May 26, 2022

The Honorable Gavin Newsom
Governor, State of California
State Capitol, First Floor
Sacramento, CA 95814

The Honorable Toni Atkins
Senate Pro Tempore
State Capitol, Room 205
Sacramento, CA 95814

The Honorable Anthony Rendon
Speaker of the Assembly
State Capitol, Room 219
Sacramento, CA 95814

Re: Response to the Governor's Cannabis Tax Proposal in the May Budget Revision

Dear Governor Newsom, Speaker Rendon, and Pro Tem Atkins,

On behalf of Origins Council, representing nearly 900 licensed small and independent cannabis businesses in six legacy producing counties throughout California, we are writing today in response to the cannabis trailer bill proposal included in the Governor's May Budget Revision.

After reviewing proposed trailer bill language, we understand that the proposal includes the following elements:

- Zeroes out the cultivation tax starting July 1, 2022, while temporarily maintaining the excise tax rate at 15%.
- Shifts excise tax collection and remittance from distribution to retail starting January 1, 2023.
- Between January 1, 2024 and July 1, 2025, allows the excise tax to potentially be increased if Tier 3 funding for social services, environmental services, and other programs generated from cannabis tax revenue falls below $670 million. $150 million in general fund dollars would be made available as backfill for fiscal years 2023-24, 2024-25, and 2025-26 to help to mitigate the likelihood of an excise tax increase.
- Beginning July 1, 2025, the excise tax would automatically increase to 19%, regardless of how much cannabis tax revenue is received.

While we strongly support the proposed changes to cultivation tax, we also have significant concerns regarding the potential for tax increases under this proposal, particularly the automatic excise tax increase which would be triggered on July 1, 2025, which would amount to a significant net increase in overall cannabis taxation.

Due to the nuanced nature of the tax proposal in the May Budget revision, we believe it is important that conversations on the trailer bill's potential impacts are informed by an analysis of the potential impacts over time. Each of the proposed elements in the proposal are considered below.

Support for Proposed Cultivation Tax Changes

We strongly support the proposal to zero out the cultivation tax beginning July 1, 2022.

Since summer of 2021, wholesale prices for outdoor cannabis have dropped from approximately $1,000/pound to approximately $300-$400/pound. During the same time period, the weight based cultivation tax on cannabis flower has increased from $154/pound to $161/pound. As a result, state cultivation taxes alone can now account for 50% or more of wholesale prices for flower. Similarly, cannabis leaves, or "trim," are currently selling for $8-$20/pound to the farmer. Cannabis leaves are currently taxed by the state at $48/pound, meaning substantially more is paid to the state as taxation than the farmer receives as revenue.

While current market conditions have highlighted the inequity of the cultivation tax, many of the cultivation tax's challenges are inherent to a farm-based tax on an agricultural product. A single weight-based tax on "cannabis flower" cannot account for widely varying grades of flower, which vary based on cultivar selection, production methodology, and seasonal conditions. Even on a single plant, larger “A-buds” are valued at a different rate from small “B-buds,” but both are subject to the same $161/pound flower tax.

Additionally, cultivation taxes are subject to complex calculation and recordkeeping requirements which impact the entire supply chain, increasing overhead costs and administrative complexity for both licensees and regulators.

Zeroing out of the cultivation tax should be a cornerstone of meaningful tax reform, and we strongly support this aspect of the proposed trailer bill.

Shift of Tax Collection and Remittance to Retail Is an Administrative Simplification - But Also an Effective Tax Increase

Conceptually, we support the proposal to shift tax excise collection and remittance from distribution to retail beginning January 1, 2023. The current structure of excise tax remittance is needlessly complicated, and changing the point of remittance to retail will result in administrative streamlining for both licensees and regulators.

As policymakers consider the relationship between the point of tax collection and the overall tax rate, however, it is important to note that changing the point of excise tax remittance to retail will also act as an effective tax increase in relation to the current tax structure if all other factors remain equal. The table below, as with other tax analysis in this document, is based on publicly-available cannabis tax data from the California Department of Tax and Fee Administration available at
https://www.cdtfa.ca.gov/dataportal/dataset.htm?url=CannabisTaxRevenues.

	Q1 2021	Q2 2021	Q3 2021	Q4 2021
Actual cannabis revenue received under current tax structure (in millions)	193.3	217.9	218.0	196.4
Counterfactual tax revenue[1]: 15% excise tax, $161/pound cultivation tax, collection at retail (in millions)	219.2	254.6	236.7	227.5
Counterfactual tax revenue: 15% excise tax, no cultivation tax, collection at retail (in millions)	185.2	213.2	193.9	188.5

[1] By “counterfactual tax revenue,” we mean the cannabis tax revenue that the state would have received in 2021 if an alternative tax structure had been in place at that time.

