



# Monterey County

168 West Alisal Street,  
1st Floor  
Salinas, CA 93901  
831.755.5066

## Board Report

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**Matter Type:** General Agenda Item

- a. Receive a report on recommendations from the Board of Supervisors Cannabis Committee concerning ordinance revisions for commercial cannabis tax rates and penalties.
- b. Consider the following revisions to the commercial cannabis tax rates and penalties:
  1. Amend the tax rate for commercial cannabis cultivation in the range of \$4.00 to \$8.00 per square foot.
  2. Amend tax rate on commercial cannabis businesses as follows:
    - i. Nursery cultivation: \$1.00 per square foot
    - ii. Manufacturers: 2.5% of gross receipts
    - iii. Distributors: 2% of gross receipts
    - iv. Testing: 1% of gross receipts
    - v. Retailers: 4% of gross receipts
  3. Amend the penalty for unpaid commercial cannabis taxes to 10% plus interest after the due date, and then an additional 10% plus interest after one month if the tax remains unpaid.
  4. Amend the definition of "canopy" contained in Chapters 7.90 and 7.100 to be consistent with the state's definition.
- c. Provide direction to staff as appropriate.

### RECOMMENDATION:

The Board of Supervisors Cannabis Committee recommends that the Board of Supervisors:

Receive a report and take action on recommendations from Board of Supervisors Cannabis Committee on the following ordinance revisions concerning the commercial cannabis tax rates and penalties:

- a. Determine the appropriate tax rate for commercial cannabis cultivation in the range of \$4.00 to \$8.00 per square foot.
- b. Amend the tax rate for commercial nursery cannabis cultivation to \$1.00 per square foot.
- c. Amend tax rate on all other commercial cannabis businesses as follows:
  - a. Manufacturers: 2.5% of gross receipts
  - b. Distributors: 2% of gross receipts
  - c. Testing: 1% of gross receipts
  - d. Retailers: 4% of gross receipts
- d. Amend the penalty for unpaid commercial cannabis taxes to 10% plus interest after the due date, and then an additional 10% plus interest after one month if the tax remains unpaid.
- e. Amend the definition of "canopy" contained in Chapters 7.90 and 7.100 to be consistent with the

state's definition.

f. Provide direction to staff as appropriate.

**SUMMARY:**

The following summarizes high level developments that have taken place with the Monterey County Cannabis Program and the state's regulatory cannabis program since FY 2015-2016:

- Successful passage of Measure Y in November 2016, which imposed a \$15 per square foot tax on cannabis cultivation with a maximum of \$25 with an annual CPI adjustment, a \$2 per square foot tax on cannabis nursery cultivation with a maximum of \$5 with an annual CPI adjustment, and a 5% tax on gross receipts of cannabis businesses with a maximum of 10% the unincorporated areas of the County.
- Numerous changes to state cannabis law, including: the approval of Proposition 64 in November 2016, which legalized adult-use and set a state excise tax; the Governor signed SB 94 in June 2017, which merged medical use cannabis and adult use cannabis into a single regulatory framework; and the issuance of emergency regulations by the three state licensing agencies (Department of Consumer Affairs' Bureau of Cannabis Control, Department of Public Health's Manufactured Cannabis Safety Branch, and the Department of Food and Agriculture's CalCannabis Cultivation Licensing Division).
- In light of the above state law changes and other factors, the economic climate for operators to sustain and enhance their cannabis businesses in Monterey County has been put in jeopardy. In particular, the cumulative state and local taxes, market saturation, a decrease in wholesale prices, increased costs to retrofit greenhouses, and increased regulatory development costs have created serious problems for the industry's growth in Monterey County.

The County retained HdL Companies to prepare a revised fiscal analysis and to recommend potential changes to the commercial cannabis tax rates. David McPherson of HdL Companies presented this analysis to the Board of Supervisors Cannabis Committee at an April 6, 2018 Special Meeting.

(Attachment A). Regarding cultivation tax rates, HdL believes the County should consider a rate of between \$4/SF and \$7/SF. HdL stated that this range of tax rates is consistent with cultivation tax rates under consideration by numerous California jurisdictions. HdL cites the cumulative tax rate (state & local), market competition, price per pound reduction, and black market activities as reasons to lower the tax rate. Adjusting the cannabis tax rate is clearly a policy decision of the Board of Supervisors. Staff concurs that the tax rate should be adjusted to some degree, at least while the industry establishes itself.

