

## **Cannabis and Corporate Law: Solving Problems in Entity Formation and Jurisdiction, Investment, Contracting**

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# Cannabis and Corporate Law: Solving New Problems in Entity Formation, Jurisdiction, Investment and Contracting

December 15, 2020  
Strafford

William Tolin Gay

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# Exploration of Legality

Federal and State Differences

State to State Differences

# Federal

- Illegal under Controlled Substances Act of 1970

	Potential for Abuse	Accepted Medical Use
Schedule I	High	None
Schedule II	High	Yes (restricted)
Schedule III	Medium	Yes
Schedule IV	Low	Yes
Schedule V	Lowest	Yes

- Agricultural Act of 2014
- Agriculture Improvement Act of 2018

# Active Compounds (Relating to Legality)

- THC - delta-9 Tetrahydrocannabinol [Acid]
  - Psychoactive
- CBD – Cannabidiol
  - Nonpsychoactive
  - Can be derived from hemp
- Terpenes

# States

## State

- Medicinal – ~~33~~ ~~37~~ ~~40~~ 48 states
  - Recreational – ~~10~~ ~~11~~ ~~12~~ 15/16 states
- 
- As of 3/18, 9/5/19, 12/15/19, 12/15/20

# State vs. State

- No Federal template, so patchwork of regulations
  - State, County, Municipality
  - “Triumph or travesty of Federalism”
- Levels of “Legality”
  - Fully legal – Medicinal and Recreational
  - Medicinal - What is needed?
  - CBD
    - Treatment of various diseases and symptoms: pain, anxiety, seizures, etc.
    - Hemp CBD fully legalized at Federal level in 2019 Farm Act
      - ≤ 0.3% THC by dry weight
    - Still outlawed in a few states

# One Thing They All Have In Common

- Every state that has legalized cannabis has seen it as a potential source of tax revenue.
  - Highly regulated
    - Licensing
    - Testing
  - Restrictions on home cultivation
  - Foreboding of Federal legalization?

# Formation Issues: Choice of Entity/Jurisdiction

- Traditional choices – C-corp; S-corp; LLC
- Other options – B-corp; cooperatives; etc.
- Anticipated path for company – growth for exit vs. cash flow?
- Tax/280E risks and impact on operations/investment
- Impact of 2017 tax law changes on traditional selection analysis
- IRC Sec. 1202 – potential significant exclusion of gain on sale of eligible\* qualified small business stock – N/A to S-corps
- Liability protections – pass-through entity structure (LLC, S-corp) can leave owners with personal tax bills

# Formation Issues: Choice of Entity/Jurisdiction

- Keep it simple – old structures may have significant consequences
- Management company structure can be a red flag for IRS and banks
- Impact on banking and investor relationships
- Investor expectations and trust
- Impact on disclosure of investor information
- State of operation vs. neutral jurisdiction (DE, NV)

# Operational Issues

Possible Permitted Activities

Contracting

Soliciting/Receiving Investments

Banking and Finance

Real Estate

Tax Issues

# Operational Issues: Possible Permitted Activities

- Cultivation
- Storage and Aging
- Processing and Extraction
- Testing
- Distribution / Transportation
- Retail Sale

# Cannabis Business Activities: Cultivation

- Outdoor
- Indoor

# Cannabis Business Activities: Storage and Aging



[https://commons.wikimedia.org/wiki/File:Drying\\_Cannabis\\_Buds.jpg](https://commons.wikimedia.org/wiki/File:Drying_Cannabis_Buds.jpg)

# Cannabis Business Activities: Processing and Extraction

- Extracts
  - Shatter
  - Rosin
  - BHO
  - Wax
  - Tinctures, etc.
- Extraction Methods
  - CO<sub>2</sub>
  - Butane
  - Propane
  - Alcohol, etc.

# Cannabis Business Activities: Testing

- For both marketing and regulatory compliance
  - Compound levels (THC, CBD, terpenes)
  - Insecticide
  - Herbicide
  - Contaminants

# Cannabis Business Activities: Distribution

- Distribution
  - Transportation

# Cannabis Business Activities: Retail Sale

- Retail license
- Security
  - Product
  - Sales proceeds
- Clientele
- Social Equity Programs

# Operational Issues: Contracting

## RISKS OF ENTERING INTO A CONTRACT IN THE CANNABIS INDUSTRY

- Cannabis is illegal federally.
- Contracts with cannabis businesses should always contain choice of law and venue provisions.
- Unlike other contracts, the choice of law **MUST** be the state where the business is licensed, and the venue **MUST** be in the state where the business is licensed.

