County of Sonoma
Agenda Item
Summary Report

APPROVED

JUN 06 2017

Clerk of the Board
575 Administration Drive
Santa Rosa, CA 95403

Agenda Item Number: 33
(This Section for use by Clerk of the Board Only.)

	AYE	NO
GORIN	✓	
RABBITT	✓	
ZANE	✓	
GORE	✓	
HOPKINS	✓	

THE WITHIN INSTRUMENT IS A CORRECT COPY OF THE ORIGINAL ON FILE IN THIS OFFICE

ATTEST: JUN 07 2017

SHERYL BRATTON, Clerk/Secretary
BY [redacted]
DEPUTY CLERK/ASST. SECRETARY

To: Board of Supervisors

Board Agenda Date: June 6, 2017

Vote Requirement: Majority

Department or Agency Name(s): County Administrator's Office
Auditor-Controller-Treasurer-Tax Collector

Staff Name and Phone Number:

Rebecca Wachsberg 707-565-3782
Sita Kuteira 707-565-3771

Supervisorial District(s):

Title: Cannabis Business Tax Ordinance

Recommended Actions:

Conduct a public hearing and consider whether to adopt a Resolution introducing, reading the title, and waiving further reading of a proposed ordinance amending Chapter 35 of the Sonoma County Code to adopt cannabis business tax rates and regulations (First Reading).

Executive Summary:

On May 23, 2017, the Board conducted a Study Session to consider policy options for various aspects of the Cannabis Business Tax Ordinance. The recommended ordinance reflects direction from the Board and feedback from the public provided during the study session, including: decreasing rates for medium cultivators and manufacturers, increasing rates for cottage cultivators, adding an initial tax rate for dispensaries, capping rates for a period of two years while providing an option to change the cultivation tax to a gross receipts basis, changing tax payment timing for outdoor cultivators, and taxing during the transition period.

Discussion:

Sonoma County Cannabis Business Tax

In December 2016, the Board adopted a series of ordinances establishing a comprehensive local program for the medical cannabis industry, including the Cannabis Business Tax. The Cannabis Business Tax (Measure A) was passed by voters in the March 7, 2017, special election with 71% voter approval. Measure A laid out a framework for taxation that set maximum allowable rates for all operator types and granted authority to the County to, among other things, set lower rates, tax certain operator types, and establish various tax administration policies.

On May 23, 2017, the Board conducted a tax policy Study Session, and examined a number of policy options related to taxation points, initial rates, rate locks or caps, payment timing, and transition period taxation. The following direction was given to staff, and is reflected in the attached ordinance being considered:

Summary of Recommendations
The recommendations discussed in this staff report are as follows:

1. Setting a 2% tax on gross receipts for medical cannabis dispensaries;
2. Decreasing the square footage tax rate for medium cultivators – outdoor from \$3.50 to \$2.00, indoor from \$18.75 to \$11.25, and mixed-light from \$10.80 to \$6.50;
3. Decreasing the manufacturing tax on gross receipts from 5% to 3%;
4. Capping initial rates until at least July 1, 2019;
5. Adjusting the payment timing for outdoor cultivators to account for the seasonal nature of the crop by prorating all tax liability among fiscal quarters two, three, and four; and
6. Taxing all businesses in operation during the transition period.

Additionally, there was significant feedback from both the Board and the public regarding the benefits and challenges associated with square footage tax rates versus gross receipts tax rates for cultivators. While the square footage rate has been recommended based on ease of administration in the absence of a comprehensive track and trace system, staff and the Ad Hoc recognize the value of taxation based on gross receipts if such a system was in place. Therefore, the ordinance was amended to give the Board the ability to change the cultivation tax from a square footage basis to a gross receipts basis during the initial two-year rate cap period, with caps on the percentage of gross receipts provided as an alternative to the initial square footage taxation rates.

The County recognizes that it is beneficial to all residents to set tax rates and policies that incentivize compliance and do not unduly burden the industry. In order to begin implementing the tax ordinance, several policies must be established and some may be reconsidered in order to maximize compliance and the success of the Sonoma County Cannabis Program. In order to gain tax implementation feedback, staff held a town hall meeting, a number of individual and small group meetings, and elicited feedback via a community survey on initial rates, different rate structures, procedures for evaluating and changing rates, and revenue expenditures, among other issues.

