



OFFICE OF THE CONTROLLER

CITY AND COUNTY OF SAN FRANCISCO

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MEMORANDUM

TO: Members of Board of Supervisors

FROM: Controller's Office

DATE: September 2022

SUBJECT: **Review of San Francisco's Cannabis Market**

Background

San Francisco voters approved Proposition D in November 2018. This proposition and its subsequent amendments, impose a tax on gross receipts from cannabis business activities, effective January 1, 2023, as shown below.

	\$0.0M - \$1.0M GR	Tier 1 \$1.0M - \$1.5M GR	Tier 2 \$1.5M+ GR
Retail Sale	0%	2.5%	5%
Non-Retail Sale	0%	1%	1.5%

The tax is applied progressively, with the first \$1.0 million of gross receipts exempted; the next \$0.5 million of gross receipts (between \$1.0 million to \$1.5 million total gross receipts) taxed at either 1% or 2.5%; and remaining gross receipts (anything above \$1.5 million total gross receipts) tax at 1.5% or 5%.

The Board of Supervisors may increase rates by 1% per year up to 7% of gross receipts with a two-thirds vote or decrease rates with a majority vote. The purpose of this memo is to briefly summarize the City's recent data on San Francisco's cannabis market, as well as state and other factors, to inform rate setting discussions.

California Context

California legalized medical cannabis with Proposition 215 (1996). Possession, cultivation, and adult recreational use of cannabis was legalized with the passage of Prop 64 (2016), which made the sale and taxation of cannabis legal effective January 1, 2018.

Proposition 64 imposed a 15% state excise tax on the purchase of cannabis products sold at retail stores and a tax by weight on cannabis cultivation. In 2021, the state collected total revenue of \$1.3 billion from its cannabis taxes. The 15% excise tax generated 52% of this revenue followed by 36% from the sales tax and 12% from the cultivation tax.

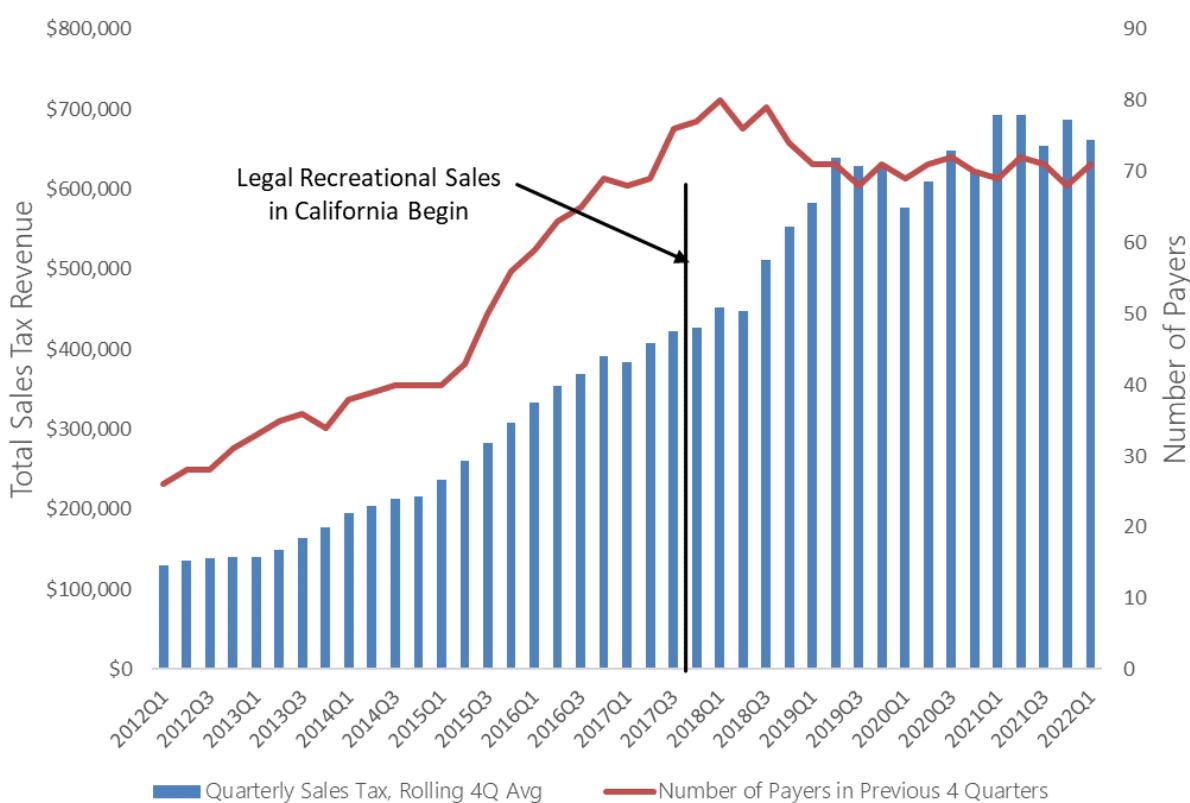
As of July 1, 2022, the cultivation tax has been eliminated by the state. The excise tax will remain at 15% for the next three years, but after that time, legislators may raise the excise tax to compensate for revenue lost from eliminating the cultivation tax. The cultivation tax was previously based on weight and differentiated by parts of the cannabis plant. The elimination of this tax was intended to simplify a complex tax structure, reduce financial burdens on struggling cannabis businesses, and help the legal market compete with the illicit market.