Staff reviewed the following factors when analyzing changing the tax rates:

- The projected costs of \$3.2M to administer the Cannabis Program for FY 18-19;
- The County budget deficit for FY 18-19 and subsequent years;
- The various needs identified in the cannabis community engagement process;
- The benefits to the cannabis industry from being in Monterey County, such as a central location in the state and agricultural knowledge;
- The pending state legislation to lower the State excise tax rate;
- Input from the local cannabis industry on the tax rates;
- The impact on Monterey County cities who have tax rates identical to the County's rates; and
- Competing tax rates in other California counties.

Also, staff received input from representatives of the local cannabis industry and reviewed their proposal for a \$4 tax rate to incentivize growth of cannabis greenhouse cultivation from the current approximate of 1M square feet to 2M square feet by December 31, 2018. ([Attachment B](#)).

On May 7, 2018, staff presented their findings and recommendations for ordinance amendments in the areas of reduced tax rates, reduced tax penalties, and a narrower canopy definition. Regarding the cultivation tax rate, staff recommended \$10 per square feet with an escalator provision as an amount that would provide relief to the industry while preserving an important revenue source to fund program operations and other County priorities. The Committee heard testimony from many industry representatives who expressed their concerns regarding the economic feasibility of sustaining their operations under the current tax rate structure. Discussion followed regarding the annualized tax payment structure and if the County had the ability to revise tax rates on a quarterly basis. Pursuant to Committee discussion, staff reviewed with the Treasurer-Tax Collector (TTC) options for retaining flexibility in Monterey County Code Chapter 7.100, which sets the tax rate. Chapter 7.100 sets a standard rate for a fiscal year as an annualized tax with payment each quarter. The TTC recommends a similar approach be used in any adjustment to the tax rate.

The Board Cannabis Committee directed staff to present recommendations to the full Board on a tax structure range to be established within the range of \$4 to \$8 per square feet for cultivation.

([Attachment C](#)). Regarding the Committee discussion, Supervisor Alejo expressed support for the \$4 per square foot tax rate to incentivize the industry. Supervisor Phillips favored an \$8 square foot rate provided that it be coupled with an aggressive enforcement campaign against illegal operations. The Committee recommended approval of the revisions of the tax rate for nurseries (\$1/SF) and the revised gross receipt tax rates for all other related cannabis businesses (manufacturers - 2.5%, distributors - 2%, testing - 1%, retailers - 4%). Staff was directed to explore the modification of the annualized tax.

The current tax ordinance contains escalators for all the tax rates. The cultivation rate is set to increase by \$5 each fiscal year starting in 2020, with an added CPI increase in 2022 and every year thereafter; the nursery rate is set to increase by \$1.50 each fiscal year starting in 2020 with an added CPI increase in 2022 and every year thereafter; and the gross receipt tax is set to increase 2.5% per fiscal year not to exceed a maximum rate of 10%. Staff did not receive a recommendation from the Committee concerning these escalator amounts. Staff recommends the escalators detailed in [Attachment C](#).

#### DISCUSSION:

At the May 7, 2018 Board of Supervisors Cannabis Committee meeting, staff presented a recommended reduced tax rate structure for cultivators, nurseries, manufacturers, distributors, testers, and retailers. The presentation described the strategy and process staff used to formulate their recommendations. The preservation and growth of the local cannabis industry is of great importance because the industry generates tax revenue, creates local jobs, and leads to the re-use/revitalization of greenhouses vacated after the departure of the cut flower industry. However, lowering the tax rate cannot be viewed solely in the light of what will benefit the industry; there are numerous other factors that should be considered in determining a revised tax rate structure.

***1. Measure Y.***

The County's commercial cannabis regulatory structure was made contingent on the passage of Measure Y so that revenue could be obtained for general governmental purposes, including covering the County's costs in administering a commercial cannabis regulatory program. If Measure Y had not have passed, the County would not have allowed commercial cannabis activities in the unincorporated areas. As such, staff recommends not lowering the tax to a level that does not cover the costs to the County to administer the Cannabis Program. However, the adjusting of the cannabis tax rates is clearly a policy decision of the Board of Supervisors.

