Other analysts say their clients pay up to “90 percent of their revenue in federal taxes.” While solving marijuana businesses’ Section 280E problem would require unlikely federal legislation that either reschedules marijuana on the Controlled Substances List or modifies Section 280E of the tax code to carve out marijuana businesses, states should craft marijuana laws that assist the nascent industry with its heavy federal tax burden.

Members of the Washington state legislature introduced a bill that would help provide some relief under 280E for legal marijuana businesses because it would repeal the 25% excise tax on wholesale transactions and replace it with one tax at the point of

115 Marijuana would need to be moved from Schedule I to Schedule III or below in order to escape Section 280E, which encompasses controlled substances listed on Schedule I. See I.R.C. § 280E (2013).
sale, effectively shifting the burden of the tax from the seller to the buyer. As Washington cannabis accountant Todd Arkley explained, “the key” to designing “marijuana sales taxes” so that businesses escape double-taxation as a result of Section 280E “is to ensure that the buyer is responsible and…the seller acts as an agent.” This solution could be used to “reduce federal tax exposure by huge amounts.”

Going further, the Tax Foundation, a D.C.-based tax policy think tank, points out that “[c]reative legislators could even redefine license fees as custodial sales taxes, by requiring retailers to collect the license fees from consumers instead of charging them directly to retailers,” thereby escaping the Section 280E problem.

Another creative potential fix to the 280E problem, discussed in detail by tax expert Pat Oglesby, would be for states to levy excise taxes on the production of marijuana rather than its sale. Currently the excise taxes in Colorado, Washington, Oregon, and Alaska are levied on the sale of marijuana, but because of Section 280E, those businesses cannot deduct state excise taxes levied on wholesale sales to retailers under §164 as a normal and ordinary business expense. But if states tax the production

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117 Email from Todd Arkley, C.P.A., Arkley Accounting Group, to Christopher Law, American University Washington College of Law Student (April 28, 2015) (on file with author).
118 One Simple State Tax Code Tweak to Favor Marijuana Taxpayers Over Tax Evaders, supra note 108.
121 State Law Fix for 280E Problem?, supra note 115.
of marijuana, rather than its sale, it might allow for businesses, especially producers, to deduct the tax on their federal return as a cost of goods sold.122 Normally businesses that “make or buy goods to sell” are allowed to deduct the cost of goods sold, including some capitalized expenses such as taxes, from gross receipts.123 Despite the 280E prohibition on claiming federal tax deductions, the United States Tax Court has held that costs of the goods sold are deductible even for businesses trafficking in drugs that are illegal under the CSA.124

In designing tax regimes that assist marijuana businesses in the face of Section 280E, state policymakers will need to be cognizant of a IRS general counsel memorandum issued in January 2015 interpreting Section 280E as prohibiting marijuana businesses from using UNICAP accounting standards outlined in IRC §263A.125 Instead, the IRS memo states that businesses must use “applicable inventory-costing regulations under §471 as they existed in 1982 when §280E was enacted.”126 Because of the confusing and rapidly changing stances on how the IRS will treat marijuana businesses that are operating legally in the states, an excise tax on production that allows marijuana businesses to deduct cost of goods sold may be an unattractive solution; at least until the IRS or courts provide further clarity on how the IRS will enforce accounting standards. The last thing state legislators will want to do is unintentionally put marijuana businesses in a more uncertain position before the IRS. The smart choice for legislators may be to

122 Id.
126 Id.
shift all marijuana taxes to the buyer, as Washington may do in the future, to reduce the Section 280E burden.

**States Should Implement Policies to Reduce Competition Between Recreational and Medical Marijuana Markets.**

If a state legalizing recreational marijuana already has a pre-existing medical marijuana market in operation, policymakers should seek to harmonize the medical market with the new recreational market. As discussed above, one of the major impediments to the recreational marijuana markets gaining larger market share more quickly in Colorado and Washington is that many users had previously gained access to the medical markets, enjoying extremely low tax rates and prices as a result. After voters passed Amendment 61 in Colorado, the “number of patients on Colorado's medical marijuana registry went up, not down… meaning more marijuana users there can avoid paying the higher taxes that recreational pot carries.”127 While many medical marijuana patients have a legitimate need for access, arguably at lower price than recreational users, states with loosely regulated medical markets will want to tighten access so that it is not an avenue for recreational users to avoid paying taxes.