San Francisco's Cannabis Market

Sales Tax Data Indicate Number of Businesses and Revenue is Stable

Because San Francisco's cannabis market is largely comprised of retail businesses, sales tax data can be used to understand changes and trends in the local market.

Figure 1: Quarterly Sales Tax Collected by Retail Cannabis Business Activities, 2012—2022



The Figure 1 above shows the number of cannabis businesses remitting sales tax and the total tax collected from sales in the first quarter of 2011 through the first quarter of 2022. Prior to Prop. 64, cannabis for medical use was not subject to sales tax if certain regulatory conditions were met, though in practice, most medical cannabis was taxed. Prop. 64 eliminated sales tax on medical cannabis, therefore, amounts in the graph above are for medical cannabis before 2018 and recreational use cannabis after 2018.

Revenue increased rapidly in the earlier part of the 2010's but since the second quarter of 2019, revenue has leveled out to an average of approximately \$650,000 of sales tax per quarter and the number of cannabis businesses has also stabilized at an average of about 70 payers.

The size distribution of San Francisco's retail cannabis businesses in calendar year 2021 is shown in Figure 2 below. About 40% of retail cannabis businesses generated less than \$1.0 million of gross receipts (exempt from tax under current structure), about 5% generated between \$1.0 and \$1.5 million of gross receipts (Tier 1 of current structure), and the remaining businesses generated more than \$1.5 million of gross receipts (Tier 2 of the current structure). About 70% of gross receipts are concentrated in cannabis retailers whose gross receipts are greater than \$10.0 million.

Figure 2: Distribution of Retail Cannabis Gross Receipts, 2021

Value of Gross Receipts	Current Tax Rate Tier Level	Number of Sellers	Total Gross Receipts (\$ Millions)	Average Gross Receipts per Seller (\$ Millions)
Less than \$1.0M	Exempt	29	8.0	0.3
Between \$1.0M and \$1.5M	Tier 1	4	7.8	1.9
Between \$1.5M and \$2.5M	Tier 2	4	9.6	2.4
Between \$2.5M and \$5.0M	Tier 2	14	50.3	3.6
Between \$5.0M and \$10.0M	Tier 2	11	74.2	6.7
Greater than \$10M	Tier 2	9	124.8	13.9
Total		71	274.7	3.9

Including the cumulative effects of state and local taxes, a San Francisco cannabis retailer with more than \$1.5 million of total gross receipts would apply a marginal tax rate of 28.7% to the sale of its next good. The taxes include state sales and excise taxes, as well as the current local excise tax and business tax.

