BOARD OF SUPERVISORS AGENDA LETTER

Agenda Number:

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

Department Name:	CEO
Department No.:	012
For Agenda Of:	May 14, 2024
Placement:	Departmental
Estimated Time:	90 minutes
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 Cultivation Taxation Options**

County Counsel Concurrence
As to form: Yes

Auditor-Controller Concurrence
As to form: NA

Treasurer-Tax Collector Concurrence
As to form: Yes

Recommended Actions:

That the Board of Supervisors:

a) Consider two alternative methods for cannabis taxation for cultivation:
   i. Option 1: Square foot tax rate with a minimum Base Tax Rate and Activity Tax Rate; or
   ii. Option 2: Hybrid structure of Gross Receipts Tax Rate with a minimum Base Tax Rate based on square footage; and
   iii. Direct staff to return on June 25, 2024 with a taxation ordinance and ballot measure for cannabis operations for the November 2024 General Election ballot; and
   iv. Direct staff to incorporate ballot language to allow for flexibility to adjust square footage tax rates at the Board's discretion without returning to the voters; OR

b) Take no action and maintain the current gross receipts taxation method; 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 March 12, 2024 hearing, the Board directed staff to return with alternative cannabis taxation structures. The request was to study two options to revise the current gross receipts tax structure as follows:

(1) Tax structure based on a hybrid model (gross receipts and square footage); and (2) Tax structure by square footage that is more aligned with the rest of the state. Further directed staff to include a minimum and a maximum and method of floatation on the state licensed area

Staff developed structures for the two options summarized below to address the Board's request.

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 consider the options and provide specific direction today in order for staff to return in June with final ballot language, as needed, to change the tax structure. A four-fifths vote of the Board is required to place a general tax ordinance on the ballot.

Discussion

Based on general Board discussion and direction from the March board hearing, staff worked to further develop two alternative taxation methods that seek to address some of the outstanding issues with the current tax structure including:

- Perceptions of inequity and little or no payment of taxes by some outdoor licensed operators;
- Ability of tax revenues to cover the ongoing uses dedicated to cannabis administration, enforcement, and education in the budget;
- Transparency of how taxes are reported, collected, and paid; and
- Staffing resources dedicated to tax reporting, collection, and compliance.

In addition, the following assumptions were made following Board deliberations in developing the options:

- maximize revenue without major increases to current rates, and ensure every licensed operator pays a minimum amount of tax;
- generate enough tax revenue to cover the ongoing uses dedicated to cannabis administration, enforcement, and education;
- consider the advantage that the greenhouse and indoor operations have with respect to number of harvest cycles and quality/value of product being cultivated.

The current tax structure is based on the gross receipts of each operation's activities involving cannabis or cannabis products. The Treasurer-Tax Collector's Office 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 County has contracted with a consultant, Hinderliter, de Lamas & Associates (HdL), to perform cannabis audit services to review individual operators' tax reporting and payment compliance with the current tax ordinance. The Treasurer-Tax Collector's Office staff administer the contract and will review the audit findings and recommendations anticipated to be completed in June 2024.

It is important to note that even if the tax structure is changed to a square foot basis for cultivation, the other taxed activities (distribution, manufacturing, etc.) are still based on gross receipts. As such, it would still be necessary for the Treasurer-Tax Collector's Office to continue auditing and determining the accuracy of cannabis operators' gross receipts. Currently, there is not much reported activity in these other activities compared to cultivation. Last fiscal year, the County collected $295,000 from taxes for all categories other than cultivation.

Factors Considered in Developing the Rate Options

Comparison to other rates in the State. The Board requested that proposed cultivation tax rates based on square footage be aligned with others in the State. Staff reviewed square footage tax structures in several counties. Rates range from $0 to a maximum of $12.50 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. Staff considered these varied ranges and used them to assess reasonableness in establishing recommended rates. Attachment A includes tax rates of Humboldt, Lake, Monterey and Sonoma counties and was previously included in the March 12, 2024 staff report. In general, current square footage tax rates for cultivation varied, with the following ranges:

- outdoor cultivation: $0 to $0.75
- mixed light: $0 to $3.00
- indoor: $0 to $12.50

Options 1 and 2 use information from other jurisdictions as well as considerations of the cannabis landscape in Santa Barbara County to guide the recommended rates.

