



November 5, 2021

Nicole Elliott
Director
Department of Cannabis Control
2920 Kilgore Road
Rancho Cordova, CA 95670

Nicolas Maduros
Director
Department of Tax & Fee Administration
450 N Street
Sacramento, CA 95814

RE: Cannabis Distribution Association (CDA) Tax Consolidation Proposal and Priorities

Dear Directors Elliott and Maduros:

The Cannabis Distribution Association (CDA) represents a diverse group of licensed cannabis distributors in California and throughout the country. Our mission is to help build a well-regulated marketplace that ensures economic viability for small businesses, promotes supply chain integrity, and ensures consumer safety.

CDA members collectively distribute over a third of all regulated cannabis goods sold in California. As such, our members are also responsible for remitting a third of all cultivation and excise taxes collected. This responsibility comes with significant costs to facilitate the collection and remittance of these taxes – increased accounting personnel, increased security personnel, and working capital to float the taxes which are often due to be remitted prior to when they are collected.

While we believe the cannabis industry is overtaxed relative to any other comparable market, we recognize that tax reduction has not been a successful legislative platform in prior years. However, there are many revenue-neutral improvements to the tax structure that can be achieved to alleviate the burden of collection through consolidation and simplification.

We believe it is critical for state policymakers to enact comprehensive tax reform in 2022 to streamline the supply chain and create more transparency for consumers and other stakeholders. It is well understood that California has nowhere near the number of licensed and operational retail shops necessary to serve the consumer base who purchase cannabis, mostly on the illicit market, and to support the over-supply of cannabis from licensed cultivation operations in the state.¹

Enclosed in this letter are the tax reform initiatives we would like to see prioritized by the Legislature and the Administration in 2022. The high-level components include: 1) consolidation of cultivation tax and excise tax, 2) enforcement and accountability for payment obligations, and 3) improving participation in the medical card program.

¹ Alexander Nieves (October 23, 2021). *California's legal weed industry can't compete with illicit market*; Politico. Available here: <https://www.politico.com/news/2021/10/23/california-legal-illicit-weed-market-516868>. Last accessed October 25, 2021.



Consolidation of Cultivation Tax and Excise Tax

A weight-based tax is not appropriate for a product with varying grades of quality within the same category. Flower can range in value from \$300-\$3,000 per pound depending on production method and quality, yet all flower is taxed at the same rate. Even on a single plant, multiple grades of flower can be produced from varying parts of the plant. A weight-based tax is less tenable than ever before as cannabis becomes more commodified due to overproduction and oversupply in California, as we've seen this past year. Flower prices this time last year were twice what they are today, and cultivators are expected to pay the same amount in taxes with a 50% reduction in income. This reality is forcing cultivators to go out of business or suffer extreme hardship.

Furthermore, cultivation taxes are inconsistently collected and remitted across the supply chain due to the complexity of the calculation and record-keeping. Prior to "entering the commercial market" (which is the trigger for the accrual of the cultivation tax), the product may change hands several times from cultivator to processor to manufacturer to distributor(s), all of whom must calculate cultivation tax and keep appropriate records. The change of hands creates confusion about how much of the end-product will truly enter the commercial market and therefore become taxable, as well as who is ultimately responsible for remitting the tax.

Cannabis or cannabis products are deemed to have entered the commercial market once the cannabis passes the required testing and quality assurance review [Revenue and Tax Code 34010 (m)]. Both a Certificate of Analysis and a quality assurance review must be completed before the cannabis enters the commercial market [Business and Professions Code 26110 (e)]. The distributor that conducts the required quality assurance review once a Certificate of Analysis is received and prior to the cannabis being sold in its final labeling and packaging to a retailer or other distributor is responsible for reporting the cultivation tax to the CDTEA during the reporting period that the cannabis entered the commercial market [Revenue and Tax Code 34012 (a)].

Consolidating the Cultivation Tax into the Excise Tax is the proposed solution to these issues and can be achieved as follows:

- A tax revenue neutral outcome would be achieved by consolidating the Cultivation Tax into the Excise Tax, and increasing the Excise Tax to $Y\%$, where $Y\% = 15\%$ (current excise tax rate) + $X\%$; whereas $X\%$ is the amount of Cultivation Taxes historically collected, expressed as a percentage of historical retail sales.

