



RON GALPERIN
CONTROLLER

December 1, 2022

Honorable Eric Garcetti, Mayor
Honorable Michael Feuer, City Attorney
Honorable Members of the Los Angeles City Council

Re: High Maintenance: Review of the City's Cannabis Regulation Efforts

Cannabis regulation policies at the state and local levels have changed significantly in recent years. In 2017, following statewide legalization the previous year, Los Angeles voters overwhelmingly approved Measure M, which allowed the City to develop a licensing and regulatory framework for commercial cannabis activity in Los Angeles. The Department of Cannabis Regulation (DCR) and other City departments have been tasked with ensuring that Los Angeles does its part to uphold Measure M's goals to make commercial cannabis activity well-regulated, fair and safe.

My office conducted this review of the City's current commercial cannabis regulation efforts and found that while some progress has been made, there is significant room for improvement in a number of areas, including: expanding strategies to deter additional unlicensed cannabis businesses from opening and operating, and improving regulatory compliance monitoring of existing licensed cannabis businesses. Additionally, the report discovered that the City's Office of Finance has not met its goal of auditing cannabis businesses every two years — making it much harder to recover taxes owed to the City due to a three-year statute of limitations.

Missed opportunities

The report outlines examples of how other U.S. cities have successfully adopted policies that designate how cannabis taxes can be used, most of which fund projects and programs that prioritize communities disproportionately impacted by the decades-long war on drugs. Like property tax revenue, sales tax and other business taxes, cannabis business taxes are deposited into the General Fund to support general City services. Currently, however, the City does not allocate cannabis business taxes for any special purpose. In the future, the City could

choose to do so, thereby funding important programs that would build equity in historically disadvantaged communities.

Enhanced strategies needed

Improving the City's approach to commercial cannabis regulation will not only address ongoing illegal operations and unmonitored activities, but also streamline DCR's operations and those of all other departments involved in the process. My report makes the following recommendations:

- **Expand the City's enforcement strategy to put more pressure on property owners** to shut down and deter unlicensed cannabis businesses from operating by imposing fines and liens.
- **Develop and implement a comprehensive regulatory compliance plan** to monitor licensed cannabis businesses and enforce its rules and regulations.
- **Revise cannabis license and application fees** to include the cost of carrying out the regulatory compliance plan.
- **Reconsider the Office of Finance's goal to audit cannabis businesses every two years** and expand efforts to prevent potential tax evasion by legal businesses.
- **Outline and adopt a spending plan for cannabis tax revenue** that aligns with the City's spending and equity priorities.

While Los Angeles has made progress in regulating commercial cannabis activity — as evident in the significant decrease of known unlicensed businesses since 2018 — there is still much work to be done. I urge City leaders to continue to pursue effective, lasting solutions that will create a cannabis market that boosts the local economy and, most importantly, protects the health, safety and well-being of our residents.

Sincerely,



RON GALPERIN
L.A. Controller

HIGH MAINTENANCE: REVIEW OF THE CITY'S CANNABIS REGULATION EFFORTS



RON  **GALPERIN**
LA CONTROLLER

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EXECUTIVE SUMMARY

The City's policy stance towards cannabis has adapted over decades in response to changes in federal and State law and evolving voter preferences. From the enhanced criminal enforcement brought on by the War on Drugs to the City's ban on most medical marijuana businesses under Proposition D (2013), cannabis possession and sales have largely been illegal until 2018.

Despite these legal restrictions, the use of cannabis products remained prevalent. A 2015 Los Angeles County Department of Public Health survey found that 11.6% of adults in the county reported using marijuana in the past year. According to the 2015 survey, marijuana use was higher among younger adults, with 27.4% of respondents aged 18-to-20 reporting some use in the past year.

A series of changes to State law, including the passage of Proposition 64 in 2016, allowed adults to legally use and possess cannabis and created a framework for legal commercial cannabis activities. As with alcohol and tobacco sales, the intent behind legalizing, regulating, and taxing commercial cannabis was to make it safer to use, mitigate its negative impacts, and raise tax revenue.

Following the passage of Prop 64, Angelenos voted in 2017 to approve Measure M to allow and tax commercial cannabis activity in the City. The City created the Department of Cannabis Regulation (DCR) in 2017 to license and regulate commercial cannabis activities. Meanwhile, the Mayor's Office formed the Cannabis Enforcement Taskforce in 2019 to coordinate multi-departmental enforcement efforts to shut down unlicensed cannabis businesses. Finally, the Office of Finance (Finance) created dedicated units to manage the collection and auditing of cannabis taxes.

The legalization of cannabis businesses led to questions about how the City could best control, regulate, and tax commercial cannabis activity, and what it should do with the new tax revenue stream. More than four years after Measure M's approval, the City is still in the process of answering those questions.

This report offers a review of the City's cannabis efforts so far. **Overall, we found that the City should do more to close down unlicensed cannabis businesses, refine tools to deter additional unlicensed businesses from entering the market, monitor licensed cannabis businesses for regulatory compliance, mitigate the risk of tax evasion by cannabis businesses, and proactively determine how cannabis business tax revenue should be spent.**

The importance of rectifying the City's oversight of commercial cannabis is critical to helping the nascent industry mature in ways that protect the health and safety of Angelenos.

What We Found

The City's current oversight regime of commercial cannabis activity began in January 2018. Since then, the Los Angeles Police Department (LAPD) reports that the number of known unlicensed cannabis businesses has decreased from 300 in 2018 to approximately 100 in June 2022. Though this reduction has been touted as a measure of progress, the actual number of unlicensed cannabis businesses is likely higher. The reported numbers for unlicensed cannabis businesses derive from complaints, service calls, and referrals that tend to focus on conspicuous entities like retail storefronts because illegal cultivation and manufacturing sites are more difficult to identify. DCR has also issued licenses to over 700 cannabis businesses. In addition, Finance has collected more than \$320 million in cannabis business taxes and found an additional \$31 million in additional cannabis tax liabilities through tax audits.

Despite this progress, there is significant room for improvement on each of these fronts.

- **The City could do more to deter additional unlicensed cannabis businesses from opening** – Current enforcement efforts have shown some success in closing unlicensed cannabis businesses. However, the enforcement tools currently being used may not be sufficiently aligned with Measure M's intent to: (1) prevent additional unlicensed cannabis businesses from opening; and (2) discourage property owners from renting to these businesses.
- **DCR has not monitored its licensees for regulatory compliance** – Since 2018, DCR has received over 7,300 cannabis-related complaints, with over 5,000 complaints remaining unprocessed with no record of a review or investigation. These complaints include troubling allegations against licensed cannabis businesses, such as sales to minors, onsite cannabis consumption by employees, and unlicensed retail cannabis sales by a business licensed by DCR for non-retail activities. DCR has also failed to conduct periodic inspections at licensed cannabis businesses to monitor regulatory compliance. **We visited six cannabis retail stores licensed by DCR and found a range of minor, moderate, and major violations at each of the storefronts.**
- **Finance has struggled to meet its goals to audit cannabis businesses** – Finance has not been able to keep up with its goal of auditing every cannabis business every two years. As a result, Finance faces an increased risk that it will not be able to audit tax periods beyond the City's three-year statute of limitations and recover some taxes owed to the City. In addition, Finance's tax audits do not do enough to address the cash-heavy cannabis industry's risk for tax evasion.

- **The City Could Proactively Determine How to Spend Cannabis Taxes** – Although some General Fund allocations go towards cannabis-related items like enforcement, regulation, and administration, the City has not developed a plan or policy for how it will spend cannabis business taxes. Our review found various examples from other local jurisdictions that the City could emulate to spend cannabis tax revenue in ways that meet policymaker priorities and community needs.

What We Recommend

The City should take additional steps to deter unlicensed cannabis businesses from operating in Los Angeles, begin monitoring licensed cannabis businesses for regulatory compliance, more effectively audit cannabis businesses to mitigate tax evasion, and proactively determine how to spend cannabis business tax dollars.

Specifically, the City should:

- expand its enforcement strategy to put more pressure on property owners to shut down and deter unlicensed cannabis businesses from operating by applying several unused enforcement methods;
- develop and implement a comprehensive regulatory compliance plan to monitor licensed cannabis businesses and enforce its rules and regulations;
- revise its cannabis license and application fees to include the cost of carrying out its regulatory compliance plan;
- reconsider its goal to audit every cannabis business every two years, and expand its efforts to address potential tax evasion by cannabis businesses; and
- develop and adopt spending plan for cannabis tax revenue to align with spending priorities.

CONCLUSION

More than five years after legalization, the City's oversight of commercial cannabis activity remains a work in progress. The continued presence of illicit cannabis businesses alongside unmonitored licensed businesses undercuts Measure M's goal of providing safer and more accessible cannabis for Angelenos. By implementing the recommendations in this report, the City can create a more fair and well-regulated cannabis market, raise tax revenue, and achieve its desired policy outcomes connected to commercial cannabis activities.

BACKGROUND

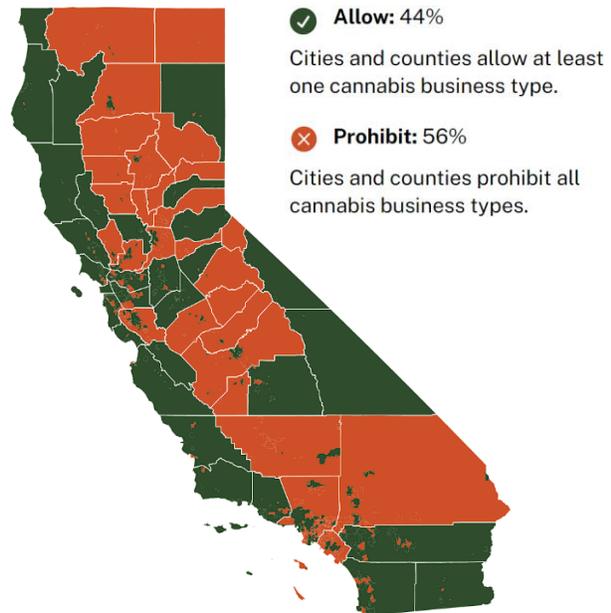
California and Los Angeles have a long history of trying to regulate cannabis. Although the federal government recently announced that it is undergoing a policy review, under current federal and State law, cannabis is categorized as a Schedule I substance, defined as “drugs with no currently accepted medical use and a high potential for abuse.” Governmental policy at the federal, state, and local level, starting especially with the War on Drugs in the 1970s, resulted in decades of enhanced criminal enforcement.

The State’s policy towards cannabis shifted with the passage of Proposition 215 in 1996. Prop 215 modified State law to allow patients and primary caregivers to obtain marijuana for medical purposes without being subject to criminal prosecution by the State. However, Prop 215 lacked a formal regulatory framework to ensure that marijuana was only used for medical purposes. This unregulated environment allowed hundreds of marijuana dispensaries to open in Los Angeles and throughout the State.

In response, the City enacted ordinances to control these dispensaries, culminating in the passage of Proposition D in 2013. Approximately 135 dispensaries were given limited immunity from enforcement, while all other marijuana businesses were banned. Subsequently, the City Attorney’s Office initiated over 1,700 criminal filings through November 2016.

A series of changes to State law, including the passage of Proposition 64 in November 2016, changed the State’s policy once again. Otherwise known as the “*Control, Regulate, and Tax Adult Use of Marijuana Act*,” Prop 64 legalized the possession and personal use of cannabis for adults aged 21 and over, and reduced criminal penalties for various other marijuana-related offenses from felonies to misdemeanors or infractions. The State also began taxing commercial cannabis activity. **To regulate cannabis, Prop 64 created a dual-track system where cannabis businesses are licensed and regulated by both the State and local jurisdictions that choose to allow commercial cannabis activity.**

Figure 1. Most Cities and Counties Still Prohibit All Cannabis Business Types



Source: CA Department of Cannabis Control, February 2022

California is still a patchwork of areas where it is and is not legal to establish a cannabis business. According to the California Department of Cannabis Control, as of February 2022, 235 (44%) of the 539 cities and counties in the State allow at least one type of cannabis business, while 56% do not allow any kind at all.

Following this shift in State policy, Angelenos overwhelmingly approved Measure M in March 2017. The approved ballot ordinance allowed the City to develop a licensing framework to authorize and regulate cannabis businesses, and established taxes for commercial cannabis activity that went into effect on January 1, 2018. **To prevent unlicensed cannabis businesses from opening and to discourage property owners from renting to these businesses, Measure M also established several enforcement mechanisms, including criminal penalties, utility disconnects, and a maximum civil penalty of \$20,000 for each day of violation.**

In 2017, the City established the Department of Cannabis Regulation (DCR) to regulate legal cannabis businesses within Los Angeles. As part of its regulatory duties, DCR is responsible for licensing commercial cannabis activities, developing rules and regulations to implement local and State laws, and monitoring and enforcing licensee compliance. Working with DCR is the Cannabis Regulation Commission, a five-member commission tasked with recommending and implementing the City's laws and regulations pertaining to cannabis-related activity.

Throughout establishing a regulatory structure, **the City Council also recognized the importance of mitigating the impact of commercial cannabis and connecting it to social policy goals.** This led to the creation of a Social Equity Program to give priority licensing to individuals and communities that were disproportionately impacted by the War on Drugs. However, other concerns exist, such as increased cannabis use among youth and quality-of-life issues for communities near cannabis businesses. As a result, there is still an ongoing debate on how the City can enhance enforcement, improve regulation and administration, and advance social policy goals connected with commercial cannabis.

