

To: Chadrick Smalley, City of Emeryville
From: MuniServices Cannabis Support Services
Date: 6/26/18
RE: Assessing taxation and cannabis business inducement options for the City of Emeryville

SUMMARY

The City of Emeryville is competing for high quality, economically viable and long-standing cannabis businesses partners. At the same time, the City is considering various revenue enhancing measures, including a potential tax on cannabis businesses which would be placed on the November 2018 ballot. To strategize this effort for the City, the City Council is expected to hold a study session on July 10, 2018. Emeryville sits in a geographically competitive environment that nevertheless holds opportunities for prudent and savvy localities. Well considered taxation strategy, economic stimulus, and cannabis industry friendly policies could help the City to develop a competitive advantage in the Bay Area.

Emeryville is looking to develop a cannabis tax that generates revenue while retaining its competitive edge vs. other area jurisdictions. The focus of competition includes three “spheres”, as follows: 1) Retail, pertaining to adjacent consumer markets e.g. Berkeley and Oakland. 2) Distribution, drawing from manufacturers both regional and statewide to move market-ready product to retailers. Competing localities include West Sacramento, Sonoma County and Santa Rosa. 3) Manufacturing, the competitive catchment can be considered statewide. Several cities and counties have gone to great lengths to attract local production including Adelanto, Desert Hot Springs, Los Angeles and others. Understanding the extent and dimensions of Emeryville’s competitors will be critical in developing attractive local tax and business culture options.

TAX STRATEGY

The City will want to consider its use of gross receipts tax which can be impacted by price fluctuations but is more universal than other options and can be applied to all commercial cannabis businesses. A square footage-based tax makes estimating revenue easier and is less impacted by price fluctuations but misses a certain volume of business activities.

Tax revenue and community benefits can be generated from agreements between the local jurisdiction and the business operators. Other impacts on tax revenue will include consumer patterns, price of inputs like labor and flower, pace of licensing roll out, and competition from the unregulated market.

PRICE DOWNWARD PRESSURE: LEGAL VERSUS UNREGULATED MARKET

There are currently issues with the cumulative effect of taxes such that legal product is often becoming less attractive in comparison to unregulated product. This is contributing to downward pressure on tax rates, including the state excise tax. Currently, it is estimated that 80% of cultivated cannabis flower in California is diverted outside of the licensed system. Much of this is

presumably exported to other states, but some portion finds its way into the California market as unregulated product. In every state that has legalized cannabis, both the licensed and unregulated price of cannabis flower is collapsing and likely has yet to hit bottom. As more licensed growers come on line and the anxiety of enforcement pressure disappears, the price of regulated flower should come down making it more competitive on price with illicitly grown flower but less of a tax generator on a per-ounce basis. Consumers, especially this newer generation of cannabis users, show a greater desire for convenience, simplicity, and willingness to pay a premium to be compliant with the law. Overall legal market share is moving away from smokables and toward edibles, vape pens and other extracts. These higher priced products require more costly equipment to manufacture and package and therefore are more difficult to reproduce effectively and cheaply in the unregulated market.

The long-term strategy for economic development to help Emeryville become the prime location for cannabis businesses will require recruiting and retaining high margin, high volume and financially healthy businesses. MuniServices analyzes revenue trends and identifies the best revenue partners and those most likely to persist through market fluctuations and consolidations. Those ideal partners will be attracted by other non-tax inducements as well, including the often-elusive combination of pro-business culture and more liberal attitudes toward cannabis operators. In return, the community should expect licensees that will give back through financial and volunteer contributions for local programs, pro-active equity considerations, competitive wages and employee development opportunities, and a “good-neighbor” approach to business in general.

COMPARATIVE TAX RATES AND STRUCTURES

Because presumably, different companies at different points in the production chain experience different profit margins, perhaps blanket-rate gross receipt taxes are not the optimal approach to cannabis taxation. Some area taxes to consider that use different rates for different types of cannabis businesses include Santa Rosa, which levies no tax for medicinal, 3% of gross receipts for adult-use retail and delivery, 2% for cultivation, 1% for manufacturing and 1% for distribution. Sonoma County levies 2% for dispensaries, \$1-\$6.50 per square foot for cultivation, 3% for manufacturing and no tax for distribution, transportation and testing. Emeryville could consider establishing rates to achieve economic development objectives, including creating an “ecosystem” of supportive, interdependent cannabis businesses.

