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Taxation of Cannabis Businesses: Essential Tax Planning Considerations

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- More than 20 years of experience representing clients on domestic and international tax matters
- Counsels clients on tax considerations relating to domestic and cross-border mergers and acquisitions, capital raising and deployment strategies, corporate structuring matters, and the drafting and interpretation of partnership and LLC operating agreements
- Represents clients on tax matters relating to licensing and other intellectual property transactions, international joint ventures and operations, tax credit transactions, and project finance and structuring
- Advises clients in a number of specialized industries, including the life sciences, renewable energy, cannabis and gig economy sectors
- *Education:* Columbia University School of Law, J.D., *Harlan Fiske Stone Scholar*; Columbia Business School, M.B.A., *Dean's List*; Carleton College, B.A., *cum laude*



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- Member of the firm's Business Department
- Represents buyers and sellers in mergers and acquisitions and other strategic transactions, as well as counsels early and mid-stage companies regarding entity formation, founder's arrangements, financings, licensing agreements, exit strategies and general corporate governance
- Clients include both public and private companies as well as venture capital investors
- Significant experience representing technology and life sciences companies
- Represents entrepreneurs as they develop their business plans and launch their companies
- Acts as trusted advisor to clients, providing the specific legal guidance needed at each stage of company development
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- Advises cannabis companies on both the tax and corporate aspects of formation, structuring, financing and mergers & acquisitions
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- Represents public and private companies on a wide range of general corporate matters, including formation, financing, mergers & acquisitions, licensing and strategic alliances, and general corporate governance
- **Education:** Georgetown University Law Center, J.D., *cum laude*; Clemson University, B.S.

- Choice of entity – Basic legal differences
 - C corporation; S corporation; LLC

- Remainder of discussion
 - 280E & Choice of entity
 - Financing tax considerations
 - Exit / M&A tax considerations

- **Basics:** 280E generally provides that no tax deductions or credits are allowed for “trafficking” in Schedule I and II controlled substances
 - Accordingly, 280E applies to disallow tax deductions and credits for the expenses of cannabis growers, product manufacturers, distributors and retailers

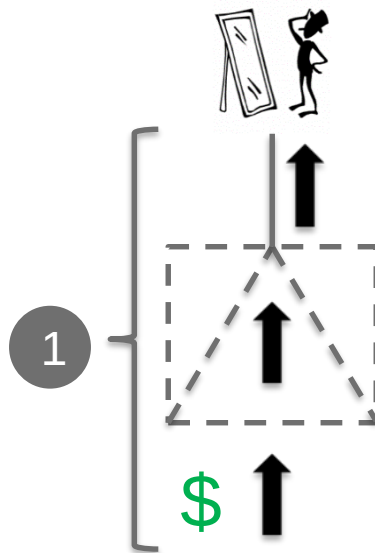
- **Status:** Congress has been working on a bill that would de-schedule marijuana (the Marijuana Opportunity Reinvestment and Expungement, or MORE, Act)
 - The bill will not be brought to the House floor before the November election
 - Not certain whether it will pass in the House; currently less support in the Senate

- Expenses included in costs of goods sold (“COGS”) are not subject to 280E
 - This is due to constitutional limitations -- there is no federal tax on gross receipts; the tax must be an “income tax”
- As such, if 280E applies, the “taxable income” of the business generally equals the gross income (i.e., gross receipts – COGS)
- Companies that are subject to 280E must use the older rules (under Code section 471) for calculating COGS, which generally limit the inclusion of indirect costs in COGS
- Note: Retail operations typically are more impacted by 280E because they generally have fewer expenses that can be included in COGS as compared to grow operations

- **Code section 471(c)**: In effect since 2018, the provision generally allows a business with less than \$25 million average gross receipts for the preceding 3 years to elect to calculate its COGS for tax purposes in the same manner as it calculates COGS for financial accounting purposes
- **Significance**: On its face, 471(c) could allow smaller cannabis businesses to move more expenses to COGS, thereby reducing their taxable gross income
 - **But**: The IRS has not issued formal guidance explicitly addressing the interaction of 471(c) and 280E
- **Takeaway**: Cannabis companies that satisfy the gross receipts test should make sure their accountants are aware of 471(c) and discuss whether/how the provision may apply to them and the associated tax benefits/risks

Single-Member LLCs

(Disregarded Entities)

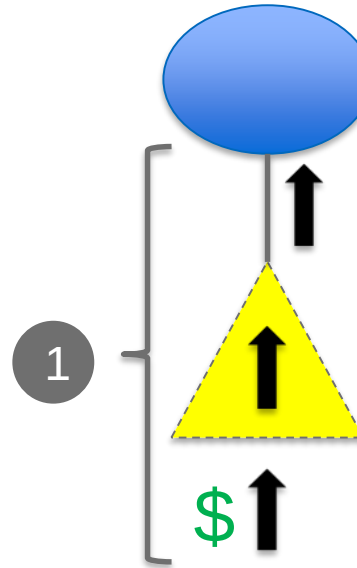


Single Layer of Tax

- Single Member is taxed on the entity's income as if the entity did not exist and the Single Member earned the income directly.

Multi-Member LLCs/ "S" Corps

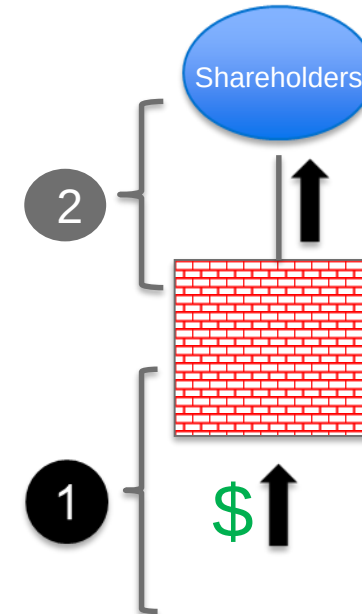
(Flow-through Entities)



Single Layer of Tax

- Each Partner/Shareholder is taxed on their allocable share of the entity's income, even if there is no actual distribution of income ("**Phantom Income**").

"C" Corps



Two Layers of Tax ("Double Tax")

- The entity is subject to an entity-level tax on its income.
- Distributions to Shareholders taxable at the Shareholder level.

- **Flow-through taxation**: Income of an LLC is reported on the LLC members' tax returns, even if no cash distributions are actually made
- **Significant 280E risk**: The members **directly** bear the risk of any tax exposure attributable to 280E; for example:
 - If the tax liability on the LLC's taxable gross income exceeds the LLC's actual pre-tax cash profit, the LLC may not be able to distribute cash to help the members pay that tax liability; but the members still would have to pay the tax liability
 - Also, personal liability for the tax (including interest and penalties, if any) if an IRS audit determines that taxable gross income was higher than reported

Business Subject to Code Section 280E (LLC)

Member-level tax (flow-through) - assumes 37% federal rate and 5% state rate

	<u>Total</u>
Gross Receipts	10,000,000
COGS	<u>(2,500,000)</u>
Gross Income	7,500,000
Non-COGS Expenses	<u>(5,000,000)</u>
Pre-Tax Cash Profit/(Loss)	2,500,000
Federal & State Tax (on Gross Income)	<u>(3,150,000)</u>
Net After-Tax Cash Profit/(Loss)	<u><u>(650,000)</u></u>

<u>Total Tax</u>	<u>Amount</u>	<u>Effective Rate on Pre-Tax Cash Profit</u>
Tax without 280E	1,050,000	42%
Tax with 280E	3,150,000	126%

Note: In this example, due to 280E, tax liability exceeds actual cash profits by \$650K

***Note: Assumes no deduction for state taxes because of \$10K limit
for individuals***

- S corps are not recommended for businesses that are subject to 280E
 - They pose the same 280E risks as LLCs (due to flow-through taxation)
- In addition, the tax rules require that S corp shareholders providing services to the S corp are required to be paid reasonable compensation
 - Double taxation results because (1) shareholders are taxed on the receipt of the compensation for their services and (2) the S corp income that was used to pay the compensation also flows through to the shareholders as taxable S corp income (because the compensation expense is not deductible by the S corp due to 280E)

- **280E considerations:** C corps mitigate, but do not eliminate, the 280E risks raised by LLCs and S corporations
 - **Very important:** Shareholders generally are not personally liable for the C corp's income tax obligations; shareholders are only subject to tax on actual distributions by the C corp
 - **Note:** As a result of 280E, a C corp still could owe corporate-level taxes in excess of its actual economic profit

- **Double taxation:** C corps have become more attractive since the federal corporate tax rate was reduced from 35% to 21% starting in 2018
 - However, still subject to double taxation (corporate- and shareholder-level taxes)
 - Would not be surprising if the corporate tax rates were to increase; if the rates increase, it could be difficult to convert back to an LLC since such a conversion is a fully taxable transaction

Business Subject to Code Section 280E (C Corporation)

Corporate-level tax - assumes 21% federal and 8% state rate

Shareholder-level tax - assumes a 20% federal and 5% state rate

	<u>Total</u>
Gross Receipts	10,000,000
COGS	<u>(2,500,000)</u>
Gross Income	7,500,000
Non-COGS Expenses	<u>(5,000,000)</u>
Pre-Tax Cash Profit/(Loss)	2,500,000
Federal & State Tax (on Gross Income)	<u>(2,175,000)</u>
Net After-Tax Cash Profit/(Loss)	<u>325,000</u>
Tax on Distribution to Shareholders	(81,250)
Net After-Tax Cash Proceeds to Shareholders	<u>243,750</u>

100% Distribution of After-Tax Cash Proceeds to Shareholders:

Total Tax	Amount	Effective Rate on Pre-Tax Cash Profit
Tax without 280E	1,168,750	47%
Tax with 280E	2,256,250	90%

No Distribution of After-Tax Cash Proceeds to Shareholders:

Total Tax	Amount	Effective Rate on Pre-Tax Cash Profit
Tax without 280E	725,000	29%
Tax with 280E	2,175,000	87%

■ LLC

- Without 280E: 42%
- **With 280E: 126%**

■ C Corp (no distribution to shareholders)

- Without 280E: 29%
- **With 280E: 87%**

■ C Corp (100% distribution to shareholders)

- Without 280E: 47%
- **With 280E: 90%**

- Cannabis companies sometimes take the position that they are also engaged in a non-cannabis business that is not subject to 280E
 - The goal is to be able to deduct the expenses allocated to the non-cannabis business operations
 - Case law and IRS guidance make this a difficult position to sustain; except in rare circumstances, the cannabis operations will “taint” the non-cannabis operations

- Some cannabis businesses divide their operations among separate legal entities based on functions
 - There can be good non-tax reasons for doing this
 - However, dividing operations solely for purposes of avoiding 280E generally does not work
 - In recent years, the Tax Court has noted that the activities of separate legal entities can be treated as a single cannabis business if they are part of a “unified business enterprise” with a single profit motive - This can have dire tax consequences
 - *Patients Mutual Assistance Collective Corporation d.b.a. Harborside Health Center v. Comm’r*
 - *Alternative Health Care Advocates, et. al. v. Comm’r* (discussed on next slide)

- **Facts:** An S corporation handled the day-to-day operations for a cannabis dispensary (a C corp)
 - The S corp and cannabis dispensary were owned by the same persons
 - The S corp provided services only to the cannabis dispensary
 - The taxpayer claimed that the S corp was a separate “non plant-touching” entity that was not subject to 280E

- **Tax Court Decision:** The Tax Court concluded that both the S corp and the dispensary were subject to 280E
 - The S corp’s primary business was a cannabis business (on behalf of the dispensary), even if the S corp never had title to the marijuana
 - This meant that **both** entities were subject to tax on their gross profit, including the S corp being subject to tax on the compensation paid to it by the dispensary for its services (with no tax deduction available to the dispensary for that expense)
 - **The Tax Court noted that “[t]hese tax consequences are a direct result of the organizational structure petitioners employed and petitioners have identified no legal basis for remedy.”**

- 280E should not be ignored; cannabis companies have significant audit risk
 - Tax authorities have access to public lists of license holders and can easily identify tax returns to be reviewed for 280E compliance
- Often poor recordkeeping by companies has been a gating issue, as a result of which taxpayers cannot substantiate calculation of COGS and are subject to penalties
 - Detailed cost segregation (COGS and non-COGS) and cost management is critical for cannabis companies
 - Companies should consider working with a payroll company that has specialized software to help with this
- There has been substantial litigation related to 280E, most of which cases have been decided in favor of the IRS
 - **Note:** Cannabis companies should consider timely filing “protective claims” for refunds of taxes attributable to 280E, given that there is ongoing litigation as to whether 280E violates the 8th Amendment (i.e., are tax rates of more than 80-90% and even in excess of 100% unconstitutional)

■ LLC

- Investors may not want the risk of flow-through taxation, particularly with 280E exposure
- LLC operating agreement will need to be negotiated (can be complex and more expensive)
- Equity compensation to employees/management can be complex and adds 280E exposure for those persons
- Qualified small business stock (“QSBS”) tax exemption on an exit is not available

■ C Corp

- Protects investors against direct 280E exposure
- Investors may want potential for QSBS tax exemption on an exit
 - No federal tax on gain on disposition of QSBS up to the greater of (i) \$10M or (ii) 10x the stockholder’s tax basis in their QSBS
 - Some (not all) of the QSBS requirements: corporation must be a C corp; shareholder has to acquire the stock from the C corp; at time of issuance, C corp can never have had more than \$50M in assets; shareholder must hold stock for more than 5 years
 - Not clear that cannabis businesses will be a qualifying business in all circumstances (e.g., cultivation activities and personal/real property leasing generally are not QSBS-eligible activities)

■ SAFEs

- **LLCs and C corps:** Proper tax treatment of SAFEs is unclear (equity vs. something else?) whether issued by an LLC or a C corp
 - **Note:** Some current “model” forms of SAFEs expressly state that the parties agree to treat as equity (although not clear that the IRS would agree with this)
- **LLCs:** Not recommended for LLCs since if a SAFE is equity in an LLC, investors are “partners” for tax purposes and have direct 280E exposure

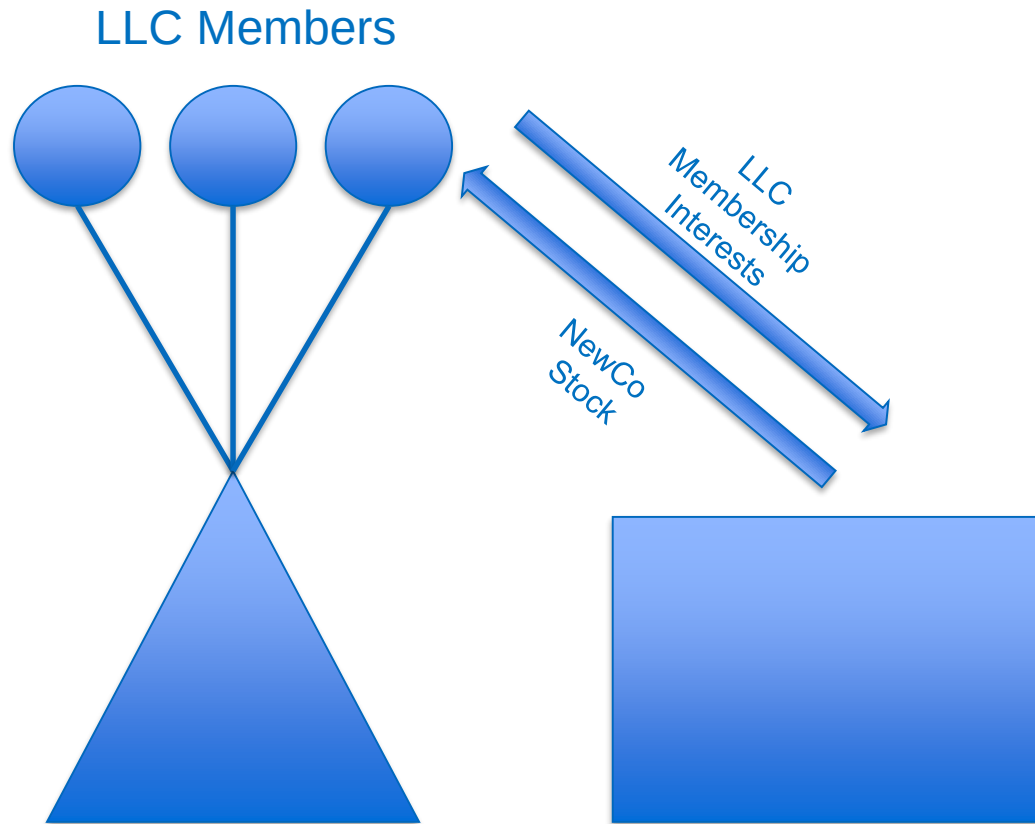
■ Convertible Debt

- **LLCs and C corps:** Lender may be taxed on deemed interest income annually, even if not paid, under the original issue discount (“OID”) tax rules; in some circumstances, additional imputed interest income to lender if below-market interest rate; subject to limited exceptions, taxable cancellation of indebtedness income (“CODI”) to the borrower company to the extent the debt is forgiven by lender
- **LLCs:** In the case of an LLC, if the convertible debt is not respected as debt for tax purposes, investors are “partners” for tax purposes and have direct 280E exposure

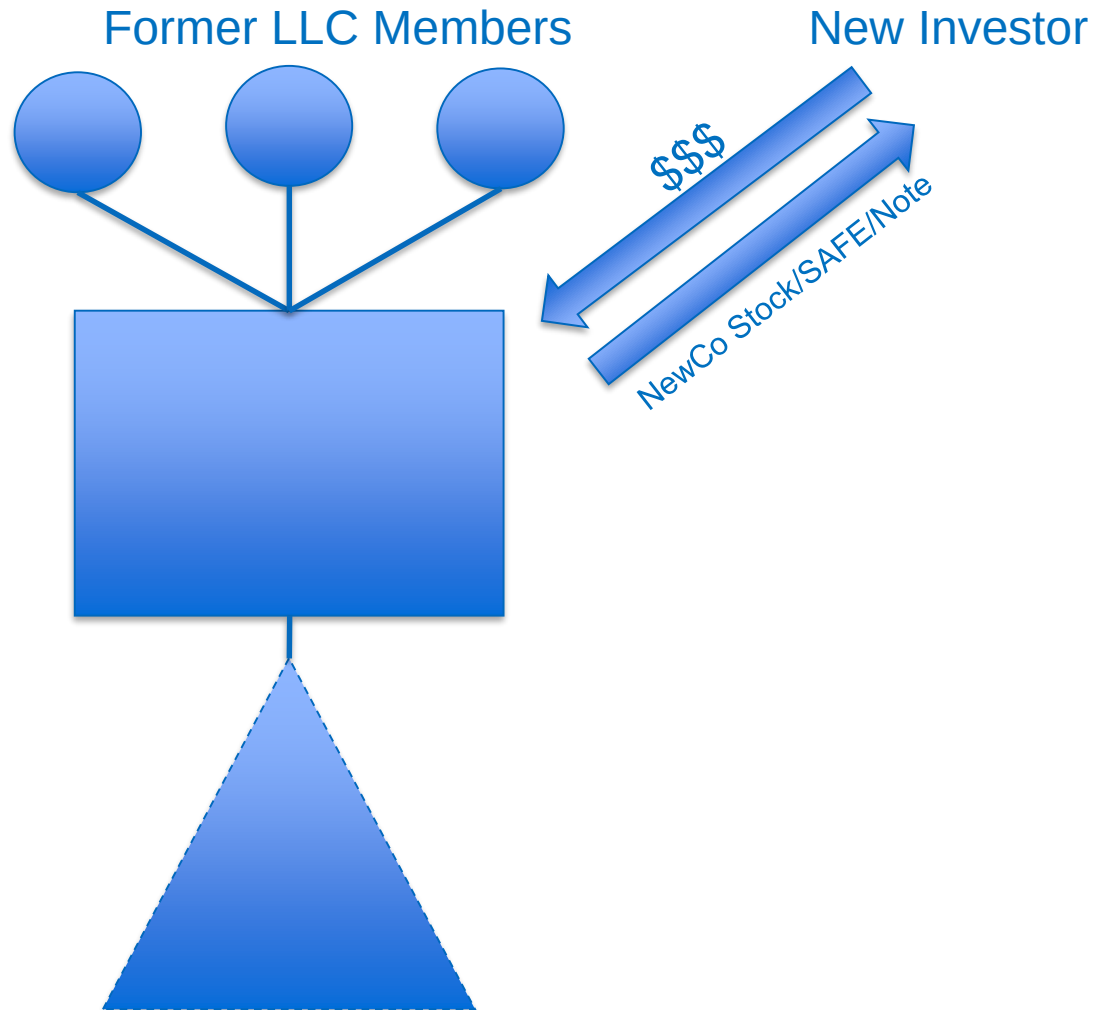
■ Common Changes

- S Corp to C Corp: relatively simple to do, with limited tax consequences
 - Conversion happens automatically if investor is not a U.S. individual or other qualifying shareholder
- LLC to C Corp: a bit more complex to do, but generally has limited tax consequences
 - Note: Debt or liabilities of LLC could trigger gain on conversion
- S Corp or C Corp to Partnership: tax cost can be prohibitive; fully taxable transaction (deemed taxable sale of the business)

- **“Check-the-Box Elections”**: an LLC can elect to be treated as a corporation (C or S) for income tax purposes; a U.S. corporation cannot make a “check-the-box” election to be taxed as a flow-through entity



- Frequently, Investors will want an existing LLC to convert to a Delaware corporation prior to investment
- However, in certain instances a conversion may not be available if the LLC (as the License Holder) needs to remain a separate legal entity for regulatory reasons
- In order to keep the LLC in existence, members can contribute all of their membership interests to a C corp (“NewCo”) in exchange for NewCo stock
- For tax purposes, analyzed like an LLC to C corp conversion

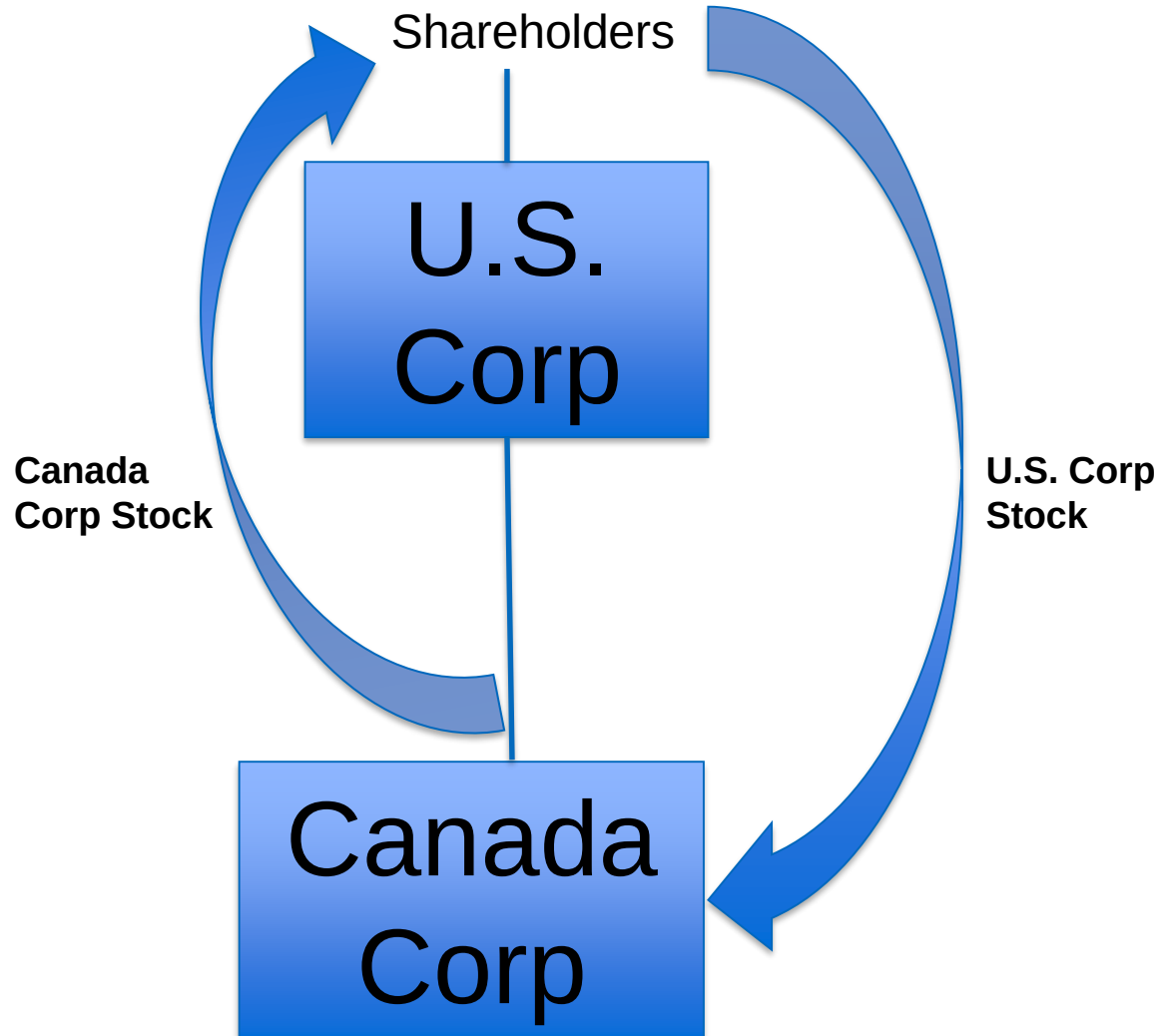


- The result is the former LLC members hold all of the corporate stock of NewCo, with LLC as a wholly-owned subsidiary of NewCo
- Exchange of former LLC Members interests for NewCo stock
- For income tax purposes, LLC is a disregarded entity (i.e., all its income is treated as earned directly by NewCo)
- Investors then indirectly invest in LLC by purchasing NewCo stock (or convertible debt/SAFEs)

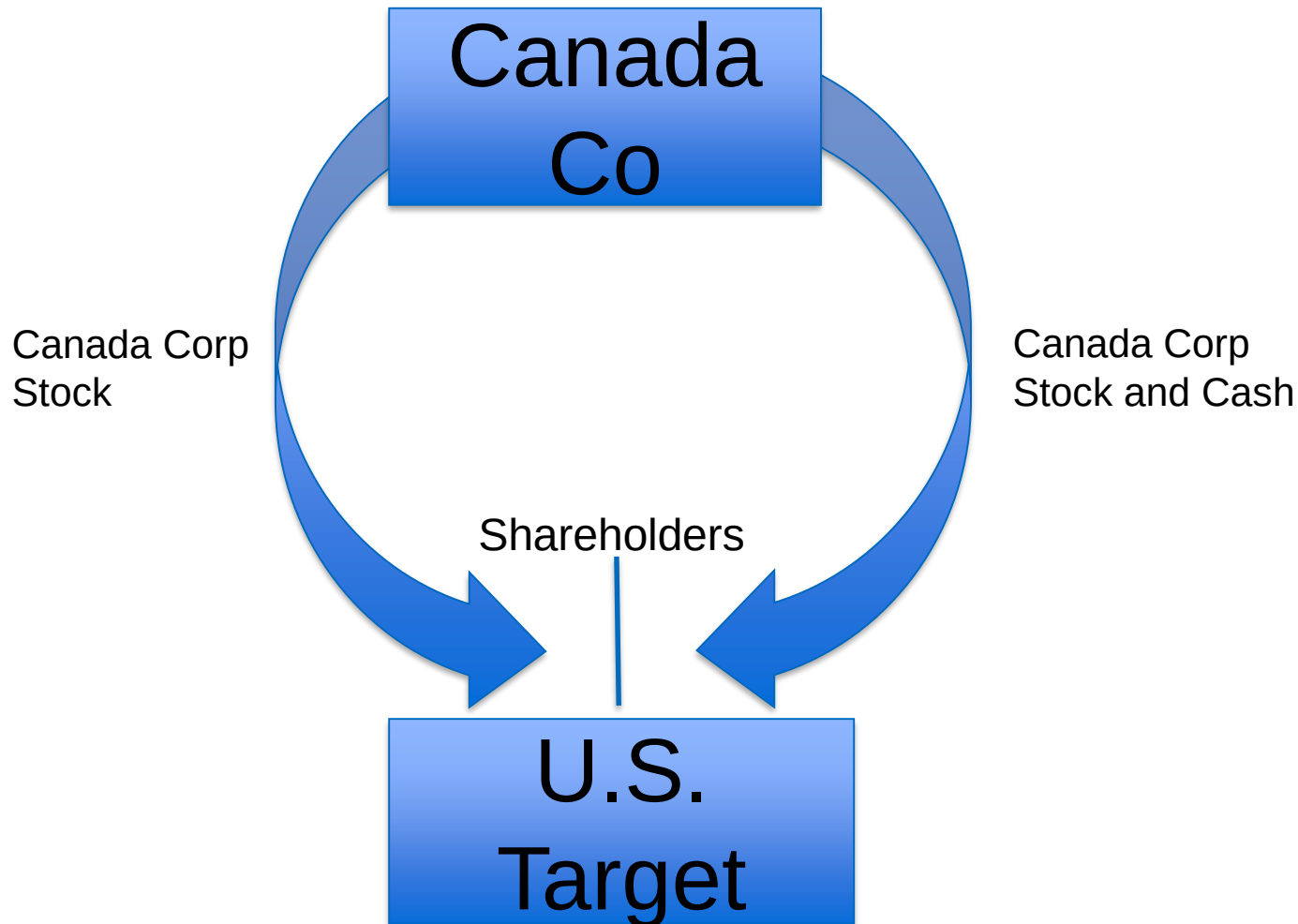
- 280E compliance issues
- Impermissible use of accelerated depreciation
- Failure to charge arm's-length prices on related party transactions
- Payroll tax compliance
 - Potential personal liability of “responsible persons” for any unpaid payroll taxes
- State tax matters
 - Compliance at the state level with 280E (if applicable)
 - Sales and use tax compliance – can be very significant exposure if failure to comply
 - Payment of any other special state and local taxes imposed on cannabis operations

Means of Exit	C Corporation	LLC
Liquidation	Generally, taxed like a deemed taxable sale of all of the assets of the C corporation (see below in next row)	Generally, no LLC-level tax; also nontaxable to members, unless cash or marketable securities received by a member in excess of the member's tax basis in its membership interest
Sale of Substantially All Assets	Generally, taxable at C corp level; shareholders also taxed on liquidating distribution (capital gain/loss)	Generally, gain or loss is taxable only to the LLC's members, with no LLC-level tax; ordinary vs. capital treatment depends on the types of assets sold
Sale of Stock or Membership Interest	Taxable only to shareholders; generally, capital gain or loss; may qualify for QSBS exemption	Gain or loss taxable only to the LLC's members, with no LLC-level tax; subject to some exceptions, capital gain or loss treatment; QSBS exemption not available

- Important: Do not assume that because a transaction provides for a significant amount of buyer stock (even 100%) as consideration that the transaction will be a nontaxable transaction!!
 - General principle: Every transaction is taxable unless it qualifies for a specific exception under the Code, such as under the “reorganization” provisions of Code section 368
- The Code section 368 reorganization provisions are only available to corporations (not LLCs)
 - If a transaction qualifies as a Code section 368 reorganization, a corporation’s stock or assets can be transferred to another corporation in a tax-free or partially tax-free transaction
- Among other things, a significant portion of the purchase price must be buyer stock (rather than cash)
 - The required percentage of stock consideration varies (from 40% to 100%) depending on the form of the transaction (asset sale; stock sale; forward merger; reverse merger; etc.)
 - The transaction still will be taxable to the seller to the extent of the non-stock consideration received (such as cash)



- Publicly list shares in Canada
 - U.S. stock exchanges generally are inaccessible to cannabis companies
- Inversion is effected by having U.S. Corp shareholders transfer U.S. Corp shares to Canada Corp in exchange for Canada Corp stock
- Under Code section 7874 “anti-inversion” rules, Canada Corp treated as a U.S. corp for all U.S. tax purposes
 - Therefore, transaction can be tax-free for U.S. tax purposes
 - U.S. Corp also potentially can be liquidated without U.S. tax consequences



- Public Canada Corp can acquire multiple existing cannabis target companies with Canada Corp stock and/or cash
- Public listing in Canada generates cash to finance acquisitions
- Since Canada Corp is treated like a U.S. corporation for U.S. tax purposes, acquisitions of U.S. target corporations using Canada Corp stock can qualify as tax-free reorganizations for U.S. tax purposes



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