The question of how to treat simultaneous recreational and medical marijuana markets for tax purposes is especially relevant in California, which will face significant challenges because of the very large medical marijuana industry that has been operating since 1996.128 Assuming that voters will want to reconcile a possible recreational market with the pre-existing medical market, “[o]ne major policy question is whether

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128 See **BLUE RIBBON COMM. ON MARIJUANA POLICY**, *supra* note 89.
[recreational] taxes would apply at the same level to patients who use marijuana for medical purposes.”129 While taxing all marijuana at the same rate would simplify the regulatory model and increase the amount of revenue to the state, it would also raise the cost of the drug for patients with a legitimate medical need.130 One solution is to unify the systems but make marijuana tax exempt for patients with a doctor’s recommendation.131 However for this to work, it will need to be more difficult for recreational users in California to receive a medical recommendation.

Washington began to overhaul its medical marijuana market in April 2015.132 The significant provisions put an end to the large “collective garden” dispensaries, which provided unregulated medical marijuana to “thousands of people” and will allow patients to “buy medical-grade products at legal recreational marijuana stores that obtain and endorse to sell medical marijuana.133 Alternatively, patients “will be able to participate in cooperative of up to four patients.”134 In addition patients that voluntarily register with the state will be exempt from sales tax but not the excise tax.135

A bill signed by the Colorado governor instructs “the Colorado medical board to adopt rules regarding guidelines for physicians who make medical marijuana recommendations for patients suffering from severe pain,” which may lessen the number

129 Id. at 12
130 Id.
131 Id.
133 Id.
134 Id.
of people who qualify for medical marijuana. Other provisions provide greater state oversight of medical marijuana “caregivers,” who grow the product, requiring them to “register with the state health agency and state medical marijuana licensing authority” so that the state can “ensure that a medical marijuana patient has only one caregiver.”

Oregon, where it is “estimated that as much as 75 percent of the medical marijuana in the state winds up going to the black market,” is taking action to increase regulations on the medical marijuana industry before its recreational system comes online. On May 27, 2015, the Oregon Senate passed a bill that “requires medical marijuana cardholders, growers, processors and dispensaries” to “be registered with the state,” puts “new limits on personal, caregiver, and collective cultivation”, and implements a tracking system for plants to prevent black market diversion.

Alaska’s legislators will likely have an easier time reconciling the state’s medical marijuana program with the new recreational market than Colorado, Washington, and Oregon. Although medical marijuana has been legal in Alaska since 1998, but use is of the program is very limited because Alaska’s law does not allow dispensaries and does not provide a legal mechanism for patients to obtain the drug.

139 Jeff Richardson, Without Dispensaries, Alaska has Avoided Federal Medical Marijuana Prosecutions, FAIRBANKS DAILY NEWS-MINER, May 22, 2011,
In Washington D.C., the medical marijuana program is relatively small but growing. If Congress continues to prevent the city from implementing a tax and regulate system, one solution local officials may consider is opening the medical marijuana program to a wider group of people to give recreational users a way to purchase marijuana legally, some activists have suggested. While this route to circumvent Congress’s spending freeze seems unlikely at the present time, it could prove attractive to D.C. policymakers if the standoff with Congress is protracted for many years. The downside to this approach is that it could invite the same challenge of reigning in medical marijuana markets with high numbers of recreational users experienced by states with very liberal medical marijuana laws.

Section V: Conclusion

State experimentation with marijuana legalization has been largely successful despite mistakes made in Colorado and Washington. While it is still early in the process, as more states decide to implement their own recreational marijuana markets, studying the experience of the states that pioneered marijuana legalization, especially in the area of taxation, will result in smoother transitions from the black and gray markets to one that is open and regulated, providing safe and labeled products to consumers while generating revenue for state governments, and satisfying central political goals expressed by voters.

140 A D.C. Doctor Makes Medical Marijuana a Specialty, supra note 83.
Activists are pushing recreational legalization ballot initiatives in at least five states including California, Nevada, Maine, Arizona, and Massachusetts, each of which could benefit from identifying ways to incorporate legal fixes for problems experienced in Colorado and Washington from the outset of implementation rather than chasing solutions later.

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