TAXATION OF THE CANNABIS INDUSTY

DISCLAIMER

It is the intent of the writer, contributors and editors to provide the most accurate and up to date information at the time of writing. Every effort has been made to verify the content with the Internal Revenue Code, Treasury Regulations and Court Cases. This should not be construed to be expert advice, your sole source of information, nor should it be used as any type of authority when representing taxpayers before the Internal Revenue Service.

Mary Jane Hourani, MM, EA, NTPI Fellow

Table of Contents

Introduction 2
Marijuana or Industrial Hemp 4
Internal Revenue Code Sections Defined 5
Application of the Law 8
The State of Michigan Marihuana Laws 15
Federal Case Law 18
Reading v. Commissioner, 70 T.C. 730 (1978) 18
Californian Helping to Alleviate Medical Problems (CHAMP) v. Commissioner, 128 T.C. 173 (2007) ... 18
Olive v. Commissioner, 792 F.3d 1146 (9th Cir. 2015) 18
Alpenglow Botanicals LLC v. U.S., 122 A.F.T.R. 2nd 2018-5035 (D. Colo. 2016), aff'd, 894 F.3d 1187 (10th Cir. 2018), cert denied (S. Ct 6-24-2019) 18
Alterman v. Commissioner, T.C. Memo 2018-83 18
Loughman v. Commissioner, T.C. Memo 2018-85 18
Alternative Health Care Advocates v. Commissioner, 151 T.C. No. 13 (2018) 19
Patients Mutual Assistance Collective Corporation, d.b.a. Harborside health Center v. Commissioner, 151 T.C. No. 11 (2018) 19
High Desert Relief. V. United States, 917 F.3d 1170 (10 Cir. 2019) 19
Feinberg v. Commissioner, 916 F.3d 1330 (10th Cir. 2019) 19
New Legislation 19
Marijuana Opportunity Reinvestment & Expungement Act of 2019 19
Appendix A – Chief Counsel Memorandum (2015-04-011) 20
Appendix B 27
Reg § 1.471-3. Inventories at cost [prior to amendment by TD 8131, 03/24/87]. 27
Reg § 1.471-11. Inventories of manufacturers [prior to amendment by TD 8131, 03/24/87]. 27
References 41

Introduction

Modern Federal income tax history began with the enactment by congress of the Revenue Act of 1912, which followed the 16th Amendment to the Constitution, giving Congress the power to tax income broadly conceived without apportioning the tax among the state according to their populations.

Between 1913 and 1939 Congress passed fourteen revenue acts. During that time, whenever it was necessary to change the law, a new law was substituted for the old with much of it taken from the old. To circumvent this cumbersome method Congress enacted Title 26 of the U.S. Code, also known as the Internal Revenue Code of 1939, so that it could be changed by amendment.

Between 1939 and 1953 the Internal Revenue Code of 1939 was amended twenty-one times until the Internal Revenue Code of 1954 was adopted, primarily to establish a more logical arrangement and to eliminate some inequities in the law.

The Tax Reform Act of 1986 (sometimes called TRA 86), which was signed on October 22, 1986, overhauling the Internal Revenue Code of 1954 to the Internal Revenue Code of 1986. In 1998 Congress passed the IRS Restructuring and Reform Act, expanding taxpayer rights and re-organizing the IRS. This is also when the IRS became more "customer friendly". Although we have seen several laws that affect the tax code, it is still rooted in the Tax Reform Act of 1986.

Since 1986 we have seen a lot of tax legislation introduced and enacted; the Economic Growth and Tax Relief Reconciliation Act of 2001**,** the Omnibus Reconciliation and Giveaway Acts of 2003 and 2004, Jobs and Growth Tax Relief Reconciliation Act of 2003, The New Energy Reform Act of 2008, the unforgettable fiscal cliff American Taxpayer Relief Act of 2012, and The Patient Protection and Affordable Care Act (commonly referred to as Obamacare) signed into law March 23, 2010 with implementation beginning October 2013. Significant tax changes occurred in 2014 and 2015 giving way to the Tax Increase Prevention Act of 2014, Protecting Americans from Tax Hikes Act of 2015 (PATH) as well as The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 and The Trade Preferences Extension Act of 2015 as the most notable. 2017 brought the Tax Cuts and Jobs Act (TCJA) and a treasure trove of corporate incentives and a permanent corporate tax rate cut to a

flat rate of 21%. The TCJA offers temporary provisions for individuals for tax years beginning January 01, 2018 through December 31, 2025, along with changes and extenders covered in the Bipartisan Budget Act of 2018 and the Consolidated Appropriations Act of 2018. The Taxpayer First Act of 2019 was enacted with an effective date of July 1, 2019, which provides for a restructure of the Internal Revenue Service. Its primary focus is to enhance customer service by providing enhanced employee training, renaming the Office of Appeals to the Independent Office of Appeals, establishing a Community Volunteer Income Tax Assistance Matching Grant Program, public notice requirements, addresses cybersecurity and identity protection concerns, and increases the failure to file penalty amongst other provisions.

This background is important to our understanding of how the current tax code affects both Individuals and Business'. What is most important in an industry subject to limitations, like the Cannabis Industry, is to understand exactly how Title 26 of the U.S. Code defines income and adjustments to income. There isn't a case through the entire history of tax reform, reconciliation bills and other acts affecting the tax code that was more important than *Edmonson v. Commissioner, T.C. Memo 1981-623* which defined the taxation of the Cannabis Industry. We will look at the implications of this case and the prohibitions it provided. The Farm Bill of 2014 introduced Industrial Hemp Pilot Programs whereas The Farm Bill of 2018 carved out Industrial Hemp products from others in the Cannabis Industry. It is vitally important to understand the distinction between Industrial Hemp and Smokable/Edible Cannabis (Marijuana) as the taxation is vastly different. Many states have legalized Medical Marijuana with some having legalized Recreational Marijuana; it is important to understand a state's licensing, regulatory and taxation requirements in addition to the Federal Tax Implications. While Marijuana may be legal at a State level it is still considered a Schedule 1 controlled substance of the Comprehensive Drug Abuse Prevention Act of 1970, Pub. L. No. 91-513 (The Controlled Substance Act). Since Article VI of the U.S. Constitution states that federal laws supersede conflicting state laws, those operating in the Marijuana industry are subject to many of the prohibitions laid out following the Edmonson Case.

The taxation limitations are not the only issues plaguing the Marijuana Industry. Since it is a Schedule 1 controlled substance it is very difficult to obtain bank accounts and other sources of funding like most other businesses. The hope was that by 2019 Congress would provide relief to this industry by relaxing banking regulations and provide a path for this industry to obtain

bank accounts, unfortunately as of the date of this writing that has not happened. In 2018, then Attorney General Jeff Sessions, walked back the enforcement approach laid out by Deputy U.S. Attorney David W. Ogden (2009) and Deputy Attorney General James M. Cole (2011) that was as long as those in the industry were in compliance with their States Cannabis Laws and timely filed all Federal and State tax returns, the Department of Justice would not pursue those under the Criminal Statutes as a priority. Deputy Attorney General James M. Cole further provided guidance in 2013 for enforcement where criminal enterprises existed and to focus on those distributing to minors.

Marijuana or Industrial Hemp

It is important to differentiate between Marijuana products and Industrial Hemp products as the taxation of each is very different. Both Marijuana and Industrial Hemp are derived from the Cannabis plant which is part of the Cannabaceae family, but that is where their similarities end. Industrial Hemp is from the plant species Cannabis sativa L. which has a delta-9 tetrahydrocannabinol (THC) concentration of not more than 0.3 percent (.3%) dry weight. Products containing a THC level greater than 0.3% are categorized as Marijuana, most commonly found in smokables or edibles.

The Farm Bill of 2014 included provisions for University sponsored Industrial Hemp research projects, which continue today. The Farm Bill of 2018, however legalized Industrial Hemp by removing it from a Schedule 1 Substance. Industrial Hemp includes products like, rope, paper, textiles, and oils most commonly known as CBD. In order to grow Industrial Hemp a farmer or grower needs to comply with the regulations set out in the bill and administered by the U.S. Department of Agriculture (USDA). The USDA issued interim final regulations on October 29, 2019 detailing the following requirements for growing Industrial Hemp (Tidgren, 2019):

1. Licensing
2. Maintaining information on the land
3. Testing THC concentrations
4. Disposing of non-compliant plants
5. Compliance provisions

6. Handling Violations

The taxation of Farmers or Growers in the Industrial Hemp industry is similar to others carrying on a trade or business without the limitations discussed later. Understanding how other Farm Commodities are taxed is crucial to compliance with this industry.

The Food and Drug Administration (FDA) has been clear that they will not regulate the Industrial Hemp industry, moreover they have been clear that at no time may this industry market products stating they "cure" ailments. It should be noted, however, that there are several Cannabinoid Epilepsy drug treatments that have been approved by the FDA, Charlotte's Web being the most notable.

Internal Revenue Code Sections Defined

26 U.S.C §61 defines income as "income from all sources derived".

1. Compensation for services, including fees, commissions, fringe benefits, and similar items;
2. Gross income derived from business;
3. Gains derived from dealings in property;
4. Interest;
5. Rents;
6. Royalties;
7. Dividends;
8. Annuities;
9. Income from life insurance and endowment contracts;
10. Pensions;
11. Income from discharge of indebtedness;
12. Distributive share of partnership gross income;
13. Income in respect of a decedent; and
14. Income from an interest in an estate or trust.

Chief Counsel addresses the application of § 61 for the marijuana industry by stating the following:

> *"Though a medical marijuana business is illegal under federal law, it remains obligated to pay federal income tax on its taxable income because §61(a) does not differentiate between income derived from legal sources and income derived from illegal sources. See, e.g., James v. United States, 366 U.S. 213, 218 (1961). Under the Sixteenth Amendment of the United States Constitution ("Sixteenth Amendment"), Congress is authorized to lay and collect taxes on income. In a series of cases, the United States Supreme Court has held that income in the context of a reseller or producer means gross income, not gross*

receipts. In other words, Congress may not tax the return of capital. See, e.g., Doyle v Mitchell Bros. Co., 247 U.S. 179, 185 ("As was said in Stratton's Independence v. Howbert, [citation omitted], 'Income may be defined as the gain derived from capital, from labor, or from both combined.'"); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) ("The power to tax income like that of the new corporation is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.")."

