280E: Overview and Analysis

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Income and Deductions Generally

- I.R.C. § 61 includes in gross income “all income from whatever source derived.”
- I.R.C. § 62(a) defines adjusted gross income as gross income less listed deductions, including those attributable to a taxpayer’s trade or business permitted under I.R.C. § 162
Pre-280E

- US v. Constantine – a tax may not impose a higher burden on illegal income and must “be imposed alike on the just and the unjust.”
- Public Policy Doctrine – Deduction is disallowed for certain payments that otherwise satisfy the definition of deductible “ordinary and necessary” business expenses, on the grounds that its allowance would frustrate a sharply defined public policy.
- I.R.C. § 162(c) – Codified public policy doctrine by denying deductions for illegal bribes, kickbacks or other illegal payments under any law of the US or law of a state.
Turning Point – Edmondson v. Commissioner, T.C. Memo. 1981-623

- Tax Court allowed taxpayer to deduct expenses associated with selling amphetamines, cocaine and marijuana.
- Deductions granted for cost of goods sold, telephone and automobile expenses and a home office deduction.
- Denied travel and entertainment expenses for a failure to substantiate.
- Congress enacted 280E in 1982 in reaction to this ruling in Edmondson.
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 Schedule 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.
Controlled Substances Act

- CSA classifies controlled substances into five schedules ranked on the basis of factors such as accepted medical use, safety under medical supervisions, and potential for abuse.
- Schedule I substances have the highest potential for abuse and no accredited medical use.
- 21 U.S.C. § 812(c)(10) – Marijuana is listed as Schedule I substance
State Legalization and US Attorney Memos

- California Proposition 215 – 1996 law making it legal for patients to obtain and use marijuana for medical purposes.
- Currently 33 states and the District of Columbia have legalized the sale of marijuana in some form.
The Cole Memorandum

October 19, 2009 – Deputy Attorney General David W. Ogden issued memorandum stating that the Justice Department would no longer make it an enforcement priority to pursue those who are in “clear and unambiguous compliance” with state medical marijuana laws (“Ogden Memo”).

July 29, 2011 – Deputy Attorney General James M. Cole repeated position

August 29, 2013 – Second Cole memo (“Cole Memo”) sets forth enforcement priorities which focus on activities that are illegal under both State and Federal laws, including:
  - Distribution of marijuana to minors.
  - Revenues going to criminal enterprises.
  - Diversion of marijuana from legal States to other States.
  - State-legal activity as a cover for illegal activity.

The Cole Memo cites strong and effective state regulatory system as a reason for DOJ attorneys and law enforcement to focus on these priorities and not activities which are compliant under these state regulations.

January 4, 2018 - Attorney General Jeff Sessions rescinds nationwide guidance specific to marijuana enforcement, specifically listing the Ogden Memo and both Cole Memos.
280E Application

- 280E disallows any deduction for ordinary and necessary business expenses, but legislative history excepts cost of goods sold.
- To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective cost of goods sold is not affected by this provision of the bill.
280E Application - Example

<table>
<thead>
<tr>
<th></th>
<th>Cannabis Business</th>
<th>Non-Cannabis Business</th>
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<tbody>
<tr>
<td>Gross Revenue</td>
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<tr>
<td>Cost of Goods Sold</td>
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<tr>
<td>Gross Income</td>
<td>$350,000</td>
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<tr>
<td>Deductible Business Expenses</td>
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<td>Taxable Income</td>
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<td>Tax Due (30% Rate)</td>
<td>$105,000</td>
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<tr>
<td>Effective Tax Rate</td>
<td>70%</td>
<td>30%</td>
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<td>Cash Flow</td>
<td>$45,000</td>
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## 280E Application - Example

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<td>Cash Flow</td>
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Californians Helping to Alleviate Medical Problems v. Commissioner (C.H.A.M.P.)

