



Legislation Text

File #: 2022-1445, **Version:** 1

To: Board of Supervisors

Department or Agency Name(s): Auditor-Controller-Treasurer-Tax Collector, County Administrator

Staff Name and Phone Number: Erick Roeser and Brooke Koop, ACTTC, 707-565-2281; Christina Rivera and McCall Miller, CAO, 707-565-2431

Vote Requirement: Majority

Supervisorial District(s): Countywide

Title:

Cannabis Tax Review

Recommended Action:

- A) Receive and review the Fiscal Analysis of the Commercial Cannabis Cultivation Industry report completed by HdL Companies
- B) Direct staff to amend Chapter 35 Cannabis Business Tax Ordinance

Executive Summary:

Following the Board's discussion and direction on March 15, 2022 regarding the County's cannabis business tax, staff is returning with the requested report and information about the pros and cons of transitioning to a gross receipts taxation model for cannabis cultivation from the current square footage model. To address the issue of if the County's cannabis business taxation model should be changed, the County contracted with HdL Companies, a subject matter expert, to conduct an analysis of the revenue and fiscal issues around changing the method of taxation. Based on the report, staff are presenting three options for consideration:

1. Maintain square footage model, but adjust rates based on HdL's tax rate convertor model, with annual review. Recommended gross receipt rate of 2.5% equating to:
 - a. \$0.75/sq. ft. for outdoor cultivation
 - b. \$12.50/sq. ft. for indoor cultivation
 - c. \$3.00/sq. ft. for mixed-light cultivation
2. Convert to Gross Receipts model (rate of 3%)
3. Extend 45% tax rate reduction with no other changes through FY 2023-2024, with additional HdL review

Staff recommends option 1, which combines the efficiency of the current taxation model based on square footage with an annual adjustment to account for changes to the market price of cannabis. This allows for control of effective rate changes that are inherent to the current model which have been burdensome on cultivators as the market prices of legal cannabis have dropped.

Discussion:

Background of Sonoma County Cannabis Business Tax

On December 13, 2016, the Board adopted Ordinance 6188, imposing a cannabis business tax on commercial

cannabis businesses; the commercial cannabis cultivation tax was imposed on a square footage basis. This established Chapter 35 of the Sonoma County Code. The Cannabis Business Tax (Measure A) was passed by voters in the March 7, 2017 special election with 71% voter approval. On June 13, 2017, the Board adopted Ordinance 6203, amending Chapter 35, setting cannabis business tax rates within the voter-approved maximum rates and establishing certain regulations.

Measure A laid out a framework for taxation that set maximum allowable rates for all operator types and granted authority to the County to, among other things, specify whether the tax on commercial cannabis cultivation will be imposed on a square footage or gross receipts basis, and set a tax rate not to exceed the maximum rates established. In addition, on April 19, 2022, the Board adopted Ordinance 6374 to temporarily reduce the commercial cannabis tax rates by 45%, effective July 1, 2021 through June 30, 2023.

HdL Contract and Report

On March 15, 2022, the Board of Supervisors requested that the Auditor-Controller-Treasurer-Tax Collector (ACTTC) and the County Administrator's Office (CAO) to analyze the pros and cons of changing the County's cannabis cultivation tax program from taxing based on square footage to a model based on gross receipts. The Board also approved the use of a consultant to assist with the analysis and recommendation. ACTTC engaged other counties with cannabis programs to learn about their respective programs and through these discussions received recommendations to engage HdL Companies as a subject matter expert in cannabis compliance services. The legal cannabis market is still new and evolving and due to this staff felt the need for a specialized service provider for the County to make the most informed decision.

HdL Companies is a public agency revenue management services provider, experienced in the development, implementation, and enforcement of cannabis management programs for local governments in California and related services. ACTTC staff worked with HdL Companies to develop a scope of work that would include a cultivation revenue analysis and fiscal analysis to examine the issues and considerations of changing the cultivation tax methodology. The Agreement for Consulting Services with HdL Companies (HdL) for cannabis compliance services was approved by the Board on June 13, 2022.

