

Counseling a Cannabis-Related Business Overview

DAVID S. RUSKIN, HORWOOD MARCUS & BERK CHARTERED WITH PRACTICAL LAW COMMERCIAL TRANSACTIONS

Search the [Resource ID numbers in blue](#) on Westlaw for more.

A Practice Note providing advice to attorneys on counseling a cannabis-related business. This Note provides a brief overview of the regulation of cannabis and considers the top legal issues faced by a cannabis-related business, focusing on the conflict between federal law and state laws where medical or adult use recreational marijuana is legal.

The emerging industry of cannabis continues to be one of the more intriguing in recent memory. With more states and countries legalizing cannabis in varying forms, the industry is likely to continue to expand. Many companies are moving into the cannabis business or expanding already existing businesses to meet the needs of the quickly growing cannabis industry.

Whether it is the harvesting of hemp for use in health products and clothing, the extraction of cannabidiol (CBD), one of cannabis' non-psychoactive cannabinoids with its proven health and wellness benefits, the cultivation and dispensing of different strains of tetrahydrocannabinol (THC)-containing marijuana for medical or adult recreational use from smoking, vaping, or ingesting edible products, or the multitude of ancillary cannabis-related companies, many of which need an infusion of capital from willing investors, the business opportunities in the cannabis world are vast.

However, cannabis remains an illegal drug at the federal level, presenting numerous challenges for cannabis-related companies and their counsel. This Note examines the top legal issues that practitioners must consider when counseling either a plant-touching cannabis company or a more indirect cannabis-related business. This Note reviews:

- Federal regulation of cannabis (see Federal Regulation of Cannabis).
- State regulation of cannabis (see State Regulation of Cannabis).

- The challenges arising from the conflict between federal and state laws in the following areas:
 - banking (see Conflict Between Federal and State Laws: Banking);
 - tax (see Conflict Between Federal and State Laws: Tax);
 - employees and workplace considerations (see Conflict Between Federal and State Laws: Employees and Workplace); and
 - bankruptcy (see Conflict Between Federal and State Laws: Bankruptcy).
- Specific challenges in the areas of real estate, intellectual property, and dispute resolution (see Specific Challenges to Consider: Real Estate, Intellectual Property, and Dispute Resolution).
- Business structuring considerations (see Business Structuring Considerations).
- Divergent state and local laws (see Divergent State and Local Laws).

FEDERAL REGULATION OF CANNABIS

Cannabis became illegal in the United States in 1937 with the Marihuana Tax Act. In 1970, Congress enacted the Controlled Substances Act (CSA) (21 U.S.C. § 801) under which cannabis was codified as an illegal substance at the highest level, a Schedule I drug under the CSA.

After years of wrangling with prohibition, some states slowly began to enact their own laws allowing for the growth, sales, and use of marijuana for medical purposes. The first major step toward broader change came in 2013, when Deputy Attorney General James Cole issued a memo (the Cole memo) stating that the US Department of Justice (DOJ) did not intend to seek prosecution against any person or company that remained in compliance with a state legal cannabis program (at that time, no fewer than 17 states had laws allowing some form of legalized cannabis). The Cole memo further identified the eight most important areas where the DOJ instead intended to focus prosecution:

- Distribution of marijuana to minors.
- Funding of criminal enterprises.

- Interstate transport.
- Growing on public property.
- Possession on federal property.
- Cover for trafficking other illegal drugs.
- Preventing use of firearms with cultivation.
- Preventing drugged driving.

In 2014, Congress approved the Rohrabacher-Farr budget amendment which prevented the use of any DOJ funds for inhibiting states from instituting medical cannabis laws. This budget amendment was another significant step toward legalization and it has been passed in some form each year since then. Despite Attorney General Jeff Sessions' rescission of the Cole memo in January 2018, there were no DOJ prosecutions against cannabis companies in 2018 and the wave of support for the numerous bills in Congress to legalize cannabis federally continued to grow. The recently enacted Agriculture Improvement Act of 2018, Public Law 115-334, commonly referred to as the Farm Bill, in December 2018, making hemp and hemp-derived products federally legal, is another sign of movement toward full cannabis acceptance.

STATE REGULATION OF CANNABIS

States are continuing to legalize cannabis in varying degrees and methods. Some states have legalized marijuana for medical use only, others for both medical and adult recreational use. Some states have begun to create a regulatory scheme for federally legalized hemp and CBD. Some states only allow for a limited use of products containing lower levels of THC, while others have agreed to decriminalize possession of smaller amounts of marijuana. Still others allow for growing and possessing marijuana but prohibit or limit selling it. Differences abound among the states and therefore the need to stay informed about the differing laws and jurisdictions. For more information, see Practice Note, *State Medical and Recreational Marijuana Laws Chart: Overview* ([7-523-7150](#)).