To better regulate the cannabis market environment and increase cannabis tax revenues, this report provides findings and recommendations to improve the City's enforcement, regulation, and taxation of cannabis businesses. In addition, this report also provides policy options and considerations for spending cannabis tax revenues.

Enforcement Against Unlicensed Cannabis Businesses

The need to regulate commercial cannabis activity was driven, in part, by a recognition that the proliferation of unregulated cannabis businesses led to increased crime and negative secondary impacts that needed to be managed and controlled. After the passage of Measure M, the City

Council adopted an ordinance limiting the number of licensed retail cannabis storefronts. With that limitation in mind, unlicensed businesses could either stop their operations and apply with DCR in hopes of getting a license or continue selling cannabis and face the risk of enforcement.

Despite establishing a licensing framework and continued enforcement by the City, crime and other adverse impacts persist, as many unlicensed cannabis businesses have chosen to continue operating.

Concerns with Unlicensed Cannabis Businesses

Unlicensed cannabis businesses are associated with a host of public health issues. For example, a 2021 study by the Los Angeles County Department of Public Health found that unlicensed dispensaries were less likely than licensed businesses to engage in business practices that restrict youth access, such as identification checks. **In addition, unlicensed cannabis businesses were more likely to engage in business practices such as offering free samples, selling illegal high-potency products, and allowing onsite consumption.**

Further, unlike products sold through licensed channels, cannabis products sold in unlicensed dispensaries may not be tested for contaminants (like pesticides or processing chemicals) or properly labeled. This lack of testing may have been a factor in the 2019 outbreak of lung illness, mainly among users of unregulated cannabis vaping products.

In addition to being a crime, unlicensed commercial cannabis activities also create issues for public safety. Because cannabis sales remain a federal crime, transactions are often conducted in cash, making dispensaries the target of robberies and other crimes. As a result, it is not uncommon for the Los Angeles Police Department (LAPD) to find firearms at unlicensed businesses. In one instance, an 18-year-old customer was shot and killed in 2019 at an unlicensed cannabis dispensary in Chatsworth by alleged gang members working there.

Public safety issues associated with unregulated cannabis are not limited to dispensaries. In November 2021, LAPD and other City departments investigated an industrial warehouse being used as an illegal cannabis grow operation. Investigators discovered several code violations, including dangerous wiring, a gas leak, and hazardous fumes from a large diesel generator, which could have caused an explosion and fire at the location.

Another concern is that unlicensed businesses operate with an unfair market advantage. Applicants for a DCR cannabis license must pay at least \$14,000 in fees that are expected to increase further as the City begins implementing the State's annual licensing requirements. There are also additional regulatory costs, including licensing fees paid to the State, and fees for permits and inspections to other local agencies to maintain compliance.

Licensed cannabis businesses also collect and pay taxes, which can be a substantial portion of the final cost to consumers. Built into the retail price of cannabis products sold by licensed businesses are State and local taxes at the cultivation, manufacturing, and distribution phases of the production chain. Further, more taxes are added as part of a retail transaction and include:

- 15% State excise tax on the wholesale market price;
- 10% Los Angeles City cannabis business tax for adult-use sales; and
- 9.5% retail sales tax on all tangible retail products in Los Angeles.

Unlicensed businesses do not face these costs, allowing them to undercut licensed businesses on price. One industry analyst estimated that spending in the State’s unlicensed market topped \$8.7 billion in 2019, nearly three times the spend (\$3.1B) in the legal market. **Every sale in the unlicensed market is potentially a loss of tax revenue for the City.**

Cannabis Enforcement Taskforce: Department Roles and Responsibilities

In 2019, the Mayor’s Office formed the Cannabis Enforcement Taskforce to coordinate enforcement efforts and shut down unlicensed cannabis businesses. The taskforce is headed by the Mayor’s Office of Public Safety, while LAPD plays a lead role in investigating and coordinating enforcement actions among several other departments. In addition, the City Attorney’s Office takes referrals from the departments and prosecutes cases as criminal or civil matters.

Table 1. City Departments Participating in the Cannabis Enforcement Taskforce

Department	Roles and Responsibilities
<p>Mayor’s Office of Public Safety</p>	<p>Heads the taskforce, and coordinates the hearing process for property owners to protest the installation or request the removal of protective devices (padlock, barricade, fence, etc.).</p>
<p>Los Angeles Police Department (LAPD)</p>	<p>Narcotics Enforcement Details (NED) in each of LAPD’s 21 geographic divisions investigate, issue cease-and-desist letters, conduct criminal search warrants, refer cases for criminal prosecution, and administer the process after the installation of protective devices. LAPD’s Cannabis Support Unit coordinates enforcement between the NEDs and other departments.</p>

Department of Cannabis Regulation (DCR)	Refers complaints of unlicensed cannabis businesses to LAPD for investigation and validates that the location is not licensed.
Los Angeles Department of Building and Safety (LADBS)	LADBS's code enforcement inspectors may participate in LAPD search warrants by conducting their own inspection warrant to identify building code violations. LADBS may also refer code enforcement issues to the City Attorney's office for prosecution. At the Taskforce's direction, LADBS will work with a contractor to install protective devices at the unlicensed cannabis business location.
Los Angeles Fire Department (LAFD)	During a criminal search warrant, LAFD's fire inspectors may participate in LAPD search warrants by conducting their own an inspection warrant to identify fire code violations, and make referrals to the City Attorney's Office for prosecution.
Department of Water and Power (LADWP)	At the Taskforce's direction, LADWP will disconnect utilities prevent the unlicensed cannabis business from re-opening.
City Attorney's Office	The City Attorney's Office provides legal advice to the Taskforce departments. Separately from the Taskforce, the City Attorney's Office will also prosecute violations by unlicensed commercial cannabis as a criminal and/or civil matter.

Although the City may know about an unlicensed cannabis business, LAPD will not always investigate it. LAPD's 2018 cannabis enforcement guidelines direct their Narcotics Enforcement Details (NEDs) to focus enforcement activities at unlicensed cannabis businesses that also involve "significant criminal activity" or complaints of illicit activity. The commanding officer at each of LAPD's 21 geographic divisions is responsible for defining what constitutes "significant criminal activity" relative to cannabis enforcement and setting priorities for their division.

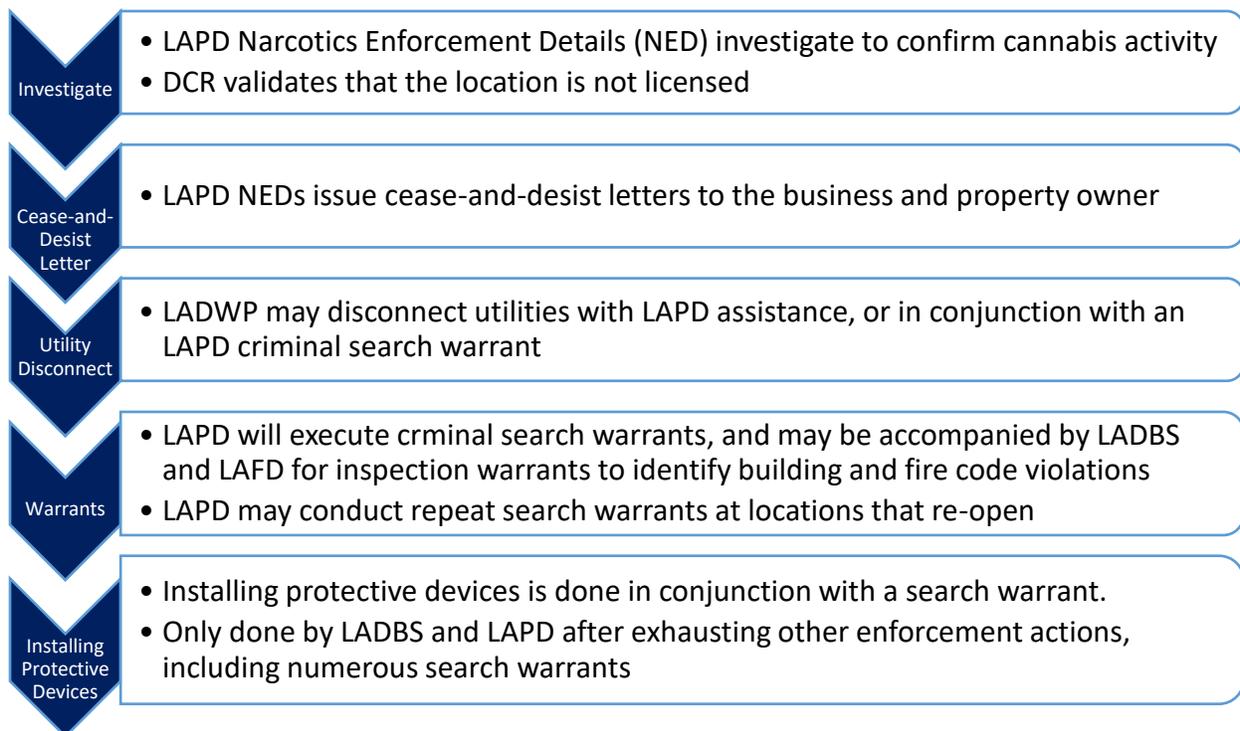
Unlicensed cannabis businesses that only involve a failure to obtain a license for the activity taking place are deferred to DCR.

Following an investigation, the taskforce departments follow a progressive enforcement approach to close down the unlicensed cannabis business. Enforcement begins with a cease-and-desist letter to the business and the property owner to try and obtain voluntary compliance before moving on to stronger methods. Most other enforcement actions center around LAPD's criminal search warrants.

While executing a search warrant, LAPD will investigate the unlicensed cannabis business for evidence of a crime, make arrests, and seize contraband (such as cannabis products, currency, and firearms). If other departments are also participating in the enforcement effort, LAPD will secure the building so that other departments can perform their enforcement actions, including utility disconnects and code inspections.

While onsite during a search warrant, LADBS and LAFD inspectors focus on finding building and fire code violations, especially those that present a health and safety concern to the building's occupants at unlicensed cannabis businesses. These dangerous code violations often include unpermitted construction, electrical work, and concealed or blocked building exits. LADBS will issue an Order to Comply to the property owner to address the code violations. LADBS will refer the case to the City Attorney's Office for misdemeanor prosecution if the property owner does not cooperate. LAFD also refers all of its cases for prosecution.

Figure 2. The Cannabis Enforcement Taskforce's Progressive Enforcement Approach



Since 2018, the City has taken many enforcement actions against unlicensed cannabis businesses, as shown in **Table 2**. However, the need for a stronger deterrent resulted in a 2021 ordinance that allows LADBS to install protective devices around the property to try and keep the property closed.

After exhausting other enforcement methods, including numerous search warrants, the Taskforce may instruct LADBS to work with a contractor to install protective devices such as padlocks, barricades, and fencing to prevent the unlicensed cannabis business from reopening. After the location is locked down, an LAPD NED investigator will provide access to the property owner to remove all property used by the unlicensed cannabis business and to address building and fire code violations.

Table 2. Enforcement Actions Against Unlicensed Cannabis Businesses

Enforcement Method	Number of Actions from 2018 to 2021
Criminal Search Warrants	1,271
Cease-and-Desist Letters to the Business*	781
Fire Code Inspections	466
Locations Inspected for Building Code Violations^	398
Utility Disconnects	408
Cease-and-Desist Letters to the Property Owner*	290
Installing Protective Devices	8

Source: Available data from LAPD, LADWP, LADBS, and LAFD

*LAPD did not start tracking cease-and-desist letters until 2019.

^LADBS building code inspections are for January 2018 through May 2022

After conducting criminal search warrants, LAPD refers misdemeanor cases of unlicensed commercial cannabis violations to the City Attorney's Cannabis Abatement and Prosecution Section. The City Attorney's Office can prosecute business owners, employees, and property owners for the operation of an unlicensed cannabis business, either as a misdemeanor crime or a public nuisance to be abated through civil litigation.

The City Attorney's Office prosecutes criminal and civil cases against unlicensed cannabis businesses in the name of the people of the State of California, and not on behalf of the City. When the City Attorney's Office prosecutes cases in the name of the people, including when it chooses to prosecute civil abatement cases in this manner, the City is not the City Attorney's client, and other City Officials (including the Council) cannot provide direction or otherwise interfere with the City Attorney's discretion in how they choose to dispose of cases.

Persons found guilty of a misdemeanor can be subject to criminal fines of up to \$1,000 and/or up to six months in jail. The City Attorney's Office may also file civil litigation for a number of related violations and pursue remedies that include a civil penalty of up to \$20,000 for each day the unlicensed cannabis business is in operation. According to the City Attorney's Office, from

January 2018 through June 2022, they have filed over 800 misdemeanor criminal cases and eight civil complaints as part of their enforcement efforts to stop **unlicensed cannabis businesses**.

