Contra Costa County

To: Board of Supervisors

From: David Twa, County Administrator

Date: May 8, 2018

Subject: FRAMEWORK FOR CANNABIS TAXATION ORDINANCE

## RECOMMENDATION(S):

CONSIDER options for the taxation of cannabis activities in the County's unincorporated area and PROVIDE direction to staff on development of a County ordinance and ballot measure.

## FISCAL IMPACT:

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 tax administration, 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 permitee.

Implementation of cannabis regulatory and taxation programs will have associated new costs and revenues that cannot be accurately predicted. The amount of tax revenue that might be generated is uncertain because the number of permitted businesses, the size of each cultivation and the amount of gross receipts generated by each business is largely

☑ APPROVE ☐ OTHER

☑ RECOMMENDATION OF CNTY ADMINISTRATOR ☐ RECOMMENDATION OF BOARD COMMITTEE

Action of Board On: **05/08/2018** ☑ APPROVED AS RECOMMENDED ☐ OTHER

Clerks Notes:

**VOTE OF SUPERVISORS**

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: May 8, 2018

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

By: , Deputy

Contact: Julie DiMaggio Enea (925) 335-1077

**cc:** CAO, DCD, Treasurer-Tax Collector, County Counsel unknown. Gross receipts alone may vary based on variables such as crop yields and wholesale prices. Estimating the size of an illegal market is difficult, as is estimating how many

FISCAL IMPACT: (CONT'D)

consumers will switch to the legal market when it is available.

While the revenue can be significant over time, it takes a lead time to develop. Revenues increased gradually in other jurisdictions, 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.

With that preface, revenue estimates are attached as **Exhibits 5 and 6**, and developed based on analyses prepared by the County's consultant, HdL Companies, Inc. These estimates are provided primarily to illustrate the number of variables involved in estimating cannabis tax revenue and speculative nature of assumptions that must be made to develop any cannabis tax revenue estimate. **The Board is advised to not to rely on these estimates for purposes of budgeting for critical public services.**

BACKGROUND:

On April 25, 2018, the Board approved the Draft Framework for Regulating Cannabis in the Unincorporated Area of Contra Costa County, and received a staff report covering zoning and health issues. This action was preceded by detailed Board discussions on November 14, 2017, October 24, 2017, July 18, 2017 and April 25, 2017, and a robust public outreach program that comprised nearly 30 public presentations throughout the county. The Board, in April 2018, made revisions to the general permit terms; placed limits on the number of cultivation permits, retail storefront permits, and stand-alone manufacturing permits in a agricultural zone, and decided to use a Request for Proposals process for those activities; selected buffers from other sensitive land uses; selected criteria for outdoor personal cultivation; and authorized delivery of cannabis in the unincorporated county area, among other changes to the earlier draft regulatory framework.

On July 18, 2017, the Board of Supervisors reviewed options for a cannabis taxation study and authorized the hiring of consultant Hinderliter, de Llamas & Associates (dba HdL Companies) to prepare a study with recommendations on taxation of various permitted activities. On October 24, 2017, the Board received a presentation by Hinderliter de Llamas (HdL) on the fiscal analysis (**Exhibit 1**) they prepared for the County on cannabis taxation options. The HdL analysis identified tax options and revenue estimates for the various types of cannabis businesses that could operate in the unincorporated County, and identified local economic impacts of the cannabis industry. The analysis also considered financial constraints, including the overall tax and regulatory burden, which may affect both the industry's long-term stability and its ability to successfully transition to a legal, regulated paradigm that can outcompete the existing black market. The analysis also provided initial information on estimated costs of regulation and enforcement.

With the April 25 approval of the zoning regulatory framework, staff and HdL have prepared a presentation (**Exhibit 2**) for the Board's discussion today regarding the development of a County unincorporated area cannabis taxation program and ballot initiative for the November 2018 election. Specifically, staff is looking for the Board's direction on the following policy and administrative questions, as well as guidance on any other issues that might pertain to development of a tax ordinance:

1. Does the Board prefer to base a cultivation tax on canopy size (s/f) or gross receipts ($$)?
2. If the Board chooses to tax cultivation based on canopy size, will it be the maximum canopy permitted or only on the area cultivated each quarter?
3. At what rate(s) will the Board tax cannabis businesses, e.g., level of taxation for each activity within the supply chain?
4. Will the initial tax levy be set equal to the maximum taxing authority or at lesser, introductory rates?
5. If the initial tax levy will be at rates lower than the maximum rates, does the Board prefer to phase increases on a fixed schedule or leave it open to future consideration?
6. To what extent, if any, does the Board want to do outreach to, and tax enforcement of, known or discovered unregulated cannabis businesses?
7. Tax appeal process: Shall the Tax Administrator's decision be final or shall there be a second and final level of appeal to the Board of Supervisors?
8. Will the Board appropriate revenue to cover department administrative and enforcement costs not recoverable through fees?

