



Monterey County

Item No.

Board Report

Board of Supervisors
Chambers
168 W. Alisal St., 1st Floor
Salinas, CA 93901

Legistar File Number: 22-096

February 01, 2022

Introduced: 1/21/2022

Current Status: Agenda Ready

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Matter Type: General Agenda Item

Introduce, waive reading of, and set March 1, 2022 at 10:30 a.m. as the date and time to consider adoption of an ordinance to:

- a. Amend Chapter 7.100 of the Monterey County Code to reduce the commercial cannabis business tax rates for mixed-light, indoor, and outdoor cultivation and distribution; and
- b. Amend Chapter 7.100 of the Monterey County Code to repeal the automatic increases on the County's commercial cannabis business tax rates; and
- c. Place a stay on delinquent commercial cannabis tax account penalties and fines on unpaid installments for the 3rd Quarter of Fiscal Year 2021-2022 of the annual commercial cannabis business tax imposed on cultivation activities provided the account is paid in full by July 1, 2022, in which case all penalties and fines will be immediately due and payable.

RECOMMENDATIONS:

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SUMMARY

The County imposes an annual business tax on cannabis businesses under Monterey County Code (MCC) Chapter 7.100. That tax is collected by the Treasurer-Tax Collector (TTC). On December 14, 2021, the Cannabis Program (Program) reported to the Board of Supervisors on the implications of the decline in wholesale price points for commercial cultivation and the impacts of that decline on the cannabis industry. The Board of Supervisors directed staff to return with a draft Ordinance, amending Chapter 7.100, that would reduce the commercial cannabis business tax rates for mixed-light, indoor and outdoor cultivation, reduce the distribution tax rate, eliminate the automatic cannabis tax increases each year, and stay penalties and fines related to cultivation tax delinquent accounts for the 3rd quarter of fiscal year 2021-2022 if paid in full on or before July 1, 2022. If the cannabis delinquent accounts are not paid in full on or before July 1, 2022 then the penalties and interest will be reinstated.

DISCUSSION:Cannabis Distribution Tax.

The distribution tax rate is currently set at 3% of gross receipts. Notably, when the distribution tax was set by the County, vertical integration was not allowed under state law. Vertical integration is when a business has control of multiple points of the supply chain. This may manifest itself through a merger or acquisition of separate businesses with distinct stages of production into one business, or it can exist in the initial structure of a business. An example of this in the cannabis industry would be an operator who has a cultivation license, a distribution license, and a retail license.

State law has since been changed; vertical integration is now allowed. Distribution is typically structured as either a wholesaler or provider of a service to transfer commercial cannabis products from one licensee to another. Licensed distributors may also provide the following services: packaging, re-packaging, labeling, relabeling, and/or storage.

Local operators are vertically integrated when their corporate structure is interrelated. Individuals who have ownership interests in multiple operations are not vertically integrated unless their corporate structure is demonstrably interrelated via documentation provided to the Secretary of State of California. Vertically integrated operators may deduct the cash value of transactions from gross receipts from their cannabis distribution tax, as outlined in MCC section 7.100.040(Q).

Distributors typically follow one of two business models:

- Buy in bulk, using purchasing power to drive per unit costs down and sell at market rates to create margins.
- Take possession of product and sell for in exchange for a service fee/pre-negotiated price.

Both business models encounter the same problem: when the business is taxed on gross receipts, the cost of goods is not always considered. This means that distributors must profit on very small margins or they will be vulnerable to undercutting by distributors in other jurisdictions that do not impose distribution taxes.

In March 2021, TTC staff observed that less than half of distributors registered with TTC reported gross receipts or paid distribution taxes in the prior two fiscal years. As a point of reference, 40 distributors were registered in FY 18-19 and 46 were registered in FY 19-20. In FY 19-20, distribution tax revenue was \$839,039. Operators were required to provide their METRC API key to the TTC by July 15, 2020 to enable the TTC to monitor transactions through the California Cannabis Authority (CCA) and confirm reported gross receipts. Following submission of the METRC API key to the CCA, the TTC observed an increase in distribution tax revenue reported. In FY 20-21, distribution tax revenue totaled \$1,230,240.