Regulatory Oversight of Licensed Cannabis Businesses

DCR’s struggles with application and license processing have been the subject of much public scrutiny and Council oversight. For example, the Council adopted new application processing requirements and timelines for DCR that went into effect at the start of our audit. DCR also faces upcoming State-imposed deadlines to move away from its current temporary licensing process and implement the State’s annual licensing requirements. **Because these issues are still being addressed, we opted to focus instead on DCR’s role as a regulator for the cannabis businesses it has already licensed.**

In addition to administering the application, licensing, and renewal process, DCR’s Licensing, Compliance, and Commission Support Unit is responsible for investigating complaints and monitoring compliance of licensed cannabis businesses. **From 2018 through October 2022, DCR issued temporary license approvals to over 700 cannabis businesses covering more than 1,300 licensed activities.**

Table 3. DCR has Licensed Over 1,300 Commercial Cannabis Activities

Licensed Commercial Cannabis Activity	Number (as of Oct. 2022)
Distribution	389
Cultivation	365
Manufacturing	316
Retail	243
Delivery	73
Testing	5
Total	1,391

Source: Available data from DCR.

Separately, DCR has received over 7,300 complaints through its online complaint portal. These complaints include reports of potential unlicensed cannabis businesses, concerns about business practices at licensed cannabis businesses, and quality-of-life issues related to cannabis use in the City.

Administration of the Cannabis Business Tax

The Office of Finance (Finance) is responsible for administering the City’s business tax, which is imposed for the privilege of engaging in business within City limits. In addition, every person engaged in business within Los Angeles must register with Finance, obtain a Business Tax Registration Certificate (BTRC), and post the BTRC at each business location.

To obtain or renew their license with DCR, all cannabis businesses must be current on any outstanding taxes due to the City. Like most other business activity in the City, commercial

cannabis is taxed on gross receipts: the total amount charged or received for all sales and commissions. Unlike the federal or State business income tax, the City's tax on gross receipts does not allow deductions for business expenses or most other costs. **Further, gross receipts tax rates for commercial cannabis activity are much higher (between 1% and 10%) than other industries (between 0.10% and 0.425%).**

Table 4. Cannabis Business Tax Rates Range from 1% to 10% of Gross Receipts

Cannabis Classification	Description	Business Tax Rate
Adult-use Sales	Sale of cannabis products, storefront or delivery, from a retailer to consumer.	10% of Gross Receipts
Medical Sales	Sale of cannabis products, storefront or delivery, from a retailer to consumer with verification of an approved medical card.	5% of Gross Receipts
Cannabis Cultivation	Sales related to the cultivation of cannabis (i.e., planting, growing, etc.)	2% of Gross Receipts
Cannabis Miscellaneous	Sales related to all other cannabis activities such as manufacturing and packaging.	2% of Gross Receipts
Cannabis Transportation	The transporting of cannabis products from one cannabis operator with a license, to another operator with a license.	1% of Gross Receipts
Cannabis Testing	The testing of cannabis and/or cannabis products in a testing laboratory.	1% of Gross Receipts

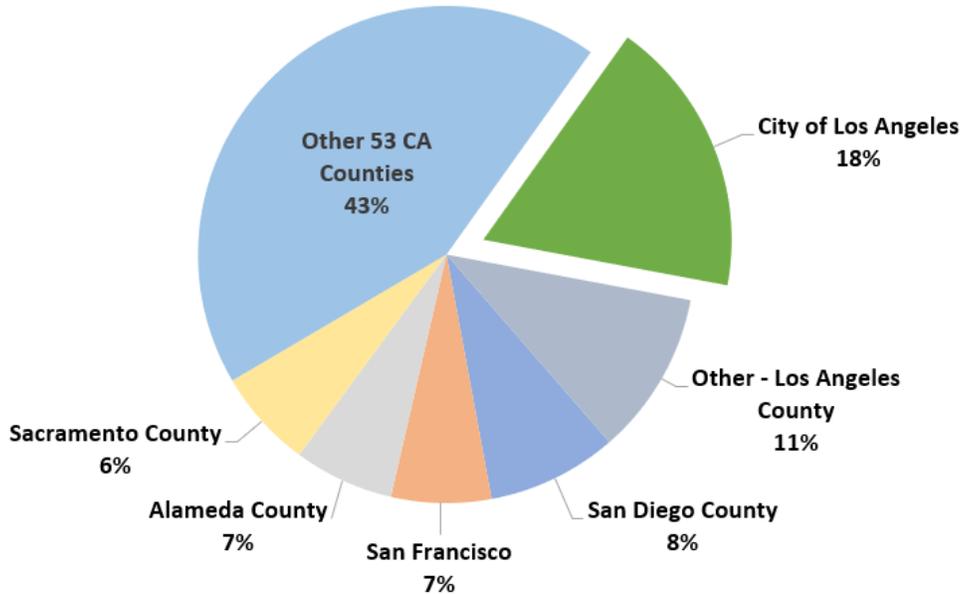
Finance established a cannabis cash collection unit to collect payments for cannabis business taxes and DCR's application and license fees. **Because commercial cannabis activity is still illegal under federal law, the industry faces difficulties obtaining banking and other financial services, making cannabis a cash-heavy industry.** As a result, the cannabis cash collection unit accepts cash payments over \$1,000 via appointment.

To mitigate the risk of tax evasion due to the industry's cash-heavy nature, and ensure that cannabis businesses pay all taxes owed to the City, Finance also established a cannabis audit unit within its Audit Division. The cannabis audit unit consists of one senior tax auditor and four tax auditors who focus only on auditing tax payments from cannabis businesses. Finance's goal is to audit every cannabis business every two years.

Cannabis-Related Tax Revenues and Spending

As shown in **Figure 3**, legal cannabis sales in the City are larger than in any other jurisdiction in the State. From January 2018 to June 2022, we estimate that the City received more than \$36 million in sales tax revenue for the City’s General Fund from taxable retail cannabis sales.

Figure 3. Cannabis Sales in Los Angeles Are Higher Than Any Other Jurisdiction in California

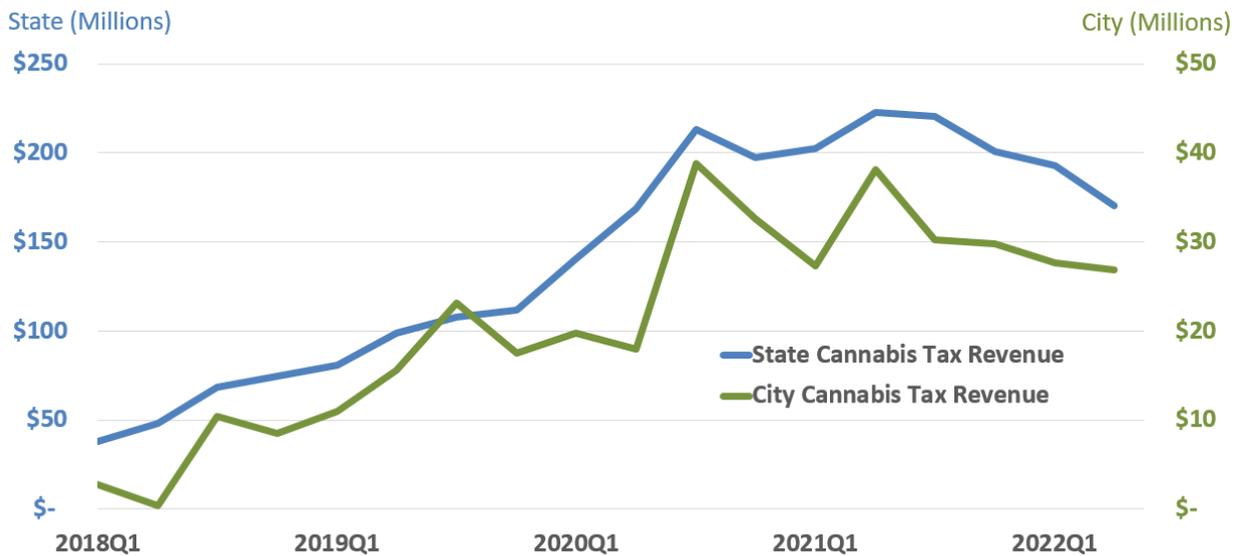


Source: Data from the California Department of Tax and Fee Administration

Even more significant was revenue from the City’s cannabis business tax, which showed substantial growth during its initial four years. Cannabis business taxes experienced year-over-year increase of more than 70% in both FY 2020 and FY 2021. From January 2018 to December 2021, the City collected more than \$320 million in cannabis business taxes.

However, cannabis business taxes have slowed in recent months. Cannabis business tax revenue is \$51 million lower than budgeted FY 2022. This slowdown in the City’s cannabis business tax revenues follows a similar pattern to the State’s cannabis tax revenues. **The recent slowdown in cannabis business taxes may be caused by various factors, including recent inflation, peak in consumption, and competition with the unlicensed market.**

Figure 4. Cannabis Tax Revenues for both the State and City Have Recently Declined



Source: State Data from CDTFA, City data from Budget Documents and Office of Finance

Currently, cannabis business taxes go to the General Fund and are spent on general City services. However, the Council has expressed several policy preferences on how the City should spend cannabis taxes to benefit those affected by cannabis, including support for social equity or to fund public works projects for communities near cannabis businesses. **To protect cannabis tax revenue and raise funding to allocate towards policymaker priorities, the City will need to shut down more unlicensed cannabis businesses and steer consumers to licensed cannabis businesses.**

EXPANDING ENFORCEMENT STRATEGIES

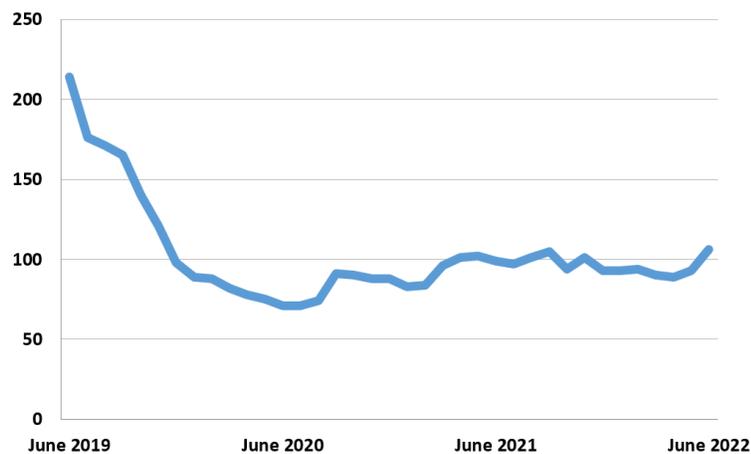
The City's past experience with illegal cannabis activities and its negative impacts, including increased criminal activity, sales to minors, and urban blight, highlight the need for effective regulation and enforcement. To that end, Measure M provided the City with enforcement tools to shut down existing unlicensed cannabis businesses, and discourage operators and property owners from engaging in or allowing illegal commercial cannabis activities.

Through the combined efforts of the Cannabis Enforcement Taskforce and the City Attorney's Office, **LAPD's monthly report of active unlicensed cannabis businesses has decreased from 297 in 2018 to 106 as of June 2022.** While this decrease in reported unlicensed cannabis businesses has been touted as a measure of progress for the City, it has its limitations.

The total number of known unlicensed cannabis businesses comes from complaints, service calls, and referrals received by the City, and businesses identified by each of LAPD's 21

geographic divisions. LAPD acknowledges that its report tends to focus on more conspicuous types of cannabis businesses like retail storefronts because illegal cultivation and manufacturing sites are more difficult to identify. **The actual number of unlicensed cannabis businesses in the City is likely higher than reported.**

Figure 5. The Number of Unlicensed Cannabis Businesses Has Not Changed Much Since 2020



Source: Available data from LAPD

Despite these limitations in identifying unlicensed cannabis businesses, **the total number has not changed significantly and has remained at or around 100 over the last two years.** For the purposes of this report, LAPD could not provide the names and locations of unlicensed cannabis businesses that were the subject of enforcement actions, which they say are not stored centrally. **However, month-to-month changes in LAPD's report suggest**

that unlicensed cannabis businesses continue to open almost as quickly as the City can shut them down.

As described below, the City's criminal enforcement of unlicensed cannabis violations is an important tool. But it has difficulties deterring more businesses from engaging in unlicensed commercial cannabis activities. Meanwhile, other enforcement methods used by the Taskforce can be effective but are no easy fix. To make more headway, the City should consider adopting additional enforcement tools to continue putting pressure on property owners and unlicensed cannabis businesses to shut down.

Criminal Enforcement's Ability to Discourage Unlicensed Cannabis is Limited

While traditional law enforcement approaches seek to deter crime with the threat or act of punishment, subject matter experts have questioned that method of operation. For example, in a 2016 paper, the National Institute of Justice (the US Department of Justice's research agency) summarized a large body of research on criminal deterrence and asserted that "increasing the severity of punishment does little to deter crime" and that "sending an individual convicted of a crime to prison is not a very effective way to deter crime."

This change in thinking has manifested into a variety of criminal justice reforms in recent years. For example, Proposition 47 (2014) reclassified a variety of “nonserious” and “nonviolent” crimes as misdemeanors instead of felonies, resulting in reduced criminal penalties. Similarly, the authors behind Prop 64 viewed many drug offenses, such as marijuana sales, as nonviolent, and sought to reduce criminal penalties to match the “minor” nature of the crime.

If tougher punishments held any power to deter crimes from happening, Prop 64’s reduction in criminal penalties for a variety of marijuana-related offenses means that traditional law enforcement methods are less likely to prevent unlicensed cannabis businesses from opening. Nevertheless, the City is still dedicating a significant portion of its enforcement resources towards criminal enforcement methods like criminal search warrants and criminal prosecution.

