

July 10, 2018

Honorable Emeryville City Council Members
1333 Park Ave
Emeryville, CA 94608

Re: July 10, 2018 City Council Agenda 12.2. [ID-2018-425](#) Direction On Potential Revenue Measures For The November 2018 Election. (Susan Hsieh), Cannabis Tax Rate Analysis

Dear Honorable Members of the Emeryville City Council,

We greatly appreciate the City of Emeryville working proactively and in an inclusive manner to establish tax measures. Responsible tax measures will strike a good balance between cannabis policy enforcement while tackling the ever challenging social matters such as reducing homelessness, expanding educational opportunities, and building infrastructure capacity that make the City of Emeryville such an amazing place to live and do business!

On July 3, 2018, the permitted cannabis businesses in the City of Emeryville collaborated to develop a better understanding of the City's priorities and to develop proactive options for implementation of responsive tax measures that will address the City's social needs, focus on enforcement of cannabis laws, while fostering the success of cannabis startups in the City. This balanced approach will work well to support the growth of existing permitted cannabis businesses, encourage underground operators to legalize, and entice accomplished cannabis businesses to join the City in this amazing legalization effort filled with new opportunities.

As we all know, the basic pillars of our economy consist of financial incentives that balance the competitive landscape with the social needs to create demand as the supply side continues to invest in the overall success of our community. As such, If a business is given an option to choose where it wants to set up shop, the leadership of that business would most likely pick a location conducive to its market reach that reasonably fits within the framework of its budget. This will help such business establish its operations and engage the community to foster demand and grow at a healthy pace to overcome competitive forces to capture market share effectively. In turn, customers will patron businesses that are easily accessible and maintain competitive pricing and high quality services.

When a market contains high demand and minimal competition, customers will pay higher prices for goods. However, when we are faced with high demand and high competition from underground markets that don't pay taxes or bear the cost of providing our community with compliant and tested products, most working class customers will be lured to go to the underground operators that provide the lowest cost. These universal laws of economics have been experienced across all industries for centuries, and cannabis is no exception to such laws that influence the masses.

Given state's "compounded" 15% excise tax on retail sales, plus the approximately \$9.25/OZ of excise tax on cultivation, plus sales tax, additional markups from local jurisdiction on top of such "compounded" tax structure across the cannabis supply channel is already viewed as a major issue in California's Cannabis legalization. In addition to these financial loads, no cannabis business is allowed to deduct standard business expenses from its federal taxes (note 280E of the IRC).

The overall impact of such highly taxed businesses is already showing deep negative signs in western states when combined with high real estate costs, high product prices to meet compliance, and high operating expenses due to a tight labor market; most of which cannot be expensed due to the federal 280E initiative. Furthermore, jurisdictions around Emeryville are "all over the map" in terms of their tax strategies and as such are most likely paying the high price of encouraging underground operators to control pricing power as opposed to those who obtained a permit and legalized. As Weedmaps across bay area shows, the high tax jurisdictions have 3 to 5 underground operators for every 1 permitted business, depending on the jurisdiction and their cannabis policies.

International market research firm, Fitch Ratings has published several reports warning how high tax rates will diminish revenues and keep underground market prices competitive into the long term. They state, "High tax rates raise prices in legal markets, reinforcing the price advantage of underground markets. California's underground markets for cannabis were well established long before the Voters legalized cannabis and are expected to dominate post-legalization production." The report said that increased enforcement may blunt the illegal market, "but high taxes may complicate such efforts by diverting in-state sales to the underground market." The entire East Bay is overrun with unregulated, untaxed, illegal providers and delivery services all of who are not subject to any of these expenses. While there are seven permitted cannabis businesses in the City of Emeryville, there are well over 3 times that amount of illegal businesses serving the City and its surrounding area without any compliant products or tax expenses.

Furthermore, as the attached whitepapers titled "Impact of Tax Rate" and "The Argument for Lower Taxes" demonstrate, many jurisdictions already experienced the growing pains of lower tax revenue actuals, increased underground operations, and licensed businesses going bankrupt due to being overtaxed during their startup phases.

As a result, we respectfully ask the Emeryville City Council to consider the following cannabis tax options that are designed to find a "sweet spot" between securing adequate tax revenue from cannabis commerce while allowing the local cannabis industry to grow and thrive methodically over the next few years as the industry matures and consolidates. In general, the Emeryville permitted cannabis businesses are supportive of a local tax. In that context, the group recommends that the City leadership consider the following factors in its tax rate decision:

1. **Retailers already pay 2%-3% of gross margins in Community Benefits.** If the City chooses to create a uniform tax structure, it should consider combining the 2% to 3% Retail Community Benefits into a uniform tax base that spans equally across all permitted cannabis businesses in Emeryville. Additional taxes on top of the existing Retailers' Community Benefit would create an undue financial burden, in particular during the initial

startup period as these retailers recover the high costs of facility development and grand opening.

