

Attachment B

CANNABIS TAXATION AND EXPENDITURES

SUMMARY

The 2024-25 Santa Barbara County Grand Jury (Jury) investigated the current Santa Barbara County cannabis tax revenue and expenditures and how they are reported. During its investigation, the Jury learned that Santa Barbara County's (County) tax revenues from the cannabis industry have been declining steadily since cannabis was approved for recreational use in California in 2018. In this same period of time, the County's expenditures in regulating the cannabis industry have increased. As a result, the expenditures covering the County's cannabis industry-related management and taxation operations (Cannabis Program) are on track to become a financial burden in the near future unless the County takes corrective measures.

The Jury also found that a significant number of growers have left the Santa Barbara County cannabis industry due to high cost of operations, price collapse, and market oversupply in part due to black-market competition.

Currently, budgeting, tax collection, and compliance activities are the responsibility of different agencies and departments in the County. Inefficiencies in the management and required reporting of the Cannabis Program can be mitigated by the creation of a centralized information database that tracks the budget, tax revenues, expenses, and administrative activities related to licensing and compliance. In addition, Cannabis Program spending can be reduced by allocating tax revenues to support only operating expenses directly related to it. Given the volatility of the cannabis market, the Jury further recommends that the County maintain the solvency of the Cannabis Program by ensuring that expenditures do not exceed cannabis tax revenues each year.

This Grand Jury Report was based on an investigation conducted from August 2024 to May 2025. The Report was in the final stages of production on June 3, 2025, when the Santa Barbara County Board of Supervisors initiated significant changes to the County's Cannabis Program, many of which are consistent with the Findings and Recommendations in this Report. This Report was not altered or amended in any way following the Board's actions.

BACKGROUND

On November 8, 2016, California voters passed Proposition 64, which legalized the cultivation and sale of cannabis for recreational and/or medicinal purposes. At that time, even though cannabis

remained illegal under Federal law, the Federal government chose not to interfere with those states that legalized it for recreational and/or medicinal use. Going forward, this legal discrepancy would create a unique challenge for California and Santa Barbara County in developing, implementing, and enforcing a cannabis program. For example, because an IRS Code (26 U.S.C., § 280E) prohibits cannabis businesses from deducting ordinary business expenses, limiting deductions for cannabis cultivators only to the cost of goods sold, cannabis businesses carry a heavier tax burden overall than other types of businesses. Further, because cannabis is still listed as a Schedule I drug (similar to heroin, cocaine, LSD, ecstasy, etc.) under Federal law, many major financial institutions are hesitant to work with cannabis businesses.

Because cannabis is still illegal under Federal law and regulated as a Schedule I drug, California has contracted with METRC Inc, a track and trace technology company, to create a customized version of their Marijuana Enforcement Tracking Reporting Compliance (METRC) software that incorporates the State's regulatory adjustments. This system is called the California Cannabis Track-and-Trace (CCTT) System that is used statewide by cannabis businesses to record the inventory and movement of cannabis and cannabis products through the commercial supply chain of the cannabis industry - "from seed to sale."

With CCTT, every plant is tagged with a tracking number and can be followed from seed germination, through cultivation, to distribution, manufacturing, and finally to retail sale. Santa Barbara County utilizes the State's CCTT system to monitor and confirm that gross receipts from cannabis are being accurately reported by local cannabis businesses to the Santa Barbara County Tax Collector.

Once the industry was legalized at the State level, the County set about developing ordinances to regulate the newly created cannabis industry within the County (Cannabis Program). To assist it in this task, the County hired Hinderliter, de Llamas & Associates (HdL) to develop a tax model for cannabis. HdL's report/recommendation, dated October 14, 2017, was presented to the County's Board of Supervisors on December 14, 2017.¹

HdL's report listed four possible approaches for the County to tax the various cannabis activities:

- Tax on the cultivation area by square foot;
- Tax on the gross receipts of a cannabis business;
- A per-unit tax on the product by weight or volume; or
- A retail sales tax at point of sale.

