

February 13, 2023

New York State Office of Cannabis Management
P.O. Box 2071
Albany, NY 12220

By e-mail: regulations@ocm.ny.gov

Re: Invitation to Comment— Adult-Use Cannabis Proposed Regulations in New York

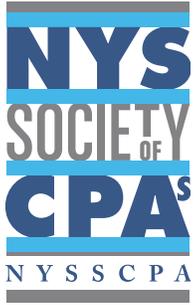
The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 21,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above-captioned invitation to comment (ITC).

The NYSSCPA's Cannabis Industry Committee deliberated the proposed regulations and prepared the attached comments. If you would like additional discussion with us, please contact Richard Laneve, Jr., Chair of the Cannabis Industry Committee, at 201-442-9665, or Keith Lazarus, NYSSCPA staff, at (212) 719-8378.

Sincerely,

Lynne M. Fuentes
President

Attachment



**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

COMMENTS ON

Adult-Use Cannabis Proposed Regulations in New York

February 13, 2023

Principal Drafters

**Elana Tamas
John V. Pellitteri
Renata Serban
Martin H. Lager**

NYSSCPA 2022–2023 Board of Directors

| | | |
|--|------------------------------------|----------------------|
| Lynne M. Fuentes, <i>President</i> | Rumbidzai N. Bwerinofa-Petrozzello | Shmueli Milecki |
| Liren Wei, <i>President-Elect</i> | Ramona Cedeno | John A. Mourer |
| Timothy J. Hammond, <i>Secretary/Treasurer</i> | Timothy J. Doyle, Jr. | Lisa Mrkall |
| Orumé A. Hays, <i>Vice President</i> | William H. Dresnack | Ronald F. Ries |
| William C. Huether, <i>Vice President</i> | Michael R. Durant | William D. Ryan III |
| Alexander Resnick, <i>Vice President</i> | Mark L. Farber | Lenore Sanchez |
| Barbara A. Marino, <i>Vice President</i> | Stephanie Gigliotti | William F. Schwenk |
| Steven M. Morse, <i>Vice President</i> | Zachary Gordon | Sharon Sica-Costanzo |
| Calvin H. Harris Jr., <i>ex officio</i> | John B. Huttlinger, Jr. | John M. Spatola |
| | Michael R. Koeppel | Denise M. Stefano |
| | Katelyn N. Kogan | Jennifer Stone |
| | Edward N. Lee | A’Isha Torrence |
| | Philip J. London | Mark M. Ulrich |
| | Philip Marciano | Natalie Verbanac |
| | Kevin Matz | Craig A. Zellar |

NYSSCPA 2022–2023 Cannabis Industry Committee

| | | |
|--------------------------------------|------------------------|-----------------------|
| Richard J. Laneve, Jr., <i>Chair</i> | Timothy T. Heck, Jr. | Shanee A. Osher |
| Renata Serban, <i>Vice Chair</i> | Jean-Pierre Henderson | John V. Pellitteri |
| Eric H. Altstadter | Noam Hirschberger | Jenna L. Raetz |
| Benjamin Beskovic | Christopher A. Johnson | Pasquale Rafanelli |
| Andrew B. Blackman | Steve Jugan | Hugh Rinaldi |
| Richard J. Bylott | Kanwal K. Kapur | Gary B. Rosen |
| Christopher G. Cheeseman | John Kavanaugh | Christine M. Saar |
| Brett Cornell | Bridget M. Kralik | Alec M. Schon |
| Jacqueline T. Coudriet | Martin H. Lager | Steven B. Shaiman |
| Nicole P. Cunningham | John R. Loughren | Justin R. St. John |
| Sean P. Cunningham | Stephen Lurie | Jeffrey M. Stern |
| Leigh A. Downing | Anthony P. Mariani | Elana Tamas |
| Yan L. Gindin | Elizabeth Marks | Joseph A. Tarasco |
| Jeffrey S. Gittler | James A. McBratney | Matthew H. VanDerbeck |
| Zachary Gordon | Robert L. Milrod | Adam M. Venokur |
| Robert E. Grubman | Mark Murray | |

NYSSCPA Staff

Keith N. Lazarus

**New York State Society of Certified Public Accountants
Comments on
Adult-Use Cannabis Proposed Regulations in New York**

General Comments

It is with the greatest respect for the intention of the Marihuana Regulation and Taxation Act (MRTA), and the efforts that the New York State Cannabis Control Board (CCB) and OCM have undertaken in order to set forth a framework for a legal cannabis industry in New York State that we submit comments in response to the Adult Use Draft Regulations.

