BOARD OF SUPERVISORS AGENDA LETTER

Clerk of the Board of Supervisors
105 E. Anapamu Street, Suite 407
Santa Barbara, CA 93101
(805) 568-2240

Agenda Number:

Department Name:	CEO
Department No.:	012
For Agenda Of:	March 12, 2024
Placement:	Departmental
Estimated Time:	1 hour
Continued Item:	No
If Yes, date from:	
Vote Required:	Majority

TO: Board of Supervisors

FROM: Department Director(s): Mona Miyasato, County Executive Officer

DocuSigned by:
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Contact Info: Nancy Anderson, Chief Assistant County Executive Officer
Brittany Odermann, Deputy County Executive Officer

SUBJECT: **Cannabis Taxation Options**

County Counsel Concurrence	**Auditor-Controller Concurrence**
As to form: Yes	As to form: NA

Recommended Actions:

That the Board of Supervisors:

a) Consider options for alternate methods or changes to the cannabis taxation structure related to cultivation:
   i. Develop tax structure for cultivation area by square foot;
   ii. Develop tax structure for cultivation by weight (pound or ounce) of cannabis product;
   iii. Provide direction to staff to maintain current taxation method (gross sales receipts); or
   iv. Provide other direction to staff on taxation methods;

b) Provide direction to staff to develop a ballot measure for cannabis taxation including creation of documents for the November 2024 General Election ballot as needed; and

c) Determine that pursuant to CEQA Guidelines section 15378(b)(5) the above actions are not a project subject to CEQA review because they are administrative activities that will not result in direct or indirect physical changes in the environment.

Summary:

At the April 2023 budget workshops, the Board directed staff to return with options for an alternate cannabis taxation structure. The request was to consider options to revise the tax structure with the following goals:

- greater predictability in forecasting revenues;
- provide more certainty to operators;

- increased transparency; and
- maximize revenue without significant increases to current tax rates.

The following three options related to the cannabis cultivation tax are summarized below:

1. Develop tax structure for cultivation area by square foot
2. Develop tax structure for cultivation by weight of cannabis product
3. Maintain current tax ordinance (gross sales receipts)

Direction to staff is requested to move forward, as necessary, to meet deadlines for a November 2024 ballot measure. To meet that deadline, staff requests the Board deliberate and provide direction today so that we could return in May with more information, the specific tax rate and conceptual ballot language. Staff would return in June with the first reading of the ordinance and July 9 for the second reading.

Background: In June 2018, the voters approved a measure establishing a general tax on cannabis operations. The current tax structure is based on the gross receipts of each operation's activities involving cannabis or cannabis products and was developed with assistance from consultant Hinderliter, de Lamas & Associates (HdL) using information they provided to the Board on December 14, 2017.

At the time, the Board was presented taxation options, including a tax on gross receipts, square footage and per unit/ounce. When making its decision on the tax structure, the Board considered several factors: stability of tax revenue streams; complexity of tax structure and compliance; potential to inadvertently keep businesses in the unregulated market if the local and state tax burden was too great; and methods for tax rate adjustments.

The current tax is computed as follows:
1. Nursery: One percent of gross receipts; and
2. Distributor: One percent of gross receipts; and
3. Manufacturing: Three percent of gross receipts; and
4. Cultivation: Four percent of gross receipts; and
5. Retail: Six percent of gross receipts; and
6. Microbusiness: Six percent of gross receipts.

On May 17, 2022, the Board revisited the tax structure and discussed various options, including a tax by square footage or hybrid options. Without a standard, indexed commodity price of cannabis, however, the conclusion was that pricing of the product would be difficult, and the Board opted to not change the gross receipt structure but instead seek to improve auditing methods.

Benefits and Challenges of Existing Tax Structure
A tax on gross receipts was deemed a more "fair" structure in that taxes are linked to revenue expected to be generated by the cultivator. The tax revenue, therefore, would align with the direction of the economy, similar to sales or transient occupancy tax, and the taxing entity would benefit from years with greater revenue. This has been the case for Santa Barbara County, which has generated more in tax revenue since fiscal year 2018/19 than four of the six largest cannabis cultivation counties in California. In addition, other jurisdictions with a tax on square footage reported that there is still difficulty verifying taxable area(s), addressing requests to fallow, and whether to collect on failed harvests. In times of low prices and revenue generation, their Boards of Supervisors have had to reduce tax rates in order to maintain a viable industry, examples of these tax rate reductions are included in Attachment B.

