NACB SYMPOSIUM

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280E – THE BASICS

- Section 280E of the IRC prohibits cannabis growers, processors, distributors, and retailers from deducting otherwise ordinary and necessary business expenses (“non-COGS business expenses”) from the gross income associated with the “trafficking” of Schedule I or II controlled substances.
- Cannabis businesses often pay effective tax rates that are 70% or higher which creates challenges to the industry and inhibits growth of the market.
- There are tax preparers and operators that would argue that 280E does not apply to state-regulated cannabis businesses; however, we do not believe that such an argument can be supported by any authority, be it the statute, current regulations or case law (Alpenglow July 3, 2018).

280E-COMMON DISALLOWED EXPENSES

- Wages and Salaries
- Utility costs such as electricity, telephone service and internet
- Health insurance
- Marketing and Advertising
- Repairs and maintenance
- Business meals and entertainment
- Payments to Contractors
- Rental fees for facilities

280E – OTHER PITFALLS

- Non-compliance with 280E will significantly impact future business valuations because of the unknown federal tax liability, and in some cases state tax liability assumed by a potential buyer.

- New partnership audit rules, which assess tax deficiencies, penalties and interest at the partnership level, mean that an investor that joins the business could pay for the sins of past investors if a future audit discovers an underpayment related to prior years.

- Businesses and taxpayers that are being overly aggressive or careless with 280E compliance may see themselves pay a lower effective tax rate today, but at the risk of future penalties, interest and a impairment in the business valuation.

280E – ANCILLARY BUSINESSES

- Cost segregation studies
- Bonus depreciation
- Section 199 Domestic Production Deduction (eliminated with TCJA)
- Research and Development (R&D)
- Work Opportunity Tax Credits
- Energy credits and incentives
- State incentives

280E – IMPACT VARIES BY OPERATION

No Problem	• Ancillary (non-plant touching) businesses
Minor Problem	• Cultivation/Production
Manageable Problem	• Vertically integrated operation
Big Problem	• Retail/Dispensary
Huge Problem	• Distribution

280E – BAD MITIGATION STRATEGIES

- Denial
- 263A – Uniform Capitalization Rules
  - 280E predates 263A; so taxpayers should look to 471, not 263A
- Allocation of admin/OH costs to non-plant touching operations
  - Square footage, revenue, hours, head count
  - May be best option for retail/dispensary operations
  - Altermed 6/13/2018
    - *"Under the circumstances, we hold that selling non-marijuana merchandise was not separate from the business of selling marijuana merchandise. First, Altermeds, LLC, derived almost all of its revenue from marijuana merchandise. Second, the types of non-marijuana products that it sold (pipes and other marijuana paraphernalia) complemented its efforts to sell marijuana. Altermeds, LLC, had only one unitary business, selling marijuana."*

280E – BETTER MITIGATION STRATEGIES

- Allocation of admin/OH costs to production operations
  - Square footage
  - Revenue
  - Hours, head count
  - Best option for cultivation, manufacturing or vertically integrated operators
- Segregation of real estate and equipment to allow accelerated depreciation
  - TCJA grants a 100% immediate deduction for certain capital expenditures (“bonus depreciation”)

280E – BETTER MITIGATION STRATEGIES

- Utilization of new 199A, QBI, pass through deduction
- Use of management company or leased employee model to allow for R&D Credit and WOTC utilization.
- Utilization of new reduced corporate tax rate (21%)

199A – QUALIFIED BUSINESS INCOME

- Effective for tax years beginning after December 31, 2017 and before January 1, 2026, that provides for a potential deduction/exclusion of up to 20% of "Qualified Business Income" ("QBI") earned by an individual, trust or an estate from a partnership, S corporation, or sole proprietorship.

- There are no limitations for deducting 20% of qualified trade or business income earned directly from a pass-through entity for married filing jointly taxpayers with taxable income less than $315,000 and $157,500 for individuals filing single. However, the 20% deduction is phased out ratably on taxable income above $315,000 and completely at taxable income of $415,000 for married filing jointly taxpayers, and on taxable income above $157,500 and up to $207,500 for single filers.

199A – QUALIFIED BUSINESS INCOME

- For taxpayers with taxable income above the phase out threshold amounts discussed above, the following additional requirements apply to qualify for the 20% deduction:
  - The business must not be a "specified service business" - generally defined as any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, or dealing in securities, partnership interests or commodities, and more broadly ***any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners***. Engineering and architectural services do qualify.
  - The amount of the potential deduction for QBI cannot exceed the greater of - 50% of W-2 wages paid by the qualified business, or the sum of 25% of W-2 wages paid by the qualifying business and 2.5% of the unadjusted basis of tangible, depreciable property.