2. **Cannabis manufacturers operate on very tight profit margins.** These entities contend with a very competitive market. High taxes would put them at risk of either relocating or going out of business to sustain their operational success. In addition, the “compounded” excise, sales, and local taxes would serve as a disincentive to legalize such entities from the “back bedrooms” or “garages” that subject household members to home invasion robberies and accident risks associated with use of non-compliant equipment.
3. **Emeryville tax benefits from Proposition 64.** A portion of the “compounded” California tax revenue that includes 15% Retail Excise Tax, \$9.25/OZ cultivation Excise Tax, and State Sales Tax are already allocated to local jurisdictions in line with proposition 64 laws. As such, over taxing permitted cannabis businesses beyond a reasonable level to meet the City’s challenges will undoubtedly force some of the businesses to seek out other more tax-friendly jurisdictions as had occurred in the neighboring cities such as Oakland.
4. **New cannabis businesses will not come to Emeryville.** Enticing innovative and accomplished cannabis businesses to set up shop in Emeryville will become very difficult in particular for testing, R&D, delivery, and edibles manufacturing. Existing accomplished businesses will either leave Emeryville and new operators would not even consider Emeryville with a combination of high taxes, expensive real estate, and tight labor market.
5. **Permitted businesses will be cash strapped.** Given the heavy investments required for building out operational startups, permitted businesses will soon be strapped for cash and go out of business given the high costs described above combined with Federal 280E that prevents cannabis companies from taking normal business deductions, including state and local taxes, payroll, rent, and other common costs of doing business as the NCIA youtube video illustrates: https://www.youtube.com/watch?time_continue=75&v=ecSfsIGqEdo

The permitted Emeryville Cannabis Businesses completely understand and agree that the City should generate tax revenue for community and infrastructure development. As such, we recommend the Honorable City Council Members consider the following options:

1. **Uniform Tax Policy.** A uniform tax policy across the entire industry would include a uniform community benefit program that covers all of the City’s social, community, and infrastructure needs in a uniform manner.
2. **Tiered Tax Policy.** A Tiered Tax Policy would keep the current retailers’ Community Benefit as is, would apply a lower tax rate to retailers, and a higher tax rate to wholesalers that do not have a Community Benefit cost associated with their permit.
3. **Scalable Tax Policy Implementation.** With a scalable tax application, the City would allow the cannabis businesses to initially pay lower start up taxes. As the state excise tax rate drops, industry consolidates, and pricing stabilizes in terms of supply and demand,

Emeryville City Council can increase the base tax rate according to revenue levels or other economic indicators that would mostly impact the highly successful cannabis businesses.

Using one of the above options, the general consensus across Emeryville's permitted cannabis businesses is that a starting rate of **1% to 2% of the gross revenue** will increase the likelihood of:

- Keeping existing permitted operations in Emeryville;
- Attracting new cannabis businesses into the city; and
- Growing tax revenue actuals using a scalable approach based on realistic revenue levels that factor industry consolidations and supply-demand factors.

A starting tax rate of 1% to 2% of the gross revenue will also enable the existing permitted businesses to reduce product prices for the customers to rapidly capture market share across the 5 Million over 21 population within the greater bay area cannabis market!

Tax rate based on square footage is not a reliable measure and is not recommended. This scenario encourages cannabis businesses to downsize their facility to control their tax exposure while raking in profits using high volume transactional sales approaches. In many instances, a larger size business model that allows for a wide range of social and therapeutic engagements to provide a fulfilling experience does not translate to high revenues compared to a smaller size facility with less emphasis on social or therapeutic values but a stronger focus on high volume transactional sales.

The Emeryville cannabis businesses appreciate City leadership's hard work to legalize cannabis and the enthusiasm for potential tax revenue that cannabis businesses can inject into the City of Emeryville general fund. We are thrilled that our local industry will be able to further support the City that stands behind us for absolute success!

Tax policies are very complicated but the solution does not have to be complicated if mutual success is the basis of such policies. Starting with low taxes and methodically increasing them along the way as the industry is better understood is the most responsible approach so that the existing or future cannabis businesses are not "spooked and surprised" with high tax policies that will force them to leave the City, go out of business, or never come in to obtain a permit.

Sincerely,

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