Leveraging The Reefer Tax: How Municipalities Can Benefit From Marijuana Regulation And Taxation

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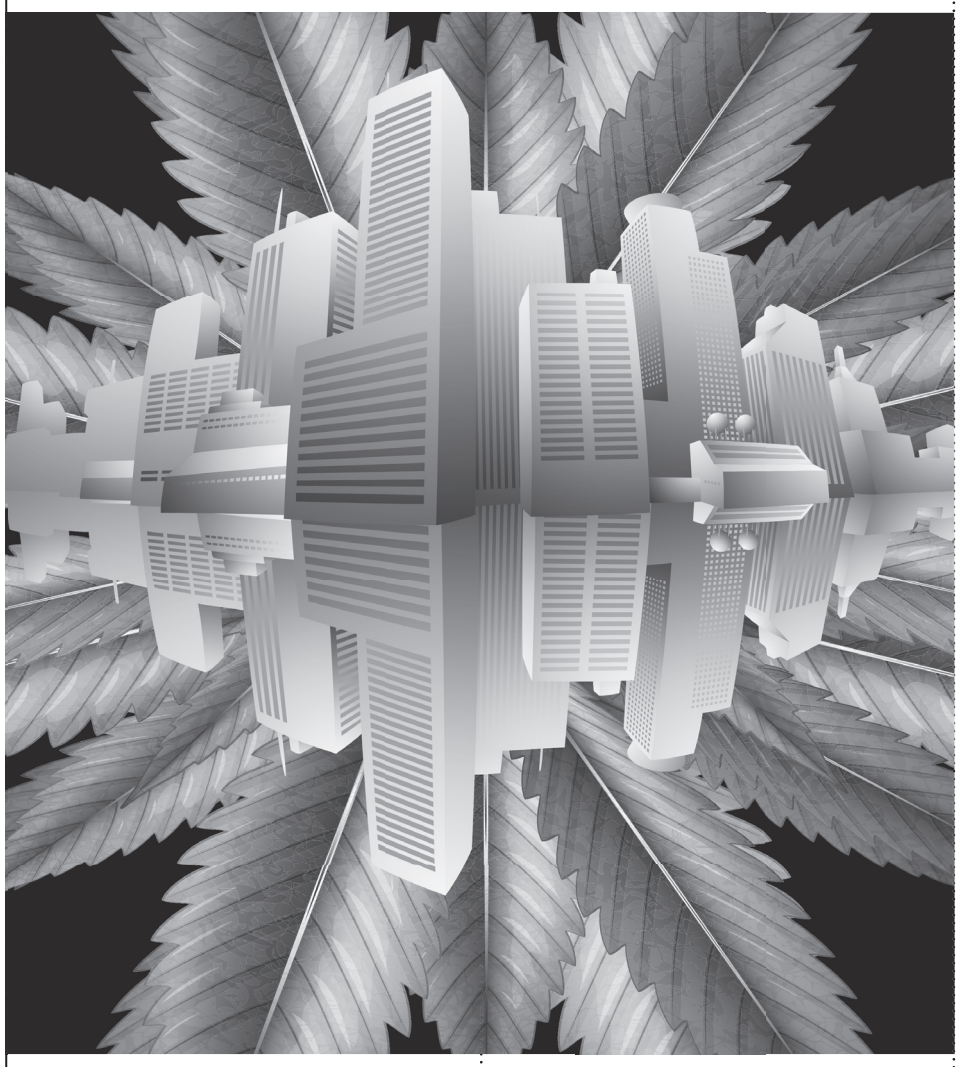

In November 2013, Colorado voters approved Amendment 64, which amended the state's constitution to permit the personal use and regulation of marijuana. On January 1, 2014, Colorado cannabis outlets opened their doors to long lines of eager customers happy to legally pay for their weed, despite a price that included a 15% excise tax and a 10% sales tax.

Notwithstanding the moral and social debates concerning this new law, which will likely dominate the media for the foreseeable future, in this article we present a modest proposal: that municipalities consider how best to maximize the financial benefit of this new revenue stream. Local agencies that receive a portion of the taxes from the sale of marijuana can leverage that revenue by pledging it to repay tax-exempt securities that can be sold to investors; the proceeds from the sale of those securities can then be used for much needed public infrastructure. The approach is not novel, with ample precedent and experience to support the construct.

Maximizing Limited Revenues

The Great Recession has cut a devastating swath through local governments: since 2007, nearly 40 cities, towns, countries, utilities, and special districts have filed for bankruptcy. While the financial outlook for some states, including California and New York, is improving, other states, including Michigan and Alabama, continue to support struggling municipalities.

