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Contra
Costa
County

To: Board of Supervisors

From: David Twa, County Administrator

Date: July 18, 2017

Subject: OPTIONS FOR CANNABIS TAXATION STUDY

RECOMMENDATION(S):

CONSIDER options for the taxation of cannabis activities in the County's unincorporated area and engaging Hinderliter, de Llamas & Associates (dba HdL Companies) to prepare a study with recommendations on taxation of various permitted activities.

FISCAL IMPACT:

Depending on the parameters of study set by the Board, we anticipate that the study can be completed at a cost not to exceed $40,000.

BACKGROUND:

On April 25, 2017, the Board of Supervisors held a workshop to discuss the potential regulation of marijuana related land uses as authorized by Adult Use of Marijuana Act (AUMA) or Proposition 64. At the conclusion of the workshop, the Board directed staff to, among other tasks, return with information on revenues (taxes and fees) feasible from transactions of cannabis cultivation, testing, manufacturing, distribution and retail sales, particularly as related to funding for youth drug use prevention and treatment, and public safety services, e.g. law enforcement and fire protection.

☑ APPROVE ☐ OTHER

☑ RECOMMENDATION OF CNTY ADMINISTRATOR ☐ RECOMMENDATION OF BOARD COMMITTEE

Action of Board On: **07/18/2017** ☑ APPROVED AS RECOMMENDED ☐ OTHER

Clerks Notes:

VOTE OF SUPERVISORS

AYE: John Gioia, District I Supervisor
Candace Andersen, District II Supervisor
Diane Burgis, District III Supervisor
Karen Mitchoff, District IV Supervisor
Federal D. Glover, District V Supervisor

I hereby certify that this is a true and correct copy of an action taken and entered on the minutes of the Board of Supervisors on the date shown.

ATTESTED: July 18, 2017

David Twa, County Administrator and Clerk of the Board of Supervisors

By: June McHuen, Deputy

Contact: Julie DiMaggio Enea
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cc:

Under the Medical Cannabis Regulation and Safety Act (MCRSA), the precursor to AUMA, local jurisdictions retain broad authority to assess fees and taxes, and are also given explicit taxation authority

BACKGROUND: (CONT'D)

>

over cannabis businesses licensed under the law. Any local taxes are subject to a vote of the people, passing wiith a simple majority for a general tax and a super majority for a special tax. MCRSA did not create any new State taxes, though operators have been required to obtain a seller's permit from the State Board of Equalization and have been subject to standard sales and use tax. Local taxes can include sales and excise taxes. Excise tax differs from sales tax in that it applies only to specific goods and is generally a flat tax (as opposed to a percentage) applied before the purchase price for specific items.

AUMA imposed the first and currently only statewide cannabis businesses taxes. A 15% excise tax is imposed on dispensary (medical) and retail (nonmedical) sales, though medical sales are exempted from the standard sales and use tax (7.5% - 10%). The initiative also imposes a cultivation tax on all cannabis at a rate of $9.25 per ounce for flowers and $2.75 per ounce for leaves. Jurisdictions that allow commercial cannabis activities and outdoor personal cultivation would be eligible for some of these tax proceeds.

State law authorizes counties to recover the costs of implementing a cannabis licensing and regulatory program (permitting and inspections) through fees. Taxes may be used to pay for other associated costs related to code enforcement, law enforcement, health impacts and education, environmental cleanup and mitigation, and other costs borne by the County that are not directly attributable to services provided to a permittee. Counties can tax a percentage of a business's gross receipts, tax per square foot of a business's operation, or do a combination of both. In addition, counties can assign different tax rates to different cannabis operations. Cost recovery for cannabis is complex and filled with challenging issues:

- **Unit of Taxation**. Taxing marijuana presents unique challenges because the product takes so many different forms, i.e., an edible, a cigarette, a liquid, or a vapor, all with a wide variety of concentrations. While excise taxes are generally imposed as a flat amount per unit, such as per gallon for gasoline or per pack for cigarettes, taxes for cannabis at the retail level are generally by percent of the sale due to the varying forms of the product.

