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Staff Report for a City of San Leandro City Council Resolution Maintaining the Current Cannabis Business Tax Rate at 6% of Gross Receipts Until June 30, 2020, and Increasing it to 7% of Gross Receipts on July 1, 2020 and 8% of Gross Receipts on July 1, 2022

SUMMARY AND RECOMMENDATIONS

Per the request of the City Council at the May 20, 2019 City Council meeting, City staff presents the attached resolution that would postpone by one year the previously established cannabis tax rate increase from 6% of gross receipts to 7% of gross receipts, which is currently set to take effect on July 1, 2019. If the proposed resolution is adopted, it would codify the following updated tax schedule, which would apply to any cannabis business, irrespective of whether it is associated with medicinal or adult use cannabis business activity in San Leandro:

- 6% of gross receipts through June 30, 2020
- 7% of gross receipts effective from July 1, 2020 through June 30, 2022
- 8% of gross receipts effective July 1, 2022

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 City Council subsequently certified these election results 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 annual 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 cost of an annual business license, as well as the annual \$60,000 dispensary operating 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 of the tax measure was meant 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 businesses operating in neighboring communities;
- recognition of the significant up-front costs associated with starting up a cannabis business; and
- ensuring that the cumulative federal, state, and local taxes imposed on such businesses would not serve to further incentivize the unregulated market.

Regional Context

Below is a list of the cannabis tax rates currently imposed in neighboring Bay Area communities, based on online research:

City of Alameda	0%
Berkeley	2.5% of gross receipts (medicinal) 5% of gross receipts (adult use)
Emeryville	3% of gross receipts (retail dispensaries and delivery) 2% of gross receipts (manufacturing) 1% of gross receipts (distribution & laboratory testing)
Hayward	Up to 15% of gross receipts
Oakland	0.12% of gross receipts (businesses with revenue < \$500K/year) 5% (medicinal), 10% (adult-use) [businesses exceeding \$500K/year]
San Francisco	5% of gross receipts (retail businesses w/ revenue >\$1M/year) 2.5% of gross receipts (retail business with revenue <\$1M/year) 1.5% of gross receipts (non-retail >\$1M/year) 1% of gross receipts (non-retail< \$1M/year)
San Jose	10% of gross receipts
Santa Rosa	3% of gross receipts
Alameda County	0% (applies to unincorporated areas)

All three of San Leandro's permitted dispensary operators currently do business in jurisdictions referenced above that impose local gross receipts taxes. Additionally, each of San Leandro's three dispensary teams previously offered to provide voluntary gross receipts contributions to the City's General Fund as part of their business plan proposals when they first applied for dispensary permits

several years ago. For example, the Davis Street Wellness Center voluntarily committed in writing to contribute 9% of its gross receipts to the City of San Leandro. In addition, Blum San Leandro offered to contribute 5% of its gross receipts to the City, and Harborside San Leandro committed to donating 4% of its gross receipts to a community benefits program fund, in addition to a 1% gross receipts and 10% net revenue contribution to the City. All of the above-referenced voluntary contributions were ultimately nullified when San Leandro voters adopted Measure NN.

Nevertheless, as of the date of writing of this staff report, only one cannabis dispensary business is legally in operation in San Leandro. However, the remaining two permitted dispensaries are in the process of completing their tenant improvements and are expected to open for business later this year, in advance of the December 31, 2019 deadline that the City Council imposed when it authorized adult use sales earlier this year. In addition, there is currently one stand-alone cannabis manufacturing business and one cannabis testing laboratory that have received conditional use permits, although neither of these businesses have yet commenced operations.

State and Federal Taxes

It is important to note that in addition to local gross receipts taxes, cannabis businesses throughout the State and region 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) established a 15% excise tax that is embedded into the retail sales price of cannabis. In addition, because the federal government still classifies cannabis as a Schedule 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 retail cannabis industry by disallowing certain standard business expense deductions. Therefore, their federal tax liability will be greater than that of a non-cannabis business of similar size and annual revenues.

Conclusion

Based on the factors stated, a reasonable argument could be made for delaying implementation by one year of the previously scheduled gross receipts tax increase. Such a delay would allow each of the teams additional time to complete any outstanding capital improvements, while also allowing additional time for the rapidly evolving regulatory environment and cannabis market to further mature. Based on the request of the City Council, city staff have prepared the attached draft resolution for the Council’s consideration, which would maintain the existing gross receipts tax at the current 6% rate for an additional one year. Absent subsequent direction from the City Council, the previously established increase to 7% would take effect on July 1, 2020, and then increase again to 8% two years thereafter.

Fiscal Impacts

Because only one cannabis business is presently in operation in San Leandro and the entirety of their first quarter earnings were generated without adult use sales being in effect, it is challenging to generate reliable General Fund revenue projections for the upcoming fiscal year. Assuming a 15% reduction in whatever revenue would have otherwise been generated (i.e. the marginal difference in revenue generated between a 6% tax rate vs. a 7% tax rate), it is conceivable the City could forgo approximately \$50,000 to \$75,000 in revenue over the course of the upcoming fiscal year by postponing the currently scheduled tax increase. However, this estimated reduction in revenue could potentially be mitigated based upon several factors, including the specific future opening dates of the other cannabis businesses, and the potential for slightly increased sales volume that could be

generated throughout the City because of a lower-tax environment for the cannabis industry.

Attachment(s) to Staff Report

- Resolution establishing the proposed medical cannabis tax rate

PREPARED BY: Eric Engelbart, Deputy City Manager, City Manager's Office