

Business Considerations and Tax Implications

Business Startup Considerations: Financing, Corporate Structure and Tax Implications

Current business owners may wish to expand their distribution to include the sale of marijuana and marijuana infused merchandise and new market entrants may be interested in innovating in this emerging sector of the economy. If you are an entrepreneur, you may be eager to take advantage of a market that is anticipated to flourish or may have newfound interest in entering into one of the sectors of the cannabis industry. Regardless of your situation, you will need a license to grow, process, or sell marijuana.

A few items for business owners and entrepreneurs to consider proactively while New Jersey works on obtaining approval to offer applications for licensing and permitting include:

FINANCING

Obtaining financing to help defray startup costs should be an early consideration for any cannabis entrepreneur. Unfortunately, in states where recreational marijuana has already been legalized, it has been our experience that larger financial institutions have generally avoided the industry to insulate themselves from the risk of penalties from federal regulators. However, there are some banks (especially smaller banks), credit unions, private lenders and investors willing to provide the financing you need.

What does this mean? Without bank credit readily available, businesses may incur higher financing costs from private lenders or investors than the businesses would incur with a traditional bank which typically provide more favorable lending rates. Financing concerns remains one of the largest impediments to the full development of the cannabis industry. Business owners will also need to weigh giving prospective shareholders significant equity and/or control in their venture, while putting into place sufficient shareholder protections to shepherd the business through its infancy. While we are seeing some handicaps placed on financing the industry, the market is creating some other interesting alternatives including rewards-based and equity crowdfunding.

CORPORATE STRUCTURE/SOLID ORGANIZATIONAL DOCUMENTS

Regardless of the business, it is important for partners to have solid organizational documents (bylaws, partnership agreements, operating agreements, etc.) since disagreements can occur at the most unexpected times. Business disputes become even more complex when the underlying activity has

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not been legalized at the federal level. Although corporate structures and business organizations are largely creatures of state law, crafting a solid partnership agreement (bylaws if a corporation or an operating agreement if a LLC) from the onset is imperative especially considering the uncertainty of the future of the cannabis industry. These agreements must be flexible enough to adapt to legislative developments that could impact the organization and its owners, similar to the casino industry.

These documents must also clearly define responsibilities among partners and quickly resolve any disagreements without having to turn to litigation in a potentially unpredictable court system. An attorney can help you draft a strong agreement with solid provisions dealing with initial contributions, potential distributions from cash flow, potential capital calls, confidential arbitration, tax provisions and buy-sells (in case relationships go south or the parties become deadlocked).

TAXATION

As the budding NJ cannabis industry will undoubtedly be highly taxed and regulated, the role of competent legal counsel will be necessary to help potential businesses by creating structures to reduce tax exposure, satisfy the regulatory requirements and shield the owners from liability.

Federal, state and local taxes become even more complex when you add marijuana into the mix. Even though the sale of marijuana hasn't been legalized under federal law, such sales remain subject to taxation pursuant to Section 280E of the Internal Revenue Code, which in turn forces cannabis-related businesses to hand over much more tax revenue compared with other small businesses. The lack of clarity at the federal level may prevent cannabis businesses from taking advantage of many tax credits or deductions that are available to other businesses. Cannabis businesses can take into account direct costs such as cost of goods sold (COGS), but may not deduct ordinary and necessary business expenses and other costs to reduce the potential taxable income; thus creating a much higher effective tax rate for the industry. Our corporate and tax attorneys are available to assist in structuring your business to bifurcate the federally legal and illegal portions of your businesses and thus reduce the eventual tax bill.

Although we don't have much guidance on how New Jersey will tax the cannabis industry, the tax structures imposed on the industries in Alaska, Oregon, California, Colorado and Washington and our own casino industry signal a robust share of revenue going to the state in the form of taxes and fees. Our attorneys are ready to advise on the inevitable sales and/or excise taxes that will be applicable to cannabis businesses.

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