MICPA
MICHIGAN ASSOCIATION OF CERTIFIED PUBLIC ACCOUNTANTS

ENTITY STRUCTURING

One of the first steps in starting your own cannabis business or investing in a business venture is to determine the right business structure. Generally, there are four main business structures to choose from: sole proprietorship, partnerships, corporations and hybrid structures such as limited liability companies (LLCs) and limited liability partnerships (LLPs). The functions of most executive management teams can often be similar across the different structures. However, the legal and tax structures of any company will have a substantial impact on its operations, and it therefore deserves a significant amount of analysis and discussion. There are many factors to consider when making this decision and each presents its own advantages and disadvantages. We have provided a general description of each.

Sole Proprietorship

A sole proprietorship is a business or entity that is solely owned by one person. The sole owner bears the responsibility of paying income tax on any profit earned through the business on his or her personal tax return. The sole owner will file their standard Form 1040 for individual taxes along with Schedule C or Schedule F, which reports profit and loss of the entity. For income tax purposes, single member LLCs are treated as sole proprietorships. However, because the individual is reporting their business activity as a sole proprietorship, the business's liabilities pass through from the business to the individual owner. A sole proprietorship may be the simplest type of business that can be established, however disadvantages may include challenges in raising capital and unlimited liability if the business is sued or experiences financial trouble.

Partnerships

Partnerships are a legal business form where two or more persons go into business for profit as co-owners and share in the profits and losses and property of the partnership. By default, a multiple member LLC is treated as a partnership for income tax purposes. Depending on the partnership structure, and whether it is general partnership, limited partnership, or LLC, one or more partners may have unlimited personal liability for partnership debts. The partnership is managed by the partnership typically though a partnership agreement, or operating agreement. This form of business has a pass-through tax treatment where all income and expense items pass through to the individual partners. Some partnership structures may allow for additional flexibility in determining disparate sharing of profit and loss items, as well as capital items. The partnership should contain a formal partnership agreement which includes items such as the property each partner has contributed and the methods used to allocate profits and liabilities, along with the requirements for changing partners.

Accounting for partnership transactions and the rules applicable to tax partnership structures can become highly complex and may require additional bookkeeping and accounting needs beyond traditional financial reporting requirements. However because of the flexibility related to allocations and structuring options, this form of structure may be favorable to some scenarios.

The Michigan Association of Certified Public Accountants
888 W. Big Beaver Road, Suite 550, Troy, MI 48084

248.267.3700 | micpa.org

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Corporations

A corporation separates the business's assets and income from its owners and investors. The creation of a corporation will also include the 'articles of incorporation' which essentially formalizes the company, and brings it into existence. With a corporation, the shareholders own the stock of the company. Depending on the size of the entity, the entity may have only a few shareholders to several thousands of shareholders who are entitled to the profits (usually in the form of dividends) of the company. The shareholders elect a director annually to care for the day-to-day responsibilities but do not do not generally share personally in the liabilities of the corporation. Corporations are commonly described as having what is called a 'corporate veil', or protection for shareholders from the corporation's liabilities. However, this veil can be disregarded if the owners do not maintain separation from the corporation, such as keeping their personal expenses separate, or in acts of fraud or negligence.

A corporation is also required to elect a board of directors and hold meetings voted by ownership/shareholders. Corporate taxes are paid prior to distributing any profits to shareholders. Shareholders then are required to pay income taxes on any dividends distributed to them. This creates the phrase double taxation which may not be ideal for some; however, for investment purposes, having a lower tax rate may be beneficial.

The legality of a corporation is also slightly different and they are required to hold meetings with shareholders and directors ensuring transparency in operations. All records of voting, directors, owners, etc. must be kept along with any company bylaws and business locations. A corporation will need to file annual reporting, financial disclosures and formal financial statements. A corporation will continue to exist as owners and members change.

C Corporations vs. S Corporations

C Corporations and S Corporations are taxed differently. An S Corporation does not pay corporate income tax, and generally combines application of corporate and partnership tax rules. S Corporation income flows to the shareholders and tax is paid at the individual level. C Corporations are subject to corporate income tax and shareholders are subject to personal income tax on the dividends they receive. A C Corporation will limit the liability of investors and shareholders', generally to no more than they've invested. C Corporations may have different types of share classes, whereas an S Corporation is only allowed to have one type of share class.

C Corporations can be more costly than any other business structure. Applicable regulations can also be stricter, which may result in higher legal and accounting fees. The double taxation of a C Corporation can also be a downside – unlike with an S Corporation, a shareholder will not include corporate losses on their personal tax returns. S Corporation owners are generally required to be paid a salary and have similar withholding and payment of Social Security and Medicare costs as employees.

A corporation or an LLC must elect to be treated as an S Corporation. There are many planning considerations that should be taken into account when determining if electing S Corporation status is right for your business.

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Hybrids: Limited Liability Company (LLC) & Limited Liability Partnerships (LLP)
Another form of business organization is the limited liability company (LLC). This type of business structure has become a very popular type of organization, and is typically available under each state's laws. The LLC is essentially a hybrid form of business that may have elements similar to a sole proprietorship, corporation, or a partnership, depending on the underlying ownership and any specific election made. Another form of organizational structure is a limited liability partnership (LLP), which is similar to a multiple member LLC in structure and in use.

Similar to corporate structures, LLCs and LLPs may provide their principals with a certain amount of liability protection; however, for income tax purposes the IRS generally will not recognize these hybrid structures as anything other than a partnership or corporation. LLCs and LLPs may designate managers or general partners of the business, who are generally responsible for daily operations or partnership liabilities, while allowing for other "limited" owners to invest in the business only and otherwise remain passive.

A particular advantage of a limited liability partnership is that it allows some of the partners in the business too limit their liability. Under such a structure, only designated partners have unlimited liability for company debts; other partners can be designated as limited partners, only liable up to the amount of their contribution(s). Limited partners are typically not active decision makers within the business.

Anyone can be a member of an LLC or LLP. The entity does not typically pay income taxes directly, however the taxable income is passed through to all members (owners) who are then required to report this on their individual tax return. There are no restrictions on who can be a member of an LLC: potential owners can include individuals, corporations, foreign entities, etc., LLCs are permitted under state statutes (regulations will vary state to state) and must file for articles of organization and an EIN. An LLC isolates the business's assets from an owner's individual assets. If the LLC is established as a partnership it will file tax Form 1065, if members elect to be treated as a corporation, they will file tax Form 1120.

LLC vs. S Corporation
Both LLCs and S Corporations pass through income to their owners. S Corporations are generally more restrictive with ownership requirements, such as they are not allowed more than 100 shareholders and cannot be owned by residents who are not U.S. citizens or any other corporate entity including other S Corporations, C Corporations, LLCs, partnerships or sole proprietorships. The legality differences include regulations such as shareholder meetings and varying stock treatment considerations. A business may be formed as an LLC but taxed as an S Corporation as long as the business can make the appropriate election and meet specific guidelines set by the Internal Revenue Service. If choosing to be taxed as an S Corporation the entity must first be registered as a C Corporation or an LLC in order to meet the guidelines of the IRS to qualify.

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Summary and Considerations

Determining how to structure a new cannabis business is one of the most important decisions you'll need to make when starting a business in the state of Michigan. The decision will heavily affect your business in several ways, including control over the business, the level of personal liability owners may carry, reporting and accounting requirements, operational considerations, and the taxes that will be paid. Often, structuring decisions made early on can carry forward, with the results impacting the business in later years. It is necessary to work with both a CPA and attorney when planning business structuring, and ensure both common law and income tax laws are followed, as well as future tax impacts are planned for accordingly.