

The Taxation of the Marijuana Business (A Primer)

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This blog post will be in two parts. The first part will provide the reader with an understanding of the laws and concepts associated with the taxation of the marijuana business. The second part will take these ideas and concepts and attempt to provide some practical operational guidance.

The First Part

The income taxation of a marijuana business, whether it be a producer, processor, wholesaler or retail establishment, is very different from a non-marijuana business. Everyone entering into the business will want to talk with a tax expert experienced in the taxation of a marijuana business in order to maximize the return on their investment.

There are several sections of the Internal Revenue Code ("IRC") that impact the taxation of the marijuana business. Businesses, in general, in which the sale of merchandise is an income producing factor, calculate their taxable income in accordance with three primary sections of the IRC. Those are code sections IRC § 162(a), IRC § 471 and IRC § 263A.

IRC § 162(a) permits the taxpayer to deduct all of the ordinary and necessary expenses associated with the business, and not directly related to the creation of the "product" (inventory), from gross receipts to arrive at taxable income. Chief Counsel Advice 201504011 permits marijuana businesses to calculate COGS on a cash basis.

IRC § 471 provides the general rule for determining the Cost of Goods Sold ("COGS") as it relates to inventory. COGS for inventory is normally accounted for on an accrual basis.

IRC § 263A, added to the IRC in 1988, expanded upon IRC § 471 and provides guidance on the costs associated with producing a product ("goods or inventory") which must be captured and allocated to the product and then deducted from the gross receipts received upon the sale of the product to arrive at the "profit" obtained from the sale of each item of product. These "captured" costs are known as COGS. Prior to the adoption of IRC § 263A the COGS were calculated solely pursuant to IRC § 471.

The "profit" obtained from the sale of product (Revenue from sale of product - COGS) is then further reduced by the IRC § 162(a) ordinary and necessary expenses to arrive at the taxable income of the business.

The taxation of a marijuana related business is different from the taxation of other businesses. Marijuana is a Schedule 1 Controlled Substance under the Controlled Substances Act (21 USC 801 *et seq.*). In 1982 Congress passed IRC § 280E, which prohibits marijuana businesses from deducting their IRC § 162(a) or ordinary and necessary business expenses from gross income when determining taxable income.

As will be discussed in Part Two, IRC § 280E denies the IRC § 162(a) deduction to those businesses that "consist of trafficking in controlled substances." Arguably this means that IRC § 162(a) deductions are available to marijuana businesses that are not involved in the "trafficking in controlled substances" of the marijuana industry. This might include producers and wholesalers.

IRC § 280E does, however, permit the deduction of COGS when product is sold in arriving at taxable income.

In 2015 the IRS issued Chief Counsel Advice 201504011 ("the CCA"), which addressed the accounting rules for the marijuana industry and how to arrive at taxable income.

Not surprisingly the CCA reiterated that IRC § 162(a) expenses are not available to the marijuana industry. The CCA also said that the COGS calculation under IRC § 471 applies and not the COGS calculation under IRC § 263A, which in essence replaced IRC § 471 but was enacted after IRC § 280E was adopted. The CCA does, however, permit a COGS deduction for indirect production-related expenses. Specifically, production-related expenses, otherwise deductible under IRC § 471, such as wages, rents, and repairs, are deductible. Marketing and general business expenses are not deductible when calculating the taxable income for a marijuana business.

IRC § 471 deals with the need for accounting for inventories. It provides that inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, ... if title thereto will pass to the purchaser of the product sold.^[1]

COGS, in the case of merchandise produced by the taxpayer includes (1) the cost of raw material 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 are appropriate portion of management expenses, but not including any cost of selling or return on capital whether by way of interest or profit. ^[2]

Indirect costs of production that may be included in the determination of COGS include:

- (a) Repair expenses;
- (b) Maintenance;
- (c) Utilities such as heat, power, and light;
- (d) Rent;
- (e) Indirect labor and production supervisory wages including payroll taxes and unemployment benefit payments;
- (f) Indirect materials and supplies;
- (g) Tools and equipment not capitalized; and
- (h) Costs of quality control and inspection.^[1]

Indirect costs that may be included in the calculation of COGS depending upon how they are treated on the taxpayer's financial statements include:

- (a) Taxes otherwise taken as a deduction under IRC § 164 (other than state, local and foreign income taxes);
- (b) Depreciation reported in financial reports and cost depletion on assets incident to and necessary for production or manufacturing operation or process;
- (c) Employee benefits including those otherwise deductible under IRC § 404;
- (d) Costs attributable to strikes, rework labor, scrap and spoilage;
- (e) Factory administrative expenses;
- (f) Officers' salaries attributable to services performed incident to and necessary for production or manufacturing operations or processes; and
- (g) Insurance costs incident to and necessary for production or manufacturing.^[4]

The COGS analysis for the retail marijuana business is simpler and the deductions are probably fewer. The retailer will include in COGS the invoice price less trade or other discounts. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the product.^[5] Accordingly, freight and service fees associated with the freight fees are added to the COGS calculation. Handling charges are also added. It is unclear whether handling costs of the product once received by the retailer are a component of COGS. They would be under IRC § 263A.^[6]

One point that should be clear by now is that the marijuana business person needs to spend the effort to properly account for the items of income and expense in order to maximize the opportunity to capture all expenses that can be attributable to COGS and thereby minimize taxable income. The books and records

should be maintained in accordance with Generally Accepted Accounting Principles ("GAAP"), and while this accounting process is more expensive, it should, in the long run, result in more captured COGS expenses and save taxes.

Conclusion

The accounting rules for the marijuana industry are complicated. IRC § 162(a) deductions are not permitted. This means that the marijuana entrepreneur will be paying taxes on cash expended for otherwise deductible business expenses. Income taxes will be paid on more than the net income from the business. This greatly increases the effective tax rate for the business.

Accordingly, real planning and proper accounting for the business operations are both necessary. Please stay tuned for Part Two of this article as I review relevant case law in this area and offer my planning ideas.

General Reference Materials

- "Marijuana Business and Section 280E: Potential Pitfalls for Clients and Activists" by Jeffrey Gramlich, Ph.D. and Kimberly Houser, J.D. *The Tax Advisor*, June 30, 2015.
- "IRS Further Limits Deductions For State-legal Marijuana Facilities" by Tony Nitti, *Forbes* January 24, 2015.

[1] 1.471-1.

[2] 1.47163(Y)

[1] 1.471-11 (c)(2)

[4] 1.471-11(c)(2)(iii)

[5] 1.471-3(b)

[6] BNA TMP 578 4th "Inventories: General Principles: LIFO Method" @ A-38

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