



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Julia H. Cooper

SUBJECT: SEE BELOW

DATE: January 2, 2019

Approved

D. D. SyL

Date

1/3/19

SUBJECT: PROPOSED AMENDMENT TO CHAPTER 4.66 OF THE SAN JOSÉ MUNICIPAL CODE TO ESTABLISH A TIERED MARIJUANA BUSINESS TAX RATE STRUCTURE FOR THE VARIOUS CATEGORIES OF MARIJUANA BUSINESSES

RECOMMENDATION

Direct the City Manager and City Attorney to return to the City Council before June 30, 2019 with an ordinance amending Chapter 4.66 of the San José Municipal Code to implement a revised Marijuana Business Tax rate structure to reduce the tax rate for the cultivation, manufacturing, testing, and distribution of cannabis.

OUTCOME

With Council direction, the Administration will work with the City Attorney to draft a proposed ordinance reducing the Marijuana Business Tax rates for certain cannabis businesses engaged in the cultivation, manufacturing, testing, and distribution of cannabis and would return to City Council for action before the end of 2018-2019.

BACKGROUND

On November 2, 2010, San José voters approved Measure U, allowing the City of San José ("City") to tax all cannabis businesses (medical and non-medical; legal and illegal) at a rate of up to 10% of gross receipts. On December 13, 2010, City Council approved Ordinance 28867 which created and set the Marijuana Business Tax ("MBT") rate at 7%, effective March 1, 2011. On June 4, 2013, City Council approved Ordinance 29262 to increase the MBT rate to 10%, effective July 1, 2013. The City's MBT rate has remained at 10% since July 1, 2013. Per the San José Municipal Code ("Code"), any person engaged in cannabis business of any kind in the City is required to prepare a MBT return to the Director of Finance identifying the total gross

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receipts, the amount of MBT (10% of gross receipts) owed, and payment of the MBT for the tax period.

While the maximum tax rate allowed under the Code and approved by the voters of San José is 10% of gross receipts, the Code gives City Council discretion to set a lower tax rate for all cannabis businesses or to establish different tax rates (up to 10%) for different categories of cannabis businesses.

The payment of the MBT and its acceptance by the City does not entitle any person to conduct any cannabis business unless the person has complied with all of the requirements of the Code and all other applicable laws. Additionally, it does not entitle any person to conduct any cannabis business in any building or premises situated in a zone or area that is a violation of any law. No tax paid under the provisions the Code shall be construed as authorization of any illegal or unlawful business or any business in violation of any ordinance of the City.

Nothing contained in Chapter 4.66 of the Code repeals, amends, replaces or in any way affects any requirements for any license or permit required by any other Title or Chapter of the Code nor in any way affects any tax, fee, or other charge imposed, assessed, or required by the Code, including the general business tax imposed by Chapter 4.76.

In November 2016, California voters passed the Adult Use of Marijuana Act, or Proposition 64, which made legal in California personal non-medical cannabis consumption and required commercial cannabis businesses to obtain State of California licenses for commercial cannabis activities that include: cultivation, manufacturing, distribution, processing, storing, laboratory testing, packaging, labeling, transporting, delivery, or sale of cannabis and cannabis products. The State of California began issuing these licenses on January 1, 2018.

The taxation applicable to cannabis in the City is as follows:

State of California Cultivation Tax¹

\$9.25 per dry-weight ounce of cannabis flowers,
\$2.75 per dry-weight ounce of cannabis leaves, and
\$1.29 per ounce of fresh cannabis plant.

State of California Excise Tax

15% applied to retail or wholesale prices, depending on the transaction.

¹ U.S. Spot Index average price per pound, as of November 30, 2018, was \$1,091 ("Weekly Report." Cannabis Benchmarks, 8 November 2018, <https://reports.cannabisbenchmarks.com/>). At the average price per pound, the above rates applicable to cultivation would be 13.6%, 4.0%, and 1.9% respectively.

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Sales Tax²

9.25% applied to the sale price.

City of San Jose MBT

10% applied to gross receipts as defined in Chapter 4.66 of the Code.