In July 2021, the Committee directed the Program to the Budget Committee with a recommendation to reduce the commercial cannabis distribution tax rate to 0% of gross receipts for three years. The Budget Committee received the report and directed staff to the Board, recommending an additional option: reduce the rate to 1% of gross receipts, to take effect either halfway through fiscal year (FY)

21-22, or at the beginning of FY 22-23. The Board directed the program to amend the commercial distribution tax to zero percent.

Commercial Cannabis Tax Structure, Rates, Delinquent Penalties, and Interest.

Staff formed a subcommittee with Industry members to further discuss the commercial cannabis tax structure and rate. The Committee received a memorandum on the subcommittee meetings on November 17th and 29th of 2021. A summary follows. The following is a summary of the Industry's request:

1. Immediate reduction in commercial cannabis cultivation tax rates.
 - a. The Industry proposes an indefinite reduction to commercial cannabis cultivation tax rates to the "3/2/1 taxing model" implemented by the Counties of Humboldt and Lake. This implies \$3/square foot (sf) for indoor cultivation, \$2/sf for mixed-light cultivation, and \$1/sf for outdoor cultivation. This proposed change would result in a 60% reduction from current cultivation tax rates of \$8/sf for indoor, \$5/sf for mixed-light and \$2.50/sf for outdoor. There are currently no licensed outdoor grow cultivators in Monterey County. The 3/2/1 taxing model was intended to be a starting point for conversation.
2. Remove the commercial cannabis automatic annual tax escalator.
 - a. The Industry requests removal of the automatic annual tax escalator. Suspensions of the escalator have occurred in the last two fiscal years. Both the FY 20-21 and FY 21-22 suspensions were, at least partially, in response to the COVID-19 pandemic. But the FY 21-22 suspension was also in response to the COVID-19 pandemic, in addition to a local outbreak of the Hop Latent Viroid in April 2021.
 - i. The operative word with this viroid is "latent," meaning that it was largely asymptomatic and not evident until later stages of cultivation where the harvest yields and potency of Tetrahydrocannabinol, the psychoactive component generated by cannabis plants, were both greatly impacted. Operators reported lower prices through the affected period, but there is not a clear indication of this within the wholesale pricing information. (Attachment A, page 27)
3. Consider placing a stay on the penalties and interest for tax payments deemed delinquent.
 - a. MCC section 7.100.080 specifies when tax payments are delinquent. MCC section 7.100.100 specifies the penalties and interest due for such delinquency. The industry requests a stay on these penalties and interest for the current fiscal year, which ends on June 30, 2022.
4. Miscellaneous comments and suggestions to assist the Industry during this period of declining wholesale price points for commercial cannabis.
 - a. Overhead costs are increasing industrywide.
 - b. Cost of goods sold, the direct costs of producing commercial cannabis products including materials and labor, is increasing, partially due to shortages in the supply chain.
 - c. Decline in the cannabis industry workforce due to layoffs.

- d. Finished goods are being sold at a much lower price point.
- e. Industry businesses are carrying accounts receivables for longer periods of time and are challenged to collect, further impacting cash flow.
- f. The Committee should consider reviewing the Program and reducing staffing levels as the business entities become fully permitted and require less County monitoring.

Additional Program Research and Analysis.

The Program conducted interviews with the CCA and the County Administrative Office Budget Director. Here is the analysis to date:

1. Decline in commercial cannabis wholesale price point and the inability to identify when a correction may take place.
 - a. The Program has been monitoring the significant decline in the wholesale price point since April 2021. Like traditional agriculture, Monterey County cannabis price points tend to be higher than other counties because the cannabis is cultivated in a desirable geographic growing region. Another explanation for a higher price point could be permittee inconsistent reporting of consignment pricing in Metrc; the Program is working with CCA and industry operators to establish best practices for reporting consignment prices. CCA met with the subcommittee members and County staff on December 1, 2021 to begin such discussions.
 - b. Relative to October 2020, average wholesale prices are down \$683 per pound, which represents a 56% decline. (See Attachment A, page 27) It is difficult to forecast if or when a correction could occur, but analysts, including CCA, project a change or correction in the spring of 2022. The Industry speculates that the change or correction may not occur for some time.
2. Increase in inventory levels among permittees in Monterey.
 - a. Compared to 2020, permittee inventory levels have increased due to the decline in wholesale price points and the “waiting game” of determining the optimal time to sell. The higher level of inventory is indicative of reduced gross sales, which impacts cash flow and could lead to delays of infrastructure improvements and employee layoffs. In July 2021, the Program required industry operators to submit employee rosters. At that time, the industry employee workforce was about 2,400. The Program could request current employee information to update the workforce count if the Board desires.
3. Preliminary discussion with the CAO Budget Director on financial impacts for the current FY.
 - a. On November 18 and 29 of 2021, the Program met with the CAO Budget Director to review financial impacts to the current fiscal year budget if the Board approved a reduction to commercial cannabis tax rates. If rates were decreased, there would be a financial impact to the current budget, reducing department services. Impacts would be dependent on the scale of tax reductions.
 - b. Based on the proposed amended commercial cannabis tax rates, there could be an estimated \$5.4m decrease in the current fiscal year of cannabis tax revenue and an estimated \$9.2m decrease in FY 22-23 compared to the cannabis revenue estimates

provided on July 1, 2021.

- c. The Cannabis Assignment balance as of December 1, 2021, is \$18,693,631.
- d. The CAO Budget Office requested proposed costs for FY 22-23 from the Program on November 15, 2021. The current FY 21-22 Program costs are \$6,334,421.18. The proposed FY 22-23 Program costs are estimated at \$6,326,124.82, but this does not include all salary increases, as some bargaining units are still in negotiations.

Ordinance to Provide Tax Relief to Cannabis Operators

The draft ordinance amends Chapter 7.100 to provide tax relief to cannabis operators. Specifically, the ordinance:

- Reduces commercial cannabis cultivation rates per square foot of authorized canopy as follows:
 - Mixed Light \$5.00 to \$3.00
 - Indoor \$8.00 to \$7.00
 - Outdoor \$2.50 to \$1.00
- Reduces distribution tax to 0% of gross receipts.
- Removes automatic increases to commercial cannabis business tax rates.
- Waives all penalties and interest on unpaid installments for the 3rd Quarter of Fiscal Year 2021-2022 of the annual commercial cannabis business tax imposed on cultivation activities provided the installment is paid on or before July 1, 2022. Penalties and interest will be reinstated on any installments not paid on or before July 1, 2022.

A redlined and clean version of the ordinance are attached to this report as Attachment B and C.

OTHER AGENCY INVOLVEMENT:

The Office of the County Counsel and Treasurer-Tax Collector’s Office were involved in the preparation of the ordinance and report. The Office of the County Counsel approved the draft ordinance as to form. The Treasurer-Tax Collector’s Office included revisions to the ordinance for the purpose of correcting spelling and grammar errors. Additionally, language was added to provide for confidentiality of tax returns and information provided by operators as well as clarification on the July 31st due date. As this date falls on a weekend, the ordinance provides direction that payments will be considered timely if received the next business day.

FINANCING:

The proposed amendments to Chapter 7.100 will impact the estimated commercial cannabis tax revenue for FY 21-22 by approximately a loss of \$5.4 million dollars. (Attachment D) The automatic escalators that were supposed to take place in FY 21-22 will not be recovered in later years.

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

Legistar File Number: 22-096

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

Prepared by: Joann Iwamoto, Cannabis Program Manager

Approved by: Nicholas E. Chiulos, Assistant CAO

DocuSigned by:

Margan Ruiz-Ignacio

1/24/2022 | 2:19 PM PST

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{On behalf of Nick Chiulos}

Attachments:

- A. Cannabis Committee Reports on Wholesale Pricing (Legistar File Nos. 21-966 and 21-1053)
- B. Draft ordinance (redline version)
- C. Draft ordinance (signed clean version)
- D. Impacts of Approved Reductions to Cannabis Tax Rates