



**CITY OF MODESTO
COUNCIL AGENDA REPORT**

DATE OF MEETING:
December 4, 2018

Date: November 7, 2018

TO: Mayor and City Council

THROUGH: Joseph P. Lopez, City Manager

FROM: Jaylen French, Director of Community and Economic Development

SUBJECT: Setting Commercial Cannabis Business Tax and Annual Commercial Cannabis Permit Fee, and Approving First Amendment to Professional Services Agreement with HdL Companies

CONTACT: Steve Mitchell, Acting Planning Manager, smitchell@modestogov.com, 577-5267

DESCRIPTION:

Consider adopting the Cannabis Business Tax previously approved by voters, at rates ranging from two-and-a-half to eight percent (2.5% to 8%) of gross receipts depending on the type of cannabis business within the City of Modesto; adopting the annual Commercial Cannabis Permit Fee for approved cannabis businesses to pay for on-going administration and monitoring of approved businesses; and approving a First Amendment to the Professional Services Agreement with HdL Companies to increase the number of cannabis-related business applications to be reviewed and to conduct annual compliance monitoring in the amount of \$1,114,500, for a total agreement amount not to exceed \$1,164,250 over five years. (Funding Source: Cannabis Business Fees)

STRATEGIC PLAN ELEMENT:

This item is consistent with the 2015-2018 Council Strategic Commitments Healthy Economy and Great Quality of Life, and Effective, Responsive and Transparent Government.

BACKGROUND:

The passage of Proposition 64, The Adult Use of Marijuana Act, in November 2016 ended the prohibition on recreational use of cannabis in California and created a statewide regulatory structure for recreational cannabis business similar to that previously approved for medical cannabis businesses. Subsequently, the Modesto City Council adopted Ordinance No. 3684-C.S. on January 16, 2018, which permitted certain commercial cannabis uses, subject to land use and zoning criteria. These regulations permit up to 10 cannabis dispensaries within City limits, but do not allow any in the downtown area. The Ordinance further established that non-retail cannabis businesses, such as manufacturing, distribution, and indoor cultivation are also allowed.

TAX RATE

In November 2017 the City Council placed before the voters a ballot measure, "Measure T," allowing the City Council to implement an excise tax on cannabis businesses within the City. Modesto voters approved Measure T, with 82.5% voting in favor of it.

Measure T established Article 11, "Cannabis Business Tax," of Chapter 2, "Taxation," of Title 8, "Finance, Revenue, and Taxation," of the Modesto Municipal Code, which allows the City Council to impose, by Resolution, an excise tax of up to ten percent (10%) on the gross receipts of cannabis businesses within the City. As an excise tax, the tax would be levied on the gross receipts of businesses and is not a sales tax levied on the purchaser. If imposed, it would apply to both recreational and medical cannabis businesses operating in the City. Revenues from a cannabis business tax would go into the City's General Fund to be used for any legitimate government purpose, including those identified in the ballot measure such as neighborhood safety, maintaining parks and recreation, and job creation.

Section 8-2.1108 of the Municipal Code establishing the method for setting the tax rate, as follows:

"(A) Every person engaged in cannabis business in the City shall pay, for the privilege of operating a cannabis business in the City, a business tax at a rate of up to ten (10) percent of gross receipts. The tax under this article shall not be imposed on cannabis businesses unless and until the City Council, by resolution, takes action to set a tax rate not to exceed ten (10) percent of gross receipts.

(B) Notwithstanding the maximum tax rate of ten (10) percent of gross receipts established under subsection (A), the City Council may, in its discretion, at any time by resolution, implement a lower tax rate for all cannabis businesses or establish differing tax rates for different categories of cannabis businesses, as defined in such resolution, subject to the maximum rate of ten (10) percent of gross receipts. The City Council may, by resolution, also increase any such tax rate from time to time, not to exceed the maximum tax rate of ten (10) percent of gross receipts established under subsection (A).

(C) In establishing different tax rates for different categories of cannabis businesses pursuant to subsection (B), the City Council may enact a rate using a basis other than gross receipts. By way of example only and without imposing any limitation on the basis of the tax rate for a category of cannabis business, the rate may be based on the square footage of the building used by or number of employees of a cannabis business. If the City Council establishes a tax rate for a cannabis business on a basis other than gross receipts, in no event shall that tax paid by a cannabis business in that category exceed ten (10) percent of the business's gross receipts."