- **Balance**. With much of the cannabis industry operating illicitly, only limited data is available to inform the setting of tax rates that strike a fair balance between covering the County's costs without crimping the cannabis industry's move into legal daylight. Sonoma County, for example, estimated it would need to generate $3.9 to $5.7 million per year to recover its cost of adding staff to multiple departments, including agriculture, health, county counsel, emergency services, planning and code enforcement, and so adopted both permit fees and an initial tax rate of up to 5%. Santa Cruz County, however, recently reported that revenues from its cannabis business tax, forecast to be $3.2 million this fiscal year, are falling short of expectations.

- **Overtaxation**. Cultivation taxes in AUMA boost the State's tax levy on the industry to close to 25%. Add in another 10-15% in local taxes and there will be a very strong incentive for growers to evade regulation and sell on the illegal market. In Santa Barbara, where the law allows up to three medical pot dispensaries in the city, 70% of voters approved a measure authorizing the City Council to levy a tax of up to 20% on gross receipts for medical and recreational marijuana businesses. Santa Barbara's tax rates led to sharp criticism of the City by industry leaders there. Colorado's effective tax rate on marijuana totals 29%: a 15 percent excise tax on the "average market rate" of wholesale marijuana + a 10 percent state tax on retail marijuana sales + the state sales tax of 2.9 percent + local sales taxes + local marijuana taxes (such as a 3.5 percent tax in Denver).

- **Federal Banking Restrictions**. Banks are reluctant to open accounts for marijuana businesses because of fears of a federal crackdown, so most cannabis business transactions — from payroll to tax payments — are done in cash. A cash-only tax system poses several problems such as dangers of being robbed, civil asset forfeiture (legal process in which law enforcement officers take assets from persons suspected of involvement with crime or illegal activity), compliance stemming from the distance to cash payment locations, and the overall workload on regulatory agencies. The question remains as to whether a county would be laundering money by depositing these cash tax revenues into its bank account. California Association of County Treasurers and Tax Collectors President and Humboldt County Treasurer-Tax Collector John Bartholomew has said that financial institutions are "encouraged" to exempt government agencies from their responsibilities to report suspicious transactions under the Bank Secrecy Act.

Lessons Learned by Other Jurisdictions

Prior to embarking on a taxation program, it would be prudent to review the lessons learned by other states who legalized marijuana prior to California doing so, and which illuminate some of the complexities of regulation and taxation. Special Report No. 231, issued in May 2016, by the Tax Foundation offered the following advice:

- **The marijuana tax rate should not be so high as to prevent elimination of the black market**. Colorado, Washington, and Oregon have all taken steps to reduce their marijuana tax rates, with Alaska considering it. Colorado concluded with strong evidence that its 30 percent tax rate did not sufficiently reduce the black market, and more recent ballot initiative proposals all over the country propose rates between 10 and 25 percent.

- **Tax rates on final retail sales have proven the most workable form of taxation**. Other forms of taxation have been proposed, such as taxing marijuana flowers at a certain dollar amount, taxing at the processor or producer level rather than the retail level, or taxing products by their level of THC. Driving factors have included the difficulties with practical implementation of these ideas, the danger of double-taxing some businesses if vertically integrated businesses (where a person or business can hold more than one cannabis license) get a tax benefit, and the favorable federal tax treatment for excise taxes as opposed to business taxes. California law limits vertical integration, though there are still some allowances for multiple license types within the state and local licensing frameworks.

- **Be conscious of the medical marijuana market**. Medical marijuana is usually more loosely regulated and less taxed than recreational marijuana. In Washington, moving non-medical sales to the retail market has proven difficult given the enormous differentials in tax rates and regulatory structure, and officials there wish the two systems had been tackled simultaneously.

- **Be cautious with revenue estimates**. While the revenue can be significant, it takes a lead time to develop. Estimating the size of an illegal market is difficult, as is estimating how many consumers will switch to the legal market when it is available. Revenues started out slowly in Colorado and Washington, both as consumers became familiar with the new system and after state and local authorities spent time and money setting up new frameworks and regulatory infrastructure.

- **Resolve health, agricultural, zoning, local enforcement, and criminal penalty issues**. These important issues have generally been unaddressed in ballot initiatives and left for resolution in the implementation process.

