THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Analysis of the Proposal to Reduce the Cannabis Business Tax on Production Facilities

OVERVIEW

Council is considering a proposal to reduce the Cannabis Business Tax (CBT) for Cannabis Production Facilities (CPFs) from 8% to 2%. This proposal is designed to increase the number of CPF operators within the City. When this proposal was heard at the Economic Development and Intergovernmental Relations Committee on November 17, 2021, our Office raised some concerns regarding the potential fiscal impact of this proposal and sought additional information on the anticipated impacts. Committee members also sought to have this information prior to hearing the item at Council. This report represents the analysis and information sought by our Office and the Committee.

BACKGROUND

Measure N, passed by City voters on November 8, 2016, authorized the City to levy the CBT on both Cannabis Retail entities and CPFs. As contained in the measure, the City is authorized to impose a tax on both types of Cannabis businesses of up to 15%. This tax is applicable to all cannabis entities operating within the City, with separate taxes on CPFs and retail entities, and also applies to entities located outside of the City but which conduct business within the City on an apportioned basis. However, if a Cannabis business operates as both a CPF and a retail entity, they would only pay the tax after the retail sale.

As stipulated in the ordinance approved by the voters, the initial tax rate was set at 5% of gross receipts and was raised to 8% for both entities on January 1, 2019. The ordinance further stipulated that the Council may raise or lower the tax at its discretion, so long as the maximum tax rate stayed at 15%. For Fiscal Year 2022, the Adopted Budget anticipated this tax to generate $23.1 million in General Fund revenue, with $21.3 million coming from Cannabis retail businesses and $1.8

million from the CPFs. However, in Fiscal Year 2021 actuals exceeded the fiscal 2022 projections, with retail taxes totaling $21.3 million and CPF taxes $2.0 million.

As further stipulated in the ordinance, the City is authorized to issue up to 40 permits for the CPFs, and another 40 permits for cannabis retail businesses. While the retail sites are limited to a total of four per Council district, there is no geographic limit placed upon the CPFs, other than zoning requirements. Currently, all 40 CPF permits have been issued. However, only 19 CPF sites are operational. The Cannabis Business Division within the Development Services Department (DSD) oversees the licensure process, while the City Treasurer's Office oversees the collection of revenue and compliance with the City's CBT regulations.

FISCAL AND POLICY DISCUSSION

As presented at the November 17th ED&IR Committee, District 7 is proposing to lower the CBT rate for CPFs from 8% to 2%. The policy justification for this change is to encourage the further development of CPF businesses, since while all permits have been issued, less than half of the sites are currently operational.

During the Committee meeting, our Office commented that we would like to have more information from City staff on the fiscal implications of this proposal, including City staff input on anticipated short-term revenue loss caused by the decreased CBT rate and how quickly the tax reduction could lead to additional CPFs becoming operational, thus lowering the revenue loss. Our office discussed these issues with City staff and the local cannabis industry, and the analysis presented below is our best estimate of the fiscal implications of the proposed tax reduction. Further, during our discussions with City staff regarding this topic, the issue of tax compliance for CPFs in particular came up repeatedly, and as such we also make a recommendation on that issue.

CBT Revenue Forecast

As presented in Table 1, the City Treasurer's Office is currently forecasting that CBT revenue attributable to CPFs would be $2.3 million in FY 2023, increasing to $3.1 million in FY 2027. These revenue numbers were provided to the Department of Finance and included in the most recent Five-Year Financial Outlook which was released in November 2021.

Table 1 ($ in Thousands)	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
Number of CPFs total	48	52	56	60	60
Number of CPFs within City	13	17	21	25	25
Number of CPFs outside City	35	35	35	35	35
Assumed Average Revenue Growth	1.5%	1.5%	1.5%	1.5%	1.5%
Total Estimated Revenue	**$ 2,348**	**$ 2,582**	**$ 2,823**	**$ 3,070**	**$ 3,116**

This forecast is based on the actual revenues derived in FY 2021 and relies on two assumptions during the out years to estimate revenues. First, the forecast assumes that the average gross receipts of each CPF grow at 1.5% each fiscal year. Second, the forecast assumes that the total number of registered CPFs paying taxes to the City increases from 41 in FY 2021 to 48 in FY 2023, and then up to 60 in FY 2026 and 2027. These numbers include both CPFs within the City of San Diego as well as CPFs that are outside of City limits but still must remit taxes to the City. Based on the

City’s Apportionment Regulation, all CPFs, regardless of operating location, must pay taxes on a portion of the revenue generated if certain conditions obtain, such as if the buyer is located within the City, if the product is delivered in the City, or if the payment is collected within the City. In FY 2021, 35 CPFs outside of the City paid taxes, while only 6 within the City did so. For the remainder of the forecast, growth in the number of CPFs outside the City remains constant, and thus most of the growth in the forecasted number of CPFs is for those that would be operating within the City. Table 1 shows both total CPFs as well as City located CPFs.