As professionals who have serviced cannabis businesses of all sizes across the US, we have a unique ability to truly understand how policy and financial factors intersect and affect the ability of cannabis entrepreneurs to succeed. We appreciate the opportunity to illustrate how certain aspects of the law and regulations will affect licensees' ability to keep the lights on and their doors open.

Our profession requires us to apply the law to all aspects of financial arrangements, and we are often privy to the true financial outlook and viability of business operations irrespective of the forward-facing messaging presented to certain investors and the general public. We will make alternative recommendations which aim to uphold the intention of the law that we believe are worthy of strong consideration and are entirely willing to engage in any and all follow up. The response to comments was considered with an earnest lens that focuses on smaller business owners, whether they are disproportionately affected by the war on drugs, minority business owners, or are simply Mom-and-Pop type operations. We have consulted and collaborated with various New York State cannabis organizations, individuals representing organizations that are focusing on opportunities for small business owners, and with multiple banking committees that discuss the ability and willingness of otherwise willing lenders to enter the New York landscape in an impactful way.

While we can comment on each particular aspect of the proposed regulations, the overall absence of flexibility in terms of consulting arrangements, advisory and financing structures in terms of lenders, investors, informal joint ventures and partnerships may ultimately prove too constraining for even the most entrepreneurial individuals to survive the generally 5-year time period that a state legal cannabis market takes to mature in the current economic state. It is our concern that the regulations crafted to defend business owners may create a circumstance where they and the state are actually an unintended and latently embedded Trojan horse.

Factors that raise the cost of legal cannabis to the consumer have already proven in other states to substantially lower retail sales, and the ability of the states to raise revenue through taxation. Numerous data sources show that when pricing is too high for the consumer, they will continue to purchase cannabis through legacy market. New York State has the most thriving legacy market in the country, and data from states, such as California and Oregon, supports incredible difficulty for license holders when retail pricing is double what it is in the legacy market as the general preliminary numbers appear to support. The comments incorporated will reflect concern

as to mitigate factors that can ultimately keep costs to business owners down, help them raise capital by allowing investors consultants, vendors and lenders ability to reasonably mitigate their level of risk so as not to preclude their participation, thereby creating more avenues for license holders to have access and support that they will rely on.

Specific Comments

A. Clarity of Definitions

i. Sole Control and Control

These terms are used throughout the draft regulations and degrees as to what constitutes control need numbers and further scope. There is no business owner or operator that makes every decision or controls every decision. On the other side, there are people with small decision-making rights that can be construed as having elements of control, such as the sole ability to make certain financial decisions in a business regarding their specific areas of expertise. Therefore, the definition of control is often given numerical values which take into account circumstances that warrant the use of different types of control. For many definitional purposes in the Internal Revenue Code (IRC), control of a business would be defined as 80% of vote and value. This threshold gives a definite methodology of measuring control and takes into account that even total control is not always 100%.

Our recommendation is to use 80% of vote and value to mean Sole Control. Other types of control can be 51%, or a majority. Control or controlling interest in part 118 right now describes different elements of control but is not practicable in understandable application of how it should be applied. The vague definition creates a Maginot line that is difficult to conceptualize in application, and, therefore, creates an inability to adhere to the law when common business practices are not addressed. Additionally, consideration should be given to distinguishing factors that might not constitute control, such as the ability of management to have day-to-day control of all facets of operations, but the most fundamental and substantial general rights of approval or major financial events controlled and retained by a business owner. This ability to distinguish ultimate control from features of control in the day-to-day operations, but not fundamental features, will ensure the substance of control is protected while not interfering with day-to-day operational and managerial decisions. Clarity should be given to what **does not** constitute control. IRC section 469 examines certain management decisions that do not constitute control in light of the larger picture. We recommend referencing the aspects described in this part of the tax law in applying meaningful distinction.

ii. The Greater of 10% Gross Income, 50% Net Profit, or \$100,000 in a Calendar Year– This measure is used throughout the Regulatory Framework and needs further clarification:

1. Calculation of Net Profit can mean Sales Less Cost of Goods Sold, and can also mean Sales Less Costs of Goods Sold, Less Operating Costs.

