



CITY OF SALINAS

Commercial Cannabis Taxation Recommendation Report

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Engineer of Work:



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Introduction

Background

Commercial Cannabis is regulated in the City of Salinas by Municipal Code Chapter 5 – Public Peace and Morals under Article VII Cannabis. The City regulates the establishment and operation of a limited number of commercial cannabis businesses (23), including cultivation, distribution, manufacturing, retail storefront (dispensaries) and retail delivery services.

The City has an existing cannabis business tax, Measure L, which was approved by Salinas voters in November 2016. The tax rates vary by cannabis business type and were initially set at 5 percent of gross receipts for retail and manufacturing businesses, and \$15 and \$2 per square foot of canopy space for cultivation and nursery businesses. The original tax rates were scheduled to increase in 2020; however, in December 2019 the Salinas City Council voted to forgo the scheduled increase. Since 2017, the City has generated roughly \$7.35 million in tax revenue.

The Salinas City Council has expressed interest in evaluating the current Salinas cannabis market to determine the strength of the businesses and identify impediments to growth including, but not limited to, taxation. To inform these discussions, the City has engaged SCI Consulting Group to perform a comprehensive, financially focused analysis of the cannabis industry in the City and prepare a Cannabis Taxation Recommendation Report which makes recommendations regarding the optimal approach to taxation.

This analysis considers existing sales revenue and taxation data, analyzes any financial constraints, and considers the best practices on taxation to maximize revenue, market stability, and economic growth. Additionally, this analysis evaluates tax rates regionally to better understand competitiveness and if this is a barrier to growing the industry in the City.

Summary and Recommendations

The analysis of Salinas' local cannabis industry indicates that it remains viable, relatively stable with the likelihood of a reasonable, limited growth over time. This is a remarkably positive finding when compared with the dynamic and challenged state of the cannabis industry statewide.

California's cannabis industry is quite mature with existing consumer demand being met (and often exceeded) by healthy regulated and non-regulated (black market) businesses. Hence, industry growth, and the associated municipal tax revenue growth, is limited to new consumers drawn to the regulated products by improved marketing, packaging, variety, effects, and safety, as well as existing consumers transitioning from the unregulated market to the regulated market. These forces affect all links in the supply chain (cultivation, distribution, testing, manufacturing, and retail.)

Long term, the City should understand that high land values and the availability of real estate will likely constrain growth of cultivation and manufacturing businesses within City limits. Retail businesses are limited by a slowly growing local demand (affected by new and newly legal consumer transactions), with some special opportunities for Salinas as a somewhat isolated regional City along the busy US 101 corridor.

The greatest area for significant growth for the City is in the manufacturing sector. Although this sector has matured (and possibly peaked) statewide, there is still huge opportunity to develop, market, and package, new types of products. Salinas is well poised with its proximity to very active cultivation sites in Monterey, San Luis Obispo, and even Santa Barbara Counties, along with its agricultural and industrial capacity and infrastructure.

The City's current rates, rate structure, number and types of businesses are generally appropriate and well within California norms. The tax revenues are leveling out, becoming more predictable and reliable, with some additional growth projected as more permitted businesses become operational. The City should continue with current policies, making field condition informed, minor adjustments (as recommended below) to tax rates, permit numbers, and types of permits as the marketplace continues to evolve over the next 10 years.

Here are the primary recommendations:

- Maintain the existing gross receipts tax rate of 5 percent on retail businesses.
- Reduce the existing tax to a rate between 2.5% and 3% on manufacturing businesses.
- Reduce the existing tax to a rate between \$7 to \$10 per square-foot of canopy on cultivation businesses.
- Maintain the current limit on the number of retail businesses (three (3) delivery and = five (5) storefront).
- Award the final cultivation permit.
- Continue to support active permittees working towards becoming operational businesses.
- Take steps to foster and support growth in the manufacturing business sector, which has the greatest growth potential.
- Continue to carefully facilitate the transition from unregulated cannabis markets to regulated cannabis businesses.

- Expand on Salinas' unique history, character, and culture to optimize all facets of the cannabis industry.
- Explore ways to increase opportunities for minority owned local businesses.

Overview of the Salinas Cannabis Market

Commercial Cannabis Business Regulation and Permitting

The City of Salinas allows all types of commercial cannabis businesses. The City issues two types of commercial cannabis business permits: Commercial Cannabis Permits (CCP) and Administrative Permits (AP). CCPs are issued for Cultivation, Delivery, Dispensary, Distribution, and Manufacturing. Administrative Permits are issued for Testing Laboratories, Small Distribution (business premises under 500 square-feet), Research and Development Facilities, and Nurseries.