26 U.S.C §62 defines adjustments to gross income as;

(1)Trade and business deductions -- *The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.*

A Trade or Business is defined as: "*(6) Activity in connection with trade or business or production of income To the extent provided in regulations, for purposes of paragraph (1)(A), the term "trade or business" includes— (A) any activity in connection with a trade or business, or (B) any activity with respect to which expenses are allowable as a deduction under section 212.*"

26 U.S.C § 212 further defines adjustments to gross income as the following, but do not confuse this with 26 U.S.C § 162, which will be discussed later. § 212 is strictly related to what is commonly known as Cost of Goods Sold, expenses directly connected to the production of income.

all the ordinary and necessary expenses paid or incurred during the taxable year--

1) *for the production or collection of income;*
2) *for the management, conservation, or maintenance of property held for the production of income; or*
3) *in connection with the determination, collection, or refund of any tax.*

26 U.S.C § 162 is commonly referred to as "Legislative Grace", since it allows for expenses that are expanded beyond the definition of § 212. The expenses defined in § 162 must meet all of the following tests:

1. Ordinary & Necessary;
2. An Expense;
3. Paid or incurred during the tax year; AND
4. Taxpayer is carrying on a trade or business.

§ 162(a) **"…***There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—*

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

A notable case in defining a Trade or Business is Commissioner v. Groetzinger, 480 U.S. 23 (1987) where this professional gambler was defined as a trade or business by meeting the 9-Factor Test used not only by the Internal Revenue Service but also by the courts. These factors are presented in Treasury Reg. § 1.183-2(b) as follows:

1. The manner in which the taxpayer carried on the activity;
2. The expertise of the taxpayer and his/her advisers;
3. The time and effort expended by the taxpayer in carrying on the activity;
4. The expectation that the assets used in the activity may appreciate;
5. The success of the taxpayer in carrying on the other similar or dissimilar activities;
6. The taxpayer's history of income or loss with respect to the activity;
7. The amount of occasional profits, if any, that are earned;
8. The financial status of the taxpayer; and
9. Elements of personal pleasure or recreation

Earlier *Edmonson v. Commissioner, T.C. Memo 1981-623* was referenced as a pivotable case directly effecting the Marijuana Industry. In this case Jeffrey Edmonson was a drug dealer who filed a Schedule C with his Individual Income Tax Return. While under examination Mr. Edmonson provided the IRS Agent books and records detailing his income and expenses including mileage, meals & entertainment, telephone, material and supplies as well as office-in-home. Upon completion of the examination the service denied all the taxpayer's expenses which he subsequently appealed. Tax Court reversed the services expense denial and allowed Mr. Edmonson all his expense including office-in-home citing Mr. Edmonson met the criteria for conducting a trade or business and met the tests for claiming ordinary and necessary expenses. It is because of this case that 26 U.S.C § 280E was enacted; prohibiting all § 162 expenses attributable to illegal operations. It further expanded § 162 to include the following:

"§ 162 C (2) Other illegal payments

No deduction shall be allowed under subsection (a) for any payment (other than a payment described in paragraph (1)) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a

trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. The burden of proof in respect of the issue, for purposes of this paragraph, as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud)."

26 U.S.C §280E *"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 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."* (Added Pub. L. 97–248, title III, § 351(a), Sept. 3, 1982, 96 Stat. 640.)

Further limiting the adjustments to gross income for the Marijuana Industry is 26 U.S.C § 471. At one point it was thought that 26 U.S.C. § 263A (UNICAP) would apply to this industry, however it has since been established that §263A was enacted after §280E thereby prohibiting the industry from its provisions. In January 2015 the Office of Chief Counsel released a Memorandum (C.C.A. 2015-04-011) clearly defining the use of § 471, "stating a taxpayer trafficking in a Schedule I or Schedule II controlled substance determines COGS using the applicable inventory-costing regulations under §471 as they existed when § §280E was enacted." The Memo goes onto indicate that the IRS either in exam or appeals may require a taxpayer to change their method of accounting if they have not properly utilized a non-inventory method of accounting. Taxpayers who carry inventory are required to use the Accrual method of accounting as well as comply with § 471-3(b) for resellers, § 471-3(c) for producers and § 471-11 full-absorption regulations.

Application of the Law

The application of § 61 is the simplest to define for the Marijuana business as Gross Receipts. The taxpayer received money, compensation, barter at Fair Value, etc., for the sale or is product.

For example: $ 100,000 of product sold

Recall too that Title 26 of the US Code states that Gross Income is defined as Gross Receipts less Adjustments to Gross Receipts (COGS). When defining Gross Business Income, we would utilize the following formula:

Gross Receipts – COGS = Gross Income ⟶ Taxable Income

The application of § 280E is also clear as prohibiting ordinary and necessary business expenses. Ordinary and necessary business expenses should be thought of as "overheard expenses".

> For example: Office supplies, insurance, rent, travel, interest, professional fees, mileage, etc.

The application of § 471 in defining Cost of Goods Sold (COGS) for this industry is not as simple as the above code sections, especially since there was an amendment on March 24, 1987 which clarified the connection between § 471 and § 263A (UNICAP). Since § 280E was enacted prior to 1987 Chief Counsels Advise from 2015 (Appendix A) clearly states that when an expense is otherwise prohibited, by § 280E in this case, it is ineligible for the benefits of other provisions in the code, § 263A as the case may be. Appendix B contains the full content of §§ 1.471-3 and 1.471-11.

§ 1.471-3(b) for resellers allows for costs by using the beginning of each year as the starting point, adding the invoice cost of COGS purchased less trade discounts except cash discounts, transportation costs as well as other direct cost associated with acquiring the product. However, most other direct costs such as seeds and plants may have to be capitalized if the method of accounting requires it, such as when using the accrual method.

§ 1.471-3(c) for producers defines inventory costs by using the beginning of each year as the starting point, adding costs of raw materials, supplies (new or consumed), direct labor and indirect production costs required for production. Production costs may include a pro-rata share of management expenses, but it may not include sales cost or return of capital regardless of whether its accounted for as interest or profit.

§ 1.471-11 defines direct and indirect costs of manufacturing/production, in the case of Marijuana it defines costs broadly for producers (growers). Direct costs are those which are directly associated with the production of the product and tend to be relatively uniform across all industries using COGS production methods.

Cost of Labor under this method may include not only direct compensation but also paid time off (§ 105(d)), payroll taxes as well as unemployment benefits.

Indirect costs may, however, be a little more challenging to define for this industry. Unfortunately, once defined may prove more restrictive as to COGS given the requirement for "full absorption". In order to not be in jeopardy of using an improper or incorrect method of inventory costing, businesses must treat both direct and indirect costs as inventory. When looking at indirect cost we can classify them into General, Fixed or Variable categories.

General indirect costs are those defined under GAAP that "facilitate reasonable groupings of such costs for the purposes of determining unit product costs." Also, other direct costs not in the Fixed or Variable categories.

Fixed indirect costs are those directly attributable to production cost that do not change significantly from one time period to the next.

Examples: rent, property taxes on the building or machinery

Variable indirect costs are those directly attributable to production cost that change significantly from one time period to the next.

Examples: materials, factory janitorial supplies and utilities

A comprehensive listing of indirect costs are listed in Appendix B and include some of the following:

1. Indirect production costs,
2. Maintenance,
3. Utilities,
4. Rent,
5. Indirect Labor and production supervisory wages/compensation/burden,
6. Indirect materials & supplies,
7. Tools & equipment not capitalized and
8. Cost of quality control and inspection.

Also included in indirect costs according to C.C.A. 2015-31-016 (June 9, 2015) is State level Excise Tax. In the State of Michigan there 10% of Gross Sales which are defined as *"the sales price for marihuana sold or otherwise transferred to anyone other than a marihuana establishment."* (MCL 333.27963)

A comprehensive listing of costs NOT included as indirect costs are listed in Appendix B and include some of the following:

1. Marketing & Advertising,
2. Selling & Distributions,
3. Interest,
4. Research and Experimental, including engineering & product development,
5. Depreciation & Amortization in excess of what is reported on taxpayer's financial statements,
6. Income taxes attributable to income received on sale of inventory, and
7. Salaries paid to officers.

Having defined COGS, both direct and indirect, there are two methods of allocation that can be used; Manufacturing Burden Rate and Standard Cost Method. Using the manufacturing burden rate allows multiple burden rates to be used when allocating certain classes of expenses.

For example: one rate for allocating rent and another for allocating utilities.

It is important to note that the code states that greater weight shall be given to the taxpayers financial reporting than to that of tax reporting especially if the tax reporting unfairly allocates indirect production costs. As a planning pointer it may be prudent to use the same method for financial and tax reporting. § 1.471-11(d)(ii)(a-c)

> *"(ii) Development of manufacturing burden rate. The following factors, among others, may be taken into account in developing manufacturing burden rates:*
>
> *(a) The selection of an appropriate level of activity and period of time upon which to base the calculation of rates which will reflect operating conditions for purposes of the unit costs being determined;*
>
> *(b) The selection of an appropriate statistical base such as direct labor hours, direct labor dollars, or machine hours, or a combination thereof, upon which to apply the overhead rate to determine production costs; and*
>
> *(c) The appropriate budgeting, classification and analysis of expenses (for example, the analysis of fixed and variable costs)."*

§ 1.471-11(d)(iii)(a-b)

> *"(iii) Operation of the manufacturing burden rate method*
>
> *(a) The purpose of the manufacturing burden rate method used in conjunction with the full absorption method of inventory costing is to allocate an appropriate amount of indirect production costs to a taxpayer's goods in ending inventory by the use of predetermined rates intended to approximate the actual amount of indirect production costs incurred. Accordingly, the proper use of the manufacturing burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of indirect production costs allocated to the goods in ending inventory and the total amount of indirect production costs actually incurred and required to be allocated to such goods (i.e., the under or over-applied burden) must be treated as an adjustment to the taxpayer's ending inventory in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total actual indirect production costs for the year then such adjustment need not be allocated to the taxpayer's goods in ending inventory unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative adjustments consistently.*
>
> *(b) Notwithstanding subdivision (a), the practical capacity concept may be used to determine the total amount of fixed indirect production costs which must be allocated to goods in ending inventory. See subparagraph (4) of this paragraph."*

The Standard Cost Method while sounding easy has a particular set of rules for its allocations. Like the Manufacturing Burden Method, greater weight is given to the financial reporting method than to the tax method; dissimilar, however are the following two concepts,

"net positive overhead variance" and "net negative overhead variance". These variance methods require the allocation of *"goods in ending inventory a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct production cost variances."*

Also identified in § 1.471-11is the use of a Practical Capacity Concept method of allocation. This is when , "*the percentage of practical capacity represented by actual production (not greater than 100 percent), as calculated under subdivision (ii) of this subparagraph, is used to determine the total amount of fixed indirect production costs which must be included in the taxpayer's computation of the amount of inventoriable costs. The portion of such costs to be included in the taxpayer's computation of the amount of inventoriable costs is then combined with variable indirect production costs and both are allocated to the goods in ending inventory in accordance with this paragraph."* When there is indirect subdivision cost this method may be applicable, however the Manufacturing Burden or Standard Cost Methods may be more common.