Ratio of outdoor to non-outdoor tax rates. In March, staff used examples of possible outdoor tax rates to non-outdoor tax rates of 1:7 and 1:8. The Board requested further review to reduce the difference and align more with other counties. The typical tax ratios around the state for outdoor versus non-outdoor operations are 1:2 or 1:3. Since Santa Barbara County tends to see higher rates of production and higher value products in greenhouse operations, staff has used the 1:3 ratio (outdoor tax rate versus non-outdoor) in the recommended rates.

Method for Adjustments to the Rate. The Board asked staff to develop a mechanism to adjust the cultivation tax rates. Cannabis production and prices vary year to year and is dependent on market fluctuations. Tax rates could be adjusted upward or downward to address the fluctuation, as other counties have done in the past. Annual adjustments could occur using California Department of Tax and Fee Administration (CDTFA) cannabis sales data as the index. The average percentage change in this index for the prior calendar year could be used to either increase or decrease the annual tax rates.

Creation of Minimum, or "Base Tax Rate": For both options directed by the Board, staff developed a minimum tax rate (base rate) based on the maximum state licensed area charged by cultivation type, as defined by the County cannabis business license. This tax rate would be the minimum applied to all cultivators. The base rate calculations used the total taxes paid by each operator in fiscal year 2022-23 divided by the maximum area allowed by their State licenses to get to a rate per square foot (SF). Rates were calculated separately for greenhouse/indoor/mixed-light (non-outdoor) and outdoor operations.

Outdoor rates were calculated first as the foundation for the base tax by calculating the average rate, taking out the lowest rates. This generated an outdoor <u>annual</u> base rate of $0.25 per square foot. This is a base (minimum) tax all outdoor operators would pay using the maximum State licensed area and is comparable to rates around the State. Using the 1:3 ratio described above, this generates a non-outdoor base rate of $0.75 per square foot.

Table 1. Base (minimum) tax rate for cultivation	
Type	**Base Rate (per SF)**
Outdoor	$0.25
Non-Outdoor (greenhouse, indoor, mixed-light)	$0.75

Option 1: Square Footage Tax with Base and Activity Rates

The Board requested an option based on square footage with minimum and maximum rates. Working together with Treasurer-Tax Collector staff, staff developed Option 1, a two-tiered proposed tax based on State licensed square footage. This proposed square footage tax system includes the base tax rate and an additional "activity" tax rate. The activity tax rate would be assessed on a per state license basis, if any activity occurred in the reporting period. The Base Rate plus this Activity Rate would generate a maximum tax rate.

These rates are competitive, scaled to cultivation type, and generate an estimated amount of revenue that closely aligns with the fiscal year 2024-25 estimated budget/uses for cannabis administration, enforcement, and education costs. This system relies on available data from the state's track-and-trace system (Metrc), which could also ease administration related to staff time for verification and compliance purposes.

Table 2. Option 1: Square Footage with Base Rate and Activity Rate (per SF)			
	Base Rate (Minimum)	Activity Rate (charged if license shows activity)	**Total = Base + Activity (Maximum)**
Outdoor	$0.25	$0.25	**$0.50**
Non-Outdoor (Greenhouse/Mixed Light/Indoor)	$0.75	$0.75	**$1.50**

Determining Activity Tax Rate. In developing the Activity Tax Rate, staff first calculated the Total (maximum) Tax rate for non-outdoor cultivation and reduced it by the Base Rate. Staff used last year as a basis given that all non-outdoor operators cultivated consistently. Similar to developing the Base Tax Rate, staff divided last year's revenue by the state licensed square footage and considered the median value. Staff recommends a total rate of $1.50 for non-outdoor cultivation. This seems reasonable and comparable to their current tax obligation. For outdoor cultivation, staff again applied the 1:3 ratio to the outdoor "activity" tax rate, resulting in a $0.50 maximum tax rate. These rates would apply to active State licenses if activity occurred on the license during the tax period. This Total tax rate would be the maximum a cultivator would be assessed if its State licensed land were active and there was activity on the license, regardless of the amount of cannabis produced or sold.