Taxing Options for Counties

Sonoma County, in March 2017, published a Cannabis Taxation Memo that discusses the various options available to counties for taxing cannabis activities, and their advantages and disadvantages. A review of cannabis taxing options may help the Board to determine the general framework for further study of cannabis taxation models particular to Contra Costa County. Following is an excerpt from that memo.

> *Dispensaries*
> *While excise taxes are generally imposed as a flat amount per unit, such as per gallon for gasoline or per pack for cigarettes, taxes for cannabis at the retail level are generally by percent of the sale. This is because cannabis can be sold by ounce, cigarette, or some other varying form. The Tax Foundation's study of Colorado and Washington found that taxes imposed on final retail sales have been the most workable form of taxation. This is because sales by other entities, and thus taxes due, are harder to track. Additionally, taxes at multiple points within the supply chain can unfairly disadvantage companies that are not vertically integrated. This is less of an issue under California law which limits vertical integration, though there are still some allowances for multiple license types within the state and local licensing frameworks.*

Cultivation
The primary methods for taxing cultivation are by square foot, gross receipts and product weight. An increasing number of jurisdictions in California have passed or proposed cultivation taxes on a per square foot basis. The main benefit of this tax is that it is easy to assess and track. Most of the cultivation permits under MCRSA are based on an allowable number of square feet for cultivation. Thus, taxes are assessed based simply on the permit the company holds. Cultivators may be opposed to this method because they may choose to cultivate less than the maximum amount allowed under their permit, or they may lose some of their crop (for example, due to pest or weather) and thus owe taxes on a worthless product. The law may have a provision for the cultivator to protest the assessed tax amount and prove unusual circumstances, providing relief while still putting the burden on the cultivator and not the local government.

Gross receipts or product weight, on the other hand, may be deemed fairer by cultivators because they are only taxed on actual revenues collected or product sold. However, under these structures it is much easier for product to evade taxation, presenting a greater enforcement and administrative burden. These concerns may be alleviated by a robust track and trace program that ensures all product is accounted for.

While some states or local jurisdictions may be looking to focus their taxes on the final retail sale, cultivation taxes could be an important source of revenue for Sonoma County. Sonoma County is a producing jurisdiction as opposed to a consuming one. The County grows and exports more cannabis than is purchased at local retail outlets. By only taxing at the retail level and not imposing taxes on cultivation, the revenue collected could be insufficient to cover the costs and mitigate the impacts imposed on the jurisdiction.

Other Cannabis Businesses
The distinct license types enable taxation at many points throughout the supply chain, including support uses such as nurseries, lab testing, distribution and manufacturing. As cautioned above, taxation of these license types can complicate administration, enforcement and collection, and disproportionately advantage integrated companies. Though similar to the benefits of taxing cultivation, Sonoma County has the potential to have a large manufacturing market and is positioned to be a major distribution hub in the industry and thus stands to benefit accordingly from a tax on these operators. Additionally, manufacturing confers an added value onto the product making it an appropriate place in the supply chain to impose an additional tax.

Taxes for nurseries may be imposed per plant, per square foot or by gross receipts. The County's land use ordinance proposes to permit nurseries with a conditional use permit and does not delineate square footage limits within the code. Each CUP could *include a square foot limit on which to impose the tax, though these sizes would not be as predictable as for cultivation permits. Other support uses are most often taxed on a gross receipt basis.*

Tiered Tax Rates

A tiered tax rate could be implemented to support small businesses. Supporting small businesses was a key component of MCRSA, which limits the size of cultivation operations, limits vertical integration and limits the number of license-types per individual or company. For a cultivation tax based on square feet, the tax per square foot could increase by license which corresponds with a larger cultivation area. Additionally, because indoor and mixed-light operations produce more product, the per square foot rate would be higher for those license types then for outdoor cultivators. Similarly, a tax based on gross receipts could be progressive, increasing the rate on higher revenues.

Tax Rate Phase-in

The tax rate on cannabis businesses may be phased in, starting lower and increasing incrementally over a number of years before reaching the final amount. Initially, there are likely to be substantial startup costs for companies coming into compliance, and a lower tax rate at first could help to offset these expenses and encourage more companies into the light. By proposing this phased approach initially, the jurisdiction need only go to the voters once as opposed to each time it looks to increase the tax rate. Another option is to get approval from the voters to tax at a higher rate and voluntarily tax the industry at a lower rate during the startup phase.

