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CONTROLLER

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Honorable Eric Garcetti, Mayor
Honorable Mike Feuer, City Attorney
Honorable Members of the Los Angeles City Council

Re: Cannabis-Related Revenue Collections

Voter approval of marijuana for adult recreational use in California brings with it both regulatory challenges and the potential for a major new City revenue source. Regulatory uncertainty starts at the federal level. The new Administration has not yet made it clear how it may seek to enforce longstanding federal laws that treat marijuana as an illegal drug, in California and the seven other states that have legalized marijuana for both recreational and medical purposes. The uncertainty extends to Sacramento where state officials are still finalizing regulations. And, locally, the number of marijuana retailers that will be allowed to operate in the City has not yet been settled.

Nevertheless, economists with marijuana industry experience estimate that first-year retail sales in the City of Los Angeles for both medical marijuana and newly legalized recreational marijuana will likely approach \$700 million. Given that voters have already approved City business taxes of up to 10% of gross receipts on recreational sales and up to 5% on medical sales, the City could be entitled to collect at least \$50 million in tax revenue from retail sales in 2018.

In order to understand the magnitude of the marijuana industry, and potential revenue, my office has created a website that maps: Marijuana dispensaries operating in the City of Los Angeles with current Business Tax Registration Certificates (BTRC), those who once held a BTRC, and those that have been the subject of actions by the Los Angeles City Attorney's Office. (<http://www.lacontroller.org/marijuana>).

In the interest of maximizing the City's tax revenues, my office consulted with industry experts and examined best practices in other states where recreational marijuana sales have been authorized.

As the City Council now moves to craft the City's regulatory framework and adopt land use policies, I ask they also take into consideration the following recommendations in order to (A) achieve more effective controls, (B) facilitate cannabis industry banking, and (C) share information among regulators.

A. Achieving More Effective Controls

The City should consider requiring marijuana business owners, investors and, in some cases, employees to:

- Employ cash-counting devices such as smart-safes as on-site repositories for cash receipts.
- Use cameras that record activities throughout a store to discourage pilferage and off-the-books sales and keep the recordings for at least 90 days. The state's first set of proposed regulations has a 30-day requirement.
- Make advance tax payments into escrow accounts until they have established an appropriate record as City taxpayers, or, in the alternative, post substantial surety bonds.
- Submit to regulation of delivery services, which have proliferated in Los Angeles without regulatory authority. New state laws will require delivery services to be licensed as retailers and operate in accord with regulations that establish "minimum security and transportation safety requirements." The City may also consider the possibility of requiring delivery services to have brick-and-mortar locations.
- Undergo financial and/or criminal background checks as a condition of local licensing. The state's first set of proposed regulations exempts employees from these checks.

B. Cannabis Industry Banking

Crucially, the City should consider what might be done to help the cannabis industry gain more open access to banking services at federally regulated financial institutions. Currently, banks and credit unions -- which are dependent on federal institutions for access to electronic money transfers and depositor insurance -- have largely declined to handle money they know comes from marijuana businesses. Securing the ability to bank cash receipts would help create high-quality trail for City tax auditors, as well as enhance public safety for marijuana business owners, employees, and the entire public.

In a largely unsuccessful attempt to address this problem, federal prosecutors and Treasury officials in the Obama Administration released guidance to banks and other financial institutions about how to deal openly with the marijuana industry. The guidance did not promise -- but then strongly signaled -- that banks that knowingly dealt with marijuana businesses would not be punished if they exercised proper care. Essentially, the guidance required banks to police their customers by researching their customers' backgrounds, inspecting their customers' stores and scrutinizing their customers' financial statements to look for evidence that their customers crossed bright lines of interest to federal prosecutors, such as shipping marijuana to states where it remains illegal. Regardless of whether banks find suspicious activities, they are required to fill out "suspicious activity reports" on their marijuana business customers every 90 days. Few bankers have been willing to take on the extra work -- so the definition of what might be considered proper care would need to be evaluated.

Another option that some have suggested for possible consideration is the creation of a public- or quasi-public bank or entity that might be structured in such a way as to accept marijuana industry deposits.

C. Information Sharing

The State of Washington has found a way to make it easier for financial institutions to police their marijuana customers, and the City should consider following its example. Washington's efforts are focused on sharing information with banks, so the banks don't have to do as much of their own research. For example, Washington requires licensees to sign waivers that allow regulators to share financial and criminal background check results with banks. The state also posts



inspection, sales and compliance records of marijuana businesses online, relieving bankers of the obligation to inspect marijuana businesses themselves.

To run a similar program at the City level, local regulators would need access to data from California's forthcoming "track and trace" inventory control system, which is expected to rely on barcodes or radio signals to track each legally cultivated marijuana plant as it makes its way from farm to market and is sold in various forms in retail stores. Such a process -- used successfully in other states that have legalized marijuana for recreational purposes -- will be critical in keeping *illegally* grown drugs, which enrich criminals and generate no taxes, from infiltrating the legal marketplace.

State law already carves a potential path to make such City action possible. Business and Professions Code 19335 allows the State to give access to local regulators to the State's inventory tracking software for medical marijuana sales. The City should urge expansion of this provision to cover recreational sales.

In Summary

Transitioning an illegal industry into a legal one presents significant challenges for local government, including many factors beyond revenues -- such as where to allow lawful marijuana businesses to locate, how to regulate their hours and how to police what remains of the illegal portion of the industry. With the right strategy, controls, banking framework, and information sharing, the City of L.A. will be better positioned to address the challenges and to collect revenues to which it will be entitled.

Respectfully,



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CITY CONTROLLER

