

MONTEREY COUNTY



Intergovernmental & Legislative Affairs Monterey Cannabis Program

Nicholas E. Chiulos
Assistant CAO

Date: May 14, 2018
To: Board of Supervisors
Fr: Joann Iwamoto, Cannabis Program Manager
Re: Commercial Cannabis Tax Rate

Attached is the submitted letter for consideration regarding Agenda File Number 18-547, "Receive a report on recommendations from the Board of Supervisors Cannabis Committee concerning ordinance revisions for commercial cannabis tax rates and penalties."



May 14, 2018

Via Email

Supervisor Luis Alejo, Chair
County of Monterey Board of Supervisors
168 W. Alisal Street, 2nd Floor
Salinas, CA 93901

RE: Cannabis Tax Rate Information for May, 22, 2018 Meeting

Dear Supervisor Alejo,

Jeffery R. Gilles, Founding Partner
Aaron Johnson, Partner
Paul A. Rovella, Partner
Jason Retterer, Partner
Robert E. Rosenthal, Partner
David W. Balch
Peter D. Brazil
Patrick S. M. Casey
Kendra L. Clark
Jeffrey S. Lind
Nevin P. Miller
Sergio H. Parra
Ronald A. Parravano
Matthew R. Rankin
E. Soren Diaz, Of Counsel
Doug K. Dusenbury, Of Counsel

On behalf of my clients, and cannabis industry partners, who are among the 900,000+ square feet (“SF”) of currently registered applicants (“Current Growers”) for cannabis related permits in Monterey County, this is to provide you with information we provided the Cannabis Standing Committee (“Standing Committee”) for its meeting held on May 7, 2018, and our support for the proposal set forth below.

The proposal, based on my discussions with Current Growers and knowledge about the financial viability of their operations at certain tax rates, would result in approximately \$4,275,000 net revenue to the County (after the expense of running the cannabis program) for the next fiscal year. The proposal would revive economic investment and expansion and would result in at least 2 million square feet of registered and permitted growers (“Anticipated Growth”).

The Anticipated Growth would almost double staff’s net revenue projection of \$2,802,976 at a tax rate of \$10/SF (“Staff’s Proposal”). Staff’s Proposal projects a failure rate that results in lost tax revenue of \$2,595,199, due to failing cannabis industry businesses. Planning for failure assures it will happen. We believe the losses would be much greater, that it stifles investment in our County, and that failure is real under Staff’s Proposal. We also believe that nothing changes in this analysis at a rate of even \$7.50/SF .

A. Our Proposal.

We request that the County modify its cannabis tax ordinance for the 2018-2019 fiscal year (“Fiscal Year”) as follows:

- For the first 6 months of the Fiscal Year, the first two quarterly payments shall be based on an annual tax rate of \$4.00 per square foot of cultivation (this would generate \$1,800,000 from Current Growers, and a total of \$4,000,000 when including Anticipated Growth, in the first 6 months of the year); and,

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- If the Anticipated Growth registered or reported equals 2 million square feet of cultivation or more by December 31, 2018, then the tax rate for the year should remain at \$4.00 per square foot (this would generate a total of \$8,000,000 for the next Fiscal Year); however,
- If the Anticipated Growth does not exceed 2 million square feet of cultivation by December 31, 2018, then the applicable tax rate for the last two quarters of the Fiscal Year should be \$5.50 per square foot (this would generate an additional \$2,475,000 after using only the Current Growers' area (with no growth), for a total of \$4,275,000 for the Fiscal Year).

The object of this proposal is to provide the County with a bottom line number (\$4,275,000) in the event no additional growth occurs next year even with a lower tax, which is extremely unlikely. At \$4.00 per square foot, my clients (I represent applicants who have capacity to utilize conservatively over 5 million square feet) have indicated to me that they will exceed the footprint reported in today's fiscal year, and I am confident that they will report 2 million square feet.

B. Reasons for Proposal and Issues Since Initial Tax.

In 2015, the cannabis industry supported the concept of a reasonable tax to accomplish two objectives: (1) establish and pay for the implementation of a cannabis program in the County of Monterey to accompany the new cannabis ordinance; and (2) provide a community benefit as a result of the new legal industry (by moving funds historically generated and remaining in a black market towards addressing addiction and providing the public with funding for other local issues). *The industry remains firm in our commitment to these two objectives.*

Our objective, which we believe is aligned with the County's, is to assure that the County has more than adequate revenue to run the program to (i) pay for law enforcement and first responders (Fire, Sheriff and District Attorneys) to bolster public safety and reduce or eliminate the impact of the black market, and (ii) pay for planners and RMA personnel to administer the permits, check compliance, issue business permits, etc. Our other objective is to allow cultivators room in their budget to finance necessary infrastructure improvements and to invest in the long term future of the industry here.