# Operational Issues: Contracting

## CANNABIS-RELATED CONTRACT ENFORCEABILITY ISSUES

- Parties may attempt to use federal law as a defense to breach of contract since the contract is illegal under federal law.
- Place an express provision in the contract to provide that federal law shall not be a defense to breach of the contract.
- Add termination clause to allow the agreement to be terminated or ended under circumstances specified in the clause.
- Activities that are legal under state law but illegal under federal law rely on courts or state legislatures to decide whether the contracts involving the activity are illicit and therefore void under contract law.

# Operational Issues: Contracting

## CHOICE OF LAW

- Contracts with cannabis businesses should always contain choice of law and venue provisions.
- Unlike other contracts, the choice of law **MUST** be the state where the business is licensed, and the venue **MUST** be in the state where the business is licensed.
- Colorado: Enforceable by State Statute
  - C.R.S. § 13-22-601 Contracts pertaining to marijuana enforceable:
    - “It is the public policy of the state of Colorado that a contract is not void or voidable as against public policy if it pertains to lawful activities authorized by section 16 of article XVIII of the state constitution and article 43.4 of title 12, C.R.S.”
- Pay attention to form contracts from national businesses.

# Operational Issues: Contracting

## DRAFTING CHECKLIST

- Paying based on revenues can cause payee to be viewed as an owner or holder of a financial interest in the business.
- Requirements that parties abide by all applicable laws regarding cannabis.
- Termination provisions (especially for legal noncompliance).
- Accounting for rapid changes in the law.
- Insurance.
- Indemnity.
- Type of payment.

# Operational Issues: Investors

- Each state has ownership/control thresholds for determining disclosure requirement for outside investors
- Control issues and intersection with regulatory requirements and restrictions
- Securities law issues
- Complexity and diligence requirements = timing cycles for funding are longer and present unique issues
- Valuation volatility
- Reverse diligence – how well do you know your investors?

## Operational Issues: Investors

- Compliance risk profile – impact on valuation and execution risk
- IP protection and risks
- Exit barriers?

# Operational Issues: Banking

## “THE BIG PICTURE”

- Rapidly Evolving State Laws and Static Federal Laws Are Creating an Unworkable Situation
  - An increasing number of states are legalizing medical and/or recreational cannabis.
  - Cannabis remains a Schedule I drug under the Controlled Substance Act, and proceeds from related activities remain subject to U.S. anti-money laundering (AML) laws, such as the Money Laundering Control Act (MLCA).
  - Given the uncertain enforcement and heavy penalties, the vast majority of financial institutions consciously avoid knowingly providing financial services to U.S. marijuana related businesses.
- Meanwhile, the Cannabis Industry is Transitioning from Mom-and-Pop Operators into Big Business, with Major Implications for Investment and Compliance.
  - While COVID-19 has increased consumption, it has created a number of distressed assets available to cannabis conglomerates.

# Money Laundering Control Act ("MLCA")

- The MLCA is the federal government's primary criminal prohibition against money laundering.
- MLCA criminalizes several forms of transactions involving funds derived from or intended to promote "specified unlawful activity," which includes activity that violates the CSA.
  - 18 U.S.C. § 1956(c)(7)(A)-(B).
- MLCA defines four (4) species of unlawful money laundering:
  - Domestic;
  - International;
  - "Sting Operation;" and
  - "Financial Institution."
- **Because conduct that violates the CSA qualifies as specified unlawful activity for the purposes of the MLCA, virtually all banking services potentially satisfy the elements of money laundering where the bank customer is engaged in the cannabis industry**

## Bank Secrecy Act (“BSA”)

- The BSA is frequently discussed in the context of anti-money laundering efforts. It is related to, but fundamentally different from, the MLCA.
  - The BSA requires financial institutions, such as the Bank, to monitor transactions, keep records, and file reports that the federal government has determined to have a high degree of usefulness in both deterring and detecting money laundering (*i.e.*, conduct that violates the MLCA).