The revenue analysis project began on June 29, 2022. ACTTC staff worked with HdL to determine a representative sample set of cultivation businesses to participate in the revenue review. An initial sample set of 35 operators was selected for the revenue analysis. Participation in the revenue analysis was completely voluntary. The goal was for HdL to perform a high-level review of the records provided by the initial sample set and identify 10 to 12 operators that included a cross-section of cultivation types and provided the most complete set of records to perform an in-depth revenue analysis of these businesses. HdL would then use the data and findings generated by the revenue analysis to conduct the fiscal analysis.

Letters were sent to the 35 initial sample set of operators on July 22, 2022, with a deadline to respond of August 22, 2022. Follow up notifications were sent by email two weeks later to remind businesses of the upcoming deadline to submit records. Nine operators provided records by the deadline which prompted ACTTC staff to send a third and final request via email to businesses requesting participation and extending the deadline to provide records to September 5, 2022. Additional responses were received by the extended deadline. Not all records provided were complete, and consequently HdL staff and ACTTC staff did additional outreach by email and phone to try and gather the missing information from these businesses. A total of seven businesses were ultimately selected for the revenue analysis. The revenue analysis portion was wrapped

up in late September 2022 and the fiscal analysis and HdL report were completed in late December 2022. The final HdL Fiscal Analysis of the Commercial Cannabis Cultivation Industry report is attached as Attachment 1.

Operator information is provided in Table A below.

Cultivation Type	Number of permitted operators*	Number of operators included in sample set	Percent of permitted operators included in sample set	Number of analysis participants	Percent of analysis participants compared to permitted operators
Outdoor	99	24	24%	4	4%
Indoor	15	8	53%	3	20%
Mixed-light	5	3	60%	0	0%

*Note: Multiple operators hold are permitted for multiple types of cultivation. Information based on license information from Department of Cannabis Control.

Highlights from the Fiscal Analysis of the Commercial Cannabis Cultivation Industry report by HdL Companies:

- Any change to the basis or rate of the County’s cultivation tax is unlikely to make a difference in which businesses succeed or fail. Factors such as: proximity to markets, cultivation infrastructure, operating efficiencies, producing under contract and distribution agreements are more indicative of business success than tax rates. (pg. 4)
- Indoor cannabis averaged \$1,230/lb. during the review period, while outdoor cannabis averaged \$308/lb, highlighting that outdoor cultivators are financially struggling to a far greater degree than indoor cultivators. (pg. 4)
- The participating cultivators provided documents and records with a varying degree of detail and completeness. Based on the information provided, HdL had to apply discretion on a case-by-case basis to determine the best methodology for estimating annual revenues for each business. (pg. 7)
- Although HdL was still able to compare the sample set with the array of license types in the County, the data shows that cultivators of the same size and using the same methods can have dramatically different gross receipts. The degree to which the sample set may be representative of all cultivation businesses in the County is therefore unknown. (pg. 8)
- Tax based on square footage may be deductible from federal taxes as a production expense under cost of goods sold (COGS). (pg. 9)
- There are many mechanisms businesses can use to avoid taxes by reducing their reported gross receipts. For local jurisdictions that utilize a gross receipts tax, HdL recommends annual revenue audits to ensure that all receipts and transaction have been properly reported and all taxes fairly remitted to the host jurisdiction. This can add an additional annual expense for the cannabis operator or business, which is typically expected to cover the cost of regulation, including annual audits. (pg. 9)
- There are a number of accounting and administrative tools and other factors which may affect how businesses report gross receipts. These factors are discussed further in Appendix A of the report (Attachment 1). (pg. 9)
- Although the state has now implemented its METRC track and trace system, the system only tracks the

movement of product across the supply chain and does not include shipped or received dollar amounts or other information that could be used to determine the gross receipts of cannabis businesses. (pg. 10)

- The size of cannabis operators in Ventura and Santa Barbara counties suggests that tax rates, alone, are not the only factor in building a stable and successful cannabis industry cluster. The relatively high tax rates compared to other jurisdictions have not made Ventura County or Santa Barbara County any less attractive to the cannabis cultivation industry. Existing and available industrial greenhouse infrastructure, efficiency of operations and the ability to reliably produce large volumes of product at a consistent price and quality have enabled these large operators to outcompete legacy growers from around the state.