- Taxpayer operated business that dispensed medical marijuana and provided caregiving services.
- IRS argued that Section 280E barred C.H.A.M.P. from deducting any expenses (excluding COGS)
- Tax Court had to make the following determinations:
  - Whether taxpayer’s involvement in trafficking of a controlled substance prevented it from deducting expenses relating to its other lines of business.
  - Whether taxpayer’s caregiver services constitutes a second line of business such that 280E does not apply.
C.H.A.M.P.

- Tax Court held that “[s]ection 280E and its legislative history express a congressional intent to disallow deductions attributable to a trade or business of trafficking in controlled substances. They do not express an intent to deny the deduction of all of a taxpayer’s business expenses simply because the taxpayer was involved in trafficking in a controlled substance.”

- With regard to the second line of business, the Tax Court stated that “[p]etitioner was regularly and extensively involved in the provision of caregiving services, and those services are substantially different from [taxpayer’s] provision of medical marijuana.”

- Allowed C.H.A.M.P. to deduct expenses incurred in providing caregiving services. The Tax Court allocated expenses based on the use of employees and facilities in each line of business.
Olive v. Commissioner

- 72 F.3d 1146 (9th Cir. 2015)
- In addition to sale of medical marijuana, taxpayer operated “Vapor Room” which offered patrons suffering from AIDS, HIV, cancer and other terminal diseases a place to socialize and consume marijuana.
- Olive argued that 280E did not apply to legal businesses under state law and that the Vapor Room had two lines of business: a marijuana dispensary and another related to the provision of other services.
- The Tax Court reaffirmed C.H.A.M.P.’s ruling that dispensing marijuana pursuant to state law still constitutes trafficking for purposes of Section 280E.
Olive v. Commissioner

Tax Court applied factors from Rupp v. Commissioner in determining whether there was two lines of business:

- Whether the undertakings are conducted at the same place;
- Whether the undertaking were part of a taxpayer’s efforts to find sources of revenue from his or her land;
- Whether the undertakings were formed as separate activities;
- Whether one undertaking benefited from the other;
- Whether the taxpayer used one undertaking to advertise the other;
- The degree to which the undertakings shared management;
- The degree to which one caretaker oversaw the assets of both undertakings;
- Whether the taxpayers used the same accountant for the undertakings; and
- The degree to which the undertakings shared books and records.

Tax Court distinguished C.H.A.M.P. in holding the Vapor Room had only one trade or business

- “Petitioner provided the additional services and activities incident to, and as part of, the Vapor Room’s dispensing of medical marijuana.”

Olive appealed to the Ninth Circuit which affirmed the Tax Court’s ruling finding that the Vapor Room’s only “trade or business” was selling medical marijuana because it never had “the dominant hope and intent of realizing a profit” from providing other services.
C.H.A.M.P. vs. Oliver

- Both cases allowed cost of goods sold to reduce gross revenue from sales.
- Is the second line of business still a viable option?
- What would happen if Rupp’s factors were applied to C.H.A.M.P. facts?
Canna Care Inc. v. Commissioner
(T.C. Memo. 2015-206)

- Canna Care was a medical marijuana dispensary in California. Under state law, it was barred from earning a profit.
- Canna Care challenged the IRS’s application of Section 280E to deny its business expense deductions and argued:
  - that medical marijuana should no longer be deemed a controlled substance;
  - that dispensing marijuana pursuant to the CCUA is not “trafficking” for purposes of Section 280E; and
  - that CHAMP was wrongly decided because the business was a single entity that did charitable work (not two separate entities) and that Canna Care was a business doing charitable work, just like in CHAMP.
- The Tax Court rejected all three arguments and upheld the IRS' disallowance of all of Canna Care’s business expenses.
  - The court found that Canna Care’s only business was selling marijuana, but noted the taxpayer’s failure to argue it had a second business.
Canna Care, Inc. v. Commissioner

- Canna Care appealed, arguing that its tax liability of 1000% of its net income violated the Eighth Amendment’s proscription against excessive fines.
- The Ninth Circuit Court of Appeals dismissed the case because the constitutional argument was not raised in the Tax Court.

