

Pot Business Succession Planning Includes Perks and Pitfalls

by Nathan J. Richman and Jonathan Curry

The successes of state-legal marijuana businesses are leading to federal gift and estate tax questions about how to pass those businesses on when the owners die.

“The valuations [of state-legal cannabis companies] are just now getting big enough to where the estates are big enough to have estate tax problems, unless someone had other wealth,” Jennifer E. Benda of Hall Estill told *Tax Notes*.

Nick Richards of Greenspoon Marder LLP said other wealth could create estate tax collection issues for taxpayers who have both businesses covered by section 280E and more conventional businesses. The IRS could see the more conventional assets as a way to collect on the increased tax liabilities that cannabis businesses face, he said.

In the same way that state-legal marijuana taxpayers have been underserved by banking professionals, the industry could be low-hanging fruit for tax professionals, including estate planners, looking for more clients, according to Richards. There’s work to be had, although because the taxpayers aren’t as formal as Big Pharma companies, professionals will have to be somewhat flexible in addition to being willing to wade into the legalization gray area, he said.

One of the overarching issues facing state-legal cannabis businesses is the impact of section 280E. That provision denies all deductions other than cost of goods sold allowances to any taxpayer whose business is trafficking Schedule I or II controlled substances in a manner prohibited by the Controlled Substances Act. It was formulated in response to a Tax Court case involving fully illegal drug sales, but now plays a prominent role in the transition by fits and starts of marijuana from illicit substance to, perhaps, merely regulated intoxicant.

For example, Wendy S. Goffe of Stoel Rives LLP said her firm just recently ended its policy of turning down clients with “leaf-touching” businesses, though she added that the issue gets “higher scrutiny than some matters with less risk involved.”

If tax advisers are hoping the IRS and Treasury will clear the haze and issue guidance in this area, they may want to think again, according to Bridget J. Crawford, a Pace University School of Law professor. The estate tax affects few taxpayers, and even fewer own cannabis business interests, which makes it unlikely that Treasury will make this a high-priority area for immediate guidance, she said.

'Tempest in a Teapot'

Benda said section 280E shouldn't affect estate taxes directly because the provision should only apply to trade or business taxation — in other words, income taxes.

But Crawford said the IRS might try to stretch section 280E to, for instance, disallow deductions for estate administration expenses. Generally, executors can choose between taking the deduction for estate administration expenses against either the estate's income tax or estate tax liabilities, she noted, but section 280E renders the income tax deduction "completely unavailable."

Crawford suggested that even though section 280E is an income tax rule, the IRS might take the position that the principle behind it extends to the estate tax side. "So forget about this nirvana of, 'Oh, you can take this on your income or estate tax return.' I think that's just going to be a solid 'No,'" she said.

Goffe, however, isn't convinced that such a scenario will ever actually materialize. "When would you be taking [section 280E expenses] as a deduction on an estate tax return? Never!" she told *Tax Notes*, arguing that if there's a cannabis business, then section 280E expenses would be taken as a deduction on the business's return.

"It's sort of a tempest in a teapot," Goffe added.

Goffe also argued that since the IRS requires estates to value the assets they hold, illegal or not, it can't later deny the estate a deduction for the cost of obtaining that valuation. "That's different than choosing to have a cannabis business knowing that you can't take a business expense deduction. They're two very different concepts," she said.

Goffe further noted that the IRS didn't try to disallow estate administrative expenses in other cases involving illegal assets, such as the case of

Manhattan art dealer Ileana Sonnabend. In that case, the IRS and Sonnabend's estate reached a settlement in which the IRS agreed not to assess the value of a piece of artwork involving a stuffed bald eagle (which by federal law made it illegal for resale) in exchange for the estate donating the art piece to a museum but not taking a charitable deduction against its estate tax liability.

Richards said he wants to harness a recent Tax Court opinion — *San Jose Wellness v. Commissioner*, 156 T.C. No. 4 (2021) — to even further limit section 280E outside the everyday buying, selling, and growing that is the conduct of a state-legal marijuana business.

