

TO: City Council

FROM: Karin Murabito
Sr. Deputy City Attorney

SUBJECT: Proposition 64 and the
Cannabis Business Tax

DATE: December 8, 2020

INFORMATIONAL MEMORANDUM

BACKGROUND

On October 28, 2020, the Rules and Open Government Committee and Committee of the Whole (the “Rules Committee”) considered a Memorandum drafted by Councilmembers Khamis and Foley which asked to explore the possibility of exempting medical marijuana from the City’s Marijuana Business Tax. The item was referred to the next Priority Setting Session anticipated to take place during the first quarter of calendar year 2021. In the meantime, the Rules Committee requested the City Attorney to review whether Proposition 64 (otherwise known as the Control, Regulate, and Tax Adult Use of Marijuana Act or “AUMA”) approved by the voters in 2016 pre-empted the City’s Marijuana Business Tax. As more fully discussed below in this Informational Memorandum, AUMA does not pre-empt the City’s Marijuana Business Tax, which is currently known as the Cannabis Business Tax.

ANALYSIS

Overview of Business Taxes and Sales Taxes

As background information for understanding the City’s Cannabis Business Tax, taxes are typically viewed as either property taxes or excise taxes. Property taxes are taxes on ownership of real or personal property with the tax triggered by the mere ownership of the property. In contrast, excise taxes are taxes on the privilege of doing something. A business tax is a type of excise tax imposed on businesses for the privilege of conducting business within a city or county. The tax is most commonly based on gross receipts or levied as a flat rate. Under the State Constitution¹, San José, as a charter city, may impose business taxes subject only to the restrictions of the limitations in the state and federal constitutions and the City Charter.

Sales tax is generally viewed as an excise tax on the “privilege of selling tangible personal property at retail.”² In California, sales taxes are imposed under the State

¹ Cal.Const. Art. XI, Section 5.

² California Revenue and Taxation Code Section 6051

Revenue and Taxation Code. Retailers engaged in business in California must register with the California Department of Tax and Fee Administration (formerly the State Board of Equalization) and pay the sales tax, which applies to all retail sales of goods and merchandise except those specifically exempt by law. Sales tax has three parts – the state tax rate, local tax rate, and any district or transactions and use tax rate that may be in effect if approved by the voters. Sales tax is imposed on the retailer (seller) on the sale of tangible personal property. Retailers oftentimes collect reimbursement for the sales tax from their customers. Even though the consumer bears the financial burden of the sales tax when a retailer collects it from him or her, ultimately the retailer is liable for paying sales tax on their sales transactions.

AUMA and Taxation of Marijuana

On November 8, 2016, AUMA came before the voters. It was approved by a majority of the voters voting on November 8, and went into effect on November 9, 2016, and legalized the nonmedical use of marijuana by persons 21 years of age and over and the personal cultivation of up to six marijuana plants. In addition, AUMA created a state regulatory and licensing system governing the commercial cultivation, testing, and distributing of nonmedical marijuana and the manufacturing of nonmedical marijuana products. It also allowed local governments to prohibit or regulate and license commercial nonmedical marijuana.

With respect to taxation of marijuana, AUMA did the following:

- imposed new state taxes on medical and nonmedical marijuana. For example, effective January 1, 2018, a cannabis excise tax was imposed upon purchasers of cannabis or cannabis products sold in this state at the rate of 15 percent of the average market price.
- imposed a separate cultivation tax on all harvested marijuana.
- prohibited the imposition of state and local sales taxes on *medical marijuana* when a qualified patient or primary caregiver for a qualified patient provides their card issued under Section 11362.71 of the Health and Safety Code and a valid government-issued identification card.³
- exempted marijuana cultivated for personal use from taxation.

Under AUMA, state and local sales tax (including the City's transactions and use .25% tax or district tax approved by the voters in 2016), which is 9.25% in San José, does not apply to medical marijuana. The public is not paying state sales tax or local sales tax on medical marijuana in San José, if the purchaser provides a valid medical marijuana identification card and government identification.

³ California Revenue and Taxation Code Section 34011 states the following:

(f) The sales and use taxes imposed by Part 1 (commencing with Section 6001) shall not apply to retail sales of medicinal cannabis, medicinal cannabis concentrate, edible medicinal cannabis products, or topical cannabis as those terms are defined in Division 10 (commencing with Section 26000) of the Business and Professions Code when a qualified patient or primary caregiver for a qualified patient provides their card issued under Section 11362.71 of the Health and Safety Code and a valid government-issued identification card.

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However, AUMA does not pre-empt all local taxation. Specifically, California Revenue and Taxation Code Section 34021 states the following:

The taxes imposed by this part shall be in addition to any other tax imposed by a city, county, or city and county. (emphasis added)

In short, while medical marijuana is exempt from state and local sales tax under certain circumstances, local taxation is not pre-empted under AUMA except for sales tax.

San José Cannabis Business Tax

In 2010, a majority of the voters approved the City's Marijuana Business Tax, Measure U, (now referred to as the Cannabis Business Tax), which is a local business tax (not a sales tax) on persons (broadly defined) conducting cannabis business activities in the City.

Specifically, Section 4.66.250 of the San José Municipal Code provides that every person engaged in cannabis business in the City shall pay a business tax at a rate of up to 10% of gross receipts, for the privilege of conducting business in the City. On July 1, 2013, the tax rate was set by the City Council at 10%. Since then, the City Council has set lower tax rates for specified types of cannabis business activities.

As discussed above, AUMA did not adversely impact or impair the City's ability to collect its Cannabis Business Tax. The Cannabis Business Tax is imposed on the persons engaged in cannabis business activities in the City, for the *privilege of conducting business* in the City, and not the purchaser of the medical or recreational cannabis. In practice, businesses oftentimes elect to pass along the tax to purchasers of the cannabis as the cost of doing business so it might look and feel like a sales tax to the purchaser, which could lead to some confusion, when actually it is a tax placed on the business operator for the privilege of doing business in San José.

CONCLUSION

Accordingly, for all the reasons set forth above, the City's Cannabis Business Tax is not pre-empted by AUMA. The City's Cannabis Business Tax is an excise tax imposed on the privilege of conducting business in San José and is not a sales tax.

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