# FinCEN Guidance (Feb. 2014)

- Providing clarity in this context should enhance the availability of financial services for cannabis businesses. This would promote greater financial transparency in the cannabis industry and mitigate the dangers associated with conducting an all-cash business.
- FinCEN guidance clarifies how financial institutions can provide services to cannabis businesses consistent with their BSA obligations.
- In general, the decision to open, close, or refuse any particular account or relationship should be made by each financial institution based on a number of factors specific to that institution.
- These factors may include its particular business objectives, an evaluation of the risks associated with offering a particular product or service, and its capacity to manage those risks effectively.
- Thorough customer due diligence is a critical aspect of making this assessment. Should consider whether business implicates Cole Memo or violates state law.

# FinCEN Guidance

## RISK ASSESSMENT DUE DILIGENCE

- Verifying with the appropriate state authorities whether the business is duly licensed and registered;
- Reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate its marijuana-related business;
- Requesting from state licensing and enforcement authorities available information about the business and related parties;
- Developing an understanding of the normal and expected activity for the business, including the types of products to be sold and the type of customers to be served (e.g., medical versus recreational customers);
- Ongoing monitoring of publicly available sources for adverse information about the business and related parties;
- Ongoing monitoring for suspicious activity, including for any of the red flags described in this guidance; and
- Refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk.

# FinCEN Guidance

- A financial institution that decides to provide financial services to a cannabis business would be required to file suspicious activity reports (“SARs”).
  - A financial institution is required to file a SAR if, consistent with FinCEN regulations, the financial institution knows, suspects, or has reason to suspect that a transaction conducted or attempted by, at, or through the financial institution:
    - (i) involves funds derived from illegal activity or is an attempt to disguise funds derived from illegal activity;
    - (ii) is designed to evade regulations promulgated under the BSA, or
    - (iii) lacks a business or apparent lawful purpose.



# What does this mean?

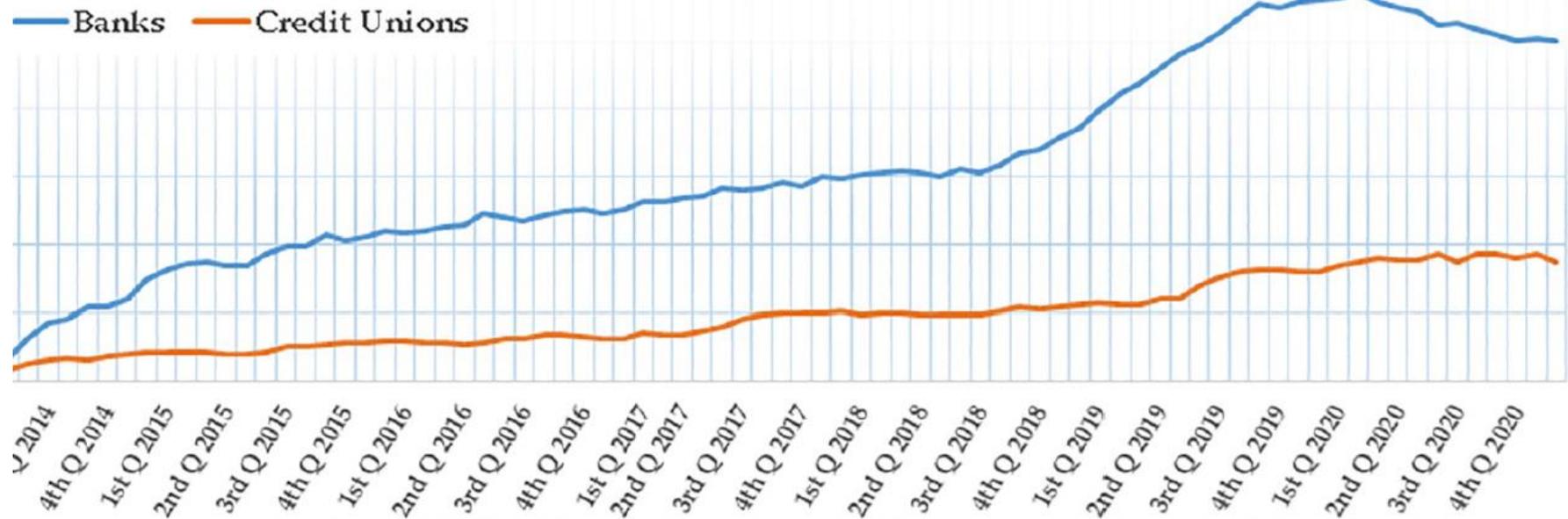
- Relying on existing Federal guidance remains perilous.
  - The FinCEN Guidance remains in effect, and some financial institutions (primarily state chartered, and not in Nevada) have accepted deposits from cannabis-related businesses.
  - BUT, in addition to the risk of federal prosecution and civil forfeiture, there are serious due diligence and reporting burdens.