- Alpenglow, a medical marijuana dispensary licensed under Colorado law, challenged the IRS’s application of Section 280E.
- As in Canna Care, Alpenglow argued that Section 280E amounted an excessive fine or penalty proscribed by the Eighth Amendment and that applying it would drive it (and “all of Colorado's legalized marijuana industry”) out of business.
- The district court noted that Alpenglow had already paid the tax liability in full and yet remained in business, but nevertheless declined to decide the Eight Amendment question because it was not pleaded in the operative complaint.
- The court also rejected Alpenglow’s argument that the Constitution forbids including ordinary and necessary business expenses in gross income.
- Alpenglow appealed to the Tenth Circuit Court of Appeals. The Court of Appeals affirmed the United States District Court’s dismissal of Alpenglow’s lawsuit, as well as the denial of Alpenglow’s Motion to Alter or Amend the Judgment.
Harborside argued that the language of section 280E, “carrying on any trade or business...that consists of trafficking in controlled substance ...” does not apply to the sale of articles and the offering of services.

Harborside’s business included the sale of cannabis. It consisted of the sale of cannabis along with non-controlled substances (apparel, books, papers, glassware, etc.) along with a variety of wellness services. It also consisted of the Harborside Brand.

The Tax Court held that the Government’s dismissal with prejudice of a civil forfeiture action against Harborside does not bar a tax deficiency determination by the IRS.
Harborside Case, 151 T.C. No. 11 (November 29, 2018)

- 280E prevents Harborside from deducting ordinary and necessary business expenses.
- Harborside was engaged in only one trade or business – trafficking a controlled substance.
- Harborside must adjust for Cost of Goods Sold according to Section 471 regulations for resellers.
- Tax Court held in subsequent opinion that Harborside acted with reasonable cause and was not liable for penalties – T.C. Memo 2018-208 (December 20, 2018).
Additional Cannabis Cases

- Alterman v. Commissioner, T.C Memo 2018-83 (June 13, 2018) (Recordkeeping; Cohan Rule)
- Loughman v. Commissioner, T.C. Memo 2018-85 (June 18, 2018) (Tax Planning; S-Corporation)
- Jabari v. Commissioner, T.C. Memo 2017-238 (November 28, 2017) (COGS; Cohan Rule)
- Alternative Health Care Advocates, 151 T.C. No. 13 (December 20, 2018)
- Green Solution Retail, Inc. v. United States America (119 A.F.T.R. 2d 2017-1658) (United States Supreme Court denied Green Solution’s Petition for Certiorari) (Anti-Injunction Act; Authority of IRS to investigate)
Management Companies

- An attempt to use a management company to circumvent 280E.
- Audit of dispensary showed expenses paid to management company. IRS audits management company which was deemed to run the dispensary.
- Appeals Officer imposed 280E on both entities
- Went to trial in December 2016 and decision issued in December 2018 disallowing deductions
Proposed Changes to 280E

- S. 3032 (Strengthening the Tenth Amendment Entrusting States Act) – treat cannabis-related activities that are legal under state law as exempt from the Controlled Substances Act
- S. 777, H.R. 1810 – Except from Section 280E businesses selling marijuana in compliance with state law.
- H.R. 1824 – Comprehensive bill to permit banking, takes state compliant marijuana out of jurisdiction of CSA, amends Section 280E in the same manner as S. 777 and H.R. 1810, provide for bankruptcy protection, protection from forfeiture provisions, and various other provisions.
- H.R. 1834 – Federal excise tax on marijuana sales based on a national average price and for an occupational tax, permit to operate a marijuana business, Federal regulation of businesses.
“Trafficking”