Tax	Rates
CA Cannabis Tax	15.000%
CA/SF Sales Tax	8.625%
SF Retail Cannabis Tax (Prop D)	5.000%
SF Gross Receipts Tax	0.079%
TOTAL	28.704%

Comments from industry participants

In addition to reviewing sales tax data, we interviewed state and local cannabis industry stakeholders and observers, including industry group representatives, academics, retailers, and one manufacturer. Some observations that surfaced:

- **Heightened Financial and Regulatory Burden.** Besides taxation at state and local levels, cannabis businesses face additional unique burdens because cannabis is classified as a Schedule 1 Controlled Substance at the federal level. This means cannabis businesses face higher effective federal tax rates because they are unable to deduct ordinary business expenses under Section 280E of the Internal Revenue Code. In addition, businesses lack access to regular banking channels, resulting in heightened security risks and therefore higher operating costs to keep cash and goods safe at retail locations.

Industry participants and observers additionally note California's regulatory compliance system is complex, creating another barrier for businesses to join the regulated market.

- **Cannabis Overproduction Led to Price Drops in 2021.** In 2021, cannabis wholesale prices plummeted throughout the state as the market was oversupplied with product. Growers had anticipated additional, sustained demand during the COVID-19 pandemic and produced more cannabis than prior years. When demand did not meet anticipated levels of supply, prices fell precipitously. As reported in news reports, the price per pound of flower in California dropped from roughly \$1,200 per pound to approximately \$700 per pound in 2021.ⁱ
- **Persistence of Illicit Market.** Interviews with industry participants suggest that unregulated sales may comprise as much as one-half to two-thirds of the total cannabis market. Business and consumer expectations about cannabis pricing and tax levels were established over 20 years between Prop 215 (1996) and Prop 64 (2016), when medicinal cannabis was legal but recreational cannabis was not. Due to this history, underenforcement, and heightened financial and regulatory burden described above, legal operators continue to struggle to compete with a large, well-established legacy market.

Benchmarking

The figure below compares cannabis excise tax rates and recent changes in select peer cities in California. Five of the six municipalities have modified their cannabis tax rates since 2018, generally by lowering their excise tax rates or further differentiating rates by business type, particularly lowering non-retail rates. Besides the jurisdictions shown in the table below, as of May 2022, nine additional jurisdictions in California also adjusted or were considering adjusting their cannabis tax rates.

Figure 2: Previous & Current Cannabis Tax Rates of Selected California Municipalities

TAX BASE		PREVIOUS TAX RATE(S)	CURRENT TAX RATE(S)	DATE OF CHANGE
Berkeley	<u>Gross Receipts</u> Same across all recreational cannabis businesses.	10%	5%	February 2018
Oakland	<u>Gross Receipts</u> Separated into two tiers (equity and non-equity) and 5 rates based on type of business	10% same across all recreational cannabis businesses	Ranges from 0.12% at lowest tier to 5% at highest tier.	December 2019
Sacramento	<u>Gross Receipts</u> Same across all recreational cannabis businesses.	4%	4% *	N/A
San Diego	<u>Gross Receipts</u> Separated into 2 rates by type of business	8%	Retail: 8% *Manufacturers & Growers: 2%	May 2022
San Jose	<u>Gross receipts</u> Separated into 4 rates by type of business.	10% same across all recreational cannabis businesses	Retail: 10% * Cultivation: 4% Manufacturing: 3% Distribution: 2% Testing: 0%	July 2019
Sonoma	<u>Gross Receipts</u>	Manufacturing: 3%	Manufacturing: 3%*	March 2022

	<u>Cultivation Tax</u> Based on square footage	Dispensary: 2% Cultivation: from \$1 - \$11.25 per sq ft	Dispensary: 2%* Cultivation: from \$0.62 - \$6.96 per sq ft	
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* Indicates no change in tax rate.