Since January 2018, the Cultivation Tax Revenue collected has ranged between 2.5% to 3.0% of Retail Sales, based on:

- Cultivation Tax Revenue: cdtfa.ca.gov/dataportal/charts.htm?url=CannabisTaxRevenues
- Retail Sales: Sales & Use Tax Revenue divided by 8.5% average Sales & Use Tax Rate



- Amend the [Revenue and Taxation Code](#) as follows:

Section 34011 (a) Effective January 1, 2018, a cannabis excise tax shall be imposed upon purchasers of cannabis or cannabis products sold in this state at the rate of ~~15~~ [Y] percent of the average market price of any retail sale by a cannabis retailer. A purchaser's liability for the cannabis excise tax is not extinguished until the cannabis excise tax has been paid to this state except that an invoice, receipt, or other document from a cannabis retailer given to the purchaser pursuant to this subdivision is sufficient to relieve the purchaser from further liability for the tax to which the invoice, receipt, or other document refers. Each cannabis retailer shall provide a purchaser with an invoice, receipt, or other document that displays the cannabis excise tax separately from the list price, the price advertised in the premises, the marked price, or other price and includes a statement that reads: "The cannabis ~~cultivation and~~ excise taxes are included in the total amount of this invoice."

- Strike all references to Cultivation Taxes in the Revenue and Taxation Code (Sections 34011, 34012, 34012.1, 34012.5, 34015) and remove references to cultivators and manufacturers in relation tax collection or remittance, since neither would maintain any role in tax collection or remittance.

Consolidation of the cultivation tax and excise tax into a single point of tax is the first of three steps toward comprehensive tax reform, and will alleviate a lot of the pain points for operators as well as regulators.

Enforcement and Accountability for Payment Obligations

Under the current regulatory framework, distributors act as a bank to the industry, often liable for remitting taxes prior to collecting them, and having no authority or recourse in the event of default or delayed payments. This creates a massive accounts receivable (A/R) issue and cash flow constraints for distributors, especially less well-funded ones, who are challenged with the burden of remitting taxes without first receiving the funds from those whose obligation it is to pay.

Tax collection at distribution is a function of the three-tier system in alcohol, yet the following protections afforded to alcohol distributors do not exist for cannabis distributors: credit law to restrict the flow of goods to retailers who are in default of credit terms, suspension of licenses upon default, and bonds that distributors can call upon when a retailer defaults. At a minimum, cannabis distributors should not be obligated to remit another operator's tax until that tax has been collected, which can be achieved by amending Regulation 3700 (j) to read as follows: *A distributor shall report and remit the cannabis excise tax due with the return for the quarterly period in which the distributor ~~sells or transfers the cannabis or cannabis products to a cannabis retailer~~ collects the excise tax from the retailer.*

The A/R issue faced by operators is crippling, as many bad actors source products from new distributors to avoid paying the distributors they already owe. It extends beyond the collection of taxes to the collection of the product invoices as well. Protections would create accountability for operators by requiring them to pay their bills in order to continue to transact with any other business. The entire supply chain would benefit from this increased accountability, as required by law.

Distributors are not only burdened by the lack of accountability and enforcement in the collection process; but also by the debilitating payment penalties that fall upon distributors when retailers fail to pay, or fail to pay on-time.

An alternate policy solution, if such protections cannot be achieved, would be to shift the point of collection of taxes from distributors to retailers. In the Legislative Analyst's Office (LAO) December 2019 report titled, "How High? Adjusting California's Cannabis Taxes", the LAO provided a comprehensive analysis of the existing cannabis tax framework and provided suggestions for improvement. The LAO states in this report that, "...we estimate that collecting taxes from retailers would result in a significantly smaller taxpayer population than collecting from cultivators or last distributors (the current point of collection)."

The LAO report also highlighted the complexity and weakness of the existing tax framework stating, "...California's cannabis taxes split these responsibilities between multiple businesses. This separation of taxpaying responsibilities weakens each business's incentive to ensure that the correct amount of tax is paid. An additional concern arises because many cannabis businesses have limited access to financial services due to federal criminalization. The current split of taxpaying responsibilities often involves cash changing hands multiple times, leading to problems with security, compliance, and enforcement. Furthermore, distributor remittance of the retail excise tax requires a markup calculation that makes the tax more difficult to administer." The LAO recommends that, "If it [Legislature] chooses to retain the ad valorem retail excise tax, we recommend it levy the tax on the retail sale and collect the tax directly from the retailer."