Commercial Cannabis Permits

The City of Salinas allows for issuance of a maximum of 23 CCP's. Since the available permits are limited, the City accepts applications only during designated "rounds", allowing for applicants to competitively apply for permits. "Table 1" below shows permit quotas, active permits (permits for businesses that are either in operation or working towards operation), and operational businesses as of August 2022.

Table 1 – Commercial Cannabis Permit (CCP) Quotas

Business Type	Permit Quota	Active Permits	Operational Businesses
Cultivation	5	3	1
Delivery	3	3	3
Dispensary	5	5	3
Distribution	5	5	2
Manufacturing	5	5	2
Total	23	21	11

"Table 2" below shows the 21 businesses that have been awarded permits and are currently either operational or pursuing operational status. The updated status of the City's 21 active CCP's is shown below.

Table 2 – CCP: Operational Status

	Business Name	Type	Business Status
1.	CannaCruz	Dispensary	Operational
2.	Compassionate Bay	Delivery	Operational
3.	Golden Essentials	Delivery	Operational
4.	Purple Trilogy	Delivery	Operational
5.	Cypress Manufacturing	Distribution	Operational
6.	Cypress Manufacturing	Manufacturing	Operational
7.	Emerald Skyway, LLC	Dispensary	Operational
8.	710 Combinator (Grupo Flor)	Manufacturing	Operational
9.	East of Eden (Grupo Flor)	Dispensary	Operational
10.	Flor X (Grupo Flor)	Distribution	Operational
11.	Flor Cultivation	Cultivation	Partially Operational
12.	Emerald Skyway Manufacturing, LLC	Manufacturing	Not Operational
13.	Emerald Skyway Cultivation, LLC	Cultivation	Not Operational
14.	E7 Salinas, LLC	Dispensary	Not Operational
15.	E7 Salinas, LLC	Distribution	Not Operational
16.	E7 Salinas, LLC	Manufacturing	Not Operational
17.	Horizon Salinas, LLC	Dispensary	Not Operational
18.	Horizon Salinas, LLC	Distribution	Not Operational
19.	Cypress Manufacturing Cultivation	Cultivation	Not Operational
20.	Sanborn Distribution	Distribution	Not Operational
21.	Sanborn Manufacturing	Manufacturing	Not Operational

Eleven (11) businesses are now operational, and ten (10) businesses are still working towards operational status, two of which have previous indefinite extensions. The delays have involved challenges related to physical building improvements and site selection as well as state licensing challenges and newly issued permits.

Administrative Permits

Unlike CCPs, there are no limits on how many administrative permits can be issued for Commercial Cannabis Businesses. Administrative permits can be applied for at any time and do not require review by the Cannabis Selection Committee. Obtaining and maintaining an Administrative Permit is considerably simpler and less expensive in comparison to the CCP process. Nonetheless, applicants for Administrative Permits are still required to obtain a state license. “Table 3” below shows the Administrative Permits that have been issued and remain active (business is operational or is working towards operational status).

Table 3 – Administrative Permits: Operational Status

	Business Name	Type	Business Status
1.	OPM Holdings	Dispensary	Operational
2.	ProForma Labs	Delivery	Operational
3.	American Biotech Testing	Delivery	Operational

In addition to the three businesses listed above, a number of other applicants have been awarded Administrative Permits but have abandoned the venture prior to achieving operational status. There have been no Administrative Permit submittals in 2022.

Cannabis Tax Revenue

Measure L, adopted by the voters of Salinas in November 2016, requires certain Commercial Cannabis Businesses to pay a commercial cannabis business tax every quarter, beginning January 1, 2017. The original tax rates were scheduled to increase in 2020; however, in December 2019 Council voted to forgo the scheduled increase. Therefore, the rates listed below remain in effect. “Table 4” lists the rates levied on each business type and the maximum tax rates.

Table 4 – Cannabis Tax Rates

Business Type	Current Rate	Maximum Rate
Retail (Dispensary)	5% of Gross Receipts	10% of Gross Receipts
Retail Delivery	5% of Gross Receipts	10% of Gross Receipts
Manufacturing	5% of Gross Receipts	10% of Gross Receipts
Cultivation	\$15/sf of Canopy	\$25/sf of Canopy
Nursery	\$2/sf of Canopy	\$5/sf of Canopy
Distribution	No Tax	No Tax
Testing	No Tax	No Tax

“Table 5” below shows cannabis revenue by businesses type that conducted commercial cannabis operations from 2017 through 2022. The taxes collected to date have been generated by just nine (9) businesses. “Table 6” compares the total cannabis industry tax revenue from 2017 through 2022.

