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OAKLAND

2019 OCT 31 PM 3: 58

AGENDA REPORT

TO: Sabrina B. Landreth
City Administrator

FROM: Adam Benson
Director of Finance

SUBJECT: Cannabis Business Tax Rates
Amendments Supplemental

DATE: October 28, 2019

City Administrator Approval

Date:

10/31/19

RECOMMENDATION

Staff Recommends That The City Council Receive An Informational Report Regarding The Proposed Ordinances To The Oakland Municipal Code Title 5, Chapter 5.04, Section 5.04.480, Medical Cannabis Businesses, And Section 5.04.481, Non-Medical Cannabis Businesses, To Reduce The Tax Rates For Cannabis Businesses.

REASON FOR SUPPLEMENTAL

This supplemental report is to provide the City Council with a summary of pending proposed changes to the cannabis business tax rates and their financial impact to the Fiscal Year ("FY") 2019-21 Adopted Policy Budget.

BACKGROUND / LEGISLATIVE HISTORY

On June 18, 2019, the City Council adopted amendments to Title 5, Chapter 5.04, Sections 5.04.480 and 5.04.481 of the Oakland Municipal Code. The amendments reduced the effective business license tax rate on cannabis business with total gross receipts of less than or equal to \$500,000 to a new fixed tax rate of 0.12 percent, or \$1.20 per \$1,000, of gross receipts. The City Council held over discussion of reducing business tax rates on cannabis business with total gross receipts in excess of \$500,000 to a future date.

ANALYSIS AND POLICY ALTERNATIVES

Financial Impact to the FY 2019-21 Adopted Budget Policy

The FY 2019-21 Adopted Budget Policy contemplated **no changes** to the existing business tax structure of five percent (5.00%) on gross receipts derived from medical cannabis and ten percent (10.00%) on gross receipts derived from non-medical cannabis assessed on cannabis business with total annual gross receipts of \$500,000 or more. Any reductions to the business tax that is effective January 1, 2020 will negatively impact both years of the Adopted Fiscal Years 2019-21 Budget.

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City Council
November 5, 2019

Table 1 is a summary of pending proposed changes that are under consideration. Table 2 is a summary of the financial impact to the FY 2019-21 Adopted Budget Policy for the respective pending proposed changes summarized in Table 1.

Table 1: Summary of Pending Proposed Changes

Tax Category / Segment	Effective January 1, 2020				
	CM Taylor	Public Proposal via CP Kaplan	CM Kalb CP Kaplan	CM Thao	Harmonized
Medical	5.00%	5.00%	5.00% ¹	5.00%	
Non-Medical	8.00%	8.00%	10.00% ¹	6.50%	
Up to \$500K	0.12%	0.12%	0.12%	0.12%	0.12%
Up to \$1.5M-Equity Only	0.12%	0.12%		0.12%	
Marginal			X		
Non-Marginal	X	X	X ¹	X	X
Cultivation (Indoor)			5.00%		5.00%
Cultivation (Outdoor)			5.00%		5.00%
Manufacturing			5.00%		5.00%
Distribution / Transport			4.50%		5.00%
Lab-Testing			0.12%	4.00%	5.00%
Retail / Delivery			5.00%		5% Medical 10% Non-Medical
Max Tax Incentive/Rebates	3.50%	4.00%	2.00% ³	4.25%	
Number of Rebate Programs ²	8	8	3	8	

¹ Applicable to businesses grossing more than \$1.5M

² Each "Condition" in a Rebate Category is counted as a Rebate Program

³ Available only for businesses grossing more than \$1M

Tax Category / Segment	Effective January 1, 2021				
	CM Taylor	Public Proposal via CP Kaplan	CM Kalb CP Kaplan	CM Thao	Harmonized
Medical	5.00%	5.00%		5.00%	
Non-Medical	8.00%	6.50%		6.00%	
Up to \$500K	0.12%	0.12%	0.12%	0.12%	0.12%
Up to \$1.5M-Equity Only	0.12%	0.12%		0.12%	
Marginal					
Non-Marginal	X	X	X	X	X
Cultivation (Indoor)			5.00%		5.00%
Cultivation (Outdoor)			5.00%		5.00%
Manufacturing			5.00%		5.00%
Distribution / Transport			4.50%		5.00%
Lab-Testing			0.12%	4.00%	5.00%
Retail / Delivery			5.00%		5% Medical 10% Non-Medical
Max Tax Incentive/Rebates	3.50%	4.00%	2.00% ²	4.25%	
Number of Rebate Programs ¹	8	8	3	8	