The key for any cannabis-related business in the current climate is simple: ensure full compliance with state and local laws. Every state's law regarding cannabis is different. For every new state law lifting a ban on cannabis in some form, the drafting and implementing of new regulations is also necessary for both medical and recreational adult use. These include requirements, just to name a handful, such as licensing and inspection of cultivation facilities, licensing for retail sales, limitations for possession and use, seed-to-sale tracking systems for thorough oversight, collection of sales taxes, and penalties for illegal conduct. With differing and changing state laws in the face of ongoing federal illegality, the margin for error is small. But the opportunities are there for diligent participants to help the industry progress. Effective legal counseling in the cannabis industry is crucial.

CONFLICT BETWEEN FEDERAL AND STATE LAWS

A primary challenge for counseling any cannabis-related business is the ongoing tension between a particular state's law, where cannabis is legal in some form, and federal law, under which cannabis remains a Schedule I illegal drug under the CSA. Until cannabis is de-scheduled from the CSA as federally illegal or a new federal law is enacted that unequivocally defers to individual state laws and

protects state-compliant businesses, the conflict between federal and state law is likely to remain a high hurdle for cannabis-related businesses to overcome.

Cannabis-related businesses of all kinds are faced with various concerns and some are forced to test the legal waters for clarity. The current unknown legal scenarios are numerous, with some state courts even having determined that federal law preempts state medical marijuana laws. Navigating the new roads being paved in this industry is likely to be challenging for cannabis-related businesses and their counsel.

Counsel should monitor the status of the pending federal bills regarding cannabis. In the most recent US Congress (115th), there were more than 60 different versions related to some form of cannabis legalization. It is expected that this session (116th Congress) is likely to push further with proposals that:

- Provide deference to state cannabis laws.
- Allow for financial institutions to do business with cannabis-related businesses without fear of criminal prosecution in states where cannabis is legal.
- Prohibit the DOJ from interaction if the cannabis-related business is in compliance with state law.

These changes, if enacted into law, would remove many legal hurdles for cannabis-related businesses, even without a full de-scheduling of cannabis from the CSA.

CONFLICT BETWEEN FEDERAL AND STATE LAWS: BANKING

MOST BANKS REMAIN HESITANT TO DO BUSINESS WITH CANNABIS-RELATED COMPANIES

Likely the most difficult current issue emanating from the conflict between federal and state laws regarding legalization of cannabis is banking. Financial institutions remain hesitant to open accounts and provide other financial services to customers the business of which remains illegal under federal law. As a result, companies operating a cannabis-related business have immediate and ongoing issues with the handling of cash generated, most notably regarding paying employees, taxes, vendors, and other third parties. These issues are in addition to the initial struggle to find a depository institution.

Financial institutions have mostly avoided the federally illegal cannabis industry to date for various reasons, including:

- No complete assurance of protection from the federal government for the federally illegal nature of the product, creating an ongoing potential legal exposure.
- Servicing cannabis-related businesses requires significantly more administration and oversight for compliance with anti-money laundering regulations and the Bank Secrecy Act (BSA), including the required filing of Suspicious Activity Reports (SARs) for disclosure of every cannabis-related transaction.

The purpose of SARs is to assist federal investigators in spotting and stopping criminal enterprises. Under the Financial Crimes Enforcement Network (FinCEN) rules, banks must file one of three types of SARs for each cannabis-related transaction. SAR's reporting is required even where operations are legal in that state. SARs not only create more scrutiny by federal regulators, but they

significantly increase the costs for the financial institution to maintain the required due diligence and additional administrative burdens. These costs are most likely to be passed along to the bank's cannabis company customer. For more information, see Practice Note, [Suspicious Activity Reporting Requirements for Financial Institutions \(6-604-9506\)](#).

For any financial institution undertaking the challenge of the cannabis industry, avoiding violations and resulting penalties requires diligent focus on the following:

- In-depth assessment and deep understanding of the customer's business, including the customer's affiliates, licensing arrangements, and Know Your Customer (KYC) compliance (see Practice Note, [USA PATRIOT ACT and Know Your Customer Requirements for Lenders \(6-504-7122\)](#)).
- Completion of significantly more documentation for regulatory reporting.
- Increased and ongoing audit activity.
- Compliance with priorities listed in the Cole memo.
- Review of internal policies and compliance procedures.
- Hiring, training and oversight of additional employees dedicated to cannabis-related businesses.

For cannabis-related businesses, deciding whether to move from operating completely in cash to using a financial institution, if the opportunity arises, also presents various concerns, including:

- Complete transparency of the business and all individuals involved.
- Increased cost, passed down from banks for increased compliance expenses.