Table 5 – Salinas Cannabis Industry Tax Revenue by Business Type (2017-2022)

Business Type	2017	2018	2019	2020	2021	2022
Delivery	\$38,989	\$102,917	\$117,138	\$197,395	\$134,572	\$16,600
Dispensary	IA	\$285,475	\$949,762	\$1,124,674	\$1,221,626	\$333,647
Cultivation	IA	IA	IA	\$8,679	\$73,539	\$19,200
Manufacturing	\$335,380	\$482,057	\$561,413	\$511,284	\$669,760	\$168,926
Total	\$374,369	\$870,449	\$1,628,314	\$1,842,033	\$2,099,497	\$538,373

IA = business type was inactive during this term, i.e. not yet conducting commercial operations and paying the cannabis business tax

Table 6 – Salinas Cannabis Industry Tax Revenue (2017-2022)

Year	Q1	Q2	Q3	Q4	TOTAL	+ / -
2017					\$374,369	
2018	\$120,737	\$143,839	\$328,894	\$276,979	\$870,449	133%
2019	\$343,833	\$432,000	\$409,701	\$442,779	\$1,628,314	87%
2020	\$470,916	\$503,765	\$357,502	\$509,849	\$1,842,033	13%
2021	\$536,363	\$525,501	\$514,153	\$449,941	\$2,025,958	10%
2022	\$448,552	\$362,404			\$810,956	

Q = Quarter (three-month period)

The Cannabis Business Tax was a new tax revenue for the City beginning in 2017. The total cannabis tax revenue significantly increased between 2018 and 2019 as new business within the City became operational. In recent years, tax revenue has continued to increase, although at a much lower rate, increasing by approximately 13% from 2019 to 2020 and 10% from 2020 to 2021.

Analysis of the tax revenue collected through the first two quarters of 2022 indicate that the cannabis revenues are beginning to flatten out as detailed in the Figure below. Tax revenues for Q1 and Q2 of 2022 are down 16% (-\$153,138) compared to the previous two quarters in 2021 (Q3 and Q4). The reduction in revenue for 2022 is partially caused by late tax payments, as four business were late on their 2022 Q2 tax payments to the City at the time of writing this report.

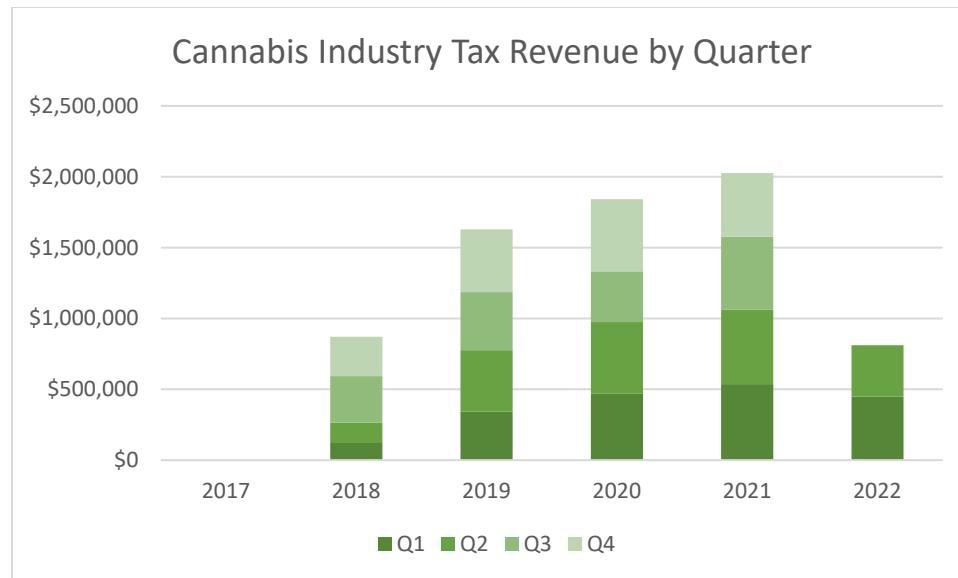


Figure 1 – Historic Tax Revenue

However, further analysis of the historical revenues by business type indicates a significant decline in retail revenues. Retail tax revenues for Q1 and Q2 of 2022 are down 21% (-\$137,242) compared to the previous two quarters in 2021 (Q3 and Q4). This decline is most likely attributed to the current economic conditions and high interest rates, which may have resulted in the reduction of cannabis purchases. Nonetheless, retail tax revenue should restore to previous levels when the economy recovers.

