



**CITY OF SALINAS
COUNCIL STAFF REPORT**

DATE: AUGUST 23, 2022
DEPARTMENT: COMMUNITY DEVELOPMENT DEPARTMENT
FROM: MEGAN HUNTER, COMMUNITY DEVELOPMENT DIRECTOR
TITLE: COMMERCIAL CANNABIS TAXATION RECOMMENDATION REPORT

RECOMMENDED MOTION:

Receive an Administrative Report on the Commercial Cannabis Taxation Recommendation Report for informational purposes. No action is required.

RECOMMENDATION:

It is recommended that the City Council receive an Administrative Report on the Commercial Cannabis Taxation Recommendation Report for informational purposes.

EXECUTIVE SUMMARY:

On February 15, 2022, City Council directed staff to hire a consultant to complete a report on recommended taxation rates after hearing testimony of multiple cannabis business owners concerned about long-term financial viability of the industry in the City. The City contracted with SCI Consulting Group which completed the report and found that Salinas' local cannabis industry "remains viable, relatively stable with the likelihood of a reasonable, limited growth over time". The report also concluded that the City's "current rates, rate structure, number and types of businesses are generally appropriate and well within California norms".

While tax revenues are leveling out, the report noted that there is potential for more growth as more permitted businesses become operational. As it relates to current taxation rates, SCI Group recommended the following:

- Maintain the existing gross receipts tax rate of 5% on retail businesses.
- Reduce the existing tax to a rate between 2.5% and 3% on manufacturing businesses.
- Reduce the existing tax to a rate between \$7 to \$10 per square foot of canopy on cultivation businesses.

BACKGROUND:

On February 15, 2022, the City Council received an annual report on the commercial cannabis industry in Salinas. During the meeting, several business owners provided testimony expressing

concern about the taxation rates for cultivation and manufacturing given the changing environment of the cannabis industry. As a result, City Council directed staff to hire a consultant to complete a report on recommended taxation rates. After conducting an RFP process, City Council approved a resolution authorizing the City Manager to enter into an agreement with SCI Consulting Group to complete the study and provide cannabis monitoring services at the end of April. SCI Consulting Group completed the study in August.

DISCUSSION:

The report highlights some good news – “Salinas’ local cannabis industry remains viable, relatively stable with the likelihood of a reasonable, limited growth over time – this is an especially positive finding when compared with the dynamic and challenged state of the cannabis industry statewide”. In terms of retail, Salinas is well situated geographically because it is somewhat isolated regionally while being located along a well-travelled Highway 101 corridor. The greatest area for significant growth for the City is in the manufacturing sector. Although this sector has matured (and possibly peaked) very rapidly statewide, there is still huge opportunity to develop, market, and package new types of products – and Salinas is well poised with its proximity to very active cultivation sites in Monterey, San Luis Obispo, and even Santa Barbara Counties, along with its agricultural-industrial-processing capacity and infrastructure.

While high taxation rates increase product prices that can drive consumers to the black market, generally Salinas taxation rates (see Table 1) are typical in California and may not have as much as an impact on growth or decline. Rather, there are likely other barriers that are affecting revenue such as non-operational businesses with permits or limited vacant land/properties. The report notes that “tax revenues are leveling out, becoming more predictable and reliable, with some additional growth projected as more permitted businesses become operational. The City should continue with current policies, making field-condition-informed, minor adjustments to tax rates, permit number, types of permits, etc., as the marketplace continues to evolve over the next 10 years.”

Table 1 - Cannabis Tax Rates

| Business Type | Current Rate | Maximum Rate |
|----------------------------|----------------------|-----------------------|
| Retail (Dispensary) | 5% of Gross Receipts | 10% of Gross Receipts |
| Retail Delivery | 5% of Gross Receipts | 10% of Gross Receipts |
| Manufacturing | 5% of Gross Receipts | 10% of Gross Receipts |
| Cultivation | \$15/sf of Canopy | \$25/sf of Canopy |
| Nursery | \$2/sf of Canopy | \$5/sf of Canopy |
| Distribution | No Tax | No Tax |
| Testing | No Tax | No Tax |

Table 2 - Salinas Cannabis Industry Tax Revenue by Business Type (2017-2022)

| Business Type | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|----------------------|------------------|------------------|--------------------|--------------------|--------------------|------------------|
| Delivery | \$38,989 | \$102,917 | \$117,138 | \$197,395 | \$134,572 | \$16,600 |
| Dispensary | IA | \$285,475 | \$949,762 | \$1,124,674 | \$1,221,626 | \$333,647 |
| Cultivation | IA | IA | IA | \$8,679 | \$73,539 | \$19,200 |
| Manufacturing | \$335,380 | \$482,057 | \$561,413 | \$511,284 | \$669,760 | \$168,926 |
| Total | \$374,369 | \$870,449 | \$1,628,314 | \$1,842,033 | \$2,099,497 | \$538,373 |

IA = business type was inactive during this term, i.e. not yet conducting commercial operations and paying the cannabis business tax

The report recommends that the City maintain the taxation rate for retail (delivery and dispensary), but consider reducing rates for manufacturing and cultivation. Based upon the tax revenues by business type shown in Table 2, the City will lose revenue in the immediate short-term as shown in Table 3. It is unclear whether the decrease in the taxation rate for these business types will result in new business, however, these manufacturing and cultivation enterprises carry greater risks/costs than retail and justifiably should be taxed at lower rates.

