

IRS Inventory Accounting Memo Geared to Cannabis Industry

by Nathan J. Richman

A recently released IRS legal memorandum appears to be intended to clarify inventory tax accounting principles for state-legal marijuana businesses despite not mentioning the restriction they face, according to practitioners.

The memo (ILM 202114019), dated January 23 and released April 9, addresses the costs that a merchandise reseller may capitalize into inventory under section 471 without addressing the limitation on deductions applicable to state-legal marijuana businesses under section 280E.

Most taxpayers aren't asking to capitalize costs to inventory and would rather immediately deduct them, with the exception of businesses subject to section 280E, Jonathan Kalinski of Hochman Salkin Toscher Perez PC told *Tax Notes*. The IRS's decision not to mention section 280E or marijuana in the memo could be part of a move to normalize the state-legal cannabis industry, he said.

Jennifer E. Benda of Hall Estill noted that the IRS Small Business/Self-Employed Division attorney who received the memo, Luke D. Ortner, works on cannabis industry inventory issues.

James D. Thorburn of Thorburn Law Group LLC said he isn't surprised that the IRS failed to explicitly mention cannabis and section 280E, especially when it is uncertain what position to take. The memo's exclusion of the section 471(c) exception could also fit that category, he said.

The IRS memo addresses a hypothetical corporation that could have made one of the small business tax accounting elections, such as the inventory alternatives under section 471(c), but hasn't done so. The taxpayer purchases and resells goods without producing any of its own.

The IRS determined that as a pure reseller not applying section 263A or 471(c), the hypothetical taxpayer may only capitalize so-called acquisition costs consisting of the invoice price of the goods it buys and the transportation costs required to take possession. The taxpayer can't capitalize things like storage, inspection, repackaging, and labor costs, according to the IRS.

While most taxpayers don't want to capitalize in favor of the timing benefit of immediate

deductions, state-legal marijuana businesses face section 280E, which denies all deductions except for cost of goods sold to businesses that traffic in controlled substances otherwise prohibited by the Controlled Substances Act. In other words, state-legal cannabis businesses don't have the luxury of worrying about timing, but try to save any deductions they can by capitalizing.

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In a 2015 legal memorandum (ILM 201504011), the IRS took the position that section 471 defines what falls within COGS not subject to section 280E.

Production Limitations

Benda said the 2021 memo follows the IRS's Tax Court win in *Patients Mutual Assistance Collective Corp. v. Commissioner*, 151 T.C. 176 (2018), very closely in defining what retail taxpayers can recover under reg. section 1.471-3. Marijuana industry taxpayers still need guidance on what producers can recover under reg. section 1.471-11, she said.

The producer inventory accounting rules generally allow more indirect costs than the retailer regulation, Benda said.

Thorburn said more and larger cannabis industry taxpayers have integrated the growing and selling portions of the business. In fact, Colorado, where he practices, originally required that sort of vertical integration for state-legal marijuana businesses, he said.

Kalinski said the taxpayer in the example, with an average of \$4 million of annual gross receipts, would be a state-legal cannabis business in its infancy. It seems like a curious and deliberate choice to use a taxpayer that could have qualified for section 471(c) but declined rather than a \$50-million-a-year business, he said.

Mom and pop cannabis shops seem to be falling by the wayside in favor of bigger, more sophisticated players, according to Kalinski. That sophistication brings more business integration, further highlighting the limit of the 2021 memo's lack of attention to manufacturers' inventory accounting, he said.

Getting It Right

Despite the absence of explicit references, taxpayers in the state-legal cannabis industry would be wise to follow the IRS's 2021 memo, according to Kalinski. Even if the memo isn't as generous as some taxpayers might hope, it does provide some certainty, he said.

The experiences on the ground might not be as negative as the memo implies, according to Thorburn. Pure retailers seem to be getting 10 percent to 20 percent more of their gross receipts allowed as COGS than a strict reading of the 2021 memo might imply, he said, adding that the trend may be related to recent drops in product costs.

Martin Martinez of Marcum LLP said the memo should be incorporated into the accounting models that taxpayers use in their Accounting Standards Codification Subtopic 740-10 analyses. Taxpayers that think the IRS is too stingy on allowing COGS under section 280E should use the memo as the starting point for calculating their financial statement reserves, he said.

Those financial statements should be a key support for taxpayers looking to take advantage of the cannabis industry's one win in Tax Court, *Californians Helping to Alleviate Medical Problems Inc. v. Commissioner*, 128 T.C. 173 (2007) (*CHAMP*), according to Martinez.

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In *CHAMP*, the Tax Court approved a taxpayer's attempt to diminish the impact of section 280E by separating its lines of business so the deduction denial didn't affect ancillary income and related deductions. Taxpayers have

tried to retroactively fit their facts to *CHAMP* with little success.

Martinez said all cannabis industry taxpayers — and especially those looking to take advantage of *CHAMP* — need to be careful because of the legal gray area and substantial impact of section 280E. That means substantial modeling and recordkeeping, he said.

There are three key components to a successful state-legal marijuana taxpayer, and just reading *CHAMP* isn't enough, according to Martinez. The taxpayer needs a sound business structure, must have its cost accounting systems in place from the beginning, and should keep its legal representatives intimately involved, he said.

Taxpayers that try to clean up their compliance later on could face risky and expensive tax accounting method changes, Martinez said.

Missing Pieces

Even though the 2021 memo didn't mention section 280E, it was surprising that some of the prominent cases involving COGS — including *Alpenglow Botanicals LLC v. United States*, 894 F.3d 1187 (10th Cir. 2018) — weren't mentioned, Thorburn said. He reiterated his call for the release of the IRS's marijuana audit guide, like the one it made for the wine industry.

The IRS likely has two reasons for not providing more guidance to the marijuana industry, according to Thorburn. First, there are some issues around what constitutes trafficking under section 280E, he said, posing the question whether it goes beyond the specific businesses to their advisers and other support personnel. Second, the IRS seems to want to have the discretion it would have if COGS was treated as a legislative grace like deductions, he said.

Benda said that despite many industry requests, she isn't sure the IRS will release public guidance for cannabis producer taxpayers, including the audit guide. She said the delay in guidance probably comes from the IRS continuing to work through the issues that state-legal marijuana poses under section 280E. ■