Medical vs. Nonmedical

Many jurisdictions have proposed to tax medical cannabis at a lower rate than nonmedical cannabis. This supports the policy of enabling access, especially to indigent patients. Colorado and Washington have both started with substantially higher tax rates for nonmedical cannabis. As a result, the medical cannabis market has not decreased, whereas initially people had thought that the nonmedical cannabis market would mostly consume it. Prop 64 cites abuse of the medical cannabis system as a reason for legalizing nonmedical cannabis, however, these strong monetary incentives can lead to continued abuse. MCRSA contains many provisions that attempt to curtail abusive practices by doctors and residents, though it is unclear how successful these laws and subsequent regulations will be at reducing unfounded doctors' recommendations for medical cannabis. Taxing nonmedical cannabis can be more thoroughly researched as the County investigates permitting adult use cannabis businesses.

Licensing Contingent on Taxation

In 2016, Monterey County adopted both a tax ordinance and a permitting ordinance, the latter of which would only go into effect if the tax was approved by the voters. The County reasoned that without the passage of the tax, it could not afford to allow the industry because it would not be able to cover all the associated costs without cutting *other programs. In our online survey staff found that at least 60% of those surveyed would support a tax on medical cannabis, with more support contingent on the reasonableness of the tax rate. To continue to ensure the County is able to fund general government services, staff has recommended that the County make effectiveness of the permitting ordinance contingent on a tax passing or identification of another funding source.*

Special Election
Under Proposition 218, an election to impose a general tax must be consolidated with a regular general election at which the members of the governing body will also be elected, unless the governing body unanimously declares an emergency requiring the tax to be placed on another election. (CA Constitution, Article XIIIC, Section 2(b)). Staff finds that the Board could make the required findings to declare an emergency and require the tax to be placed on the March or June election, particularly because the next supervisorial election is not until November 2018.

Cannabis Taxation in Contra Costa County
County staff met with David McPherson of Hinderliter de Llamas (HdL), which has over 30 years of experience providing revenue enhancement and consulting services to local governments in California, and specific knowledge and expertise in cannabis management, including regulatory processes and staffing plans. For prior clients, HdL has offered the following services related to the taxation of cannabis:

- Assistance in identifying key internal stakeholders to attend meetings; defining roles of the participants, discussing schedules and scope of services.

- Design of process steps and best practices, and development of strategies for the taxation of various permit classifications.

- Preparation of a fiscal analysis and revenue forecast based on a variety of assumptions for both medical and nonmedical cannabis commercial activities to be permitted in the County.

    - Preparation of a fiscal revenue report identifying tax options and revenue estimates, including excise tax and sales tax assumptions, where applicable, for the various types of cannabis businesses that may be permitted to operate in the County. This analysis will consider cannabis industry trends, demographics, and geographical location of the County in the State of California.

    - Identification of the economic impacts of the cannabis industry in Contra Costa County and analysis of the financial constraints that may impact the cannabis industry, in order to limit the tax burden on the businesses to ensure long term stability.

- Development of a ballot measure that will ensure the best tax strategy for the capturing of revenue for the County and which complies with Proposition 218.

- Creation and design of a ballot measure to tax the various medical cannabis categories that will be permitted in the County;

- Design in the ordinance an administrative procedure policy related to delinquencies, payment process, appeals, exemptions and other administrative requirements to be utilized by the County for the implementation and collection of the tax, upon adoption; and

- Creation of ballot measure language that will capture the taxation of medical cannabis and non-medical cannabis, if applicable. The ballot measure will properly define all the tax elements, definitions and administrative functions to ensure that the tax is equitable and provides administrative flexibility in the design.

HdL can provide a general analysis of all taxing options, their projected revenue and impact on the industry, or three or four scenarios based on assumptions and parameters established by the County. Additionally, HdL can serve as an advisor to the County on the cannabis regulatory program. The estimated cost for these services is $40,000. Should the Board wish to limit the study to only taxation matters, the contract cost would likely not exceed $30,000.