The following provides more detail on each of the areas considered during the Study Session, and the direction given to staff:

Taxation Points
Measure A set initial tax rates for cultivation and manufacturing, while rates for all other operators were set at 0%. Cultivation was chosen as a taxation point because Sonoma County is a producing county; as a county we grow far more cannabis than is sold or consumed locally. Additionally, most of the industry impacts addressed by the county are related to cultivation (crime, environmental damage, etc.). Manufacturing was also chosen because this is a point in the supply chain where there is a value added to the cannabis product, making additional taxation appropriate. Overall, the taxation points were limited for administrative feasibility and to prevent a significant cumulative supply chain impact.

In the tax survey, cultivation and manufacturing placed second and third among survey respondents for most appropriate taxation points. Dispensaries and retail sales locations placed first among survey respondents, who cited high retail profits and transparency as key reasons. Because the County consumes less cannabis than it produces and even less of that consumption is from a dispensary purchase, it would be difficult to only tax at this point in the supply chain and make up for taxes lost on cultivation and manufacturing. However, if this taxation point is added, it could relieve pressure on profits for operators earlier in the supply chain, allowing the County to tax cultivation and manufacturing at a lower rate. Additional reasons for taxing dispensaries are that dispensaries have been regulated longer and those operating will not be incurring as much startup costs, taxes will likely be easier to collect and enforce, and a tax here would make up for the fact that under Proposition 64 medical cannabis was exempted from the standard State sales and use tax that is shared with the local jurisdiction. Additionally, these revenues would be more predictable as operating dispensaries and their sales are known. Sales tax records indicate that sales for dispensaries in the unincorporated area was $22.5 million in 2016. Assuming these sales continue, a 2% local sales tax rate would yield revenues of $450,000.

Board direction: The Board directed staff to begin taxing cultivation, manufacturing, and dispensaries.

Initial Rates

From the survey and direct feedback from operators, there is concern that while most of the proposed initial rates are reasonable, some of the higher rates are prohibitive. It has also been noted that too steep of a progressive curve may incentivize operators to figure out ways around the rate structure, such as incorporating several different companies. Enforcing against this behavior may be difficult, however, large land use fines would apply and help to disincentivize this behavior. In general, those surveyed were in favor of the progressive rate structure that supports smaller growers, so long as the progression was not too steep. To even out this curve, the highest tax rate may be decreased and/or the lowest tax rate may be increased. This would also decrease the incentive to game the system through innovative business structures. In the table below, the medium operator (up to 1 acre for outdoor and 22,000 sq. ft. for indoor and mixed-light) cultivation rates, which were developed to equate to 5% of gross receipts, have been reduced to the per square foot rate that is intended to equate to 3% and is equal to the lower tier paid by small cultivators (5001 – 10,000 sq. ft.). Additionally, the cottage rate has been increased from the square footage rate equal to 0.5% to the rate equal to 1% of gross receipts. Another comment from the survey was that the cultivation rate structure was too complicated, these changes would help to address this issue while still meeting the intended policy goals.

Operator	Maximum Rate	Current Starting Rate	Recommended Starting Rate
Outdoor cultivator			
Cottage (1C) 25 plants	$10/sq. ft. or 10%	$0.50	***$1.00***
Specialty (1) 5,000 sq. ft.		$1.40	$1.50
Small (2) 10,000 sq. ft.		$2.10	$2.00
Medium (3) 1 acre		$3.50	***$2.00***
Indoor Cultivator			
Cottage (1C) 500 sq. ft.	$38/sq. ft. or 10%	$1.88	***$3.75***
Specialty (1) 5,000 sq. ft.		$7.50	$7.50
Small (2) 10,000 sq. ft.		$11.25	$11.25
Medium (3) 22,000 sq. ft.		$18.75	***$11.25***
Mixed-light Cultivator			

Cottage (1C) 2,500 sq. ft.	$22/sq. ft. or 10%	$1.08	***$2.25***
Specialty (1) 5,000 sq. ft.		$4.32	$4.50
Small (2) 10,000 sq. ft.		$6.48	$6.50
Medium (3) 22,000 sq. ft.		$10.80	***$6.50***
Manufacturing	10%	5%	***3%***
Dispensaries	10%	0%	***2%***
Nurseries, Distributors, Labs, Transporters	10%	0%	0%

Decreasing some of these rates makes the County more competitive with neighboring jurisdictions. Those actual rates are as follows:

Jurisdiction	**Cultivation**	**Manufacturing**	**Dispensaries**
Santa Rosa	2%	1%	3% (nonmedical)
Mendocino	2.5%	$2,500	2.5%
Humboldt	$1, $2, $3	-	-
Santa Cruz	7%	-	7%
Monterey	$15 (indoor)	5%	5%

For purposes of comparison, normalized rates shown as a percent of gross sales are as follows:

Jurisdiction	**Cultivation**	**Manufacturing**	**Dispensaries**
Sonoma County (current)	1% - 5%	5%	0%
Sonoma County (recommended)	1% - 3%	3%	2%
Santa Rosa	2%	1%	0% (medical) 3% (nonmedical)
Mendocino	2.5%	< 1%	2.5%
Humboldt	1%	-	-
Santa Cruz	7%	-	7%
Monterey	4%	5%	5%

Board direction: The Board directed staff to decrease the highest taxation rates for cultivation and manufacturing, increase the lowest taxation rate for cultivation, and add a tax on dispensaries consistent with the recommended starting rates proposed above.

Additional recommendation: There was considerable feedback that a gross receipts tax for cultivation would be preferred over a square footage tax as it more fairly captures tax revenue that is proportionate to their own revenues. To balance that with the sizable concern regarding enforceability, the Board directed staff to move forward with a square footage tax until a track and trace system is in place that allows the County to adequately track cannabis production to ensure accurate gross receipts reporting. Based on this feedback and direction, a provision was added to the recommended Ordinance that would allow the Board of Supervisors to change the cultivation tax to a gross receipts tax prior to July 1, 2019, so long as the rates for each cultivation license type do not exceed the following:

Cultivator Type	Max. Gross Receipts Tax Rate
Cottage	1%
Specialty	2%
Small	3%
Medium	3%

Rate Lock or Cap

Pursuant to the Ordinance, the Board has the authority to change rates by ordinance at any time. However, operators and investors have requested certainty with regards to taxation rates in order to calculate their return on investment and justify the upfront costs of improvements, equipment, land, and permits. A method employed by other jurisdictions is locking in or capping the rates for a certain period of time. It is recommended here that the Board cap rates for two years. Two years provides both some certainty as well as flexibility to adjust once we have sufficient local market data. One year would not provide much certainty and it would be difficult to gather and analyze enough data during that time to justify rate changes. Longer than two years would provide more certainty for the industry but limit the Board's ability to be responsive to local market conditions. Rates could be locked so that they cannot be increased and/or decreased during that time. Disallowing rate increases provides certainty for the industry, while disallowing rate decreases may allow the County sufficient time to evaluate the effect of certain tax rates without prematurely being pressured to decrease rates. However, removing the opportunity to decrease rates significantly limits flexibility that may be required to bring the industry into compliance with the new Program.

Other jurisdictions have included similar policies to increase rate certainty for the industry. Santa Rosa's tax measure that will be voted on in June proposes to lock in rates for periods of two years; Mendocino County's ordinance locks their initial 2.5% rate until July 1, 2020; and Monterey County's ordinance locks in their initial rate of $15 per square foot through June 30, 2020. Mendocino and Monterey then have set amounts the rate will or can increase per year following that, which is another policy that could be considered. The proposal here only entails locking in rates for the first two years (July 1, 2017 to July 1, 2019), while leaving the issue of future rate changes to be discussed by the Advisory Group and the Ad Hoc in more detail.

Board direction: The Board directed staff to cap the initial rates for two years, allowing rate decreases but no rate increases until July 1, 2019. As noted above, the Board would still be allowed to change the cultivation tax from square feet to gross receipts, so long as the rates do not exceed those listed above.

Payment Timing

The Ordinance states that operators shall file and pay due taxes at least quarterly. Concern has been raised regarding outdoor cultivators because the product is not harvested until Q2 of the fiscal year. Having taxes due in Q1 would require businesses to pay taxes before they have received revenue for the year, which is fiscally difficult for businesses and may decrease compliance. Staff recommends that for outdoor cultivators only, the Q1 tax requirement be a zero filing, with all tax liability being spread among the remaining three quarters. This raises concerns regarding cultivators' ability to harvest a crop and dismantle a grow operation and evade taxes entirely. However, the operators that are likely to do that are not the same operators that will be applying for permits and complying with other parts of the Program. Operations that will seek to avoid taxes are likely to do so regardless of the due dates for tax payments.

