



COUNTY OF HUMBOLDT

For the meeting of: 3/26/2019

File #: 19-455

To: Board of Supervisors

From: County Administrative Office

Agenda Section: Time Certain Matter

SUBJECT:

11:00 a.m. - Potential Updates to the Commercial Cannabis Cultivation Taxation Process

RECOMMENDATION(S):

That the Board of Supervisors:

1. Receive the staff report regarding potential updates to the commercial cannabis cultivation taxation process, and take action as appropriate.

SOURCE OF FUNDING:

General Fund - Cannabis Excise Tax

DISCUSSION:

On December 18, 2018, your Board received a report from the Marijuana Ad Hoc Committee and directed staff to bring back options regarding potential modifications to the county's cannabis excise tax, including, without limitation, a possible amendment to land use permits and changes to the current billing cycles.

Background:

Legal Authority:

California Revenue and Taxation Code Section 31021.5 (formerly California Business and Professions Code Section 19348) allows counties to impose an excise tax, pursuant to existing law, on the privilege of cultivating, manufacturing, producing, processing, preparing, storing, providing, donating, selling or distributing cannabis or cannabis products. In addition, California Revenue and Taxation Code Section 7284 allows the board of supervisors of any county to impose a license tax upon each and every kind of lawful business transacted in the unincorporated areas of the county.

Development and Approval of the Commercial Cannabis Cultivation Taxation Process:

In April 2016, Fairbank, Maslin, Maullin, Metz & Associates conducted a survey of likely voters in order to gain insight on the probability of a cannabis excise tax passing, and to gauge the priorities expressed by the citizens of Humboldt County. The highlights of that polling are as follows:

- 79 percent of those polled said there was a “great need” or “some need” for more local funding.
- Three-quarters of those polled supported a commercial cannabis cultivation tax measure.
- Respondents supported higher taxes for large cultivation areas, as well as indoor and mixed light cultivation sites.
- A broad range of spending was supported for environmental cleanup, children’s services, law enforcement and road repairs.

On June 28, 2016, your Board directed staff to prepare, for voter approval, an ordinance which authorized the imposition of a cannabis excise tax with taxation rates based on the square footage of permitted cultivation areas for commercial cannabis operations. This methodology was selected over a gross receipts tax primarily for the simplicity of monitoring and calculating the amount of taxes due. County agencies are not generally equipped to track sales for individual businesses; this is done more at the state and federal levels, and Humboldt County staff does not have a mechanism to track that information. Also, creating the ordinance as an excise tax for the privilege of cultivating cannabis based on square footage of permitted cultivation areas allowed for more clarity in terms of monitoring and calculating the amount of taxes due. In addition, your Board felt that a square footage calculation would incentivize the small outdoor farmer by providing those cultivators with the most cost-effective tax mechanism.

The tax rate structure that was originally proposed by staff on June 21, 2016 included rates that ranged from \$1 to \$6 per square foot of permitted cultivation area for outdoor and indoor commercial cannabis operations, respectively, with mixed light operations being the middle range. The tax rates, depending on type of cultivation, would gradually increase as the square footage of the permitted cultivation area increased. It should be noted that public opinion research done in the lead up to Measure S was based on rates ranging to \$12 per square foot. However, on June 28, 2016, your Board directed staff to replace the previously proposed rates with a more straightforward tax rate of \$1 per square foot for outdoor cultivation, \$2 per square foot for mixed light cultivation and \$3 per square foot for indoor cultivation, without a graduated increase as the square footage grew. This was a reduction of nearly 50 percent over the initial proposal.

The chart below compares the cost percentage of the cannabis excise tax as it relates to taxes on other products such as alcohol, cigarettes and timber. The excise tax percentage is based on estimated yields (per a 2013 study by Jonathan Caulkins, BOTEK Analysis, Carnegie Mellon University, which was contracted by the State of Washington, Liquor and Cannabis Board) and current estimated wholesale prices per pound (\$700 for outdoor, \$800 for mixed light, \$1,450 for indoor). The Caulkins study states that the average yield is 40 grams per square foot per harvest, while staff’s analysis cuts that number in half to take in to account ancillary space that is essential for production, but which is not itself harvested, such as space for seedlings and walkways.

