Assembly Bill 307: Simplification of Cannabis Tax

Prepared for: Nevada Assembly Revenue Committee

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Dear Chair Backus and members of the committee:

On behalf of Reason Foundation, I thank you for accepting these comments and making them part of the public record. Reason Foundation is committed to ensuring that state cannabis markets are well-designed and fulfill the promise of drug legalization by successfully transitioning market participants to the legal and regulated market.

Complicated and punitive tax rates on legal marijuana goods create a tax-induced price distortion that favors illicit goods. Legal cannabis goods compete with both illicit goods for which supply chains have been established over decades and with intoxicating hemp-derived cannabinoids. These substitute goods do not face the same regulatory and tax burdens as state-licensed marijuana. Large-scale surveys show that marijuana consumers prefer to buy regulated marijuana goods when the price is comparable, but they will not pay more for these goods than they would for illicit alternatives.[1]

Jurisdictions that assess taxes at multiple levels of the supply chain cause taxes to "pyramid" or accumulate within the price of the underlying good in a way that is non-transparent to consumers. This approach also complicates tax compliance and requires both taxpayers and tax administrators to devote greater time to preparing and reviewing tax filings.

A particular complication with *ad valorem* wholesale marijuana taxes emerges when a cultivator or manufacturer transfers inventory to a retail dispensary under common ownership. The owners are incentivized to transfer the inventory at a minimal declared price in order to evade the wholesale tax. To counter this possibility, regulators in Colorado and Nevada conduct quarterly market surveys among licensees to determine a declared "market price" for marijuana goods. They then assess the current 15% tax rate against the declared market price per pound of marijuana transferred to determine a cultivator's tax liability. This approach obscures the fact that marijuana is produced at different levels of quality and marketability. Low-quality marijuana that would fetch a lower market price is effectively taxed at higher rates while high-quality marijuana is effectively taxed at lower rates.

Nearly all states with regulated marijuana markets do not assess an *ad valorem* wholesale tax. This is unique to Colorado, Illinois and Nevada. Alaska and New Jersey assess wholesale taxes at a fixed rate per pound of marijuana produced, but neither of those states impose a retail excise tax.

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[1] Samantha Goodman, Elle Wadsworth, and David Hammond, "Reasons for Purchasing Cannabis from Illegal Sources in Legal Markets: Findings Among Cannabis Consumers in Canada and U.S. States, 2019-2020," Journal of Studies on Alcohol and Drugs, Vol. 83, No. 3, pp/ 392-401 (2022), https://www.jsad.com/doi/abs/10.15288/jsad.2022.83.392?journalCode=jsad.

Reason Foundation has always recommended that states with regulated marijuana markets levy a single excise tax at the point of retail sale. Assembly Bill 307 proposes to do this by repealing the existing wholesale tax. However, this change would be coupled with an increase in the retail excise tax rate from 10% to 14.25%. While some states exempt cannabis goods from the general sales tax, Nevada does not. Nevada also authorizes local governments to assess an additional 3% retail excise tax. As a result, the total retail tax on legal marijuana goods could amount to 25.5%, which would be higher than in most states with legal markets.

The Cannabis Compliance Board has submitted a fiscal note estimating that these tax changes would yield an additional $153 million in tax revenue per biennia. Assembly Bill 307 would be improved if these tax changes were designed to be revenue-neutral so as to minimize the distortive effect of taxes on legal marijuana goods. Nevada lawmakers and regulators have rightly voiced concern over the continued presence of illicit marijuana markets. The best means of displacing these illicit goods is to establish a tax and regulatory environment that allows legal goods to compete on price.

Sincerely,
Geoffrey Lawrence, Research Director and Director of Drug Policy
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Drug Policy Project
at Reason Foundation

The **Drug Policy Project** at Reason Foundation offers pro-bono consulting to public officials and stakeholders to help them design and implement drug policy reforms for legalized medical cannabis and effective harm reduction policies.

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Overview of Marijuana Taxes

Taxes on marijuana businesses and consumers are assessed at each of the federal, state, and local levels. These taxes may include federal and state corporate income taxes, business franchise fees, general sales taxes, local property taxes, general and marijuana-specific business licensing fees, and marijuana excise taxes assessed and the state and local levels.

