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:	May 17, 2022
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
	Contact Info:	Jeff Frapwell, Assistant County Executive Officer Brittany Heaton, Principal Analyst, Cannabis
SUBJECT:	**Cannabis Taxation Options**	

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County Counsel Concurrence
As to form: Yes

Auditor-Controller Concurrence
As to form: NA

Recommended Actions:

That the Board of Supervisors:

a) Receive an update on cannabis taxation, and the following options for alternate methods or changes to the cannabis taxation structure:
   i. Develop tax structure for cultivation area by square foot;
   ii. Develop a hybrid tax structure with a minimum tax on cultivation set by square footage;
   iii. Provide direction to staff to maintain current taxation method and return to the Board with proposed amendments to cannabis ordinance(s) clarifying current requirements to improve compliance (staff recommendation); or
   iv. Provide other direction to staff on taxation methods; and

b) 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 Text:

At the April 14, 2022 budget workshop, the Board directed staff to return promptly with options related to alternate cannabis taxation structures and provide a recommendation of whether to pursue another model. The request was to consider options to tighten up the tax structure with the goals of: possibly generating more revenue with greater predictability; providing more certainty to operators and transparency to the public; and perhaps providing a more verifiable approach to cannabis cultivation taxation. 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 a hybrid tax structure with minimum tax on cultivation set by square footage
3. Maintain and amend Chapter 50A tax ordinance

Direction to staff is requested to move forward, as necessary, to meet deadlines for a November 2022 ballot measure.

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 of an operation's activities involving cannabis or cannabis products. The current tax is computed as follows:

1. Nursery: One percent of gross receipts; and
2. Distributor (excluding distributor transport only): 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.

To date, it has been difficult to ensure compliance since gross receipts are self-reported by operator. When the ordinance was established the State offered that track-and-trace data (METRC) would be available to the County. This access has yet to materialize. As a result, 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 may help inform compliance with the existing tax ordinance and proposals to establish alternate tax rates. The County is also working with a consultant to perform cannabis financial monitoring and individual audits but the results of this contract are not yet available.

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

A tax on cultivation area by square foot is currently the most common method used by local jurisdictions, although many California counties are actively pursuing efforts to move away from this model. 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 are exploring 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 would be based on state licensed square footage. Staff reviewed square footage rates in several counties. Current rates range from \$0.15 to \$25.00 per square foot among counties that allow cultivation. These ranges reflect recent temporary adjustments that many jurisdictions made to lower taxes on cannabis operations to offset historically low wholesale prices. A table of Local Cannabis Tax Rates for Selected Counties, per their ordinance, is included as Attachment A. Using rates of $1.00 - $3.00 per square foot, an example is provided below in Table 1, although it is highly unlikely that the county would receive revenues at this level since the tax burden would affect the ability of many operations to remain viable. Attachment B includes specific examples of projected annual tax payment due based on type and size of operation for this option. These rates and projected annual revenue are for illustrative purposes only. These are not proposed rates, however; they are representative rates compared to other counties. State licensed acreage is estimated to be seventy-five percent of total permitted acreage when cap is reached countywide.

Table 1. Projected Tax Revenue Using Cultivation Area by Square Foot

	Est. State Licensed Acreage	Est. Square Footage	Example Rate $/SF	Projected Annual Revenue	
Indoor/Mixed Light	150	6,534,000	$3.00	$	19,602,000
Outdoor	1171	51,008,760	$1.00	$	51,008,760
			Total	$	70,610,760

Assumptions:
Countywide Acreage cap is reached
Seventy-five percent of county permitted acreage (acreage cap) is estimated state licensed acreage
Rates are for illustrative purposes only
May result in tax burden greater than operator revenue

Pros:
- Provides more certainty for annual revenue projections
- Billable with an annual payment structure
- Easy to predict and stable
- Ease of tax compliance and monitoring efforts
- Would generate full area/acreage revenue and could eliminate need to establish mandate to grow or forfeit acreage under the cap as discussed in concept during past hearings

Cons:
- Does not account for market fluctuations unless an index is established
- Industry standard data to base indexing on is not readily available
- Possible annual adjustments to county tax needed to keep operations viable when coupled with the rate of state taxes
- May discourage cultivators from operating in the legal, regulated market
- Cultivation area would need to be verified in the field
- The State is proposing changes to licensing types which could impact how square footage is determined
- Requires ballot measure

<u>Option 2 – Develop Hybrid Tax Structure with Minimum Tax on Cultivation</u>

This tax approach establishes an annual minimum payment based on the county permitted cultivation area. The minimum tax would apply to every operator in the acreage cap regardless of whether or not cannabis is grown on the property to promote tax compliance and provide more certainty for annual revenue projections. Operators would continue to report gross receipts and pay at the existing percentage rates established in Chapter 50A when the amount owed exceeds the minimum tax. Similar to Option 1, this option may require establishing different minimum rates for each cultivation license type, i.e. indoor and outdoor, 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.