Our recommendation is that this measure is defined as Net Income according to GAAP.

2. In the context of the compensation arrangement with another person and compensation in excess of \$100,000

Our recommendation is that an advisor who is contracted by a business owner to provide valuable professional services such as advisory related to accounting, tax, legal, and other professional services is not deemed to have ownership or elements of control.

3. **We also recommend** adjusting the \$100,000 threshold by either elimination or determination based on business size. The \$100,000 threshold for a high revenue grossing business is less material than for a company that operates on a smaller scale and does not make sense in the context of the upfront business consulting and advisory that may be required when accounting for size and scale.

iii. **Undue Influence**

Regulations do not include consulting, such as accounting in service providers that are subject to non-exempt agreements restrictions. In a circumstance where an accountant provides both accounting and advisory services to a licensee, the advisory portion should be explicitly be protected under the penumbra of accounting services. Similarly, outside consultants, such as outsourced CFOs, do accounting work, but also make important financial decisions outside the scope of accounting. Where does that work stand in terms of the consultants that undue influence rules may apply? Additionally, certain consultants and management companies service every type of licensee. It seems byzantine to restrict outsourced management companies and consultants from servicing various types of licensees when their specialty areas and experience can be beneficial to various types of licensees. Going back to the outsourced CFO example, this consultant will have the ability to make and influence financial decisions and will be hired to do so. Management companies also may provide training to employees of various types of licensees.

If restrictions are placed on the amounts that consultants may be compensated for valuable and specialized services, particularly in earlier years, this can result in unintended consequences that appear to be arbitrary. It does not appear to effectuate the intention of the law to impose barriers to access when normal consulting agreements are executed, and performance and consideration reflects the value provided for work that is done in an advisory or consulting capacity.

The imposition of potential deemed ownership on services performed to the extent the value of the services received exceed a threshold amount (and the same types of restrictions that are placed on variable interest rates and commissions) does not take into account potentially flexible arrangements. For example, if an agreement is structured in such a way that a business is granted reprieve from market interest or commission rates in the first few years of operation in order to allow for a licensee to establish itself, and then in later years larger commission, or rates of interest are paid to make up for the ability to pay less early on, the regulations as drafted actually can prevent such terms, and create the inability of flexible arrangements that would favor a business owner.

Our recommendation is that this restriction is lifted for circumstances that are substantively and, overall, below the threshold limitations when taking arrangements that over time reflect restricted commission or interest restrictions that would otherwise create financial nexus as a True Party of Interest (TPI).

iv. Need For Examples

Our recommendation is that each section that describes limitations concerning: the definition of TPI, Control, Undue Influence Violations and Categorization as TPI, Passive Investor, and restrictions placed on financiers and that could reclassify them as having any features of ownership, should have clear examples which differentiate a circumstance that would be defined as a violation and those that would be considered a non-violation. Exceptions to general rules that take into account normal and non-predatory business practices that may be helpful to licenses should be listed so as not to create an overly regulated market that defeats its own purposes.

v. Financial Arrangements

Common financial arrangements include certain levels of personal guarantees when there is otherwise no ability for recourse in events of non-payment. It is not possible to make agreements for which there is no available collateral or guarantee that they can have something to recuperate if they are not paid.

Our recommendation is that these restrictions create inequity in risk undertaken and should be adjusted or limited to allow for protection. Without the ability to have recourse, it will not make sense to make financial agreements of any sort without very little levels of risk of default. This will limit the ability of small business owners to enter into common business arrangements. Additionally, as mentioned earlier, control in business operations is also not currently available as recourse, making it very difficult to find pathways to fair agreements and without modification, this will severely limit the pool of people willing to do business with cannabis licensees.

B. Operational Concerns

i. De-Minimis Ownership

Our strong recommendation is to implement the ability to completely disregard de-minimis ownership, such as overall ownership of less than 5% in any one business (calculated utilizing related party definitions). This will drastically change the ability of small business owners to garner support from various outside sources who operate in a non-predatory, normal business context.