STATE CHARTERED BANKS AND CREDIT UNIONS

Some state chartered banks and credit unions have still decided to take on cannabis-related businesses, taking cover under the support of the FinCEN guidance in 2014 and the ongoing "assurance" from FinCEN and recent attorney general statements that a bank's full compliance with the BSA regulations serves as protection. The guidelines pronounced by FinCEN, however, include extremely strict due diligence and reporting obligations to the government. Accordingly, most banks still consider the obligations too onerous and the risk too great.

ALL CASH BUSINESS

For many current cannabis-related businesses, the only real option is an all cash business. This unusual operational quagmire results in additional concerns unlike almost any other business, such as:

- **Additional security measures needed.** The current all cash nature of cannabis-related businesses presents a scenario ripe for robbery. Daily cash payments from customers requires on-site safes and significant full-time security of the premises.
- **Cash transportation concerns.** Moving money off the premises also requires additional security measures.
- **Logistical issues with paying employees, vendors, and taxes.** With employees and vendors getting paid in cash, special measures also need to be undertaken for safety and record keeping. Even payment of taxes requires special efforts between the business and the tax collector.

Addressing these additional concerns results in at least one consistent problem for the cannabis-related business, more expense.

Even a company that is only ancillary to the industry may find that its own banking relationships may be hindered by transacting directly with a cannabis business. This depends on the bank's concerns with potential money-laundering and BSA implications.

PRACTITIONER TIPS

To address banking-related challenges, counsel for a cannabis-related business should:

- Determine whether the client is interested in working with a bank, after analyzing the pros and cons.
- Search the state and neighboring states for banks or credit unions that are already working with cannabis-related businesses and start a discussion.

When counseling financial institutions doing business with a cannabis-related company, counsel should understand their concerns and identify the additional obligations for banks when working with cannabis-related businesses.

CONFLICT BETWEEN FEDERAL AND STATE LAWS: TAX SECTION 280E PROHIBITION OF BUSINESS EXPENSE DEDUCTIONS FOR CANNABIS BUSINESSES

Under the Internal Revenue Code (the Code), a business is entitled to deduct its ordinary and necessary business expenses for carrying on its trade or business in calculating taxable gross income (26 U.S. Code § 162).

Maximizing business expense deductions is a common tax strategy. Regardless of the industry, decreasing overall federal tax liability can be accomplished by deducting numerous allowable business expenses, including employee compensation, rent, business interest, marketing and advertising, insurance, utilities, and other taxes. But these deductions are not available for cannabis businesses. Under Section 280E of the Code, business expense deductions are prohibited for any trade or business that involves "trafficking in controlled substances." In light of the current inclusion of cannabis as a controlled substance under Schedule I of the CSA, cannabis businesses are included in this prohibition dictated in Section 280E and therefore must pay taxes on all their revenue without the benefit of being able to use business expenses (other than a narrowly defined "costs of goods sold") to reduce their taxable income.

Some cannabis companies have argued to the IRS that they should at least be allowed to deduct business expenses incurred for separate lines of business not directly related to the sale of cannabis. The IRS and various reviewing courts have consistently held to-date that if any part of the business relates to cannabis, then Section 280E prohibits all business expense deductions, even if that trade or business also engages in other activities. Because of Section 280E, the federal tax liability for cannabis businesses is significantly higher than for other companies. The effective income tax rates for cannabis businesses can easily reach 70 to 90 percent, making it difficult to even stay in business.

CREDIT FOR COST OF GOODS SOLD IS PERMITTED

All is not lost, however, as cannabis businesses are still able to take a credit for Cost of Goods Sold (COGS), which can potentially include these important expenses:

- Cost of the product.
- Storage.
- Direct labor.

For example, a COGS credit allows a marijuana seller or dispensary to deduct the purchase price of its inventory, which is the wholesale cost of the product. The COGS credit is actually most helpful as a tax deduction to cultivating facilities. These businesses can realize more benefit than most other cannabis-related businesses, as they can deduct costs for growing the product, such as:

- Electricity.
- Labor.
- Fertilizer.
- Water.

PRACTITIONER TIPS

Cannabis-related businesses and their counsel can try to address the tax-related challenges by the following tips:

- **Minimize non-COGS expenses, anywhere possible.** Minimizing operating costs is essential. For example, a smaller retail space should help reduce monthly rent or mortgage payments, require fewer employees, and generate smaller utility bills.
- **Try to separate any non-cannabis aspect of the business into a different entity.** Apportioning non-COGS expenses to a non-cannabis entity, to the extent possible, can potentially result in at least some tax savings. For example, a cannabis business may, if reasonable:
 - assign part of its space to the separate line of business; or
 - apportion part of its employee time and cost to the separate line of business.
- **Keep thorough and accurate records.** Expect to be audited. The IRS has dedicated employees for Section 280E analysis and detailed records are requested.
- **Early on, engage a certified public accountant (CPA) experienced with 280E and cannabis-related businesses.** Especially while 280E is still in play for cannabis-related businesses, a CPA must be engaged.

