



Cannabis Reporting: Recreational, Medical, Illegal

Start time: 2 pm Eastern / 1 pm Central
 12 Noon Mountain / 11 am Pacific

Note: You should be hearing music while waiting for webinar to start.

View the “Technical Issues” troubleshooting guide in the Materials drop-down menu on the left side of this page.

Upon Completion of this Course, You Will Be Able to:

- Prepare the appropriate tax schedules when cannabis is illegal at the federal level, but legal in many states
- Summarize unique accounting and tax reporting methods for the industry
- Calculate cost of goods sold
- Prepare Schedule C for a cannabis business

Take-a-Ways

- Know the industry
 - Cannabis vs. CBD vs. hemp
- Know the client
 - Ask the right questions
- Know the law
 - §§280E and 471



Take-a-Ways, Cont.

- Method of accounting
 - Cash, accrual, and small business exception under TCJA
- The best method of accounting for regular business may not be the best method of accounting for a cannabis business
- By attending this session, if you never do a return for a cannabis business, you will learn about the small business exception for inventory accounting

Know the Industry

2022

Federal:

Illegal

States:

Recreational

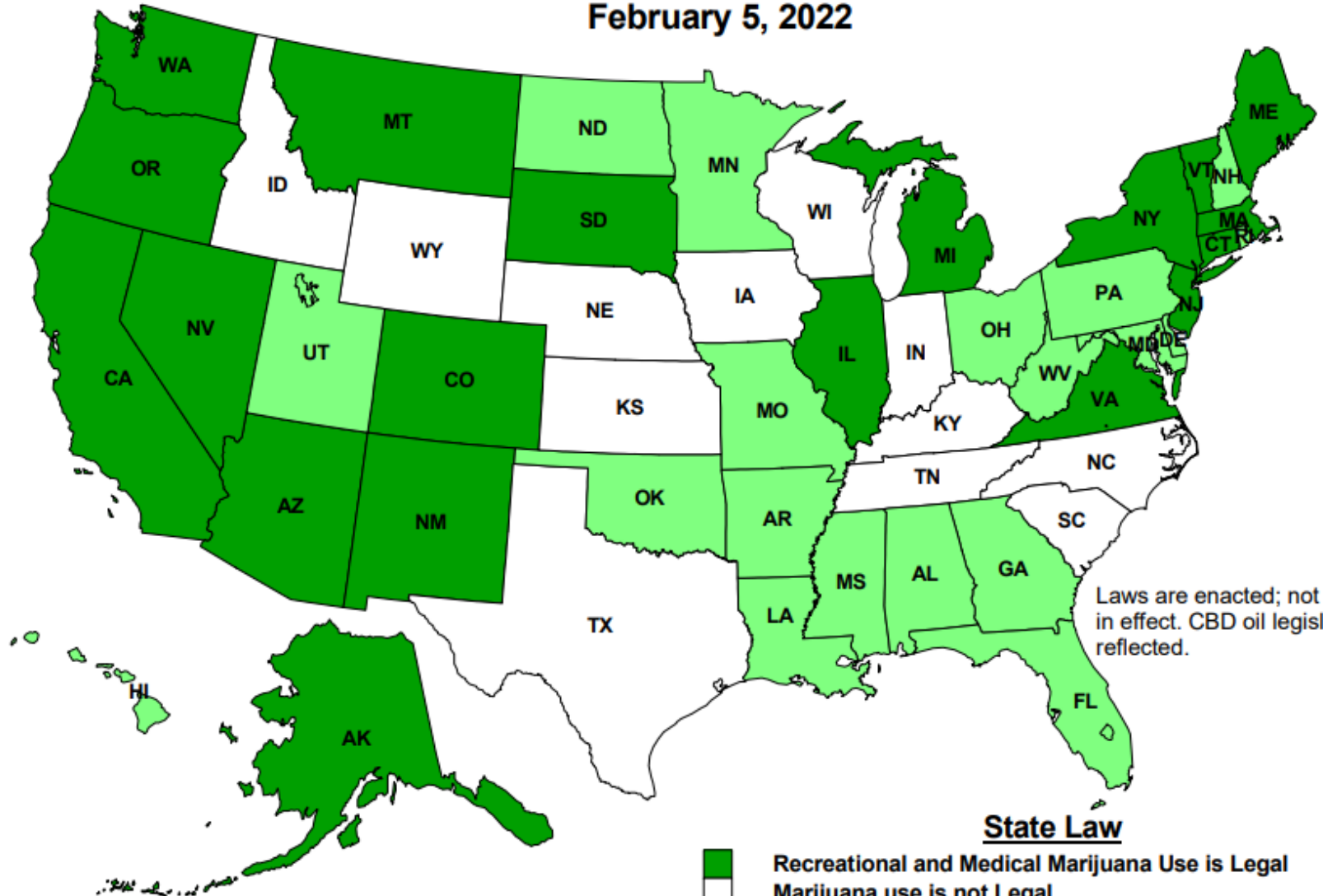
Medical

Illegal

States with Legalized Marijuana




American Nonsmokers' Rights Foundation

February 5, 2022



Laws are enacted; not yet necessarily in effect. CBD oil legislation is not reflected.

