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August 24, 2017

Ms. Trista Gonzalez, Chief
California Department of Tax and Fee Administration
Tax Policy Division (MIC 92)
450 N Street
Sacramento, CA 94279-0092

VIA: Email: Trista.gonzalez@cdtfa.ca.gov

Re: Cannabis Tax Regulations

Dear Ms. Gonzalez,

Thank you for providing us with the opportunity to make this submission on behalf of the California Cannabis Industry Association (CCIA). This submission is being made in response to the Discussion Paper issued on July 21, 2017, and the interested parties meeting which was held on August 2, 2017.

We would like to express our appreciation for you and your staff's concerted efforts to establish regulatory guidelines that will help enable the cannabis industry to comply with the new and complex tax laws.

The California Cannabis Industry Association (CCIA) was formed to unite the cannabis industry in California and to allow it to speak with one voice at the state and local levels. CCIA strives to educate and act as a resource to lawmakers and regulatory agencies regarding all areas of the cannabis industry. It is CCIA's mission to promote the growth of a responsible and legitimate cannabis industry and work for a favorable social, economic, and legal environment for our industry in the state of California. Representing hundreds of businesses, they are the unified voice of the cannabis industry in California.

As the leading association in the cannabis industry, CCIA is significantly interested in doing its part to help make certain that clear and comprehensive regulations are established. CCIA's goal is to work alongside the California Department of Tax and Fee Administration (CDTFA) to help lay the groundwork for guidelines that will enable its members and the industry as a whole to achieve a very high level of voluntary compliance. To that end, we offer the following comments and suggestions.

I. Penalty established under Revenue and Taxation Code (RTC) section 34013, subdivision (e).

Based on our reading of the law, the intent of Proposition 64, Senate Bill 94, other related bills, and from communications with the framers of the cannabis law, it our opinion that the penalty provided for under RTC section 34013 is discretionary, and that it should be limited to 50 percent. Further, we believe the penalty should only apply when a person knowingly fails to pay the tax, not when there is a failure to pay *timely* and/or an unintentional error in reporting.

RTC section 34013, subdivision, (e) provides:

“Any person who fails to pay the taxes imposed under this part shall, in addition to owing the taxes not paid, **be subject to** a penalty of at least one-half the amount of the taxes not paid, and shall **be subject to** having its license revoked pursuant to Section 26031 of the Business and Professions Code or pursuant to Chapter 3.5 (commencing with Section 19300) of Division 8 of the Business and Professions Code.” (Emphasis added)

CDTFA's July 21, 2017, rule making discussion paper provides proposed regulatory language for the penalty as follows:

“(d) Penalty for Taxes Not Paid. In addition to any other penalty imposed pursuant to the Fee Collection Procedures Law (commencing with section 55001 of the Revenue and Taxation Code or any other penalty provided by law) a penalty, as set forth in paragraphs (1)-(3) of this subdivision, applies to the amount of cannabis excise tax or cannabis cultivation tax not paid in whole or in part **within the time** required pursuant to sections 34015, 55041.1, and 55086, of the Revenue and Taxation Code.

(1) The first **failure to timely pay** the cannabis excise tax or cultivation tax by the due date, within an 18-month period, shall incur a penalty of 50 percent of the amount of the unpaid taxes.

(2) The second **failure to timely pay** the cannabis excise tax or cultivation tax by the due date, within an 18-month period, shall incur a penalty of 60 percent.

(3) The third or subsequent **failure to timely pay** the cannabis excise tax or cultivation tax by the due date, within an 18-month period, shall incur a penalty of 75 percent.” (Emphasis added)

By its language, the proposed regulation imposes a penalty on people that fail to “**timely**” pay the tax. Under the proposed regulation, a person that attempts to comply, but fails to pay its tax timely due to unforeseen or unanticipated circumstances by one day, would receive a penalty of at least 50 percent. The language of the statute, however, does *not* state that the penalty will apply to people that do not pay “within the time” prescribed law, it states that “[a]ny person who fails to pay the taxes,” will be subject to a penalty.

We believe there is a difference between a person that fails to pay the tax altogether and a person that intends to pay the tax, but does so late or makes an unintentional error in reporting. A person that pays, albeit late, does not involve a failure to pay the tax, there is merely a failure to do so timely. If there was an intent to punish any person that failed to pay the tax “within the time” prescribed by law, we believe the law would have referenced “time,” in some manner. (See, e.g., RTC §§ 6476, 6477 [which clearly address the failure to “timely” pay the tax].) Because such a factor could have been easily incorporated into the law, as it is in other late payment penalty tax statutes, but was not, we believe the rules of statutory construction support that a failure to pay *timely* should not be read into the law. Including a timeliness factor in the regulation unnecessarily and impermissibly expands the law to include virtually any failure, which simply does not make sense considering the severity of the penalty.

