LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com

MONDAY, JUNE 15, 2020

PERSPECTIVE

Should you change your accounting method? An emerging cannabis loophole

By Andrew Gradman, Abraham Finberg and Rachel Wright

For cannabis businesses, federal income taxes can be ruinous — even in loss years. Unlike other industries, which pay income taxes only on actual income, cannabis businesses, defined in federal law as drug traffickers, are singled out for an extra tax on a portion of their expenses. As a result, even the best tax planning tends to be complex and unpredictable. Recently, however, planners have become interested in a simple loophole which could eliminate cannabis's disparate tax treatment entirely.

The technique turns on a distinction between two kinds of expenditures. Since 1982, drug traffickers have been denied the deductible kind (those which, when paid or accrued, are netted against gross income to arrive at taxable income). However, they are still allowed capital expenditures (those which, when an asset is eventually disposed of, are netted against gross receipts to arrive at gross income). Thus, much cannabis tax planning revolves around trying to capitalize otherwise-deductible expenses.

For other industries, Congress actually encourages this behavior. For example, Internal Revenue Code 263A aggressively capitalizes the indirect costs of inventory; compared to an immediate deduction, this accelerates the payment of taxes. However, IRC 263A cannot be used to capitalize expenses which would not otherwise have been deductible. In addition, businesses generally may not capitalize costs when doing so would not "clearly reflect income." IRC 446(b), 471(a). According to Treasury, this test would be failed by a retailer capitalizing indirect costs. TR 1.471-3. Thus, cannabis retailers face a particularly heavy burden: While they can generally avoid being taxed on their "direct" costs of materials and labor, they cannot avoid being taxed on "indirect" costs such as repair expenses, maintenance, utilities, rent, indirect labor (e.g. supervisory wages), costs of quality control and inspection, marketing, advertising, R&D, and pension contributions. TR Section1.471-11(c).

This is where the new IRC 471(c) comes in. Where IRC 471(c) applies, it suspends the "clearly reflect income" requirement in IRC 446(b) and 471(a). For tax-filing purposes, businesses can choose any method of accounting which reflects how they actually maintain their own internal books — even one which capitalizes the indirect costs for retailers, and even one which fails to clearly reflect income. To the extent cannabis retailers choose to capitalize nondeductible indirect costs in this fashion, they can shelter these costs from tax when they eventually dispose of the capitalized asset.

Although no guidance has yet been issued, there is cause for comfort. First, while this may feel like an unintended loophole, it aligns directly with IRC 471(c)'s business- friendly purpose, which is to simplify the inventory accounting rules for small, owner-run businesses. Second, unlike IRC 280E, which bars illegal trafficking businesses from taking deductions, and 263A(a), which broadly capitalizes merchandisers' costs but carves out costs which are otherwise nondeductible, IRC 471(c) contains no such prohibition. Third, the IRS has long been aware of IRC 471(c)'s far-reaching potential. See Rev. Proc. 2018-40 (requesting public comments). More recently, in a March 30, 2020 report, the IRS acknowledged that it had been approached by several practitioners asking about IRC 471(c)'s impact on cannabis. The report does not concede the point; it concludes, "The effect of the law is still uncertain." Still, its failure to offer any rebuttals is telling.

Executing this plan is a twostep process. Both will be handled by the business's CPA. First, the taxpayer modifies how it keeps its books and records. The point is to allocate indirect expenses to the cost of goods sold. For taxpayers not using GAAP, "books and records" and "accounting procedures" could mean various things, but as recommended by the American Institute of Certified Public Accountants in its July 15, 2019, policy letter, it could include accountants' workpapers (whether recorded on paper, electronically or other media); journal entries; or prepared financials. The AICPA also recommends that written accounting procedures should not be necessary, as long as the taxpayer can demonstrate it has treated costs consistently and has supporting documentation to reflect that. It also encourages that books and records "include receipts or invoices from transactions undertaken by the taxpayer, canceled checks, accounting journals and ledgers, spreadsheets, account statements, and exported data from electronic accounting software programs, such as QuickBooks."

Once that is done, the taxpayer then formally requests the IRS to change its "method of accounting," for tax purposes, to reflect this new recordkeeping system. Here, the process benefits from the 2018 law's general effort to streamline small business practices. The taxpayer simply submits Form 3115, Application for Change in Accounting Method. The request is subject to a "reduced filing requirement," and is also entitled to automatic IRS consent. See Rev. Proc. 2015-13 (general rules for changes of accounting method); Rev. Proc. 2018-31 Section 22.19, as added by Rev. Proc. 2018- 40 Section 3.02(3) (special rules for section 471).

Taxpayers should also consider amending prior-year returns. In its policy letter, the AICPA urged the IRS to "direct examiners to suspend current examination activity for taxpayers with average annual gross receipts of $25 million or less" for issues involving capitalizing costs and methods of accounting for inventory, and suggested that "prior year audit protection" is necessary for issues where the taxpayers will file a Form 3115 changing accounting methods for 2018 and later.

The method has some limits. First, it is not available for taxpayers subject to GAAP. Second, it requires a certain degree of owner involvement in management (i.e., no "tax shelters," as so defined). Third, the business must pass a "gross receipts test": For the past three years, average annual gross receipts may not exceed $25 million. Fourth, although there is nothing in the law to stop taxpayers from capitalizing all indirect costs, they should discuss the best arrangement with their tax team. Fifth, if the IRS (somehow) defeats these positions, taxpayers would face audits; back taxes; interest; and penalties.

Making a change in accounting method under 471(c) is the most exciting technique in cannabis tax planning today. It has strong support in the code and growing support among thought leaders; it yields a large tax savings from a small investment in tax planning. The only catch is the lack of regulatory guidance. Treasury should make this a priority. With every passing year, cannabis becomes a more mainstream fixture in the U.S. economy. It is time for cannabis tax planning to become as open and transparent as the industry it represents. ■

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