The State of California Medical Marijuana Program allows counties within the State to issue patients a Medical Marijuana Identification Card (“MMIC”). A MMIC is available to patients with chronic illnesses or medial conditions that warrant the use of medical cannabis for treatment. The requirements to qualify for a MMIC include written documentation from a licensed physician verifying the need for medical cannabis to treat the medical condition, proof of residency, and an annual payment of \$100, or \$50 if a Medi-Cal beneficiary. When cannabis is purchased by a MMIC cardholder, the transaction is exempt from Sales Tax, however the City’s MBT remains applicable. Additionally, the State’s Cultivation Tax and Excise Tax is imposed to the product through the supply chain prior to the product’s final sale as medical cannabis. With the City’s current sales tax rate of 9.25%, a MMIC cardholder would need to purchase approximately \$1,081, or \$541 if a Medi-Cal beneficiary, of medical cannabis to realize an actual monetary savings by possessing the MMIC. The Finance Department performed polling of the City’s registered cannabis businesses and determined that less than 1% of cannabis purchased in the City is done so by MMIC cardholders.

ANALYSIS

The City’s MBT is an excise tax imposed on all persons, broadly defined, engaged in cannabis business activity in the City including, but not limited to, the planting, cultivation, harvesting, transporting, manufacturing, compounding, converting, processing, preparing, storing, packaging, wholesale, and/or retail sales of cannabis and any ancillary products, medical and non-medical. Currently, the City has 16 cannabis businesses that are registered and approved to operate within the City under Chapter 6.88 of the Code.

The below table reflects the adopted budget as well as historical revenue generated from the MBT (in millions).

	<u>FY 2016-17</u>	<u>FY 2017-18</u>	<u>FY 2018-19</u>
Adopted Budget	\$7.2	\$9.4	\$13.5
Actual	\$10.5	\$13.0	N/A

The figures for 2016-2017 are for sales of medical cannabis primarily by the 16 registered City cannabis businesses. The figures for 2017-2018 are a combination of medical cannabis only

² Sales and Use Tax within the City of San Jose is 9.25%. The percentage distribution is as follows: State of California (5.500%), Santa Clara County (0.875%), Santa Clara Valley Transportation Agency (1.125%), and Public Safety Fund (0.500%), and City of San Jose (1.250%).

(July 1, 2017-December 31, 2017) and medical and non-medical cannabis (January 1, 2018-June 30, 2018) sales. With the passage of Proposition 64, the sale of non-medical cannabis at the 16 registered cannabis businesses began in January 2018. The majority of the City's MBT collected in 2017-2018 was derived from retail and delivery sales.

The passage of Proposition 64, in addition to legalizing in California the non-medical use of cannabis by persons 21 years of age or older, set State rules for personal non-medical cannabis plant cultivation, and decriminalized non-medical cannabis commercial business activity that takes place through the industry supply chain, such as commercial cultivation, manufacturing, testing, and distribution. A brief description is provided below of commercial cannabis business activities and the status of such activities in the City.

Cultivation

Cultivation is the process of, but not limited to, planting, growing, harvesting, drying, curing, grading, or trimming cannabis. The City currently does not permit commercial cannabis cultivation other than by the City's 16 registered cannabis businesses.

Manufacturing

Manufacturing is the process of producing or preparing cannabis or cannabis products including the labeling, relabeling, packaging, or repackaging of cannabis or cannabis products. The City currently does not permit commercial cannabis manufacturing outside of the City's 16 registered cannabis businesses, however, Item 4.1 (a) and (b) on the City Council agenda proposes a land use and regulatory framework for this use.

Laboratory Testing

Laboratory testing is the process of testing cannabis for potency and harmful substances, such as pesticides, mold, and bacteria. The City currently does not have land use or regulatory categories for cannabis laboratory testing, however, Item 4.1 (a) and (b) on the City Council agenda proposes a land use and regulatory framework for this use.

Distribution

A cannabis distributor procures, sells, and/or transports cannabis between other cannabis businesses, such as cultivators, manufacturers, or retailers. Distribution does not include delivery to customers. Some cannabis distribution currently takes place as wholesale transactions from the City's 16 registered cannabis businesses. Item 4.1 (a) and (b) on the City Council agenda proposes a land use and regulatory framework for cannabis distribution.