- Section 280E does not define “trafficking”
- Tax Court has defined term to mean “engaging in commercial activity,” or to “buy and sell regularly” CHAMP, 128 T.C. at 182
  - Tax Court has applied this definition broadly to merely providing medical marijuana to patients and customers, even if legal under state law
- Only one other provision in the Code defines trafficking—section 7208 ("Knowingly or willfully buy[ing], sell[ing], offer[ing] for sale, or giv[ing] away . . . washed or restored stamp[s] to any person for use.")
- 21 U.S.C. § 801(2) (Congressional findings and declarations: controlled substances) describes trafficking as “[t]he illegal importation distribution, and possession and improper use of controlled substances.”
Application of Section 280E to Extraterritorial Conduct

- 280E disallows deductions and credits for a trade or business that consists of trafficking in controlled substances that is prohibited by federal law or the law of any state in which the trade or business is conducted.

- What happens if the taxpayer is dealing with controlled substances in a country where the use, manufacture, and/or sale of controlled substances is legal?
  - Example: Canada legalized limited use of recreational cannabis in October 2018 by the Cannabis Act.

- Section 280E piggybacks on the meaning of “trafficking” for purposes of the Controlled Substances Act.
Application of Section 280E to Extraterritorial Conduct

- The Controlled Substances Act is a criminal statute, and its provisions generally apply only to conduct within the United States unless “the narcotics statutes . . . were intended to have extraterritorial application.” United States v. Wright-Barker, 784 F.2d 161, 167 (3d Cir. 1986)

- Criminal statutes generally apply to domestic conduct only, except if: (1) the statute is clearly intended to apply to extraterritorial conduct or (2) the conduct is intended to cause or actually causes an effect within the United States.

- One case frequently cited for the latter proposition that demonstrates this principle at the federal-state level is Strassheim v. Daily, in which a defendant was convicted of fraudulently selling defective machinery in Michigan by means of bribery, even though the bribery occurred in Illinois. The Court ruled that “[a]cts done outside a jurisdiction, but intended to produce and producing detrimental effects within it, justify a state punishing a cause of the harm as if he had been present at the effect.” 221 U.S. 280, 285 (1911)
Territorial Sovereignty

- Sovereign nation generally cannot punish conduct outside its borders, unless it seeks to regulate “the activities, interests, status, or relations of its nationals outside as well as within its territory.” Restatement (Third) of Foreign Relations Law, section 402(2).

- However, if “another state may have an interest in regulating the activity” or “the likelihood of conflict with regulation by another state” is high, the principle of territorial sovereignty may preclude regulation of extraterritorial conduct.” Restatement (Third), section 403(2).

- Where the laws of two nations conflict, “a state should defer to the other state if that state’s interest is clearly greater.” Restatement (Third), section 403(3).
Presumption Against Extraterritoriality

- Presumption against extraterritoriality provides that “unless a contrary intent appears, [legislation of Congress] is meant to apply only within the territorial jurisdiction of the United States.”  

- Also, “[w]hen a statute gives no clear indication of an extraterritorial application, it has none.”  

- One of the primary purposes of this doctrine is to “protect against unintended clashes between our laws and those of other nations which could result in international discord.”  
  *Id.*

- Because Canada has legalized medical and recreational uses of cannabis in limited quantities, if the United States were to attempt to apply Section 280E and/or the Controlled Substances Act, there would be clear potential for international discord.
Provisions of Controlled Substances Act with Potential Extraterritorial Application

- 21 U.S.C. § 955: prohibits bringing or possessing controlled substances on board a vessel or aircraft “arriving in or departing from the United States”

- 21 U.S.C. § 952: prohibits importing controlled substances into the United States “from any place outside thereof”

- 21 U.S.C. § 959: prohibits “manufactur[ing] or distribut[ing] a controlled substance” with intent or knowledge that the substance will be imported into the United States
  - § 959(c) provides an express extraterritorial hook: “This section is intended to reach acts of manufacture or distributed committed outside the territorial jurisdiction of the United States.”
Financial Crimes Enforcement Network ("FinCEN")