***2. Cost to administer the Cannabis Program.***

The County Cannabis Program is complex, labor intensive, and involves 10 County departments in the administration, permitting, tax collection, enforcement, public/industry outreach, and public health sectors. Staff has worked extensively to calculate the realistic projected cost to administer the Program in FY18-19. The cost was reviewed by the Cannabis Committee in March 2018. On April 24, 2018, the Board of Supervisors reviewed and preliminarily approved a Program cost of \$3.2 M for FY18-19, while recognizing that a final decision would not occur until the County budget hearings in June 2018. This dollar amount represents the minimum program cost that should be funded in FY18-19, unless the Board chooses to further adjust Program costs. A significant cost component will be enforcement against illegal black market operators. This enforcement priority has been strongly voiced by the industry.

***3. County budget deficit for FY18-19 and subsequent years.***

The County is facing a significantly constrained budget for FY18-19 and the foreseeable future. Simply put, expenses for critical public services have outpaced revenues. The FY18-19 deficit is projected to be approximately \$36M. Balancing the budget and protecting critical County services is expected to result in dramatic reductions in other County services, as well as elimination of many filled and vacant positions in the County workforce. All sources of discretionary revenue will be absolutely critical to help address the County's budget deficit. A conservative reduction in cannabis tax rates will assist the industry, while also preserving critical discretionary revenue to fund other County priorities. A series of charts are attached to this memo as [Attachment D](#) which depict the amount of expected revenue over and above Program operation costs that would be available for the Board to allocate for other needed County programs and services. These charts show revenue generated from the three cultivation tax rate alternatives discussed in the HdL report: \$15/SF, \$7/SF, and \$4/SF.

***4. Needs Identified in the Community Engagement Process.***

Recently, at the direction of the Board of Supervisors, staff conducted an extensive community engagement process to obtain input from the public regarding how cannabis tax revenue should be spent over and above Program operating costs. A significant amount of public input determined that early childhood education and health/behavioral health were critical areas that the public felt should be funded to some extent with cannabis general tax revenue. The level of adjustment in the cannabis tax rate will determine the amount of revenue available to help fund such programs, or other programs, should the Board desire to do so.

***5. Benefits of Monterey County to Cannabis Industry.***

Although market competition in the California cannabis industry is strong, there are significant benefits to locating and operating in Monterey County including:

- a) Centrally located in the state;
- b) Available and skilled agricultural workforce;

- c) Well-developed transportation network; and
- d) “Greenhouse focused” County regulatory structure which significantly benefits those who chose to invest in greenhouses for cannabis cultivation.

**6. Legislation to lower State tax rate (AB 3157 - Lackey).**

Legislation was introduced to lower the State of California’s excise tax rate. On May 8, 2018, AB 3157, the bill that would reduce the cannabis state tax rate from 15% to 11% for 3 years, passed out of the Assembly Business and Professions Committee. It should be noted that AB 3157 contains language to “reinstate the current tax rate if revenues are not enough to cover state agency costs.”

**7. Impact on Monterey County cities.**

City managers in Monterey County cities that permit commercial cannabis activities are closely monitoring the tax rate discussion at the County level and are concerned about how lower County tax rates may impact their jurisdictions. It is highly likely that whatever tax rate is ultimately established by the Board, pressure will follow to change tax rates in the cities which will in turn impact city budgets and ability to fund critical programs within their jurisdictions cannabis tax rates and revenue. Comparative tax rates within Monterey County cities which permit cannabis are show in [Attachment E](#).

**8. Industry input.**

Staff recently met with representatives of the local cannabis industry who propose a significant reduction in taxes to incentivize the industry to increase their square footage of cultivation, with an increase in taxes if certain square footage targets are not met. ([Attachment B](#)). While staff appreciates the industry proposal conceptually, we have concerns with the proposal, including:

- a) Difficult to draft as an ordinance.
- b) Difficult to administer and validate.
- c) Could fund basic Cannabis Program operation costs, but reduces revenue available to fund other critical County budget needs.
- d) The speculative nature of the proposed increase in greenhouse square footage.

All the cultivation area in the DRC applications total approximately 8.5 million square feet; however, about 75% of the Use Permit/Coastal Development Permit applications have not been filed. Some representatives have stated they believe that the area of cultivation will increase if taxes are lowered, thereby resulting in no net loss (and possible increase) of tax revenue. Staff intends to establish a filing deadline of August 1, 2018. Those not filing will not remain in good standing, meaning they cannot legally continue to grow without completing the County permit process. This will provide a better forecast for what Monterey County should expect for legal growing operations.