If cannabis taxes had been collected at retail and all other aspects of the cannabis tax structure had remained the same throughout 2021, CDTFA data suggests that the total tax burden on the cannabis industry would have increased by $112.3 million, or 13.6%.[2]

The structural tax increase triggered by shifting collection to retail is significant enough that zeroing out the cultivation tax and maintaining the excise tax rate at 15% would result in a relatively small overall tax decrease. Had this structure been in place over the past year, CDTFA data suggests that total tax revenue would have decreased by $44.9 million, or about 5.4%.

Automatic Increase of Excise Tax to 19% Beginning July 1, 2025 Would be a Net Tax Increase

Considering the large structural increase in cannabis taxation triggered by moving excise tax remittance to retail, the combination of 1) changing the point of remittance and 2) the proposed automatic excise tax increase to 19% would trigger a substantial net tax increase on the industry beginning July 1, 2025 - even considering the zeroing out of the cultivation tax.

	Q1 2021	**Q2 2021**	**Q3 2021**	**Q4 2021**
Actual cannabis revenue received under current tax structure (in millions)	193.3	217.9	218.0	196.4
Counterfactual tax revenue: 19% excise tax, no cultivation tax, collection at retail (in millions)	234.6	270.0	245.6	238.7

Applied counterfactually to 2021, the tax structure proposed for implementation beginning July 1, 2025, would have increased total cannabis taxes by $163.3 million, or 19.8%.

Given this analysis, we have significant concerns with the tax policy proposed in the trailer bill beginning July 1, 2025. The licensed cannabis market already faces serious challenges in competing with illicit alternatives, and additional tax increases will only drive more consumers to purchase cannabis outside the regulated market. Additionally, it is not clear to us how the 19% excise tax rate was determined, and why this increase is proposed to be automatic, rather than conditionally tied to revenue benchmarks (as is the case between January 1, 2024 and July 1, 2025).

[2] All numbers included here calculate "total cannabis tax revenue" by adding the net total of the cannabis cultivation tax and cannabis excise tax. Sales and use tax data is not included in these calculations. Alternative models that include sales and use tax data as part of "total cannabis tax revenue," yield slight differences in the estimated percentage increase or decrease to cannabis tax revenue. However, the directionality of projected revenue changes under a given tax model is the same regardless of whether sales and use tax is included.

<u>Conditional Increase of Excise Tax Rate Between January 1, 2024 and July 1, 2025</u>

Between January 1, 2024, and July 1, 2025, trailer bill language would allow the excise tax rate to be adjusted at a rate up to 19%, but no lower than 15%, to ensure that Tier 3 programs continue to be funded at a baseline of $670 million. $150 million would be allocated over this time period to help maintain the $670 million baseline, and potentially avoid an increase to excise taxes.

We estimate that the net tax change attributable to the elimination of cultivation tax, in conjunction with moving excise tax remittance to retail, would be a net tax decrease of 5.4%. With the proposed $150 million backfill, we project that even modest market growth during this time period would be adequate to hit revenue benchmarks necessary to prevent an increase to excise tax.

In terms of tax models, we appreciate this conditional approach, which moves away from fixed standards. As we have found with the cultivation tax, fixed standards create significant challenges when applied to the nascent and extraordinarily dynamic pre-federal legalization landscape.

Additionally, proposed trailer bill language grants authority for excise tax to remain at 15% based on revenue benchmarks, but appears to leave this as a discretionary decision for administrative agencies. We recommend that the benchmarks for determining excise tax during this period be set based on clearly-defined conditional triggers, and not left as discretionary decisions.

<u>Inclusion of Equity Provisions</u>

We are disappointed to not see specific provisions to support equity operators included in proposed trailer bill language. Our rural legacy producing communities have been heavily impacted by the War on Drugs over many decades, and are struggling to stabilize our local regulated cannabis industries, due to being under-resourced rural communities contending with complex and expensive environmental licensing requirements.

Further, we are deeply concerned about the substantial challenges faced by equity operators in urban areas, many of whom are also small and independent businesses. For example, over the past several years, many urban equity operators have suffered armed robberies, vandalization and business losses in the millions - in some cases multiple times.

While the crisis facing the California cannabis industry is universal and systemic in its impact, we feel that social equity businesses need to be a priority within any tax relief policy. A number of potential policies to provide support for equity operators have been proposed, such as SB

1293 (Bradford), which would provide equity-qualified operators with tax credits against personal or corporate income taxes. We support the inclusion of additional equity provisions which are developed in collaboration with representative organizations of equity operators.

<u>Funding for Retail Expansion</u>

In addition to changes to tax policy, the proposed May Budget Revision contains $20.5 million in funding to incentivize local jurisdictions to license additional retail outlets. We support this proposal, which would help to address a severe lack of cannabis retail access throughout California, and which would help drive additional tax revenue for Tier 3 allocations by expanding the overall size of the market. Facilitating pathways for success within the regulated market will help to establish mutual benefit for both a thriving cannabis industry and stable revenue for Tier 3 programs.

Thank you for your consideration,

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