Moreover, RTC section 34013, subdivision (a), provides that the cannabis tax shall be administered in accordance with the Fee Collection Procedures Law (FCPL), RTC section 55001, et seq. The FCPL contains RTC section 55042 which imposes a penalty of 10 percent for the failure to pay the tax “within the time required.” By referencing the FCPL, RTC section 34013, subdivision (a), establishes a penalty of 10 percent for a failure to pay “within the time required.” (RTC § 55042, subd. (a).) Therefore, it is incongruous to conclude the same code section establishes a separate penalty for the same exact thing, i.e., failure to pay “within the time required.” There is no reasonable basis to conclude the law intended to create two separate late payment penalties within the same code section.

According to a plain reading of the statute, we believe the words “subject to,” mean that a person is susceptible to the penalty, i.e., it is discretionary. Making a person “subject to” a penalty does mean the penalty “must” or “shall” apply. The BTC’s interpretation of the words “subject to” in Code section 34013, as it pertains to a license revocation, also supports that it

does not mean the penalty is mandatory. Code section 34013, subdivision (e), states that a person shall be “subject to having its license revoked.” But, there is no claim that a person “must” or “shall” have its license revoked if it inadvertently underreports its tax obligation or if it fails to file a timely return. The same meaning should be applied to the penalty.

A review of other mandatory penalties under in the RTC are instructive and further support that the penalty established under section 34013 is not intended to be mandatory. Mandatory penalty statutes contain language that make it clear the penalty is mandatory, e.g., by stating that a person “shall pay a penalty of 6 percent,” or “shall pay a penalty of 10 percent of the amount of tax.” (RTC §§ 6477, 30281, subd. (b).) Further, every known penalty that exceeds 25 percent requires an element of knowledge. (See RTC §§ 30211, 6485, 6485.1, 6597.) Penalties for late payments or unintentional errors are generally limited to 10 percent. (See RTC §§ 6476, 6477, 6478 6480.4, 30281.) The amount of the penalty, in itself, supports that it is intended to apply to people that knowingly do not pay the tax.

We believe the penalty is designed to deter people from operating outside of the framework of the law and to punish those that intentionally fail to pay. Under the proposed regulation, our concern is that only those people that actually attempt to comply, but fail to do so notwithstanding good faith efforts, will be subject to the exorbitant penalty. Ultimately, it will be those that register and attempt to comply that will be most likely to have encounters with the CDTFA and thereby be subject to the imposition of the penalty.

We propose the following regulatory language for the penalty established under RTC section 34015 (e):

“Penalty for Taxes Not Paid. In addition to owing the taxes not paid, a person shall pay a penalty of 50 percent if it is determined the person knowingly failed to pay the taxes due.”

We believe the other penalties provided for under the Fee Collection Procedures Law should also be clearly described in a regulation, rather than merely referenced, since most people will have difficulty cross-referencing and understanding different sections of the law. Sales and Use Tax Regulation 1703, provides a good example of a regulation that describes multiple penalties that may apply, in addition to guidelines for available relief. We encourage the BTC to draft a regulation for penalties associated with the cannabis tax law that is similar to Regulation 1703. Doing so will help to put people on notice of the penalties they are subject to and it will provide needed guidelines for obtaining available relief.

II. Timing of the remittance of retail cannabis tax in consideration of the option to collect the tax from a retailer within 90 days after the sale or transfer in an arm's length transaction. (RTC §§ 34011, subd. (b)(1), 34015, subds. (a), (c).)

RTC section 34011, subdivision (a), imposes a tax “upon purchasers” at the rate of 15 percent. RTC section 34011, subdivision (b)(1), provides a distributor with the option of collecting the 15 percent retail excise tax 90 days after its sale. RTC section 34015, subdivision (a), establishes a quarterly reporting and payment basis “[u]nless otherwise prescribed by the board pursuant to subdivision (c).” RTC section 34015, subdivision (c), provides the CDTFA with the authority to prescribe different due dates for reporting taxes applied in an arm's length transaction.

First, it is important to recognize that the retail cannabis tax is imposed upon purchasers and retailers are required to collect and pay it over to a distributor for submission to the CDTFA. (RTC §§ 34011, subds. (a), (b) 34015.) There are significant concerns that a distributor and/or retailer will not have the ability to pay the tax prior to the time that it is actually imposed upon and collected from a purchaser. The virtually exclusive use of cash as a means of payment by the industry and the inability to use banking and financing institutions heightens this issue and concern. RTC sections 34011 and 34015 address this concern. If a distributor exercises its legal right to collect the tax 90 days after its sale, it should be permitted to report the tax in the period in which the tax is collected. Therefore, we request that the CDTFA exercise its authority granted under RTC section 34015, subdivision (c), and establish a regulation which requires a distributor to report the excise tax imposed on arm's length transactions in the quarter following the quarterly period in which the sale is made, i.e., 90 days following its sale to the retailer.