¹ See the 2019-2020 Santa Barbara County Grand Jury's Report entitled "Cannabis," p. 15-18.
<https://sbcgj.org/wp-content/uploads/2022/02/Cannabis.pdf>

Ultimately, HdL recommended, and the County agreed, on a tax model that was based on the gross receipts of the various cannabis businesses, with quarterly reporting to the County.² The various cannabis business taxable categories and their respective tax rates are:

- Nursery: 1% of gross receipts. Nurseries include operations which, in essence, deal with seedlings, immature plants, and clones.
- Distributor: 1% of gross receipts (excludes Distributors for Transport Only). Distributors are involved in the procurement, sale, and/or transport of cannabis and cannabis products between two or more cannabis businesses.
- Manufacturing: 3% of gross receipts. Manufacturers are those operators who are engaged in the processing, packaging, holding/storing, and labeling of cannabis.
- Cultivation: 4% of gross receipts. Operators are those who plant, grow, (whether indoor or outdoor) and harvest mature plants.
- Retail: 6% of gross receipts. Retailers are those who work in storefront and non-storefront, e.g., web-based, settings.
- Microbusiness: 6% of gross receipts. A microbusiness is a business that is engaged in any of the above-described categories except Nurseries.

Because of declining tax revenues and concerns about the transparency of a cannabis business' gross receipts report, the Jury has focused its investigation on the County's cannabis tax revenue, expenditures, and related administrative processes.

METHODOLOGY

In support of its investigation, the Jury interviewed:

- Santa Barbara County Supervisors
- Santa Barbara County Tax Collector staff
- Santa Barbara County CEO staff
- Cultivators in Santa Barbara County
- Knowledgeable industry observers and analysts

The Jury also reviewed:

- Documents from the Offices of the County CEO, Tax Collector, and the Sheriff's Office
- Tax data from the Santa Barbara County Cannabis Program
- Published articles and literature on cannabis taxation within Santa Barbara County

The Jury also visited the facilities of multiple local cannabis businesses.

² See Santa Barbara County Code, Chapter 50A.

DISCUSSION

Cannabis Tax Revenue

While initially the County received a “green rush” of cannabis tax revenue, that revenue has since declined steadily from its high of \$15.7 million in 2020-2021 to less than \$6 million in 2023-2024. Since 2017, there has been no change in the County’s cannabis tax model/structure, which remains based on a cannabis business’ gross receipts. Table 1 reflects these declining tax revenues based on the financial data the Jury collected during its investigation.

Issues adversely impacting tax revenues of the County’s Cannabis Program include the following factors:

- Market oversupply has caused cannabis prices to drop from approximately \$1,200 per pound in 2020 to a low of \$250 per pound in 2025³
- Competition from out-of-County illegal suppliers has also driven the market price of cannabis down, reducing the profit margins of legitimate cannabis businesses and thereby, reducing their ability to recoup their costs
- Unregulated and cheaper synthetic products have also adversely impacted the sale price of cannabis products
- High tax rates have resulted from the unavailability of Federal tax deductions for cannabis businesses, which means their tax burden, compared to other businesses, is higher
- High cost of permits, licenses, and compliance fees:
 - A. Initial Application Fee: Ranging from \$5,180 to \$10,450, depending on the license type and operational scope
 - B. Annual Renewal Fee: Between \$2,803 and \$4,989
 - C. Compliance Management Fee: Fixed fees ranging from \$2,593 to \$4,276, replacing the previous deposit-based model
- High start-up costs related to infrastructure, security, and maintenance are forcing many of the cultivators out of business because they cannot recoup their initial investments and be profitable

The combined effects of all these factors have led to a steady decline in cannabis tax revenue in Santa Barbara County. The current Cannabis Program revenue in the first quarter of fiscal year 2024-25 was only \$1.3 million. This is the lowest first-quarter cannabis tax revenue since the Cannabis Program's inception in 2018.

³ Burns, Melinda. “The Downward Trend in Cannabis Tax Revenues.” *The Santa Barbara Independent*, Published January 27, 2025. <https://www.independent.com/2025/01/27/the-downward-trend-in-cannabis-tax-revenues/>

Cannabis Tax Expenditures

When Santa Barbara County approved the cultivation, processing, manufacturing, distribution, and sale of cannabis products for recreational use in Santa Barbara County in 2018, the County developed expenditure projections based on the expected “green rush” of cannabis tax revenue.

The initial Cannabis Program operating budget was developed to cover the full cost of staff time associated with licensing, application reviews, compliance checks, renewals and enforcement, and to provide funding for County deferred maintenance and capital projects. Unfortunately, the steady decline in cannabis tax revenue since 2020-2021 is projected to make the Cannabis Program a financial burden to the County in the future after the reserves, which are kept in a dedicated fund, are spent if the cannabis tax revenue and expenditures are not balanced (see Table 1).