Retail Sales

A cannabis retailer sells cannabis or cannabis products directly to a consumer. Retail sales are currently permitted at the storefronts of the City's 16 registered cannabis businesses, as authorized under Title 6 of the Code. The MBT is 10% of gross receipts as defined in Chapter 4.66 of the Code.

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Delivery Sales

Cannabis delivery sales, similar to retail sales, are cannabis sales delivered directly to a consumer. Delivery sales are currently permitted from the City's 16 registered cannabis businesses approved under Title 6 who that have achieved registration to make deliveries. The MBT is 10% of gross receipts as defined in Chapter 4.66 of the Code.

The City's current MBT rate is set at 10% of gross receipts for all cannabis business activities as defined in Chapter 4.66 of the Code that take place within the City. Thus, if the City were to expand regulations to allow more cannabis business activity within the City, the gross receipts generated from the additional cannabis business activity in the City would be subject to the City's existing MBT rate, which is 10%.

Staff has reviewed cannabis taxation trends across the State. In many cities, commercial cannabis business activities are taxed at a lower rate than the final, retail activity. A reduced or tiered tax rate structure for cannabis manufacturing, distribution, cultivation, and laboratory testing would provide for differing tax rates at different points in the product supply chain and make the City competitive with other large California cities and neighboring jurisdictions.

Below are the current and recommended MBT rates for differing categories of cannabis business activity:

<u>Marijuana Transaction</u>	<u>Current Rate</u>	<u>Recommended Rate</u>
Cultivation	10%	4%
Laboratory Testing	10%	0%
Manufacturing	10%	3%
Distribution	10%	2%
Retail / Delivery Sales	10%	10%

For the past few years, San José has been the only jurisdiction in Santa Clara County to provide for the legal transfer/sale of medical (and since 2018, non-medical) cannabis. However, with the passage of Proposition 64, neighboring jurisdictions have enacted their own local legislation, opening the door for the sale of medical and non-medical cannabis in these communities. Within Santa Clara County, the cities of Morgan Hill, Mountain View, and Santa Clara all placed cannabis tax measures on the November 6, 2018 ballot and obtained voter approval.

Additionally, the City of Campbell has a moratorium on cannabis sales through April 1, 2019, but is expected to allow cannabis sales after the moratorium expires. The remaining cities in Santa Clara County do not allow the operation of cannabis businesses. The expansion of cannabis businesses to new jurisdictions in Santa Clara County may lead to a reduction in gross sales receipts at businesses operating in the City as there will be alternative options for purchasing cannabis products.

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Below is the comparative tax rate analysis for cities within Santa Clara County.

Jurisdiction	Cultivation	Manufacturing	Testing	Distribution	Retail / Delivery
San José (Current)	10%	10%	10%	10%	10%
San José (Proposed)	4%	3%	0% ³	2%	10%
<i>Neighboring Santa Clara County Cities</i>					
Morgan Hill	Varies by Sq. Ft. (~3%)	4%	2%	4%	6%
Mountain View	9%	9%	9%	9%	9%
Santa Clara	5%	5%	3%	3%	5%
Campbell ⁴	7%	7%	7%	7%	7%

Below is the comparative tax rate analysis for select Northern California cities.

Jurisdiction	Cultivation	Manufacturing	Testing	Distribution	Retail / Delivery
San José (Current)	10%	10%	10%	10%	10%
San José (Proposed)	4%	3%	0%	2%	10%
<i>Other Northern California Cities⁵</i>					
Berkeley: non-medical	5%	5%	5%	5%	5%
medical	2.5%	2.5%	2.5%	2.5%	2.5%
Oakland: non-medical	10%	10%	10%	10%	10%
medical	5%	5%	5%	5%	5%
Sacramento	4%	4%	4%	4%	4%
Santa Cruz	8%	8%	1%	2%	8%

³ Although the proposed MBT rate for Testing is 0%, these businesses will remain subject to the General Business Tax imposed under Chapter 4.76 of the SJMC.

⁴ Moratorium on cannabis sales in the city until April 1, 2019; rate would be 7%.