However, the gross receipts system has been difficult to track for compliance. To date, it has been challenging to ensure accurate collection since gross receipts are self-reported by the operator and difficult to forecast revenues under current cannabis market conditions. When the ordinance was established the State offered that track-and-trace data (METRC) would be available to the County to assist with validation of the numbers. However, it wasn't until June 2023 that access became available to local jurisdictions in the form of METRC Viewer, a read-only platform. Prior to that, in September 2021, the Board approved membership in the California Cannabis Authority (CCA), a Joint Powers Authority (JPA). The purpose of the organization is to develop and manage a state-wide data platform that will gather, collect, and analyze information from a variety of data sources into one resource, to help local governments ensure cannabis regulatory compliance. The County's membership provides the CCA with the ability to collect data from local cultivation sites, point of sales, as well as taxation and socioeconomic data. By combining these data points, the County can better understand how much cannabis is grown in a given area and the revenue that product produces. This data has helped inform compliance with the existing tax ordinance and more recently, proposals to establish alternate tax rates.

County staff continue to be challenged in forecasting revenue due to cyclical cultivation cycles, reliance on successful harvests, variable yields, and instability of wholesale pricing. In addition, prices vary widely based on the type of product; i.e. fresh cannabis plant and bio-mass versus processed/dried cannabis flower. Market price, product source, product quality, and product end use/utility all impact the price or value of any cannabis transfer. The fact that many cultivators are sending "wet" or "fresh" flower off site to be processed elsewhere means that the highest value product is being created off-site, and in almost all cases out of the County.

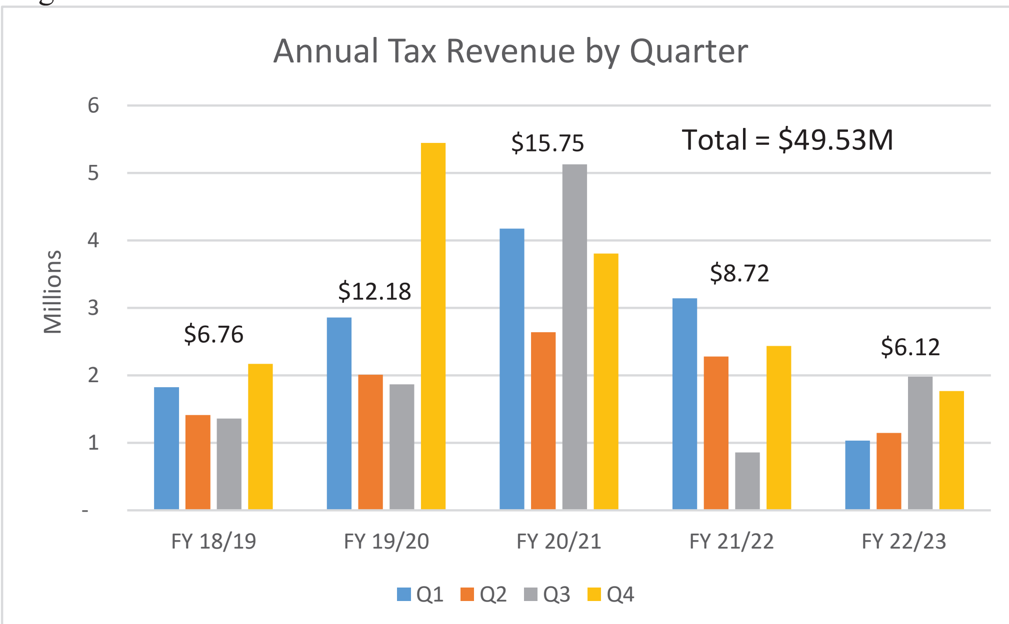
However, staff in the Treasurer-Tax Collector's Office report that their office is compiling quarterly analyses of METRC transfers and working directly with operations to communicate reporting expectations. This communication has resulted in the continued decrease of non-reporting and reporting unit discrepancies, allowing the tax reporting process to make forward progress. When discrepancies do occur, their office works with the operations and requires revised quarterly reports to be submitted as part of tax compliance. With the ongoing review of available data and future audit findings, their office anticipates taking the knowledge gained to work with the CEO's office on future enhancements.