**1. <u>Method for Taxing Cannabis Cultivators</u>**

The primary methods for taxing cultivation are by square footage of the canopy and by gross receipts. Following is a discussion of both methods. HdL has recommended a canopy tax.

<u>Square Footage of Canopy</u>. This is a tax rate applied to the square footage allowed by the approved permit. The tax can be designed to apply to either the permitted canopy or the actual canopy being grown on a particular day in a tax reporting quarter. State law defines canopy as the designated area described in the license (or permit) that will contain mature plants at any point in time. The advantage of a canopy tax to the County is that the revenue is predictable, stable and, comparatively, simpler to administer.

A disadvantage for growers involves the effective tax rate, or the amount of tax when compared to a cultivator's revenue. With a canopy tax, the effective tax varies depending on the amount produced (volume), the quality of the product, the wholesale price and other environmental impacts. For example, cultivators starting out, cultivators producing a lower quality product, or cultivators producing a strain with less density will experience a higher effective tax rate because their revenues are low. The result is a regressive tax system. However, the regressive nature of the tax dissipates as the cultivator's revenue reaches a certain breakeven point.

With a canopy tax, there is no guarantee the cultivator's business produces enough resources to pay the tax. This is especially true during the first year harvest. A few mitigating suggestions include delaying the tax just for cultivation for one year, timing the tax payment with the harvest season or including a payment deferral program.

Some growers have argued that a canopy tax is unfair because it forces growers to pay the tax even if they experience crop losses, such as with a fire or other natural disaster. Another argument often voiced by growers in opposition of a canopy tax is that a tax based on the permitted square footage of their facility instead of the actual square footage cultivated ignores those permits which contain square footage expressly included for future expansion. Also, another argument against is that a canopy tax does not account for growers who cultivate and harvest for a fraction of a year. If the Board so chooses to mitigate those concerns, the County ordinance could include provisions for temporary relief from the tax requirement when a disaster causes crop losses or when the full permitted canopy will not be cultivated.

Gross Receipts. This is a tax on the gross receipts of the cultivator similar to that imposed on retail dispensaries, manufacturers and distributors. Tax revenue will fluctuate depending on production levels, product quality, crop yield, wholesale prices and other environmental factors. One negative aspect of the gross receipts method is that it is sensitive to the growing cycle, which would cause cyclical revenue streams and tax revenues throughout the fiscal year. This could create a cash flow problem if tax revenues fund recurring costs like salaries and benefits.

Gross receipt taxes are progressive in that cultivators pay taxes only on the product they produce, sell, and which generate revenue. The levy of a gross receipts tax is in proportion to each operator's revenue. However, every dollar of revenue earned by the cultivator carries a tax burden to the County; there is no cap on taxes like there is with the canopy tax. As a result, the effective tax rate may be higher under a gross receipts tax for high producing growers than it might be under a canopy tax.

Note the gross receipts tax is on gross receipts and not on profits.

**2. Cultivation Tax Based on Canopy Size: Permitted Canopy or Cultivated Canopy**

This decision applies only to a canopy tax and not a gross receipts tax. Generally, the decision distills to choosing a tax that is predictable, stable and easy to administer, but not sensitive to a grower's revenue cycle vs. a tax that is sensitive to the grower's revenue cycle but more difficult to administer and forecast. With the Board's previous decision to cap cultivation to 10 for the first two years, the choice between these two methods may be less relevant, as it is much more likely that the 10 approved businesses will cultivate the full canopy.