CONFLICT BETWEEN FEDERAL AND STATE LAWS: EMPLOYEES AND WORKPLACE

Workplace protections and related employment issues are directly affected by both the inconsistent federal and state laws and also by the changing laws in each state regarding cannabis in addition to changing interpretations of those laws. These employment-related issues concern not just cannabis-related businesses but **all employers** in states with statutes allowing some form of legal cannabis.

No state requires employee accommodations for recreational adult use, even where this use has been otherwise legalized. The vast majority of states do not require accommodation for medical adult

use, even where medical use is legal, but some courts have taken the position that off-site use of medical cannabis may be a reasonable accommodation under state law.

EMPLOYMENT-RELATED ISSUES IN STATES ALLOWING MEDICAL MARIJUANA

In states allowing for medical marijuana use, the medical conditions that qualify for legal cannabis use can differ. For example, more restrictive jurisdictions like Iowa allow only for the use of cannabidiol to treat specific medical conditions enumerated in the statute (Iowa Code Ann. § 124E.12). On the other end of the spectrum, California permits the use of medical cannabis for any condition approved by a physician. Although the state offers an identification card, all that is required for medical cannabis access is a written recommendation from a physician (Cal. Health & Safety Code § 11362.7(f), defining “qualified patient”).

In states where conditions are specifically articulated, where a patient qualifies under one of the identified conditions in the state, a medical practitioner typically must provide that patient with a certification in some established form. The patient then generally must register with the state to become a legal medical marijuana “cardholder.”

State Employment Protections for Medical Marijuana Cardholders

Employees that are registered medical marijuana cardholders (employee-cardholders) have protections under the medical marijuana law enacted in some, but not all, states. Many of the state statutes regarding medical cannabis specifically address whether the law affects an employer’s treatment of an employee-cardholder. Currently, the medical marijuana laws in the following states contain language specifically prohibiting discrimination against employee-cardholders:

- Arizona.
- Connecticut.
- Delaware.
- Illinois.
- Maine.
- Minnesota.
- Nevada.
- New Mexico.
- New York.
- Oklahoma.
- Rhode Island.

These state statutes generally contain exceptions to the protection of employee-cardholders, to the employer’s benefit, for example where:

- Drug testing is required for that job under federal law (for example, the US Department of Transportation requires drug and alcohol screening for commercial vehicle drivers).
- Nondiscrimination against an employee-cardholder may cause the employer to lose either a monetary or a licensing-related benefit under federal law.

State laws allowing medical marijuana use also typically carve out exceptions for on the job use, possession, or impairment scenarios so that employers can still control activity in the workplace and

during work hours. Some of these state laws also prescribe that the existence of marijuana reflected in an employee's drug test, within limits, cannot alone be a basis for establishing on the job use or impairment during work hours.

Some states, such as California and Colorado, expressly allow employers to provide no additional workplace protections for medical marijuana users, whether in hiring or continued employment. Employee-cardholders in these states do not have employment protections under the medical marijuana law, even if they are following state law and limit their use to off-duty hours.

For detailed information regarding state medical marijuana laws, see Practice Note, State Medical and Recreational Marijuana Laws Chart: Overview: Medical Marijuana ([7-523-7150](#)).

PRACTITIONER TIPS

Courts are increasingly issuing decisions interpreting the various state laws on workplace protections and related employment issues. Employers should carefully review the applicable state laws and interpretive case law for all relevant states when drafting drug-testing and substance-abuse policies. (For information about state laws on drug testing, see Drug Testing Laws: State Q&A Tool.)

Businesses that already have drug policies in place should review them for potentially appropriate revisions based on the changing state cannabis laws and court interpretations. While employers may not be required to accommodate on-the-job use, making reasonable accommodations for registered medical users in appropriate jurisdictions is likely a sound approach that is likely to withstand judicial scrutiny. More tailored policies for employee-cardholders are likely to decrease litigation risk compared to blanket policies excluding marijuana users from employment.

CONFLICT BETWEEN FEDERAL AND STATE LAWS: BANKRUPTCY

Cannabis-related businesses do not have access to the protections of the Bankruptcy Code. Because the Bankruptcy Code is a federal statute, cannabis-related businesses are prohibited from accessing bankruptcy protections until cannabis is de-scheduled as an illegal substance under the CSA.