Cannabis Excise Tax		2.28-3.78%
Timber Tax*		2.90%
Wine Tax**	\$0.20/Gallon	Varies
Alcohol Tax**	\$3.30/Gallon	Varies
Cigarette Tax**		16%

*California Dept of Tax and Fee Administration

**salestaxhandbook.com

On November 8, 2016, a local cannabis excise tax at a rate of \$1 per square foot for outdoor cultivation, \$2 per square foot for mixed-light cultivation and \$3 per square foot for indoor cultivation was approved by a majority vote of the people of Humboldt County with a voter approval rate of nearly 66 percent. The ballot language citizens voted upon stated that revenues generated by the cannabis excise tax could be used to maintain and improve essential services, including, without limitation, public safety; crime investigation and prosecution; environmental cleanup and restoration; children and family mental health; drug rehabilitation; job creation and other county services.

Previous Modifications to the Commercial Cannabis Cultivation Taxation Process:

On March 27, 2018, your Board amended certain sections of the Commercial Marijuana Cultivation Tax Ordinance and adopted administrative regulations related to the collection and remittance of cannabis excise taxes in order to accommodate the cannabis industry. The changes to the tax ordinance included: collecting the tax on a calendar year; a reduction in tax penalties for unpaid cultivation taxes; and authorization for the Treasurer-Tax Collector to waive or cancel penalties resulting from nonpayment where circumstances were beyond the tax payer's control. Your Board also directed staff to prepare an amendment to the Commercial Cannabis Land Use Ordinance which would allow cannabis farmers to reduce the square footage of their permitted cultivation area, when declared prior to the year in which cultivation will be decreased, in order to receive a reduced tax rate.

The Humboldt County Planning and Building Department currently allows for modifications to commercial cannabis cultivation permits through written request if received prior to the cultivation season, or as late as June for some cultivators. It should be noted that while reductions to cultivation square footage decreases revenue for the county, it increases the workload of Planning and Building staff, as well as Treasurer-Tax Collector staff who process cannabis excise tax bills. Planning and Building is attuned to the needs of cultivators and the various circumstances that may arise. The current structure allows the department to work with cultivators in meeting those various needs.

Local and State Support of the Cannabis Industry:

On November 13, 2018, your Board directed staff to return to the Board with a "...collective cannabis marketing and branding strategy and grant program for cannabis impacted communities." Your Board

subsequently approved “Project Trellis: The County of Humboldt Cannabis Micro-grant, Marketing, and Local Equity Program” on March 12, 2019. This program is broken down into the following parts:

- A micro-grant program aimed at providing capital assistance and business resources to Humboldt County cannabis businesses.
- A marketing and promotional campaign designed to promote Humboldt grown cannabis as a national and industry brand.
- A local equity program to serve those communities and individuals impacted by the war on drugs, which serves as part of the qualifying criteria to receive California Senate Bill 1294 (SB 1294) funding authorized by the Bureau of Cannabis Control.

The purpose of Project Trellis is, in part, to develop a framework for supportive programs designed to sustain and expand the cannabis industry within Humboldt County, to assist cannabis businesses as they work to overcome the financial and logistical challenges of coming into compliance with applicable legal requirements, and protect services provided by cannabis excise tax revenues by helping populations and communities in Humboldt County who were adversely affected by the criminalization of cannabis.

In addition, the State of California legislature has introduced California Assembly Bill 286, which, if passed, will temporarily reduce state excise taxes for legal cannabis businesses from 15 percent to 11 percent, and suspend state cultivation taxes altogether through 2022. This proposal is designed to promote the legal market and allow for those who have come into compliance to better compete with the illegal market. This is positive news for local cultivators as there has been concern expressed over the ability of farmers to comply with the mandated regulations.

Benefits of Local Commercial Cannabis Cultivation Taxation:

Since the approval of the cannabis excise tax, the county has received \$17.6 million in additional revenues. These revenues have made it possible to allocate \$1.6 million to children and family services, \$10.6 million to public safety and \$878,776 for job creation. In addition, the county has been able to make substantial contributions to Americans with Disabilities Act projects, deferred maintenance, Public Agency Retirement Services and public reserves.

Issues Pertaining to the Current Commercial Cannabis Cultivation Taxation Process:

Tax Methodology:

An excise tax, also known as selective sales or differential commodity tax, is levied for the sales of specific goods or services. Excise taxes are considered indirect taxes because they are not charged directly to an individual but rather are paid by the producer or seller of an item. Accordingly the county’s cannabis excise tax can be assessed on cultivation area, total production or gross receipts. Some local cannabis cultivators have expressed a desire to transition the current cannabis excise tax to a production-based methodology.

