

SENATE COMMITTEE ON GOVERNANCE & FINANCE

California Cannabis in a Turbulent Time

February 14, 2017

Committee Background

This paper provides background information for members of the Senate Committee on Governance and Finance for its oversight hearing on February 14, 2017, "California Cannabis in a Turbulent Time." The hearing will explore several issues relating to cannabis tax collection, and is intended to identify obstacles and possible reforms needed to maximize cannabis tax collection.

The hearing will address three main issues:

- Current medical cannabis sales and use tax collection;
- Obstacles to administering and collecting medical cannabis sales and use tax, and;
- The status of implementation of Proposition 64's tax provisions.

To provide a context for members of the Senate Committee on Governance and Finance, this paper:

- Summarizes current federal and state law;
- Examines medical cannabis sales and use tax collection, and;
- Describes the tax provisions in Proposition 64.

Federal Law

Federal law prohibits the manufacture, possession, sale, or distribution of cannabis. Congress enacted the Controlled Substances Act (CSA) as part of the Comprehensive Drug Abuse Prevention and Control Act of 1970. The CSA sets forth five "schedules" of specified drugs and other substances designated "controlled substances." For a drug or other substance to be designated as a "Schedule I" controlled substance, the substance must have "a high potential for abuse," and has "no currently accepted medical use in treatment in the United States." Federal law lists cannabis as a Schedule I controlled substance.

The Cole Memo. On August 29, 2013, the U.S. Department of Justice (DOJ) issued guidance to federal prosecutors regarding cannabis enforcement under the CSA (referred to as the "Cole

Memo"). The Cole Memo reiterated DOJ's commitment to enforcing the CSA consistent with Congress' determination that cannabis is a dangerous drug that provides a significant source of revenue to large-scale criminal enterprises, gangs, and cartels. In furtherance of this objective, the Cole Memo instructed DOJ attorneys and law enforcement officials to focus on the following eight enforcement priorities:

- Preventing the distribution of cannabis to minors;
- Preventing revenue from cannabis sales from going to criminal enterprises, gangs, and cartels;
- Preventing the diversion of cannabis from states where it is legal under state law to other states where it is illegal;
- Preventing state-authorized cannabis activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
- Preventing violence and the use of firearms in the cultivation and distribution of cannabis;
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with cannabis use;
- Preventing the growing of cannabis on public lands and the attendant public safety and environmental dangers posed by cannabis production on public lands, and;
- Preventing cannabis possession or use on federal property.

The Cole Memo's priorities guide the DOJ's enforcement of the CSA cannabis related conduct. While the Cole Memo's guidance was issued in response to recent cannabis legalization initiatives in other states, it applies to all DOJ cannabis enforcement nationwide.

Medical Cannabis Legalization.

Prior to 1996, both federal and state law prohibited the possession, possession with intent to sell, cultivation, sale, transportation, importation, or furnishing of cannabis. However, in 1996, California voters approved Proposition 215, known as the Compassionate Use Act of 1996 (CUA). Under CUA, qualified patients with specified illnesses, and their primary caregivers, cannot be prosecuted for possessing or cultivating medical cannabis upon the written or oral recommendation or approval of an attending physician. Thus, CUA allowed qualified patients and primary caregivers to obtain and use medical cannabis.

The Legislature clarified CUA by enacting SB 420 (Vasconcellos, 2003). SB 420 exempted qualified patients and caregivers from prosecution for using, or collectively or cooperatively

cultivating medical cannabis, and established a medical cannabis card program for patients to use on a voluntary basis. SB 420 provides a safe harbor for qualified patients regarding the amount of cannabis they may possess and the number of plants they may maintain. It also protects patients with valid identification cards from both arrest and criminal liability for possession, transportation, delivery, or cultivation of cannabis. Thus, California's estimated \$1 billion dollar medical cannabis industry exists amid a conflict between federal and state law, and within state law itself. The industry remained largely unregulated at the same level until 2015.

Medical Marijuana Regulation and Safety Act.

In 2015, the Legislature enacted the Medical Marijuana Regulation and Safety Act (MMRSA), a package of legislation that comprehensively regulates many aspects of medical cannabis including cultivation, manufacturing, transportation, distribution, sale, and product safety. The MMRSA comprises three bills: SB 643 (McGuire, 2015), AB 243 (Wood, 2015), and AB 266 (Bonta, 2015). In 2016, several bills made slight changes to the MMRSA, including renaming the Act the Medical Cannabis Regulation and Safety Act (MCRSA). Among other provisions, MCRSA:

- Creates the Bureau of Medical Cannabis Regulation (the Bureau) within the Department of Consumer Affairs to oversee and enforce the state's medical cannabis regulations in collaboration with the Board of Equalization (BOE), the California Department of Public Health, and the California Department of Food and Agriculture (CDFA);
- Establishes categories of licenses for various medical cannabis activities, such as cultivation, manufacturing, distribution, transportation, and sale, and provides certain state agencies with the authority to issue those licenses and enforce their terms;
- Requires CDFA in collaboration with the Bureau to implement a program that allows regulators to uniquely identify each legally cultivated medical cannabis plant and trace that plant throughout the distribution chain;
- Prohibits licensees from commencing activity under the authority of a state license until the applicant has obtained a license or permit pursuant to the applicable local ordinance;
- Protects the ability of local governments to pass and enforce laws, licensing requirements, and zoning ordinances, and;
- Authorizes local governments to establish a licensing system for the cultivation of medical cannabis through their current or future land use authority, and prohibits the cultivation of medical cannabis without obtaining both a state license—issued by CDFA—and a local license.