¹ Each "Condition" in a Rebate Category is counted as a Rebate Program

² Available only for businesses grossing more than \$1M

Table 2: Summary of Approximate Financial Impact for Pending Proposed Changes

Councilmember	Effective January 1, 2020				
	Proposed Tax Rates	Estimated Revenues	Financial Impact to Adopted Budget FY 2019-20 \$14,567,893 <u>Without</u> Tax Rebates	Tax Rebates (Max) ⁴	Financial Impact to Adopted Budget FY 2019-20 \$14,567,893 <u>With</u> Tax Rebates
CM Taylor	See Table 1	\$10,907,899	(\$3,659,994)	(\$381,776)	(\$4,041,770)
Public Proposal via CP Kaplan	See Table 1	\$10,907,899	(\$3,659,994)	(\$436,316)	(\$4,096,310)
CM Kalb / CP Kaplan	See Table 1	\$11,715,411	(\$2,852,482)	(\$234,308)	(\$3,086,791)
CM Thao	See Table 1	\$9,125,735	(\$5,442,158)	(\$387,844)	(\$5,830,001)
Harmonizing Rates for Non-Retailers	See Table 1	\$10,776,000	(\$3,791,893)	N/A	N/A

Councilmember	Effective January 1, 2021				
	Proposed Tax Rates	Estimated Revenues	Financial Impact to Adopted Budget FY 2020-21 \$15,733,167 <u>Without</u> Tax Rebates	Tax Rebates (Max) ⁴	Financial Impact to Adopted Budget FY 2020-21 \$15,733,167 <u>With</u> Tax Rebates
CM Taylor	See Table 1	\$11,780,531	(\$3,952,636)	(\$412,319)	(\$4,364,955)
Public Proposal via CP Kaplan	See Table 1	\$10,104,201	(\$5,628,966)	(\$404,168)	(\$6,033,134)
CM Kalb / CP Kaplan	See Table 1	\$8,238,155	(\$7,495,012)	(\$164,763)	(\$7,659,775)
CM Thao	See Table 1	\$9,315,388	(\$6,417,779)	(\$395,904)	(\$6,813,683)
Harmonizing Rates for Non-Retailers	See Table 1	\$11,625,958	(\$4,107,209)	N/A	N/A

⁴ Estimated Revenues multiple by Maximum Percentage of Proposed Tax Rebates

Harmonizing Medical and Non-Medical Tax Rates for Non-Retailers:

Most retailers can easily determine whether a cannabis purchase is for medical or for non-medical use by verifying whether the purchaser has a valid state-issued Medical Marijuana Identification Card (“MMIC”)¹. Unfortunately, non-retailers have no such ability because they engage directly with businesses and most hold both a medical and non-medical State permit. In short, most non-retailers have no way of knowing how much of their gross receipts are derived from medical or non-medical sales. Hence, the separation of the gross receipts for non-retailers cannot be easily done.

One possible course of action is to harmonize the two tax rates (5% & 10%) into one tax rate (such as 5%) for non-retailers. The financial impact for such harmonization is outlined in Table 2. The tax rates for retailers would remain the at 5% (medical) and 10% (non-medical).

Proposed Tax Incentive/Rebate Programs

The financial impact, as outlined in Table 2 above, represents the maximum amount of tax rebate as proposed in the rebate programs. All proposals in Table 2 contemplate both lowering the tax rates for all cannabis businesses **and** providing further tax reductions in the form of rebates to cannabis businesses that meet the specified rebate criteria.

A tax incentive/rebate, as proposed in all programs, is a refund of the taxes paid after cannabis businesses meet a certain threshold as outlined in each program (Table 3). Cannabis businesses would be required to report gross receipts and pay the taxes based on the tax rates

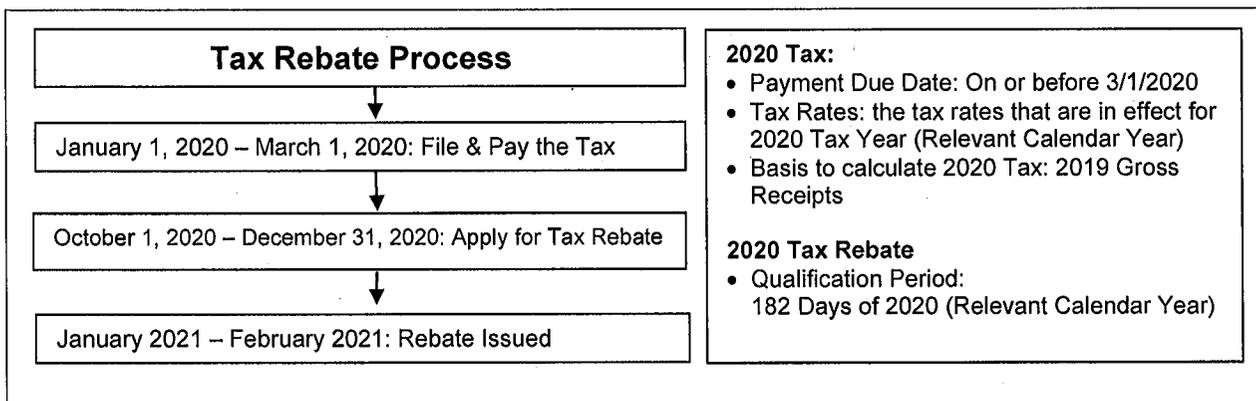
¹ The validation of MMIC is also used for the purpose of exempting Sales and Use Tax.

that are in effect for the tax year in question. Following the close of the tax year or at the time the subsequent tax year is due and payable, businesses would then apply and submit documentation for the purpose of verification of eligibility for the rebates. If approved, businesses would either receive a refund of the taxes or a credit of the previously paid taxes toward the business tax obligation for the following year. The cycle would continue as long as the tax rebate programs are in effect.

