

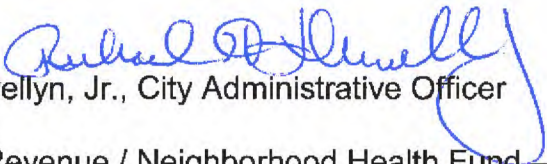
REPORT FROM

OFFICE OF THE CITY ADMINISTRATIVE OFFICER

Date: June 15, 2018

CAO File No. 0160-00323-0050
Council File No. 14-0366-S18
Council District: All

To: City Council

From: Richard H. Llewellyn, Jr., City Administrative Officer 

Reference: Cannabis Tax Revenue / Neighborhood Health Fund – Cannabis Reinvestment Act Special Tax Ballot Measure and Gross Receipts Tax Rate Reduction Ordinance (Motion 9A)

Subject: **PRELIMINARY FISCAL IMPACT OF PROPOSED SPECIAL CANNABIS GROSS RECEIPTS TAX AND GENERAL FUND CANNABIS GROSS RECEIPTS TAX RATE REDUCTION**

RECOMMENDATIONS

1. Instruct the Office of the City Administrative Officer to provide Council with an updated revenue impact analysis for the proposed ballot measure and tax reduction ordinance by August 14, 2018.

SUMMARY AND DISCUSSION

On June 5, 2018, the City Council adopted the Rules, Elections, and Intergovernmental Relations Committee Report, as amended by Motion 9A and Motion (Krekorian - Wesson), to include a special cannabis gross receipts tax ballot measure on the November 2018 ballot. The proposed tax rate is \$10 per \$1,000 of gross receipts (1 percent). The purpose of the special tax measure is to use the revenue derived from this special tax to fund a new Cannabis Reinvestment Trust Fund (CRTF), which will in turn provide funding for cannabis regulation, youth education, and public improvements (C.F. No. 14-0366-S18). Additionally, with the approval of the proposed measure by voters, an ordinance to reduce the existing cannabis gross receipts tax rates is proposed for subsequent implementation. The Office of the City Administrative Officer (CAO) was instructed to report back on the fiscal impact for the proposed special tax and corresponding gross receipts tax rate reduction.

It is important to note that due to the adoption of the new cannabis tax remittance schedule, the first quarterly payments for legalized cannabis businesses will not become due until July 2018. For this reason, there is no data to validate the current gross receipts tax revenue estimate assumed in the 2018-19 Adopted Budget for cannabis business activity or the estimated impacts for the proposed ballot measure and tax reduction. The Office of Finance reports that remittances for the first and second quarters will be recorded by the first week of August, at which point relevant data will be available for an analysis of general fund gross receipts tax revenue from cannabis businesses, and the projected impact to receipts from the special tax and proposed tax reduction. It is recommended that this Office be instructed to report back with a revised fiscal impact analysis by August 14, 2018.

Therefore, the following analysis should be viewed as a preliminary exercise to provide a potential order of magnitude impact from the proposed special tax measure and subsequent rate reduction.

Approximately \$40.2 million in gross receipts tax revenue from cannabis activity is assumed in the 2018-19 Adopted Budget. Of this amount, \$25.4 million represents projected ongoing receipts from recreational, medical, and miscellaneous cannabis business activities. Approval for a special cannabis tax of 1 percent is estimated to generate approximately \$4.37 million annually for the CRTF. The estimate, based on 2018-19 revenue assumptions, does not reflect the impact of annual growth. This estimate does not include projected tax revenue from cannabis management companies and event organizers or surcharge receipts from cannabis laboratory tests and tickets for cannabis events, as there is insufficient information to currently quantify these activities.

Subsequent to the approval of the special tax, a reduction to the existing cannabis gross receipt tax is proposed for implementation. The proposed reduction to existing cannabis gross receipts tax rates includes: a 2 percent reduction to the medical cannabis and recreational cannabis rates to be restored in 0.5 percent increments over four years; a 0.75 percent reduction to the distribution and testing laboratory rate to be restored in 0.25 percent increments over three years; and, a 1.5 percent reduction to the cultivation and manufacturing rate to be restored in 0.5 percent increments over three years. The tax rate on business activities that include the consumers' use of cannabis or cannabis products on the business premises will remain unchanged. The lower tax would be implemented on January 1, 2020 for the 2020 tax period and the reduction will be completely phased out by January 1, 2024 for the 2024 tax period, with tax receipts fully restored by fiscal year 2024-25.

The first full-year impact of reducing the existing cannabis gross receipts tax rate is \$8.28 million in decreased general fund revenue in fiscal year 2020-21. This impact lessens as existing rates are restored over three or four years, according to the type of cannabis business activity. The cumulative impact of the tax rate reduction, from the 2020 tax period to the 2024 tax period, is approximately \$21.7 million in reduced general fund revenue. Over the same period of time, the special cannabis tax is estimate to generate \$21.9 million in revenue for the CRTF (from fiscal year 2019-20 to fiscal year 2023-24). The estimates, based on 2018-19 revenue assumptions, do not reflect the impact of annual growth.

FINDINGS

The 2018-19 Adopted Budget assumes approximately \$30.2 million in general fund revenue from the gross receipts tax on recreational, medical and miscellaneous cannabis business activity, of which \$4.8 million is considered one-time revenue. An additional \$10 million in unidentified cannabis gross tax receipts is included in the Unappropriated Balance, equating to \$40.2 million in total cannabis gross receipts tax for fiscal year 2018-19. Of the \$40.2 million, \$25.4 million may be considered ongoing receipts from recreational, medical, and miscellaneous cannabis business activities. The \$25.4 million estimate is based on \$12 million in gross receipts tax revenue from medical marijuana activity recorded for the 2017 tax period, with additional revenue extrapolated for recreational cannabis sales and other miscellaneous business activity.