While tax revenues for 2022 are currently on a projection to decline, tax revenues for the remaining 2022 quarters (Q3 and Q4) and 2023 have the potential to surpass the previous year's total if additional businesses initiate operations.

Analysis of Current State and Local Tax Structure

The legal, regulated cannabis industry in California has seen significant growth and investment over the past few years. Despite this growth, the regulated industry has fallen well below its initial projections due to its inability to eliminate the illegal market.

The combination of regulatory and licensing costs and administrative burdens; high taxes, and local bans affecting large areas of the State are all factors that have contributed to significant delay to full emergence of the legal industry. Further, legalization has resulted in huge increases in cultivation both legal and (albeit counter-intuitively) illegal, while demand has only grown slightly, resulting in an overproduction of wholesale cannabis and a huge drop in prices, thus a reduction in profitability.

Most estimates indicate that 65 percent to 80 percent of all cannabis commerce in California is still unregulated, and it will likely take 10 or more years of enforcement, incentives, and capitalistic forces to reduce that to a more reasonable 10%.

It is expected that the California cannabis industry will continue to undulate dynamically under market and regulatory forces, but that these will decrease over time.

State Cannabis Taxes

Approval of Proposition 64 in November 2016 by California voters imposed two new cannabis taxes: a state excise tax of 15% on purchases of cannabis or cannabis products and a wholesale cultivation tax of \$9.25 per dry-weight ounce of cannabis flower and \$2.75 dry-weight ounce of leaves or trim. The State cultivation tax, which is indexed for inflation, increased to \$10.08 per ounce and \$3.00 per ounce for the 2022 calendar year. In addition to the cultivation and excise tax, commercial cannabis sales are subject to the sales and use tax, which is 9.25% in the City of Salinas.

Assembly Bill 195

On June 30, of 2022, California Governor Gavin Newsom signed Assembly Bill 195, which amends the California Revenue and eliminates the cultivation tax¹. Effective July 1, 2022, harvested cannabis that enters the commercial cannabis market is no longer subject to the cultivation tax. Under AB-195, the cannabis excise tax will be maintained at the current rate of 15% for the next three years but can be increased up to 19% beginning in 2025 to recoup losses from the elimination of the cultivation taxes. Furthermore, effective January 1, 2023, the collection of the excise tax will shift from distributors to retailers.

Local Cannabis Tax Rate

During the early years of legalization, high local cannabis tax rates were very common across the State and for the most part acceptable amongst the cannabis industry when profit margins were high. Some of the early adopters in the State to legalize cannabis, approved cannabis tax rates across all license types as high as 10% - 15% of gross receipts and \$25/sf for cultivation. However, as the regulated cannabis industry has matured, the combination of increased market competition, rising licensing and regulatory costs, and the collapse of wholesale cannabis prices has pushed the industry to the brink of collapse.

Local tax rates have been trending downward and stabilizing to a sustainable rate across the State due in part to local governments trying to maintain a competitive edge with neighboring jurisdictions who have legalized commercial cannabis and recognizing the need to grant tax relief for cannabis businesses.

“Table 7” below compares the current Salinas cannabis tax rates to the rates of nearby jurisdictions. For the most part, Salinas’ current tax rates are comparable and competitive with nearby cities.

¹ https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202120220AB195

Table 7 – Local Cannabis Tax Rates, Nearby and Selected Cities

	Cultivation	Nursery	Manufacture	Distributor	Testing	Retail
Hollister	\$7/sf	5%	5%	5%	5%	5%
Marina	5%	5%	5%	5%	5%	5%
Merced	2.5%	2.5%	\$2.50/sf	2%	\$0/sf	7%
Monterey¹	2%	2%	2%	2%	1%	4%
Pacific Grove¹	NA	NA	NA	NA	NA	6%
Salinas	\$15/sf	\$2/sf	5%	NA	NA	5%
Santa Cruz	7%	7%	7%	2%	1%	7%
Seaside	2%	2%	2%	2%	2%	6%
Watsonville	\$10/sf	\$1/sf	2.5%	NA	NA	5%

¹ Measures on November 2022 General Election

Retailers

Retailers (Storefront and Delivery) are the most localized of all cannabis business types because they serve the needs of a particular geographic area. While cultivators, manufacturers, and distributors have the ability to sell their products to other businesses throughout the State, retailers serve the local community by selling cannabis products directly to customers. As a result, the growth and success of retailers in Salinas is directly related to the market demand for cannabis in the area.