The figure below shows the cumulative impact of federal, state, and local excise taxes on potentially comparable products. Such taxes are often referred to as "sin taxes," as their goal is to discourage use of potentially harmful products by increasing their prices. The revenue generated by these taxes are sometimes used to support programming that offsets potential harm. Although taxes at each level of government can vary by volume, potency, and business attributes, this analysis assumes standard units sold by large businesses.

Figure 3: Current Federal, State, and Local Tax Rates for Comparable Products

	Soda	Beer	Wine	Cocktail	Cigarette	Joint without Prop D Tax	Joint with 5% Prop D Tax
Unit Size	12 oz	12 oz	5 oz	1.5 oz	1	1 gram	1 gram
Example Potency	25+ Calories	5% ABV	13% ABV	50% ABV	10 mg Nicotine	25% THC	25% THC
Example Cost per Unit*	\$2	\$3.50	\$4.25	\$10	\$0.50	\$11	\$11
Federal Tax	-	\$0.05	\$0.04	\$0.16	\$0.05	-	-
State Tax	-	\$0.02	\$0.01	\$0.04	\$0.14	\$1.65	\$1.65
Local Tax	\$0.12	-	-	-	\$0.05	-	\$0.55
Sales Tax	\$0.17	\$0.30	\$0.37	\$0.86	\$0.04	\$0.95	\$0.95
Total Tax	\$0.29	\$0.37	\$0.42	\$1.06	\$0.28	\$2.60	\$3.15
Example Total Tax Rate	15%	11%	10%	11%	57%	24%	29%

*Alcohol cost per unit is taken from the to-go menu at a large Union Square restaurant. Cost per cigarette assumes \$10 per pack. The price for one joint is the median price for a pre-rolled joint of the items sold from delivery service Eaze in San Francisco.

Note: The table does not account for typical units consumed.

Taxes imposed on these goods range from \$0.29 per unit of soda to \$2.60 per unit of cannabis and comprise 10% to 57% of the total cost per unit. Should San Francisco's currently suspended excise tax of 5% (for large retail business) be imposed, the total tax for a serving of cannabis would increase from \$2.60 to \$3.15, or from 24% to 29% of the total cost per unit. Adjusted for the typical price per unit, though not for the typical number of units consumed, cannabis would be taxed at two to three times the rate of alcohol and roughly half the rate of cigarettes.

Principles for Tax Rate Setting

Below are common principles for policy makers to consider when establishing tax policy and setting tax rates. These criteria may conflict with each other, requiring trade-offs:

(1) Revenue Generation. The FY 2023-24 budget assumes that the current cannabis business tax rates will be implemented and will generate \$10.4 million in revenue, primarily from retail sales. This estimate is based on historical sales tax data. For every percentage point increase or decrease in the tax rate, the revenue generated is estimated to increase or decrease by about \$2.0 million, as shown in the table below. The stability (ability to generate predictable flows over time) and adequacy (dollar value) of revenue is also an important component to revenue generation. The figure below shows the impact to changing the tax rates on gross receipts for retailers.

Figure 4: Revenue Estimate for Various Retail Cannabis Tax Rates (\$ millions)

		Tier 2 Tax Rate							
		0%	1%	2%	3%	4%	5%	6%	7%
Tier 1 Tax Rate	0.0%	0.0	2.1	4.0	6.2	8.1	9.9	11.7	13.3
	1.0%	0.2	2.3	4.2	6.4	8.3	10.1	11.9	13.5
	2.0%	0.4	2.5	4.4	6.6	8.5	10.3	12.1	13.7
	2.5%	0.5	2.6	4.5	6.7	8.6	10.4	12.2	13.8
	3.0%	0.6	2.7	4.6	6.8	8.7	10.5	12.3	13.9
	4.0%	0.8	2.9	4.8	7.0	8.9	10.7	12.5	14.1
	5.0%	0.9	3.0	4.9	7.1	9.0	10.8	12.6	14.2
	6.0%	1.1	3.2	5.1	7.3	9.2	11.0	12.8	14.4
	7.0%	1.2	3.3	5.2	7.4	9.3	11.1	12.9	14.5

Tier 1 tax rate is for businesses with gross receipts between \$1.0 million and \$1.5 million.