This model requires all licensed cannabis operators to pay a minimum base tax to the County. The additional activity tax is levied and paid when there is activity on a State license as indicated in Metrc.

Table 3 provides the total estimated annual value of a base tax using the proposed rates stated above and the current State licensed square footage of each cultivation type in the County.

Estimated Tax Revenue Scenarios - Base (minimum) Tax Rate. The proposed Base Tax Rate would generate an estimated $5.4 million given the existing State licensed square feet. This amount of revenue closely aligns with the fiscal year 2024-25 estimated budget and uses for cannabis-related activities.

Table 3. Estimated Annual Revenue from Base (Minimum) Tax Rate

Cultivation Type	Base SF Rate	Square Feet (SF)	***Estimated* Annual Base SF Tax**
Outdoor	$0.25	12,265,912	**$3,066,478**
Non-Outdoor (Greenhouse/Indoor/Mixed-Light)	$0.75	3,068,800	**$2,301,600**
		Total	**$5,368,078**

Estimated Tax Revenue Scenario – Total Tax. Staff estimated the maximum potential tax revenues, which would include the Base plus Activity Tax Rate. In this case only the state licenses that show activity during the quarter, and their associated square footage, are charged the additional Activity Rate. Table 4 estimates annual revenue from the Total Tax Rate under Option 1. The calculations use the fiscal year 22-23 quarterly data to demonstrate the proportion of licenses that would be subject to the Activity Tax Rate.

Table 4: Estimated Annual Revenue from Total Tax Rate (Base + Activity) Tax Rate

Cultivation Type	*Estimated* Annual Base SF Tax Revenue	Activity Annual Rate	Estimated Activity SF	Estimated Annual Activity SF Tax Revenue	**Total Estimate Due for Annual (Base + Activity)**
Outdoor	$3,066,478	$0.25	4,892,224	$1,223,056	$4,289,534
Non-Outdoor (Greenhouse/Indoor/Mixed-Light)	$2,301,600	$0.75	2,608,350	$1,956,263	$4,257,863
				Total	**$8,547,397**

Tax assessment. The taxed square footage would be based off the state licenses held on the first day of each quarter.

- Q1: July 1
- Q2: October 1
- Q3: January 1
- Q4: April 1

The activity tax would be calculated at the end of each quarter using Metrc to determine if activity was performed on the license at any time during the quarter. The sum of the base and activity tax will be the total billed and owed for the quarter.

Benefits/Challenges of this model. The largest benefit of this option is that it provides greater transparency and ease of verification because it is based on State licensed square footage. The information required to bill and verify is available through Metrc and does not rely on reporting from operators. In addition, it establishes a guaranteed minimum tax, and therefore, tax revenue to the County, and a maximum tax when license activity occurs.

The challenge for the operators is that it applies the Activity Tax Rate to the State licensed area in operation, regardless of how much product is being produced or revenue earned, in addition to requiring a base amount.

Setting a maximum rate could also be a detriment to the County, in that revenues would be limited to maximum tax rate applied regardless of market booms. For example, if all State licensed areas were in operation, under Option 1, the maximum revenue generated would be $10.7 million, as compared to $15.7 million in cannabis tax revenue generated in FY 2020-21. In either Option 1 or 2, if this new structure drove out operators without replacement operators, tax revenue could be less. In addition, setting rates that the market and operators can bear while maintaining a valuable revenue stream for the County could continue to be a challenge.

Option 2 – Hybrid Tax Structure of Gross Receipts Tax with a Base Tax based on Square Footage

In reviewing other cannabis tax models for cultivation around the State, staff could not find a current example of a hybrid model that incorporates both gross receipts and square footage at the same time. One county attempted a hybrid model early on but changed their structure for multiple reported reasons including non-payment and logistics of truing up tax reporting and collection. These models have been used in commercial and retail lease agreements typically as a combined, minimum area tax (by square foot of space) in addition to a gross receipts tax. Staff proposes a slightly different model for cannabis cultivation.

