

SENATE COMMITTEE ON GOVERNANCE & FINANCE OVERSIGHT HEARING

Preparing for California's Green Gold Rush – Implementing Prop 64 Taxes

July 19, 2017
9:30 AM
California State Capitol
Room 112

Committee Background

On January 1, 2018, the nonmedical use of cannabis by adults ages 21 and over will become legal in California under Proposition 64, the Control, Regulate and Tax Adult Use of Marijuana Act, approved by the voters on November 8, 2016. Proposition 64, as amended by SB 94 (Committee on Budget and Fiscal Review, 2017), includes the following tax provisions:

- **Excise Tax.** Imposes upon purchasers an excise tax at a rate of 15% of the average market price of the cannabis product, effective January 1, 2018.
- **Cultivation Tax.** Imposes upon cultivators a tax on all harvested cannabis that enters the commercial market, effective January 1, 2018, at the following rates:
 - \$9.25 per dry-weight ounce of cannabis flowers.
 - \$2.75 per dry-weight ounce of cannabis leaves.
- **Sales and Use Tax Exemption.** Exempts medical cannabis from the sales and use tax, effective November 9, 2016. State law imposes the sales and use tax on retailers for the privilege of selling tangible personal property, absent a specific exemption. As such, nonmedical cannabis will be subject to the sale and use tax.

The excise, cultivation, and sales and use taxes related to cannabis will be collected by the new California Department of Tax and Fee Administration (CDTFA), to whom most of the tax administration responsibilities of the Board of Equalization (BOE) were transferred by a recently enacted budget trailer bill (AB 102, Committee on Budget, 2017).

In practice, administration of the Prop 64 by CDTFA taxes will depend upon the coordinated efforts of several state agencies charged with implementing the licensing and regulatory scheme imposed by Prop 64, since all commercial cannabis activity must be conducted between licensees. For example, the cultivation tax is to be collected from cultivators licensed by the California Department of Food and Agriculture (CDFA) by distributors licensed by the Department of Consumer Affairs (DCA) for remittance to the CDTFA. (In cases where the harvested cannabis is sent not to a distributor but to a manufacturer for further production, it is the manufacturer, licensed by the California Department of Public Health (CDPH), who must

collect and remit the cultivation tax.) Similarly, the excise tax will be collected by licensed distributors from retailers licensed by the DCA for remittance to the CDTFA. But before DCA will issue a retailer license, it will require the applicant to acquire a seller's permit from CDTFA for the purpose of collecting and remitting sales and use tax. All of these agencies and departments will need to obtain the software necessary to implement online licensing capabilities (apart from CDPH, which already has this ability). Moreover, Prop 64 envisions implementation of fully functional "track and trace" software, accessible to state agencies, local governments and licensees, to track cannabis from cultivation through retail sale. Thus, the implementation of the Prop 64 taxation scheme will be a team effort, not simply the responsibility of the CDTFA.

The timeline set forth by Prop 64 for the commencement of the legal adult use commercial market, January 1, 2018, is extremely aggressive. It may not be realistic to think that the state's regulatory infrastructure for the evolving commercial market necessary to administer these taxes will spring forward, fully formed, on that date. For example, any cannabis made available for sale in the commercial market in early 2018 will not have been "tracked and traced" from seed to sale as contemplated by the initiative, because it's already been harvested and entered the commercial market. It will take time to enroll cultivators, manufacturers, and distributors, as well as to integrate the system into cannabis planting and harvesting schedules.

Today's hearing offers the opportunity to assess the readiness of California state agencies to meet the implementation timelines established by Prop 64. What can the public expect to see on January 1, 2018?

History of Cannabis Regulation in California

California's evolving cannabis law over the past 20 years exemplifies the adage that the states are "laboratories of democracy." Over this time, as voters in California and other states approved ballot initiatives legalizing first the medicinal and eventually the recreational use of cannabis, the federal prohibition on the manufacture, possession, sale, or distribution of cannabis remained in force. The federal Controlled Substances Act of 1970 still classifies cannabis as a "Schedule 1" controlled substance, with "a high potential for abuse," and "no currently accepted medical use in treatment in the United States."