While the court in *San Jose Wellness* denied depreciation and charitable contribution deductions, Richards pointed to the discussion of "carrying on" a business as a potential opening.

Section 280E only applies to taxpayers "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." The Tax Court in *San Jose Wellness* acknowledged that, while it didn't matter for that taxpayer, "carrying on is narrow in the sense that it applies only to expenses incurred while conducting a trade or business, and not to expenses incurred before a business commences or after its conclusion."

Richards said he'd like to use that language for any marijuana taxpayer expenses coming outside the active conduct of the business. Not only start-up and wind-down costs, but administration expenses for estates holding state-legal marijuana businesses, and even the expenses of holding companies containing those businesses, could avoid section 280E, he said.

Planning Considerations

Both Benda and Richards said one of the most important considerations for state-legal cannabis business succession planning is the preservation of state-issued licenses.

For those tax attorneys and other advisers that do take on clients with cannabis businesses in their estate plans, they need to be clear and upfront on the legal unknowns, according to Crawford. Estate planners already have to implement estate plans in an ever-changing tax landscape, and when a cannabis business is

involved, they'll want to be extra careful in planning, such as by providing for an alternate disposition if a specific result or determination is made, she said.

Another reason the cannabis business estate tax area lacks precedent is that some cannabis businesses are owned through many layers of entities, according to Crawford. A cannabis license might be owned by an LLC, which is itself owned by another LLC or partnership, and so on, so some estate planners may not have "drilled down deep enough to realize what is the one immovable matryoshka doll at the center layer of the Russian nesting dolls," she said.

"I think because that one immovable little doll in the middle of the nesting dolls is a cannabis license, we have to think super carefully about the layers around it," Crawford added.

An estate plan for a cannabis business owner needs to address how a license will flow to the taxpayer's successors while preserving regulatory approval, Benda said, adding that the need to preserve the business's license can limit the range of entity-based estate tax planning options available to marijuana business owners. The banking industry's reticence on marijuana could mean that a taxpayer hoping to use trusts for planning purposes won't be able to find a willing trustee, even if they can overcome the state law regulatory hurdle, she said.

Those planning hurdles could also extend to taxpayers' ability to make spousal transfers and take advantage of a couple's combined lifetime exception, according to Benda. However, there may also be an opportunity for good planning, she said.

On one hand, a taxpayer may want to use non-cannabis assets or have a cannabis business interest immediately liquidated to take advantage of the spouse's lifetime exclusion amount, Benda said. On the other hand, some of the difficulties that cannabis businesses face could justify substantial valuation discounts that could allow the couple more benefit from the exclusion, she said.

First, when section 280E increases the business's tax liability, the estate could factor that into a discounted cash flow analysis to reduce the valuation, according to Benda. Second, the much-debated possibility of federal criminal drug

enforcement could factor into the discount rate's risk factor and substantially deflate the reported value of the business, she said.

Richards said that while standard estate planning discount factors should apply, he is skeptical of the possibility of aggressively discounting state-legal cannabis businesses in estate planning. While the logic behind those discounts is sound, he's seeing people pay large amounts of money for those businesses. In fact, sometimes people pay millions of dollars for the state licenses alone, he said.

The IRS and valuation experts will surely be considering those facts when assessing and formulating valuation opinions, Richards said.

Smoke-Filled Rooms

A cannabis business could find other aspects of estate tax planning going up in smoke, according to Crawford, who suggested that the IRS might try to argue that a taxpayer isn't entitled to the marital deduction when a cannabis business is passed from one spouse to another.

In that scenario, the taxpayer would likely have the better case, because generally, state law determinations of property rights are respected for estate tax purposes, Crawford said. But in the absence of precedents, it's conceivable that the IRS could make that argument, she said.

"Estate tax audits are not always about the issues; they're very often about a strategic bargaining with the taxpayer," Crawford explained. "You always keep an eye on that practicality of the law that's on the books and the law as it develops in the settlement room — or the settlement Zoom." ■