While working on the forecast, our Office developed a methodology that projected the anticipated revenues from CPFs within the City and outside of the City separately from one another, in order to see the differences in revenue assumptions from both categories of CPFs. This is different than the methodology utilized by the City Treasurer’s Office, as their methodology does not differentiate between CPFs inside and outside the City. We believe that splitting CPFs inside and outside the City in the forecast could create more clarity and provide more accurate estimates, since it allows for greater control of various variables that impact the forecast.

Once we developed this methodology, we realized that splitting up the two categories of CPFs dramatically increases the revenue assumptions within the forecast itself, both from a baseline perspective and future forecasted revenues. This is due to the fact that the average taxable annual revenue for the City based CPFs is much higher than those outside of the City, and thus grows much faster than those outside of the City. As such, we created a new forecast of the current policy, utilizing the same variables as the City Treasurer but just the new methodology. The differences between the two forecasts are shown in Table 2.

Table 2 ($ in Thousands)	**FY 2023**	**FY 2024**	**FY 2025**	**FY 2026**	**FY 2027**
Original Baseline	$ 2,348	$ 2,582	$ 2,823	$ 3,070	$ 3,116
New Baseline	$ 3,546	$ 4,492	$ 5,466	$ 6,468	$ 6,565
Difference	**$ 1,197**	**$ 1,910**	**$ 2,643**	**$ 3,398**	**$ 3,449**

In order to forecast the implications of the current proposal, our Office consulted with DSD as well as with the local industry to determine how quickly new CPFs may come into full operation if the tax rate is reduced, as well as how many businesses would come into operation without the tax rate reduction. Our Office concluded that the City Treasurer’s forecast in regards to the number of CPFs operating within the City is reasonable, and we worked with DSD to determine a new growth forecast for CPFs within the City under the proposed CPF tax rate reduction, which is displayed in Table 3. Table 3 also includes an increased the rate of growth in the average annual gross receipts of each CPF, based both on past trends and the implication that a lower tax rate may spur these businesses to grow their operations more quickly than currently projected. In our forecast of the reduced tax rate, we have increased the rate of growth in average annual receipts from 1.5% to 5.0% in each year for those CPFs operating within City limits.

Of note, based on these consultations, our Office decided to not change any of the factors regarding the CPFs that currently operate outside of the City but pay taxes to the City due to eligible activities within the City. Forecasting the implications of these entities is much more difficult because while more CPFs from outside the City may choose to do business with retailers inside the City, they may also be crowded out of the local market by the increase in production from the new CPFs that are developed in response to this tax rate change. As such, our Office determined that no change to this aspect of the forecast was best. Further, our Office did not project any changes to the current FY 2022 revenue assumptions for the rest of the year. Since the implementation date of this ordinance is the beginning of May 2022, it would only impact sales within the last two months of the fiscal year, and the FY 2022 impact would be minimal.

Table 3 ($ in Thousands)	**FY 2023**	**FY 2024**	**FY 2025**	**FY 2026**	**FY 2027**
Number of CPFs within City	20	26	30	35	40
Assumed Average Revenue Growth	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
CPF Revenue from within City	$ 1,138	$ 1,553	$ 1,882	$ 2,305	$ 2,766
Number of CPFs outside City	35	35	35	35	35
Assumed Average Revenue Growth	*1.5%*	*1.5%*	*1.5%*	*1.5%*	*1.5%*
CPF Revenue from outside City	$ 172	$ 174	$ 177	$ 179	$ 182
Total Estimated Revenue	**$ 1,309**	**$ 1,727**	**$ 2,058**	**$ 2,484**	**$ 2,948**
New Baseline Forecast (Table 2)	$ 3,546	$ 4,492	$ 5,466	$ 6,468	$ 6,565
Estimated Revenue Difference	**$ (2,236)**	**$ (2,765)**	**$ (3,407)**	**$ (3,983)**	**$ (3,617)**

After including the new forecasted CPF growth and increasing the rate of growth in average gross receipts for companies inside of the City, the new forecast yielded the expected revenue between $1.3 million and $2.9 million, as displayed in Table 3. As such, it is anticipated that this policy change would decrease estimated revenue to the City, based on the updated forecast from our Office, between $2.2 million and $3.6 million per year. This represents our Office's best estimate of the potential revenue loss to the City if the Council were to agree to lower the tax rate from 8% to 2% for CPFs only.

For reference, we *also* ran the forecast using the same methodology that the City Treasurer's Office currently uses for their CBT revenue forecast, which does not break out CPFs inside and outside the City. As mentioned, this report's methodology of forecasting revenue estimates from those CPFs inside and outside the City and separately increases the revenue assumptions for the CBT, both in the baseline forecast and in the forecast for the new reduced tax rate. Because this report's methodology represents a departure from past practice, we also include a comparison of the proposal using Treasurer's methodology, utilizing the same increased growth assumed in Table 3, as Appendix 1 of this report.