| Table 1 | | | | | |
|---|---------------|----------------------|-----------------------|---------------|---------------------------|
| Cannabis Program Tax Revenues and Expenditures | | | | | |
| | Tax Revenue | Ongoing Expenditures | One-time Expenditures | FY Net | Fund Ending Balance |
| FY 2018-19 | \$ 6,760,700 | \$ 2,190,500 | \$ 2,847,800 | \$ 1,722,400 | \$ 1,722,400 |
| FY 2019-20 | \$ 12,182,200 | \$ 3,216,500 | \$ 1,822,300 | \$ 7,143,400 | \$ 8,865,800 |
| FY 2020-21 | \$ 15,746,600 | \$ 4,889,700 | \$ 4,056,900 | \$ 6,800,000 | \$ 15,665,800 |
| FY 2021-22 | \$ 8,718,800 | \$ 7,883,200 | \$ 2,933,400 | \$ -2,097,800 | \$ 13,568,000 |
| FY 2022-23 | \$ 6,117,400 | \$ 7,763,000 | \$ 3,641,200 | \$ -5,286,800 | \$ 8,281,200 |
| FY 2023-24 | \$ 5,770,300 | \$ 4,291,100 | \$ 1,055,200 | \$ -1,148,800 | \$ 7,132,400 |
| FY 2024-25 | \$ 5,411,300 | \$ 6,794,500 | \$ 1,547,400 | \$ -2,930,600 | \$ 4,201,900 ⁴ |
| FY 2025-26 | \$ 5,529,800 | \$ 6,715,900 | \$ 2,682,500 | \$ -3,868,600 | \$ 1,203,700 ⁵ |

Figures in italics are based upon projected estimates.

Since taxes are based on self-reported gross receipts, there has been concern about potential underreporting of cannabis revenue by individual operators. A sum of \$300,000 was allocated by the Board of Supervisors to develop a cannabis tax auditing process and perform auditing of cannabis businesses. Hinderliter, de Llamas & Associates (HdL) was hired to assist the County with the development of a cannabis application fee structure, tax structure, and to perform fiscal analysis and audits. HdL completed three audits for a total cost of \$27,000 in the fiscal year 2024-2025 with the following results:

- 1 audit completed with no issues;
- 1 audit completed with objections (under review); and
- 1 audit never completed because the business license was relinquished.

The Jury learned that six additional audits are planned for the next fiscal year.

⁴ This figure excludes \$2,090,600 in earmarks for deferred maintenance and capital projects.

⁵ This figure is based on a projected July 1, 2025, fund balance of \$5,072,300.

The 2025-2026 Santa Barbara County cannabis compliance and enforcement expenditure allocation of \$3,290,800 takes up a large portion of the Cannabis Program budget (see Table 2). However, compliance and enforcement actions are less imperative now that illegal cannabis cultivation activities are declining in the County. In addition, the number of licensed cannabis businesses has also been declining. Consequently, cannabis compliance and enforcement costs should be readdressed to evaluate opportunities for lowering the current enforcement expenditures and the number of personnel supporting cannabis compliance.

| Table 2 | | |
|--|---------------------|--------------------------------|
| Cannabis Revenue vs. Compliance and Enforcement Costs | | |
| | Tax Revenue | Compliance & Enforcement Costs |
| FY 2018-19 | \$ 6,760,700 | \$ 2,104,300 |
| FY 2019-20 | \$ 12,182,200 | \$ 2,711,800 |
| FY 2020-21 | \$ 15,746,600 | \$ 2,755,400 |
| FY 2021-22 | \$ 8,718,800 | \$ 2,419,400 |
| FY 2022-23 | \$ 6,117,400 | \$ 2,391,000 |
| FY 2023-24 | \$ 5,770,300 | \$ 3,129,500 |
| FY 2024-25 | \$ <i>5,411,300</i> | \$ 3,242,900 |
| FY 2025-26 | \$ <i>5,529,800</i> | \$ 3,290,800 |

Figures in italics are based upon projected estimates.

Cannabis Tax Oversight, Compliance, and Enforcement

Santa Barbara County has faced significant challenges with its cannabis tax revenue system due to its reliance on self-reported gross receipts from cannabis operators. This approach has led to issues with compliance, transparency, and revenue shortfalls. Current problems include:

- Cannabis businesses can fail to submit tax reports, report zero earnings, or submit late reports. Operators may exploit legal loopholes by selling products to themselves at artificially low prices to minimize tax liabilities.
- The County's Tax Collector staff can have issues with verifying the accuracy of self-reported figures, making enforcement difficult and time-consuming.
- The cannabis-related expenditures associated with oversight, compliance, enforcement, and the County's planned non-cannabis deferred maintenance and capital projects are projected to surpass the revenues collected from cannabis taxes.
- The County's reliance on self-reported gross receipts has made it difficult to evaluate their accuracy. This self-reporting system has made it challenging for budget analysts to predict revenue and for auditors to ensure compliance.