Necessity breeds creativity, especially in the public sector. Perpetually budget-strapped municipalities have become quite adept at leveraging or supplementing relatively meager revenue allocations to pay for expensive but vital infrastructure, including roads, utilities, schools, and parks. Effective financing structures, including tax increment financing, special district financing, and tax sharing arrangements, have provided local governments much needed funds to continue building vital infrastructure and balance their budgets. The new marijuana tax may provide another financing opportunity for local governments to meet their public capital and operating obligations.

Leveraging Dedicated Revenue Streams: The California Gas Tax Model

The sale of securities remains the most popular method employed by municipalities to finance capital improvements and operations. The payment of principal and interest to owners of those securities is generally secured by a stream of revenue, typically either taxes (such as sales taxes, special taxes, or transient occupancy taxes) or user fees (such as utility payments). The promise of a new tax, such as the new Colorado marijuana tax, is not just in the annual budgetary bump for a municipality, but also in the prospect of leveraging that revenue stream to finance pressing infrastructure and operating needs.

In 2007, the City of Oxnard, California, pioneered a mechanism to leverage the state's gasoline tax that earned the transaction The Bond Buyer's "Far West Deal of the Year" and that has since been duplicated many times in that state. California cities and counties receive a portion of the state's 18-cents-per-gallon tax on the sale of gasoline and diesel fuel. The California Constitution requires that those tax revenues be used for the construction, improvement, maintenance, and operation of public streets and highways. The cost

to construct and maintain local streets and highways, however, often substantially exceeds the gas tax revenues received by a city or county in any given year. In addition, because only 25% percent of the gas tax revenues received by a city or county may pledged to pay bonded indebtedness incurred to finance street and highway construction, and because such indebtedness must be voter-approved, bond financing is severely constrained.

To advance the delivery of infrastructure, the City of Oxnard, together with its legal and financial consultants, devised a financing structure that allowed them to leverage their future gas tax revenues to finance current transportation infrastructure needs, while avoiding the 25% limitation, the voter-approval requirement, and Constitutional debt limitations. Under this innovative financing structure, the City agreed simultaneously to (i) sell designated unimproved City streets to another City-controlled public agency (in this case, a joint powers authority) pursuant to a sale agreement and (ii) purchased the newly constructed or improved streets from that joint powers authority pursuant to an installment purchase agreement. The City also agreed to construct and improve the designated streets as the agent of the joint powers authority. The purchase price of the improved streets was paid from installment payments made by the City solely from gas tax revenues received over 30 years – and the City pledged all of its gas tax revenues, not merely a percentage thereof, to pay the installment payments.

This financing structure required no additional security beyond the gas tax revenue pledge, such as a backstop general fund pledge, and a triple-A rated bond insurer insured the financing based on a gas-tax-revenue-only pledge.

Weed Bonds: How Would They Work?

Assuming the current marijuana-friendly trend continues across the country, each state will decriminalize and regulate the plant according to its own needs and political values. Consequently, the provisions of each law will likely vary as to the mode of collection and distribution of funds, as well as the restrictions as to their use. Nevertheless, the Colorado law is a good starting point to begin thinking about structures that might effectively channel and leverage the prospective tax revenues to optimal public application.

If the amount of marijuana tax revenues becomes regular and relatively dependable, and the state or localities do not place limitations on the bonding of such revenues, local governments in Colorado, including school districts, may be able simply to issue revenue bonds secured by their share of the prospective tax revenues, much the way municipalities issue water or electricity revenue bonds.

Amendment 64 provides for an excise tax to be levied on marijuana sold or transferred in the state at a rate not to exceed 15% prior to January 2017, with the state's General Assembly determining the rate thereafter. The amendment also authorizes the state to impose a sales tax, which is currently set at 10%. The first $40 million in revenue raised annually from any such excise tax is required to be credited to the Public School Capital Construction Assistance Fund, which provides financial assistance for school construction, as well as various educational programs throughout the state. The remaining revenues will be used for administration and regulation purposes. But some of the funds are expected eventually to find their way to local municipalities. In addition, local municipalities are permitted to enact their own regulations and levy additional sales taxes on the sale of marijuana. For instance, the City of Denver has enacted an additional 3.5% tax on sales within the city.

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Most states, however, including Colorado, are likely to limit the use of the proceeds from the sale of such bonds. In such cases, the model that the City of Oxnard utilized to leverage its gas tax revenues might serve as a workable financing

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template. Using a joint powers authority, the governmental agency could sell or lease the proposed project area to the JPA pursuant to a an installment sale or lease agreement, and then purchase the newly constructed improvements back from the JPA, which would pledge those sale or lease payments to the investors in the municipal security.