## Depository Institutions Filing SARs re Providing Services to Cannabis Related Businesses

As of 9/30/2020, FinCEN has received a total of 156,598 SARs using the key phrases associated with marijuana related businesses.

Source: FinCEN



# Secure and Fair Enforcement Banking Act (SAFE Banking Act)

- Passed the House in September 2019. Held in Senate committee, where it languished due to the COVID-19 pandemic.
- Key Provisions:
  - Aims to improve public safety by expanding financial services to cannabis-related legitimate businesses and service providers and reducing the amount of cash at such businesses.
  - Provides a safe harbor from Federal banking regulators taking certain actions against depository institutions solely for providing financial services to cannabis-related legitimate businesses or service providers.
  - Provides that proceeds of a transaction conducted by a cannabis-related legitimate business or service provider shall not be considered proceeds of an unlawful activity under the MLCA solely because the transaction was conducted by such business.
  - Provides certain protections from (i) liability under any Federal law for depository institutions and insurers that provide financial services to cannabis-related legitimate businesses or service providers, and (ii) forfeiture of certain collateral for depository institutions that provide financial services to such businesses.
  - Requires financial institutions to comply with FinCEN's guidance when filing suspicious activity reports (SARs) related to cannabis-related legitimate businesses and service providers.
  - The SAFE Banking Act provisions were included in the Health and Economic Recovery Omnibus Emergency Solutions ("HEROES") Act Covid-19 relief bill passed in the U.S. House in May 2020. They were again included in a bill approved by the house 214–207 in October.