Even if a cannabis-related business fully complies with state laws, it still cannot obtain federal bankruptcy protection while cannabis remains illegal under federal law (despite the DOJ's current practice of non-prosecution) because:

- A reorganization plan that permits or requires illegal activity (such as a violation of the CSA) cannot be confirmed (see §1129(a)(3), Bankruptcy Code).
- Bankruptcy trustees, as fiduciaries of the bankruptcy estate, cannot administer estate assets without violating the CSA and should not be required to do so.

Failing cannabis companies do have other options, which include state sanctioned assignment for the benefit of creditors (see Practice Note, Assignments for the Benefit of Creditors: Overview ([W-006-7771](#))) or receivership (see Practice Note, Corporate Receiverships: Overview ([W-013-1951](#))). Liquidation of assets or complete sale of the business can still occur under those scenarios,

but without official bankruptcy protection. These non-bankruptcy alternatives still help with creditor concerns and are typically a preferable process to an unstructured winding down of the company, which may leave creditors angry and in pursuit of the business owners to personally satisfy any outstanding debts.

However, non-bankruptcy alternatives lack certain benefits available in bankruptcy. Under the Bankruptcy Code, the debtor or trustee:

- Has the opportunity to object to certain creditor's claims (see Practice Note, Objections to Claims: Overview ([W-008-8970](#))).
- Can avoid payments made by the company to third parties during the 90 days before the bankruptcy filing and further back (one year) if the payment is to a company insider (see Practice Note, Preferential Transfers: Overview and Strategies for Lenders and Other Creditors ([6-381-6416](#))).

Cannabis companies also cannot benefit from:

- The automatic stay, which automatically stops substantially all litigation against the debtor immediately on filing a bankruptcy petition, giving the struggling company breathing room from its creditors' pursuit of payment, and is helpful to a judge or trustee gathering and evaluating a company's assets and liabilities (see Practice Note, Automatic Stay: Overview ([9-380-7953](#))).
- The ability to reject burdensome executory contracts and unexpired leases and curb ongoing contractual damages (see Practice Note, Executory Contracts and Leases: Overview: Rejection ([8-381-2672](#))).
- A bankruptcy judge and bankruptcy court rules for controlling the entire process.

For more information, see Practice Note, State-Legalized Marijuana Businesses and Access to the Bankruptcy Code ([W-014-7152](#)).

SPECIFIC CHALLENGES TO CONSIDER: REAL ESTATE, INTELLECTUAL PROPERTY, AND DISPUTE RESOLUTION REAL ESTATE

While some states, such as Arizona, Illinois, and Oklahoma, expressly prohibit discrimination by landlords against tenants for legal use of cannabis, federal law prohibits knowingly opening, leasing, renting, using, or maintaining any place to permanently or temporarily manufacture, distribute, or use any controlled substance (21 U.S.C. § 856(a)(1)). Despite the DOJ's policy of non-prosecution, property owners considering leasing property to an entity engaged in cannabis-related activity should still conduct due diligence before entering into a lease to determine whether that lease violates any state and local laws or other contractual restrictions, including:

- Zoning restrictions.
- Deed covenants.
- Mortgage provisions.
- Financing terms.

There are risks to a landlord that leases its property to a tenant that sells or cultivates cannabis, including:

- The landlord may lose its property and the rent paid by the cannabis tenant because of forfeiture if the federal government prosecutes the landlord for leasing its property to a tenant that sells or cultivates cannabis.

- A landlord may lose its property insurance coverage for leasing to a cannabis tenant.
- Payment of rent by cash causes security and financial complications.
- The landlord can be in default under its loan documents for its lender financing of the property for violating requirements to comply with applicable laws and other provisions of the loan documents.
- A potential purchaser may be reluctant to acquire property with a cannabis tenant.
- Environmental issues arise with the storage and disposal of cannabis and cannabis-related products.
- The licensing of the cannabis business for operation at the landlord's property can be costly and time consuming.
- Private land use covenants, conditions, and restrictions can be violated by the operation of a cannabis business on the property.
- Refinancing a loan on the property can be difficult.

Tenant's also have the same concerns. A cannabis tenant should also:

- Negotiate for a lease termination right if the state or municipality where the property is located no longer legalizes the production or sale of cannabis.
- Restrict the landlord's access to sensitive areas of the premises that store cannabis.