To maintain clarity for reporting purposes, the reporting timeframe should not vary for arm's length transactions. In other words, if a distributor or manufacturer contracts to collect the tax *prior to* 90 days on some transactions and at 90 days for others, to maintain consistency and ease in the reporting requirements, all of the subject tax should be due in the quarter following the period in which the sale occurs.

III. Timing of the due date of the cultivation tax vs. the presumption of sale and taxability upon removal from a cultivation site.

RTC section 34012, subdivision (a), states that the cultivation “tax shall be due *after* the cannabis is harvested *and enters the commercial market.*” (Emphasis added) Enters the commercial market means the cannabis “has completed and complies with all quality assurance, inspection, and testing.” (RTC § 34010, subd. (m).) A distributor shall collect the cultivation tax upon entry into the commercial market. (RTC § 34012, subd. (h)(1).)

In summary, the forgoing provisions establish that the cultivation tax is due and subject to collection *after* it has been tested and approved for commercial sale. But, RTC section 34012, subdivision (i), establishes a presumption of taxability for “[a]ll cannabis removed from a cultivator’s premises.” The question becomes, what happens when a distributor is inspected and it has possession of untaxed cannabis that it removed from a cultivator’s premises without collecting or reporting tax, because it is waiting for samples of the cannabis to be tested? The cannabis may be subject to seizure under RTC section 34016, subdivision (c). Thus, it is recommended that the presumption of taxability be clearly identified in a regulation as being rebuttable. The regulation should explain that prior to presuming that tax applies, it must be established that it has “entered the commercial market,” i.e., has completed and complies with all quality assurance, inspection, and testing. A person should not be forced to prove a negative in order to avoid the presumption of taxability. In other words, a person should not be forced to prove that cannabis has *not* completed and complies with all quality assurance, inspection, and testing, since doing so may be virtually impossible.

IV. Average Market Price computation.

RTC section 34010, subdivision (b) defines average market price. Regulatory guidelines should be established that clearly explain how the “Average Market Price” is computed. The applicable regulation should explain how the computation is carried out, including a description of what costs the markup should be applied to, and how the tax is computed therefrom. We believe it would be significantly beneficial to provide *at least one* example of how the average market price is computed, and how it flows into the tax computation. There is a lot of confusion on this issue in the industry and clear guidelines are needed to enable greater compliance.

V. Markup Percentages

RTC section 34011, subdivision (a), imposes an excise tax of 15 percent on the “average market price” of cannabis or cannabis product sold in the state. RTC section 34010, subdivision (b)(1), defines “average market price” as the following:

“In an arm’s length transaction, the average market price means the average retail price determined by the wholesale cost of the cannabis or cannabis products sold or transferred to a cannabis retailer, *plus a mark-up*, as determined by the [CDTFA] on a bi-annual basis in six-month intervals.” (emphasis added)

CDTFA’s establishment of the mark-up is of significant importance to CCIA. An overstated mark-up, even if only in place for six-months, will have a potentially crippling effect on the industry since actual margins are anticipated to be very low.

Based upon various discussions with numerous members of CCIA, it is anticipated that the average mark-up for cannabis products in this newly formed market will be *no greater than* 20 percent. CCIA members anticipate that the average wholesale cost of cannabis will be higher than what has been reflected in past cannabis sales because there will be significantly higher costs to comply with what will likely be the most heavily regulated industry in the state. There is also a concern with a lack of supply, as a result of there being a lack of licensed distributors and cultivators in the market initially (creating a choke point in the supply chain), which will drive wholesale costs higher. Further, it is anticipated that the average retail selling price will be driven down through more prevalent competition at the retail level. The net result will be a lower average markup than what has existed historically.

Ultimately, data gathered from actual recreational transactions after January 1, 2018, will permit the CDTFA to compute a more accurate markup percentage going forward. For the first six months, however, the best information available to CCIA supports that the average mark-up for cannabis products will be *no greater than* 20 percent.

In addition, CCIA suggests establishing multiple product categories with associated mark-ups for different varieties of cannabis because different grades and types of cannabis products may carry different mark-ups. Examples of different mark-up categories may include: manufactured products (edibles), different grades of cannabis (low, medium, high), and cannabis oils. CCIA is hoping to work with the CDTFA in the future to help establish these different product categories and related mark-ups.

VI. Form of Invoices, Receipts and Other Documents

RTC section 3401, subdivision (a), instructs a retailer of cannabis to provide a purchaser with a receipt that lists includes the following statement, “the cannabis cultivation and excise taxes are included in the total amount of this invoice.”