# Obligations for Financial Institutions Under SAFE Banking Act

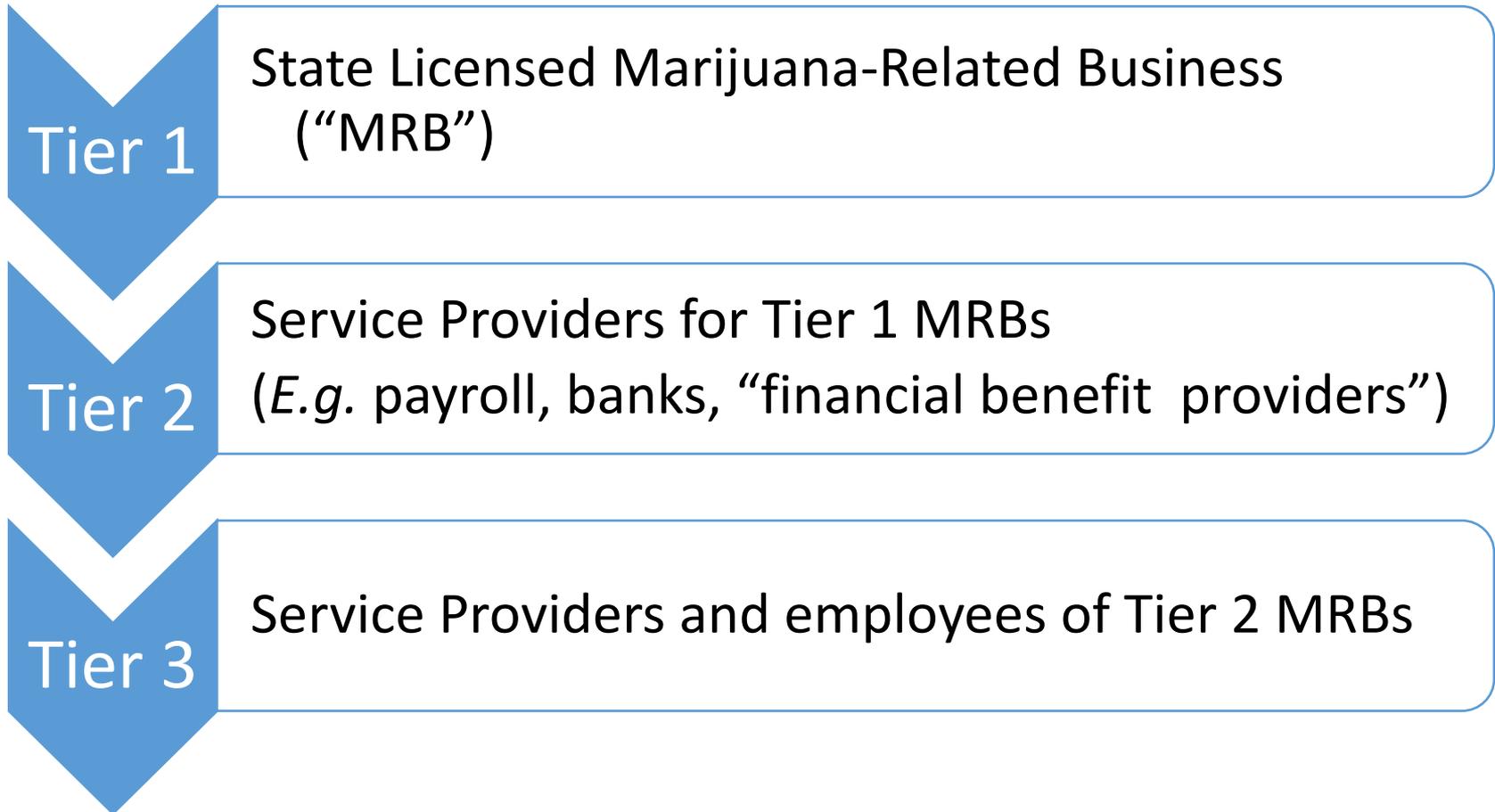


- No Obligation to Provide Financial Services
- Modified Reporting Obligations for Financial Institutions
  - The SAFE Banking Act amends the BSA requirements for filing SARs.
    - Requires financial institutions that report suspicious transactions to comply with appropriate guidance issued by FinCEN if the reason for the SAR relates to cannabis-related legitimate businesses or service providers
    - Requires the Treasury Secretary to ensure that guidance issued by FinCEN:
      - Is consistent with the SAFE Banking Act's purpose and intent; and
      - Does not significantly inhibit financial institutions from providing services to cannabis-related legitimate businesses or service providers in State or local jurisdictions that permit such cannabis-related activity.

# Hemp Business: 2019 Guidance from Financial Regulators

- Joint guidance issued by primary federal bank regulatory agencies, in consultation with the Conference of State Bank Supervisors.
- Confirms that banks may provide banking services to the hemp industry just as they may for any other agricultural commodity.
- Banks no longer required to file a SAR on customers solely because they are engaged in the growth or cultivation of hemp in accordance with applicable law and regulations.
- Banks must comply with applicable regulatory requirements for customer identification, suspicious activity reporting, currency transaction reporting and risk-based customer due diligence, including the collection of beneficial ownership information for legal entity customers.
- Limitations of guidance?

# Banking Issues Impact More Than Just Plant-Touching Businesses



# What Should Tier 2 & 3 MRBs Do?

- If you are an MRB providing a financial product or service, you must:
  - Implement an “AML/BSA” Program
    - Program must have a **deep vetting** of all Tier 1 MRB clients.
    - Collection of Documentation
      - Tax Returns, Bank Statements, Financials, State Licensing Submission Package
      - Background Checks of all owners and financially interested parties
      - A “Site Visit” to check for visual infractions that would violate:
        - Cole Memo Priorities
        - State Regulations



# Tier 1 MRBs



- Comply with applicable state and local regulations
- Don't obscure the nature of your business
  - Non-descript names are a red flag
    - *e.g.*, a “consulting,” “holding,” or “management” company
  - Don't bank hop
  - Don't mess around with overly complicated business structures for tax benefits

# Maintaining A Banking Relationship

- Recognize your business is highly regulated or serving a highly regulated client. All MRBs, including the bank, are going to face intense scrutiny.
- Keep your house in order
  - Business structure
  - AML/BSA Program
  - Get diverse, quality professional advice



# Operational Issues: Real Estate

- Title Insurance
- Secured Lending
- Lease Agreements – “lawful purpose”
- Tenancy Issues
  - Demands on property: power, water, ventilation, compressed gas
  - Security – valuable property and cash
  - Nuisance – other tenant complaints
- Defaulting tenant – abandoned property

# Lease Agreement Provision: Unlawful Activity

“Tenant will not use or occupy, or permit any portion of the Premises to be used or occupied, in violation of any law, ordinance, order, rule, regulation, certificate of occupancy, or other governmental requirement, now or after the date of this Lease affecting the Premises.”