Criminal Search Warrants

When executing a search warrant, LAPD will search all employees and other personnel on-site (often resulting in arrests) and seize all cannabis products, currency, firearms, and any other property that could constitute evidence showing that the crime of operating an unlicensed cannabis business has occurred.

However, search warrants are costly to execute. Due to the number of sworn officers and time involved, LAPD estimates that each search warrant in FY 2022 for unlicensed cannabis costs about \$15,800 in straight time to conduct. But LAPD’s Narcotics Enforcement Details have multiple priorities besides unlicensed cannabis enforcement. **According to LAPD, most search warrants are conducted by sworn LAPD officers on overtime, increasing the cost of unlicensed cannabis enforcement.**

Although making arrests and seizing contraband can make it more difficult for unlicensed cannabis businesses to operate, LAPD notes that the most persistent operators will quickly reopen. Enforcement against unlicensed cannabis is a significant drain on public resources as LAPD has executed more than 1,200 search warrants between 2018 and 2021. **According to LAPD, some unlicensed cannabis business locations will reopen within days or even hours after a search warrant is executed, and will likely be the site of more search warrants.**

Table 5. Outcomes from Search Warrants at Unlicensed Cannabis Businesses

Search Warrant Outcomes	Number
Felony Arrests	1,516
Misdemeanor Arrests	1,698
Currency Seized	\$8,084,725
Guns Recovered	482
Pounds of Cannabis Seized	418,860

Source: LAPD. Available data from 2018 to 2021

Criminal Litigation

Following the execution of criminal search warrants, LAPD will refer misdemeanor cases to the City Attorney's Office for prosecution. Under the Los Angeles Municipal Code (LAMC), operating, working at, or renting property to an unlicensed cannabis business is classified as a misdemeanor. Those convicted can be punished with up to six months of jail time and/or up to \$1,000 in criminal fines.

From January 2018 through June 2022, the City Attorney's Office has exercised its prosecutorial discretion to file 863 criminal complaints as part of its enforcement efforts against unlicensed commercial cannabis activities. Available data from the City Attorney's Office showed that 83% (548) of the 654 criminal cases filed in 2020 and 2021 with a disposition as of February 2022 were either diverted from criminal prosecution or had their cases dismissed.

According to the City Attorney's Office, the number of court diversions is largely outside their control. State legislation (Assembly Bill 3234, 2020) authorizes Superior Court judges to divert a misdemeanor case from the proceeding with criminal prosecution, even over the objection of prosecuting attorneys. Cases are dismissed at the end of the court-determined diversion period if the defendant has complied with the judge's terms, conditions, and programs deemed appropriate.

The City Attorney's Office explained that while the courts will offer criminal diversion for unlicensed cannabis business violations, one of the terms and conditions of diversion is almost always a prohibition on engaging in further illegal commercial cannabis activity. In this way, the City Attorney's Office reports that it still successfully closes unlicensed cannabis businesses, even while many cases are being diverted from further prosecution.

The actual penalties are often low for cases that result in a misdemeanor verdict or plea. The City Attorney's Office stated that very few defendants for unlicensed cannabis violation cases have ever served jail time. The City Attorney's Office also explained that for those who are sentenced with jail time, defendants often do not serve their entire sentence due to early release policies. If imposed by the court, misdemeanor fines that top out at \$1,000 also do not represent a significant punishment for a commercial crime as profitable as unlicensed cannabis.

Even if criminal penalties are not high, a criminal conviction alone may be enough for some types of defendants to avoid unlicensed cannabis violations. The City Attorney's Office stated that criminal prosecution is a valuable tool in enforcement against property owners because they tend to be highly motivated to avoid or mitigate the damage of a criminal record.

However, for those who regard a misdemeanor criminal record with little consequence, the

outcomes of criminal enforcement are unlikely to deter them from participating in illicit commercial cannabis activity.

The City's Other Enforcement Methods Have Had Mixed Results

While a significant portion of the City's enforcement resources is used for criminal enforcement methods, the City has also deployed other methods. These include code enforcement, civil litigation, utility disconnects, and installing protective devices to abate the unlicensed commercial cannabis activity. Though encouraging, these other enforcement methods are not always effective at deterring unlicensed cannabis businesses.

Building and Fire Code Inspections

Although LADBS and LAFD's efforts are directed at the property owner, code enforcement does not currently address the unlicensed cannabis business at the root of the problem. During inspections, LADBS and LAFD focus on code violations related to the building structure and fire/life safety hazards. According to LADBS, their enforcement efforts typically do not note the unlicensed cannabis business activity that likely caused the code violations.

Code enforcement also follows the misdemeanor prosecution route. LADBS explained that only about 20% of property owners at unlicensed cannabis businesses responded to the department's initial Order to Comply to correct building code violations. After that, many cases are referred to the City Attorney's Office for prosecution. LAFD's route to criminal prosecution is even faster, as all fire code violations are packaged as a criminal referral. According to the City Attorney's Office, criminal cases for code enforcement issues are only settled after the violations have been resolved.

While criminal prosecution may be effective in resolving the specific code violations, it is unclear how effective they are for preventing or discouraging the unlicensed commercial cannabis activity that likely caused the violations.

Civil Litigation

Measure M's authors noted that it was necessary to have large monetary penalties to "prevent persons and entities from opening and operating...illegal...cannabis businesses and to discourage property owners from renting to these kind[s] of...cannabis businesses." In addition, the authors of Measure M believed that "large monetary sanctions are a rational way to discourage the proliferation of illegal businesses." Under Measure M, large monetary penalties can be obtained as a remedy through civil litigation in the form of a \$20,000 maximum penalty for each day of violation.

From 2018 through June 2022, the City Attorney's Office filed eight civil complaints for the following alleged violations and requested remedies.

Table 6. Alleged Civil Violations by Unlicensed Cannabis Businesses

Alleged Violation	Code or State Law	Summary of Requested Remedies
Unlicensed Commercial Cannabis Activity	LAMC 104.15	Temporary restraining order, preliminary and permanent injunction, civil penalty up to \$20,000 per day in violation, other costs
Unpermitted Use	LAMC 12.21	Temporary restraining order, preliminary and permanent injunction, civil penalty up to \$2,500 per day in violation, other costs
Public Nuisance	Civil Code 3479	Permanent injunction, abatement order
Drug Abatement	Health and Safety Code 11570-11587	Temporary restraining order, preliminary and permanent injunction, civil penalty up to \$25,000
Unfair Competition	Business and Professions Code 17200-17210	Temporary restraining order, preliminary and permanent injunction, receivership, civil penalty of \$2,500 for each violation

Source: City Attorney's Office and Civil Complaints Filed

However, the time and resources required to pursue civil litigation against unlicensed cannabis violators make it impractical as an enforcement tool in most cases. The City Attorney's Office also clarified that civil courts tend toward settlement as opposed to trial. As a result, many civil cases against property owners reach a stipulated judgment that includes permanent injunctive terms barring unlicensed commercial cannabis activities on any of their properties, and deferred or substantially reduced civil penalties compared to the maximum that could be obtained through trial.

For example, in one civil case, the City Attorney's Office collected over \$41 million in default judgments, most of which comprised of the \$20,000 per violation civil penalty applied to hundreds of violation days against the business operators. Meanwhile, the City Attorney's Office settled with the property owners for \$350,000 in civil penalties, and a permanent injunction preventing them from participating in or renting to any commercial cannabis activity in Los Angeles.

Five of the eight civil cases filed have an outcome as of June 2022, with most cases requiring one to two years to reach a point of resolution. Where the City has been awarded default judgments because the defendant did not answer the lawsuit, the City Attorney's Office

explained that those judgments are often difficult to collect and require locating the violator and identifying their assets.

The time and resources required, and the realities of civil litigation as presented by the City Attorney's Office, undercut Measure M's premise that a large monetary penalty obtained through public nuisance abatement cases can be relied upon to deter unlicensed cannabis businesses from opening.

Utility Disconnects and Installing Protective Devices

In early 2019, LADWP began disconnecting utilities at unlicensed cannabis business locations. While the loss of power can significantly disrupt operations, anecdotally, **LAPD estimates that half of unlicensed cannabis businesses that had their utilities disconnected have re-opened.** These businesses have been known to rely on generators, steal or borrow power from their neighbors, or reconnect the power after being disconnected.

Installing protective devices (padlock, barricade, and fencing) on an unlicensed cannabis business can also be effective in some situations, but is not a foolproof method. LAPD also estimates that about half of padlocked unlicensed cannabis businesses re-open after removing the protective devices. **We attempted to call each of the 17 locations that were padlocked between October 2021 and May 2022 and found three had re-opened while four more provided information about alternative locations.**

The City's Enforcement Strategy Could Use More Tools to Hold Property Owners Accountable

While no single enforcement method can guarantee compliance, the City should consider using every tool at its disposal to shut down unlicensed cannabis businesses. Given the challenges with criminal enforcement and civil litigation, there are other methods that the City can use to both threaten and impose significant financial consequences as a way to discourage illegal cannabis businesses from opening in the first place.

The following is a non-exhaustive list of additional enforcement tools that the City could use to supplement its current approach. These tools would allow the Cannabis Enforcement Taskforce to apply more pressure on property owners to ensure that unlicensed cannabis activity is not occurring on their property.

Issuing Citations for Causing or Allowing Unlicensed Commercial Cannabis Activity

The City Council can authorize departments to enforce certain violations of the City's code through the Administrative Citation Enforcement (ACE) program. **ACE was designed as an**

alternative enforcement mechanism to: (1) deter code violations; and (2) reduce the amount of City resources used for enforcement, thereby freeing up City Attorney legal resources and court dockets for more serious violations and civil actions. In addition, issuing citations does not waive the City's right to pursue criminal, civil, and other legal remedies.

As an alternative to criminal enforcement, the City Attorney's Office has issued over 1,380 ACE citations to employees of unlicensed cannabis businesses who have no financial interest in the business. **However, the ACE program can also be used to address violations involving unpermitted or unallowed uses of buildings, structures, or land.**

Unlicensed commercial cannabis activity is a clear example of unallowed land use. Under its well-established authority to control land use within Los Angeles, the City's cannabis ordinances make it unlawful for property owners to rent, lease, or otherwise allow any commercial cannabis activity to occupy or use their building or land without a license from the State and DCR. In addition, commercial cannabis activity is not a permitted use in any zone, making unlicensed cannabis businesses a violation of the City's Planning and Zoning code.

To cite property owners or other persons responsible for causing or allowing unlicensed commercial cannabis activity, the Council could authorize LADBS or another City department to issue ACE citations for unallowed land use. Although LADBS is granted the power to enforce the City's zoning ordinances, the department views unlicensed commercial cannabis activities as a drug enforcement issue best handled by law enforcement. Regardless of which entity the Council designates as the issuing department for ACE citations, the associated fines for land use violations could be a large enough monetary penalty to discourage property owner from renting to unlicensed cannabis businesses.

Table 7 demonstrates that, in some situations, an ACE fine for unpermitted use could exceed the City's \$20,000 per day maximum civil penalty for unlicensed cannabis violations. ACE fines would also be easier to issue when compared to the \$20,000 per day maximum civil penalty that can only be obtained through court judgment after resource-intensive civil litigation.

Table 7. Administrative Fines for Unlicensed Cannabis Can Be Very Costly

Square Footage of the Improvement or Use in Violation	Administrative Fine (Quadrupled)* Per Day of Violation		
	First Violation	Second Violation	Third and Subsequent Violations
250 to less than 500	\$1,000 (\$4,000)	\$2,000 (\$8,000)	\$4,000 (\$16,000)
500 to less than 2,500	\$2,000 (\$8,000)	\$4,000 (\$16,000)	\$8,000 (\$32,000)
2,500 to less than 5,000	\$3,000 (\$12,000)	\$6,000 (\$24,000)	\$12,000 (\$48,000)
5,000 to less than 10,000	\$4,000 (\$16,000)	\$8,000 (\$32,000)	\$16,000 (\$64,000)
10,000 to less than 25,000	\$8,000 (\$32,000)	\$16,000 (\$64,000)	\$32,000 (\$128,000)
25,000 or more	\$16,000 (\$64,000)	\$32,000 (\$128,000)	\$64,000 (\$256,000)

Source: LAMC 11.2.04(a)(2)

*Fines are quadrupled if no permit could have been obtained and no variance was sought.

ACE citations for unallowed land use are a continuing violation that must be corrected. **The department issuing the ACE citation would have to provide property owners with a reasonable amount of time to stop the unlicensed commercial cannabis activity,** and issue fines that accrue daily if left uncorrected. Continued noncompliance could result in substantial penalties for violators. Further, since cannabis-related activities are not a land use for which the City can issue a permit, violators can be subject to administrative fines of four times the normal amount set for land use violations.

For property owners concerned about the threat of significant monetary penalties, ACE citations are a readily available tool that the City could use. For example, the City of Santa Ana reported some success in using administrative fines in its fight against unlicensed cannabis businesses. Santa Ana code enforcement officers issued administrative citations and fines to property owners for \$1,000, \$2,500, and \$5,000 for the 1st, 2nd, and subsequent violations for renting to unlicensed cannabis businesses. In describing its process, **Santa Ana code enforcement officials emphasized the importance of maintaining pressure on the unlicensed cannabis business from multiple angles to obtain compliance.**

As another example, Los Angeles County is in the process of implementing an administrative penalty geared specifically against unpermitted cannabis activities. In January 2022, the Board of Supervisors adopted a nuisance abatement ordinance allowing the County's Department of Regional Planning to issue notices of violation and orders to abate unpermitted commercial cannabis activities. Mirroring penalties codified in State law, the Department of Regional Planning is also authorized to impose administrative penalties of up to \$30,000 per day if the property owner does not cooperate to stop unpermitted cannabis activities on their property.