Case Study: Tommy Toker is a reseller of Marijuana. He purchases his product from Wasteland Farms. His sales were $ 25,000, product cost $ 10,000, transportation cost of the product $ 2,500, bags and packaging cost $ 500, advertising and marketing $ 3,000, bookkeeping/accounting $ 1,200, rent including utilities $ 12,000, travel/trade show $ 500.

Sales		**25,000.00**
COGS		
Product	10,000.00	
Transportation	2,500.00	
Bags & Packaging	500.00	
Total COGS		13,000.00
Gross Profit		**12,000.00**
Expenses		
Advertising	3,000.00	
Bookkeeping	1,200.00	
Rent	12,000.00	
Travel/Trade Show	500.00	
Total Expense		16,700.00
Net Income		**(4,700.00)**

Taxable Income

Restricted by 280E

Case Study: Sarah Stoner of Stoner Farms is a producer (grower) of Marijuana. Her sales were $ 75,000. She purchased seeds for $ 1.50 each and planted 5 acres, $ 43,500 (average of 2600-5800 per acre). Her labor to plant and cultivate was $ 15,000, soil enrichment $ 2,200, fuel and equipment for planting was $ 1,000, Laboratory fees, $ 1,000 verifying the THC was below .3% and transportation costs $ 1,000. She also had bookkeeping fees of $ 1,200, Marketing $ 3,000, Continuing Education with USDA of $ 500 as well as Travel/Trade Show expense of

$ 500. She is buying the property from her Dad who has been farming his whole life; her loan payments are $ 500 per month at 0%.

Sales		**75,000.00**
COGS		
Product	43,500.00	
Soil	2,200.00	
Labor	15,000.00	
Laboratory	1,000.00	
Transportation	1,000.00	
Fuel & Equipment	1,000.00	
Total COGS		63,700.00
Gross Profit		**11,300.00**
Expenses		
Advertising	3,000.00	
Bookkeeping	1,200.00	
Continuing Education	500.00	
Travel/Trade Show	500.00	
Total Expense		5,200.00
Net Income		**6,100.00**

Case Study: Peter Piper of Reefer Inc is a producer (grower) who uses a greenhouse he rents from an unrelated party which includes a small office of 1500 sq. ft. He purchases seeds for $ 1.50 each and plants 10 acres, with a cost of $ 60,000. He has soil/planting material costs of $ 10,000, Labor to plant & cultivate $ 23,000, Office Labor $ 5,000, Officer Salaries $ 50,000 Utilities – water $ 3,000, Utilities – electricity $ 8,000, Transportation costs $ 1,000, Advertising $ 3,000, Bookkeeping $ 1,200, Travel/Trade Show $ 500. Reefer's sales were $ 245,000 and Laboratory fees of $ 3,000 to verify the THC level is great than .3%

Sales		**245,000.00**
COGS		
Product	60,000.00	
Soil	10,000.00	
Labor	23,000.00	
Laboratory	3,000.00	
Transportation	1,000.00	
Utilities - Water	3,000.00	
Utilities - Electricity	7,968.00	
Total COGS		97,000.00
Gross Profit		**148,000.00**
Expenses		
Advertising	3,000.00	
Bookkeeping	1,200.00	
Office Labor	5,000.00	
Officer Compensation	50,000.00	
Travel/Trade Show	500.00	
Utilities - Electricity	32.00	
Total Expense		59,700.00
Net Income		**88,300.00**

Taxable Income

Restricted by 280E

Utilities Allocation:

10 acres = 435600 sq. ft.
Total sq. ft w/office = 437,100

Greenhouse is 99.6%

The case studies illustrate the interplay of all the code sections, § 61, § 280E and § 471, related to the Marijuana Industry and the restrictions. It is vitally important that the application of these code sections is strictly adhered to when advising taxpayers in the Marijuana Industry, especially when providing tax preparation services. Given the confines of 26 U.S.C taxpayers in the Marijuana Industry will pay tax on a larger percentage of their income than taxpayers without restrictions to expenses. Understanding the complexities of Federal Law is imperative even when most states have some form of legalized Marijuana, either Limited Medical, Medical and/or Recreational Laws.

The State of Michigan Marihuana Laws

The State of Michigan has enacted three laws related to marijuana, and they have chosen to use the name Marihuana. The Medical Marihuana Act of 2008, also known as the care giver act, provids that if there was a "bona-fide physician-patient relationship" and the physician determined marijuana to be a proper course of Treatment. In these cases, the patient could either grow their own marijuana or seek the assistance from a registered caregiver. The Medical Marihuana Facilities Licensing Act of 2016 defined the expanded licensing process to include growers, processors, provisioning centers, secure transporters and safety compliance facilities. It further provided for specific Industrial Hemp licenses. Many believe this Act was in preparation for a recreational use act by providing a framework for commercial growing, transporting, monitoring and testing of marijuana. The Marihuana Tracking Act of 2016 directly addressed commercial trafficking. The Michigan Regulation and Taxation of Marihuana Act of 2018 legalized Recreational Use of marijuana following voter approval in the general election of November 6, 2018 and states the following:

333.27952 Purpose and intent.

Sec. 2.

The purpose of this act is to make marihuana legal under state and local law for adults 21 years of age or older, to make industrial hemp legal under state and local law, and to control the commercial production and distribution of marihuana under a system that licenses, regulates, and taxes the businesses involved. The intent is to prevent arrest and penalty for personal possession and cultivation of marihuana by adults 21 years of age or older; remove the commercial production and distribution of marihuana from the illicit market; prevent revenue generated from commerce in marihuana from going to criminal enterprises or gangs; prevent the distribution of marihuana to persons under 21 years of age; prevent the diversion of marihuana to illicit markets; ensure the safety of marihuana and marihuana-infused products; and ensure security of marihuana establishments. To the fullest extent possible, this act shall be interpreted in accordance with the purpose and intent set forth in this section.

333.27953 Definitions.

Sec. 3.

As used in this act:

(a) "Cultivate" means to propagate, breed, grow, harvest, dry, cure, or separate parts of the marihuana plant by manual or mechanical means.

(b) "Department" means the department of licensing and regulatory affairs.

(c) "Industrial hemp" means a plant of the genus cannabis and any part of that plant, whether growing or not, with a delta-9 tetrahydrocannabinol concentration that does not exceed 0.3% on a dry-weight basis, or per volume or weight of marihuana-infused product, or the combined percent of delta-9-tetrahydrocannabinol and tetrahydrocannabinolic acid in any part of the plant of the genus cannabis regardless of moisture content.

(d) "Licensee" means a person holding a state license.

(e) "Marihuana" means all parts of the plant of the genus cannabis, growing or not; the seeds of the plant; the resin extracted from any part of the plant; and every compound, manufacture, salt, derivative, mixture, or preparation of the plant or its seeds or resin, including marihuana concentrate and marihuana-infused products. For purposes of this act, marihuana does not include:

(1) the mature stalks of the plant, fiber produced from the stalks, oil or cake made from the seeds of the plant, any other compound, manufacture, salt, derivative, mixture, or preparation of the mature stalks, except the resin extracted from those stalks, fiber, oil, or cake, or any sterilized seed of the plant that is incapable of germination;

(2) industrial hemp; or

(3) any other ingredient combined with marihuana to prepare topical or oral administrations, food, drink, or other products.

(f) "Marihuana accessories" means any equipment, product, material, or combination of equipment, products, or materials, which is specifically designed for use in planting, propagating, cultivating, growing, harvesting, manufacturing, compounding, converting, producing, processing, preparing, testing, analyzing, packaging, repackaging, storing, containing, ingesting, inhaling, or otherwise introducing marihuana into the human body.

(g) "Marihuana concentrate" means the resin extracted from any part of the plant of the genus cannabis.

(h) "Marihuana establishment" means a marihuana grower, marihuana safety compliance facility, marihuana processor, marihuana microbusiness, marihuana retailer, marihuana secure transporter, or any other type of marihuana-related business licensed by the department.

(i) "Marihuana grower" means a person licensed to cultivate marihuana and sell or otherwise transfer marihuana to marihuana establishments.

(j) "Marihuana-infused product" means a topical formulation, tincture, beverage, edible substance, or similar product containing marihuana and other ingredients and that is intended for human consumption.

(k) "Marihuana microbusiness" means a person licensed to cultivate not more than 150 marihuana plants; process and package marihuana; and sell or otherwise transfer marihuana to individuals who are 21 years of age or older or to a marihuana safety compliance facility, but not to other marihuana establishments.

(l) "Marihuana processor" means a person licensed to obtain marihuana from marihuana establishments; process and package marihuana; and sell or otherwise transfer marihuana to marihuana establishments.

(m) "Marihuana retailer" means a person licensed to obtain marihuana from marihuana establishments and to sell or otherwise transfer marihuana to marihuana establishments and to individuals who are 21 years of age or older.

(n) "Marihuana secure transporter" means a person licensed to obtain marihuana from marihuana establishments in order to transport marihuana to marihuana establishments.

(o) "Marihuana safety compliance facility" means a person licensed to test marihuana, including certification for potency and the presence of contaminants.

(p) "Municipal license" means a license issued by a municipality pursuant to section 16 of this act that allows a person to operate a marihuana establishment in that municipality.

(q) "Municipality" means a city, village, or township.

(r) "Person" means an individual, corporation, limited liability company, partnership of any type, trust, or other legal entity.

(s) "Process" or "Processing" means to separate or otherwise prepare parts of the marihuana plant and to compound, blend, extract, infuse, or otherwise make or prepare marihuana concentrate or marihuana-infused products.

(t) "State license" means a license issued by the department that allows a person to operate a marihuana establishment.

(u) "Unreasonably impracticable" means that the measures necessary to comply with the rules or ordinances adopted pursuant to this act subject licensees to unreasonable risk or require such a high investment of money, time, or any other resource or asset that a reasonably prudent businessperson would not operate the marihuana establishment.