There have been significant changes or errors in the assumptions that led to the \$15 per square foot. Those changes or errors in assumptions are summarized as follows:

1. State taxes were not included in initial review. The state now imposes a tax of \$148 per pound. According to HdL's current report, this new tax rate "leaves little room for local jurisdictions to work within if they wish to remain under the total cumulative tax rate of 30%. This is an important benchmark to allow the local industry to compete against the black market and against other regulated cannabis businesses from around the state."

2. The price per pound has dropped significantly and faster than anyone had anticipated. The report that HdL prepared for the County originally believed the price of cannabis would hold at an average of over \$1800 per pound. In a matter of 6 months last year, the price ended up between \$600 and \$800 per pound on average, less than half of the County consultant's initial projection. The impact of this is it more than doubles the impact of the \$15/SF tax (the impact is essentially \$30/SF).
3. PG&E will not upgrade necessary infrastructure. The original HdL report based the \$15/SF tax on the ability of the industry to harvest at least 5 times per year. Without power upgrades, the industry is forced to use very little supplemental lighting in the winter, which results in an average number of harvests between 2 harvest during the summer and fall months, and a half-yielding harvest in the winter/spring months. The impact of this is to double the cost of the tax, because one half of the yield is available to sell (and when added to the impact of the price per pound dropping, the effective tax rate is up to \$60/SF).
4. Existing infrastructure has been inadequate and requires major capital expenditures to fight humidity. The available greenhouse space is located north of Chualar, where in the summer months the fog is prevalent, which leads to problems with humidity and mold. There is not one greenhouse that has been ready, turnkey, to walk into and begin cultivation. Every square foot in Monterey County requires some type of retrofitting, and most of it is very expensive (HVAC systems to control/dehumidify air as it enters the greenhouse is an example, as well as building walls and separating growing rooms to assure more control over a smaller area). Also, important to note, is that the state has issued regulations that require growers to comply with pharmaceutical grade testing for microbial and pathogens. We support that standard, but it has been at significant expense.
5. Permit reports, processing and the application process in general has been longer than anticipated. A typical application takes 6-12 months for simple remodeling and building permits in some cases. Many of my clients in the CUP process have taken over a year to get to hearing. We acknowledge that it is due to the fact that all applicants are applying at same time, but it has had an unforeseen impact on ability to finance operations at more favorable rates (which get better with permits in hand).
6. The Monterey County Regional Fire District Tax is likely to pass, adding \$0.18 per square foot of tax on the Current Growers. In addition to the State taxes, we are very concerned about the cumulative effects of these taxes on the industry. We support the fire tax, but ask that you please consider this in determining that \$4.00/SF of County tax is prudent.
7. The black market has getting bigger and bolder with no enforcement. We understand that the County is working on solutions to this. However, the black market in California is a large reason the price per pound has dropped significantly, and when they do not have to

pay any tax, are not held to labor standards that those in the legal market are held to, and sell to any state in the nation, it creates a burden and punishes those that are engaged in this program the right way.

C. The Industry Numbers Supporting \$4.00/SF.

We provided County staff with an overview of the costs associated with cultivation and the impact the tax rate has to a cannabis business under a number of scenarios, which we attach to this letter, at the Standing Committee. The industry remains available to discuss particular line items and supporting information.

The table essentially shows that the industry breaks even at \$4.50/SF, and has a 1% profit margin at \$4.00/SF, under current market conditions. The expenses include capital expenditures for renovations (which supports industry and tax revenue growth), but they do not include depreciation, nor Selling, General and Administrative expenses ("SG&A).

Many of the costs on the table are fixed, including the state tax. The major variable to the industry's success or failure is on the County tax.

D. Conclusion.

In order for the industry to maintain, and even grow, I respectfully request that you approve a tax rate of \$4.00 per square foot; and if the industry fails to provide 2 million square feet by December 31, 2018, that the tax rate is raised to \$5.50/SF. We believe this will provide incentives for new cultivators to voluntarily participate in the legal system, and will significantly reduce or eliminate the effect of the black market on our local cultivators, if enforcement is tethered to the lower tax rate.

Very truly yours,

JRG Attorneys at Law



Aaron P. Johnson

APJ:jj

Enclosure