INTELLECTUAL PROPERTY

Currently, US intellectual property law affecting a cannabis-related business differs depending on whether the business is seeking:

- **A trademark.** Cannabis-related businesses are not allowed to obtain a federal trademark from the US Patent and Trademark Office for goods or services that are unlawful under the CSA. Many companies are still filing trademark applications for lawful, ancillary goods and services, for example, website informational services in the cannabis field. Some are also filing applications for goods or services that violate the CSA in the likelihood that the law changes while their applications are pending. For more information, see Article, Trademark Registration in the Cannabis Industry ([W-018-7396](#)).
- **A patent.** Cannabis-related businesses are still able to obtain patents regardless of the CSA scheduling of cannabis because there is no requirement that the underlying use be in "lawful commerce," like there is for a federal trademark. Available patents include:
 - utility patents for new formulations or use techniques (currently the most popular patent type);
 - design patents for product design; and
 - plant patents for specific types of marijuana plants reproduced from a specific parent (currently few of these exist).
- It is still unknown how and whether federal courts may interpret the laws when patents are challenged or otherwise litigated, while cannabis remains an illegal substance under the CSA.
- **Copyright protection.** Copyright protection is also available from the US Copyright Office, even while cannabis is illegal under the CSA. To obtain a copyright, the work must be:

- original and creative;
 - fixed in some tangible form of expression; and
 - for more than just a passing duration.
- A cannabis-related business is not prohibited from registering its works, which can include brochures, artwork, and related videos. Unlike other forms of intellectual property, copyright protection does not necessarily require registration. However, registration for a copyright is beneficial for the holder if litigation occurs over the copyright because it provides a basis for:
 - an infringement claim;
 - proof of ownership; and
 - statutory damages.

For more information on intellectual property issues generally, see Practice Note, Intellectual Property: Overview ([8-383-4565](#)).

DISPUTE RESOLUTION

Uncertainty surrounding whether and how the federal courts may address disputes involving a cannabis-related business and cannabis issues remains a potential issue while cannabis is an illegal substance under the CSA.

When counseling a cannabis-related business regarding dispute resolution, counsel should be aware of the jurisdictional options for hearing the dispute, including:

- Diversity or a federal question jurisdiction for federal court.
- State court.
- Arbitration.

When drafting and negotiating written agreements for a cannabis-related business, counsel should consider the potential for dispute resolution, including whether to include:

- A venue provision in the agreement, so that disputes are resolved exclusively in a particular jurisdiction, where:
 - cannabis is legal in the state; and
 - the federal court has previously agreed to hear cannabis-related disputes.
- A choice of law provision so that a particular state's law is followed, even if the dispute is heard in a different jurisdiction.
- A designation of the state court as the exclusive forum with a waiver of the right of removal to federal court.
- An arbitration provision to:
 - avoid potential illegality defenses raised in a court; and
 - reduce costs.

For more information on choice of forum and choice of law generally, see Practice Notes, Choice of Law and Choice of Forum: Key Issues ([7-509-6876](#)) and Arbitration vs. Litigation in the US ([W-006-5897](#)).

Because transactions concerning cannabis are illegal under the CSA, there remains a risk that courts do not enforce the parties' rights and obligations as violative of public policy. By contrast, most arbitrable tribunals, applying the separability doctrine, do not decline to hear a case even where the underlying agreement may be illegal or invalid. Courts generally enforce arbitration agreements and awards in the face of assertions that to do so is against public policy (see Practice

Note, Challenges to Arbitral Awards in the US Based on Public Policy Violations ([W-007-8103](#)). Parties should also choose a state in which transactions in cannabis are legal as the arbitral seat (see Practice Note, Choosing an Arbitral Seat in the US ([1-501-0913](#))).

For more information on arbitration and dispute resolution, see Practice Note, Drafting Arbitration Agreements Calling for Arbitration in the US ([2-500-4624](#)) and Standard Clause, General Contract Clauses: Alternative Dispute Resolution (Multi-Tiered) ([9-555-5330](#)).

BUSINESS STRUCTURING CONSIDERATIONS

When forming any business, the first step is to decide on a strategic business structure. Using an entity to operate a business is desirable because, as a general rule, the equity owners of an entity are not personally liable for the entity's liabilities.

Similar to other industries, the most commonly used entity types for a cannabis-related business include:

- A corporation, whether a C-corporation or an S-corporation (see Practice Note, Forming and Organizing a Corporation: C- or S-Corporation? ([7-381-9674](#))).
- A limited liability company (LLC) (see Forming an LLC Checklist ([2-381-1369](#))).

Particular state cannabis law requirements, however, may drive the decision to use another business entity type, such as a non-profit or cooperative entity. For more information on structuring a business generally, see Choosing an Entity Comparison Chart ([7-381-0701](#)).

Analyzing in which jurisdiction to form a cannabis-related business generally focuses on the same considerations as those for other types of businesses, including whether a state:

- Is more cannabis-friendly for licensing purposes.
- Has corporate statutes (like Delaware) that tend to favor majority owners over minority owners.
- Tends to favor (like California) consumer rights over corporate privacy.