To move forward, departments participating in the Cannabis Enforcement Taskforce, with the assistance of the City Attorney's Office, should work together to determine how they can use ACE citations against property owners and other persons responsible for causing or allowing unlicensed cannabis businesses.

Policymakers should also consider updating the ACE program. In particular, the following changes should be made to meet current needs.

- **Updated fine amounts** – Fines for unpermitted improvements and use have remained the same since ACE was enacted in 2013 and could be updated to match inflation. The original Council motion requested that fines be automatically updated to keep up with inflation, but this was ultimately left out of the ordinance enacting ACE.
- **Clear collection procedures** – The ACE ordinance is not clear on how the City should collect unpaid fines. The LAMC could be updated with specific administrative procedures to allow the City to place uncollected ACE costs: (1) onto the County's tax roll as a special assessment against the parcel of land; or (2) as a lien on the property where the unpermitted improvement or unpermitted use violation occurred. This could make it easier for the City to impose costs on property owners that lease to unlicensed cannabis businesses.
- **Fines for illegal cannabis cultivation** – Recent State legislation (AB 2164, 2018) would allow the City to amend its ACE program to target illegal cannabis cultivation, as described below.

While the Taskforce's efforts are mainly focused on unlicensed dispensaries, illegal cannabis cultivation sites are also a concern in the City. Indoor cultivations often require a significant amount of power to operate, and could overload the system and pose a danger to the City's electrical power infrastructure.

To combat this growing problem, the City could adopt an ordinance modifying its ACE program to allow for the **immediate** imposition of fines for violations that exist as a result of, or to facilitate, the illegal cultivation of cannabis. Under AB 2164, the City is only required to provide a reasonable period of time to correct the problem in certain situations.

To avoid the immediate imposition of fines, the property owner must demonstrate that: (1) the tenant is in possession of the property; (2) the lease agreement prohibits the cultivation of cannabis; and (3) they did not know, or have actual notice, that the tenant was illegally cultivating cannabis. This is where City's cease-and-desist letters become useful in providing actual notice.

Cannabis Enforcement Costs Can Be Imposed as a Lien

In 2019, the Council passed an ordinance authorizing departments to recover costs for enforcement actions against unlicensed cannabis businesses. The legislative rationale and intent behind the ordinance was that enforcement costs are a drain on public resources that should be borne by the property owners renting to unlicensed cannabis businesses.

Following the ordinance's passage, the City Administrative Officer (CAO) requested the departments participating in unlicensed cannabis enforcement to compile and submit cost reports. Recoverable costs include direct and indirect costs for administrative and civil actions, while costs related to criminal enforcement are not allowed under State law. However, only LAPD and LADWP have, so far, regularly prepared reports on their recoverable enforcement costs to the CAO.

Enforcement costs for administrative and civil actions can quickly add up. Based on available cost reports, the average cost for LADWP to disconnect utilities was about \$640, but could vary widely depending on site-specific circumstances. LAPD's recoverable enforcement costs in 2020 averaged over \$4,400 per location. If reported, LADBS and LAFD's code inspection costs can also be included. In addition, contract costs for padlocking a property are estimated to average \$5,000 per site. The LAMC also allows the City to add a 40% administrative fee on top of enforcement costs proposed as a lien. But despite these potentially high costs, **no departments have submitted their unlicensed cannabis enforcement costs to the City Council to be recorded as a lien.**

To impose enforcement costs as a lien, participating enforcement departments should track costs on a location-specific basis. Cost reports prepared by LAPD and LADWP so far have combined all enforcement costs to report a per quarter or per year total. But since enforcement actions take place at hundreds of locations each year, it may be cost-prohibitive to track and impose liens on every location. The Cannabis Enforcement Taskforce should develop a policy to prioritize which locations should have a lien imposed.

In addition, the Taskforce should develop procedures to report costs as a proposed lien for the Council's confirmation, following requirements laid out in the Los Angeles Administrative Code (LAAC) 7.35.3 or any other applicable law.

Receiverships can be used to take control of properties housing unlicensed cannabis businesses

As a last resort, the City Attorney's Office may consider incorporating receiverships as part of its litigation strategy to shut down unlicensed cannabis businesses. Receivers are court-appointed officers who carry out and enforce the court's orders. If no other enforcement methods are

likely to be effective, cities can petition the court to appoint a receiver that temporarily takes control of a property to abate a nuisance. We found several examples of other cities that successfully used receiverships to shut down unlicensed cannabis businesses.

The City of Riverside used receiverships extensively as part of its enforcement efforts. According to an Assistant City Attorney at the Riverside City Attorney's Office, receiverships were a critical tool in its strategy to shut down over 30 illegal dispensaries between 2016 and 2018. While Riverside found early success in asking the court for an immediate order to appoint a receiver, the city had to change tactics in later years as the court became more willing to give property owners an opportunity to comply before moving to the drastic measure of taking over their property.

To address this issue, the Assistant City Attorney explained that Riverside was often able to get a temporary restraining order long before the civil case reached a judgment. Under the CA Drug Abatement Act, **the State legislature declared that every building or place used to unlawfully sell, serve, store, keep, manufacture, or give away any controlled substance (including cannabis) is a nuisance that must be enjoined, abated, and prevented.** If a prosecuting city attorney can demonstrate that a building is being used in this way, the court is **required** to allow a temporary restraining order or injunction to abate and prevent the continuance or recurrence of the nuisance.

In Riverside's experience, illegal dispensaries typically continued operating in violation of the restraining order, resulting in the court's appointment of a receiver to enforce the court's order. The receiver would then be empowered to take full possession of the property and immediately remove the illegal cannabis business.

Just the threat of losing their property could be enough to convince some property owners to stop leasing to unlicensed cannabis businesses. Should the City Attorney's Office consider using receiverships in the future, then the City's cease-and-desist letters should be modified to make it clear to property owners that their property could be the subject of a receivership takeover.

Successfully using court-appointed receivers was a turning point for Riverside's enforcement efforts against illegal cannabis businesses. **According to Riverside's Assistant City Attorney, holding the property owner responsible was critical for stopping new illegal marijuana storefronts from opening up.** Several other local jurisdictions, including Santa Ana, Jurupa Valley, and others have used receivers to shut down illegal cannabis businesses.

Per the CA Health and Safety Code, receiverships can also be appointed to take control of a substandard building that poses a danger to the health and safety of residents or the public. **During inspections at unlicensed cannabis businesses, LADBS and LAFD often find significant**

building and fire code violations—including unapproved electrical work, unpermitted partition walls, and lack of exits—that meet the State’s definition for substandard buildings. Unlicensed cannabis businesses are also a nuisance under the City’s ordinance, another substandard building condition.

Although typically used for residential properties, it is possible to use Health and Safety Code receiverships to take control of substandard commercial buildings as long as the City can make the case that a receiver is needed to remedy the situation. For example, Santa Ana’s City Council approved their City Attorney to use Health and Safety Code receiverships in at least four properties that housed six different illegal dispensaries. In its petition to appoint a receiver, Santa Ana described in detail the substandard conditions at the unlicensed cannabis business, as well as the extensive law enforcement and code enforcement efforts that have failed to bring it into compliance.

If appointed, Health and Safety receiverships offer several other advantages to address unlicensed cannabis businesses that refuse to shut down.

- **Getting other parties involved** – All persons with a recorded interest in the property, such as the mortgage-holding bank, must be notified that a petition for a receivership will be filed. These recorded interests could step in to require the property owner to stop the unlicensed cannabis activity.
- **Receivership costs are the property owner’s responsibility** – The receiver’s costs for managing and repairing the property are the property owner’s responsibility, and can be imposed by the court as a super priority lien above all other liens. The receiver can even enter into contracts, collect rents, and use the property as collateral to borrow and pay for repairs to correct violations on the property.
- **City enforcement costs may be recovered** – If a substandard building is found to substantially endanger the health and safety of residents or the public, the court is required to order the property owner to pay for the City’s reasonable and actual costs, including for inspections, investigations, enforcement actions, attorney fees or costs, and all costs of prosecution.

Although receiverships are a powerful remedy, obtaining them is not without challenges. The City Attorney’s Office notes that the courts are hesitant to implement receiverships, and that other cities that have used it to shut down illegal cannabis businesses do not have to contend with Los Angeles’ scale. While that may be true, receiverships may still be an effective, albeit drastic, remedy to shut down the most stubborn unlicensed cannabis businesses.

Recommendations

With some planning and coordination, the three enforcement tools described above are readily available for the City to use. However, they are by no means an exhaustive list of methods and tactics. **To continue shutting down unlicensed cannabis businesses, the City should explore using any and all tools to hold property owners responsible for allowing unlawful activities to occur on their property.**

To update its provisions to meet current needs and use the Administrative Citation Enforcement (ACE) Program against unlicensed cannabis businesses, the City Council should consider the following:

1. Instruct LAPD and LADBS, with the assistance of the City Attorney's Office and other relevant departments, to report back on how the Cannabis Enforcement Taskforce could begin issuing administrative citations and fines to unlicensed cannabis businesses and property owners for the unpermitted improvements and unallowed uses they have caused or allowed. The report back should include:
 - a. A decision on which department should issue administration citations for causing or allowing unlicensed cannabis businesses.
 - b. The process by which administration citations and fines would be issued as part of the Cannabis Enforcement Taskforce's progressive enforcement model.
 - c. A determination if fines for unlicensed commercial cannabis activities can be quadrupled because cannabis-related activities are not a land use for which the City can issue a permit.
 - d. Any necessary ordinance changes to facilitate the Cannabis Enforcement Taskforce's use of ACE citations and fines against unlicensed cannabis businesses.
2. Request the City Attorney's Office for a report back evaluating the feasibility and implementation options for the following:
 - a. Adopting any necessary changes requested by LAPD and LADBS to facilitate the Cannabis Enforcement Taskforce's use of ACE citations and fines against unlicensed cannabis businesses.
 - b. Adding provisions to the ACE ordinance to target illegal cannabis cultivation, per Assembly Bill 2164 (2018), so that fines can be immediately imposed for violations that exist as a result of, or to facilitate, the illegal cultivation of cannabis.
 - c. Updating administrative fine amounts to track inflation.

- d. Creating collection procedures so that unpaid fines can be administratively imposed as a lien or special assessment.

To impose liens onto property owners for recoverable costs related to unlicensed cannabis enforcement:

3. The Cannabis Enforcement Taskforce, with the assistance of the City Administrative Officer, should develop protocols for selecting which properties will be subject to a proposed lien, and procedures for tracking, reporting, and confirming enforcement costs as a lien for allowing unlicensed cannabis businesses to operate.

Finally, as a drastic remedy to shut down the most uncooperative unlicensed cannabis businesses:

4. The City Attorney's Office should, as part of its civil litigation strategy, consider petitioning the court for a receivership to take control of unlicensed cannabis businesses and the property they occupy.

REGULATORY MONITORING OF LICENSEES IS LACKING

The City enacted Measure M to license and regulate commercial cannabis activity and mitigate its potentially negative impacts, which include: (1) increases in use, particularly among youth; (2) quality-of-life issues for neighborhoods and communities near cannabis businesses; and (3) other unlawful activities such as drug trafficking or product diversion to or from the unlicensed market.

While the 2021 LA County Public Health study found that unlicensed cannabis businesses were more likely to engage in concerning practices, the study also found that licensed dispensaries also had issues. For example, the public health researchers found that, among the 37 licensed dispensaries visited in late 2018 and early 2019, five offered free samples and two sold illegal high-potency cannabis products. Although licensed to operate as a legal cannabis business, a strong regulatory presence is still needed to mitigate the potential harm to consumers.

To create and maintain a well-regulated industry that protects Angelenos from the potential harms of cannabis-related activity, DCR must monitor and enforce licensee compliance with State and local laws.

Thousands of Cannabis-Related Complaints Have Not Been Addressed

DCR receives complaints primarily through an online complaint portal on its website. From January 2018 through June 2022, DCR received over 7,300 cannabis-related complaints. **Table 8** shows the workflow status, including 800 complaints that have been referred to LAPD for unlicensed cannabis enforcement, and 240 kept by DCR for further investigation because it relates to their licensees. Another 1,247 complaints have case notes or other activity indicating some level of review and action by DCR.

Table 8. DCR Has Not Processed Over 5,000 Cannabis-Related Complaints

Workflow Status	Number
Unprocessed	5,056
Some Activity by DCR	1,247
Referred to LAPD	800
Kept for DCR Enforcement	240
No Status	4
Total	7,347

Source: DCR. Available data from 2018 to 6/15/22

However, more than 5,000 complaints remain unprocessed with no indication of their work status. We reviewed a limited number of unprocessed complaints and found that many could generally be categorized as follows:

- personal cannabis use, which DCR does not regulate;
- alleged unlicensed commercial cannabis activity, which would be referred to LAPD;
- quality-of-life issues in connection with a licensed cannabis business, such as customer behavior in the public, which DCR believes is outside their regulatory purview; and
- complaints against licensed cannabis businesses that DCR should investigate.