If any of the proposed tax incentive/rebate programs is approved, staff recommends the City Council places a sunset provision to suspend such programs after the verification and the refund of taxes paid for two tax cycles. For example, if an approved tax incentive/rebate program is to start for 2020 Tax Year, the program would end following the verification and the refund of taxes paid for the 2021 Tax Year. It should be noted that managing a tax rebate program of the proposed complexity will be labor intensive and require additional staff of 3-5 full-time-equivalent employees.

The recommendation to suspend any approved tax incentive/rebate programs after two tax cycles is to allow staff the opportunity to analyze the effectiveness of the programs and return to the City Council with the results and recommendations whether to reinstate the program or to recommend policy alternatives.

Table 3: Tax Rebate Process



Financial Impact for Proposals to begin in 2022 (FY 2021-23 Budget Policy)

For all proposed changes beginning in calendar year 2022, staff cannot determine the financial impact without knowing the adopted tax rates for calendar year 2020 and/or 2021.

Financial Impact Beyond Estimated Revenues

In addition to the financial impact as a result of lower estimated revenue, some pending proposed changes would result in added expenditures that in turn create greater financial impact to the current two-year adopted budget. These include:

1. Loss of operational and customer service efficiencies for upstream cannabis businesses: If the City continues to have different tax rates for medical and non-medical, the cannabis businesses upstream from the dispensaries will no longer be able to report and file annual

taxes on-line. The filing process for upstream businesses will continue to be manual and require additional staff time. For the 2019 tax year, the Administration implemented an administrative policy that enabled the manual separation of the gross receipts for the application of both tax rates on upstream businesses by analyzing the gross receipts remitted by all cannabis retailers and determining the “universal” percentages of gross receipts taxes that upstream business need to remit.

2. **Computer Software Re-Configuration Costs:** the current local tax software is capable of expanding to accommodate the changes from existing medical and non-medical tax rates to a segmented tax structure and its respective tax rates or a special tax rate intended for equity businesses. However, there are development costs associated with making the changes. Staff, in consultation with the City’s current software provider, estimated that the costs for the changes would range from \$250,000 to \$350,000 depending on the complexity and the versatility of the re-configuration of the software.
3. **Additional Staffing Costs:** the proposed changes from existing medical and non-medical tax rates to a segmented tax structure or a special tax rate intended for equity businesses coupled with as many as eight (8) different tax incentive/rebate programs will produce significant additional work to ensure proper compliance, especially in the areas of refunding taxes paid to those applying for the tax incentive/rebate programs. The Administration worked hard to achieve a complete satisfactory finding based on the City Auditor’s latest Business Tax Refunds Audit Report dated September 3, 2019. To ensure complete satisfaction continues, the Administration would need to add a minimum staff of 3-5 FTEs at an estimated added cost of \$450,000 to \$750,000 during the FY 2020-21.

FISCAL IMPACT

The FY 2019-21 Adopted Policy Budget includes estimated General Purpose Fund revenues derived from cannabis business activities of \$14.6 million in year one and \$15.7 million in year two. The financial impact, as outlined in Table 2 above, ranges from a low of \$7.9 million to a high of \$12.6 million.

In addition to the fiscal impact to the FY 2019-21 Adopted Policy Budget, the financial impact related to the re-configuration of the computer system to accommodate the changes would be a one-time cost ranging from \$250,000 to \$350,000 depending on the changes and the versatility the computer system needs to have in order to administer various tax programs. In addition to the reconfiguration of the local tax software, additional staff of 3-5 FTEs would be required to audit and ensure compliance with the program. The estimated cost is at \$450,000 to \$750,000.

Staff is recommending against the adoption of the proposed changes because of the negative financial impact to the FY 2019-21 Adopted Policy Budget. If any of the proposed changes is approved, the change would necessitate a cut in services or an identification of alternative funding source to re-balance the FY 2019-21 Adopted Policy Budget.

ACTION REQUESTED OF THE CITY COUNCIL

Staff recommends that the City Council receive this informational report regarding the proposed changes amending Oakland Municipal Code Title 5, Chapter 5.04, Section 480, Medical Cannabis Business, and Section 481, Non-Medical Cannabis Businesses, to reduce the tax rates for cannabis businesses.

For questions regarding this report, please contact Margaret O'Brien, Revenue & Tax Administrator, (510) 238-7480.

Respectfully submitted,



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Finance Department

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