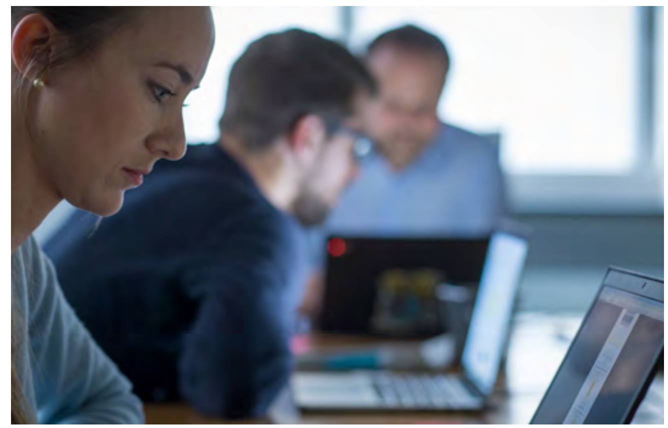
BONUS DEPRECIATION

- The Act increases the “bonus depreciation” deductibility percentage from 50% to 100% for property acquired and placed in service after September 27, 2017, and before January 1, 2023.
- Bonus depreciation percentage phases down by 20% per year for most assets, except for certain property with longer production periods. Hence first-year bonus depreciation will no longer be available after 2026.
- Allows assets eligible for bonus depreciation to apply to purchases of both new and used property.
- 280E limits depreciation to straight line useful lives as reported in GAAP basis financial statements.

STRUCTURING CONSIDERATIONS

C-Corp Vs Pass Through Entity

- Operations (cultivation vs retail)
- Comfort with 199A – IRS guidance expected in July.
- Exit strategy
- Regulator/license limitations
  - Ability to segregate operations
- Investor Limitations
  - “Political” concerns
  - Passive vs active investors, Real Estate Professionals
  - Type of investor (PE fund Vs high net worth individuals)



VALUATION ISSUES

- Valuations within the growing cannabis industry are not consistent with operator or investor expectations; this can be due to lack of available transaction data, or misinterpretation of perceived risks
- Real Estate Valuation of Grow Facilities and Dispensaries, the lack of available transactional data has led to undervaluation of tangible assets in the Cannabis Industry.
- Many facilities have historically been acquired in all cash purchases and built-out at the operators own cost, it can be difficult for local appraisers to extract meaningful sales and lease information.
- In lieu of actual data points, many appraisers have opined that the risk associated with potential federal seizures exacerbates capitalization and discount rates.
- Appraisal reports reflect effective capitalization rate that have been doubled, and well outside conventional rates observed in all other asset classes.
- There is risk attributable to operations, this risk can be quantified, reconnaissance indicated that total seizures by the Federal government are mostly *de minimus,* assuming the business operates in full compliance with State and local municipal laws (see Cole memo).
- Most grow houses should have higher values than typical industrial facilities; not unlike smaller data centers, which often have similar power, utility safeguards and redundancy, and security needs. Data Centers typically have lease rates 2 to 3 times that of average industrial rents, which is also consistent with lease rates for grow-houses observed in the marketplace.

VALUATION ISSUES – PERCEIVED RISK FACTORS

The high perceived risk of a business achieving its financial goals increases the rate of return that a buyer requires to invest in that business. This perceived risk is elevated due to a lack of peer group performance benchmarks and visibility of transaction pricing metrics. A higher required rate of return translates into lower value.

- Little or no track record of operations
- Limited banking and lending options
- Regulations, licensing and fees vary greatly by state & local markets
- Potential enforcement of federal regulations
- Punitive tax regulations
- Limitations on marketing and promotion
- Risk of audits (IRS and other)
- Increasing competition and market dynamics


OUR TEAM

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Michael Harlow is a partner and the Co-Practice Director for the DC Metro Tax Practice for CohnReznick. As such, Michael enjoys working with a variety of clients across the Washington region. He has more than 15 years of experience in public accounting serving clients in attestation, accounting, and tax advisory roles Michael has extensive experience across multiple real estate-related industries including homebuilding, land development, residential management, commercial management, and land engineering.

He also serves as a practice leader in the firm's Hospitality Practice where he works with privately-owned hotel and restaurant companies. Most recently, Michael has taken a lead role in the CohnReznick Cannabis Practice, bringing his existing skill set to this emerging industry. He is a Certified Public Accountant in the state of Maryland.

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Maier N. Rosenberg, CPA, CGMA, is a partner with CohnReznick. He has more than 30 years of experience providing business advisory, accounting, and auditing services to privately held and public companies in the emerging and middle-markets. Maier leads the efforts of our Firm's Financial Services Industry Practice and Manufacturing and Distribution in our Southern California offices. He advises a number of companies in these industries on performance, compliance, and accounting matters.

In addition, Maier is a member of the Firm's Private Equity and Venture Capital and Cannabis Industry Practices. In this capacity, Maier actively participates in target identification and analysis, financial due diligence and pre/post-merger integration and operational consulting. Maier also serves clients in the professional services industry.