Few jurisdictions allow outdoor cultivation *and* have a per square foot tax, so there are not many examples on how to handle the concern presented by these policies. In Humboldt County, taxes are collected biannually by ordinance, at Q2 and Q4, mitigating the concern. Other ordinances that would require payments in Q1 have not been tested, and most contain a clause that would give them the authority to adjust payment timing to facilitate tax collection.

Lastly, note that taxes for all other operators in the County would be due quarterly, though operators would have the option of paying more frequently and the Tax Collector could require a more frequent schedule of payments as well.

Board direction: The Board directed staff to require that taxes be due quarterly for all operators except outdoor cultivators, for which taxes will be due only in Q2, Q3, and Q4.

Transition Period Taxation

In general, operators will not be allowed to operate, and thus not be liable for taxes, until their permits are issued. During the transition period included in the Land Use Ordinance and the Code Enforcement Temporary Penalty Relief Program adopted May 23, 2017, however, operators will be allowed to continue operating while permits are being processed or during the time they have to come into compliance with the ordinance. The policy consideration in favor of taxing all these businesses is that if they are operating and generating revenue they should be taxed. One concern is that businesses may be liable for taxes and then have their permit denied, forcing them to incur additional costs to move or modify their businesses. This would be a risk of operating before a permit is finalized. However, a mitigating factor is if the permit was denied and the operation ceased, they would no longer be liable for taxes as of that date.

Another concern is that this subjects farmers in rural residential or on other non-permit-eligible parcels to tax liability, even though they must close down their farm and find another location. Same as above, these farmers would not be liable for taxes as soon as they cease operations. Also, not taxing these operators would put those applying for permits and paying taxes at a great disadvantage. Lastly, some cultivation operations on rural residential parcels are multiple acres in size, and not just small mom-and-pop businesses. Exempting these operations from taxes for this season would be counter to the policy goal and detrimental to revenues.

Additionally, staff recommends that permit approval be subject to the operator being current on its tax payments. If the operator has not paid taxes due, the permit (either on that property or another that the operator has) *shall not* be approved.

Board direction: The Board directed staff to include a provision that all existing and current operators under the transition period be liable for taxes based on the permit size that the operator would fall into.

Prior Board Actions:
May 23, 2017: Study Session providing direction for the recommended tax ordinance. April 11, 2017: Approval of staffing and budgetary adjustments to implement the Cannabis Program, adoption of the 2017 Cannabis Ad Hoc Committee Charter, and approval of the Advisory Group Selection and Work Plan. December 20, 2016: Final adoption of Cannabis Land Use Ordinance. December 13, 2016: Final adoption of Cannabis Business Tax Ordinance and Cannabis Health Ordinance. December 6, 2016: Calling the March Special Election for the Cannabis Business Tax Ordinance.
Strategic Plan Alignment Goal 1: Safe, Healthy, and Caring Community
Adopting the Cannabis Business Tax Ordinance will encourage compliance with the Cannabis Program, which supports the County's Strategic Plan goals by enabling permitting, regulation, and taxation of cannabis operations to maintain the health and safety of our communities, protect our environmental resources, and promote positive economic activity.

Fiscal Summary

Expenditures	**FY 16-17 Adopted**	**FY 17-18 Projected**	**FY 18-19 Projected**
Budgeted Expenses			
Additional Appropriation Requested			
Total Expenditures			
Funding Sources			
General Fund/WA GF		$3.94 million	
State/Federal			
Fees/Other			
Use of Fund Balance			
Contingencies			
Total Sources		**$3.94 million**	

Narrative Explanation of Fiscal Impacts:
There are no expenditures associated with this item. The current tax rates set by Measure A would generate an estimated $3.77 million in FY 17-18. With the changes recommended in this item, total Cannabis Business Tax revenue would increase to an estimated $3.94 million, a difference of $170,000. Decreased tax rates for medium cultivators and manufacturers are expected to be partially offset by increased compliance, with the remainder of the difference due to the addition of the dispensary tax.

Staffing Impacts

Position Title (Payroll Classification)	**Monthly Salary Range** (A – I Step)	**Additions** (Number)	**Deletions** (Number)

Narrative Explanation of Staffing Impacts (If Required):

Attachments:

Attachment A: Draft Board of Supervisors Resolution
Attachment B: Draft Cannabis Business Tax Ordinance

Related Items "On File" with the Clerk of the Board: