



City of Emeryville

CALIFORNIA

MEMORANDUM

DATE: September 17, 2018
TO: James N. Holgersson, Interim City Manager
FROM: Charles S. Bryant, Community Development Director
SUBJECT: Study Session Regarding Initial Cannabis Business Tax Rates

RECOMMENDATION

Staff recommends that the City Council consider the following report from staff regarding cannabis business tax rates and provide direction to staff.

BACKGROUND

At its December 19, 2017 Study Session and after reviewing public opinion polling results, the City Council directed staff to place a cannabis tax measure on the November 2018 ballot. Additionally, the City Council placed a housing bond on the June 2018 ballot, and continued to consider other potential revenue measures for November 2018. Accordingly, the City engaged EMC Research to conduct additional public opinion polling after the June 2018 election to determine the viability of various revenue measures, again including a cannabis tax.

On July 10, 2018, the City Council reviewed the results of the June 2018 polling and reaffirmed the direction to staff to proceed with the preparation of a cannabis business tax for the November 2018 ballot. The City Council requested staff develop implementing ordinances for consideration, with options for how the tax rate would be set and/or modified in the future.

On July 24, 2018, the City Council considered three options for the cannabis business tax ordinance to be placed before voters. All three options provided for flexibility in setting different rates for different types of cannabis businesses (i.e. manufacturing, distribution, storefront retail, delivery, etc.) and all three options contemplated the form of the tax to be a gross receipts tax not to exceed 6%. Option 1 provided for the tax rate to be set by a simple majority vote of the City Council. Option 2 provided for the initial tax rate to be set by a simple majority vote, with the rates fixed for a period of five years, with any modifications to the rates after the five-year period subject to a supermajority (i.e. 4/5) vote of the City Council. Option 3 was similar to Option 2 except that lowering tax rates after the initial period would require a simple majority vote of the City Council, while raising rates after the initial period would require a supermajority vote.

The City Council selected Option 1 – rates set and subject to modification by simple majority vote of the City Council – with a maximum rate of 6% of gross receipts. The resolution and ordinance implementing this direction has been submitted to the Alameda County Register of Voters and the measure has been designated “Measure S”.

During the proceedings outlined above, the City Council received comments from the Emeryville cannabis business community regarding the current state of the market and the potential impacts of cannabis business taxation. Of particular concern was the businesses' desire for certainty and stability of the City's tax policy, as this influences the businesses' ability to plan for the future while adapting to changing regulations and market factors as the cannabis industry is normalized.

To address these concerns and pursuant to Council direction, staff has prepared the following discussion to facilitate a City Council study session on initial cannabis tax rates in advance of Measure S. This session can lead to the City Council's adoption of cannabis tax rates by resolution at a future meeting, dependent on the passage of Measure S, which would send a signal to the cannabis business community on the City's intent and allow the businesses adequate time to plan for the new tax.

DISCUSSION

A brief report produced by municipal revenue consultant firm MuniServices regarding basic tax strategy, current market conditions, and tax rates and structures was included as part of the City Council's July 10, 2018 agenda materials. This report is attached again for convenience (Attachment 1). This staff report builds on the MuniServices report and includes a discussion of the current regulatory environment's impacts on the market, a snapshot of the cannabis industry in Emeryville today, and strategic considerations for taxation policy.

The Current Market Environment

Cannabis is an emerging market unlike any other owing to its long history of prohibition and ties to medical usage. As states incrementally liberalize cannabis regulation while federal prohibition remains in place, a patchwork of markets with varying rules, taxation schemes and customer profiles is developing state-by-state with little opportunity for interstate transactions. Because this is a fluid regulatory environment, companies must remain nimble to respond to changing requirements.

California's history of permitting medical cannabis combined with some local communities' relaxed approach to regulation and enforcement created a robust informal supply chain and customer base¹ that long predates the current, regulated market. This has created challenges for firms that choose to participate in the regulated market as the costs of compliance (seed to sale tracking, testing, distributor relationships, packaging and labeling, etc.) combined with significant state and local taxation cause the retail price of regulated product to exceed the retail price of unregulated product, putting these businesses at a disadvantage.

¹ Schroyer, J (2018, August 8). *Study: Nearly 1 in 5 California marijuana consumers buy from black market*. Retrieved from <https://mjbizdaily.com/consumer-study-nearly-1-in-5-california-consumers-buy-from-black-market/>

The persistence of the informal market due to these cost advantages is cited as a major reason for lower than expected sales of regulated product, as reflected by state excise tax revenues². This has led to calls to revisit state and local tax rates to ensure the regulated market – with its attendant product safety and revenue benefits – can establish itself³.