One interpretation of this statute that was discussed at the interested parties meeting was that the dollar value of the 15 percent excise tax had to be listed on the receipt itself. If a retailer is required to separately state the amount of excise tax it paid to its distributor for the product being sold, a competitor will be able to establish the retailer’s cost of that product by dividing the amount of excise tax shown on the receipt by 15 percent. That knowledge could undermine the marketplace because competitors would be able to determine the wholesale costs and the mark-ups applied to various products. That information, in turn, could create problems and disputes with suppliers.

We suggest that the regulatory language simply instruct the retailer to include the required statement, “The cannabis cultivation and excise taxes are included in the total amount of this invoice”, on the receipt, invoice or other document.

In the alternative, the 15 percent excise tax could be separately stated but based on the retailer's retail selling price of the product. However, this would give rise to a difference in the amount of tax due and the amount collected. For that reason, we believe the best alternative is to only require the above statement.. This would satisfy the requirement for a purchaser to obtain proof of the taxes paid and permit retailers to operate without disclosing confidential information.

Further, it would be beneficial to everyone in the industry if there were examples provided by the CDTFA of receipts, invoices and other documents involving transactions and transfers between the following parties:

- Cultivator and Distributor/Manufacturer
- Manufacturer and Distributor
- Distributor acting solely as a transporter of cannabis
- Distributor and Retailer
- Retailer and Customer

Such samples may be more appropriately issued in a pamphlet or website guide that is specific to the cannabis industry. CCIA remains available for input on creating sample documents that are acceptable to the CDTFA.

VII. Guidelines for Refunds of Overpaid Tax

“The board may prescribe, adopt, and enforce regulations relating to the administration and enforcement of this part, including, but not limited to, collections, reporting, **refunds**, and appeals.” (RTC 34013, subd. (b).) RTC section 34012.5, subdivision (b), establishes that a distributor or a manufacturer may refund undue or excess taxes collected from a cultivator or retailer and that the distributor or manufacturer may claim a credit for the refund on its return. This includes cultivation taxes that were collected on cannabis that fails quality assurance, inspection, and testing. (RTC § 34012, subd. (h)(4).) We believe a separate line item should be added to the cannabis tax return for “credits for overpaid taxes on a prior return.” Further, guidelines should be established in a regulation which clearly describe the procedures for taking a credit on a return or filing a claim for refund, and the documents which may be used to support the credit or refund.

VIII. Security Requirements

RTC section 34014, subdivision (b), provides that the CDTFA “may require” cannabis businesses to provide security to cover the liability for taxes. The statute goes on to state that the

“[CDTFA] may waive any security requirement it imposes for good cause,” and that good cause “includes, but is not limited to, the inability of a [person] to obtain security due to a lack of service providers...” “In fixing the amount of any security required by the [CDTFA], the [CDTFA] shall give consideration to the financial hardship that may be imposed on licenses as a result of any shortage of available surety providers.”

Because the requirement for security is clearly permissive, we believe the CDTFA should not impose a requirement for security unless there is a failure to timely remit taxes due. In the event security is deemed to be required by the CDTFA, it should seek to set the amounts low, at least for the first two years (2018-2019), to make sure an undue hardship is not created. To the extent a cannabis business can show it has been unable to obtain a surety bond, the CDTFA should consider such inability to be “good cause” to waive the security requirement. Evidence to show a business is unable to obtain a surety bond should consist of a letter of denial from a surety provider.

IX. Sales and Use Tax Compliance

Cannabis businesses will also be subject to sales and use tax compliance requirements. While such requirements may not be appropriately addressed within cannabis excise tax regulations, the BTC should issue written guidelines to the industry to describe the relevant sales and use tax compliance requirements. Guidelines should include, but not be limited to, the following:

- Registration requirements;
- Reporting requirements;
- Proper support for sales for resale, i.e., timely and complete resale certificates accepted in good faith;
- Proper support for sales of medical cannabis;
- Use tax obligations for purchases of assets and supplies;
- Application of tax to delivery charges.

X. Factors not considered or addressed by the industry in the emergency rulemaking process.

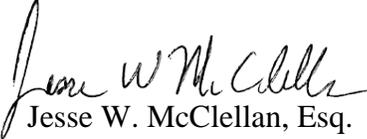
Participation by the cannabis industry is vital to the success of the rulemaking process. Because a complete set of regulations have not been drafted by the CDTFA prior to the emergency regulation comment period, issues may arise in the regulation drafting process that were not considered or addressed by the industry. To help ensure any such issues are properly addressed in the impending regulations, we encourage the CDTFA to send requests for submissions by interested parties for input prior to submitting a final draft of the proposed

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regulations to the Office of Administrative Law. Alternatively, regulatory guidelines on issues that have not been considered should be held in abeyance pending the final rulemaking process.

Thank you for the consideration given to our suggestions and concerns and please do not hesitate to contact me should you have any questions.

Very truly yours,



Jesse W. McClellan, Esq.
James Dumler, CPA
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On behalf of CCIA

Cc: CCIA