The discord between federal and state law presented several challenges to the development of California's cannabis industry. For example, federal and state food and drug laws intended to protect consumers do not apply to cannabis. As the state moved toward legalization, it had to develop testing protocols to ensure the safety, purity, and potency of the product. California could not responsibly authorize the use of cannabis for medicinal or other purposes absent effective consumer health and safety protections.

In light of state ballot initiatives to legalize possession of cannabis and regulate its production and sale, the United States Justice Department (DOJ) in 2013 issued guidance to all United States Attorneys as to its enforcement priorities (the so-called "Cole Memo"). The Cole Memo reiterated DOJ's commitment to enforcing the Controlled Substances Act 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 use its limited investigative and prosecutorial resources to address the most significant threats, which include the prevention of:

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

The Cole memo implies a safe harbor for state cannabis activity and encouraged states such as California to develop comprehensive regulatory systems designed to deter the threats identified therein. Colorado and California, for example, incorporated “track and trace” software into their regulatory protocols to protect against the “inversion” of illegally grown product into the regulated commercial market and the “diversion” of legally grown cannabis into the black market.

But the Cole memo, lacking the force of law, has not facilitated access to the nation’s banking system for the cannabis industry. Although federal law does not expressly prohibit marijuana banking, banks are concerned that servicing cannabis businesses could expose them to prosecution under the federal Bank Secrecy Act and anti-money laundering rules. The cash-intensive nature of the cannabis industry has complicated tax collection in states that have legalized cannabis use and exposed industry participants to the risk of serious crime.

Compassionate Use Act - 1996

Prior to 1996, both federal and state law prohibited the possession, possession with intent to sell, cultivation, sale, transportation, importation, or furnishing of cannabis. In 1996, California voters approved Proposition 215, otherwise known as the Compassionate Use Act (CUA). The CUA protects qualified patients and primary caregivers from prosecution related to the possession and cultivation of cannabis for medical purposes, if recommended by a physician. The CUA also prohibits physicians from being punished or denied any right or privilege for making a medical cannabis recommendation to a patient. Thus, CUA allowed qualified patients and primary caregivers to obtain and use medical cannabis.

SB 420 (Vasconcellos, 2003) clarified the CUA by establishing a medical cannabis card program and a safe harbor regarding the amount of cannabis that qualified patients may possess. It also protects patients with valid identification cards from both arrest and criminal liability for possession, transportation, delivery, or cultivation of cannabis.

The protections offered by the CUA fostered the growth of cannabis collectives and cooperatives mostly unregulated and untaxed (though the state did apply sales tax to medical cannabis products), subject only to the patchwork regulation of local governments. The CUA did not create a statutory framework for regulating or taxing cannabis. The industry would remain largely unregulated at the state level until 2015.

Medical Cannabis Regulation and Safety Act (MCRSA) – 2015-16

In 2015, the Legislature enacted the Medical Marijuana Regulation and Safety Act (MMRSA) to comprehensively regulate cultivation, manufacturing, transportation, distribution, sale, and product safety in the medical cannabis industry. MMRSA consisted of three separate pieces of legislation: SB 643 (McGuire, 2015), AB 243 (Wood, 2015), and AB 266 (Bonta, 2015). The following year, this legislation was renamed the Medical Cannabis Regulation and Safety Act (MCRSA) (SB 837, Committee on Budget and Fiscal Review, 2016).

Among its provisions, MCRSA established the Bureau of Medical Marijuana Regulation (Bureau) within the Department of Consumer Affairs to oversee and enforce the state’s medical cannabis regulations, in collaboration with the California Department of Public Health (CDPH) and the CDFA. Additionally, MCRSA prescribed the medical cannabis distribution chain by requiring all cultivators, manufacturers, and producing dispensary licensees to send medical cannabis and products to a distributor for presale quality assurance and inspection, and batch testing by a testing laboratory.

MCRSA directed CDFA, in consultation with the Bureau, to implement a “track and trace” program to assign unique identifiers to each legally cultivated medical cannabis plant and trace the plant through the distribution chain.