Historical Tax Revenues

The County began collecting taxes in fiscal year 2018-19, to date, under the current gross receipts tax structure more than $50M has been collected. Figure 1 shows annual cannabis tax revenues, by quarter through fiscal year 2022/23. The estimate for fiscal year 2023/24 is similar to collections last fiscal year, approximately $6M. The tax revenue was a needed resource to fund Board discretionary programs and projects.

In 2021 and first part of 2022, the cannabis market saw a drastic price compression due to a statewide oversupply of product in the legal market. This led to the loss of several licensed operators in our County, as well as in process applicants withdrawing their applications. The loss in number of operators was despite the fact that the current gross receipts tax structure is not a fixed cost and is only paid if/when product is transferred. As a result, the County did not see the need to adjust or otherwise suspend tax collection. At the same time, as of July 1, 2022 the State ended the cultivation tax (per ounce) that was imposed on harvested cannabis to try and encourage the sustainability of the regulated, legal market. Many local jurisdictions around the State are following suit attempting to lower the tax burden on operators to support the legal market.

Figure 1.



According to industry sources and local operators, cannabis prices have improved slightly and currently remain steady. Nonetheless, we continue to see reductions in outdoor cultivation volumes with several outdoor operations choosing not to grow any cannabis, fallowing acreage to maintain operating capital in hopes of a greater market rebound. At the peak, in FYs 2019/20 and 2020/21, the County had between 70 and 80 state licensed operators, as of the second quarter of fiscal year 2023/24, the total licensed operator count is down to 60. In reviewing similar counties that use a square foot-based method, the loss appears more drastic in at least one county where they have seen a greater than 40% decrease in number of operators even with significant, Board approved tax rate reductions. Currently, of the top cannabis cultivation counties in California, Santa Barbara County's revenues remain one of the highest since inception, and the highest in FY 2022/23.

Alternative Taxation Method Options

In response to Board direction to explore other taxation methods with the stated goals of greater predictability in forecasting revenues; providing more certainty to operators; increased transparency; and maximizing revenue without significant increases to current tax rates, staff reviewed three options discussed below. **Options 1 and 2 would create new structures and require a ballot measure to implement**. Each option is discussed in relation to the goals and ability to attain them.

Option 1 – Develop Tax Structure for Cultivation Area by Square Foot

A tax on cultivation area by square foot is currently one of the most common methods used by local jurisdictions. As a response to the price compression that occurred over the last year many jurisdictions using this flat fee structure were compelled to reduce their taxes to maintain a viable, legal cannabis industry and in some cases explored other taxation methods. Coupled with state cultivation and excise taxes this flat tax based on cultivation area resulted in some operators owing more in taxes than the revenues they could bring in, effectively pushing legal operators to close. This option could require establishing different rates for each cultivation license type and an opportunity to adjust the rate either through board action or an applied index to try and stay ahead of drastic market swings.

Cultivation area measurement could be based on state licensed square footage or county licensed acreage (converted to square footage). The former being the specific cannabis cultivation area as defined by the State and the latter being the total permitted cannabis operation area under the County land use permitting process. Staff reviewed square footage rates in several counties. Rates range from $0 to a maximum of $25.00 per square foot among counties that allow cultivation. These ranges reflect temporary adjustments that many jurisdictions made to lower taxes on cannabis operations to offset historically low wholesale prices, and the maximum that a County could impose.

A square footage model would be billable with an annual payment structure, meeting the goal of providing more certainty to operators and potential greater transparency overall. An increasing number of jurisdictions in California have passed or proposed cultivation taxes on a per square foot basis. Most of the cultivation licenses are based on an allowable number of square feet for cultivation. Taxes are assessed based simply on the license type the company holds. Cultivators may be opposed to this method because they may choose to cultivate less than the maximum amount allowed under their permit, or they may lose some of their crop (for example, due to pest or weather) and thus owe taxes on a worthless product. On the other hand, the amount of the tax liability would be known upfront so there would be no tax surprises for either the cultivator or the County. In addition, recent State legislation (Senate Bill 833) will allow operators to apply for an "inactive" status upon State license renewal when they choose to fallow or otherwise not grow cannabis. An alternative tax rate may need to be considered for these circumstances.