Additional guidance is provided in the Emergency Rules set forth by the Secretary of State on July 3, 2019, established by the Marijuana Regulatory Agency.

The following types of licenses are available through an extensive application process:

1. Class A Marihuana Grower
2. Class B Marihuana Grower
3. Class C Marihuana Grower
4. Marihuana Processor
5. Marihuana Retailer
6. Marihuana Safety Compliance Facility
7. Marihuana Secure Transporter
8. Marihuana Microbusiness
9. Excess Marihuana Grower
10. Marihuana Event Organizer
11. Temporary Marihuana Event
12. Designated Consumption Establishment

The licensing fees are as follows:

State License Type	Initial Licensure Fee	Renewal Fee	State License Type	Initial Licensure Fee	Renewal Fee
Class A Grower	4,000.00	Bottom 33% - 3,000 Middle 33% - 4,000 Top 33% - 5,000	Retailer	25,000.00	Bottom 33% - 20,000 Middle 33% - 25,000 Top 33% - 30,000
Class B Grower	8,000.00	Bottom 33% - 6,000 Middle 33% - 8,000 Top 33% - 10,000	Secure Transporter	25,000.00	Bottom 33% - 20,000 Middle 33% - 25,000 Top 33% - 30,000
Class C Grower	40,000.00	Bottom 33% - 30,000 Middle 33% - 40,000 Top 33% - 50,000	Safety Compliance Facility	25,000.00	Bottom 33% - 20,000 Middle 33% - 25,000 Top 33% - 30,000
Excess Grower	40,000.00	Bottom 33% - 30,000 Middle 33% - 40,000 Top 33% - 50,000	Event Organizer	1,000.00	1,000.00
Microbusiness	8,000.00	Bottom 33% - 6,000 Middle 33% - 8,000 Top 33% - 10,000	Temporaty Event	See Rule 63	N/A
Processor	40,000.00	Bottom 33% - 30,000 Middle 33% - 40,000 Top 33% - 50,000	Designated Consumption Establishment	1,000.00	1,000.00

Federal Case Law

Reading v. Commissioner, 70 T.C. 730 (1978)

While this case is outside the scope of the Marijuana Industry it clearly defines COGS as "…expenditures necessary to acquire, construct or extract a physical product that is to be sold; the seller can have no gain until he or she recovers the economic investment that he or she has made directly in the actual item sold." Moreover, it consistently applied the COGS equation:

beginning inventory + current-year production costs – ending inventory = COGS

Californian Helping to Alleviate Medical Problems (CHAMP) v. Commissioner, 128 T.C. 173 (2007)

This case is pivotable in established precedent of business with a dual purpose. CHAMP was a recognized counseling center that also provided alternative medicine in the form of Medical Marijuana. The service disallowed §162 ordinary and necessary expense for the entire business. CHAMP argued that they had two distinct divisions and maintained its books/records accordingly. Tax Court agreed with CHAMP and reversed the services position.

The primary takeaway from this case should be the establishment of separate books and records for each division, that which is subject to §280E restrictions and that which is not.

Olive v. Commissioner, 792 F.3d 1146 (9th Cir. 2015)

Unlike the CHAMP case, Olive argued it too had a dual-purpose business, however it was unable to establish that to be true. The 9th Circuit Court argued that selling snacks, movies, games with some counseling was not significant enough to substantiate a dual-purpose business.

Alpenglow Botanicals LLC v. U.S., 122 A.F.T.R. 2nd 2018-5035 (D. Colo. 2016), aff'd, 894 F.3d 1187 (10th Cir. 2018), cert denied (S. Ct 6-24-2019)

Alpenglow has been busy fighting against the application of §280E even though the courts have been quite clear regarding its application in this industry. In its final attempt it sued the IRS for a refund stating the service had exceeded its statutory and constitutional authority by denying expenses. Ultimately its petition was denied by the courts, who upheld the application of §280E.

Alterman v. Commissioner, T.C. Memo 2018-83

Another dual-purpose business arguing that §280E does not apply to its ancillary business or selling nonmarijuana trafficking products, papers, pipes, etc. Alterman maintained a chart of accounts dividing only the income received. Tax court noted that the sale of nonmarijuana merchandise "complemented its efforts to sell marijuana." It also noted "that if selling nonmarijuana merchandise was considered a separate business, then the expenses of that business would be deductible".

Loughman v. Commissioner, T.C. Memo 2018-85

An interesting case whereas this is one of the first to address a Sub-chapter S Corporations Officer Compensation. Loughman argued that the officer compensation should not be subject to §280E, rather qualified under §471 as part of production costs. They further argued

that should the service and the courts subject officer compensation to §280E it essentially causes the same dollar to be taxed twice; once by the corporation and again at the shareholder level as wages. The courts upheld the services position and disallowed officer compensation under §471.

Interesting to note this case gives rise to the question of what type of entity is best suited for this industry. It would appear from this case that Sub-chapter S may not be the best choice.

Alternative Health Care Advocates v. Commissioner, 151 T.C. No. 13 (2018)

Similar to the Loughman case where officer compensation was denied, in this case so too was employee compensation. Again, upholding §280E.

Patients Mutual Assistance Collective Corporation, d.b.a. Harborside health Center v. Commissioner, 151 T.C. No. 11 (2018)

The court found that Harborside was a reseller, therefor was unable to capitalize indirect expense other than those listed under §471 for a reseller. They were determined to be a reseller since they did not engage in the production of any product, they merely sold product obtained from nurseries or growers.

High Desert Relief. V. United States, 917 F.3d 1170 (10 Cir. 2019)

The District Court and the 10th Circuit Court both found that the IRS has the right to summons records and investigate, even though High Desert argued the IRS does not have civil audit power. The courts cited that §280E is a civil statute, thereby providing the IRS authority.

Feinberg v. Commissioner, 916 F.3d 1330 (10th Cir. 2019)

This case is a tough one not only for the Marijuana Industry because it could transcend across other industries. The court found that the taxpayer has the evidentiary burden of proof that in this case §280E did not apply.

New Legislation

Marijuana Opportunity Reinvestment & Expungement Act of 2019

On November 20, 2019 the House Judicial Committee pass this act 24 – 10, and H.R 3884 was introduced. Should this act pass it would remove Marijuana from Schedule 1 of the Controlled Substance Act, there by removing the restrictions of §280E. There would also be a provision to decriminalize some Marijuana convictions, offenses or cases retroactively.

Appendix A – Chief Counsel Memorandum (2015-04-011)

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: 201504011
Release Date: 1/23/2015
CC:ITA:6 – LFNolanII
POSTS-125750-13
UILC: 280E.00-00, 61.00-00, 263A.00-00, 446.00-00, 446.01-00, 471.00-00

Date: December 10, 2014

To: Matthew A. Houtsma
Associate Area Counsel (Small Business/Self-Employed)
CC:SB:5:Den:2

From: W. Thomas McElroy, Jr.
Senior Technician Reviewer
Office of Associate Chief Counsel (Income Tax & Accounting)
CC:ITA:6

Subject: Taxpayers Trafficking in a Schedule I or Schedule II Controlled Substance -- Capitalization of Inventoriable Costs This advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES (1) How does a taxpayer trafficking in a Schedule I or Schedule II controlled substance determine cost of goods sold ("COGS") for the purposes of §280E of the Internal Revenue Code ("Code")? (2) May Examination or Appeals require a taxpayer trafficking in a Schedule I or Schedule II controlled substance to change to an inventory method for that controlled substance when the taxpayer currently deducts otherwise inventoriable costs from gross income?

CONCLUSION (1) A taxpayer trafficking in a Schedule I or Schedule II controlled substance determines COGS using the applicable inventory-costing regulations under §471 as they existed when §280E was enacted.

POSTS-125750-13 2 (2) Yes, unless the taxpayer is properly using a non-inventory method to account for the Schedule I or Schedule II controlled substance pursuant to the Code, Regulations, or other published guidance.

BACKGROUND In the Comprehensive Drug Abuse Prevention and Control Act of 1970, 21 U.S.C. §801–971 (1970), ("Controlled Substances Act" or "CSA"), Congress created a regime to curtail the unlawful manufacture, distribution, and abuse of dangerous drugs ("controlled substances"). Congress assigned each controlled substance to one of five lists (Schedule I through Schedule V). See §812 of the CSA. Schedule I includes: (a) opiates; (b) opium derivatives (e.g., heroin; morphine); and (c) hallucinogenic substances (e.g., LSD; marihuana (a/k/a marijuana); mescaline; peyote).

Though a medical marijuana business is illegal under federal law, it remains obligated to pay federal income tax on its taxable income because §61(a) does not differentiate between income derived from legal sources and income derived from illegal sources. See, e.g., James v. United States, 366 U.S. 213, 218 (1961). Under the Sixteenth Amendment of the United States Constitution ("Sixteenth Amendment"), Congress is authorized to lay and collect taxes on income. In a series of cases, the United States Supreme Court has held that income in the context of a reseller or producer means gross income, not gross receipts. In other words, Congress may not tax the return of capital. See, e.g., Doyle v Mitchell Bros. Co., 247 U.S. 179, 185 ("As was said in Stratton's Independence v. Howbert, [citation omitted], 'Income may be defined as the gain derived from capital, from labor, or from both combined.'"); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934) ("The power to tax income like that of the new corporation is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.").

Section 61(a) defines "gross income" broadly using 15 examples of items that are includible in gross income. Consistent with the Sixteenth Amendment, §61(a)(3) provides that gross income includes net gains derived from dealings in property, which includes controlled substances produced or acquired for resale. "Gains derived from dealings in property" means gross receipts less COGS, which is the term given to the adjusted basis of merchandise sold during the taxable year. Section 1.61-3(a) of the Income Tax Regulations. See also §§1001(a); 1011(a); 1012(a). As the Tax Court explained in Reading v. Commissioner, 70 T.C. 730, 733 (1978), "[t]he 'cost of goods sold' concept embraces expenditures necessary to acquire, construct or extract a physical product which is to be sold; the seller can have no gain until he recovers the economic investment that he has made directly in the actual item sold." A taxpayer derives COGS using the following formula: beginning inventories plus current-year production costs (in the case of a producer) or current-year purchases (in the case of a reseller) less ending inventories. In general, the taxpayer first determines gross income by subtracting COGS from gross receipts, and then determines taxable income by

POSTS-125750-13 3 subtracting all ordinary and necessary business expenses (e.g., §162(a)) from gross income.