Permitted Canopy. The simplest method based on the definition of canopy in state law would be to apply the tax to the permitted canopy. The permitted canopy is a known factor and would be the simplest to administer. This method produces a predictable and stable level of tax because the tax applies without regard to production or sales. As a predictable and stable method of taxation, the County can responsibly direct tax revenues towards recurring expenses resulting from cannabis impacts and is generally simple to calculate and administer. It results in a fixed cost for the cultivator. Once reaching a break-even point, additional gross receipts of the cultivator contribute directly to the business's other costs or add to its profits.

A tax on the full canopy may present a hardship for cultivators who, for whatever reason, do not plant the full canopy. However, the canopy tax could be set low enough initially to provide ease of entry into this market and a fixed and known cost for cultivators. A significant advantage is knowing the tax burden prior to license approval. In addition, this method indirectly caps the tax because of state laws limiting canopy sizes.

Cultivated Canopy. The square footage of the cultivated canopy can vary greatly from quarter to quarter, particularly for an outdoor cultivation. There may be many reasons why the full permitted canopy is not cultivated at any given time. Some will argue that this creates a complex tax structure difficult to administer and resulting in unpredictable tax revenues year after year. How can the County select a point in time from which to measure the canopy and calculate the tax that will produce fair and equitable results for all growers in Contra Costa County? The answer is we cannot if we are basing the tax on the actual cultivated canopy. This tax method would require cultivators to declare in advance the square footage to be cultivated and may require inspections to validate the cultivated area. This method would be more complex to administer and susceptible to underreporting, but may be viewed as the fairer method by cultivators.

### 3. Tax Rate for Each Activity

The distinct license types enable taxation at many points throughout the supply chain, including cultivation, lab testing, distribution, manufacturing, retail and delivery. Tax rates can be set to incentivize or discourage different activities. The County should establish tax rates high enough to produce sufficient revenues to offset the cost of administering the tax and enforcing the unregulated market. Conversely, the County should set the tax rates low enough to avoid overtaxing this new and emerging industry. If the tax burden combining local and state taxes is too high, it may lead to an unsustainable cannabis industry in Contra Costa County. Some businesses may opt to relocate their businesses to a lower taxing jurisdiction or seek out the black market for sale of their product. **Exhibit 3** illustrates the tax program that HdL has recommended for Contra Costa County. **Exhibit 4** illustrates the cumulative state and local tax burden should the Board decide to adopt HdL's recommended tax rates. Industry experts generally agree that the maximum cumulative tax burden should not exceed 30% to create a sustainable legal cannabis market.

Another policy decision is setting the rate low or eliminating the tax altogether for license types that are desirable in our County. Another consideration is to set a tax rate that discourages migration to other lower taxing jurisdictions or at least nullifies the impact between adjacent jurisdictions.

### 4 & 5. Introductory and Maximum Tax Rates and Phasing in Increases

Other options commonly under consideration when choosing a cannabis tax rate include:

- Set the tax rate low with the option of the Board of Supervisors to increase the rate, sometimes after the expiration of a certain number of years to allow the industry to stabilize.
- Index the tax rate for inflation, also after a number of years.
- Set a minimum and a maximum tax rate and allow the Board of Supervisors to select the appropriate tax rate given the circumstances and experience.

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 introductory tax rate could help to offset these expenses and encourage more businesses to enter the legal market. By proposing a phased approach initially, the County need only go to the voters once as opposed to each time it looks to increase the tax rate. Another option is to obtain approval from the voters to tax at a higher rate and then voluntarily tax the industry at a lower rate during the startup phase.

Staff advises building flexibility into the taxing framework allowing adjustments if needed over time as this industry matures. Such a framework makes the tax rate scalable and responsive to what happens in our county. The Board will have discretion to raise rates in the future up to a voter-approved maximum.

### 6. Tax Enforcement

There will be a significant financial incentive for cannabis businesses to obtain an adult-use permit and pay taxes: they must do so to obtain a valuable state license to operate in California. Even so, enforcement is the foremost method of deterring illegal operations and tax avoidance. The Board is asked to provide direction on what additional resources should be directed to engaging unpermitted businesses.