Following the passage of the Cannabis Business Tax, the City Council approved an Ordinance amending the Zoning Code to allow approved cannabis businesses to operate in identified

areas of the City with a special permit. City staff is in the process of reviewing the applications for such businesses. All applicants must obtain City Council approval following a public hearing to obtain a permit. The approved businesses must also receive a state cannabis license prior to operating.

ANNUAL PERMIT FEE

The City's Commercial Cannabis Ordinance authorizes the City to establish permit fees for commercial cannabis operators by resolution. At the time of adoption of the Commercial Cannabis Ordinance, the City Council approved a resolution establishing permit application fees, which pay for the costs of staff and consultant time to process commercial cannabis permits. At the time, staff indicated that there would be a follow-up action to establish an annual permit fee, which would pay for the costs of on-going administration and monitoring of approved cannabis businesses.

HDL CONTRACT

Staff and Council recognized early on that expert consultant assistance would be necessary in order to review and evaluate cannabis business applications, and to assist City staff in establishing tax rates and an annual permit fee. Three proposals were received as a result of a Request for Proposal process. HdL Companies was selected due to their experience and expertise related to cannabis business permitting, financial and regulatory processes.

The City entered into a Professional Services Agreement (PSA) with HdL Companies on July 9, 2018. The PSA scope of work authorized HdL to review, score and rank cannabis dispensary applications, and to determine the Annual Permit Fee for permitted businesses' on-going compliance inspections. The PSA budget was capped at \$49,750.

DISCUSSION:

TAX RATE

City staff, working with consultant HdL, reviewed data related to various cannabis tax rates, including potential revenue, impacts on the businesses, as well as possible effects on encouraging the illegal cannabis market to continue. City staff and the consultant proposed three (3) options for setting tax rates. The City Council Ad Hoc Cannabis Committee, comprised of Mayor Brandvold and Council Members Grewal and Kenoyer, reviewed the materials and selected the tax rates shown in the attached Resolution. City staff supports the Committee recommendation.

This action will impose the Cannabis Business Tax, pursuant to Section 8-2.1108 of the Modesto Municipal Code, at rates ranging from two-and-a-half to eight percent (2.5% to 8%) of gross receipts depending on the type of cannabis business within the City. If approved, the Cannabis Business Tax rates would be as follows:

<u>Business Type</u>	<u>Percentage of Gross Receipts</u>
Retail	8%
Distribution	6%
Microbusiness	4%
Manufacturing	4%
Cultivation (indoor only)	2.5%
Testing Labs	2.5%

ANNUAL COMMERCIAL CANNABIS PERMIT FEE

HdL analyzed the City's total cost burden associated with cannabis business administration and monitoring activities. HdL interviewed the City Manager and individual staff from Code Enforcement, City Attorney, Police, Fire and Finance, that will be involved in the on-going administration and monitoring of permitted cannabis businesses. Based on these interviews and their experiences in administering other commercial cannabis programs, HdL provided an estimate of staff time and costs, including equipment needs and training costs.

The City also intends to utilize HdL to provide periodic inspections and annual financial audits of permitted cannabis businesses (see below), and the costs for these services is also included in the proposed Annual Permit Fee.

The analysis determined that the annual Commercial Cannabis Permit Fee should be set at \$21,740. The attached Annual Commercial Cannabis Permit Fee Cost Analysis provides the detailed breakdown of HdL's analysis. There are a couple things to note about the annual Commercial Cannabis Permit Fee. First, the calculations assumed that the City would have 14 permits, the maximum of 10 dispensaries and 4 non-dispensary businesses. As the City gains more experience administering the permitted businesses, and as the number of businesses expands or contracts, the annual Permit Fee may need to be adjusted. Also, it is important to note that the annual Permit Fee only pays for the costs associated with on-going administration of legally permitted cannabis businesses – it does not pay for enforcement activities associated with illegal cannabis businesses.