**9. Timing.**

The next year is expected to be one of transition in the cannabis industry. In January 2019, the State will no longer issue temporary licenses. All cannabis operators must obtain County permits and business licenses by this time to operate legally. Some staff feel that the cannabis industry should operate for a longer period of time before the County considers any tax rate adjustment. Currently, tax collection is based on operators submitting an initial business permit application certifying the amount of square footage the operator intends to have in production. There is a significant lack of independently verifiable data about the local cannabis industry. Staff expects this to begin to be addressed in the coming fiscal year due to State licensing requirement, as well as the County’s participation in the California Cannabis Authority which will create and maintain a comprehensive database on industry activities.

**10. Schedule.**

After the Board gives direction regarding the cannabis tax rates, staff will draft and present appropriate ordinance amendments to the Board in June or July 2018 for the adjusted tax rates to be retroactive to July 1, 2018.

**11. Public Comment.**

At the May 7, 2018 Cannabis Board Committee meeting, several industry representatives provided input. Their concerns generally addressed the following areas:

- Economic feasibility to sustain cannabis operations with the current tax rates.
- Inability to make current tax payments.
- Infrastructure expenses to expand cultivation operations.
- Pacific Gas & Electric's ability to meet energy demands in a timely manner.
- Tax rate reduction will allow for cultivation expansion.

**12. Modifications to the Annualized Rate Methodology.**

The current ordinance for commercial cannabis tax is imposed on a fiscal year basis and is due and payable in quarterly installments. The collection of an annual tax is standard practice in the state and other local jurisdictions. The annual tax is also what was proposed to the voters in the Measure Y ballot measure. Property and transient occupancy taxes are also based on an annual tax rate. Based on Committee direction, staff reviewed various tax methodologies, compared practices against the State and other jurisdictions, and discussed with the TTC the opportunities and potential challenges of revising tax rates during a fiscal year. Staff concluded that the variation in an annual tax rate could create numerous issues, including the following: added complexity to the standard practices of issuing tax bills; increased staff time in auditing calculations and record keeping; and increased costs to process changes and software system changes in fiscal years where budget deficits occur and the County goals to increase efficiencies and standardize processes.

The Treasurer-Tax Collector is available to verbally address the factors in favor of retaining the annual tax and the associated annual rate.

Staff understands and supports the need to modify the tax rate, amend other ordinance language where applicable, and continue to strengthen the foundation and structure of the Monterey County Cannabis Program. The State licensing agencies, our local cannabis industry, and our Program is one of dynamic change. Staff continues to work diligently and requests consideration to institute standard processes, where possible, such as an annual standard tax rate. Staff anticipates that in the coming fiscal year, the Program will be able to gain traction in data visibility through the California Cannabis Authority, the State's Track and Trace Program, and the CalCannabis Cultivation Licensing Compliance and Enforcement Inspections which will begin in May 2018.

**OTHER AGENCY INVOLVEMENT:**

The Board of Supervisors Cannabis Committee, County Counsel's Office, Resource Management Agency, and Treasurer Tax Collector have been involved in the review of cannabis tax rates.

**FINANCING:**

Monterey County's Cannabis Program is funded in County Administrative Office - Department 1050, Intergovernmental and Legislative Affairs Division - Unit 8054, Cannabis. Adjustments of the cannabis tax rate will impact the amount of revenue available to fund the operation of the programs, as well as to fund other Board of Supervisor priorities.

**BOARD OF SUPERVISORS STRATEGIC INITIATIVES:**

The Monterey County Cannabis Program addresses each of the Strategic Initiative Policy Areas that promote the growth of a responsible and legal Monterey County cannabis industry.

Mark a check to the related Board of Supervisors Strategic Initiatives

- Economic Development
- Administration
- Health & Human Services
- Infrastructure
- Public Safety

Prepared by: Joann Iwamoto, Program Manager II, x3017

Approved by: Nicholas E. Chiulos, Assistant CAO, x5145

**Attachments:**

- A: HdL Final Analysis of the Commercial Cannabis Industry, Executive Summary, dated March 30, 2018
- B: Memo re. Letters Received from Industry
- C: Current and Proposed Cannabis Tax Structure
- D: General Fund Net Revenue Scenarios
- E: Comparison of Jurisdiction Tax Rates