### 7. Tax Appeal Process

The Board is asked to decide if it shall be the final hearing body for cannabis tax appeals or if that responsibility shall be delegated to the Treasurer-Tax Collector. Generally, the appeal process is envisioned as two levels: first appeal to the Treasurer-Tax Collector and second/final appeal to the Board of Supervisors, whose decision would be final and conclusive. However, the Board may choose to establish only one level of appeal, to be administered either by the Treasurer-Tax Collector or the Board.
Level 1: Administrative Hearing before the Treasurer-Tax Collector (TTC)

- Hearing request within 15 days of receiving notice of taxes due
- TTC to hold hearing, with notice, within 35 days of request

- Written notice of TTC decision

Level 2: Hearing before the Board of Supervisors

- Hearing request within 15 days of receiving final decision of TTC
- Clerk of the Board shall schedule hearing and give written notice
- Board decision shall be final and conclusive

**8. Revenue Appropriation for Department Administrative and Enforcement Costs**

Staff anticipate additional work and costs should the County enact cannabis regulatory and tax programs. While much of the new work can be funded through permit and service fees, there will be new and additional work that cannot be funded with fee revenue. Examples of such activities include:

- Code enforcement response to unpermitted activities and neighborhood complaints, including regarding personal cultivation
- Sheriff response to increased criminal activity and neighborhood complaints
- Investigation of illegal cannabis businesses
- Sheriff security for County regulators and Tax Administrator during cannabis inspections
- Investigation of environmental damage (unravel LLC companies to determine who is responsible for cleanup costs following environmental damage)
- Eradication of environmentally damaging illegal marijuana farms
- Fire suppression and investigation
- Seeking payments for environmental cleanup and mitigation
- Youth substance abuse education and treatment programs
- Outreach and tax levy to known cannabis businesses operating illegally
- Cannabis tax appeal process

The effort that will be required of County departments to assume these new and additional responsibilities is difficult to predict. Other than identify what types of activities might be necessary, County departments have been reluctant to attempt to quantify what resources might be necessary because doing so would be highly speculative at this point. For this reason, staff suggests that the Board consider making a provision in the budget for these types of activities and consider allocating those resources to the affected departments once more is known about increased workload. The earliest cannabis tax revenue is not anticipated to be received before the fall of 2019. The Board could consider directing an appropriate amount of the early proceeds to support additional workload of County departments and allocating them as needed.

CONSEQUENCE OF NEGATIVE ACTION:

If the Board were not to provide clear direction on cannabis taxation, staff would lack the necessary policy guidance to prepare a draft ordinance and ballot measure language and resolution for the November 2018 election.

CLERK'S ADDENDUM

***Speakers: Sean Casey, First 5 (letter attached); Yanwie Leng, Contra Costa County Coalition against Recreational Marijuana; Mae Leng, Rose Garden Oncore Homeowners Association; Patrick Irion, resident of Pleasant Hill; Jiyun Xu, resident of Moraga; Mikki Norris, Cannabis Consumer Campaign; Chris Conrad, Friends of Prop 64; Renee Lee, Rossmoor Medical Marijuana Club; Azad Aramandla, resident of San Ramon; Patty Hoyt, ADAPT San Ramon; Ryan Doronila, resident of Concord. The Board directed staff to prepare an ordinance establishing a tax on various commercial cannabis activities, to be placed on the November 2018 ballot. The Board directed that the ordinance include the following provisions: 1. The tax will be a general tax. 2. The tax on commercial cannabis cultivation will be based on the square footage of a permitted canopy. 3. The ordinance will establish initial tax rates and maximum tax rates, with automatic inflation adjustments of the maximum tax rates. The Board may make annual adjustments to the tax rates. 4. The ordinance will include penalties for delinquent payments. 5. The tax and tax appeals will be administered by the Treasurer-Tax Collector. The Board also directed staff to examine existing fees and evaluate whether additional fees should be proposed to recover the County's reasonable costs of providing services related to proposed County cannabis ordinances.***

<u>ATTACHMENTS</u>

Exhibit 1: HdL Fiscal Analysis of Contra Costa Cannabis Market

HdL Powerpoint Presentation: California Cannabis Status

Exhibit 2: Powerpoint Presentation

Exhibit 3: HDL Recommended Cannabis Tax Rates for Contra Costa County

Exhibit 4A: HDL Cumulative Tax Analysis for Maximum Tax Levy

Exhibit 4B: HdL Cumalative Tax Analysis for Initial Tax Levy

Exhibit 5: Revenue Estimate Comparing Canopy Tax to Gross Receipts Tax Method for Cultivation

Exhibit 6: Estimated Cannabis Tax Revenue Summary for All Permit Types