For the purpose of determining how many retailers Salinas can support, it is reasonable to assume that demand for cannabis in the City will remain constant. Therefore, permitting too many cannabis retailers will not increase demand or create new consumers but will simply result in lower sales volumes per retailer. In other words, the local retail market will eventually reach a saturation point.

Cannabis retailers have been operating in the City since 2018. Retailers are currently capped at five (5) storefront businesses and three (3) delivery businesses. As of August 2022, the City has issued all available CCPs for both business types; however, two of the storefront businesses are not currently operational.

A common metric used to determine how many retail businesses a jurisdiction can support assumes one retailer for every 15,000 to 20,000 people. With eight (8) permitted retailers, the City currently has a population per retailer of 19,500. Under this assumption, the City has reached the market density of retailers that they can reasonably support.

Table 8 – Nearby Cannabis Retailers

City/County	Population	Retailers	Population per Retailer
Capitola	10,090	2	5,045
Marina	40,100	3	13,367
Salinas	156,177	8	19,522
Santa Cruz	65,011	5	13,002
Seaside	34,063	7	4,866
Watsonville	52,398	3	17,466

Next, we analyzed the retail tax revenues collected by the City to determine whether the retail cannabis market has reached its saturation point. From 2017 to 2020, the tax revenue collected by the City steadily increased as six of the City's eight permitted retail businesses became operational. Revenue from 2020 to 2021 increased by only 3 percent, which may indicate that the market is nearing the saturation point. Furthermore, tax revenues for Q1 and Q2 of 2022 are down 21 percent compared to the previous two quarters in 2021 (Q3 and Q4); however, this is most likely to due to current state of the economy which is impacting retail purchases by consumers as previously discussed.

Table 9 – Salinas Retail Cannabis Tax Revenue (2017-2022)

Year	Retail	Delivery	TOTAL	+ / -
2017	IA	\$38,989	\$38,989	
2018	\$285,475	\$102,917	\$388,392	896%
2019	\$949,762	\$117,138	\$1,066,900	175%
2020	\$1,124,674	\$197,395	\$1,322,069	24%
2021	\$1,221,626	\$134,572	\$1,356,199	3%
2022*	\$501,709	\$16,600	\$518,309	

* Tax revenue reported through two quarters

Although the retail industry in Salinas as a whole has experienced growth up until this year, the delivery businesses have not been as successful in comparison to storefront retailers, as indicated by the tax revenue collected by the City. Delivery businesses are in direct competition with the storefront retailers in the City, licensed delivery services from other jurisdictions, and Salinas is somewhat isolated from other populous areas, which makes this a difficult business model to be successful.

Based on the analysis above, there are indications that retail cannabis market in the City is reaching its saturation point. Given that there are two permitted retail businesses who are not yet operational, it is recommended that the City not consider permitting additional retail locations at this time and instead, continue to support the active permittees working towards becoming operational businesses. Lastly, SCI recommends that the City maintain the current gross receipts tax rate of 5 percent on retail. This rate is currently competitive with nearby municipalities as well as the standard rate SCI typically recommends to municipalities that we work with.

Cultivation

In recent years, the cannabis cultivation sector has faced some unprecedented challenges. An oversupply of cultivated cannabis has resulted in a crash in wholesale cannabis prices. This, combined with high local and state taxes has pushed the industry towards collapse. The elimination of the state cultivation tax provides much needed tax relief to cannabis cultivators. However, tax reform may be required locally in Salinas as well.

Cannabis cultivation in Salinas is currently taxed at \$15 per square-foot of canopy space, which is much higher than many neighboring jurisdictions as detailed in “Table 6” above. A square-footage tax has advantages and disadvantages for Salinas cannabis businesses. The advantage is that cultivators know their total annual tax liability upfront and have the ability to plan and budget accordingly. The downside is that a square-foot based tax can impact the cost of production and fails to account for profitability of the business since the business is required to pay the tax regardless of productive output.