On June 5, 2018, the City Council requested the City Attorney to prepare an ordinance and resolution to place a special cannabis gross receipts tax ballot measure on the November 6, 2018

ballot. The City Attorney was also requested to prepare a second ordinance to reduce the existing cannabis gross receipts tax rates, contingent upon the approval of the special cannabis gross receipts tax by voters (C.F. No. 14-0366-S18).

The proposed ballot measure, known as the Cannabis Reinvestment Act, authorizes a special cannabis tax of \$10 per \$1,000 of gross receipts (1 percent) for all commercial cannabis activity currently subject to the existing cannabis gross receipts tax rate, and applies this same rate to cannabis management companies and event organizers. Additionally, the measure authorizes \$5 surcharges on tests conducted by a licensed commercial testing laboratory and on tickets sold for temporary cannabis events. The measure also creates a new Cannabis Reinvestment Trust Fund (CRTF) where the revenues derived from the special tax and surcharges will be deposited to fund cannabis regulation, youth education, and public improvements. The new tax would be effective on January 1, 2019 for the 2019 tax period, and first remittances will be realized during the final quarter of the 2018-19 fiscal year.

Using the same assumptions that yielded the 2018-19 estimate for ongoing cannabis gross receipts, the special cannabis tax is projected to generate approximate \$4.37 million in CRTF special fund revenue, annually. This estimate does not include projected tax revenue from cannabis management companies and event organizers or surcharge receipts from cannabis laboratory tests and cannabis event tickets. These specific activities are not reflected in existing business tax data and may not necessarily correlate with prior medical cannabis retail activity.

The proposed reduction to existing cannabis gross receipts tax rates includes: a 2 percent reduction to the medical cannabis rate (from \$50 to \$30 per \$1,000 of gross receipts) and recreational cannabis rate (from \$100 to \$80 per \$1,000 of gross receipts) to be restored in 0.5 percent increments over four years; a 0.75 percent reduction to the distribution and testing laboratory rate (from \$10 to \$2.50 per \$1,000 of gross receipts) to be restored in 0.25 percent increments over three years; and, a 1.5 percent reduction to the cultivation and manufacturing rate (from \$20 to \$5 per \$1,000 of gross receipts) to be restored in 0.5 percent increments over three years. The tax rate on business activities that include the consumers' use of cannabis or cannabis products on the business premises will remain unchanged. The lower tax would be implemented on January 1, 2020 for the 2020 tax period, and reduction to remittances will first be realized during the final quarter of the 2019-20 fiscal year.

Using the 2018-19 budget assumptions for cannabis-related tax revenue, the tax reduction equates to a decrease of approximately \$8.28 million in general fund revenue for the first full-year fiscal year of implementation. The impact lessens over the following fiscal years until the reduction is phased out. As there is no data to quantify business activities that include the on-site consumption of cannabis and cannabis products, the estimate assumes all cannabis activities will be eligible for the lower rates. The total impact of the tax rate reduction equates to an approximate \$21.7 million reduction in general fund revenue over five fiscal years, presuming that all 2018-19 budget assumptions remain constant. The first full year impact of the proposed tax reduction will occur in fiscal year 2020-21. The reduction will be completely phased out by January 1, 2024 for the 2024 tax period, with tax receipts fully restored by fiscal year 2024-25.

Table 1 Revenue Impact of Proposed Special Fund Tax and General Fund Tax Reduction by Fiscal Year. (Amounts in million dollars)

| Fiscal Year | 2018-19 | 2019-20 | 2020-21 | 2021-22 | 2022-23 | 2023-24 | 2024-25 |
|---------------------------|---------|------------------|---------|---------|---------|---------|---------|
| Base General Fund Revenue | 25.4 | 25.4 | 25.4 | 25.4 | 25.4 | 25.4 | 25.4 |
| Special Fund Revenue | 0.80 | 4.37 | 4.37 | 4.37 | 4.37 | 4.37 | 4.37 |
| General Fund Reduction | | -1.6 | -8.28 | -6.10 | -3.93 | -1.76 | 0.00 |
| Base General Fund Revenue | | \$127.03 million | | | | | |
| Special Fund Revenue | | \$21.86 million | | | | | |
| General Fund Reduction | | -\$21.67 million | | | | | |

Notes: Revenue from a tax period will be recorded over two fiscal years. Base General Fund revenue corresponds to projected ongoing receipts from cannabis business activities for 2018-19. To simplify findings, no annual growth assumptions are included in the analysis.

The projected impact to revenue from the proposed special tax ballot measure and general fund tax reduction has inherent risk due to the unavailability of data on the new recreational cannabis market and the adoption of the new cannabis tax remittance schedule, which postponed 2018 tax period remittances (and thus data) to the following fiscal year. Moreover, as the Office of Finance has been instructed to only collect the gross receipts tax from businesses that have been granted a provisional license by the Department of Cannabis Regulation, there are currently fewer businesses that are expected to remit gross receipt taxes than for the prior 2017 tax period. According to Office of Finance, the first opportunity to evaluate the budget assumptions for cannabis collections under the new quarterly format will be the receipt of the first and second quarter renewal submissions in July. These two quarters will be delinquent after July 31, which means an initial analysis of actual receipts cannot be completed until the first week of August. It is recommended that this Office be instructed to report back with a revised fiscal impact analysis by August 14, 2018, prior to submitting the fiscal analysis ballot language for the proposed special tax measure.

FISCAL IMPACT STATEMENT

The recommendations in this report have no impact to the General Fund. Subsequent actions associated with placing a measure of the November 2018 ballot and the intent of the proposed ballot measure and ordinance will have a General Fund impact to be identified in separate reports.