Senate Bill 833 Implications

Senate Bill 833, approved by the Governor in October 2023, requires the Department of Cannabis Control to allow a cultivation licensee to change the type of size of a cultivation license or to place a cultivation license in inactive status. The bill would authorize a licensee, at the license renewal, to change an existing cultivation license to a type with a smaller maximum canopy size. It would also require a license in inactive status to remain in inactive status until the license is renewed and to pay a reduced license fee. The bill required that these provisions begin on March 1, 2024, however the emergency regulation text wasn't released until February 21st. A public review period is required before the regulations can go into effect. Staff will continue to monitor bill implementation.

Estimated Square Foot Calculation Methodology

In an attempt to calculate local tax rates that maximize revenue without major increases to current rates, staff reviewed total taxes paid by each operator in FY 2022/23 compared to the total acreage licensed in the County and averaged a price per square foot (SF). Example rates were calculated separately for greenhouse/indoor and outdoor operations. The estimated total results for 50 (30 greenhouse/indoor and 20 outdoor) cultivators used in this calculation are shown in Table 1.

Table 1. Example Square Footage Tax – Acreage Permitted by County

Type	Avg SF equivalent rate	Approved Acreage	Square Feet (SF)	*Estimated* Annual SF Tax	2022-23 Annual Gross Receipts Tax	Difference
Greenhouse/Indoor	$0.96	128.14	5,581,778	$5,358,507	$4,394,462	$970,653
Outdoor	$0.13	652.42	28,419,415	$3,694,524	$837,988	$2,278,531
Total		780.56	34,001,194	$9,053,031	$5,232,450	$3,699,184

Note: 1 Acre = 43,560 SF

Detail of these calculations as well an estimate for tax rates and areas licensed by the State are shown in Attachment A. The estimated annual SF tax total of $9.0M in Table 1 assumes that all operations are viable and that the taxable area is the county approved acreage, which may not be the case. For example, using this method of rate calculation, 11 out of 30 greenhouse/indoor operators would pay an annual equivalent amount greater than they paid in FY 2022/23. In outdoor cultivation, 17 out of 20 operators would pay an annual equivalent greater than FY 2022/23. Paying this flat rate could push those farms out of operation. This, in turn affects the goal of predictability to aid in forecasting revenues. In addition, many operators continue to point out that the county approved acreage associated with their business license is larger than the cultivation canopy by as much as fifty percent. Ultimately, it is difficult to determine how much acreage the County would end up collecting taxes on using this new model, especially if market conditions do not continue to improve.

Option 1 considerations for development are summarized below:

- Billable with an annual payment structure
- Potential ease of tax compliance and monitoring efforts
- Increases transparency when taxes owed are calculated simply rate by area
- Could generate full area/acreage revenue and eliminate mandate to grow or forfeit acreage under the cap requirement in Chapter 50
- Does not account for market fluctuations unless an index is established
- Possible annual adjustments to county tax needed
- Industry standard data to base indexing on is not readily available
- Does not account for the price differential in cultivation “styles”; i.e. the value of the product transferred offsite
- Predictability is contingent on the ability of operators to remain licensed and pay taxes regardless of market conditions
- Cultivation area would need to be verified in the field; have to decide between county approved acreage and cultivation canopy
- Recent state legislation allows operators to claim “inactive” license status or downsize cultivation area upon approval; final regulation language is still in review
- Scheduling considerations for tax assessment, business license issuance/renewal, and State license renewals

Option 2 – Develop Tax Structure for Cultivation by Weight of Cannabis Product

Staff briefly reviewed a tax approach that would rely on operators to report weight of cannabis produced. The benefit of this option is that operators are required to report weight in the track and trace system and could provide the METRC transfer report for the tax reporting period. In contrast to gross receipts that are not reported into the METRC system. Similar to Option 1, this option requires establishing different minimum rates for each cultivation type, i.e. cannabis flower, cannabis leaves, fresh cannabis plant, etc. at an amount considered reasonable regardless of market fluctuations. Alternately, these rates could be indexed or adjusted by board action and vary year-to-year.