Sales and Use Tax on Medical Cannabis

State law imposes a sales and use tax on retailers for the privilege of selling tangible personal property, absent a specific exemption. The tax is based upon the retailer's gross receipts from sales in this state. Generally, medicine is exempt from the sales and use tax, but medical cannabis does not satisfy the following elements to qualify for the exemption. To be exempt, medication must be:

- Prescribed by an authorized person and dispensed on a prescription filled by a pharmacist;
- Furnished by a licensed physician to his or her own patient, or;
- Furnished by a health facility for treatment pursuant to a licensed physician's order, or sold to a licensed physician.

Thus, the sale of medical cannabis is subject to both the state and local sales and use tax.

Collection of Sales and Use Tax

BOE currently collects tens of millions of dollars annually in sales and use tax revenue from medical cannabis retailers. However, this only represents a fraction of the potential sales and use tax revenue that should be subject to collection, due to several challenges unique to the cannabis industry, specifically:

- **Underground Sales.** The medical cannabis industry exists alongside an underground market that sells cannabis tax free to customers. Additionally, prior to the passage of Proposition 64 last November, use of recreational cannabis was illegal in California, so an individual without a medical cannabis card could only purchase cannabis in the underground market.
- **Nowhere to Bank.** Individuals who run a medical cannabis dispensary in compliance with California law have severely limited access to the banking system for business use. Cannabis is classified as a Schedule I drug under federal law, so its cultivation, sale, and possession can constitute a felony. Therefore, the majority of banks and credit unions have decided not to accept cannabis dispensaries as customers for fear of federal sanctions. As such, less than 1% of all banks and credit unions nationwide provide banking services to cannabis businesses.
- **Cash Based Industry.** Due to the limited availability of banking services to the medical cannabis industry, many retailers must remit their sales tax liability using cash payments, creating a number of logistical and safety issues. Specifically, acceptance of large amounts of cash creates a security issue for BOE staff. The additional cash collection of Proposition 64 excise taxes will only exacerbate risk of robbery and the well-being of BOE staff.

- **BOE Cash Policy.** Prior to February 3, 2014, BOE did not accept cash payment of tax liability. On February 3, 2014, BOE issued a policy memo providing an exemption for taxpayers who demonstrated that the policy would pose a hardship if they were unable to pay in cash. The policy specified that district offices would review the exemption request and, if approved, coordinate a date and time to collect cash payments from taxpayers. Exemptions are approved on a case by case basis.

At the December 14, 2016 BOE board meeting, BOE outlined cash acceptance policies. Policy options included:

- **Accept cash payments at banks.**
 - Taxpayers would contact BOE staff who would coordinate with a bank representative to schedule an appointment for onsite cash exchanges for direct deposit into BOE's account.
 - **Create tax service centers at existing government buildings.**
 - BOE would partner with other federal, state, or local agencies to provide secure locations in which to accept cash.
 - **Create BOE offsite cash acceptance facilities at strategic locations.**
 - BOE would construct secure cash acceptance facilities at strategic locations, such as the unoccupied BOE facility in Santa Ana, California. These strategically located offsite offices would be designed with sufficient security provisions to mitigate the risk of robbery. Taxpayers must make cash payments at one of these locations. BOE staff must perform cashiering functions at these offsite locations, which would have updated security features.
 - **Install cash acceptance systems at BOE offices.**
 - BOE would work in partnership with the State Treasurer's Office to secure cash acceptance safes through third parties. The safes would be placed in a secure area, with security cameras trained on the safe twenty-four hours a day, accessible only by BOE employees. The third party service provider is responsible for securely transporting cash off-site and monitoring safe activity.
 - **Follow the existing “no cash” policy.**
- **BOE Field Offices.** BOE has 22 field offices throughout California, but not all field offices accept cash payment of sales and use tax, so taxpayers must carry large amounts

of cash to a small number of offices. Additionally, BOE field offices are not evenly distributed throughout the state, nor are offices proximate to the epicenter of the cannabis industry. For example, there is only one field office north of Sacramento. As a result, after January 1, 2018, many growers north of Sacramento must drive five or more hours each way to remit taxes to BOE.

Proposition 64

On November 8, 2016, California voters approved the Control, Regulate and Tax Adult Use of Marijuana Act (Act), which legalized the recreation use of cannabis by adults age 21 and older.

The Act imposes a cannabis excise tax upon purchasers of cannabis or cannabis products sold in this state at the rate of fifteen percent (15%) of the gross receipts of any retail sale by a dispensary. The sales and use tax does not apply to the sale of medical cannabis.

Additionally, the initiative establishes a cultivation tax at the following rates;

- \$9.25 per dry-weight ounce on cannabis flowers.
- \$2.75 per dry-weight ounce on cannabis leaves.

The Act allows BOE to adjust the tax rate for cannabis leaves annually to reflect fluctuations in the relative price of cannabis flowers to cannabis leaves. It also, requires CDFA, in consultation with the Bureau and BOE, to expand the track and trace program.

The cultivation tax would not apply to cannabis cultivated for personal use or cultivated by a qualified patient or primary caregiver in accordance with the CUA.