These large operators also have the advantage of proximity to the largest cannabis market in the state. From conversations with some of these businesses, we understand that they commonly work from a market demand model, where cannabis is grown under contract with distributors or large retailers. Effectively, their product has largely been sold before it is even planted. (pg. 12-13)

- Cannabis cultivation taxes are most commonly assessed on a square-footage basis, but they may also be assessed by gross receipts or by weight. HdL has developed a methodology for converting each of these tax methods so as to create an equivalent rate with the others. This allows the host jurisdiction to ensure that their cultivation tax rates are generally consistent with the rates being applied by other jurisdictions around the state, even when they are using different taxing methods. (pg. 14)
- Outdoor cultivation has struggled to find a place in the cannabis market. Although HdL used \$300 per pound as an average for the analysis, they are aware that many outdoor growers are struggling to find buyers at even \$100 per pound if at all. (pg. 15)
- The review showed that indoor cultivators generated far greater gross receipts than outdoor cultivators. The average indoor grow generated nearly \$6 million, while the average outdoor grow generated only \$355,232. (pg. 17)

Survey of Selected Other Jurisdictions Cannabis Cultivation Tax Rates (Attachment 2)

The following cities and counties were surveyed for information on their cannabis taxation methodologies and rates: Humboldt, Lake, Mendocino, Monterey, Nevada, SF City/County, San Luis Obispo, Santa Barbara, Santa Cruz, Yolo, and Santa Rosa. The information provided by these jurisdictions is summarized below:

- 3 jurisdictions tax based on square footage
- 7 jurisdictions tax based on gross receipts
 - 2 jurisdictions are either considering or will be transitioning to a square footage model effective July 1, 2023
- 1 jurisdiction allows the taxpayer to determine method of taxation (either gross receipts or square footage)

The tax rates vary widely for both the square footage and gross receipts models:

- Square footage:
 - Outdoor: \$0.15/sq ft - \$5.00/sq ft
 - Indoor: \$0.45/sq ft - \$7.00/sq ft
 - Mixed-light: \$0.30/sq ft - \$4.02/sq ft
- Gross receipts: 2.5% - 8%

Sonoma County Cannabis Tax Fund Budget and Program Costs

The cannabis program costs are covered by cannabis business tax revenues and cannabis business tax fund

balance. As taxable canopy declined by 1/3 in FY 2022-2023, and is projected to be similar in FY 2023-2024 and possibly beyond, the program has relied on and will continue to rely on fund balance to make up the difference. In June 2021, the Board committed to a Cannabis Program Update and Environmental Impact Report with an estimated total cost of \$2.3 million, utilizing cannabis tax fund balance, over four fiscal years through FY 2024-2025.

Cannabis program costs include staff in five County departments, legal costs (County Counsel and external counsel), other contract services, and the Environmental Impact Report and Cannabis Program Update (See Attachments 3 and 4). Estimated program costs start at \$2.2 million for FY 2023-2024, increasing to \$2.5 million in FY 2027-2028. Department costs for the Department of Health Services Environmental Health Division and Department of Agriculture / Weights & Measures (AWM) are offset by permit fees, estimated to be \$185,000 for FY 2022-2023. Permit Sonoma permit fees are not included as those permits are at-cost billed to the applicants.

Options and Staff Recommendation

After review of the analysis by HdL Companies, staff developed and evaluated the following three options, in conjunction with information received from HdL, and determined the advantages and disadvantages of each option. A full list of pros and cons is found in Attachment 5.

Options:

1. Maintain square footage and model, but adjust rates based on HdL’s tax rate convertor model, with annual review. Recommended rate of 2.5% gross receipts equating to:
 - a. \$0.75/sq. ft. for outdoor cultivation
 - b. \$12.50/sq. ft. for indoor cultivation
 - c. \$3.00/sq. ft. for mixed-light cultivation
2. Convert to Gross Receipts model (rate of 3%)
3. Extend 45% tax rate reduction with no other changes through FY 2023-2024, with additional HdL review

Staff Recommendation: Option 1

Based on the analysis, staff recommends Option 1 as it maintains the current taxation model based on square footage with an annual adjustment to account for changes to price, enabling effective control of rate changes, which have proven to be burdensome to cultivators in the current taxation model. This Option is within the scope of authority granted to the Board of Supervisors by the voters in approving the cannabis business tax.