Methodology for Hybrid Option 2. Option 2 is a cultivation gross receipts tax rate (4%), as assessed now, but with the same minimum (Base Tax Rate) as proposed in Option 1. In this option, cultivators would be assessed the **greater of** the Base Tax ($0.25/SF for outdoor; $0.75/SF for non-outdoor) based on total State licensed area, or the 4% gross receipts tax. If it is determined that the base tax is greater than gross receipts; operator pays the base tax. If base tax is less than gross receipts; operator pays gross receipts tax. Similar to Option 1, operators would pay the Base Tax Rate regardless if there was cultivation activity occurring.

Estimated Tax Revenue for Hybrid Scenario. Similar to Option 1, the estimated Base Tax Rate revenue would be $5.4 million (see Table 3). The tax revenue under Option 2 would not be less than the existing gross receipts system since there would be a guarantee of the Base Tax Rate as long as the operator has an active State license. Based on reported data for FY 2022-23, an estimated $8.0 million could have been generated in tax revenue (as opposed to the $5.8 million tax revenue collected in the existing system that year).

Table 5: Estimated Annual Revenue from Hybrid Tax Model			
Cultivation Type	*Estimated* Annual Base SF Tax Revenue	*Estimated* Annual Gross Receipts Tax Revenue	**Total *Estimate* for Annual Hybrid Model**
Outdoor	$2,907,748	$371,365	**$3,279,113**
Non-Outdoor (Greenhouse/Mixed Light/Indoor)	$706,500	$3,982,654	**$4,689,154**
		Total	**$7,968,267**

Tax assessment.
The taxed square footage for the base or minimum tax would be based off the state licenses held on the first day of each quarter, as in Option 1.

- Q1: July 1
- Q2: October 1
- Q3: January 1
- Q4: April 1

Gross receipts would be reported at the end of each quarter.

Benefits/Challenges of this model. The benefit of this model is that some portion is based on market conditions (gross receipts) and therefore, the County and the grower share in the benefits when market conditions are profitable. It also provides a floor or guarantee, as in Option 1.

One challenge is that it doesn't provide the same level of transparency as a solely square-foot based model and does not reduce the current administrative burden of verifying and auditing gross receipts. However, the appropriate administrative processes and structures regarding gross receipts review, developed over the last 2 years, are making progress with tax payment compliance.

As in Option 1, if this new structure drove out operators without replacement operators, tax revenue could be less. Similar to Option 1, setting rates that the market and operators can bear while maintaining a valuable revenue stream for the County could continue to be a challenge.

Additional Considerations for Tax Structure

Adjustments for vertical integration considerations. The Board did not direct staff to develop options on other tax categories other than cultivation. However, operators have raised concerns in the past that the County's existing gross receipts tax structure does not recognize vertical integration, in which operators perform all aspects of the cannabis supply chain ("seed to sale"). In particular, this concern has been raised regarding nursery and distribution activities. Options 1 and 2 do not resolve this concern regarding vertical integration.

Adjustments to Tax Rates to allow flexibility. In reviewing existing tax structures and conducting informal surveys with staff responsible for developing ordinance language and administering tax reporting and collection, it was clear that the jurisdictions that built flexibility into their ordinance to adjust rates and change tax methods/structure were the best equipped to handle market volatility.

For Options 1 and 2, the Board could consider ballot language that provides this flexibility by allowing the Board to change tax rates at its discretion without returning to the voters, as is allowed in other counties.

- This would entail specifying minimum and maximum ranges in the ballot measure. The County could develop a methodology, such as using the CDTFA data described above, to guide increases or decreases to the tax rates. Staff would recommend the following ranges for the ballot measure:
    - Option 1: Total Base and Activity Tax Rate of $0.05 to $10.00 for outdoor; and $0.15 to $25.00 for non-outdoor.
    - Option 2: Base Tax Rate of $0.05 to $5.00 for outdoor; and $0.15 to $15.00 for non-outdoor
- Alternatively, or in addition, the ballot language could include an automatic rate adjustment (for all cultivation tax rates discussed in Options 1 and 2 based on CPI (Consumer Price Index), but allow the Board to waive the rate adjustment at its discretion.