MCRSA preserved local control by protecting the right of local governments to pass and enforce laws, licensing requirements and zoning ordinances. It also prohibited a state licensee from commencing activity until the applicant has obtained the applicable local license or permit.

Medicinal and Adult-Use Cannabis Regulation and Safety Act (MAUCRSA - *Prop 64 as amended by SB 94* – 2016-17)

Prop 64, in extending the reach of state regulation to adult-use, nonmedical cannabis, largely built upon the regulatory structure enacted by MCRSA. The same agencies responsible for licensing and regulating medicinal use under MCRSA will perform those functions for the nonmedical market. DCA remains the lead regulatory agency and the renamed Bureau of Cannabis Control retains oversight and coordination responsibilities. SB 94 essentially merged Prop 64 and MCRSA into a single regulatory structure for commercial cannabis activity, spawning yet another acronym, the Medicinal and Adult-Use Cannabis Regulation and Safety Act (MAUCRSA).

With respect to tax administration, the most significant change made by MAUCRSA was to shift the responsibility for collecting the cultivation tax from CDTFA to distributors. The law

clarifies that tax is due after the cannabis is harvested and “enters the commercial marketplace,” defined to mean after it has completed and complied with all quality assurance, inspection and testing. At that time, the distributor will collect the tax from the cultivator and remit it CDTFA. By shifting the point of collection in this manner, CDTFA will receive remittances from about 250 distributors instead of 25,000 to 35,000 or so cultivators, which greatly simplifies its administrative responsibilities. (Where the cultivator does not send the cannabis to a distributor but to a manufacture for processing into a cannabis product, the cultivation tax collection duty will fall on the manufacturer, who will collect the tax and remit it to CDTFA.)

In a similar manner, MAUCRSA shifted the responsibility for remitting the excise tax to CDTFA from retailers (who eventually may number in the thousands) to distributors, who will collect the excise tax from retailers, in most instances, on or before 90 days after the sale or transfer of cannabis or cannabis product to the retailer.

With respect to both the cultivation tax and the excise tax, moving the point of collection to the distributor should improve tax compliance, since there are fewer taxpayers and thus less potential for tax evasion.

Senate Committee on Governance and Finance Oversight Hearing

California Cannabis in a Turbulent Time

February 14, 2017

The Senate Governance and Committee conducted an oversight hearing on cannabis issues on February 14, 2017, just three months after the voter approval of Proposition 64 (but four months before the enactment of SB 94). Governor John Hickenlooper of Colorado offered testimony concerning Colorado’s experience with the legalization of recreational cannabis. (Colorado voters approved Colorado Amendment 64 in November 2012, which took effect in January 2014. Similar to California, Colorado previously had legalized medical cannabis, in 2000.)

Based on his experience, Governor Hickenlooper cautioned committee members to take precautions to ensure that edible cannabis products are not packaged in a way that is appealing to children, and that the potency of products is clearly labeled. He also stressed the need to communicate to the public the danger that cannabis poses to the developing minds of children and adolescents. On an encouraging note, Governor Hickenlooper indicated that the track and trace software implemented in Colorado was working well, allowing regulators to ensure the integrity of the commercial market and monitor tax compliance.

The committee heard from a number of industry participants who touched on a range of issues, including Jerred Kiloh, Owner, The Higher Path Collective; Kristin Nevedal, Founder and Chair, International Cannabis Farmers’ Association; and Sarah Grew, Director, Sierra County Growers Association. The lack of banking services was by far the biggest concern of the collectives and dispensaries. The growers implored state officials to conduct outreach on the new tax and regulatory requirements of Prop 64.

Law enforcement was represented by Sergeant David Woolsey, Division of Medical Marijuana Control, San José Police Department and Thomas D. Allman, Sheriff-Coroner, Mendocino County. The officers noted that there is a degree of serious crime associated with the cannabis

black market, including homicide and environmental damage caused by illegal labs. These problems should be mitigated by the new licensing and regulatory protocols imposed by Prop 64.

Wendy Sollazzi, Department of Finance Division Manager, City of San José, discussed the challenge of collecting the City's 10% Marijuana Business Tax mostly in cash.