Table 3 - Potential Tax Revenue Loss by Business Type Based Upon 2021

| Business Type | Base Year 2021 | \$10 sq ft/ 3% | \$8.50 sq ft/ 2.5% | \$7 sq ft/ 2.5% |
|----------------------|-------------------|-------------------|-----------------------|--------------------|
| Cultivation | \$73,539 | \$49,026 | \$41,672 | \$34,318 |
| Manufacturing | \$669,760 | \$401,856 | \$334,880 | \$334,880 |
| Total | \$743,299 | \$450,882 | \$376,552 | \$369,198 |

In summary, the report identifies the following recommendations:

Taxation

- Maintain the existing gross receipts tax rate of 5% on retail businesses.
- Reduce the existing tax to a rate between 2.5% and 3% on manufacturing businesses.
- Reduce the existing tax to a rate between \$7 to \$10 per square foot of canopy on cultivation businesses.

Permitting

- Maintain the current limit on the number of retail businesses (3 delivery and 5 storefront).
- Award the final cultivation permit.
- Continue to support active permittees working towards becoming operational businesses.

Economic Development

- Take steps to foster and support growth in the manufacturing business sector, which has the greatest growth potential.
- Continue to carefully facilitate the transition from unregulated cannabis markets to regulated cannabis businesses.
- Work on expanding cannabis opportunities to minority owned, local businesses.
- Expand on Salinas' unique history, character, and culture to optimize all facets of the cannabis industry.

CEQA CONSIDERATION:

The City of Salinas has determined that the proposed action is not a project as defined by the California Environmental Quality Act (CEQA) (CEQA Guidelines Section 15378). Because the proposed action and this matter have no potential to cause any effect on the environment, or because it falls within a category of activities excluded as projects pursuant to CEQA Guidelines section 15378, this matter is not a project.

STRATEGIC PLAN INITIATIVE:

The recommendations in the Commercial Cannabis Taxation Recommendation Report will help meet the City Council Strategic Goal of Effective and Culturally Responsive Government as it will help apply data-driven management to decision-making. The recommendations will also advance the Goal of Economic Development by encouraging a diverse and thriving economy around commercial cannabis.

DEPARTMENTAL COORDINATION:

City departments coordinate on cannabis taxation as it involves both revenue and land use. The Community Development Department (CDD) coordinates regularly with the Finance Department regarding cannabis taxation and the Legal Department as it relates to the Salinas Municipal Code and Commercial Cannabis. If City Council recommends action to adjust taxation rates, CDD will work with the Legal Department to amend the Code.

FISCAL AND SUSTAINABILITY IMPACT:

It is hard to quantify the overall impact on the reduction in tax rates on revenue over time because it remains to be seen if reducing these rates will promote greater growth and stability in Salinas' commercial cannabis industry. The immediate impact can be extrapolated as shown in Table 3.

Using 2021 revenues for illustration, a tax rate of 3% of gross receipts as opposed to 5% would reduce revenue by \$267,904 per year. A tax rate of 2.5% would result in a \$334,880 reduction in revenue per year. A decrease in the rates for cultivation will have a less dramatic impact on current revenue since this business type is less developed in the City. At \$10 per sq ft, the revenue loss is \$24,513, at \$8.50 per sq ft, it is \$31,867, and at \$7 per sq ft it is \$39,221.

If City Council decides upon a more aggressive cut in tax rates to \$7 per sq ft of canopy for cultivation and 2.5% for manufacturing, the potential annual loss in the immediate short term could be approximately \$374,101 per year. To minimize this financial impact to the City, it may be better to take a more moderate approach of \$10 per sq ft of canopy for cultivation and 3% for manufacturing resulting in a loss of \$292,417. The City can re-evaluate this change after 1-2 years and determine if further reduction is needed.

ATTACHMENTS:

- Commercial Cannabis Taxation Recommendation Report, SCI Group Consulting
- Overview Presentation of Commercial Cannabis Taxation Recommendation Report
- SCI Consulting Group Presentation on Commercial Cannabis Taxation Report