Guidance

- Processing money from marijuana sales puts federally insured banks at risk of racketeering charges.
- Most financial institutions have not allowed marijuana-related businesses to open accounts.
- On February 14, 2014, FinCEN issued guidance based on the Cole Memorandum and clarifying Bank Secrecy Act ("BSA") expectations for financial institutions that service marijuana-related businesses.
FinCEN Guidance

- Mainly addresses the handling of cash, on which the marijuana business almost exclusively had relied until recently.
- Mandates a case-by-case analysis of institution-specific factors, including business objectives, an evaluation of the risks associated with offering a particular product or service, and the capacity to manage those risks effectively.
Risk Assessment under FinCEN Guidance

- Thorough customer due diligence is critical and should include:
  - Verifying that the business is licensed and registered;
  - Reviewing the license application and related documentation submitted by the business to operate its business;
  - Requesting information from state licensing and enforcement authorities;
  - Understanding the normal and expected activity for the business, including the types of products sold and type of customers;
  - Ongoing monitoring of adverse public information;
  - Ongoing monitoring for suspicious activity; and
  - Periodically revisiting information obtained in customer due diligence.
Filing Suspicious Activity Reports (“SARs”)

- Obligation to file SARs is not alleviated by a state law legalizing marijuana-related activity.
- Must be filed if financial institution knows, suspects, or has reason to suspect that a transaction:
  - Involves funds derived from illegal activity or is an attempt to disguise funds derived from illegal activity;
  - Is designed to evade regulations promulgated under the BSA; or
  - Lacks a business or apparent lawful purpose.
- Two types of SARs: “Marijuana Limited” and “Marijuana Priority”
“Red Flags”

- FinCEN guidance lists warning signs or “red flags” that suggest a marijuana-related business may be engaged in an activity implicating a Cole Memorandum enforcement priority or violating state law.
- Red flags may indicate a need for additional due diligence, including requesting information from other financial institutions under Section 314(b).
Examples of “Red Flags”

- Appearance that customer is using state-licensed marijuana-related business as a front to launder money.
- Inability to produce satisfactory evidence of licensing.
- Inability to demonstrate legitimate source of significant outside investments.
- Customer seeks to conceal or disguise involvement in marijuana-related business activity.
- Publicly available information about the business, owners, managers, or other related parties shows negative information (e.g., criminal record, involvement in illicit activity).
- Business, owners, managers, or other related parties are or have been subject to an enforcement action by the appropriate state or local authorities.
- Business engages in international or interstate activity.
- Owners or managers reside outside the state in which the business is located.
- Business is on federal property or the marijuana sold was grown on federal property.
- Business's proximity to a school isn't compliant with state law.
Selected Topics

- Significance of § 280E to a Cannabis Business
- Impact Of Tax Reform on the Cannabis Industry
  - New Tax Rates and Choice of Entity
  - Additional Provisions
- Common Accounting / IRS Audit Issues
- Key Tax Issues in M&A Transactions / Raising Capital
- Non-Tax Legal Issues (Employment; Real Estate)
- Attorneys representing Cannabis businesses.
## Significance of §280E to a Cannabis Business

<table>
<thead>
<tr>
<th>Types of Business</th>
<th>§280E Status</th>
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<tbody>
<tr>
<td>Producer / Processor</td>
<td>§280E Less Significant due to COGS Reduction</td>
</tr>
<tr>
<td>Retailer</td>
<td>§280E Highly Significant</td>
</tr>
<tr>
<td>Wholesaler / Distributer</td>
<td>§280E Highly Significant</td>
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<tr>
<td>Ancillary / Unrelated Businesses</td>
<td>Paraphernalia §280E Not Significant</td>
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<td>Branded Merchandise §280E Not Significant</td>
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<tr>
<td>Others</td>
<td>Leasing Business §280E Less Significant</td>
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<tr>
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<td>§280E and Intellectual Property</td>
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<td></td>
<td>§280E and Management Companies / PEOs / Agents</td>
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<td>§280E and Hemp</td>
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# Impact of Tax Reform on Cannabis Industry