The Board could also opt not to provide this flexibility.

<u>Schedule for November 2024 Cannabis Tax Ballot Measure</u>

The schedule must be adhered to for placement of a new measure on the November 2024 ballot. 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. We would anticipate the measure taking effect July 1, 2025. This would give staff enough time to make changes to Chapter 50 (Cannabis Business Licenses) and ensure appropriate processes are in place to administer the new tax structure.

June 25th: 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)

<u>Background</u>

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 reviewed 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. Based on the direction, TTC staff contracted for additional financial monitoring audits with consultant Hinderliter, de Lamas & Associates (HdL) on a select number of cannabis operations. According to HdL, the first round of comprehensive audits is scheduled to be complete by the end of June 2024.

Again, on March 12, 2024, the Board heard information related to cannabis taxation options. The Board directed staff to return with specific options for changing the structure that could be developed for a potential ballot measure in November 2024.

<u>Current Tax Ordinance (Gross Receipts)</u>

The County began collecting cannabis taxes in fiscal year 2018-19, to date, under the current gross receipts tax structure more than $50M has been collected. The estimate for fiscal year 2023-24 is similar to collections last fiscal year, approximately $6M. The tax revenue was a useful resource to fund Board discretionary programs and projects over the last four years. Nonetheless, challenges persist with the current tax structure and it may be prudent to move forward with development of one of the alternate methods.

The County is currently working with consultant Hinderliter, de Lamas & Associates (HdL) to perform cannabis audit services. Treasurer-Tax Collector's Office (TTC) staff administer the contract and will review the audit findings. Those findings will potentially impact how the current tax ordinance, Chapter 50A is administered, as well as the data collected from operators, and influence potential administrative amendments to the ordinance. County staff continue to work with operators to ensure consistency in reporting taxable transfers and calculating taxes due based on realistic market pricing. Currently, 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. This work could provide an opportunity to use existing financial monitoring and audit findings to influence needed amendments.

Staff in the Treasurer-Tax Collector's Office report that their office compiles quarterly analyses of the Metrc transfers and works directly with operators 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 operators 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. As noted above, the first round of comprehensive audits is scheduled to be complete by the end of June 2024. Unfortunately, the timing of the audit results and the schedule to place items on the November ballot may not align.

Fiscal Analysis:

Staff developed the proposed base tax rates to generate the revenue needed to cover the cost of administration of the cannabis program including the contract for financial audits, as well as the ongoing funding commitments to enforcement and cannabis education (total of $4.9 million). However, additional costs for ongoing deferred maintenance and staff in County Counsel have also been paid from ongoing cannabis revenue ($1.9 million) for a total $6.8 million.

The proposed alternative taxation method options are anticipated to generate a base tax amount of approximately $5.4 million with additional tax revenue estimated at $2-3 million generated from either the activity tax using the square footage model or gross receipts using the hybrid model.

	24-25 Estimated Ongoing Uses
(431,500)	012-CEO: Cannabis Program Administration
(370,000)	053-P&D: Appeals Costs
(480,900)	065-TTC: Cannabis Program Admin
(135,000)	065-TTC: HDL Contract
(1,417,400)	**Subtotal Cannabis Program Admin Costs**
(3,342,900)	Countywide Enforcement Costs*
(160,000)	043-Bwell: Cannabis Education
(4,920,300)	**Subtotal Cannabis Program Admin, Enforcement, and Education Costs**
(1,572,800)	18% Deferred Maintenance
(301,400)	013-CoCo: BOS Approved Deputy CoCo
(6,794,500)	**Total 24-25 Estimated Ongoing Uses**

*Enforcement is for illegal and unregulated market activities.
Total includes costs in the following Departments: Sheriff, District Attorney, Planning & Development, County Counsel, County Executive Office, and Public Health

Attachments

Attachment A: California County Square Foot Tax comparison

Authored by:

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