In the absence of accountability in the tax collection process through credit law and other protections, CDA is supportive of shifting the point of collection to retail. This shift would further simplify the excise tax reconciliation process for industry and regulators by removing the complexity of audits around arm's length versus non-arm's length transactions and eliminating the need for the average markup rate.

Should tax collection and remittance remain at the point of distribution, an excise tax based on the wholesale invoice value rather than the retail value would be prudent to eliminate the issues described above. For example, if the consolidated excise tax on retail sales were 18%, at an average markup rate of 80% the effective wholesale excise tax would be 32.4% of the wholesale invoice value. While the point of tax collection would remain at distribution, the retailer's excise tax obligation would end upon payment of the 32.4% wholesale excise tax, and no further reconciliation would be required.



Improve Participation in the Medical Card Program

Cannabis is widely recognized as an effective medicine that is recommended to patients for a variety of diagnoses. California’s Compassionate Use Act of 1996 listed as its first priority: “[t]o ensure that seriously ill Californians have the right to obtain and use marijuana for medical purposes.²” Patients diagnosed with cancer, AIDS, anorexia, and those who suffer from severe nausea utilize cannabis to reduce their nausea, increase their appetite, or counteract side-effects from their other medications. Those who have been diagnosed with glaucoma, migraines, or chronic pain are recommended cannabis by their physician to reduce the pain and discomfort associated with their afflictions. A quick stop into a medical dispensary would also reveal many patients who rely on cannabis to fight insomnia, anxiety, and as a means of easing the transition away from opioid addiction.

It is a commonly held principle across the country that medicine should never be taxed, and California is no exception. In Regulation 1591 of the Sales and Use Tax Regulations the CDTFA definition of medicine includes: “[a]ny substance or preparation intended for use by external or internal application to the human body in the diagnosis, cure, mitigation, treatment or prevention of disease and which is commonly recognized as a substance or preparation intended for that use.³” The Compassionate Use Act of 1996 has been around for 25 years and acknowledges the use of cannabis as a treatment for a multitude of afflictions; this places cannabis squarely within the CDTFA’s definition of medicine.

Though cannabis patients can avoid some of the heavy taxes levied on cannabis (e.g., not the cultivation tax, excise tax, nor most local taxes), the current cannabis medical card program is failing to serve the majority of medicinal cannabis patients due to the cost, complexity and inconvenience of the program. The results speak for themselves. California has the largest population in the country (39.7m) and the largest number of cannabis patients, yet a paltry .00029 of them (approximately 113,500 all-time) participate in the plan, with fewer than 5,000 new cards issued annually -- hardly reflective of the true number of people who rely on cannabis for medicinal purposes. By way of comparison, with a population that is about half of California, Florida has six times the number of medical patients. In other words, the majority of cannabis patients in California are paying taxes on their medicine. Policymakers should agree that this is unacceptable and should be immediately addressed.

Worse than taxing medicine, many patients who can’t afford these levies are forced to turn to the illicit market because of the significant cost differentials. The lack of testing and quality control issues with illicit products are well-known and patients should be the last people that the state wants to price out of legal cannabis.

The current Medical Marijuana ID Card (MMIC) program requires patients to apply for the card at their county health department. This process should be made digital and facilitated through an online portal at

² Health and Safety Code Sec. 11362.5(b)(1)(A)

³ <https://www.cdtfa.ca.gov/lawguides/vol1/sutr/1591.html>

the state level, to increase participation in the program and meet the needs of the patients it is intended to serve. Furthermore, the MMIC program should be optional for patients but not required in order for them to obtain the tax-exempt benefit. Evidence of a medical cannabis recommendation obtained from a medical professional and provided at the point of sale should be sufficient for patients to conduct a tax-exempt purchase at retail. State law should make medical purchases exempt from the consolidated excise tax in addition to the sales and use tax. The state should encourage local municipalities to modify their ordinances to make medicinal cannabis purchases exempt from local taxes as well.

The Governor and Legislature have taken bold steps to help remove barriers and streamline the implementation of regulations through the consolidation of the regulatory agencies into the new Department of Cannabis Control. We ask for your leadership again to consolidate the collection and remittance of cannabis taxes to achieve efficiencies and remove unnecessary barriers for the industry, to simplify the process for the state's tax collectors, and to increase access to cannabis for medical patients.

On behalf of the CDA board, we look forward to working with you on these important issues and others heading into the New Year.

Sincerely,



Jennifer Gallerani
Board Co-Chair



Lauren Fraser
Board Co-Chair