



Agenda Report

MEETING DATE: Tuesday, March 9, 2021

TO: City Council

FROM: COMMUNITY DEVELOPMENT DIRECTOR MERRIAM
SUZI MERRIAM, COMMUNITY DEVELOPMENT DIRECTOR
CINDY CZERWIN, ADMINISTRATIVE SERVICES DIRECTOR

SUBJECT: ORDINANCE ADOPTING MODIFICATIONS TO SECTIONS 3-6.1201 (DEFINITIONS) AND 3-6.1206 (AMOUNT OF TAX OWED) OF THE CANNABIS TAX ORDINANCE TO INCLUDE MODIFIED TAX RATES FOR THE WATSONVILLE CANNABIS BUSINESS TAX AS FOLLOWS: (PURSUANT TO SECTION 3-6.1232 OF THE WA

STATEMENT OF ISSUES:

Modification of Title 3-6 of the Watsonville Municipal Code to amend the tax rate for cultivation and retail sales of cannabis, adding a separate tax rate for nursery plants and processing, and updating definitions to meet current state law and best practices.

RECOMMENDED ACTION:

Staff recommends that the City Council:

1. Amend Chapter 3-6 to adjust cannabis tax rates as follows:
 - 5% tax on gross receipts for retail cannabis; and
 - \$10 per square foot tax of canopy area for cannabis cultivation; and
 - \$1 per square foot tax of canopy area for cannabis nurseries and immature plants; and
 - 2% on gross receipts for cannabis processing; and
2. Amend Chapter 3-6 text to meet current state regulations and best practices.

DISCUSSION:

On November 8, 2016, California voters passed Proposition 64 (The Adult Use of Marijuana Act), which legalized cannabis in California. The deadline to pass permanent state regulations governing the cultivation, manufacture, distribution, testing and sales of cannabis was January 1, 2018.

On November 8, 2016, Watsonville voters passed Measure L, the Watsonville Marijuana Business Tax, 74.2% to 25.8%. Measure L implemented a tax on cannabis cultivation, manufacturing, and retail sales.

On December 13, 2016, the Council adopted Ordinance No. 1345-16, adding a new Chapter 52 (Cultivation, Processing, Manufacture, Distribution, Testing and Sale of Nonmedical Cannabis) of Title 14 (Zoning) of the Watsonville Municipal Code. The ordinance prohibited all recreational cannabis business activities in the City.

On April 25, 2017, the Council adopted [Ordinance No. 1352-17](#), adding a new Chapter 14-53 to the Watsonville Municipal Code. Ordinance 1352-17 permitted and regulated medical cannabis cultivation and manufacturing within the City. Use of recreational or “adult-use” cannabis continued to be prohibited in the City.

The Governor signed SB 94 also known as the [Medicinal and Adult-Use Cannabis Regulation and Safety Act](#) MAUCRSA on June 27, 2017

On December 7, 2017 the California State Bureau of Cannabis Control adopted Emergency Regulations to clarify and make specific licensing and enforcement criteria for commercial cannabis businesses under MAUCRSA.

MAUCRSA became effective on January 1, 2018 and rescinded the December 7, 2017 Emergency Regulations.

On January 16, 2018, the Council adopted Ordinance 1362-18 [\(codified at WMC 14-53 101 et seq\)](#) which allowed cultivation and manufacture of recreational cannabis and rescinded Ordinance 1361-18 which prohibited recreational cannabis. Ordinance 1362-18 became effective on March 15, 2018.

On March 13, 2018, the Council adopted [Ordinance 1364-18 which amended WMC 14-53](#) Ordinance 1362-18 and allowed existing cultivation and manufacturing facilities to distribute recreational cannabis. Ordinance 1364-18 became effective April 26, 2018.

On June 9, 2020, the Council adopted Ordinance 1404-20, which repealed and replaced Ordinance numbers 1362-18 and 1364-18, and adopted modifications to Title 14 (Zoning) regarding the cultivation, manufacture, distribution, testing, delivery and retail sales of cannabis and cannabis products.

On September 15, 2020, the City’s cannabis application period for 30 days, closed on October 15, 2020.

On February 17, 2021, the City issued Notices of Decision to all cannabis businesses who submitted Pre-Applications during the application period.

Proposed Modifications

In the last year, staff has worked with HDL on modifications to the current cannabis tax ordinance. This included changes to the tax rate, timing of payments, and modification to the definitions in order to bring the ordinance into alignment with current industry standards.