In 1981, the Tax Court allowed an illegal business to recover the cost of the controlled substances (i.e., amphetamines; cocaine; marijuana) obtained on consignment and also to claim certain business deductions (a portion of the rent he paid on his apartment which was his sole place of business, the cost of a small scale, packaging expenses, telephone expenses, and automobile expenses). See Jeffrey Edmondson v. Commissioner, T.C. Memo. 1981-623.

In 1982, Congress enacted §280E, which reverses the holding in Edmondson as it relates to deductions other than the cost of the controlled substances. Section 280E reads as follows: 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 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.

Under Explanation of Provision, the Senate Report reads as follows: All deductions and credits for amounts paid or incurred in the illegal trafficking in drugs listed in the Controlled Substances Act are disallowed. To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill.

S. REP. NO. 97-494 (Vol. I), at 309 (1982). The Senate bill was adopted in conference.

CONF. REP. NO. 97-760, at 598 (1982), 1982-2 C.B. 661.

When enacting §280E, Congress exercised its authority to withhold the legislative grace mentioned in New Colonial Ice Co., supra. It is important to understand that §280E even disallows a deduction for expenses that are not illegal per se (e.g., salaries; rent; telephone). Thus, §280E has a greater reach than §162(c), which disallows a deduction for specified illegal payments (e.g., bribes; kickbacks).

When §280E was enacted, taxpayers using an inventory method were subject to the inventory-costing regulations under §471. Specifically, resellers were subject to §1.471- 3(b), and producers were subject to §§1.471-3(c) and 1.471-11 ("full-absorption regulations").

POSTS-125750-13 4

Four years after enacting §280E, Congress enacted the Tax Reform Act of 1986, which added the uniform capitalization rules of §263A to the Code. Under §263A(a), resellers and producers of merchandise are required to treat as inventoriable costs the direct costs of property purchased or produced, respectively, and a proper share of those indirect costs that are allocable (in whole or in part) to that property. Flush language at the end of §263A(a)(2) provides, "Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph."

The flush language at the end of §263A(a)(2) was added by §1008(b)(1) of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA")1 (P.L. 100-647), reprinted in 1988 U.S.C.C.A.N. 4621, as a retroactive, technical correction. Under Explanation of Provision, the Senate Report reads as follows: The bill also clarifies that a cost is subject to capitalization under this provision only to the extent it would otherwise be taken into account in computing taxable income for any taxable year. Thus, for example, the portion of a taxpayer's interest expense that is allocable to personal loans, and hence is disallowed under section 163(h), may not be included in a capital or inventory account and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner. S. Rep. No. 100-445, at 104 (1988).

The Tax Court has tried a few cases involving taxpayers that sell medical marijuana. In the seminal case in this area, the Tax Court held that the taxpayer trafficked in medical marijuana, which is a Schedule I controlled substance, and that §280E disallows all deductions attributable to that trade or business. The Tax Court also held, however, that §280E does not disallow the deductions attributable to the taxpayer's separate and lawful trade or business. Californians Helping to Alleviate Medical Problems, Inc., v. Commissioner, 128 T.C. 173 (2007) ("CHAMP"). In CHAMP, the government conceded that §280E does not prohibit a taxpayer from claiming COGS. Id. at 178, n. 4. In other cases involving nonmedical marijuana or other Schedule I controlled substances, the Tax Court recognized that §280E does not disallow adjustments to gross receipts for COGS. See, e.g., Peyton v. Commissioner, T.C. Memo. 2003-146; Franklin v. Commissioner, T.C. Memo. 1993-184; McHan v. Commissioner, T.C. Memo. 2006-84.

Applied literally, §280E severely penalizes taxpayers that traffic in a Schedule I or Schedule II controlled substance but don't use an inventory method for the controlled substance. When required to use an inventory method, a taxpayer also is required to use an accrual method for purchases and sales of merchandise. See §§1.471-1; 1.446- 1

TAMRA began as the Technical Corrections Act of 1988 (S. 2238) and the Miscellaneous Revenue Bill of 1988 (H.R. 4333).

POSTS-125750-13 5

1(c)(2)(i). But see §1.61-4(b).2 Thus, the taxpayer will capitalize inventoriable costs when incurred and will remove these costs from inventory when units of merchandise are sold. Stated differently, the taxpayer will compute COGS as an adjustment to gross receipts. On the other hand, when not required to use an inventory method, a taxpayer might be permitted to use the cash method. See, e.g., §446(c)(1). See also Rev. Proc. 2001-10, 2001-1 C.B. 272; Rev. Proc. 2002-28, 2002-1 C.B. 815. Under the modified cash method as described in Rev. Proc. 2001-10 and Rev. Proc. 2002-28, a reseller may account for merchandise as "inventories" or as "materials and supplies that are not incidental." See §1.162-3 (a)(1). When a unit of merchandise is sold, the reseller will account for that cost as a deduction from gross income in the taxable year that the unit is sold or the payment is received, whichever is later. Similarly, a cash-method producer or farmer will deduct production expenses from gross income in the taxable year paid and, thus, will have no basis in the merchandise that it eventually sells. In the case of a cash-method reseller, producer, or farmer, the obligation to pay an income tax on gains derived from the sale of a controlled substance creates a tension between the accepted interpretation of "income" under the Sixteenth Amendment and §280E, which disallows all deductions of a trade or business trafficking in a Schedule I or Schedule II controlled substance.

ANALYSIS ISSUE 1: How does a taxpayer trafficking in a Schedule I or Schedule II controlled substance determine COGS for the purposes of §280E?

To resolve this issue, we will consider: (1) when and how an item becomes an inventoriable cost; (2) what Congress intended to include within the meaning of inventoriable costs when they enacted §280E; and (3) whether Congress changed their definition when they enacted §263A.

To be deductible by a business enterprise, a business expense (e.g., salaries; rent) must be "ordinary and necessary" within the meaning of §162 and must satisfy the timing requirements of §461. Once these requirements are satisfied, the amount of that expense is deducted in the current taxable year, unless another provision of the Code or regulations requires this deduction to be deferred to a subsequent taxable year, capitalized to an asset, or disallowed entirely. See, e.g., §§267(a)(2); 471(a); 263A(a); 280E. For example, in the case of a producer of property, inventory-costing rules typically require the capitalization of costs that are "incident to and necessary for production or manufacturing operations or processes" (e.g., §1.471-11(b)(1)) or costs that "can be identified or associated with particular units or groups of units of specific property produced" (e.g., §1.263A-1(e)(2)). Thus, when one of these inventory-costing regulations applies, a producer must capitalize, as an inventoriable cost, what otherwise

2 The rule that applies to farmers is different from the rule that applies to producers and resellers. A farmer using an overall accrual method also must use an inventory method because of its use of an accrual method.

POSTS-125750-13

would have been a deduction under §162 and must keep that cost in inventories until the taxable year that the producer sells the merchandise. At that point, the producer includes those costs in COGS and accounts for COGS as an adjustment to gross receipts.

As noted above, the legislative history of section 280E states that "[t]o preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill." When §280E was enacted in 1982, "inventoriable cost" meant a cost that was capitalized to inventories under §471 (as those regulations existed before the enactment of §263A). The specific regulations are §1.471-3(b) in the case of a reseller of property and §§1.471-3(c) and 1.471-11 in the case of a producer of property. Thus, a marijuana reseller using an inventory method would have capitalized the invoice price of the marijuana purchased, less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the marijuana. Similarly, a marijuana producer using an inventory method would have capitalized direct material costs (marijuana seeds or plants), direct labor costs (e.g., planting; cultivating; harvesting; sorting), Category 1 indirect costs (§1.471-11(c)(2)(i)), and possibly Category 3 indirect costs (§1.471-11(c)(2)(iii)).

Section 263A increased the types of costs that are inventoriable compared to the rules under §471, but did not revolutionize inventory costing. A reseller still is required to treat the acquisition costs of property as inventoriable. Now, a reseller also is required to capitalize purchasing, handling, and storage expenses. In addition, both resellers and producers are required to capitalize a portion of their service costs, such as the costs associated with their payroll, legal, personnel functions. Thus, under §263A, resellers and producers of property are required to treat some deductions as inventoriable costs.

Section 263A is a timing provision. It does not change the character of any expense from "nondeductible" to "deductible," or vice versa. For a taxpayer to be permitted to treat an expense as an inventoriable cost, that expense must not run afoul of the flush language at the end of §263A(a)(2) — "Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph." See §1.263A-1(c)(2)(i).

Read together, §280E and the flush language at the end of §263A(a)(2) prevent a taxpayer trafficking in a Schedule I or Schedule II controlled substance from obtaining a tax benefit by capitalizing disallowed deductions. Congress did not repeal or amend §280E when it enacted §263A. Furthermore, nothing in the legislative history of §263A suggests that Congress intended to permit a taxpayer to circumvent §280E by treating a disallowed deduction as an inventoriable cost or as any other type of capitalized cost. In fact, the legislative history of §263A(a)(2) states that "a cost is subject to capitalization . . . only to the extent it would otherwise be taken into account in computing taxable income for any taxable year." If a taxpayer subject to §280E were allowed to capitalize "additional §263A costs," as defined for new taxpayers in §1.263A-

POSTS-125750-13

1(d)(3),3 §263A would cease being a provision that affects merely timing and would become a provision that transforms non-deductible expenses into capitalizable costs. Thus, we have concluded that a taxpayer trafficking in a Schedule I or Schedule II controlled substance is entitled to determine inventoriable costs using the applicable inventory-costing regulations under §471 as they existed when §280E was enacted.

ISSUE 2: May Examination or Appeals require a taxpayer trafficking in a Schedule I or Schedule II controlled substance to change to an inventory method for that controlled substance when the taxpayer deducts otherwise inventoriable costs from gross income?

A cash-method producer of a Schedule I or Schedule II controlled substance, such as marijuana, typically will deduct all production costs in the taxable year paid and, thus, will not have any adjusted basis in the product that it produces. When §280E is applied in the case of a producer trafficking in a Schedule I or Schedule II controlled substance, and all deductions from gross income are disallowed, the producer's taxable income for each taxable year will be significantly higher than what it would have been if the producer had used a permissible inventory method and recouped its production costs through COGS. Furthermore, the producer will not be able to take those disallowed production costs into account in any future taxable year. Thus, in this scenario, the overall cash method does not clearly reflect income because of the operation of §280E.4 Stated differently, even a producer trafficking in a Schedule I or Schedule II controlled substance is subject to tax on "gains derived from dealings in property," not on gross receipts. Section 61(a)(3). This rule regarding "gains derived from dealings in property" applies equally to a reseller trafficking in a Schedule I or Schedule II controlled substance.