Finally, the committee heard from state agency representatives who at that time were just beginning to develop their plans for implementing the Prop 64 taxes, including Amy Tong, Director, California Department of Technology (CDT); Jim Houston, Undersecretary, CDFA; and Michele Pielsticker, Legislative and Research Division Chief, Board of Equalization.

Ms. Tong and Mr. Houston laid out their plans to implement a "track and trace" program to assign unique identifiers to each legally cultivated medical cannabis plant and trace the plant through the distribution chain. Ms. Pielsticker fielded several questions concerning the BOE's shifting stance toward the cash payment of tax liabilities by cannabis industry participants, and discrepancies in tax collections among the four BOE districts.

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The purpose of today's hearing, coming five months after the committee's initial oversight hearing, is to follow up on the efforts of the responsible state agencies charged with implementing the Prop 64 taxes, which will take effect in less than six months.

1. Lori Ajax, Chief, Bureau of Cannabis Control, DCA.

Lori Ajax is Chief, Bureau of Cannabis Control within DCA, and likely the state official most responsible for implementing Prop 64. She will offer an overall assessment of California's implementation efforts to date. In addition, she will address the status of DCA's efforts to license distributors and retailers. Finally, she will discuss the provisions of SB 94 that require the Bureau, by July 1, 2018, in coordination with the Department of General Services, to establish an office to collect fees and taxes in the County of Humboldt, County of Trinity, or County of Mendocino in order to ensure the safe payment and collection of cash in those counties.

2. Amy Tong, Director, CDT.

Amy Tong, Director, CDT, will discuss the status of the technology projects needed to implement the licensing and taxation requirements of Prop 64. In particular, she will address the status of the "track and trace" Cannabis Activity Tracking (CAT) Solution contract that CDT recently awarded to Franwell, Inc. (Although the system will be operated by CDFA, CDT conducted the procurement.)

The CAT Solution will track cannabis from cultivation through retail sale. State law requires licensees, including cultivators, to enter specified data into the "track and trace" CAT system when moving cannabis. Since cannabis can only be moved from one licensee to another, all

licensing systems must share license data with the CAT solution. Licensees will be able to mark cannabis to identify the amount of tax due, and when it changes possession, composition, packaging or size and retain the cultivation tax history.

3. Amber Morris, Branch Chief, Cannabis Program, CDFA

Amber Morris, Branch Chief, Cannabis Program, CDFA, will discuss the status of the emergency regulations CDFA plans to issue to implement the cultivator licensing program. CDFA had issued draft regulations in April to implement the cultivator licensing program under MCRSA and was within the review period when SB 94 was enacted. As a result, CDFA withdrew the draft regulations from the Office of Administrative Law and plans to reissue emergency regulations this fall. (The details of the new regulations under MAUCRSA will closely resemble those proposed for MCRSA.)

4. Suzanne Buehler, Director, Business Taxes and Fees Division, and Richard Parrot, Deputy Director, Business Taxes and Fees Division, CDTFA

Finally, Ms. Buehler and Mr. Parrot from the CDTFA will update the committee on how the CDTFA will respond to the concerns raised about the BOE at the first oversight hearing and how the new CDTFA plans to coordinate tax administration with the other state licensing entities under Prop 64.

It is worth noting that statutes enacted since the first committee oversight hearing have to a large degree mitigated concerns raised about BOE at that time. Most notably, the transfer of the responsibilities for the sales and use tax, cultivation tax and excises tax to the new CDTFA should ensure uniform administration and enforcement of those tax laws. The discrepancies between the four BOE districts should no longer be a problem.

Additionally, the transfer of the collection responsibilities for the cultivation tax and excise tax to distributors under SB 94 will greatly simplify CDTFA's administrative tasks. Again, the CDTFA's point of contact will be with roughly 250 distributors rather than thousands of cultivators and retailers. Moreover, the distributors will mostly be larger and more diversified business entities relative to the cultivators and retailers, and thus should have better access to banking services, which should mitigate the cash payment issue to some degree.

Nonetheless, the CDTFA representatives will be prepared to discuss their plans to accept cash payments as well as the status of the emergency regulations they plan to issue this fall to clarify some of the technical issues raised by SB 94.