But What About the Fed?

One of the great advantages that issuers of municipal securities enjoy derives from the exemption of interest payments available to investors. When an investor can avoid taxation on its muni bond interest, the low interest bond is able to compete with higher interest corporate bonds for a spot in the investor's portfolio. But when such exemption is unavailable, or only available on a state level and not from the federal government, the interest rate that the issuer would have to pay to make up for the loss of that exemption can quickly become prohibitively high.

The tax analysis for marijuana bonds will be interesting, to be sure. Notwithstanding the various marijuana laws throughout the country (twenty states and D.C. currently have laws legalizing marijuana in some form), the sale and use of marijuana is still illegal under federal law. The federal government has been inconsistent in its approach to the legalization of marijuana at the state level. In 2009, Attorney General Eric Holder announced that the Department of Justice would stop enforcing the federal marijuana laws against persons and business in compliance with local and state law. Nevertheless, in 2011, the Department of Justice began notifying property owners that any property being utilized by medical marijuana tenants was subject to seizure and forfeiture by the federal government. Yet, after the passage of the Washington and Colorado laws permitting the recreational use of marijuana, the Obama administration announced that it would not challenge laws legalizing marijuana, so long as those states maintained strict rules involving the sale and distribution of the drug. Deputy Attorney General James M. Cole followed with a memo that directed federal prosecutors to focus on eight areas of enforcement, rather than spending time targeting individual users. Those areas include preventing distribution of marijuana to minors, stopping the growing of marijuana on public land, keeping pot from falling into the hands of cartels and gangs, and preventing the diversion of marijuana to states where it remains illegal.

Further complicating matters, many potential underwriters for bonds secured by a marijuana tax, including state-chartered banks, are reluctant to provide traditional services to marijuana businesses, fearing that federal regulators and law enforcement authorities might fine them or otherwise impose sanctions for violating prohibitions on money-laundering, among other federal laws and regulations.

Another impediment to marketing a "weed bond" is the potential resistance on the part of the IRS in upholding an exemption of interest on a validly issued municipal security that is secured by revenue from an activity that is illegal under federal law. If the IRS balks, the question becomes: will the exemption from state taxes (if available) be incentive enough for investors to purchase the securities at an interest rate that is affordable to the municipality?

However, a potential work-around is to have the municipalities pledge an amount equal to the marijuana generated sales tax from their general fund. Thus, the municipality would be committed to pay the bond debt service from its coffers irrespective of the source. The increase in general fund dollars from the sale of marijuana would allow for the coverage on the bonds, but the security would not be from the tax itself.

Given the mounting pressures on municipalities to find funding sources for their ever-increasing costs, answers to questions of tax exemption and use of proceeds hopefully will be worked out in short order. As the country's laws and customs ease with respect to the regulation and taxation of marijuana, great benefit could result for local governments if the federal government and bond market embrace the new revenue source with equal acceptance. It may not be long, then, before the walls of your neighborhood school smell slightly of oregano.

EDITOR'S NOTE:

The mind-blowing fiscal dimensions of legalized marijuana were robustly demonstrated at IMLA's recent Top 50 meeting in Denver. Hosted by City Attorney Scott Martinez and Deputy City Attorney Cristal De-Herrera, our two-day event in early June concluded with a field trip to the nation's largest legal weed cultivation facility.

Housed in a nameless and non-descript warehouse on the edge of the Mile High City, the indoor farm covers nearly three acres–120,000 square feet– of carefully coddled cannabis. The plants, all females, live in individual tubs, tens of thousands of them, organized by genotype and provenance. Insulated from insects, herbivores and poachers, they mature rapidly, stretching upward beneath the relentless haze of enough grow lamps to illuminate a triple-A baseball stadium, nursing on precisely-titrated feedings of mountain water and select nutrients.

It takes an army of 430 workers to serve this windowless hive, arrayed across many disciplines. Some raise newborns in a segregated compound, where select clippings from adult plants magically clone, spawning future generations. Battalions comb through the shoulder- high forest of mature specimens, laboriously snipping prime buds and leaves of optimal potency, like pickers in a tea plantation. Their harvest is then sorted at a score of large metal tables, where dozens separate the valuable bits from the chaff. Other employees staff the facility's extraction area, coaxing rich molasses residues from mounds of green silage. A kitchen team carefully incorporates the dark extract into precisely-crafted chocolate wafers, to be sheathed in foil and commercial wrappers looking as all-American as a Hershey bar. Behind it all, a technical