Assuming a tax rate of 2.5%, and using the HdL tax rate convertor model, FY 2023-2024 projected cannabis cultivation tax revenue can be seen in Table B below.

Cannabis Business Type	Verified (taxable) canopy (FY 2022-2023)*
Cultivation Type and Tax Rate	
Outdoor \$0.75/sq. ft.	\$653,400
Indoor \$12.50/sq. ft.	\$691,515

Mixed-light \$3.00/sq. ft.	\$23,522
Total projected cultivation tax revenue	\$1,368,437
Operation Type	
Retail	\$428,000
Manufacturing	\$84,000
Total projected cannabis tax revenue	\$1,880,437

*Permitted and verified (taxable) canopy is as of 12/2022. Retail and Manufacturing projected revenue based on FY21-22 actual revenue collected.

It is difficult to predict when the market price of cannabis will rebound, whether verified and taxable canopy numbers will increase, and what the program update will include, hence a conservative approach to estimated cannabis cultivation tax revenue through FY 2027-2028. Based on that assumption, the recommended cannabis cultivation tax rate, with cannabis tax fund balance, will meet the estimated cannabis tax revenue projections necessary to maintain the annual cannabis program costs through FY 2027-2028.

Strategic Plan:

N/A

Prior Board Actions:

June 13, 2022 - HdL Contract for Gross Receipts Review (

[<https://sonoma-county.legistar.com/LegislationDetail.aspx?ID=5679349&GUID=DBAF0162-7DB2-44E0-B08C-883C2714E581&Options=&Search=>](https://sonoma-county.legistar.com/LegislationDetail.aspx?ID=5679349&GUID=DBAF0162-7DB2-44E0-B08C-883C2714E581&Options=&Search=>))

April 19, 2022 - Adoption of Ordinance No. 6374, temporarily reducing the commercial cannabis cultivation tax rate by 45% effective July 1, 2021 through June 30, 2023 (

[https://sonoma-county.legistar.com/LegislationDetail.aspx?ID=5552456&GUID=CA51C391-F51F-4BDD-B912-3F2A83817AB1&Options=&Search=\)](https://sonoma-county.legistar.com/LegislationDetail.aspx?ID=5552456&GUID=CA51C391-F51F-4BDD-B912-3F2A83817AB1&Options=&Search=))

FISCAL SUMMARY

Expenditures	FY 22-23 Adopted	FY23-24 Projected	FY 24-25 Projected
Budgeted Expenses			
Additional Appropriation Requested			
Total Expenditures			
Funding Sources			
General Fund/WA GF			
State/Federal			
Fees/Other			
Use of Fund Balance			
Contingencies			
Total Sources			

Narrative Explanation of Fiscal Impacts:

Fiscal impacts will depend on the option selected by the Board of Supervisors. Converting to a gross receipts model would require additional costs related to audit and compliance (estimated at \$200,000 annually, pending Board decision), thus increasing costs. Cost impacts of options 1 and 3 would be minimal, as the program currently operates based on a square footage model. The tables in the Discussion section of this report lay out potential revenues under the recommended option 1. Option 2 would require further analysis, while option 3 would not impact current revenues.

Staffing Impacts:			
Position Title (Payroll Classification)	Monthly Salary Range (A-I Step)	Additions (Number)	Deletions (Number)

Narrative Explanation of Staffing Impacts (If Required):

N/A

Attachments:

- Attachment 1 - Fiscal Analysis of the Commercial Cannabis Cultivation Industry by HdL Companies
- Attachment 2 - Other Jurisdictions Cannabis Cultivation Tax Rates
- Attachment 3 - Cannabis Program Budget
- Attachment 4 - Cannabis Program Staffing
- Attachment 5 - Summary of Options

Related Items "On File" with the Clerk of the Board:

None