



# ***CITY COUNCIL AGENDA REPORT***

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MEETING DATE: MARCH 3, 2020

ITEM NUMBER: PH-2

**SUBJECT: INTRODUCTION OF AN ORDINANCE PROVIDING FOR A TEMPORARY REDUCTION OF THE BUSINESS TAX SET FORTH IN ARTICLE 5 (ADMINISTRATION) OF CHAPTER I (BUSINESS TAX) OF THE COSTA MESA MUNICIPAL CODE AS AUTHORIZED BY MEASURE X, THE COSTA MESA MEDICAL MARIJUANA MEASURE, AS AMENDED, THAT IS LEVIED UPON THE LAWFUL DISTRIBUTION, MANUFACTURING, TESTING, AND/OR RESEARCH AND DEVELOPMENT OF MARIJUANA**

**DATE: FEBRUARY 18, 2020**

**FROM: FINANCE DEPARTMENT, CITY ATTORNEY'S OFFICE, AND DEVELOPMENT SERVICES DEPARTMENT**

**PRESENTATION BY: KELLY A. TELFORD, CPA, FINANCE DIRECTOR, TARQUIN PREZIOSI, ASSISTANT CITY ATTORNEY, AND BARRY CURTIS, ECONOMIC AND DEVELOPMENT SERVICES DIRECTOR**

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## **RECOMMENDATION:**

Staff recommends that the City Council introduce for first reading, by title only, Ordinance No. 20-xx (Attachment 1), providing for a 24-month temporary reduction of the business tax set forth in Article 5 (Administration) of Chapter I (Business Tax) of the Costa Mesa Municipal Code as authorized by Measure X, the Costa Mesa Medical Marijuana Measure, as amended, that is levied upon the lawful distribution, manufacturing, testing, and/or research and development of marijuana.

## **BACKGROUND:**

Pursuant to California Constitution Article XI, Section 7 and the California Government Code Section 37100, local agencies may adopt regulations to protect the health, safety and welfare of the public and may declare what use and condition constitutes a public nuisance.

On November 8, 2016, the electorate of the City of Costa Mesa voted on Measure X, and approved the Costa Mesa Medical Marijuana Measure, codified by way of Ordinance No. 16-15 (Attachment 2). Measure X sets forth the following:

- Legalizes and provides regulations for the following in the City of Costa Mesa as defined below:
  - *Distributors*: a person engaging in the business of purchasing medical marijuana from a licensed cultivator, or medical marijuana products from a licensed manufacturer, for sale to a licensed dispensary.
  - *Manufacturers*: a person that conducts the production, preparation, propagation, or compounding of manufactured medical cannabis or medical marijuana products either directly or indirectly or by extraction methods, or independently by means of chemical synthesis at a fixed location that packages or repackages medical marijuana or medical marijuana products or labels or relabels its container.
  - *Research and Development Laboratories*: a facility, entity or site in the City that performs research into and/or the development of medical marijuana or medical marijuana products.
  - *Testing Laboratories*: a facility, entity or site in the City that offers or performs tests of medical marijuana or medical marijuana products.
  - *Transporter*: a person authorizing the transport of medical marijuana or medical marijuana products.
- The specific area in the City within which medical marijuana distributors, manufacturers, processors, research and development laboratories, testing laboratories and transporters can be located;
- Provides for City regulation of these medical marijuana businesses in a manner consistent with the statewide regulations to be adopted by the California Department of Consumer Affairs and other state agencies, including the departments of Food and Agriculture and Public Health;
- Reaffirms the existing ban on dispensaries and cultivation within the City;
- Imposes a gross receipts tax on all medical marijuana distributors, manufacturers, processors, testing laboratories, transporters, and research and development laboratories, as well as any other marijuana or marijuana business at a rate of six percent (6%) of gross receipts;
- Provides that any future changes or amendments to Ordinance 16-15, including any future changes or amendments to any Municipal Code section affected by the Measure or a reduction in the tax imposed by this Measure, may occur in the manner set forth in the Government Code and the Costa Mesa Municipal Code (CMMC). This would also not require voter approval; and
- Provides that any future change or amendment to Ordinance 15-16 related to dispensaries and/or cultivation or the specific area within the City where medical marijuana businesses may be located shall require voter approval.

On April 3, 2018, the City Council adopted Ordinance 18-04 (Attachment 3) that amended certain provisions of Measure X in order to allow for the manufacturing, processing, researching, testing and wholesale distribution of adult-use marijuana.

On November 11, 2019, the City received a letter from the Cannabis Industry (Attachment 4) with several requests for the City's consideration. One request referenced in the letter is to reduce the gross receipts tax on marijuana manufacturing, distribution and testing

businesses to two percent (2%). Subsequently, on December 17, 2019, the City Council approved the formation of an Ad Hoc Committee of the Council to evaluate the City's marijuana tax rates and regulations and directed staff and the Cannabis Ad Hoc Committee to return with a fiscal analysis and recommendation on the potential reduction of the business tax rates across the varying business types.

Prior to staff's receipt of the Cannabis Industry Letter, the Finance Department and Development Services Department had been working with HdL Companies, the City's marijuana business tax consultant, on monitoring and evaluating this revenue stream and making projections and recommendations based on varying economic indicators and tax models.