In our view, Examination and Appeals have the authority under §446(b) to require a taxpayer to change from a method of accounting that does not clearly reflect income to a method that does clearly reflect income regardless of whether that change results in a positive or negative §481(a) adjustment.5 When a producer or reseller of a Schedule I

3 Section 1.263A-1(d)(3) provides, in part, "For new taxpayers, additional section 263A costs are defined as the costs, other than interest, that the taxpayer must capitalize under section 263A, but which the taxpayer would not have been required to capitalize if the taxpayer had been in existence prior to the effective date of section 263A."

4 In addition, the overall cash method might not clearly reflect income because of §1.61- 4(b) or §1.471-1.

5 Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. The Commissioner has broad discretion to determine whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. See Thor

POSTS-125750-13

or Schedule II controlled substance uses a method of accounting that causes a tax result contrary to the Sixteenth Amendment, to §61(a)(3), and to the legislative history of §280E, the proper exercise of the above-mentioned authority is warranted. Section 446(b). See also Rev. Proc. 2002-18. See also IRM 4.11.6.7.1 (05-13-2005). Consequently, if a producer or reseller of a Schedule I or Schedule II controlled

substance is deducting from gross income the types of costs that would be inventoriable if that taxpayer were properly using an inventory method under § 471, it is an appropriate exercise of authority for Examination or Appeals to require that taxpayer to use an inventory method, to use the applicable inventory-costing regime (as discussed under Issue (1) of this memo), and to change from the overall cash method to an overall accrual method.6 However, if that taxpayer is not required to use an inventory method (for example, small taxpayers properly using the modified cash method under Rev. Proc. 2001-10 or Rev. Proc. 2002-28 or farmers), it is not an appropriate exercise of authority for Examination or Appeals to require that taxpayer to use an inventory method. Instead, Examination or Appeals should permit that taxpayer to continue recovering, as a return of capital deductible from gross income, the same types of costs that are properly recoverable by a taxpayer both trafficking in a Schedule I or Schedule II controlled substance and using an inventory method under § 471. Thus, for example, a producer of a Schedule I or Schedule II controlled substance should be permitted to deduct wages, rents, and repair expenses attributable to its production activities, but should not be permitted to deduct wages, rents, or repair expenses attributable to its general business activities or its marketing activities.

Please call Leo F. Nolan II or Amy Wei at (202) 317-7007 (not a toll-free number) if you have any questions.

Power Tool Co. v. Commissioner, 439 U.S. 522 (1979); RCA Corp. v. United States, 664 F.2d 881 (2d Cir. 1981), cert. denied, 457 U.S. 1133 (1982).

6 The §481(a) adjustment required to implement this method change does not include any amount attributable to non-inventoriable costs disallowed under §280E in any taxable year.

Appendix B

Reg § 1.471-3. Inventories at cost [prior to amendment by TD 8131, 03/24/87].

Cost means:

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit. See §1.471-11 for more specific rules regarding the treatment of indirect production costs.

(d) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are: (1) Farmers and raisers of livestock (see § 1.471-6); (2) miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see §1.471-7); and (3) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see §1.471-8).

Notwithstanding the other rules of this section, cost shall not include an amount which is of a type for which a deduction would be disallowed under section 162(c), (f), or (g) and the regulations thereunder in the case of a business expense.

Document Title:Reg §1.471-3 Inventories at cost [prior to amendment by TD 8131, 03/24/87].
Checkpoint Source:Prior Final & Temporary Treasury Regulations (RIA)
© 2019 Thomson Reuters/Tax & Accounting. All Rights Reserved.

Reg § 1.471-11. Inventories of manufacturers [prior to amendment by TD 8131, 03/24/87].

(a) Use of full absorption method of inventory costing. In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income (as required by section 471 of the Code), both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the "full absorption" method of inventory

costing. Under the full absorption method of inventory costing production costs must be allocated to goods produced during the taxable year, whether sold during the taxable year or in inventory at the close of the taxable year determined in accordance with the taxpayer's method of identifying goods in inventory. Thus, the taxpayer must include as inventoriable costs all direct production costs and, to the extent provided by paragraphs (c) and (d) of this section, all indirect production costs. For purposes of this section, the term "financial reports" means financial reports (including consolidated financial statements) to shareholders, partners, beneficiaries or other proprietors and for credit purposes.

(b) Production costs.

(1) In General. Costs are considered to be production costs to the extent that they are incident to and necessary for production or manufacturing operations or processes. Production costs include direct production costs and fixed and variable indirect production costs.

(2) Direct production costs.

(i) Costs classified as "direct production costs" are generally those costs which are incident to and necessary for production or manufacturing operations or processes and are components of the cost of either direct material or direct labor. Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are considered in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product. See §1.471-3 for the elements of direct material costs. Direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor. For the treatment of rework labor, scrap, spoilage costs, and any other costs not specifically described as direct production costs see §1.471-11(c)(2).

(ii) Under the full absorption method, a taxpayer must take into account all items of direct production cost in his inventoriable costs. Nevertheless, a taxpayer will not be treated as using an incorrect method of inventory costing if he treats any direct production costs as indirect production costs, provided such costs are allocated to the taxpayer's ending inventory to the extent provided by paragraph (d) of this section. Thus, for example, a taxpayer may treat direct labor costs as part of indirect production costs (for example (by use of the conversion cost method), provided all such costs are allocated to ending inventory to the extent provided by paragraph (d) of this section.

(3) Indirect production costs.

(i) In general. The term "indirect production costs" includes all costs which are incident to and necessary for production or manufacturing operations or processes other than direct production costs (as defined in subparagraph (2) of this paragraph). Indirect production costs may be

classified as to kind or type in accordance with acceptable accounting principles so as to enable convenient identification with various production or manufacturing activities or functions and to facilitate reasonable groupings of such costs for purposes of determining unit product costs.

(ii) Fixed and variable classifications. For purposes of this section, fixed indirect production costs are generally those costs which do not vary significantly with changes in the amount of goods produced at any given level of production capacity. These fixed costs may include, among other costs, rent and property taxes on buildings and machinery incident to and necessary for manufacturing operations or processes. On the other hand, variable indirect production costs are generally those costs which do vary significantly with changes in the amount of goods produced at any given level of production capacity. These variable costs may include, among other costs, indirect materials, factory janitorial supplies, and utilities. Where a particular cost contains both fixed and variable elements, these elements should be segregated into fixed and variable classifications to the extent necessary under the taxpayer's method of allocation, such as for the application of the practical capacity concept (as described in paragraph (d)(4) of this section).

(c) Certain indirect and production costs.

(1) General rule. Except as provided in paragraph (c)(3) of this section and in paragraph (d)(6)(v) of §1.451-3, in order to determine whether indirect production costs referred to in paragraph (b) of this section must be included in a taxpayer's computation of the amount of inventoriable costs, three categories of costs have been provided in subparagraph (2) of this paragraph. Costs described in subparagraph (2)(i) of this paragraph must be included in the taxpayer's computation of the amount of inventoriable costs, regardless of their treatment by the taxpayer in his financial reports. Costs described in subparagraph (2)(ii) of this paragraph need not enter into the taxpayer's computation of the amount of inventoriable costs, regardless of their treatment by the taxpayer in his financial reports. Costs described in subparagraph (2)(iii) of this paragraph must be included in or excluded from the taxpayer's computation of the amount inventoriable costs in accordance with the treatment of such costs by the taxpayer in his financial reports and generally accepted accounting principles. For the treatment of indirect production costs described in subparagraph (2) of this paragraph in the case of a taxpayer who is not using comparable methods of accounting for such costs for tax and financial reporting see paragraph (c)(3) of this section. For contracts entered into after December 31, 1982, notwithstanding this section, taxpayers who use an inventory method of accounting for extended period long-term contracts (as defined in paragraph (b)(3) of §1.451-3) for tax purposes may be required to use the cost allocation rules provided in paragraph (d)(6) of §1.451-3 rather than the cost allocation rules provided in this section. See paragraph (d)(6)(v) of § 1.451-3. After a taxpayer has determined which costs must be treated as indirect production costs includible in the computation of the amount of inventoriable costs, such costs must be allocated to a taxpayer's ending inventory in a manner prescribed by paragraph (d) of this section.

(2) Includibility of certain indirect production costs.

(i) Indirect production costs included in inventoriable costs. Indirect production costs which must enter into the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his financial reports) include:

(a) Repair expenses,

(b) Maintenance,

(c) Utilities, such as heat, power and light,

(d) Rent,

(e) Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan.

(f) Indirect materials and supplies,

(g) Tools and equipment not capitalized, and

(h) Costs of quality control and inspection,

to the extent, and only to the extent, such costs are incident to and necessary for production or manufacturing operations or processes.

(ii) Costs not included in inventoriable costs. Costs which are not required to be included for tax purposes in the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his financial reports) include:

(a) Marketing expenses,

(b) Advertising expenses,

(c) Selling expenses,

(d) Other distribution expenses,

(e) Interest,

(f) Research and experimental expenses including engineering and product development expenses,

(g) Losses under section 165 and the regulations thereunder,

(h) Percentage depletion in excess of cost depletion,

(i) Depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports,

(j) Income taxes attributable to income received on the sale of inventory,

(k) Pension contributions to the extent that they represent past services costs,

(l) General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(m) Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities taken as a whole rather than to production or manufacturing operations or processes.

Notwithstanding the preceding sentence, if a taxpayer consistently includes in his computation of the amount of inventoriable costs any of the costs described in the preceding sentence, a change in such method of inclusion shall be considered a change in method of accounting within the meaning of sections 446, 481, and paragraph (e)(4) of this section.

(iii) Indirect production: costs includible in inventoriable costs depending upon treatment in taxpayer's financial reports. In the case of costs listed in this subdivision, the inclusion or exclusion of such costs from the amount of inventoriable costs for purposes of a taxpayer's financial reports shall determine whether such costs must be included in or excluded from the computation of inventoriable costs for tax purposes, but only if such treatment is not inconsistent with generally accepted accounting principles. In the case of costs which are not included in subdivision (i) or (ii) of this subparagraph, nor listed in this subdivision, whether such costs must be included in or excluded from the computation of inventoriable costs for tax purposes depends upon the extent to which such costs are similar to costs included in subdivision (i) or (ii), and if such costs are dissimilar to costs in subdivision (i) or (ii), such costs shall be treated as included in or excludable from the amount of inventoriable costs in accordance with this subdivision.