Each of these considerations varies based on the specific nature of the cannabis-related business and the practical goals of the enterprise.

C-CORPORATION, S-CORPORATION, OR LLC?

A C-corporation is generally chosen as the entity structure if the business intends to raise funds from outside investors. Given the current difficulty of obtaining financing from banks and other traditional financial institutions, cannabis-related businesses tend to obtain capital directly from investors in exchange for equity interests in the company. A C-corporation is the favored investment vehicle because a C-corporation:

- **Can issue different classes of stock to its investors.** For example, a C-corporation can create a class of preferred stock that affords an investor attractive premiums or preferential distributions. An S-corporation, on the other hand, only allows for one class of stock and therefore cannot create a preferred class of stock.
- **Can grant qualified stock options to employees.** A C-corporation can use these as an important recruiting and retention mechanism

for key employees. An LLC can issue profits interests or non-qualified options (to acquire a membership interest) to its employees.

- **Is more suitable for a potential initial public offering (IPO).** An IPO allows investors to become shareholders by purchasing stock in the C-corporation, allowing the company to amass significant capital. Except in certain industries (such as energy), an LLC is not usually publicly traded and often must be converted to a corporation before an IPO. Currently, cannabis-related companies cannot be traded publicly in the US.
- **Protects its shareholders from personal liability relating to the company's federal income tax.** This is an important difference when deciding between a C-corporation, on the one hand, and an LLC or an S-corporation, on the other hand. For LLCs and S-corporations, the tax liability flows through to the equity owners.

The primary disadvantage in choosing a C-corporation over an LLC or S-corporation is the double taxation of C-corporations. The income of a C-corporation is taxed both:

- **At the entity level.** A C-corporation must pay corporate income tax.
- **At the shareholder level.** Shareholders must pay individual income tax when corporate income is distributed by using dividends.

Double taxation can be enough to prevent a business from choosing to operate as a C-corporation. However, the recent reduction in the corporate tax rate from 35% to 21% under the Tax Cuts and Jobs Act (TCJA) has tempered this deterrent. After the TCJA, it may be more advantageous in some cases to operate as a C-corporation, even with the double taxation. The determination hinges on a variety of factors, including the projected combined entity and individual tax rates on business operations and other non-tax factors. For more information, see C-Corporation and Partnership Tax Comparison Chart ([W-016-0126](#)).

Other disadvantages of C-corporations include the formal requirements to create and maintain a C-corporation, such as:

- Adopting bylaws.
- Properly identifying officers and directors.
- Maintenance of detailed books and records.
- Holding an annual shareholder meeting and board meetings.

These corporate formalities are costly, especially compared to LLCs which are not subject to these requirements.

Advantages of an LLC over a corporation include:

- **More flexible and less costly organization and management.** LLCs are governed by an operating agreement, which is written and agreed to by the members (owners) of the LLC and governs the structure and operations of the company. Operating agreements can be customized and amended, by their terms, fairly easily. LLCs are not required to maintain the same strict formalities, with a board of directors and bookkeeping requirements, as corporations. Where there are a small number of owners acting as the primary funders of the business, an LLC is often the preferred structure.

- **No double taxation.** The profits and losses of the business flow through to the members of the LLC. The entity itself is not taxed on the income of the company. Instead, each LLC member is taxed on the individual share of income distributed.

An LLC is typically preferred to a C-corporation if:

- The business plan reflects a maximum distribution of funds to its investors rather than a reinvestment of those funds for growth of the business.
- The business owners contemplate additional property contributions and distributions after initial entity formation.
- The business owners expect the business to operate at a loss.
- The business owners qualify for the new IRC Section 199A 20% deduction for qualified business income earned directly or indirectly from pass-through entities (including an LLC).
- The business owners prefer the flexibility of an LLC's operating agreement and seek fewer corporate formalities.

If a later analysis deems taxation as a C-corporation preferable, an LLC generally can be converted into a C-corporation. For more information, see Practice Note, Partnership to C-Corporation Conversion: Tax Issues ([W-016-7924](#)).

S-corporations are generally **not preferred** over either an LLC or a C-corporation due to the substantial limitations on the availability of the S-corporation election. For example, an S-corporation must be an eligible US entity and can have:

- Only one class of stock.
- No more than 100 stockholders.
- With certain limited exceptions, only US individuals (citizens or residents) as stockholders.

(IRC § 1361.)

For more information, see Practice Notes, Choice of Entity: Tax Issues ([1-382-9949](#)) and Taxation of S-Corporations ([6-551-5345](#)).

For more information on LLCs, see Practice Note, LLC Agreement Commentary ([1-381-0515](#)) and Standard Documents, LLC Agreement (Multi-Member, Manager-Managed) ([3-500-9206](#)) and LLC Agreement (Single Member) ([2-381-2420](#)) and Practice Note, Taxation of Partnerships ([W-000-6885](#)).