Additionally, we recommend that if willing lenders, consultants, or investors that would otherwise fail any tests based on their ownership either in other states, or in New York State, that elements of de-minimis control, and de-minimis ownership be worked into the regulations to be disregarded for other purposes of the regulations, with provision of examples provided to clarify how licensees can gain access to support without unintentional violations of the regulations to them or service providers. Control also can potentially be disregarded when tied to time periods or specific circumstances and instances of control that are considered normal, and non-predatory in a business context. Please see the below examples.

ii. **Management Service Provider Restrictions**

Management companies often undertake employee payments for tax and liability purposes and is common practice. The ability of management companies to service cannabis businesses for liability purposes and for tax purposes should be respected. Interests only in small portions of a business profit in addition to fees for services received when actively servicing an industry can be useful in minimizing fees, and only having the ability to benefit further in profitable scenarios.

Our recommendation is to adjust the restrictions of prohibitions on common financial arrangements that work for various purposes and setting limits on fees not to exceed fair market value of services, and to place limitations on the amount of profits interest that a management company has rights to. Additionally, for management service companies or their employees that have ownership rights in businesses outside of New York State, it should be re-examined as to whether they should be able to service all types of New York State Cannabis businesses provided that they are unable to directly make contracting decisions relating to companies that they hold ownership interests in so that there is no presumptive conflict of interest present.

iii. **Subcontractor Restrictions: § 124.5(a)**

Clarity on how to bring a specialist in when a business owner requires specialized advice or services that they resolve through subcontracting. A common example of subcontracting would be if a processor does not have adequate machinery, or capacity at a certain point to complete certain processing activities.

Our recommendation is that limitations on subcontracting are limited to very specific circumstances, with provision of examples.

- iv. It is stated that the business should maintain “*adequate books and records to demonstrate ... actual cost of doing business, using accounting standards and methods regularly employed in the determination of costs for the purpose of federal income tax reporting.*”

Given that for federal income tax purposes, only cost of goods sold are allowed as deductions, **our recommendation** is to keep accounting records according to US GAAP. This clarification will be consistent, should both be implemented, with definition of net income and will be more representative of the business operations.

C. Impact of 280E and THC Tax on Cash Flow – Example and Recommendations

The purpose of providing the illustration below is to contextualize the onerous impact of 280E in comparison to a retail business with similar expenditures and revenues that is not subject to the provision. This example provides scope into how the cash flow of businesses will be affected as compared to a business that is not subject to 280E. 280E has the biggest impact on retailers for tax reasons relating to calculation of **Costs of Goods Sold**. The chart also illustrates the differential impact of the THC potency level tax on the financial position of a retailer, taking into account economic considerations of competition with the thriving illicit market that is generally able to charge half of the retail price of the regulated market. It is our assumption that based on data provided by various studies, retailers are generally not passing off increased costs that are incurred to consumers. Although the potency tax is not an inflationary cost, the appetite of today’s consumer reflects a willingness to pay somewhat more for their purchases, but overall are purchasing less. The impact on the economy is expected to curb consumer spending further. We do not believe that retailers will broadly increase the price of cannabis beyond what a consumer is willing to spend, and our expectation is that the retailer and general market will be impacted significantly by a potency tax, and that the State will see significantly reduced sales with the imposition of tax on sales beyond what a consumer is willing to absorb as was the case in various states until correction occurred.

Our recommendation is that the THC tax have an emergency pause for small businesses or businesses owned by individuals that are mandated protection as part of the MRTA’s mandate to support communities most harmed by the war on drugs. We will come back to the recommendation in more detail when examining the after-tax effect of various state forms of business support.

The simple and conservative example provided demonstrates that a dispensary that can be considered a small business can have gross sales of \$2,288,500, and with expenses that are not exorbitant, actually will need to borrow or raise an additional \$330,240 in order to pay down its true costs of operation. In this example, the vast majority of the economic deficiency creating a

scenario that may cause this business to close down is the effect of the THC tax imposed by the state. Factors that allow the cost of the product to be reduced can serve to increase sales, increase retail tax collection, and can absorb the expenses of the retailer in this example that are largely fixed based on regulatory requirements.

