

IRS tightens inventory rules for marijuana businesses

Eligible tax deductions remain limited for cannabis industry

By Dennis Brager



Marijuana sellers have a host of problems that other businesses don't have. Somewhere near the top of that list is the inability to deduct for tax purposes most legitimate expenses that other businesses routinely write off to arrive at their proper income on which taxes are paid.

BRIEF BACKGROUND: In 1982 Congress passed Internal Revenue Code Section 280E, which provides that no deductions are allowed in carrying on a trade or business which consists of trafficking in controlled substances.

This means that expenses which are not illegal themselves can't be deducted by marijuana sellers even in states where the sale of marijuana is legal. For example, wages, lease payments and office supplies are all non-deductible. However, items that are part of the costs of goods sold (COGS) are not subject to this rule, and thus COGS can reduce income. This makes the determination of what items properly belong in COGS extremely important.

THE IRS MEMORANDUM: In a legal memorandum released by the IRS earlier this year, the IRS discussed some of the arcane details of how to calculate COGS. The memorandum points out that a marijuana reseller would normally include in COGS such things as the purchase price of the marijuana, less trade or other discounts, plus transportation charges incurred in acquiring the marijuana.

A marijuana grower includes in COGS its direct material costs including those associated with seeds, plants, cultivating, harvesting and sorting, plus certain other costs.

So far so good, but as explained in the IRS memorandum, six years after Congress outlawed "regular" deductions for marijuana businesses, Congress passed a

new law.

This new law, implemented in 1988, was written to make it harder for businesses to deduct their expenses on a current basis.

This new law, found in Section 263A of the Internal Revenue Code, was not focused on marijuana businesses. It is unlikely that Congress was thinking about marijuana businesses at all when it wrote this law. How did the new law make it harder for businesses to deduct their expenses? It said that certain types of expenses which previously had been treated as deductions when paid would now be required to be included in inventory; that is to say in COGS. For most businesses this is a bad thing.

Consider a business that is selling widgets. Perhaps widgets are not selling very well in a recession so the business rents a warehouse to store the widgets until better times come along.

Prior to 1988 the business could deduct the cost of renting the warehouse as the expense was being paid. After 1988 the business would have to add the warehouse rental to its COGS, and would not get a deduction until the year in which the widgets were sold.

However, for marijuana businesses, including additional items in COGS is helpful because it converts otherwise non-deductible items into deductible COGS. Unfortunately, the IRS legal memorandum says "Not so fast!" The legal memorandum argues that just because Congress required most businesses to delay deducting their expenses, it didn't mean that

marijuana businesses could convert some of their expenses from non-deductible to deductible.

It is important to understand that a "legal memorandum" is not the law. Only Congress passes laws, and the courts interpret what Congress meant anytime the law is unclear.

The IRS can issue certain pronouncements called treasury regulations, which, generally speaking, the courts accept at face value, and are almost like the laws that Congress passes. However, a legal memorandum is only the interpretation by one attorney at the IRS as to what the law means. Indeed, every legal memorandum (and this one is no different) says at the beginning, "This advice may not be used or cited as precedent."

Despite that warning, IRS personnel, generally rely on such memoranda and

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internal documents in auditing taxpayers. This legal memorandum was written by an attorney in Washington, D.C. to an attorney in the Denver office of the IRS in response to a request from the Denver attorney.

We can, thus, safely assume

that there is some marijuana business in Colorado, which is about to have a portion of its COGS disallowed. In turn, that may ultimately lead to a court case to determine whether or not the IRS memorandum is correct.

BEWARE: In the meantime, marijuana businesses that use a more expansive interpretation of COGS are on notice that this may be an issue if they are audited, and it may subject the business to various penalties in addition to more taxes.

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