At this time, our Office takes no position on the merits of the policy proposal regarding the tax rate change. While we estimate that such a change would decrease City revenues, we would also recognize that decreasing the CPF tax rate might spur the creation of more businesses in this sector within the City. As such, this is a policy proposal with competing priorities and implications that the Council must weigh in making its decision.

Compliance for CPFs Paying the CBT

While researching this proposal, our Office discovered that City staff appear to have some difficulty in ensuring CPF businesses are complying with the City's CBT regulations. According to staff, while there are 21 CPF businesses currently operating within the City, only 13 can be considered in full compliance with the City's CBT regulations. Of those 13 in compliance, only seven of are currently paying taxes to the City. Two businesses are vertically integrated, and thus do not need to pay taxes, while another four are testing labs that are also exempt. Eight existing CPF businesses appear to be out of compliance with the City's CBT regulations. City staff did note that three of these businesses are currently working towards compliance, but another five are non-compliant and either have been referred or are being referred to the City's Delinquent Account Program.

There are several obstacles to ensuring compliance. While retail outlets are easy to find and have their City licenses tied to a particular business, tracking CPFs and ensuring that they are paying what they are supposed to be paying has been more difficult. Part of this is due to the fact that the Conditional Use Permits for the CPFs are tied to locations, and multiple businesses can be operating at one location. Further, as noted above, not all CPFs are subject to the CBT due to either vertical integration or being a testing lab. Finally, not all CPFs know about the City's CBT regulations and in some instances have been operating for several years before realizing that they owe the City significant penalties and back taxes, creating an even greater financial challenge to come into current compliance.

City staff from both the City Treasurer's Office and DSD note that they are working more closely together on this issue, and that their efforts to bring non-compliant businesses into compliance have been more effective in recent months. However, City staff also noted that more could be done to improve compliance efforts, especially if more businesses are expected to become operational in the near future. While ensuring compliance with the CBT is important under current conditions, it will be essential if the existing tax rate is reduced. **As such, our Office recommends that City staff comment on their current compliance efforts during the Council meeting, and potentially bring new compliance policies back to the appropriate City Council Committee.** We believe this recommendation is important regardless of if the tax reduction proposal is accepted.

CONCLUSION

Following the request at the November ED&IR Committee meeting to provide a fiscal impact of the proposal to lower the tax rate on CPFs from 8% to 2%, our Office worked with the appropriate City staff and industry contacts to forecast this proposal's potential fiscal impacts to the City's General Fund. Based on the expected rate of growth in CPFs from this proposal, our Office estimates that the City would forego between $2.6 million and $3.6 million in revenue annually over the next five fiscal years compared to our forecast of the market under the current tax rate. That noted, the decision to keep or lower the CPF tax rate remains a policy question for Council.

Our Office also recommends City staff comment on their compliance efforts to get CPFs to pay the appropriate taxes to the City, and potentially bring back new compliance policies to the appropriate City Council Committee for consideration. Our Office would like to thank the City staff from the City Treasurer's Office, DSD, as well as the local industry for their assistance to us in researching this report, and if requested we are more than willing to assist the Council on this issue.

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Results of a Combined Methodology Forecast

As mentioned in the main report, our Office utilized a different methodology to determine both the baseline revenue estimates for the City under the current CBT tax rate, as well as the potential revenue for the new tax rate if it is reduced. Table 1 below displays the key factors and assumptions in the City Treasurer's forecast, while Table 2 shows the key factors and revenue assumptions under the tax reduction proposal if the forecast utilized the combined methodology of the City Treasurer's original forecast.

Table 1 ($ in Thousands)	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
Number of CPFs total	48	52	56	60	60
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Number of CPFs outside City	35	35	35	35	35
Assumed Average Revenue Growth	1.5%	1.5%	1.5%	1.5%	1.5%
Total Estimated Revenue	**$ 2,348**	**$ 2,582**	**$ 2,823**	**$ 3,070**	**$ 3,116**

Table 2 ($ in Thousands)	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
Number of CPFs total	55	61	65	70	75
Number of CPFs within City	20	26	30	35	40
Number of CPFs outside City	35	35	35	35	35
Assumed Average Revenue Growth	5.0%	5.0%	5.0%	5.0%	5.0%
Total Estimates Revenue (at 2%)	**$ 696**	**$ 810**	**$ 907**	**$ 1,025**	**$ 1,153**
Baseline Forecast (Table 1)	$ 2,348	$ 2,582	$ 2,823	$ 3,070	$ 3,116
Estimated Revenue Difference	**$ (1,652)**	**$ (1,772)**	**$ (1,916)**	**$ (2,044)**	**$ (1,962)**