### **ANALYSIS & FISCAL IMPACT:**

Since Costa Mesa was on the forefront of legalizing the distribution, manufacturing, testing, and/or research and development of marijuana, the six percent (6%) tax rate was set by comparing the City to other local jurisdictions. In that climate, there was collective interest in helping marijuana businesses get permitted and operate legally while increasing City revenues. However, since Measure X was passed by the voters, a number of new regulatory challenges have been created and the overall industry continues to face immense challenges that directly correlate to the City's marijuana business tax revenue.

First, Proposition 64 (Prop 64) – *The Control, Regulate, and Tax Adult Use of Marijuana Act* passed in 2016, which allowed the State of California to create two (2) state excise taxes on marijuana. The first is a 15 percent retail excise tax, effectively a wholesale tax under current law. The second is a tax based on the weight of harvested plants, often called a cultivation tax. In addition to these two taxes, there are several layers of additional taxes for marijuana companies, which have contributed to severe economic challenges for these businesses and contributed to lower City revenue than anticipated. The taxes currently levied on marijuana companies includes:

1. 15 percent state excise sales tax on retail sales;
2. Cultivation tax of \$9.25 per ounce (recently increased to \$9.65);
3. California State sales tax of 7.25 percent on all retail items, including marijuana, plus an automatic local sales tax of up to 1 percent;
4. Local businesses taxes (i.e. Costa Mesa 6 percent business tax);
5. State income tax (marijuana companies file tax returns just like any other California business, but the deductions, credits and payment methods may be different); and
6. Federal income tax on gross income.

Pursuant to the Internal Revenue Code Section 280E, businesses that traffic in controlled substances cannot deduct any expenses incurred in carrying on the production, distribution and sale of controlled substances. Essentially, this federal statute mandates that marijuana companies must pay taxes on all of their revenue without the benefit of being able to use business expenses to reduce their taxable income.

Based on the layers of taxes outlined above, many marijuana companies are facing considerably large combined tax rates that has limited the amount of business they can generate. This lack of business has equated to lower revenues than anticipated for the City. At this time, the City has eight (8) manufacturers and distributors in operation. However, the City has 20 additional businesses that have received their permits, but are not yet

operational. While these additional businesses are permitted, it's anticipated that the businesses may not be opening operations imminently due to the financial challenges, including the local, state and federal taxes, facing the industry. The short-term fiscal impact of reducing the tax rate is limited by the gross receipts currently being generated by these business types. The City did not begin collecting marijuana business tax until Fiscal Year 2018-19, thereby also providing limited data to support accurate revenue projections. The table below provides a summary of the estimated General Fund fiscal impact from reducing the business tax rate from six percent (6%) to varying lower rates. The projection assumes a flat tax reduction across distribution, manufacturing, testing and research and/or development.

Projected General Fund Revenue Impact of Reducing Gross Receipts Tax		
	Estimated Annual Tax Revenue	Potential City Revenue Reduction
Marijuana Gross Receipts Tax at 6% (Current)	\$ 647,185	\$ 0
Marijuana Gross Receipts Tax at 4%	\$ 431,457	\$ 215,728
Marijuana Gross Receipts Tax at 2%	\$ 215,728	\$ 431,457
Marijuana Gross Receipts Tax at 1%	\$ 107,864	\$ 539,321

This projection is based solely on the revenue projections for Fiscal Year 2019-20. Based on the above analysis, if the tax rate were to be reduced to 2 percent, currently licensed manufacturers and distributors, would need to collectively increase their annual gross receipts from approximately \$10.8 million to approximately \$32.4 million to maintain the City's estimated annual tax revenue (based on the City's current tax rate of 6 percent of \$647,185. Otherwise, the analysis reflects a General Fund revenue loss of approximately \$431,457. However, the potential increase in the rate of business openings is not included in these projections. In theory, reducing the gross receipts tax rate would make Costa Mesa a more competitive destination for marijuana businesses and may encourage some of the 20 approved-but-not-operating businesses to commence operation. While the retail of marijuana depends on location, manufacturing, distribution, testing and research and/or development, does not. Therefore, reducing the tax for these businesses is anticipated to result in an increase in demand for business locations within the City in the green zone and encourage approved businesses to begin operations. While local tax rates are only one of many variables that businesses consider when determining where to locate, the competitiveness of such rates has a significant impact on business investment decisions.