While we could not review and categorize all 5,000 unprocessed complaints, **we found troubling allegations against licensed cannabis businesses, such as sales to minors and onsite cannabis consumption by employees—which are exactly the types of business behaviors and practices that DCR was established to regulate.**

We identified one example which highlights the serious risks associated with a regulatory system that is unable to vet and investigate public health and safety concerns. DCR received a complaint about one licensed cannabis business that sold products that made consumers sick. **A few months before it issued the business' cannabis license, DCR received its first complaint about a customer that became violently ill after consuming a cannabis product that the business sold without a retail license.** At the time of the complaint, the business in question was in the process of applying for its license to conduct cannabis cultivation, manufacturing,

and distribution, all of which are non-retail activities that involve sales from one licensee to another licensee.

Since then, DCR has received several more complaints about the business, though those complaints remain unprocessed. DCR referred the initial complaint to LAPD to investigate the allegation of unlicensed cannabis activity. But, per its 2018 cannabis enforcement guidelines, LAPD has deferred the complaint to DCR because the matter involves a business licensed by DCR. Though the complaints remain unsubstantiated, they raise enough concerns to warrant an investigation by DCR. **During the course of our review, the business in question was still licensed for non-retail activities and continues to sell cannabis products to the public on its website.**

Many of the same types of troubling allegations can be found among complaints retained by DCR for further investigation and potential enforcement. Among the 240 complaints that DCR retained, 157 were still open or pending review as of June 2022. These 157 complaints also include allegations related to sales to minors, onsite consumption, and unlicensed activities by licensed businesses.

DCR explained that it does not currently have the staff resources in place to investigate these complaints. In 2021, DCR submitted a request for positions that would focus on regulatory compliance, which was not acted on. Currently, DCR's Licensing, Compliance, and Commission Support Unit is responsible for reviewing applications, as well as investigating complaints regarding commercial cannabis activity, and monitoring the compliance of licensed cannabis business. **But given the public scrutiny DCR has faced, the Licensing, Compliance, and Commission Support Unit has mainly focused on application and license reviews. Investigations and compliance monitoring have suffered as a result.**

In addition, DCR has not been able to hire and retain its special investigators. Through a work-sharing agreement with the Personnel Department, two special investigator positions are authorized and assigned to DCR to conduct complaint investigations. However, according to DCR, they have historically had problems hiring and retaining personnel for those positions and there is currently only one investigator.

As part of its State grant received in December 2021, DCR is now in the process of establishing a separate Compliance and Enforcement Division. According to the unit's program manager, DCR is in the middle of the hiring process to bring on a total of two senior management analysts and two management analysts to supplement the special investigator that was recently hired. After these positions are filled, DCR plans to begin reviewing and investigating complaints.

DCR Has Not Conducted Periodic Inspections to Monitor Regulatory Compliance

In addition to responding to complaints, creating a well-regulated business environment requires proactive measures like periodic compliance inspections. While DCR conducts site inspections as part of its licensing and renewal process, these inspections are scheduled in advance. This gives the business ample opportunity to prepare for and pass the inspection.

However, conditions during a scheduled inspection may not represent actual business practices that could violate DCR's rules and regulations. As with unprocessed complaints, **DCR has not conducted periodic regulatory compliance inspections of its licensees because its personnel are primarily focused on application and license reviews.**

To test compliance, we visited six cannabis retail stores licensed by DCR that historically had a high number of complaints or several concerning complaints. While onsite, we looked for compliance with a number of requirements that we believed should be plainly visible or apparent, covering violation types ranging from minor to major.

Table 9. We Observed Several Regulatory Violations at Every Dispensary We Visited

Regulatory Requirement (Violation Type)	Licensed Dispensary					
	#1	#2	#3	#4	#5	#6
DCR and State license, City business tax registration, and Neighborhood Liaison contact information must be prominently displayed in an area that is within plain sight of the public (Minor)	✗	✗	✓	✗	✗	✗
"No Loitering, Public Drinking, or Public Smoking/Consumption of Cannabis" signs are clearly posted inside and outside the business premises (Minor)	✗	✗	✗	✗	✗	✗
All employees shall display an identification badge at all times while conducting business operations (Minor)	✗	✗	✓	✗	✗	✓
Sold cannabis products must be placed in an exit package that follows State requirements (i.e., child-resistant and tamper-evident, etc.) (Moderate)	✓	✗	✓	✗	✗	---*
Cannabis products shall not be readily accessible to customers without assistance (Moderate)	✓	✓	✗	✓	✓	✗
No sales through exterior openings, such as a drive through or walk-up windows (Major)	✓	✓	✓	✗	✓	✓

Source: Audit staff site visits on 8/9/2022.

*There were no customers during our site visit at this dispensary.

All six dispensaries followed certain basic requirements, such as conducting an identification check, having camera surveillance and security personnel onsite, and not providing free samples. However, we observed several regulatory violations at every dispensary we visited, including some categorized by DCR as moderate and major violations.

While most violations we observed were minor, these requirements still serve to create a well-regulated business environment. For example, five of six dispensaries we visited did not display their neighborhood liaison's contact information. Licensees are required to designate a neighborhood liaison that interacts with and takes complaints from the community. Many of the quality-of-life concerns that currently go to DCR should be addressed by the licensee and its neighborhood liaison instead.

The lack of proper exit packaging at some dispensaries was also problematic. The State requires exit packaging to be: (1) child-resistant to make it difficult for children under five years of age to open; and (2) tamper-evident to indicate to the customer if the package has been opened. **Three of the six dispensaries sold cannabis products without proper exit packaging and used simple paper bags instead.**

Two dispensaries also had cannabis products in containers that were easily accessible to customers without the assistance of the licensee's personnel. For example, the containers shown in **Figure 6** were openly displayed at the counter of a dispensary we visited, allowing any customer to walk up and inspect the quality of the cannabis. If the dispensary we visited was busier, it could have been difficult to prevent customers from taking the containers home without paying for the product.

Another dispensary we visited was in the process of upgrading its walk-up window. Sales through exterior openings, such as drive-throughs or walk-up windows, are strictly prohibited under DCR's regulations. **Major violations like this can be subject to administrative fines worth up to \$42,026 (three times the current license fee).**

Figure 6. Cannabis Products Were Easily Accessible at This Dispensary



Source: Audit staff site visits on 8/9/2022

Given how new cannabis' legal status is under State law and the lack of inspections by DCR, violations are to be expected. **DCR should make its regulatory presence known through frequent onsite visits and inspections to educate, train, and bring the industry into compliance.**

We spoke with other jurisdictions that permit cannabis businesses and found that they conducted periodic inspections at every one of their licensees' business premises. **While the scale of licensed commercial cannabis activity in these jurisdictions are smaller by comparison, their regulatory experience offers lessons for the City.** The frequency of inspections varied depending on the type of cannabis business, specific risk factors for each business type, the jurisdiction's risk tolerance, and available staff resources. To standardize the inspection process, each of the local jurisdictions also developed policies and procedures, inspection checklists, and other tools to ensure consistency.

Table 10. Other Local Jurisdictions Conducted Cannabis Inspections at Varying Frequencies

Local Jurisdiction	Inspection Frequency
Pasadena	Every 2 weeks (Dispensaries)
Sacramento (City)	Every 30 days (Dispensaries); Every 60 days (Other Types)
Yolo County	Every Month (Cultivators)
Vista	3 Times a Year (Dispensaries)

A common theme among different local jurisdictions we spoke to was a concern about product diversion to or from the unlicensed market. For example, Yolo County permits commercial cannabis cultivation in unincorporated parts of the county, and inspects their cultivator's operations monthly. According to Yolo County's inspection program manager, cannabis can grow from seed to harvest in less than three months. In his view, it is necessary to inspect his cultivators at least once a month to track the inventory of cannabis plants at each stage of the growing cycle and mitigate the risk of product diversion.

To create a well-regulated business environment, DCR should develop a regulatory compliance plan that lays out how it will begin conducting periodic and proactive inspections and investigations. DCR should follow suit and also develop the necessary policies, procedures, and protocols so that it can consistently conduct inspections and investigations, and issue progressive discipline (such as warnings, notices of violations, fines, and license revocation) for the violations it finds.

DCR Needs to Adjust Regulatory License Fees

DCR can set its own fees, subject to Council approval, to cover the cost of its regulatory regime. DCR's license fees should include the cost of reviewing applications, issuing licenses, performing investigations and inspections, and activities required to regulate the cannabis industry. **While DCR's license and application fees do include the estimated costs of issuing an annual license, it does not include the cost of periodic compliance inspections throughout the year.** If DCR had included the costs of inspections and investigations, it would have the revenue required to hire inspectors and investigators to respond to complaints and monitor regulatory compliance.

A good practice for regulatory agencies is to include the full cost of compliance and monitoring into its fees. For example, the City's tobacco retailer licensing program's annual licensing fees include the cost of enforcement efforts like the decoy program to better ensure that retailers are not selling to minors. **Other local jurisdictions we spoke to that permit commercial cannabis activities (including Sacramento, Yolo County, and Vista) fund their compliance efforts from the license fees they charge.**

As part of its regulatory compliance plan, DCR should determine the frequency and estimated cost of regular inspections, investigations, and complaint responses. Given the number of complaints about sales to minors, DCR should also consider the need to develop a decoy program to test compliance with sales to minors. DCR should then factor these costs into its license fees as part of an updated fee study for the City Council's approval.

DCR May Need to Revisit the Job Classifications Used for Its Compliance Division

DCR should continue with its hiring process to bring on new senior management analysts and management analysts so that it can begin responding to complaints and regularly inspecting licensed cannabis businesses as soon as possible. However, if DCR finds it challenging to hire suitable candidates or retain staff within its Compliance and Enforcement Division, it could be because management analyst job classifications are not the right fit for the job.

Staff in DCR's Compliance and Enforcement Division would essentially act as code enforcement officers, working in the public to enforce compliance with regulations that impact public health, public safety, and quality-of-life in the community. As code enforcement officers, DCR's management analysts would likely spend most of their time out in the field to: (1) inspect and enforce compliance at over 700 licensed cannabis businesses; and (2) respond to complaints in a timely manner.

Inherent to any code enforcement officer's job is the possibility of confrontation while interacting with members of the public that do not want to comply. In trying to gain

compliance, conflicts may be inevitable and require DCR compliance staff to practice conflict management and resolution skills to de-escalate the situation. As part of their regular job, DCR's Compliance and Enforcement staff would likely have to:

- gain access to and inspect or investigate a private cannabis business;
- interact with business employees who may be adversarial; and
- issue progressive discipline that includes warnings, notices of violation, fines, and more.

Job classifications in the City's management analyst ladder are meant to handle a wide variety of administrative functions within the City, such as budgeting, program and grant administration, or human resources. **It remains to be seen if management analysts can perform the duties of a code enforcement officer.**

If DCR is unable to hire or retain sufficient staff in its Compliance and Enforcement Division, it should consider adapting an existing classification or creating a new inspector classification. **Other cities use general code compliance officer job classifications to inspect licensed cannabis businesses.** Unfortunately, the City does not have a general code inspector or compliance officers, and instead only has specialized classifications. If DCR cannot borrow an existing inspector classification, it should consider creating one for cannabis inspections.

As part of its regulatory compliance plan, DCR should also consider staff safety. Regardless of job title or classification, State law recognizes any government employee as a code enforcement officer if they have the authority to issue citations or file formal complaints to enforce any statute, rule, regulation, or standard to meet health, safety, and welfare requirements. California Senate Bill 296 (2021) requires all local jurisdictions that employ code enforcement officers to develop safety standards. To address safety concerns arising from the line of duty, DCR regulatory compliance plan should include safety standards and training for compliance staff.

Recommendations

To improve regulatory oversight of the licensed cannabis industry in Los Angeles, the Department of Cannabis regulation should:

5. Develop and implement a comprehensive regulatory compliance plan to monitor licensed cannabis businesses and enforce compliance. At minimum, the plan and its implementation should include:

- a. Goals and objectives for regulatory compliance, including how frequently DCR plans to inspect its licensees, how quickly it will respond to complaints, and how it will prevent sales to youth through programs like decoy operations.
 - b. Policies, procedures, and other documents to standardize, streamline, and provide guidance to staff on how the department will conduct periodic inspections and investigations of licensed cannabis businesses, respond to complaints, and issue progressive discipline.
 - c. How DCR will address unprocessed and pending complaints.
 - d. Safety standards and training applicable to code enforcement officers inspecting or investigating licensed cannabis businesses.
 - e. Estimated staffing and funding requirements to implement the plan.
6. Revise its license and application fees to include the cost of carrying out its regulatory compliance plan.
 7. Consider adapting an existing or creating a new inspector or code enforcement job classification if it has difficulty hiring or retaining staff in its Compliance and Enforcement Division. Alternatively, DCR could enter into an agreement with another department to utilize inspector or code enforcement job classifications to conduct regulatory inspections of licensed cannabis businesses.

FINANCE SHOULD REEVALUATE ITS CANNABIS AUDITS

As the industry continues to mature, cannabis has become a valuable source of General Fund revenue for the City. In FY2021, business taxes from the cannabis industry alone accounted for 20% of all business taxes collected by the City. To ensure that licensed cannabis businesses are current on their tax obligations, the City's goal is to audit every business every two years.

However, as DCR licensed more cannabis businesses, Finance has struggled to keep pace with this objective.

In addition, Finance could do more to address the risk of tax evasion that is associated with cash-heavy business operations like cannabis. For tax authorities like Finance, tax evasion through cash skimming, sales system manipulation, and other methods are a real threat to their mission of generating revenue to fund government services that serve all Angelenos.

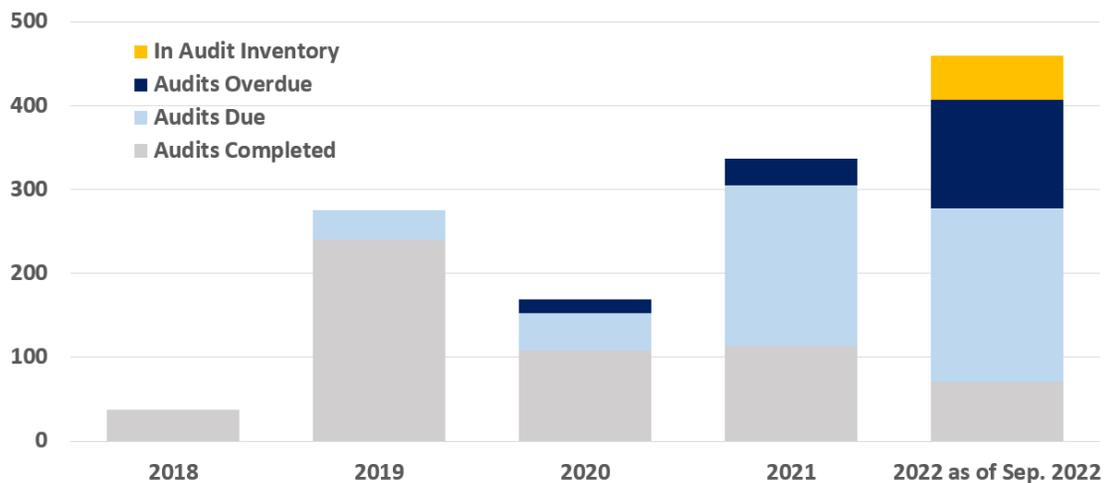
Finance Is Struggling to Keep Pace with Its Two-Year Cannabis Audit Cycle

Typically, cannabis businesses are due for their first tax audit one year after their initial registration with the department. Subsequent audits would be due two years after their last audit to maintain the two-year cycle. Beyond these timeframes, tax audits become overdue.

From 2018 to September 2022, Finance completed 568 cannabis business tax audits and identified over \$31.5 million in additional tax liabilities.

However, many cannabis businesses are overdue for an audit. **Finance must complete over 335 tax audits of cannabis businesses that are due or overdue in 2022 to keep up with its two-year audit cycle.** This includes more than 224 tax audits that were due or overdue but not completed in 2021. As of October 2022, Finance had planned to complete 53 tax audits for the year, with the remaining due or overdue audits to be rolled over into the next year.

Figure 7. Finance Has a Large Backlog of Cannabis Tax Audits Due or Overdue in 2022



Source: Analysis of Tax Audit Data from the Office of Finance

To try and keep up with the two-year audit cycle, Finance has increased the length of the tax period under review. In 2018 and 2019, Finance completed 277 tax audits, though most cannabis businesses did not have a lengthy business history to review. But beginning in 2020, a growing number of Finance’s audits have covered tax periods that are two or more years (see **Table 11**). For example, Finance completed 90 cannabis tax audits in 2021 that included tax periods covering two or more years.

Table 11. Tax Periods for Cannabis Audits Are Approaching Three Years

Length of Tax Period Being Audited	Number of Audits Completed					Total
	2018	2019	2020	2021	2022	
0 and up to 2 Years	37	240	54	23	8	362
2 and up to 2.5 years	---	---	23	26	2	51
2 and up to 3 Years	---	---	31	41	54	126
More than 3 Years	---	---	---	23	6	29
Total	37	240	108	113	70	568

As Finance's audit backlog continues to grow, it faces an increased risk that it will not recover some taxes owed to the City. The LA Municipal Code generally limits Finance to filing an action to collect delinquent business taxes from the three most recent years, though the department is also allowed to make tax assessments going back as far as six years if there is a substantial understatement of 25% or more in taxes. As of December 2021, there were 19 cannabis businesses that registered with Finance in 2018 or 2019 and that have not been audited. **If Finance were to audit these 19 businesses now, the general statute of limitations would prevent the department from filing a lawsuit to recover any taxes owed from cannabis sales before September 2019.** Finance's audit backlog will only worsen as the number of licensed cannabis businesses continues to increase.

To address this issue, Finance can either obtain more staff resources to accomplish its goal, or change its goal of auditing every cannabis business every two years. Finance completed 108 audits in 2020 and 113 audits in 2021, which the department believes is a reasonable workload that is on par with the pace of audits completed during the pandemic for other types of businesses. Finance also believes that achieving a two-year audit cycle helps to better ensure that the City will collect more taxes due from the newly legal cannabis industry; all tax periods within the three-year statute of limitations are audited for taxes due.

But unlike other commercial enterprises, the City has chosen to audit every cannabis business. **Of the 499 tax audits completed through 2021, more than one-third (172) resulted in zero additional tax liability or a refund for the cannabis business.** In addition, only 103 of the remaining 329 completed audits resulted in additional tax liabilities greater than \$50,000. By choosing to audit every cannabis business, Finance is not effectively using its tax auditors to recover the most taxes due.

Finance should reevaluate its goal to audit every cannabis business every two years, and consider a risk-based approach to select which businesses to audit. Finance could weigh business size, tax payment history, prior audit results, and other risk factors to select businesses to audit that are more likely to have large unpaid tax obligations. Otherwise, Finance should determine how many additional tax auditors it needs to meet the two-year audit cycle and present its request to policymakers for consideration.

Tax Audits Could Do More to Address Risks for Tax Evasion

From the perspective of a taxing authority, businesses that tend to transact heavily in cash—including restaurants, laundromats, and retail cannabis—have a higher risk of tax evasion that should be addressed during audits. But despite having a specialized unit dedicated to auditing

the industry, it is not clear what additional steps Finance is taking to mitigate the risk of tax evasion for cannabis sales.

Tax audits by Finance's cannabis audit unit largely consist of desk procedures that do not go far enough to provide reasonable assurance that all gross receipts from all business activities are identified and taxed appropriately. Finance's tax auditors typically establish gross receipts by reconciling total sales gleaned from accounting records, point-of-sale systems, tax returns, and other available documentation. A sample of transactions are also tested to ensure that the correct tax rate was applied, such as 10% for retail sales or 5% for verified medical sales.

Although Finance stated that their tax auditors can and do take additional steps to verify cannabis business activities, such as onsite field visits, these steps are not documented or required. **We did not find any additional procedures to address underreporting or other forms of tax evasion in Finance's cannabis audit guide or in a sample of completed tax audits we reviewed.**

Even simple steps like checking the business' website can be revealing and have implications for the tax audit. As discussed in an earlier section of this report, DCR issued a non-retail license to a cannabis business that was allegedly conducting unlicensed retail sales. Finance completed its tax audit of the same business several months later. **During the course of the tax audit, the cannabis business admitted to conducting retail cannabis sales earlier that year, which should have been a red flag for Finance to take additional steps and ensure that all gross receipts were reported.** One of those additional steps could have included reviewing the cannabis business' application to Finance for a business tax registration certificate, which showed that it began operating in 2015, which suggests that it may have taxable gross receipts long before Measure M went into effect.

While Finance could try to conduct tax audits more quickly to meet its two-year audit cycle, doing so could further compromise its ability to detect potential tax evasion. If Finance reevaluates its goal to audit every cannabis business every two years, the department should also rethink how it conducts cannabis tax audits to better assure that it can identify all taxes owed to the City.

Finance should incorporate audit techniques used by other tax authorities when facing cash-heavy industries. For example, tax audit guides from the Internal Revenue Service and the California Department of Tax and Fee Administration emphasize the need to validate operations and review the business' inventory, sales, and cash handling processes through field visits and interviews.

Information gained from these additional audit procedures help to assess the risk of underreporting and may identify areas that require further attention. If these tax evasion risks are identified, Finance's tax auditors could use well-established audit techniques, like counting sales transactions to estimate revenue, reconciling inventory changes with sales, or inspecting the sales system to potentially identify unreported transactions. Although time-consuming to conduct, these additional audit steps could be worth the investment to identify potential tax liabilities from higher risk businesses.

Finance's Protocol for Accepting Cash Payments Could Be More Efficient

To accept cash payments from cannabis businesses for business taxes and DCR's regulatory fees, Finance established a time-consuming cash-counting process to validate currency payments. For cash payments of \$1,000 or more, cannabis businesses must make an appointment and present the payment in person. To ensure accuracy, two Finance staff conduct the cash count and verify the payment amount. In addition, because large, in-person cash payments present a security risk, two LAPD officers are onsite during these appointments to safeguard the process. **According to Finance staff, a cash count appointment can range from 30 minutes to 90 minutes to conduct.**

In FY 2022, Finance accepted over 1,500 cash payments over \$1,000. These large cash payments represented 14% of transactions processed (10,638) for cannabis businesses and 21% (\$26.3 million) of revenue received (\$125.1 million). Meanwhile, the FY 2022 budget allocated for Finance's cannabis cash collection operation and LAPD's associated security services were almost \$1 million. Although Finance states that it is legally required to accept cash payments, we found that there are more efficient ways to conduct this process.

For example, the City of Sacramento does not conduct its own cash count, instead relying on the cannabis business and the city's banking partner to do it. Cannabis businesses in Sacramento are required to provide their cash payments in a bank deposit bag, which reduces their appointments down to five or ten minutes. By reducing the time required for each appointment, Sacramento staff believe that the security risk is also reduced to the point where they only need licensed security personnel onsite instead of police officers.

Sacramento then transfers the cash deposit bags to its bank to conduct a cash count to verify the amount. Because banks will always conduct a cash count, this saves Sacramento employees a step in their process. Sacramento will then debit or credit the cannabis business for any discrepancies between the taxpayer's deposit and the bank's cash count.

Recommendations

To more effectively audit and collect cannabis business taxes, Finance should:

8. Re-evaluate its goal of auditing every business every two years and consider a risk-based approach to selecting which businesses to audit.
9. Reexamine their cannabis audit procedures and incorporate additional steps to mitigate the risk of underreporting and other forms of tax evasion.
10. Explore other methods to accept cash payments from cannabis businesses more efficiently.

SPENDING PRIORITIES FOR CANNABIS TAX REVENUE

As the State and the City changed their policy stance to support legalization, a focus of the Council's policy discussion turned towards how commercial cannabis activity could be used to benefit disproportionately affected communities. For the City, this meant giving priority to cannabis license applicants that met one or more social equity criteria, such as having a prior cannabis arrest or conviction, residency status in an area disproportionately impacted by the War on Drugs, or meeting the low-income threshold level. **While DCR's social equity licensing process is still ongoing, the City has many other options to consider to make an impact.**

In 2018, City policymakers proposed the Cannabis Reinvestment Act. **If enacted, the Cannabis Reinvestment Act would have created additional cannabis taxes beyond those imposed under Measure M and allocated the revenue for specific purposes, including youth development, social equity, and new services and projects for areas affected by newly licensed cannabis businesses.** However, the Cannabis Reinvestment Act was never placed on the ballot for voters to consider.

More recently, a citizen-sponsored petition for a ballot measure known as the "Los Angeles Equity Fund: A Community Reinvestment Initiative" would have forced changes onto the current cannabis taxation regime. If passed, the initiative would reduce existing cannabis business taxes, and direct a significant portion of remaining tax revenues into a special fund for a variety of specified uses, including:

- support for social equity applicants;
- funding for enforcement against unlicensed cannabis businesses;
- job and youth programs; and
- a pilot slavery reparations program.

The petition has until March 2024 to gather enough signatures and file with the City for certification. **If the citizen-sponsored petition makes it onto the next election cycle's ballot, this would not be the first time the City would have to react to a ballot initiative that could take away its authority to set policy.**

Measure M was quickly drafted in response to a competing initiative (Measure N) that would have restricted the City's ability to create or amend regulations for commercial cannabis activities. More recently, an initiative placed on the March 2024 ballot would have allowed residents to file a lawsuit and force the City to implement Mobility Plan projects, garnering responses from the Council to find alternatives to carry out the Mobility Plan.

The fact that the petition for the LA Equity Fund initiative was approved for circulation demonstrates an ongoing debate on spending priorities the City should engage with. To inform the legislative discussion, the sections below describe how the City treats its cannabis business taxes, highlight several ways other jurisdictions have used their cannabis tax revenue, and provide several policy options for the City Council to consider.

The City Does Not Allocate Cannabis Business Taxes for Any Special Purposes

Like property tax revenue, sales tax, and other business taxes, cannabis business taxes are deposited into the General Fund to fund general City services. As a valuable source of General Fund revenue, cannabis business taxes are not earmarked for any special purpose. However, the City can make General Fund appropriations to achieve specific policy goals tied to commercial cannabis activities. By contrast, DCR's fees and other fund sources that make up the Cannabis Regulation Special Trust Fund can only be spent on activities related to DCR and its mission of regulating licensed cannabis businesses.

