What to Know If You Have High Hopes for Marijuana Legalization

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Gov.-elect Phil Murphy's victory is encouraging for proponents of marijuana legalization and those who object to mass incarceration for marijuana-related offenses. Industry advocates are hopeful that the election results signify rapid growth for New Jersey's budding cannabis industry.

Though we don't know what the future holds, based on Murphy's campaign promises, the cannabis industry in the Garden State is well-positioned for growth during his tenure. Although the campaign emphasized marijuana legalization as a social justice program, the possible economic stimulus to the state cannot be overstated. The legal cannabis industry in New Jersey has been projected to be as large as $1.3 billion, potentially generating more than $300 million in revenue for the state. By way of example, Colorado has increased its tax coffers by over a half-billion dollars since legalization in 2014, with that state pulling in $200 million in 2016 alone. With a significantly larger population, New Jersey stands to generate even more tax income.

Depending on the Murphy's legislative successes in this industry, enthusiastic participants may rush in to create a rapidly expanding legal marketplace. Nationally, the cannabis industry recorded $6.7 billion in sales in 2016 and is on track to reach $50 billion per annum by 2026. Already, close to 30 states permit the use of medical marijuana while recreational use is permitted in eight states plus the District of Columbia. As millennials and successive generations age, we are likely to see increasing majorities in favor of marijuana legalization. As such, business owners should be cognizant of the industry and the rapidly changing legislative landscape.

The federal buzzkill: 3 factors to consider before launching your business

Although there is no shortage of liberalization in the state, lack of action at the federal level will make any movement to modernize the current cannabis regime extremely difficult. As long as Jeff Sessions remains the attorney general, we expect to hear continued negative depictions about recreational drugs and its users. Without any movement at the national level towards legalization or even decriminalization, conflicting federal and state laws and regulations will temper industry growth. Notwithstanding rapidly changing social mores concerning cannabis, we do not anticipate any legislation being proposed by Congressional Republicans and Democrats in Washington for the near future. Alas, maturation of the industry will be led by the states for the time being.

Before you start any cannabis related venture in the Garden State, here are three things you need to consider. Please note that this list is not meant to be exhaustive and does not include the many regulatory hurdles sure to face cannabis ventures in our state. Please consult an attorney before beginning your business.

1. **Financing.** One of the largest concerns from business owners arising from the lack of federal action is with respect to lending and financing (difficulty of obtaining typical bank services is another related issue). Obtaining financing to help defray startup costs should be an early concern for any cannabis entrepreneur. With marijuana, still a Schedule I drug and selling it is a federal crime, larger financial institutions have generally avoided the industry to insulate themselves from the risk of stiff penalties from federal regulators. From a banker's risk perspective, it would be difficult to collect on a loan when the principals are in jail for distribution. However, there are some banks (especially smaller ones) and credit unions willing to lend to such enterprises.

Since larger banks tend to avoid the market, industry participants aren't eligible for the more favorable lending rates normally available to typical bank customers. Cannabis business owners are essentially locked out of the small business lending market. Without bank credit readily available, they are forced to incur higher financing costs from private lenders or investors willing to provide capital. As a result, businesses are subject to nonmarket lending rates or forced to provide prospective shareholders significant equity and/or control in their pot venture. While there are severe handicaps placed on the industry, the market is creating some interesting alternatives including utilizing rewards-based and equity crowdfunding. While the potential of your cannabis venture may be stratospheric, access to capital may be the greatest obstacle for this promising industry in the short term.

2. **Solid Organizational Documents.** Regardless of the business, it is important for partners in a venture to have solid organizational documents (bylaws, partnership agreements, operating agreements, etc.) since disagreements are often inevitable. Business disputes become more complex when the underlying activity is illegal at the federal level.

Although corporate structures and business organizations are largely creatures of state law, it becomes more important to craft good partnership agreements (bylaws if a corporation or an operating agreement if an LLC) from the onset considering the uncertainty surrounding the core business activity. These agreements must necessarily incorporate flexibility to adapt to legislative developments that could impact all facets of the organization from permissible owners of the entity (similar to the casino industry) to the manner in which the product is sold.

Courts, even in jurisdictions where marijuana is legal, may not be in the best position to opine on business disputes in this emerging industry as many industry specific disputes would predictably be cases of first impression. As such, the governing document must also clearly demarcate 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).

3. **Taxation.** Federal, state and local taxes are confusing in their current form for any business. However, they become even more complex when you add marijuana into the mix. Even though the sale of marijuana remains illegal under federal law, such sales remain subject to taxation pursuant to Section 280E of the Internal Revenue Code; which in turn forces more tax revenue to be handed over as compared with other small businesses. The lack of clarity at the federal level also prevents legitimate cannabis businesses from taking advantage of many tax credits or deductions that are available to other businesses. Ironically, these credits and deductions had been created to foster growth for small businesses. Although we don't have much in terms of guidance on how New Jersey will tax the cannabis industry, the tax structures imposed on the industries in Colorado and Washington state could be an indication that a robust share of any revenue generated will go to the state in the form of taxes and fees.

Many states view this industry as an avenue to raise much needed funds and New Jersey appears poised to succumb to this siren's song. Since New Jersey's cannabis industry will undoubtedly be highly taxed and regulated, competent legal counsel will be a necessary precondition as they will be required to help potential businesses create structures to reduce tax exposure, satisfy the regulatory requirements and shield the owners from liability.

Note: Attorney General Jeff Sessions rescinded the favorable Obama-era Dept. of Justice guidance referenced in this article on January 4, 2018.

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