As part of this analysis, the Cannabis Ad Hoc Committee completed a comparison of the City's marijuana business tax rates for its various business types to other comparable cities in Southern California that allow for commercial marijuana activity. Based on initial research, the cities of Stanton and of Long Beach most recently modified their business tax rates. The City of Stanton authorized a four percent (4%) business tax on all non-retail marijuana businesses while the City of Long Beach reduced its business tax on distributors, manufacturers, and testing laboratories from six percent (6%) to one percent (1%). With these business types not dependent on location and with other jurisdictions in close proximity to Costa Mesa with lower business taxes for these business types, the City may not remain competitive unless a tax reduction, even if temporary, is considered. Based on the preceding information that outlined the layers of taxes the marijuana companies face, many of the companies are facing combined tax rates of approximately 35 percent. Higher rates do not necessarily equate to more revenue for the City. In order for this industry to

survive, the City needs to provide a supporting environment for it to do so. In this industry, anything that makes the community less competitive works against the City. This is evident based on the Committee’s recent meetings with the business owners in the local marijuana industry. Based on those conversations, the industry is already considering whether or not to expand and/or retain operations in Costa Mesa, or whether to expand/relocate into Long Beach, due to the recently reduced tax rate of one percent (1%). While Costa Mesa does not have the highest rate, it is not the lowest and if it makes geographical sense, businesses are likely to relocate or setup operations in jurisdictions with lower rates. However, this is not to say that Costa Mesa does not have its geographical advantages with its central, coastal location in Southern California. As a result, the committee is not recommending a one percent (1%) tax rate, but a two percent (2%) tax rate. The table below provides a summary of the Committee’s research:

<b>Comparable Cities by Region</b>				
<b>City</b>	<b>Population</b>	<b>Distribution Tax Rate</b>	<b>Manufacturing Tax Rate</b>	<b>Lab Testing</b>
Bellflower	77,682	5%	5%	5%
Carson	93,799	18%	18%	18%
<b>Costa Mesa</b>	<b>115,296</b>	<b>6%</b>	<b>6%</b>	<b>6%</b>
Culver City	39,860	2%	4%	1%
La Puente	40,686	10% (Medical only)	10% (Medical only)	10% (Medical only)
Long Beach	478,561	1% (recently reduced from 6%)	1% (recently reduced from 6%)	1% (recently reduced from 6%)
Los Angeles	4,054,400	1%	2%	1%
Malibu	12,957	2.5% (Adult-use only)	2.5% (Adult-use only)	2.5% (Adult-use only)
Maywood	28,044	up to 10%	up to 10%	up to 10%
Pasadena	144,388	2%	2.50%	1%
Pomona	155,687	up to 6%	up to 6%	up to 6%
Santa Ana	338,247	6%	6%	5%
Stanton	38,305	4%	4%	4%
West Hollywood	36,723	7.5% (Adult-use only)	7.5% (Adult-use only)	7.5% (Adult-use only)

The long-term impact of a reduction of the marijuana business tax is less clear. This uncertainty is based on the belief that non-retail marijuana businesses have much greater flexibility in the long-term to adjust supply in response to changes in local tax rates. This is known as the tax elasticity of supply and is difficult for staff to estimate without collecting greater amounts of tax revenue data from licensed businesses. For this reason, staff is unable to provide a long-term General Fund fiscal impact projection for the proposed reduction and is thereby also only recommending a temporary reduction of this tax to further evaluate this impact while remaining competitive in this market.

In addition and pursuant to Title 9, California Code of Regulations, local agencies may collect taxes from all marijuana businesses, including illegal operators. Introduction of the proposed Ordinance would initiate the process for a temporary reduction of the marijuana business tax for legal, licensed businesses. As a result, any taxes collected from illegal operation would be collected at the maximum tax rate of six percent (6%).

Staff is recommending introduction and first reading of the proposed Ordinance to provide a temporary reduction of the business tax that is levied upon the lawful distribution, manufacturing, testing and/or research and development of marijuana.

**ALTERNATIVES CONSIDERED:**

The City Council may consider several alternatives:

1. The City Council could choose not to provide for a temporary reduction of the business tax set forth in Article 5 (Administration) of Chapter I (Business Tax) of the Costa Mesa Municipal Code as authorized by Measure X, the Costa Mesa Medical Marijuana Measure, that is levied upon the lawful distribution, manufacturing, testing, and/or research and development of marijuana and provide alternative direction to staff.
2. The City Council could provide direction to temporarily reduce the business tax levied upon the lawful distribution, manufacturing, testing, and/or research and development of marijuana to an alternative tax rate.
3. The City Council could direct the Cannabis Ad Hoc Committee to complete additional research and provide subsequent recommendations.

**LEGAL REVIEW:**

The City Attorney’s Office has reviewed and approved this agenda report as to form and prepared the proposed Ordinance.

**CITY COUNCIL GOALS & PRIORITIES:**

This item is in accordance with *City Council Goals & Priorities No. 3 – Keep the City Fiscally Sustainable. To address our long-term obligations as well as immediate needs.*

**CONCLUSION:**

Staff recommends that the City Council introduce for first reading, by title only, Ordinance No. 20-xx, providing for a 24-month temporary reduction of the business tax set forth in Article 5 (Administration) of Chapter I (Business Tax) of the Costa Mesa Municipal Code, as authorized by Measure X, the Costa Mesa Medical Marijuana Measure, as amended, that is levied upon the lawful distribution, manufacturing, testing, and/or research and development of marijuana.

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City Attorney

- ATTACHMENTS:
1. [Proposed Ordinance No. 20-xx](#)
  2. [Ordinance No. 16-15](#)
  3. [Ordinance No. 18-04](#)
  4. [Cannabis Industry Letter to the City of Costa Mesa, dated November 11, 2019](#)