Option 2 considerations for development are summarized below:

- Operator back up is available through METRC (although inputs are self-reported and not verified)
- Maintains a proportional tax structure; operators pay on product produced and transferred for sale
- Allowance for waste when crops are tainted or otherwise adversely affected (i.e. mildew, pests, flooding, etc.)
- May be difficult to establish minimum tax rate with limited information
- Relies on operator inputs/self-reporting
- May add another level to compliance and reporting

This option does not provide more predictability than the current tax structure as it relies on volume of cannabis produced; tax liability is not known until product is harvested. There is arguably more transparency since the average volume of cannabis per square foot is captured in current data collected and could be used for compliance purposes, however many operators in the County process off-site (out of County) making pricing data difficult to apply uniformly.

Option 3 – Maintain Current Tax Ordinance (Gross Sales Receipts)

The County is currently working with consultant Hinderliter, de Lamas & Associates (HdL) to perform cannabis audit services on a select number of cannabis operations. Treasurer-Tax Collector's Office (TTC) staff currently administer the contract and will review the audit findings. Those findings will potentially impact how Chapter 50A is administered, the data collected from operators, and influence potential administrative amendments to the ordinance. Also, membership in CCA and access to METRC Viewer as discussed above, allows the multi-departmental cannabis team to read and review data for compliance with specific goals to improve revenue collection and adherence to cannabis-related statutes in general. This option would maintain the existing taxation method, allowing County staff to continue to work with operators to ensure consistency in reporting taxable transfers and calculating taxes due based on realistic market pricing. To date, TTC staff are working with operators individually to understand their business models, product type(s), and movement through the supply chain to provide guidance on accurate reporting and tax payment. The recent market fluctuations adversely affected the ability to predict revenues. These conditions are predicted to continue for the near future as the market stabilizes and additional retail outlets for the legal market come on-line.

Option 3 considerations are summarized below:

- Allows for clarifying language to be added to the ordinance
- Opportunity to use existing financial monitoring and audit findings to influence needed amendments
- Enhances the data collection process for further analysis

- Allows for research into developing a standard pricing for compliance reviews
- Gross receipt method accounts for market fluctuations
- Does not require a ballot measure so long as tax not increased
- Gross receipts are self-reported
- Operations that do not grow/have taxable transfers would not pay taxes unless or until mandate to grow or forfeit acreage under the cap becomes operative
- Annual revenue projections are complex and currently, difficult to predict

This option may become more predictable as the local industry evolves and staff continue to understand market conditions and pricing. Transparency through regular audits and financial monitoring could be improved over time as well. The goal of providing more certainty to operators in knowing what is owed in taxes up front is not achieved with this structure however, the tax liability is proportional to sales receipts meaning an unsuccessful harvest or the ability to fallow would not adversely affect an operation. The certainty of this "reduced risk" can be helpful for operators to remain financially viable.

Schedule for November 2024 Cannabis Tax Ballot Measure

The following broad schedule must be adhered to for placement of a new measure on the November 2024 ballot. These dates are tentative as the County Elections Office has not published the final deadlines. Placing a new cannabis general tax on the ballot, would require 4/5 vote of the Board of Supervisors. A simple majority of Santa Barbara County voters would have to approve the tax measure to be successful.

May 7th: Introduction of options for cannabis related taxation rates for inclusion on the November 2024 ballot as needed. Direct staff to develop required ballot language to implement preferred option.

June 18th: First reading of ordinance regarding taxation of cannabis related operations.

July 9th: Second reading of ordinance and request measure to be placed on ballot; ballot language must be final at this time. Hold hearing to consider recommendations regarding authorization to submit a direct argument in favor of a cannabis operations tax ballot measure and authorization to direct argument authors to provide rebuttal if needed. (4/5 vote required)

Fiscal and Facilities Impacts:

NA

Fiscal Analysis:

NA

Attachments

Attachment A: Option 1 – Tax by Square Foot Worksheet
Attachment B: Sample CA Counties, Tax Rate by Square Foot (SF)

Authored by:

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