The Cannabis Industry in Emeryville Today

As of August 2018, seven cannabis businesses have been authorized to operate in Emeryville. Of these, two are storefront retailers, three are manufacturers, one is a delivery service, and one is a distributor. Because the number of businesses is small, staff cannot provide revenue estimates by business type without disclosing proprietary revenue information; however, in the aggregate these seven businesses are expected to generate combined gross revenues of approximately \$40 million annually once all of the businesses' operations are at full ramp-up.

The two storefront retail businesses include Rochambeau, Inc. doing business as (dba) NuLeaf, and East Bay Therapeutics. NuLeaf expects to commence operations in late 2018/early 2019, while East Bay Therapeutics is currently operating in soft launch mode with full operations expected to commence in September 2018. Because the storefront retail operators were selected through a competitive Request for Qualifications process, which weighed community benefits and other factors, these operators are subject to conditions of approval of their Cannabis Business Operator's Permits that require contributions that amount to approximately 2% of gross receipts. Additionally, sales tax collected from these retailers effectively results in an additional 1% of gross revenue returning to the City. Both of these operators were selected in part due to their ability to serve a regional market.

The three manufacturers include Sunderstorm, a manufacturer of edibles; Versagenix, which makes topicals and tinctures; and Aves11 dba Kikoko, which makes tea. These businesses have located in Emeryville in part because of the City's supportive regulatory environment and Bay Area location. These businesses are essentially small startups with significant growth potential and are not as location-dependent as retailers for their customer base. Because they are relatively early-stage companies, they also have not yet built up a large specialized workforce that would influence the businesses' location decisions.

The delivery service is Golden State Cannabis. This is also an early stage company, focused on delivery of cannabis product to end users especially in the I-680 corridor of the East Bay. While not as location dependent for customers as storefront retail

² Schroyer, J. (2018, August 16). *Black market cited as CA nets only \$74 million on second-quarter marijuana taxes*. Retrieved from <https://mjbizdaily.com/second-quarter-california-marijuana-taxes-nets-only-74-million-black-market-factor/>

³ Pearson, E. (2018, April 2). *Reduce state cannabis taxes to level the field for licensed growers*. Retrieved from <https://www.sfchronicle.com/opinion/openforum/article/Reduce-state-cannabis-taxes-to-level-the-field-12799928.php>

businesses, delivery services are more location sensitive than manufacturers or distributors as reasonable proximity to customers is a matter of practicality.

The sole cannabis distributor business in Emeryville is Kiva Sales and Service. This is the distribution arm with ties to Kiva Confection, an established, leading edibles brand. In addition to Kiva Confection products, Kiva Sales and Service distributes several partner brands and is expanding its offerings. As noted above, distribution and manufacturing are not as location dependent for sales, because their customers are dispensaries and delivery services located statewide.

All the businesses listed above are currently required to pay 0.1% of gross receipts to the City in the form of business tax. This low, existing tax rate has been cited by several of the businesses as a motivator for locating in Emeryville. Conversely, several of these businesses have expressed interest in moving from Emeryville if tax rates are set higher than other competitive locations. The tax rates at these locations is discussed further below and in Table 1.

Interest in locating cannabis businesses in Emeryville remains strong. Economic Development and Housing and Planning staff field several calls per week from business operators, consultants and brokers in search of space for cannabis businesses. A few of the state's leading cannabis businesses have expressed interest in Emeryville, but are awaiting resolution of the tax rate discussion before advancing plans. This anecdotally confirms that non-retail cannabis businesses are sensitive to local tax rates, which is suggested by research regarding location decisions of traditional (non-cannabis) firms discussed further below.

Strategic Considerations

Research suggests that businesses' location decisions are influenced by state and local taxation factors, and that the sensitivity to tax rates is greater for firms located within metropolitan areas⁴. Though this research predates the legalization of cannabis and applies to traditional firms, it may be inferred that cannabis businesses are also making location decisions in consideration of local tax rates.

As noted above, certain types of cannabis businesses may be less dependent on location factors for customers than others. Storefront retailers and delivery firms will look to locate near their retail customer base, while testing firms may look to locate near manufacturing firms. Manufacturing and distribution firms can be located nearly anywhere in the state with reasonable transportation facilities since transport costs are unlikely to be a large component of total costs.

Therefore, the City should consider its place in the competitive environment for these businesses and whether it can establish tax policy that puts the City at a competitive advantage.

⁴ Phillips, J., & Goss, E. (1995). The Effect of State and Local Taxes on Economic Development: A Meta-Analysis. *Southern Economic Journal*, 62(2), 320-333.