The costs listed in this subdivision are:

(a) Taxes. Taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes) attributable to assets incident to and necessary for production or manufacturing operations or processes. Thus, for example, the cost of State and local property taxes imposed on a factory or other production facility and any State and local taxes imposed on inventory must be included in or excluded from the computation of the amount of inventoriable costs for tax purposes depending upon their treatment by a taxpayer in his financial reports.

(b) Depreciation and depletion. Depreciation reported in financial reports and cost depletion on assets incident to and necessary for production or manufacturing operations or processes. In computing cost depletion under this section, the adjusted basis of such assets shall be reduced by cost depletion and not by percentage depletion taken thereon.

(c) Employee benefits. Pension and profit-sharing contributions representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor incident to and necessary for production or manufacturing operations or processes. These other benefits include workmen's compensation expenses, payments under a

wage continuation plan described in section 105(d), amounts of a type which would be includible in the gross income of employees under nonqualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees such as safety, medical treatment, cafeteria, recreational facilities, membership dues, etc., which are otherwise allowable as deductions under chapter 1 of the Code.

(d) Costs attributable to strikes, rework labor, scrap and spoilage. Costs attributable to rework labor, scrap and spoilage which are incident to and necessary for production or manufacturing operations or processes and costs attributable to strikes incident to production or manufacturing operation or processes.

(e) Factory administrative expenses. Administrative costs of production (but not including any cost of selling or any return on capital) incident to and necessary for production or manufacturing operations or processes.

(f) Officers' salaries. Salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes.

(g) Insurance costs. Insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment.

A change in the taxpayer's treatment in his financial reports of costs described in this subdivision which results in a change in treatment of such costs for tax purposes shall constitute a change in method of accounting within the meaning of sections 446 and 481 to which paragraph (e) applies.

(3) Exception. Except as provided in paragraph (d)(6) of §1.451-3, in the case of a taxpayer whose method of accounting for production costs in his financial reports is not comparable to his method of accounting for such costs for tax purposes (such as a taxpayer using the prime cost method for purposes of financial reports), the following rules apply:

(i) Indirect production costs included in inventoriable costs. Indirect production costs which must enter into the computation of the amount of inventoriable costs (to the extent, and only to the extent, such costs are incident to and necessary for production or manufacturing operations or processes) include:

(a) Repair expenses,

(b) Maintenance,

(c) Utilities, such as heat, power and light,

(d) Rent,

(e) Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage

continuation plan under section 105(d)), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan,

(f) Indirect materials and supplies,

(g) Tools and equipment not capitalized,

(h) Costs of quality control and inspection,

(i) Taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes.),

(j) Depreciation and amortization reported for financial purposes and cost depletion,

(k) Administrative costs of production (but not including any cost of selling or any return on capital) incident to and necessary for production or manufacturing operations or processes,

(l) Salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes, and

(m) Insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment.

(ii) Costs not included in inventoriable costs. Costs which are not required to be included in the computation of the amount of inventoriable costs include:

(a) Marketing expenses,

(b) Advertising expenses,

(c) Selling expenses,

(d) Other distribution expenses,

(e) Interest,

(f) Research and experimental expenses including engineering and product development expenses,

(g) Losses under section 165 and the regulations thereunder,

(h) Percentage depletion in excess of cost depletion,

(i) Depreciation reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports,

(j) Income taxes attributable to income received on the sale of inventory,

(k) Pension and profit-sharing contributions representing either past service costs or representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor. These other benefits include workmen's compensation expenses, payments under a wage continuation plan described in section 105(d), amounts of a type which would be includible in the gross income of employees under nonqualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees such as safety, medical treatment, cafeteria, recreational facilities, membership dues, etc., which are otherwise allowable as deductions under chapter 1 of the Code,

(l) Cost attributable to strikes, rework labor, scrap and spoilage,

(m) General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(n) Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes.

(d) Allocation methods.

(1) In general. Indirect production costs required to be included in the computation of the amount of inventoriable costs pursuant to paragraphs (b) and (c) of this paragraph must be allocated to goods in a taxpayer's ending inventory (determined in accordance with the taxpayer's method of identification) by the use of a method of allocation which fairly apportions such costs among the various items produced. Acceptable methods for allocating indirect production costs to the cost of goods in the ending inventory include the manufacturing burden rate method and the standard cost method. In addition, the practical capacity concept can be used in conjunction with either the manufacturing burden rate or standard cost method.

(2) Manufacturing burden rate method.

(i) In general. Manufacturing burden rates may be developed in accordance with acceptable accounting principles and applied in a reasonable manner. In developing a manufacturing burden rate, the factors described in paragraph (d)(2)(ii) of this section may be taken into account. Furthermore, if the taxpayer chooses, he may allocate different indirect production costs on the basis of different manufacturing burden rates. Thus, for example, the taxpayer may use one burden rate for allocating rent and another burden rate for allocating utilities. The method used by the taxpayer in allocating such costs in his financial reports shall be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect production costs to the ending inventory. Any change in a manufacturing burden rate which is merely a periodic adjustment to reflect current operating conditions, such as increases in automation or changes in operation, does not constitute a change in method of accounting under section 446. However, a change in the concept upon which such rates are developed does

constitute a change in method of accounting requiring the consent of the Commissioner. The taxpayer shall maintain adequate records and working papers to support all manufacturing burden rate calculations.

(ii) Development of manufacturing burden rate. The following factors, among others, may be taken into account in developing manufacturing burden rates:

(a) The selection of an appropriate level of activity and period of time upon which to base the calculation of rates which will reflect operating conditions for purposes of the unit costs being determined;

(b) The selection of an appropriate statistical base such as direct labor hours, direct labor dollars, or machine hours, or a combination thereof, upon which to apply the overhead rate to determine production costs; and

(c) The appropriate budgeting, classification and analysis of expenses (for example, the analysis of fixed and variable costs).

(iii) Operation of the manufacturing burden rate method

(a) The purpose of the manufacturing burden rate method used in conjunction with the full absorption method of inventory costing is to allocate an appropriate amount of indirect production costs to a taxpayer's goods in ending inventory by the use of predetermined rates intended to approximate the actual amount of indirect production costs incurred. Accordingly, the proper use of the manufacturing burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of indirect production costs allocated to the goods in ending inventory and the total amount of indirect production costs actually incurred and required to be allocated to such goods (i.e., the under or over-applied burden) must be treated as an adjustment to the taxpayer's ending inventory in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total actual indirect production costs for the year then such adjustment need not be allocated to the taxpayer's goods in ending inventory unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative adjustments consistently.

(b) Notwithstanding subdivision (a), the practical capacity concept may be used to determine the total amount of fixed indirect production costs which must be allocated to goods in ending inventory. See subparagraph (4) of this paragraph.

(3) Standard cost method.

(i) In general. A taxpayer may use the so-called “standard cost” method of allocating inventoriable costs to the goods in ending inventory, provided he treats variances in accordance with the procedures prescribed in paragraph (d)(3)(ii) of this section. The method used by the taxpayer in allocating such costs in his financial reports shall be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect

production costs to the ending inventory. For purposes of this subparagraph, a “net positive overhead variance” shall mean the excess of total standard (or estimated) indirect production costs over total actual indirect production costs and a “net negative overhead variance” shall mean the excess of total actual indirect production costs over total standard (or estimated) indirect production costs.

(ii) Treatment of variances.

(a) The proper use of the standard cost method pursuant to this subparagraph requires that a taxpayer must reallocate to the goods in ending inventory a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct production cost variances. The taxpayer must apportion such variances among his various items in ending inventory. However, if such variances are not significant in amount in relation to the taxpayer's total actual indirect production costs for the year then such variances need not be allocated to the taxpayer's goods in ending inventory unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative variances consistently.

(b) Notwithstanding subdivision (a), the practical capacity concept may be used to determine the total amount of fixed indirect production costs which must be allocated to goods in ending inventory. See subparagraph (4) of this paragraph.

(4) Practical capacity concept.

(i) In general. Under the practical capacity concept, the percentage of practical capacity represented by actual production (not greater than 100 percent), as calculated under subdivision (ii) of this subparagraph, is used to determine the total amount of fixed indirect production costs which must be included in the taxpayer's computation of the amount of inventoriable costs. The portion of such costs to be included in the taxpayer's computation of the amount of inventoriable costs is then combined with variable indirect production costs and both are allocated to the goods in ending inventory in accordance with this paragraph. See the example in subdivision (ii)(d) of this subparagraph. The difference (if any) between the amount of all fixed indirect production costs and the fixed indirect production costs which are included in the computation of the amount of inventoriable costs under the practical capacity concept is allowable as a deduction for the taxable year in which such difference occurs.

(ii) Calculation of practical capacity.

(a) In general. Practical capacity and theoretical capacity (as described in (c) of this subdivision) may be computed in terms of tons, pounds, yards, labor hours, machine hours, or any other unit of production appropriate to the cost accounting system used by a particular taxpayer. The determination of practical capacity and theoretical capacity should be modified from time to time to reflect a change in underlying facts and conditions such as increased output due to automation or other changes in plant operation. Such a change does not constitute a change in method of accounting under sections 446 and 481.

(b) Based upon taxpayer's experience. In selecting an appropriate level of production activity upon which to base the calculation of practical capacity, the taxpayer shall establish the production operating conditions expected during the period for which the costs are being determined, assuming that the utilization of production facilities during operations will be approximately at capacity. This level of production activity is frequently described as practical capacity for the period and is ordinarily based upon the historical experience of the taxpayer. For example, a taxpayer operating on a 5-day, 8-hour basis may have a “normal” production of 100,000 units a year based upon three years of experience.

(c) Based upon theoretical capacity. Practical capacity may also be established by the use of “theoretical” capacity, adjusted for allowances for estimated inability to achieve maximum production, such as machine breakdown, idle time, and other normal work stoppages. Theoretical capacity is the level of production the manufacturer could reach if all machines and departments were operated continuously at peak efficiency.