As noted above, your Board chose to base the county's cannabis excise tax on the square footage of permitted cultivation areas primarily for the simplicity of monitoring and calculating the amount of taxes due. A production-based tax methodology would have been largely contingent on the self-reporting of cannabis cultivator activities, which would require additional staff monitoring and potentially resulted in unpredictable tax payments due throughout the cultivation season. The county's track and trace program, which your Board on March 19 directed staff to end, was in a pilot stage during the time that Measure S went to the ballot. The program provided improved capabilities to track cannabis through the distribution chain, but at that point was not able to effectively track production for all cultivators to the degree that the county would be able to use it to administer a production-based tax. The program was still being developed at this point as staff and a limited number of cultivators worked to determine the types of information they could track, how it would be verified, and whether all cultivators would be required to use the program, among other issues. The state's track and trace program was not up and running at the time, and is still not being used by even a majority of local cultivators. In addition, while all state-licensed cultivators will eventually have to use the state's program, this program is suited to state needs and will not necessarily provide the tools the county needs to implement an effective production or gross receipts tax. Implementation of a production or gross receipts tax would require approval by a majority vote of the people of Humboldt County.

Mendocino County has established a 2.5 percent gross receipts excise tax with a required minimum due ranging from \$1,250 to \$5,000. On March 12, 2019, the Treasurer-Tax Collector (TTC) for Mendocino County reported to the Mendocino Board of Supervisors that only 40, or 4 percent, of an estimated 1,000 cultivators, reported they had sales that met the minimum requirement. The TTC also stated that the reporting mechanism was 100 percent self-reporting with no independent verification taking place. Approximately \$594,000 had been collected to date, with an additional \$3.5 million in additional bills being sent in order to meet the minimum tax requirement. It had previously been estimated that the cannabis industry in Mendocino County was close to \$1 billion, however the tax payments of \$594,000 are representative of a \$24 million industry.

Tax Rate Structure:

Concerns have also been expressed regarding the \$1 to \$3 tax rates that are currently being imposed on local commercial cannabis cultivation operations. Your Board is able to reduce these rates at any point in time; however, any proposed increases would require voter approval. Reductions to the current tax rate structure will significantly inhibit the county's ability to support the cannabis industry with programs such as Project Trellis, and provide for children's mental health services, job creation and public safety.

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Tax Billing Cycle:

The county's cannabis excise tax bills are generated by the Humboldt County Treasurer-Tax Collector's Office, and are similar to the property tax billing process. The bills are generated based on a calendar year with the first installment due in May and the second in November. Outdoor cultivators have expressed concern over this process as the majority of their expenditures take place at the beginning of the cultivation season, with revenues coming in after the harvest season. As a result, your Board may want to consider a single billing cycle that is due in February, after cultivators have

harvested the summer crop and cultivated for the entire calendar year.

Permit Effective Date:

Local commercial cannabis cultivators have expressed concerns over the effective date of commercial cannabis cultivation permits. Permits currently become effective on the date of issuance, which is also the date upon which the county's cannabis excise tax is imposed. Many applicants are unable to cultivate until they install infrastructure on the property, which may take several months. During this time, applicants are unable to cultivate, but are still responsible for paying excise taxes.

Crop Loss:

Many cultivators have also expressed concerns over crop loss since the county's cannabis excise tax would still be due regardless of the fruitfulness of a harvest. The federal government regulates crop insurance programs; currently there are no federal crop loss assistance programs that benefit cannabis producers. There is potential for cultivators to obtain private insurance; however, private crop insurance policies generally only cover losses from certain conditions including, without limitation, fire, weather-related impacts, theft or for damages to structures and crop production infrastructure. Losses caused by mold, disease or poor cultivation practices are generally not covered by crop insurance policies.