# Lease Agreement Provision: Lawful Purpose

“Tenant will only use or occupy, or permit any portion of the Premises to be used or occupied, for a lawful purpose, now or after the date of this Lease.”

# Which Is Better?

“Tenant will not use ... the Premises ... in violation of any law....”

vs.

“Tenant will only use ... the Premises ... for a lawful purpose....”

# Operational Issues: Tax and 280E

- No **deduction or credit** shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of **trafficking in controlled substances** (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.
- No “Shell Games”!!!
- Spiderwebs just make things more difficult
- \$800 Franchise Tax on each entity

# Operational Issues: Tax and 280E

- IRC §280E disallows deductions or credits paid or incurred **in carrying on a trade or business whose activities consist of trafficking in a controlled substance.**
- IRC 199A allows a deduction at the individual level for qualified business income (QBI)
- Can owners of cannabis passthrough entities take the 199A deduction?
  - Distinction between amounts incurred as expense vs. amount reported as income
  - Medical marijuana – is it in the field of health?
  - Enough wages?

# Operational Issues: Key Tax Court Cases

- Edmondson v. Comm’r, T.C. Memo. 1981-623
  - Allowed business expense deductions for taxpayer who sold drugs.
  - In 1982, Congress enacts IRC 280E in direct response.
- Californians Helping to Alleviate Med. Problems, Inc. (CHAMP) v. Comm’r, 128 T.C. 173 (2007)
  - Taxpayer operating a separate wellness business can deduct business
- expenses.
- Olive v. Comm’r, 139 T.C. 19 (2012)
  - Not allowed to deduct business expenses because dispensing of marijuana and the providing of services and activities shared a close and inseparable organizational and economic relationship.
- Canna Care, Inc. v. Comm’r, T.C. Memo. 2015-206
  - IRC §280E precludes deduction of business expenses; no Excessive Fines Clause defense.

# Operational Issues: Key Tax Court Cases

- Alterman v. Comm’r, T.C. Memo. 2018-83
  - Tax Court could not use Cohan rule to estimate COGS because inadequate recordkeeping.
  - In 1982, Congress enacts IRC §280E in direct response.
- Alternative Health Care Advocates v. Comm’r, 151 T.C. No. 13 (2018)
  - S Corporation that exclusively managed a separate dispensary entity cannot deduct business expenses under IRC §280E.
  - Dispensary operated as a C corporation
  - S Corporation handled hiring employees, paying expenses, including
- advertising, wages, and rent.
  - Court holds only difference was that C corp. had title to marijuana.

# Operational Issues: Key Tax Court Cases

- Patients Mutual Assistance Collective Corporation d.b.a. Harborside Health Center, 151 T.C. No. 11 (2018)
  - Harborside argued that because it was CA compliant, IRC §280E did not apply.
  - Raised some of the same issues as prior cases and also new ones.
- Whether res judicata precludes IRS from arguing it was engaged in trafficking in controlled substance (Based on dismissed forfeiture action)
  - Whether its business “consisted” of trafficking in a controlled substance under IRC 280E (Argued that consist of meant 280E applied only to businesses that exclusively trafficked in controlled substances)
  - What it could include in COGS
- Patients Mutual II, T.C. Memo. 2018-208
  - Harborside not liable for accuracy-related penalty.

# Operational Issues: IRS Offers in Compromise

- Calculation of reasonable collection potential involving businesses cultivating and selling marijuana in states where activity is permitted. Memorandum for Director, Specialty – Offers, Liens and Advisory, Control No. SBSE-5-0416-0016, Expiration April 28, 2017 impacting IRM 5.8.5. 5.8.7.
- Offer will not be rejected just on “public policy” grounds.
- Reasonable collection potential will be determined without regard to deductions not allowed by IRS Section §280E. This will make most offers in compromise not viable.

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THANK YOU!

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