A further disadvantage is that Santa Barbara County does not have a central cannabis reporting department/program. The County relies on multiple departments, agencies, and programs for cannabis oversight, compliance, and enforcement as shown below:

- The County Executive Office's Cannabis Division oversees the regulation and licensing of commercial cannabis activities, including issuing permits, ensuring compliance with local ordinances, and managing the licensing process.
- The Sheriff's Office is responsible for enforcement against illegal cannabis activities. It also collaborates with multiple agencies and departments to ensure oversight and enforcement of cannabis regulations.
- The County's Department of Planning and Development is required to ensure the proposed activity aligns with zoning regulations and to monitor ongoing compliance.
- A County cannabis business license is issued by the Tax Collector after obtaining a land use entitlement; this license is required for all commercial cannabis operations and must be renewed every year.

Santa Barbara County, as in all of California, continues to struggle with a market oversupply of cannabis largely due to out-of-county illegal competition. Estimates suggest approximately 60% of California's cannabis is sold through illicit channels.

While the illicit cannabis retail market poses a large problem throughout the State, the illicit cannabis cultivation problems have been declining in Santa Barbara County. The Jury discovered that the law enforcement reports filed with the State indicate that there has been negligible illicit cannabis cultivation activity in Santa Barbara County for the past three years. In addition, the Jury learned that the State provides grants to counties to combat illegal cannabis activity; the Santa Barbara County Sheriff's Office received grants from the State in excess of two million dollars for such purposes within the past few years.

CONCLUSION

The Cannabis Program began with the expectation that it would provide a windfall of tax revenue to Santa Barbara County. However, those expectations are no longer being met due to changing market conditions. Cannabis tax revenue has been steadily declining in Santa Barbara County since fiscal year 2021-22. Current County expenditures from cannabis tax revenue on deferred maintenance and capital projects, licensing, monitoring, compliance, and enforcement are projected to become a financial burden to Santa Barbara County in the near future if the current cannabis tax structure and expenditures are not reviewed and revised to account for the continuing decline in cannabis tax revenue.

FINDINGS AND RECOMMENDATIONS

Finding 1: Cannabis tax revenues have been declining due to market oversupply and price collapse, stressing the County's operating expenditures for the Cannabis Program.

Recommendation 1: The Grand Jury recommends that the Board of Supervisors ensure that the Cannabis Program's annual operating expenditures do not exceed annual cannabis tax revenues.

Finding 2: The County's allocation for deferred maintenance and capital project expenses from cannabis tax revenue has not been adjusted to reflect the decline in tax revenue over the past five years.

Recommendation 2: The Grand Jury recommends that the Board of Supervisors revisit its capital projects allocation to be funded by cannabis tax revenues, ensuring that such allocations do not exceed available funds.

Finding 3: Current County budget projections indicate that Cannabis Program ongoing expenditures will exceed expected cannabis tax revenues by \$1.1 million in fiscal year 2025-26, posing a burden on County taxpayers.

Recommendation 3: The Grand Jury recommends that the Board of Supervisors prioritize covering the direct operating costs of the Cannabis Program so as to achieve more balanced budgets in the future.

Finding 4: Currently Santa Barbara County's budgeting, tracking, and reporting of cannabis-related revenue, expenses, and compliance violations are decentralized, making it difficult to provide comprehensive and detailed information on demand.

Recommendation 4: The Grand Jury recommends that the Board of Supervisors direct the County Executive Officer to develop an automated and centralized information database to track and report the budget, revenues, expenses, and administrative activities related to licensing and compliance specific to the Cannabis Program.

Finding 5: Despite declining illicit cannabis cultivation activity in the County, a significant portion of the County's cannabis tax revenues continue to be allocated to combat this activity each fiscal year.

Recommendation 5: The Grand Jury recommends that the Board of Supervisors annually re-evaluate the allocation of cannabis tax revenue for combating illicit cannabis cultivation activity in the County.

REQUIREMENTS FOR RESPONSES

Pursuant to California Penal Code §933 and §933.05, the Grand Jury requests each entity or individual named below to respond to the findings and recommendations within the specified statutory time limit.

Responses to Findings shall be either:

- Agree
- Disagree with an explanation
- Disagree partially with an explanation

Responses to Recommendations shall be one of the following:

- Has been implemented, with a summary of the implementation actions taken
- Will be implemented, with an implementation schedule
- Requires further analysis, with an analysis completion date of fewer than 6 months after the issuance of the report
- It will not be implemented with an explanation of why

Santa Barbara County Board of Supervisors - 90 days

Findings 1, 2, 3, 4, 5

Recommendations 1, 2, 3, 4, 5