To better understand overall impact of the square-footage tax, SCI has developed on model to convert the City’s square-foot tax to an equivalent gross receipt tax. A study conducted by BOTE Analysis for the Washington State Liquor and Cannabis Board conservatively estimated the average indoor cultivation yield at 38.6 grams/ft²/harvest, or 0.085 pounds/ft²/harvest². Indoor cultivators typically average four (4) harvest cycles per year, which equates to 0.34 pounds/ft²/year. For a 10,000 square foot cultivation facility, this means they can produce around 3,400 pounds per year.

² Jonathan Caulkins, Matthew Cohen, and Luigi Zamarra, “Estimating Adequate Licensed Square Footage for Production,” Prepared by BOTE Analysis Corporation for Washington State Liquor and Cannabis Board, https://lcb.wa.gov/publications/Marijuana/BOTEC%20reports/5a_Cannabis_Yields-Final.pdf.

According to Cannabis Benchmarks, the current average indoor price of cannabis is \$1,364 per pound³. For our model, we have conservatively estimated the price at \$1,000 per pound which equates to roughly \$3.4 million in gross receipts for a 10,000 square foot facility. At the City's current tax rate of \$15 per square foot, the annual cannabis tax owed is \$150,000, so the gross receipt tax equivalent works out to roughly 4.41% (\$3.4 million/\$150,000).

The tables below model the gross receipt tax equivalent for tax rates at \$15, \$10, and \$7:

Table 10 – Gross receipt Tax Equivalent at \$15 per sqft

Canopy (sf)	Yield @ 0.34lb/sf/yr	Price per lb	Gross Receipts	Tax @ \$15/sf	Gross Receipt Equivalent
10,000.00	3400.00	\$1,000	\$3,400,000	\$150,000	4.41%

Table 11 – Gross receipt Tax Equivalent at \$10 per sqft

Canopy (sf)	Yield @ 0.34lb/sf/yr	Price per lb	Gross Receipts	Tax @ \$10/sf	Gross Receipt Equivalent
10,000.00	3400.00	\$1,000	\$3,400,000	\$100,000	2.94%

Table 12 – Gross receipt Tax Equivalent at \$7 per sqft

Canopy (sf)	Yield @ 0.34lb/sf/yr	Price per lb	Gross Receipts	Tax @ \$7/sf	Gross Receipt Equivalent
10,000.00	3400.00	\$1,000	\$3,400,000	\$70,000	2.06%

Our analysis indicates that the City's current rate of \$15 per square foot is much higher than nearby municipalities. Typically, SCI recommends a tax rate at \$7 per square-foot for cultivation businesses. In order to remain competitive with nearby municipalities and to provide tax relief, SCI recommends that the City consider lowering the cultivation tax to a rate between \$7 and \$10 per square foot. While this reduction will result in a reduction in tax revenues from each business, it may incentivize the three non-operational businesses to commence operations.

³ <https://www.cannabisbusinesstimes.com/cannabisindex/>

Manufacturing

The cannabis manufacturing industry continues to innovate and expand, offering the greatest area for significant growth within the cannabis industry. Although this sector has matured (and possibly peaked) very rapidly statewide, there is still significant opportunity to develop, market, and package new types of products. As the regulated market continues to slowly expand, we anticipate the demand for manufactured cannabis products to increase as well.

Due to Salinas' close proximity to very active cultivation sites in Monterey, San Luis Obispo, and even Santa Barbara Counties, along with its agricultural and industrial- capacity and infrastructure make it an attractive location for prospective businesses. However, low vacancy rates within the industrial zones in the City may impede growth. Furthermore, expansion of the cannabis manufacturing sector could potentially create an increased demand and price for the limited number of available properties, resulting in the displacement of existing businesses, which may not align with the City's goals.

Cannabis manufacturing businesses are currently capped at five (5) business within the City. The City has issued all five permits, with two (2) operational businesses and three (3) businesses who have not yet started operations. Overall, the two manufacturing businesses have displayed steady growth with tax revenues fluctuating quarter to quarter but increasing each year. Despite this growth, these businesses have expressed concerns with profitability related to the existing tax rates associated with manufacturing in the City.

Manufacturing businesses are currently taxed at 5 percent of gross receipts. Our analysis indicates that this rate is comparable and competitive to other nearby municipalities, but there are surrounding cities with lower rates. Typically, SCI recommends a tax rate between 2% - 3% of gross receipts for manufacturing businesses. SCI recommends that the City consider lowering the manufacturing tax to a rate between 2.5% and 3%. While this reduction will result in a reduction in tax revenues from each business, it may incentivize the remaining three non-operational businesses to commence operations.