State and Local Excise Taxes

States and localities generally assess special excise taxes on either marijuana cultivation or retail sales, or both. In most states, these excise taxes are *in addition to* general sales tax and other business taxes. The following table compares the tax rates found in each state:

State	Retail Excise Tax	Avg. Gen. Sales Tax	Addt'l Local Excise Tax	Total Retail Tax	Wholesale Tax
AK		N/A	Varies	0.00%	$800/pound
AZ	16%	8.37%	2%	26.37%	
CA	15%	8.85%	Varies	23.85%	
CO	15%	Exempt	Varies	15.00%	15%
IL*	10%, 20%, 25%	8.84%	3.5%	22.34% - 37.34%	7%
MD	9%	Exempt		9.00%	
ME	10%	5.50%		15.50%	$335/pound
MA	10.75%	6.25%	3%	20.00%	
MI	10%	6%		16.00%	
MO	6%	8.36%	3%	17.36%	
MT	20%	N/A	3%	23.00%	
NV	10%	8.24%	3%	21.24%	15%
NJ		6.60%	2%	8.60%	$17.60/pound
NM	12%	7.60%		19.60%	
NY**	9%	Exempt	4%	13.00%	$0.005, $0.008, $0.03 /mg THC
OH	10%	7.24%		17.24%	
OR	17%	N/A	3%	20.00%	
RI	10%	7%	3%	20.00%	
VA	21%	5.77%	3%	29.77%	
VT	14%	6.36%		20.36%	
WA	37%	9.40%		46.40%	

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*Illinois assesses different retail excise tax rates on marijuana flower (10%), edibles (20%) and concentrates (25%).
**New York assesses different wholesale tax rates per milligram of THC in flower ($0.005), concentrates ($0.008) and edibles ($0.03).

Federal Income Tax Issues

According to Section 280E of the Internal Revenue Code and related case law, marijuana companies are not permitted to deduct most legitimate business expenses on their federal corporate income tax returns. The standard applying to most businesses generally allows expenses that are both "ordinary and necessary" for the operation of the business to be deducted from gross income. Marijuana companies, however, are only permitted to deduct the direct costs of purchasing or generating inventory, known as "cost of goods sold" and nothing else. This effectively transforms the corporate income tax into a 21% tax on gross margin rather than net income.

Black-Market Substitution Effect

Policymakers should understand that tax decisions cannot be made in a vacuum. Facing higher tax rates, consumers generally display one of two behaviors: (1) they consume less of the taxed good; or (2) they seek alternative distribution channels, including illicit sellers. Extensive work has documented the relationship between state cigarette taxes, for instance, and cross-state smuggling in cigarettes. Perhaps unsurprisingly, the states with the highest cigarette taxes have the highest inbound smuggling activity. The Tax Foundation has estimated that 56.8 percent of all cigarettes consumed in New York comes from smuggled sources.[1]

Marijuana may be even more susceptible to a black-market substitution effect than alcohol or tobacco. Until very recently, marijuana has been supplied nearly exclusively through black-market channels in the United States and these alternative supply chains remain firmly established. Data on seizures of marijuana at the Mexican border indicate that legalization of marijuana by several states has led to a dramatic reduction in cross-border illegal trafficking.[2] Excessive tax and regulatory treatment, however, could quickly reverse this trend. California, for instance, juxtaposes high tax and regulatory costs on its legal market against a vibrant black market. As consumers selected cheaper black-market options, sales of legal marijuana totaled to nearly a half-billion dollars less during the first year of its recreational program than the year prior, when only medical marijuana was legal.[3]

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[1] Scott Drenkard, "Cigarette Taxes and Cigarette Smuggling by State, 2015," *The Tax Foundation* Fiscal Fact No. 565, https://taxfoundation.org/cigarette-tax-cigarette-smuggling-2015/.

[2] David Bier, "How Legalizing Marijuana Is Securing the Border: The Border Wall, Drug Smuggling, and Lessons for Immigration Policy," *Cato Institute* Policy Analysis No. 860, https://www.cato.org/publications/policy-analysis/how-legalizing-marijuana-securing-border-border-wall-drug-smuggling#endnote-041.

[3] Thomas Fuller, "Now For the Hard Part: Getting Californians to Buy Legal Weed," *The New York Times,* 2 January 2019, https://www.nytimes.com/2019/01/02/us/buying-legal-weed-in-california.html.

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