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<tr>
<th>New Tax Rates and Choice of Entity</th>
<th>C Corporation Likely More Relevant</th>
<th>21% corporate rate</th>
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<tr>
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<td>Liability Protection</td>
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<td>LLC / Flow Through Less Relevant</td>
<td>Pass through deduction is a deduction disallowed by §280E</td>
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<td>Uncertainty of which businesses are service businesses (e.g. PEOs)</td>
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<td>Personal liability for Taxes</td>
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<td>Additional Provisions</td>
<td>Is §280E Still Relevant? Yes!</td>
<td>There were no law changes related to §280E.</td>
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<td>Expensing Provisions</td>
<td>May be significant benefit if allocate to COGS</td>
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<td>Cash vs. Accrual</td>
<td>Increased Threshold for Cash Basis Taxpayers $280E may lessen this incentive</td>
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<td>Interest Expense Limitations</td>
<td>Consolidated Test vs. Separate Trade or Business Test</td>
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<td>State Tax Conformity – Excise Taxes</td>
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# Common Accounting / IRS Audit Issues

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<tr>
<th>Lack of Adequate Books and Records</th>
<th>Challenges to get information</th>
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<tr>
<td>Not all CPAs created equal – “Everyone” is an expert!</td>
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<td>Typically Unaudited Financial Statements</td>
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<td>Consistency between businesses – is there a chart of accounts?</td>
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<td>Cash based businesses</td>
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<tr>
<th>Lack of Industry Knowledge</th>
<th>Lack of knowledgeable accounting staff and sophistication</th>
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<td>Lack of industry best practices</td>
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<tr>
<th>Inventory Methods</th>
<th>COGS vs. Non-COGS – Separate trades or business (case law discussion earlier);</th>
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<tr>
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<td>Different rules for different kinds of businesses</td>
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<td>Inventory Methods – CCA 201504011 vs. Full Absorption + §263A;</td>
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<td>Depreciation Challenges</td>
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<td>What is the treatment on your Accounting books and records? Book / Tax Conformity?</td>
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<table>
<thead>
<tr>
<th>Overall Complexity of Tax Regimes</th>
<th>Many businesses lack tax sophistication; many advisors are learning as you go</th>
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<tbody>
<tr>
<td></td>
<td>Almost certainty that companies will face IRS and state and local tax audits on a regular basis (e.g. sales taxes)</td>
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<thead>
<tr>
<th>Additional Accounting / Tax Concerns</th>
<th>Cash / Banking problems – Form 8300s required for reporting cash payments greater than $10,000; Paying taxes in cash.</th>
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<tr>
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<td>Additional Liability for CPAs / Attorneys</td>
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<td>Be very selective in taking on clients!</td>
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# Key Issues in M&A Transactions / Raising Capital

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<th>Section</th>
<th>Details</th>
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<tbody>
<tr>
<td>§280E Creates</td>
<td>Many businesses do not generate material after tax revenue and cash flows to pay investors or reinvest: little retained earnings</td>
</tr>
<tr>
<td>Scarcity of Capital</td>
<td>Access to Traditional Banking and public markets challenging</td>
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<tr>
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<td>Are times changing? Private Equity, Cross Border Transactions – Canada is legal.</td>
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<td>Valuation and §280E</td>
<td>How do you value a Cannabis business generally?</td>
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<td>What is §280E Liability?</td>
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<tr>
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<td>Will buyer inherit §280E liability? Drafting Considerations?</td>
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<td>How does §280E impact overall cash flows?</td>
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<tr>
<td>Restructuring</td>
<td>Applies to both internal and external transactions</td>
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<td>Transferability of Licenses – Impact of mergers and “check the box”</td>
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<td>Tax Act limits tax deductions for some debt financing</td>
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<tr>
<td>Service Provider Restrictions</td>
<td>Restrictions on 3rd Party Services Providers imposed by Legal and Accounting profession and governmental authorities</td>
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