Oakland has the distinction of being the first city in the nation to tax cannabis, in 2009, though Oakland’s rates (10% for adult use cannabis and 5% for medical) are high enough that many are asking for tax rates to be lowered. A key advantage for Oakland is that the City allows most types of cannabis businesses. There may be economies of scale for allowing businesses to cluster from a municipal standpoint in that enforcement or other inspection and business improvement efforts can be concentrated. Richmond and Sacramento both use 4% tax rates across the board for all types of businesses. Berkeley recently voted to lower the city’s tax rate on recreational cannabis from 10% to 5%, demonstrating the aforementioned downward pressure on tax rates.

Some jurisdictions that have adopted tax structures that seek to prioritize or incentivize particular types of cannabis businesses. For example, a jurisdiction that is interested in becoming a hub of edibles manufacturing, or product testing can adopt competitive tax rates for those types of businesses. Municipalities are coopting broad parameters for taxation such as one city that is charging cannabis licensees 1% of gross sales, or San Bernardino which charges \$5 for every square foot of dispensary space. Los Angeles charges 10% on adult use retail but 5% for medical dispensary sales and 2% on cultivation. The development agreement between a Los Angeles based vendor and the City of Maywood is a direct 6% tax. Another community has opted to impose a flat \$30,000 per year, and others are working through fee agreements to raise revenue. It is a competitive landscape regardless: Moreno Valley just undercut its neighbors Perris and San Jacinto who are at up to 15% and 10% on cannabis growing operations. Desert Hot Springs has made a strong push for outside investment by allowing cultivation, manufacturing, testing and dispensing and introducing a simple tax structure of \$25 per square foot of cultivation space for the first 3,000 square feet and \$10 per square foot for any additional cultivation space above that. Statewide, tax rates range from 2.5% to as high as 20% on retail sales, and between \$3 and \$50 a square foot for growers. San Jacinto established tax ceilings of 15% and \$50 per square foot.

Businesses with non-profit tax structure, most of which are organized as mutual benefit corporations (MBCs) to allow asset distribution upon dissolution or mergers with for-profits, will have to demonstrate caution when establishing a corporate structure. The California Franchise Tax Board states, "They are not eligible for California franchise and income tax exemption, as they do not meet the requirements as described in Internal Revenue Code Section 501(c) or California Revenue and Taxation Code (R&TC) Section 23701." And other firms claim that non-profit corporations can receive exemptions from both state and federal corporate taxes, and from state and county local taxes. Emeryville may have some latitude to offer incentives to companies organized this way.

SUMMARY AND CONSIDERATIONS

Indeed, California cannabis taxes are some of the highest in the nation, second only to the State of Washington, and this has resulted in calls for lowering the tax burden on these operators. Cannabis businesses pay corporate taxes like their non-industry counterparts, take no deductions on federal taxes (due to 280E), and get hit with additional city and state taxes specific to cannabis. The effective tax rates in Los Angeles for retail operators is 57%, cultivation 45%, manufacturing 35%, distribution 35%, and testing 34%. It is worth noting that excise (15%) and sales tax (8.5%) are passed on directly to the consumer.

Consequently, keeping taxes in the lower-end of the spectrum may attract California and national talent and business investment. This could also put Emeryville in a stronger position if legalization establishes a national foothold and state borders begin to fall – at least between the Western contiguous states that have already legalized the products.

The City of Emeryville has the ability to make licensing contingent upon prospective licensees demonstrating past provision of community benefits or agreeing to do so in the future. Additionally, the City should consider the dimensions of benefits correlated with gross receipt-based taxes, specifically if these taxes apply to retailers. As a result of a competitive “Request for Qualifications” process, the City currently requires its two proposed dispensaries to commit approximately 2% of gross receipts to community benefit programs, a portion of which comes directly to the City and can be used for general fund purposes.

Overall, Emeryville may have the elements at its disposal to create a cluster of high-quality cannabis related businesses. Establishing tax rates and a friendly cannabis business environment will require a vision that incorporates stakeholder input, creative ordinance authorship, and a city based implementation team that has a strong mandate and patience to see the strategy through.