



# INVENTORY

## General

The calculation of inventory valuation directly correlates to future cost of goods sold amounts, once the inventory is sold. For cannabis businesses, an accurate computation of cost of goods sold is necessary in order to compute their federal taxable income. An adjustment for cost of goods sold is, in general, the only allowable reduction from gross receipts when determining federal taxable income. A CPA can help your cannabis business design procedures to help capture costs that are able to be capitalized into inventory, as well as for when those costs can then be considered costs of goods sold. The technical information below is best to review and discuss with your CPA.

## Application

The calculation of inventory value for federal income tax purposes for cannabis businesses follows the regulations under Internal Revenue Code Section 471. Specifically, marijuana businesses must generally apply the rules according to Treasury Regulations §§ 1.471-3 and 1.471-11, Inventories at Cost and Inventories of Manufacturers, respectively.

Section 1.471-3(b) applies for resellers of property, including provisioning centers. Sections 1.471-3(c) and 1.471-11 apply for producers and manufacturers of property, including cultivators and processors. The IRS and Tax Courts have consistently upheld the applicability of these regulations for cannabis businesses when determining allowable inventory costs.

Read Treasury Regulation Section 1.471-3 here: [§ 1.471-3](#)

Read Treasury Regulation Section 1.471-11 here: [§ 1.471-11](#)

## Costs Generally Includible in Inventory, per Treasury Regulations

For **provisioning centers** following § 1.471-3(b), the cost of inventory includes the inventory's invoice price less trades and discounts (purchase price), plus the cost of transportation and other necessary charges incurred in acquiring possession of the inventory.

For **cultivators and processors** following § 1.471-3(c), the cost of inventory includes the cost of raw materials and supplies used in producing the product (direct costs), expenditures for direct labor, and incident and necessary indirect production costs. Costs of selling or return on capital are specified as not includible.

§ 1.471-11 expands upon the specific costs that may be capitalized to inventory for manufacturers. Generally, both cultivators and processors follow these rules. The regulation begins with the requirement to use the full absorption method of inventory costing, and then expands upon the concept of direct cost inclusions. From here, considerable detail is included related to costs both allowable and not allowable within the computation of indirect costs capitalized to inventory.

Specifically: Indirect production costs includible in inventory include repair expenses, maintenance, utilities, rent, certain indirect labor, indirect materials and supplies, tools and equipment not capitalized, and costs of quality control and inspection. See § 1.471-11(c)(2)(i).



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Specifically: Indirect production costs includible in inventory include repair expenses, maintenance, utilities, rent, certain indirect labor, indirect materials and supplies, tools and equipment not capitalized, and costs of quality control and inspection. See § 1.471-11(c)(2)(i).

Additionally, certain indirect production costs may also be capitalized to inventory depending on the treatment in the taxpayer's financial records. These costs must be incident and necessary to the production process and include taxes otherwise allowable under § 164 attributable to production assets such as state and local personal property taxes, depreciation and depletion reported in financial reports, employee benefits, costs attributable to strikes, rework, scrap and spoilage, administrative costs of production, certain officer's salaries, and insurance costs. See § 1.471-11(c)(2)(iii).

Conversely, costs specifically stated as not included in inventoriable costs include marketing, advertising, and selling expenses, other distribution expenses, interest, research, experimental and product development expenses, losses under § 165, depreciation and amortization reported for federal income tax purposes in excess of depreciation reported by the taxpayer in their financial reports, income taxes attributable to the sale of inventory, certain pension contributions, and general, administrative, and officer salary expenses incident and necessary to the taxpayer's activities as whole rather than the production or manufacturing operations. See § 1.471-11(c)(2)(ii).

Generally, the above rules apply to taxpayers whose financial reporting method is comparable to the tax basis method for calculating inventory costs. Similar, but separate rules apply and should be referenced if the taxpayer is not following the tax basis of accounting for inventory costs for financial reporting purposes. See § 1.471-11(c)(3).

### **What about § 263A?**

While §§ 1.471-3(b) and 1.471-3(c)(3) both reference the rules under § 263A, the IRS and Tax Courts have consistently held that cannabis businesses must apply the rules for inventory costing as they were when 280E was enacted. 280E was enacted in 1982, while 263A was not enacted until 1986. Therefore, the rules under 263A which may require additional costs be capitalized to inventory generally should not be applied.

Resource: [IRS Memorandum 20150411](#)

### **What about § 471(c)?**

It is unclear whether § 471(c), enacted with the Tax Cuts and Jobs Act, may be allowable for cannabis businesses. While the Congressional Research Service cited this subsection in their report on "The Application of Internal Revenue Code 280E to Marijuana Businesses: Selected Legal Issues", no guidance, conclusion, or relatable Tax Court determination currently exists. It is important to note that 471(c) references materials and supplies deductions defined under § 1.162-3; the Courts have held that deductions afforded under § 162 are not allowable for cannabis businesses. Additionally, applying a similar assumption as to why 263A is unapplicable based on that it was enacted after 280E, a similar determination and assumption may be reasonable to apply to 471(c).



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## Best Practices

Cannabis businesses should work with their CPA to determine an appropriate process for accounting for inventoriable costs and cost of goods sold. Generally, this is accomplished by starting with detailed categorization and documentation of expenditures capitalized to inventory within the accounting system, per the above rules referenced. While direct costs may be more obvious, the allocation of indirect expenditures must follow a consistent and allowable method.

Capturing information relevant to compute cost of goods sold and the appropriate allocation and reconciliation to inventory requires information both from the business's inventory systems (including METRC and any additional inventory management systems), as well as support for how costs were assigned to the products sold. Generally, retailers with high sales and product quantity volumes may require this information to be processed within their point of sales system, and should ensure their system adequately supports these reporting needs. Cultivators and processors on the other hand, often find the inventory costing and computation of cost of goods sold may require both manual spreadsheets and software (if available), and to be much more complex in nature.