In analyzing this scenario, assume that this operator would be able to raise enough money from an experienced investor or financier. However, the financials demonstrate that providing capital to this business would be risky and as the regulations are drafted, there would be little to allow a lender or investor to mitigate risk.

In this scenario, the financier or lender would likely seek to mitigate its risk by wanting input in business and financial decision making which is common business practice, particularly if the financier or investor has experience with navigating the aforementioned scenario. It is reasonable to expect to give over a degree of control during the time period that principal is being recuperated, whether from an investor or a financier.

Our recommendation is to create more flexibility in regulations for collateral when reasonable. The entrepreneurial risk undertaken by minority business owners should be rewarded with the ability to be entrepreneurial, and to think and act creatively and with a larger degree of their own ability to ascertain non-predatory circumstances.

Financial Impact of 280E: Comparison to a Non-MRB

Partnership

| | Retail Non-Cannabis | Retail Dispensary |
|--|--|----------------------|
| Gross Sales | 2,288,500 | 2,288,500 |
| Cost of Goods: | | |
| Purchases | 755,205 | 755,205 |
| Other Expenses including Licensing | | |
| <i>*Potency Based Tax - Conservative Assumption Used that all sales are flower and that potency is 25%</i> | <i>*Retailer Does not directly pay THC Potency tax but it will be Built into the Cost of purchases that would otherwise be commensurate with \$755,205</i> | 256,808 |
| | (755,205) | (1,012,013) |
| Gross Profit | 1,533,295 | 1,276,487 |

| | | | | |
|---|---------|----------------|----------------|------------------|
| G&A: | | | | |
| Labor and payroll taxes | 446,900 | | 446,900 | |
| Rent | 105,000 | | 105,000 | |
| Administration | 126,000 | | 185,000 | |
| Banking and finance costs on 500k loan | 39,500 | | 99,000 | |
| Insurance | 10,000 | | 75,000 | |
| Compliance | 18,000 | | 183,080 | |
| Depreciation | 150,000 | (895,400) | 30,000 | (1,123,980) |
| Book Income | | 637,895 | | 152,507 |
| Non-Deductible expense IRC 280E | | 0 | | 1,123,980 |
| Taxable Income | | <u>637,895</u> | | <u>1,276,487</u> |
| Federal Income Tax @ 37% tax rate imposed on individual partners | | 236,021 | | 472,300 |
| New York Income Tax @ 6.85% tax rate imposed on individual partners | | <u>43,696</u> | | <u>10,447</u> |
| | | <u>279,717</u> | | <u>482,747</u> |
| Effective income tax rate imposed on individual partners | | 43.85% | | 316.54% |
| Net after tax cashflow | | 358,178 | | (330,240) |
| Annual Debt Service Payments on \$500,000 (principal over 120 months) | | 50,000 | | 50,000 |
| Net after tax and debt service cash flow | | 308,178 | | (380,240) |

D. Tax and Accounting Considerations

i. State Assistance: Grants, Loans and Tax Credits, Abatements, or Tax Freeze - Comparison of After-Tax Effect

The value of grants provided by organizations or New York State constitutes taxable income to a business owner based on the tax law, and New York State general conformity to federal tax law. Therefore, providing capital through the use of grants is less effective than providing a dollar-for-dollar reduction of tax imposed on a business. A tax reduction such as the removal or limitation of the application of the THC tax is not considered taxable income, and therefore, the impact of providing one dollar via a grant vs one dollar of tax relief is far superior in the form of tax relief. The net effect of receiving a grant after reducing each dollar received for state and federal income tax imposed on the grant results in only \$0.56 of every dollar retained by the recipient under the tax rate assumptions is used in the chart above.

In contrast to the economic reduction in efficacy of grant provision, a lower sales tax or potency-based tax results in no tax imposed on the savings, thereby allowing for each dollar to generate an economic impact at its fullest force.

The types of state assistance that generally do not result in taxable income include income or sales tax relief, or most state business tax credits issued for sales tax on business purchases, other tax credits issued to licensees, loan guarantees, or property tax abatements in the event that a licensee is also considered the owner of the underlying real property.