CONTRACT AMENDMENT

As noted previously, the City intends to utilize HdL to assist with on-going administration and monitoring of permitted cannabis businesses. More specifically, HdL will perform three compliance inspections per year on each cannabis business, and conduct an annual financial audit of each business. HdL will also conduct additional background checks of cannabis business employees and assist the City with the issuance of identification badges to cannabis industry employees. The amendment also provides for HdL's assistance in processing additional cannabis business applications beyond 2018. These additional services will be needed on an on-going basis. Therefore, the work described in the amended PSA scope is proposed to be conducted over a two-year period, with three one-year extensions at the City's option, as stated within paragraphs 2 and 10 of the original Agreement. The total anticipated costs associated with the PSA would increase by \$1,114,500 to \$1,164,250 (see Fiscal Impact, below, for additional detail) over the contract term.

FISCAL IMPACT:

TAX RATE

Adopting this tax and implementing collection procedures will require Staff time. The City would use fees imposed on these businesses, and if necessary, revenues from the tax to pay for Staff time to administer the tax.

The amount of revenues collected from the tax would depend greatly on the type and number of commercial cannabis businesses operating in the City. Although the City could collect taxes from a business operating illegally, the majority of revenues would come from legal businesses.

Consultant HdL estimates that with the proposed tax rates, the City will collect approximately \$3.2 million in annual revenues. This number can vary, though, depending on number, size, and success of the businesses.

ANNUAL PERMIT FEE

Cannabis businesses will be subject to payment of the annual Commercial Cannabis Permit Fee of \$21,740. As noted above, it is expected that this fee will cover the costs of staff time and HdL assistance, but the fee may need to be adjusted periodically as the City gains more experience administering the cannabis permit program. And as also noted above, the annual Commercial Cannabis Permit Fee does not cover the costs of enforcement on illegal businesses; these costs will need to be paid for by proceeds from the cannabis business tax or other funding sources.

CONTRACT AMENDMENT

Costs for HdL's assistance with permit applications will be paid by previously-adopted cannabis business application fees. HdL's inspections and monitoring costs will be paid from annual permit fees, which are being scheduled for adoption by the Council at an up-coming meeting. The new contract cost associated with the Agreement is proposed to increase by \$1,114,500, from \$49,750, to \$1,164,250. The attached scope of work details how the additional budget total is derived.

The scope of work, and associated budget, is based on an assumed anticipated volume of work (e.g. number of proposed business subject to application processes, financial audits and/or compliance reviews). Should it become apparent prior to the Agreement termination date that the assumed anticipated volume of work will be exceeded, then staff will return this item to Council with a budget adjustment request to cover the additional costs.

COMMITTEE RECOMMENDATION:

A Council Ad Hoc Committee was appointed to discuss various cannabis matters, including a cannabis business tax, and to make recommendations to Council. The Ad Hoc Committee reviewed the proposed tax rates, Annual Commercial Cannabis Permit Fee and contract amendment on October 16, 2018, and recommended that the Council consider adopting the cannabis business tax rates, the Annual Commercial Cannabis Permit Fee and approve the contract amendment with HdL.

RECOMMENDED COUNCIL ACTION:

Staff Recommendation:

Resolution adopting the previously approved cannabis business tax at rates ranging from two-and-a-half to eight percent (2.5% to 8%), depending on the business type, gross receipts of all engaged in cannabis businesses in the City.

Resolution adopting the Annual Commercial Cannabis Permit Fee for the City Commercial Cannabis Permit related to cannabis businesses.

Resolution approving a First Amendment to the Professional Services Agreement with HdL Companies to increase the number of cannabis-related business applications to be reviewed and to conduct annual compliance monitoring in the amount of \$1,114,500 for a total contract amount of \$1,164,250 over five years, and authorizing the City Manager, or his designee, to execute the Amendment.

Approved by:

Jaylen French,
Director of Community and Economic Development

Joseph P. Lopez, City Manager

Attachments:

1. Resolution for Tax Rate
2. Resolution for Annual Commercial Cannabis Permit Fee
3. Resolution for HdL Amendment
4. Annual Commercial Cannabis Permit Fee Executive Summary and Cost Analysis
5. Draft Amendment to Professional Services Agreement with HdL Companies
6. Original Professional Services Agreement with HdL Companies, July 9, 2018
7. Exhibit A-1: Scope of Work, October 22, 2018