SPECIAL CONSIDERATIONS FOR CANNABIS-RELATED BUSINESSES

Calculating business income is basically the same for C-corporations and LLCs. However, special consideration should be given to cannabis-related businesses regarding how Section 280E affects business income. Determining how income may be affected can influence how and when distributions are to be made, if at all.

Analyzing income projections and distributions may drive the decision on entity type (see C-Corporation, S-Corporation, or LLC?). Counsel should consider the full picture of the business as part of the entity choice and remember that business structuring considerations for the cannabis industry may also be affected by:

- Rapidly changing state laws.
- Expected revisions to federal law in the near future, whether:
 - a full de-scheduling of cannabis from the CSA;
 - allowing complete deference to state laws; or
 - a smaller fix to Section 280E.

DIVERGENT STATE AND LOCAL LAWS

Counsel for a cannabis-related company must fully understand the state and local laws where the client is located and operates. Compliance with the varying statutory and regulatory regimes in all jurisdictions is both challenging and of paramount importance in the cannabis industry.

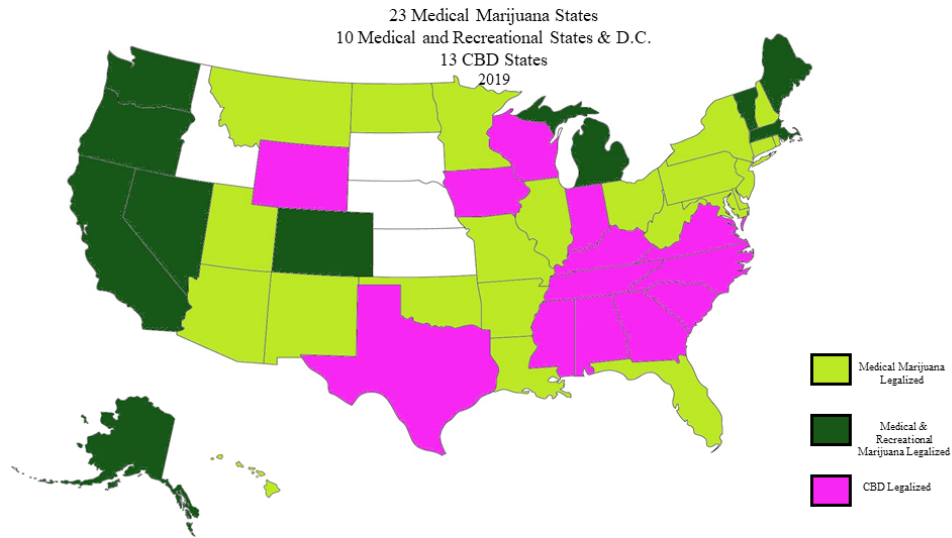
There is no uniformity among those states that allow for some form of legalized cannabis. Some states allow for both medical cannabis use and adult recreational cannabis use, while others allow legal cannabis solely for medical use. Some states allow for cannabis, or CBD, but only with low levels of THC (see, [Map of Legalized Cannabis States](#)).

Among those states allowing some form of legal cannabis, each has its own regulatory scheme for licensing and virtually all cannabis-related activities. Regulations can cover not only the cultivation and selling of cannabis, but also related issues like testing of product for quality and quantity, packaging, and product branding.

Counsel should also be aware of the ordinances of the relevant local municipality and county government. The local jurisdictions within each state (cities, counties, and villages) can have their own, more restrictive, regulations regarding possession, sale, and use of cannabis than the particular state's laws. For example, local ordinances may restrict the location of or even completely prohibit a marijuana cultivator, dispensary, or a related business, even where the state's statute allows for medical or adult recreational cannabis.

Compliance with the various laws relevant to a particular location can be challenging. Additional compliance with the various rules and regulations for other governing bodies makes it even more challenging. As a best practice, all cannabis-related businesses should have a dedicated compliance team to keep focus on the multitude of rules, regulations and requirements, many of which are likely to be different from business to business, depending on what the cannabis-related business is doing and where.

MAP OF LEGALIZED CANNABIS STATES



ABOUT PRACTICAL LAW

Practical Law provides legal know-how that gives lawyers a better starting point. Our expert team of attorney editors creates and maintains thousands of up-to-date, practical resources across all major practice areas. We go beyond primary law and traditional legal research to give you the resources needed to practice more efficiently, improve client service and add more value.

If you are not currently a subscriber, we invite you to take a trial of our online services at legalsolutions.com/practical-law. For more information or to schedule training, call **1-800-733-2889** or e-mail referenceattorneys@tr.com.