(d) Example. The provisions of (c) of this subdivision may be illustrated by the following example:

Corporation X operates a stamping plant with a theoretical capacity of 50 units per hour. The plant actually operates 1960 hours per year based on an 8-hour day, 5 day week basis and 15 shut-down days for vacations and holidays. A reasonable allowance for down time (the time allowed for ordinary and necessary repairs and maintenance) is 5 percent of practical capacity before reduction for down time. Assuming no loss of production during starting up, closing down, or employee work breaks, under these facts and circumstances X may properly make a practical capacity computation as follows:

```
Practical capacity without allowance for down
  time based on theoretical capacity per hour
  is (1900 X 50)..................................    98,000
Reduction for down time (98,000 X 5 percent).......     4,900
Practical capacity..............................    93,100
```

The 93,100 unit level of activity (i.e., practical capacity) would, therefore, constitute an appropriate base for calculating the amount of fixed indirect production costs to be included in the computation of the amount of inventoriable costs for the period under review. On this basis if only 76,000 units were produced for the period, the effect would be that approximately 81.6 percent (76,000, the actual number of units produced, divided by 93,100, the maximum number of units producible at practical capacity) of the fixed indirect production costs would be included in the computation of the amount of inventoriable costs during the year. The portion of the fixed indirect production costs not so included in the computation of the amount of inventoriable costs would be deductible in the year in which paid or incurred. Assume further that 7,600 units were on hand at the end of the taxable year and the 7,600 units were in the same proportion to the total units produced. Thus, 10 percent (7,600 units in inventory at the end of the taxable year, divided

by 76,000, the actual number of units produced) of the fixed indirect production costs included in the computation of the amount of inventoriable costs (the above-mentioned 81.6 percent) and 10 percent of the variable indirect production costs would be included in the cost of the goods in the ending inventory, in accordance with a method of allocation provided by this paragraph.

(e) Transition to full absorption method of inventory costing.

(1) In general.

(i) Mandatory requirement. A taxpayer not using the full absorption method of inventory costing, as prescribed by paragraph (a) of this section, must change to that method. Any change to the full absorption method must be made by the taxpayer with respect to all trades or businesses of the taxpayer to which this section applies. A taxpayer not using the full absorption method of inventory costing, as prescribed by paragraph (a) of this section, who makes the special election provided in subdivision (ii) of this subparagraph during the transition period described in subdivision (ii) of this subparagraph need not change to the full absorption method of inventory costing for taxable years prior to the year for which such election is made. In determining whether the taxpayer is changing to a more or less inclusive method of inventory costing, all positive and negative adjustments for all items and all trades or businesses of the taxpayer shall be aggregated. If the net adjustment is positive, paragraph (e)(3) shall apply, and if the net adjustment is negative, paragraph (e)(4) shall apply to the change. The rules otherwise prescribed in sections 446 and 481 and the regulations thereunder shall apply to any taxpayer who fails to make the special election in subdivision (ii) of this subparagraph. The transition rules of this paragraph are available only to those taxpayers who change their method of inventory costing.

(ii) Special election during two-year-transition period. If a taxpayer elects to change to the full absorption method of inventory costing during the transition period provided herein, he may elect on Form 3115 to change to such full absorption method of inventory costing and, in so doing, employ the transition procedures and adopt any of the transition methods prescribed in subparagraph (3) of this paragraph. Such election shall be made during the first 180 days of any taxable year beginning on or after September 19, 1973 and before September 19, 1975 (i.e., the "transition period") and the change in inventory costing method shall be made for the taxable year in which the election is made. Notwithstanding the preceding sentence if the taxpayer's prior returns have been examined by the Service prior to September 19, 1973, and there is a pending issue involving the taxpayer's method of inventory costing, the taxpayer may request the application of this regulation by agreeing and filing a letter to that effect with the district director, within 90 days after September 19, 1973 to change to the full absorption method for the first taxable year of the taxpayer beginning after September 19, 1973 and subsequently filing Form 3115 within the first 180 days of such taxable year of change.

(iii) Change initiated by the Commissioner. A taxpayer who properly makes an election under subdivision (ii) of this subparagraph shall be considered to have made a change in method of accounting not initiated by the taxpayer, notwithstanding the provisions of §1.481-1(c)(5). Thus, any of the taxpayer's "pre-1954 inventory balances" with respect to such inventory shall not be taken into account as an adjustment under section 481. For purposes of this paragraph, a "pre-1954 inventory balance" is the net amount of the adjustments which would have been required if

the taxpayer had made such change in his method of accounting with respect to his inventory in his first taxable year which began after December 31, 1953, and ended after August 16, 1954. See section 481(a)(2) and § 1.481-3.

(2) Procedural rules for change. If a taxpayer makes an election pursuant to subparagraph (1)(ii) of this paragraph, the Commissioner's consent will be evidenced by a letter of consent to the taxpayer, setting forth the values of inventory, as provided by the taxpayer, determined under the full absorption method of inventory costing, except to the extent that no determination of such values is necessary under subparagraph (3)(ii)(B) of this paragraph (the cut off method), the amount of the adjustments (if any) required to be taken into account by section 481, and the treatment to be accorded to any such adjustments. Such full absorption values shall be subject to verification on examination by the district director. The taxpayer shall preserve at his principal place of business all records, data, and other evidence relating to the full absorption values of inventory.

(3) Transition methods. In the case of a taxpayer who properly makes an election under subparagraph (1)(ii) of this paragraph during the transition period—

(i) 10-year adjustment period. Such taxpayer may elect to take any adjustment required by section 481 with respect to any inventory being revalued under the full absorption method into account ratably over a period designated by the taxpayer at the time of such election, not to exceed the lesser of 10 taxable years commencing with the year of transition or the number of years the taxpayer has been on the inventory method from which he is changing. If the taxpayer dies or ceases to exist in a transaction other than one to which section 381(a) of the Code applies or if the taxpayer's inventory (determined under the full absorption method) on the last day of any taxable year is reduced (by other than a strike or involuntary conversion) by more than an amount equal to 33⅓ percent of the taxpayer's inventory (determined under the full absorption method) as of the beginning of the year of change, the entire amount of the section 481 adjustment not previously taken into account in computing income shall be taken into account in computing income for the taxable year in which such taxpayer so ceases to exist or such taxpayer's inventory is so reduced.

(ii) Additional rules for LIFO taxpayers. A taxpayer who uses the LIFO method of inventory identification may either—

(a) Employ the special transition rules described in subdivision (i) of this subparagraph. Accordingly, all LIFO layers must be revalued under the full absorption method and the section 481 adjustment must be computed for all items in all layers in inventory, but no pre-1954 inventory balances shall be taken into account as adjustments under section 481; or

(b)

(1) Employ a cut-off method whereby the full absorption method is only applied in costing layers of inventory acquired during all taxable years beginning with the year for which an election is made under subparagraph (e)(1)(ii).

(2) In the case of a taxpayer using dollar value LIFO, employ a cut-off method whereby the taxpayer must use, for the year of change, the full absorption method in computing the base year cost and current cost of a dollar value inventory pool for the beginning of such year. The taxpayer shall not be required to recompute his LIFO inventories based on the full absorption method for a taxable year beginning prior to the year of change to the full absorption method. The base cost and layers of increment previously computed shall be retained and treated as if such base cost and layers of increment had been computed under the method authorized by this section. The taxpayer shall use the year of change as the base year in applying the double extension method or other method approved by the Commissioner, instead of the earliest year for which he adopted the LIFO method for any items in the pool.

(4) Transition to full absorption method of inventory costing from a method more inclusive of indirect production costs.

(i) Taxpayer has not previously changed to his present method pursuant to subparagraphs (1), (2), and (3) of this paragraph. If a taxpayer wishes to change to the full absorption method of inventory costing (as prescribed by paragraph (a) of this section) from a method of inventory costing which is more inclusive of indirect production costs and he has not previously changed to his present method by use of the special transition rules provided by subparagraphs (1), (2) and (3) of this paragraph, he may elect on Form 3115 to change to the full absorption method of inventory costing and, in so doing, take into account any resulting section 481 adjustment generally over 10 taxable years commencing with the year of transition. The Commissioner's consent to such election will be evidenced by a letter of consent to the taxpayer setting forth the values of inventory, as provided by the taxpayer determined under the full absorption method of inventory costing, except to the extent that no determination of such values is necessary under subparagraph (3)(ii)(b) of this paragraph, the amount of the adjustments (if any) required to be taken into account by section 481, and the treatment to be accorded such adjustments, subject to terms and conditions specified by the Commissioner to prevent distortions of income. Such election must be made within the transition period described in subparagraph (1)(ii) of this paragraph. A change pursuant to this subparagraph shall be a change initiated by the taxpayer as provided by §1.481-1(c)(5). Thus, any of the taxpayers "pre-1954 inventory balances" will be taken into account as an adjustment under section 481.

(ii) Taxpayer has previously changed to his present method pursuant to subparagraphs (1), (2), and (3) of this paragraph or would satisfy all the requirements of subdivision (i) of this subparagraph but fails to elect within the transition period. If a taxpayer wishes to change to the full absorption method of inventory costing (as prescribed by paragraph (a) of this section) from a method of inventory costing which is more inclusive of indirect production costs and he has previously changed to his present method pursuant to subparagraphs (1), (2), and (3) of this paragraph or he would satisfy the requirements of subdivision (i) of this subparagraph but he fails to elect within the transition period, he must secure the consent of the Commissioner prior to making such change.

Document Title:Reg §1.471-11 Inventories of manufacturers [prior to amendment by TD 8131, 03/24/87].
Checkpoint Source:Prior Final & Temporary Treasury Regulations (RIA)

References

(n.d.). Retrieved from Michigan Legislature: https://www.legislature.mi.gov

(n.d.). Retrieved from U.S. Congress: https://www.congress.gov/

(n.d.). Retrieved from Internal Revenue Service: http://irs.gov

26 U.S.C., Revenue Procedures, Publications. (n.d.). Retrieved from Internal Revenue Service: http://www.irs.gov

Land Grant University Tax Education Foundation. (n.d.). *National Income TAX Workbook 2016 - 2019.* Kelso, WA: Davis Brothers Brothers Printing.

State of Michigan, Dept of Licensing & Regulatory Affairs. (2019, July 3). Adult - Use Marihuana Establishments, Emergency Rules.

Thompson Reuters. (n.d.). RIA Checkpoint.

Tidgren, K. A. (2019, October 30). USDA Issues Rules for Domestic Hemp Production Program. *The AG Docket, Perspective on Current Agricultural Law Issues*.

United State Congress. (2019). *Taxpayer First Act of 2019, Pub. L. No. 116-25.*