Modification Process

Watsonville Municipal Code Chapter 3-6.1232 allows the City Council to make modifications to the Cannabis Tax as long as those amendments do not increase the voter-approved tax rate or create a new tax. The following actions do not constitute an increase of the tax rate:

- (a) The restoration of the tax rate to a rate no more than set by this chapter, if the Council has acted to reduce tax rate;
- (b) The increase of the tax rate from a prior rate if the increase is to a rate no more than allowed by this chapter;
- (c) An action that interprets or clarifies the methodology of the tax, or any definition applicable to the tax, so long as interpretation or clarification (even if contrary to some prior interpretation or clarification) is not inconsistent with the language of this chapter;
- (d) The establishment of a class of persons that is exempt or excepted from the tax or the discontinuation of any such exemption or exception (other than the discontinuation of an exemption or exception specifically set forth in this chapter); or
- (e) The collection of the tax imposed by this chapter, even if the City had, for some period of time, failed to collect the tax.

The proposed modifications fall under subsection (c), as staff is proposing to update definitions, lower the tax rate for cultivation and retail sales, and modify the timing and payment of taxes.

Fiscal Analysis of the Commercial Cannabis Industry prepared by HDL

On March 3, 2020, HDL provided the City with a draft analysis of taxation on the cannabis industry throughout California, and provided recommended modifications for the City of Watsonville to both maintain parity with other jurisdictions in the state and region and ensure that Watsonville cannabis businesses are able to remain competitive with businesses throughout the state. HDL provided an updated draft analysis, based on staff input in November, 2020.

Measure L, passed by voters in 2016, established a tax on the cultivation, manufacturing, and retail sales of cannabis as follows:

Type of Business	Tax Rate
Cultivation	\$20/square foot
Manufacturing	2.5%
Retail Sales	10%

Since legalization of cannabis in 2016, the cannabis industry and regulatory framework for the industry have changed dramatically. Legalization has created a competitive, free-market for cannabis businesses which did not exist before, while startup and operational costs have

skyrocketed. Anyone considering establishing a cannabis business legally now must consider these costs, as well as the local tax structure in the particular jurisdiction. As the City looks to attract new types of cannabis businesses to Watsonville, we must pay attention to the tax structures in neighboring jurisdictions. Current tax rates in nearby jurisdictions are listed in the table below.

Cannabis Taxes in Nearby Jurisdictions				
	Cultivation	Nursery	Retail	Manufacture
Watsonville	\$20/sf	\$20/sf	10%	2.5%
Salinas	\$15/sf	NA	5%	5%
Marina	5%	5%	5%	5%
Hollister	\$7/sf	5%	5%	5%
Santa Cruz County	6%	7%	7%	6%
Monterey County	\$8/sf	\$1/sf	4.5%	3.5%
City of Santa Cruz	6%	6%	7%	6%

As shown in the table above, Watsonville's tax rates are higher than any other jurisdiction in the area except for the manufacturing tax. Given that the City will be considering approval of additional cannabis businesses to open business in the City in 2021, it is necessary to adjust the City's current cannabis tax rates nearer to industry standards.

Cultivation Tax

The current tax rate of \$20 per square foot historically applied to all plants, both flowering canopy and immature plants. The revised Cannabis Ordinance revised the definition of canopy, which separated out immature plants and nurseries from flowering canopy so that they can be taxed at different rates, which is the industry standard. In addition, the revised Ordinance now regulates processing licenses, which is the "drying, curing, grading, or trimming of cannabis within a permitted cannabis cultivation facility or as part of a standalone cannabis processing facility." This additional cultivation activity is taxable under WMC Chapter 3-6.

Staff proposes a revised tax rate for cultivation operations as follows:

Cannabis Business Type	Current Rate	Proposed Rate
Flowering Canopy	\$20/sf	\$10/sf
Nursery/immature plants	\$20/sf	\$1/sf
Processing	NA	2% of gross receipts

The previous Cannabis Ordinance also limited the size of a cultivation facility to 5,000 square feet, while the current ordinance allows cultivation up to 22,000 square feet. For those cultivators that expand operations up to the 22,000 square foot limit, the reduced taxation amounts will encourage this expansion while the City may not experience a significant

reduction in tax received. An analysis of the potential difference in tax revenue based on the reduced tax is outlined below.

Cannabis Cultivation: Current Structure							
Cultivation	#Sites	Avg SF	Canopy area (80%)	Nursery area (20%)	Cultivation tax @ \$20/sf	Nursery Tax @ \$20sf	Total Revenue
Scenario 1	6	5,000	4,000	1,000	\$480,000	\$120,000	\$600,000
Scenario 2	6	11,000	8,800	2,200	\$1,056,000	\$264,000	\$1,320,000
Scenario 3	6	22,000	17,600	4,400	\$2,112,000	\$528,000	\$2,640,000

Cannabis Cultivation: Proposed Structure							
Cultivation	#Sites	Avg SF	Canopy area (80%)	Nursery area (20%)	Cultivation tax @ \$10/sf	Nursery Tax @ \$1/sf	Total Revenue
Scenario 1	6	5,000	4,000	1,000	\$240,000	\$6,000	\$246,000
Scenario 2	6	11,000	8,800	2,200	\$528,000	\$13,200	\$541,200
Scenario 3	6	22,000	17,600	4,400	\$1,056,000	\$26,400	\$1,082,400

HDL recommended a cultivation tax of \$7 per square foot, however the tax rate in Monterey County, the City's closest competitor, is currently set at \$8 per square foot, and the only jurisdiction in the tri-county area with a lower tax is Hollister. In order to provide a competitive tax rate while continuing to provide support to City staff in monitoring and compliance, staff recommends that the cultivation tax rate be reduced from \$20 per square foot to \$10 per square foot for flowering canopy. This halving of the cultivation tax for flowering canopy combined with the \$19 per square foot reduction for non-flowering plants should significantly reduce the cost burden for the City's growers while providing needed tax revenue for the City.