Competitive Jurisdictions

The following table includes the existing cannabis tax policies of select jurisdictions that are known to compete for cannabis businesses interested in Emeryville:

Table 1

Jurisdiction	Rate Cap	Current Rate(s)	Notes/Comments
Berkeley	10% adult 2.5% medical	5% all uses (adult) 2.5% all uses (medical)	Lowered adult use tax from 10% to 5% in 2018, due to informal market
Oakland	10% adult 5% medical	10% all uses (adult) 5% all uses (medical)	Rates fixed by measure, 2018 measure proposed to permit City Council to set lower rate and allow deduction of expenses
Richmond	5%	5% all uses	
Santa Rosa	8%	3% Retail (adult) 0% Retail (medical) 1% Manufacturing 0% Distribution 0% Testing	Initial rates are fixed for a 2-year term. A 5/7 City Council vote is required for rates over 5%
Sonoma County	10%	2% Retail 3% Manufacturing 0% Distribution 0% Testing	
West Sacramento	N/A	Retail prohibited 2.5% Manufacturing, 2.5% Distribution 2.5% Testing	City revenues through “voluntary” project-specific development agreements, all have been for 2.5% of gross
Los Angeles	10% Retail (adult) 5% Retail (medical) 2% Manufacturing 1% Distribution, Testing, Research	10% Retail (adult) 5% Retail (medical) 2% Manufacturing 1% Distribution 1% Testing	Ballot measuring increasing tax by 1% tabled by City Council in 2018

Source: City websites and interviews.

Timing

As noted above, Measure S would set a rate cap of 6% for Emeryville. Within the context of rapidly changing and complex regulations and a thriving informal market, the Council could consider setting initial rates at the lower end of the scale. This would allow both existing and future cannabis businesses to become established in Emeryville at a time when their business location decisions are most sensitive to tax policy. As the market matures and businesses expand and build their workforces, the businesses may become

more location-dependent and consequently may be able to absorb additional tax burden, particularly if state excise taxes are reduced.

Differential Rates

Another consideration is exercising the flexibility to set different tax rates for different types of cannabis businesses to attract complementary businesses and build an industry “cluster”, which combined would create a stronger economy than a single business reliant on outside firms for its workforce, customers and supply chain. Clusters encourage the formation of new businesses, encourage innovation, and generally improve the productivity of businesses⁵. Currently, Emeryville has the beginnings of a cannabis industry cluster but lacks companies specializing in extraction (which is a manufacturing use type), testing and packaging. Establishing initial tax rates that are competitive for underrepresented business types could position the City to attract such firms. If successful, existing and future cannabis firms would have local supply chain options available to them and the City would benefit from the gross receipts of each of these businesses in the supply chain, increasing total revenue from the industry.

FISCAL IMPACT

As noted above, specific revenue projections for various cannabis business tax rates cannot be publicly provided, due to the small number of businesses involved and the potential to reveal proprietary sales figures. In the aggregate, staff estimates that every one percent of gross receipts tax would equate to approximately \$400,000 in revenue from the current, existing cannabis business base; however each percentage point increase in tax rates could be expected to generate less marginal revenue in future years as businesses choose to locate in lower tax jurisdictions. For manufacturing and distribution businesses especially, this rate of diminishment may be significant.

As outlined above, the longer term fiscal impacts due to future growth or contraction of the cannabis industry in Emeryville is difficult to estimate and is particularly sensitive to the initial cannabis business tax rates. In general, the lower the initial rates, the greater opportunity for future sales growth due to success (expansion, increased sales) of existing businesses and attraction of additional businesses.

STAFF COMMUNICATION WITH THE PUBLIC

Staff has discussed revenue and taxation issues with Emeryville cannabis businesses over the past year in the course of providing business attraction and retention services.

CONCLUSION

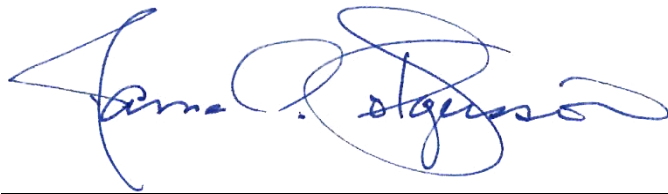
Staff recommends that the City Council provide direction to staff on the following questions:

⁵ Porter, M.E. (1998). Clusters and the New Economics of Competition. *Harvard Business Review*. November-December 1998. No. 98609

1. What is the City's vision for the cannabis industry in Emeryville?
2. Is the City Council prepared to discuss initial cannabis business tax rates in advance of the passage of Measure S?
3. If "yes", what initial rates should be established for the following business types:
 - a. Storefront Retail
 - b. Non-storefront Retail (delivery)
 - c. Distribution
 - d. Manufacturing
 - e. Testing
4. Does the City Council have other policy goals related to the cannabis industry in Emeryville?

PREPARED BY: Chadrick Smalley, Economic Development and Housing Manager

**APPROVED AND FORWARDED TO THE
CITY COUNCIL OF THE CITY OF EMERYVILLE:**



James N. Holgersson, Interim City Manager

ATTACHMENT:

1. MuniServices Cannabis Tax Report dated June 26, 2018