Since the FY 2019 annual budget process, the City has budgeted some General Fund revenues for cannabis-related purposes, as shown in **Table 12**. While City policymakers have made changes to the annual budget throughout the fiscal year due to changing budget constraints and competing priorities, **as a proportion of the cannabis business tax, the City has budgeted between 7% and 30% towards cannabis-related items.**

Table 12. The City Has Budgeted Some General Fund Revenue for Cannabis-Related Items

Cannabis-Related Spending from the General Fund (Annual Budget)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
Expected Revenue from the Cannabis Business Tax	\$45.4 M	\$64.4 M	\$99.3 M	\$157.0 M	\$154.7 M
Unlicensed Businesses Enforcement	\$3.8 M	\$13.7 M	\$8.3 M	\$10.9 M	\$8.2M
LAPD	\$2.4 M	\$10.0 M	\$5.0 M	\$5.0 M	\$5.0 M
City Attorney	\$1.4 M	\$1.5 M	\$1.7 M	\$1.9 M	\$1.7 M
LAFD	---	\$2.2 M	\$1.6 M	\$2.0 M	\$0.9 M
LADBS	---	---	---	---	\$0.5 M
DCR	---	---	---	---	\$0.1 M
Commercial Cannabis Business Enforcement (Unappropriated Budget)	---	---	---	\$2.0 M	---
Cannabis Tax Administration	\$1.7 M	\$0.6 M	\$0.5 M	\$0.5 M	\$0.5 M
Finance: Tax Audit Unit*	\$0.5 M	---	---	---	---
Finance: Secure Cash Acceptance	\$0.6 M	\$0.6 M	\$0.5 M	\$0.5 M	\$0.5 M
Finance: Security and Other*	\$0.5 M	---	---	---	---
Cannabis Regulation	\$1.1 M	\$4.9 M	---	---	\$3.0 M
Public Information Campaign	---	\$1.0 M	---	---	---
Social Equity Support	---	\$3.0 M	---	---	\$3.0 M
LAFD Cannabis Inspection	\$1.1 M	\$1.2 M	---	---	---
Total Cannabis-Related Spending (% of Cannabis Revenue)	\$6.5 M (14%)	\$19.3 M (30%)	\$8.8 M (9%)	\$11.4 M (7%)	\$8.6 M (8%)
Remaining Cannabis Business Tax Revenue for Other Priorities	\$38.8 M	\$45.1 M	\$90.5 M	\$145.6 M	\$142.9 M

*Budgeted funding transitioned to the Cannabis Regulation Special Trust Fund in FY 2020.

Because it is just one of many General Fund revenue sources used to fund general City services, spending against the cannabis business tax cannot be tracked.

Spending against budgeted cannabis business taxes could be tracked if City policymakers identified specific policy priorities, projects, or programs for the revenue source. For example, Long Beach's annual budget tracks and summarizes how the city spends its cannabis business taxes. Although Long Beach's cannabis business tax is a general tax, their city council prioritized spending of the tax towards cannabis regulation and enforcement, and public health and safety. Under Long Beach's cannabis business tax, spending under public health and safety include the cost of:

- two Quality-of-Life police officers responsible for referring individuals to services and assisting in mental health evaluations;
- a Clean Team to coordinate homeless cleanups in the City; and
- health Department programming to maintain support for homeless services

The following sections provide several more examples of other local jurisdictions allocating cannabis taxes toward specific uses and adjusting tax rates to support certain policy goals.

Council Could Still Allocate a Portion of Cannabis Taxes Toward Specific Uses

Prop 64 has provisions to allocate a portion of cannabis taxes toward specific purposes. Likewise, the City could adopt an ordinance allocating a percentage of cannabis tax revenue or total dollar amount to achieve a specific policy or goal. Below are several examples of other cities that adopted policies, enacted ordinances, or proposed ballot measures to designate how their cannabis taxes can be used.

- **Vista** – As part of its budget discussion, the Vista city council expressed an interest in capping the amount of cannabis tax revenue going toward the General Fund at \$4 million, and using the excess revenue to fund special projects. For example, **because FY 2021 cannabis tax revenues were estimated at \$5.1 million, based on the City of Vista's adopted policy, \$1.1 million in excess revenues became available to be allocated for other projects.** For the Vista's operating budget for FY 2022 and FY 2023, the council used the excess funding to approve a variety of priorities, including youth scholarships, youth cannabis prevention and intervention, and other projects.
- **Santa Cruz** – In November 2017, the Santa Cruz city council adopted a policy to designate 12.5% of the city's cannabis business tax revenue to create a dedicated Children's Fund. The purpose of the Children's Fund was to enhance and expand early childhood development and prevention programs, and vulnerable youth programs, without supplanting existing Santa Cruz services or investments. **Taking it one step further, the Santa Cruz city council proposed a ballot measure in 2021 to amend its**

city charter and increase the cannabis business tax allocation to the Children's Fund to 20%. The ballot measure was overwhelmingly approved by 83% of voters and enshrined the policy into Santa Cruz's city charter.

- Santa Ana** – Shortly after voters approved Measure Y in November 2018 to tax commercial cannabis businesses in Santa Ana, the city council passed an ordinance to create a cannabis public benefit fund. **Two-thirds of all cannabis tax revenues are deposited into the fund, and currently at least half of the cannabis fund (one-third of cannabis tax revenue) must be allocated by the City Council to fund new, additional, or enhanced youth services.** The remainder of the cannabis benefit fund (one-third of cannabis tax revenue) can be used to enforce cannabis regulations and other nuisance laws to improve the quality-of-life of residents. Since the cannabis fund's creation, Santa Ana has spent its cannabis tax revenues to fund Library and Parks & Recreations programs for youth (including an anti-drug program), and enforcement and compliance efforts for both licensed and unlicensed cannabis businesses.

City policymakers could do the same and adopt a policy, ordinance, or ballot measure to designate a portion of cannabis business taxes to fund the policy priorities that the Council expressed in its proposed Cannabis Reinvestment Act or any other new programs or projects.

Cannabis Tax Rates Could Be Reduced to Support Certain Policy Goals

In addition to spending cannabis business taxes, the City Council could also reduce the tax rate to support some policy goals. The current cannabis tax regime reflects the maximum tax rates allowed by Measure M. Relative to other jurisdictions, the City currently has one of the highest tax rates for adult-use retail sales.

Table 13. The City Has One of the Highest Tax rates for Adult-Use Retail Sales

Jurisdiction	Maximum Tax Rate	Current Tax Rate
Los Angeles City	10%	10%
Long Beach	12%	8%
Los Angeles County	6%	4%
Santa Ana	10%	8%
San Diego	15%	8%
San Francisco	1% to 5%	Suspended until 2023
Oakland	10%	0.12% to 5%
Sacramento City	4%	4%

While any further increases would require voter approval, Measure M allows the City Council to lower tax rates by ordinance. Though this would result in lower revenue, lowering tax rates is one way to help the City incentivize or achieve certain policy goals. Below are several examples of other jurisdictions that reduced cannabis business taxes support policy goals.

- **Supporting licensed cannabis businesses competing against unlicensed businesses** – To enhance the competitiveness of its cannabis businesses, the Oakland City Council adopted an ordinance in 2019 to reduce its retail cannabis tax rate from 10% to a tiered-tax structure that caps out at 5%. In response to the cost of running a licensed cannabis business and to combat the illicit market, San Francisco has, for two years in a row, suspended its cannabis business tax in 2021 and 2022. Other cities like Long Beach and Costa Mesa have reduced their cannabis taxes for similar reasons. More recently, the State passed legislation to suspend its cannabis cultivation tax beginning in January 2023 to combat the illicit market and encourage consumers and businesses to enter into the legal, regulated cannabis market.
- **Attracting certain types of licensed cannabis businesses** – The City of San Diego reduced its tax rate for cannabis production facilities from 8% to 2% to attract more indoor cannabis farms and cannabis manufacturers to open their doors in the city. After finding that it had one of the highest cultivation taxes among peer local jurisdictions surveyed, the City of Desert Hot Springs also eliminated its \$25.50 per square foot tax on cannabis cultivation on lots less than 3,000 square feet and set a flat tax rate of \$10.20 per square foot.
- **Supporting social equity or other policy goals** – In addition to reduced tax rates, the Oakland city council adopted an ordinance in 2019 to create tax rebates that support social equity and other goals. Cannabis businesses in Oakland can qualify for a variety of tax rebates that can reduce their tax rate to as low as 2.5%. For example, cannabis businesses with a workforce that consists of 30% or more Equity Employees (that meet certain social equity criteria) can reduce their business tax rate by 0.50%.

If the City Council chooses to explore tax rate reductions to meet certain policy goals, it would have to balance those goals against other policy priorities, such as revenue generation and even public health. For example, some policy analysts argue that high cannabis taxes would decrease access among price-sensitive groups and incentivize the illicit market, while lowering cannabis tax rates could encourage use and increase the cost of marijuana use and abuse within the community.

Recommendation

The City should not wait to see if the citizen-sponsored petition becomes a ballot initiative and risk losing the ability to determine how much to tax cannabis businesses and how that revenue should be spent. Policymakers still have an opportunity to proactively decide how cannabis tax revenues should be spent to align with their priorities.

To maintain control and exercise their policymaking role, the City Council should:

11. Revisit the goals and spending priorities expressed through its work on the proposed Cannabis Reinvestment Act, and consider developing and adopting a spending plan for cannabis business taxes.

CONCLUSION

More than five years after legalization, the City's oversight of commercial cannabis activity remains a work in progress. The continued presence of illicit cannabis businesses alongside unmonitored licensed businesses undercuts Measure M's goal of providing safer and more accessible cannabis for Angelenos. By implementing the recommendations in this report, the City can create a more fair and well-regulated cannabis market, raise tax revenue, and achieve its desired policy outcomes connected to commercial cannabis activities.

RECOMMENDATION TABLE

Number	Recommendation
Responsible Entity: City Council	
1	<p>Instruct LAPD and LADBS, with the assistance of the City Attorney’s Office and other relevant departments, to report back on how the Cannabis Enforcement Taskforce could begin issuing administrative citations and fines to unlicensed cannabis businesses and property owners for the unpermitted improvements and unallowed uses they have caused or allowed. The report back should include:</p> <ul style="list-style-type: none"> a. A decision on which department should issue administration citations for causing or allowing unlicensed cannabis businesses. b. The process by which administration citations and fines would be issued as part of the Cannabis Enforcement Taskforce’s progressive enforcement model. c. A determination if fines for unlicensed commercial cannabis activities can be quadrupled because cannabis-related activities are not a land use for which the City can issue a permit. d. Any necessary ordinance changes to facilitate the Cannabis Enforcement Taskforce’s use of ACE citations and fines against unlicensed cannabis businesses.
2	<p>Request the City Attorney’s Office for a report back evaluating the feasibility and implementation options for the following:</p> <ul style="list-style-type: none"> a. Adopting any necessary changes requested by LAPD and LADBS to facilitate the Cannabis Enforcement Taskforce’s use of ACE citations and fines against unlicensed cannabis businesses. b. Adding provisions to the ACE ordinance to target illegal cannabis cultivation, per Assembly Bill 2164 (2018), so that fines can be immediately imposed for violations that exist as a result of, or to facilitate, the illegal cultivation of cannabis. c. Updating administrative fine amounts to track inflation. d. Creating collection procedures so that unpaid fines can be administratively imposed as a lien or special assessment.
11	<p>Revisit the goals and spending priorities expressed through its work on the proposed Cannabis Reinvestment Act, and consider developing and adopting a spending plan for cannabis business taxes.</p>

Number	Recommendation
Responsible Entity: City Attorney's Office	
4	As part of its civil litigation strategy, consider petitioning the court for a receivership to take control of unlicensed cannabis business and the property they occupy.
Responsible Entity: Multiple Departments	
3	The Cannabis Enforcement Taskforce, with the assistance of the City Administrative Officer, should develop protocols for selecting which properties will be subject to a proposed lien, and procedures for tracking, reporting, and confirming enforcement costs as a lien for allowing unlicensed cannabis businesses to operate.
Responsible Entity: DCR	
5	<p>Develop and implement a comprehensive regulatory compliance plan to monitor licensed cannabis businesses and enforce compliance. At minimum, the plan and its implementation should include:</p> <ul style="list-style-type: none"> a. Goals and objectives for regulatory compliance, including how frequently DCR plans to inspect its licensees, how quickly it will respond to complaints, and how it will prevent sales to youth through programs like decoy operations. b. Policies, procedures, and other documents to standardize, streamline, and provide guidance to staff on how the department will conduct periodic inspections and investigations of licensed cannabis businesses, respond to complaints, and issue progressive discipline. c. How DCR will address unprocessed and pending complaints. d. Safety standards and training applicable to code enforcement officers inspecting or investigating licensed cannabis businesses. e. Estimated staffing and funding requirements to implement the plan.
6	Revise its license and application fees to include the cost of carrying out its regulatory compliance plan.
7	Consider adapting an existing or creating a new inspector or code enforcement job classification if it has difficulty hiring or retaining staff in its Compliance and Enforcement Division. Alternatively, DCR could enter into an agreement with another department to utilize inspector or code enforcement job classifications to conduct regulatory inspections of licensed cannabis businesses.
Responsible Entity: Finance	
8	Re-evaluate its goal of auditing every business every two years and consider a risk-based approach to selecting which businesses to audit.

Number	Recommendation
9	Reexamine their cannabis audit procedures and incorporate additional steps to mitigate the risk of underreporting and other forms of tax evasion.
10	Explore other methods to accept cash payments from cannabis businesses more efficiently.