Tier 2 tax rate is for businesses with greater than \$1.5M in gross receipts.

The shaded cell is the total revenue for the starting tax rates in Prop. D.

(2) Fairness. Another core principle of taxation is the concept of fairness. If a class of taxpayers are technically subject to a tax but not required to pay it due to differential enforcement, then taxpayers could view the tax as unfair. In the context of the cannabis market, the persistence of a large, untaxed illegal market results in unfair taxation. The ability to shift illegal businesses into the regulated market will be important for sustaining a fair tax.

(3) Simplicity and transparency. Taxes that are simple and transparent make clear what the tax rate is and who should pay it, making it easier for individuals and businesses to understand their obligations and entitlements. They are also easier for taxing agencies to enforce and collect. Furthermore, the more complex a tax scheme is, the more likely businesses will respond with aggressive tax planning, which can result in unintended policy impacts.

(4) Administrative efficiency for both the government and tax payers. Compliance costs to businesses and administrative costs for government should be as low as possible.

(5) Progressiveness. Progressive tax structures have different rates for different payers, based on individuals' or businesses' ability to pay. The federal income tax and the City's gross receipts tax are examples of progressive tax rate structures. The current structure of the cannabis tax – with different tiers based on gross receipts and retail vs non-retail business types – has this feature.

(6) Responsiveness to economic, social, and environmental externalities. Another consideration for policymakers is to understand how the tax interacts with the wider economic, social, and environmental

context and either promote or conflict with other policy objectives. In the case of a local cannabis excise tax, important factors include:

- Financial sustainability of individual businesses and the cannabis sector as a whole;
- Social equity, making sure those most harmed by the War on Drugs have reduced barriers to business opportunities to partly redress past harms; and
- Mitigation of public health effects.

Policy Considerations

We offer some considerations for policymakers as they consider possible policy options regarding the tax:

- **The San Francisco cannabis market appears to have reached or is nearing a steady state over the past two years.** After a period of rapid change following legalization of recreational sales in California, approximately 70 retailers are generating a stable level of approximately \$270 million in annual gross receipts.
- **The cannabis industry faces significant challenges, including unique cost pressures, a persistent illicit market, extreme volatility in pricing, and a high total tax burden.** These continuing dynamics have lead policy makers to temporarily suspend the local tax during the past two years. The San Francisco tax is currently scheduled to go into effect on January 1, 2023 absent additional policy action.
- **Larger neighboring jurisdictions currently have some level of local tax in effect.** While many larger neighboring peer cities and counties have reduced local taxes in recent years, San Francisco is the largest with no current tax currently in effect.
- **Align choices regarding the local Tax with future State tax actions.** Given recent state-level elimination of the cultivation tax and potential increase to retail excise tax in 2025, San Francisco should align its choice (whether to permit the tax to go into effect in 2023, suspend it, or adopt a lower tax) with this date. Adopting an interim approach until this time would permit the City to monitor changes in the industry during this time and then longer-term choices in 2025 with full information regarding the State's ultimate tax approach.
- **The City could consider a more progressive tax structure.** Should policymakers proceed with interim rates until 2025, the City could consider a more progressive tax structure, potentially increasing the small business exemption from levels adopted by the voters, which would decrease the number of establishments subject to the tax. For example, while 52% of businesses earn less than \$2.5 million in gross receipts, they generate only 10% of total industry gross receipts in the City.

ⁱ "Price per Lb. of Cannabis Falls in California Due to Massive Overproduction," accessed March 4, 2022, <https://www.foodengineeringmag.com/articles/99944-price-per-lb-of-cannabis-falls-in-california-due-to-massive-overproduction>.