Another alternative to the provision of grant money, which creates a taxable event on the receipt of the full amount, is the provision of loans that can be forgiven over the course of time if certain requirements are met. Incremental forgiveness of loans creates a tax only on the amounts forgiven for that tax year, and, therefore, imposes substantially less of a tax burden all at once, when a business owner likely does not have the capacity to pay tax on the full amount, and over time can stagger and absorb the tax, and hopefully have the cash reserves to pay incremental amounts of tax over the course of time.

ii. State Loan Guarantees

Another factor that directly affects the ability of lenders to issue debt at lower interest rates is to mitigate risk to them. When the risk of lending money is lower, debt can be issued at lower interest rates. Not only does interest rate reduction directly preserve capital, but it also is not a deductible tax expenditure for purposes of 280E. Therefore, the true economic effect of a lowered interest rate is a multiple of the dollar saved directly.

Our recommendation is to utilize structure already in place for state guarantees of debt issued to certain types of qualifying businesses. The effect of guaranteeing debt allows the state to have reprieve from the initial capital outlay and raising the funds for such endeavor.

E. Other Tax Related Recommendations

i. Expansion of Sec. 123.10 (e)(2)(iv) Determination of What a Retail Dispensary May Sell:

Regulations that place constraints on products and services that may be offered by cannabis retailers can close off access to relief from federal taxation. The advantageous tax scenario is for most retailers cut off from potential application based on the prohibition imposed on retailers of selling items that are not ancillary to the cannabis business. This is because when a business has revenue streams and certain factors that reflect the presence of two businesses instead of one (regardless of entity formation), the tax ramifications in certain circumstances can be that only one revenue stream is restricted from taking business deductions and credits, and the other income stream can be treated for tax purposes as a non-cannabis business. The ability to be treated as operating two businesses as opposed to one for tax purposes can afford the ability to substantially absorb the high tax and regulatory cost of the cannabis operations. Small business owners who do not have their own cash reserves to dip into their savings. Cutting off licensees from solutions that mitigate the impact of 280E, coupled with regulation provisions that too severely restrict the ability of business owners to raise capital from certain types of investors and financiers, increase the potential economic burdens and decrease options for finding workable solutions.

Please see the example that we have provided above, showing that with the same sales, and all of the same expenses, a cannabis retailer would have to borrow money (over \$350,000) in order to stay in business while retail business with the same income and expenses (outside of those imposed by 280E) will have a cash reserve of over \$300,000. Any ability to provide flexibility in a retail operations ability to procure non-cannabis income can theoretically allow them to have tremendous swing in their ability stay in business independently and having other options than to rely on raising outside capital as a solution to liquidity issues.

Tax court cases have often focused on whether an entity or its owners operated one or two businesses, and this is because of the tremendous tax advantage of having two. Case law has pointed towards a clear distinction in the separate business of not being respected when goods and services provided merely reflect an ancillary relationship to the dispensary (similar to what the regulations appear to allow presently). Based on the significant advantage of having more than ancillary income, it is of great significance to remediate the way this part of the regulations are written to the greatest extent possible.

Our recommendation is to clarify that restriction applies to sale of goods and not to services, or other revenue streams that entrepreneurs may undertake. Additionally, flexibility should be applied to the determination of what can be sold in a dispensary with

consideration to the rigid definition being a considerable obstacle. Additionally, as the example above reflects, separate businesses can serve to help business owners further financial independence based on the ability to have income that is not taxed under 280E.

ii. Opinion of CPA for Cooperative qualification Under Subchapter T

An opinion is something that an accountant is most likely not willing to give based on legal risk undertaken in a substantially gray area, and in the event that they would be, this cost would be substantial.

Our recommendation is to remove the opinion from a CPA as an option and replace it with something coming either from an attorney or another source, which still would likely be exclusionary from a cost perspective, but more realistic in willingness to give an opinion.

iii. Tax on Illicit Cannabis

Clarity on the nexus between entities that may be found to be in violation of Adult Use Regulations and any fulfillment of contracts or obligations taken care of that were executed before or during a period of time where the licensee is in the process of correcting or answering summonses, should be provided for whether and how a tax on illicit cannabis would be levied.