Using minimum rates of $0.25 - $0.75 per square foot, an example is provided below in Table 2. These rates represent 25% of the flat fee proposed in Option 1 and again, are for illustrative purposes only. Attachment B also includes specific examples of projected annual tax payment due based on type and size of operation for this option.

Table 2. Projected Minimum Annual Tax Revenue Using Minimum Tax

	Est. Permitted Acreage	Est. Square Footage	Example Rate Minimum Rate $/SF	Projected Minimum Annual Revenue
Indoor/Mixed Light	200	8,712,000	$ 0.75	$ 6,534,000
Unincorporated Inland Area	1561	67,997,160	$ 0.25	$ 16,999,290
			Total	$ 23,533,290

Assumptions:
Countywide Acreage cap is reached
Approximately 11% of total permitted acreage countywide is Indoor/Mixed Light
Rates are for illustrative purposes only

Pros:

- Ensures that every operator holding acreage in the cap contributes a minimum amount of taxes
- Perceived to be an equitable and balanced tax system for cannabis
- Establishes a minimum tax while still allowing for taxes on gross receipts over a specified amount

Cons:

- May be difficult to establish minimum tax rate with limited information
- Relies on operator inputs/self-reporting
- Adds another level to compliance and reporting
- Requires ballot measure

<u>Option 3 – Maintain and Amend Chapter 50A Tax Ordinance (Staff Recommendation)</u>

The County is working with consultant Hinderliter, de Lamas & Associates (HdL) to perform cannabis financial monitoring and audit services. 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 amendments to the ordinance. Also, since membership in CCA as discussed above, the CEO's Office leads a Compliance Task Force with participation from several departments responsible for law and code enforcement including the TTC's Office. The team is currently learning how to read and review the data from CCA and establishing department charters for compliance. This work began in earnest in early 2022 and the results are pending. The goals are to improve revenue collection and adherence to cannabis-related statutes in general.

The Cannabis Licensing division and the Cannabis Tax division will work collaboratively to present amended drafts of Chapter 50A and Chapter 50 that will further clarify the methodology of the tax, as well as define certain sections for better administration. Chapter 50 ordinance amendment topics include use it or lose it acreage provisions, or mandate to grow; review of cultivation area and determining acreage; allowance for fallowing; and possible additional compliance requirements. These changes will occur incrementally over the next twelve months.

Pros:

- 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 pricing index for potential future use
- Allows for further research into alternative taxation methods
- Gross receipt method accounts for market fluctuations
- Does not require a ballot measure so long as tax not increased

Cons:

- Gross receipts are self-reported
- Operations that do not grow/have taxable transfers would not pay taxes unless mandate to grow or forfeit acreage under the cap is established as discussed in concept during past hearings
- Annual revenue projections are complex and not as certain

Incentivizing Processing in the County

The Board also expressed interest in exploring ways to incentivize processing activities in the County to maximize the value of taxable cannabis product transfers. In order to encourage in-county cannabis processing your board could include direction with Options 1 or 2 to establish a lower, specific rate for processing. A cumulative maximum tax rate could also be added in the ordinance to promote vertical integration including in-county processing activities.

Schedule for November 2022 Cannabis Tax Ballot Measure

The following broad schedule must be adhered to for placement of a new measure on the November 2022 ballot.

May 17th: Introduction of options for cannabis related taxation rates for inclusion on the November 2022 ballot as needed. Direct staff to develop required ballot language to implement preferred option.

June 28th: First reading of ordinance regarding taxation of cannabis related operations.

July 12th: 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.

Performance Measure:

NA

Contract Renewals and Performance Outcomes:

NA

Fiscal and Facilities Impacts:

NA

Fiscal Analysis:

NA

Attachments

Attachment A: Local Cannabis Tax Rates by Square Foot for Selected Counties
Attachment B: Example Rates and Revenues for Option 1 and 2

Authored by:

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