Potential Updates to the Commercial Cannabis Cultivation Taxation Process:

The following are options for your Board to consider when contemplating changes to the cannabis excise tax process:

- Submit a new ballot measure regarding the imposition of a production- or gross receipts-based tax. This option is not recommended since it will require additional work from staff and is highly contingent on self-reporting. The county does not currently have appropriate tools necessary for an effective production-based tax program. This option also requires voter approval, which creates the potential for a significant loss of needed revenues.
- Reduce the current tax rate structure of \$1 per square foot for outdoor cultivation, \$2 per square foot for mixed light cultivation and \$3 per square foot for indoor cultivation. A reduction to the current tax rates can be done without voter approval, however, if your Board wanted to increase the tax rate at any point in time in the future, that would require voter approval. This action is not recommended by staff as a reduction in cannabis excise tax revenues will significantly impact the county's ability to support the cannabis industry through Project Trellis, provide for children's mental health services, job creation and public safety. The voters of Humboldt County expressed a desire for the cannabis industry to be taxed and for those revenues to be utilized for these purposes.
- Modify the current billing cycle to allow cannabis excise taxes to be billed in January and due in February, in order to capture all approved permits for the entire calendar year.

This option should allow cultivators enough time after harvest to have been compensated for the sale of their crops. Selecting this option would cause the May and October bills to be sent out in January. Funds have been budgeted for the current fiscal year with the anticipation of this billing. As of March 21, 2019, \$10.6 million has been received in cannabis excise tax revenues, with \$17.7 million budgeted for fiscal year 2018-2019. Such a modification to the billing cycle would cause revenues to be approximately \$7.4 million less than budgeted. This reduction in cannabis excise tax revenues would have a significant impact on fund balance and budget development, leaving an estimated year-end fund balance of \$4 million as opposed to the \$11.4 million as reported in the Mid-Year Budget Review on February 26, 2019.

- Add Flexibility for modifying commercial cannabis cultivation permits. Adoption of the CCLUO (2.0) included a provision to allow cultivators to notify the Planning and Building Department that they would cultivate less than their total allowed square footage. This is the cultivation area reported by the Planning and Building Department for the annual excise tax calculation. The CCLUO requires this declaration be made by January 31 of each year. The CMMLUO (1.0) does not contain such a provision. In the light of the direction from the CCLUO, Planning and Building has allowed cultivators to declare a reduced cultivation area for their permits if received prior to the cultivation season. This has been accepted as late as June for some areas that are in the mountains and do not start cultivating until June or July. The Planning and Building Department expects to continue this practice as it allows cultivators to have some control over how much they cultivate and the corresponding excise tax responsibility. It would be beneficial to modify the CCLUO to grant this flexibility to 2.0 applications, and to legislate that this applies to the CMMLUO. This ordinance modification would not likely generate a great deal of controversy and can easily be undertaken. A consideration in setting a deadline date may be to correlate the cultivation declarations to the mailing of excise tax bills. This would set the declaration deadline at March 31 each year. Cultivators may view this date as too early in the season to know what the permitted cultivation area should be. As a result, your Board may want to consider allowing amendments through June 30 or even later. While the current practice could appear subjective it does allow decisions to be made based upon the unique circumstances such as cultivation in locations that are still covered in snow in March and April. It should be noted that any changes adopted by your Board to the cultivation declaration process may also influence the decision regarding modification of the current tax billing cycle.
- Take no action regarding potential updates to the current commercial cannabis cultivation taxation process.

FINANCIAL IMPACT:

Cannabis planning and code enforcement has generated \$8.7 million in revenues since fiscal year 2016-2017, with \$6.4 million in corresponding expenditures, leaving \$2.6 million for future permit processing and code enforcement activities. Cannabis excise tax bills of \$24.2 million have been generated since fiscal year 2016-2017, with \$17.8 million in tax payments received.

Moving to a single cannabis excise tax bill per calendar year will reduce current year revenues by an estimated \$7.4 million and push that revenue forward to be collected in fiscal year 2019-2020. Changes to the tax rate structure, as well as amendments to square footage of cultivation area, could have significant impacts on revenues and the county's ability to support the cannabis industry, provide for children's mental health services, job creation and public safety. Those impacts are unknown at this time. Consideration of a reduction of the current rate or moving to a production or gross receipts tax, would require significant analysis from staff and guidance from your Board on the parameter of those changes in order to evaluate the extent of those impacts.

OTHER AGENCY INVOLVEMENT:

N/A

ALTERNATIVES TO STAFF RECOMMENDATIONS:

Board discretion.

ATTACHMENTS:

N/A

PREVIOUS ACTION/REFERRAL:

Board Order No.: I-1, M-1, I-3, I-1, H-1, I-2, I-1

Meeting of: 6/21/16, 6/28/16, 3/27/18, 11/13/18, 12/18/18, 2/26/19, 3/12/19