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Staff Report for a Resolution Setting the Cannabis Business Tax at 7% of Gross Receipts Until June 30, 2019, and Increasing to 8% of Gross Receipts on July 1, 2019 and 9% of Gross Receipts on July 1, 2021

SUMMARY AND RECOMMENDATIONS

The City Manager recommends that the City Council consider the attached resolution that would set the Cannabis Business Tax rate at 7% of gross receipts. Beginning July 1, 2019, the tax would then automatically increase to 8% of gross receipts, and on July 1, 2021, it would automatically increase to 9% of gross receipts.

BACKGROUND

In November 2016, Measure NN (the "Cannabis Business Tax") was approved by a majority of San Leandro voters, enacting new cannabis business tax provisions as part of Chapter 2-21 of the Municipal Code. The results of this election were subsequently certified by the City Council on December 19, 2016. The provisions of the measure allow the City to impose a tax on all businesses located within the City that make use of any component or derivative of the cannabis plant, at a maximum rate of 10% of gross receipts. Measure NN does not legalize or otherwise permit cannabis businesses in San Leandro and the cannabis business tax is in addition to the annual permit fee that is designed to recover the City's costs in regulating these businesses.

Prior to bringing Measure NN before the voters, City officials and staff declared during various public meetings and community events that the intention of the "up to 10%" language was to provide flexibility in the rate at which the tax would be imposed. Factors supporting such flexibility include:

- ensuring that local cannabis businesses maintain their competitiveness with other neighboring communities,
- recognition of the significant up-front costs with starting up a cannabis business, and

- ensuring that the cumulative federal, state, and local taxes imposed on such businesses would not inadvertently incentivize a black market.

Below is a list of the cannabis tax rates currently imposed in neighboring Bay Area communities:

- Berkeley: 2.5% of gross receipts
- Oakland: 5% of gross receipts
- San Jose: 10% of gross receipts
- Hayward: Up to 15% of gross receipts

Consistent with the City's adopted medical cannabis dispensary ordinance, in 2015 and 2016 the City Council awarded three medical cannabis dispensary permits. One of those entities (Harborside San Leandro) is expected to begin serving patients in a few months. The other two approved dispensary operators (Davis Street Wellness Center and Blum San Leandro) must still submit their conditional use permit applications. As such, it is important for the City Council to formally establish the rate of local tax that will be imposed on those businesses so that such costs may be incorporated into their business plans and product pricing.

Staff recommends that the Council impose a rate of 7% of gross receipts, which would remain in effect until June 30, 2018. Staff also recommends that the rate then increase to 8% of gross receipts on July 1, 2019, and then increase to 9% of gross receipts on July 1, 2021. Staff recommends this graduated implementation to recognize that each of the dispensaries have significant upfront capital and tenant improvement costs before they will be able to commence operations. In addition, each of the three dispensaries are subject to an annual \$60,000 permit fee that recovers some of the City's direct costs to enforce the medical cannabis dispensary permit program.

State and Federal Taxes

It is important to note that in addition to a local gross receipts tax, San Leandro's cannabis businesses also face significant state and federal taxes as part of their operations. For example, Proposition 64 (which legalized the non-medical adult use of cannabis statewide as part of the November 2016 election) included a 15% excise tax that will be imposed on the retail sales price of cannabis. In addition, because the federal government still classifies cannabis as a Class I controlled substance, cannabis businesses are subject to higher federal taxes than other businesses. More specifically, Federal law 26 USC §280E (also known as "Rule 280E") arguably burdens the cannabis industry by disallowing standard business expense deductions. Traditionally, non-cannabis companies may legally deduct from gross sales nearly all of their costs of goods sold and their business expenses. Costs of goods sold are the direct costs attributable to the production of the goods sold. For a cannabis business, this amount includes the costs of the materials used in creating the good, along with the direct labor costs used to produce the good. The expenses would be advertising, professional services, and office supplies, to name a few. However, because of Rule 280E, cannabis businesses are disallowed from taking deductions from gross sales for business expenses, other than cost of goods. Therefore, their federal tax liability will be greater than that of a non-cannabis business of similar size and annual revenues.

Nevertheless, most local jurisdictions that allow cannabis businesses to operate have imposed their own local voter-authorized gross receipts taxes. All three of San Leandro's permitted dispensary operators currently do business in such jurisdictions, including Harborside's San Jose facility, which is subject to a 10% gross receipts tax. Additionally, the Davis Street Wellness Center voluntarily offered

to contribute 9% of its gross receipts to the City of San Leandro as part of its proposal for a medical cannabis dispensary permit. Blum San Leandro's facility in Oakland is currently subject to Oakland's 5% gross receipts tax. The City of Oakland is also in the process of developing and implementing a new Equity Permit Program that would establish significant new requirements and restrictions on new cannabis businesses that would not be applicable in San Leandro.

It is also important to note that all three of San Leandro's medical cannabis dispensary permit holders will be providing various programs designed to offer reduced cost and/or free medicine for low-income, terminally ill, or otherwise disadvantaged patients.

Next steps

In addition to this recommended action, there are several other cannabis business-related decisions that will be brought forward for City Council consideration in the coming months. Per the Council's direction at its December 19, 2016 meeting, staff will bring back for the Council's consideration various proposed San Leandro Zoning Code amendments that would facilitate non-retail cannabis manufacturing and laboratory testing businesses to operate in certain sections of the City's industrial areas. If the Council were to authorize such cannabis businesses to operate, they too would be subject to the local gross receipts tax.

Per the City Council's direction at its February 21, 2017 meeting, staff will present a discussion related to the recreational/ adult use of cannabis that was authorized by Proposition 64. As part of that discussion, staff seek direction from the City Council regarding whether the three permitted medical cannabis dispensaries should be allowed to sell cannabis to the public without a doctor's recommendation. Per Proposition 64, such sales could begin as early as January, 2018, subject to state and local approval. Both of the above items are tentatively scheduled for discussion at the May 1, 2017 City Council meeting. Lastly, two out of the three previously permitted medical cannabis dispensaries still need to submit conditional use permit applications to the Community Development Department for review and consideration by the Board of Zoning Adjustments.

Fiscal Impacts

Because none of the three permitted dispensaries are operating yet, it is difficult to forecast precisely how much revenue would be derived from the recommended 7% gross receipts tax. However, using estimates provided by the permitted dispensaries' various proposals, staff estimates that the proposed tax could generate at least \$500,000 annually for the City's General Fund during the first year of implementation.

Attachment(s) to Staff Report

- Resolution establishing the proposed medical cannabis tax rate

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