⁵ The City and County of San Francisco is excluded from the above table because their rate structure is much different from other jurisdictions. Currently, cannabis businesses are treated like any other business and required to pay the general business tax, based on gross receipts. In the future, a separate cannabis tax will be added to cannabis businesses. On November 6, 2018, voters approved a Cannabis Tax in the City and County of San Francisco via Proposition D, which imposes tax on gross receipts at rates of 1% or 1.5% for non-retail/delivery cannabis business sales and 2.5% or 5% for retail/delivery cannabis business sales. In both non-retail/delivery and retail/delivery scenarios, the lower of the two rates is to be imposed on gross receipts of \$500,001-\$1,000,000 and the higher of the two rates is to be imposed on gross receipts over \$1,000,000. The implementation date of this cannabis tax is January 1, 2021.

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Staff developed the proposed San José MBT tiered tax rates after a comparative analysis of the enacted and anticipated cannabis tax rates from other jurisdictions in Santa Clara County and Northern California. The recommended rates were set strategically to allow the City to provide a competitive tax environment should Council decide to approve commercial cannabis manufacturing, distribution, and laboratory testing.

Staff is recommending that the MBT rate for testing laboratories be set at 0%. These businesses are required under State law to be independent from any other cannabis licensee and provide a valuable role in ensuring the safety of the cannabis supply chain.

EVALUATION AND FOLLOW-UP

Revenues recognized from the MBT will be reported to the Public Safety, Finance and Strategic Support Committee as part of the Bi-Monthly Financial Report. If the recommendation for a tiered MBT structure is approved by Council, staff will return with an ordinance in 2018-2019.

POLICY ALTERNATIVES

Alternative #1: City Council does not elect to approve the recommended tiered MBT rate structures discussed in this memorandum.

Pros: The City's MBT rate would remain unchanged at 10% which is higher than the proposed new rates for the respective commercial cannabis business activities.

Cons: The City's MBT for commercial cannabis activities will be higher than neighboring jurisdictions and will likely deter commercial cannabis businesses from choosing to establish operations within the City.

Reason for not recommending: The current MBT rate has been imposed on all cannabis business activities since July 1, 2013. Maintaining a single rate structure, applicable at 10%, would likely deter commercial cannabis businesses from establishing operations within the City.

Alternative #2: Establishment of a reduced delivery/retail MBT rate for medical marijuana.

Pros: A MBT rate lower than 10% would be determined for MMIC cardholders.

Cons: The City's MBT rate structure would be more complicated and administratively burdensome for City staff and cannabis businesses to collect and maintain this information for a small consumer base. This could also lead to lower MBT revenue should MMIC cardholder spending increase in the City.

Reason for not recommending: MMIC cardholders benefit from cost-saving through Sales Tax exemption and, in some instances, receive discounted prices from retailers. Since the passage of Proposition 64, few patients have chosen to obtain the MMIC and are, instead, purchasing cannabis without indicating that they are patients.

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PUBLIC OUTREACH

At the May 21, 2018 community meeting regarding the proposed Zoning Code changes and cannabis business category expansion, comments were made related to the rate at which cannabis is taxed at the state and municipal levels. Since the inception of the cannabis program, staff has consistently heard such concerns, including a desire from the industry that MBT rates be differentiated for wholesale operations and retail sales.

This memorandum will be posted to the City's website for the January 15, 2019 Council meeting.

COORDINATION

This report has been coordinated with the Police Department, the Planning, Building, and Code Enforcement Department, the City Manager's Budget Office, and the City Attorney's Office.

COMMISSION COORDINATION/INPUT

This item does not require any input from a board or commission.

COST SUMMARY/IMPLICATIONS

Over time, as more neighboring cities allow retail sales of cannabis, the City may experience declining MBT revenue.

In order to be more competitive with neighboring cities, staff recommends reducing the City's current MBT for certain cannabis businesses as discussed herein.

CEQA

Not a Project, File No. PP17-007, Preliminary direction to staff and eventual action requires approval from decision-making body.

/s/

JULIA H. COOPER
Director of Finance

For questions, please contact Rick Bruneau, Deputy Director of Finance, at (408) 535-8310.