Processing Tax

The state created a cannabis processing license that allows for the separate drying, curing, and processing of cannabis, which is also allowed as part of a cultivation license. Staff recommends that a tax of 2% of gross receipts be applied to cannabis processing businesses. The amount of revenue generated from a processing tax is reliant on the size of the business and amount of cannabis processed through the facility annually. Based on applications received for processing permits, tax revenue could be as little as \$3,600 to more than \$40,000 per year.

Retail Tax

The City's retail tax rate is currently set at 10%, which is significantly higher than the tax charged throughout the county and region. The table below shows the current tax rates in surrounding jurisdictions.

Retail Cannabis Taxes in Nearby Jurisdictions	
	Retail
Watsonville	10%
Salinas	5%
Marina	5%
Hollister	5%
Santa Cruz County	7%
Monterey County	4.5%
City of Santa Cruz	7%

Based on geography, Monterey County is the closest jurisdiction to Watsonville, and a retail dispensary exists right over the river in Pajaro. In considering competition for future dispensaries in Watsonville, the city must be sensitive to tax rates in these nearby jurisdictions. It is for this reason that staff recommends that the city adjust the retail cannabis tax rate to 5% in order to reduce the competition that city cannabis retailers may have with nearby retailers in other jurisdictions.

HDL estimates that the tax revenue generated annually from 3 retail dispensaries paying a rate of 5% would be between \$266,227 and \$582,785 per year.

Total Estimated Revenue from Cannabis Businesses

Based on the report prepared by HDL and the number of facilities that the city may be permitted in 2021, the expected tax revenue is outlined below.

Estimated Annual Tax Revenue				
Business Type	# Permits	Proposed Rate	Revenue- Low End	Revenue- High End
Cultivation	6	\$10/sf	\$246,000	\$1,082,400
Nursery	6	\$1/sf	\$6,000	\$26,400
Processing	2	2%	\$3,600	\$40,000
Manufacturing	15	2.5%	\$900,000	\$900,000
Retail	3	5%	\$266,227	\$582,785
Total			\$1,421,827	\$2,631,585

The tax structure adopted by Watsonville voters in 2017 had a companion bill that directed how cannabis tax revenue would be distributed between different city departments. The distribution table, with revenue projections is illustrated below. This revenue is used to fund enforcement by the Community Development, Fire and Police Departments and provide for prevention programming in the Parks and Community Services Department and Library.

Department	Portion of Tax Revenue	Low-End	High-End
Police Department – Personnel	20%	\$284,365	\$526,317
Fire Department – Personnel	15%	\$213,274	\$394,737
Community Development Department – Personnel	20%	\$284,365	\$526,317
Parks and Community Services – Personnel	15%	\$213,274	\$394,737
Parks and Community Services - Programming	10%	\$142,183	\$263,158
Library – Personnel and Resources	8%	\$113,746	\$210,526
Non Profit Grants – Recipients Determined by Council	12%	\$170,619	\$315,790

SUMMARY:

In 2021, the City will see a large expansion of cannabis businesses, and it is essential that the City adjust the cannabis tax rates so that these businesses can compete in the statewide marketplace. These businesses will bring in jobs for local residents and will serve to increase the local tax base. The adjustment in cannabis tax rates will not only help support the cannabis businesses but will also serve to support the regulated cannabis market, as the easier, cheaper, and more reliable it is for consumers to access safe cannabis legally, the less reason they will have to purchase cannabis through the black market.

STRATEGIC PLAN:

The modifications to the Cannabis Tax Ordinance support Goal 2 (Fiscal Health) of the 2018-2020 Strategic Plan.

FINANCIAL IMPACT:

Although the tax rates are proposed to be reduced through this modification, they are balanced with an expansion of the local cannabis industry so that the reductions are outweighed by additional types of businesses, including retail. Ultimately, cannabis tax revenues will be increased through the expansion of the permitting program as outlined in this staff report.

ALTERNATIVE ACTION:

The City Council may have staff return with modified tax rates after public hearing, or may choose not to modify the current tax structure.

ATTACHMENTS AND/OR REFERENCES:

- 1) Fiscal Analysis of the Commercial Cannabis Industry prepared by HDL Companies