State Law

-  Recreational and Medical Marijuana Use is Legal
 -  Marijuana use is not Legal
 -  Medical Marijuana Use, but not Recreational, is Legal
- Note: In total, medical marijuana use is legal in 38 states.

To see a map of state and local laws prohibiting smoking and vaping marijuana, visit <https://no-smoke.org/wp-content/uploads/pdf/marijuana-smokefree-laws-map.pdf>

Note: American Indian and Alaska Native sovereign Tribal laws are not reflected on this map.

Know the Client

Cannabis/Marijuana Trade Business

Recreational



Medical



Illegal



Consumer

Caregiver

Grower/producer

Retailer

Test labs

Transportation

How Do We Ask Our Clients the Question...



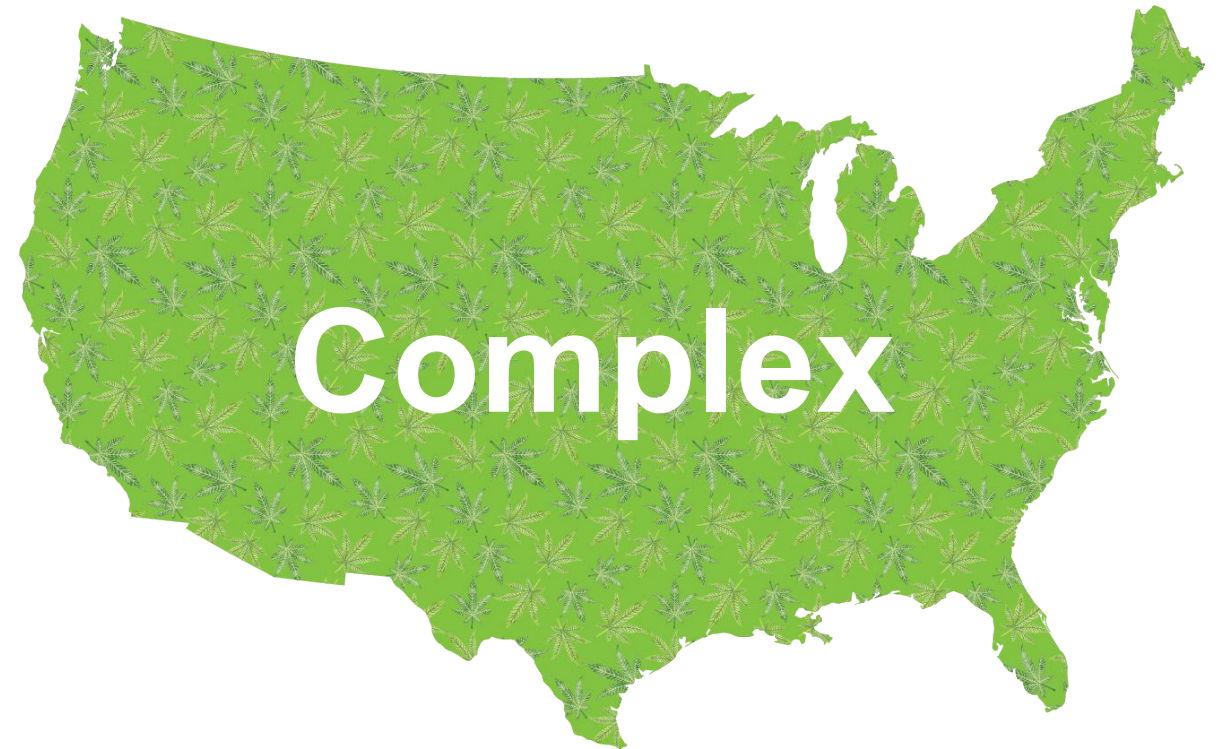
Sorry I must be blunt, but are you involved in growing, selling or distributing marijuana?



Know the Law

Know Your State's Laws

- States levy three types of excise taxes
 - Percentage of price
 - Retail or wholesale
 - Weight
 - Per ounce
 - Drug's potency
 - THC level
- Some states use a mixed system
- Some states also charge a flat tax
- Some states also charge sales tax



Controlled Substance Act (CSA)



- Legislation passed in 1970 made marijuana a Schedule 1 narcotic, along with heroin, meth and LSD
- The CSA established the federal drug policy under which the manufacture, importation, possession, use and distribution of certain substances are regulated

U.S. Code §61 – Gross Income Defined

- **ALL income is taxable** and provides that gross income includes **net gains derived from** dealings in property, which includes controlled substances
- **“Gains derived from dealings in property”** means **gross receipts less cost of goods sold (COGS)**

COGS

IRC §471 General Rule for Inventories

What Does This Mean?



$$\frac{\text{Gross receipts} - \text{COGS}}{\text{gross profit}}$$

= taxable income

IRC §471 General Rules for Inventories

- **§471(a)** – If the use of inventories is necessary to clearly determine income, inventories shall be taken in a manner **conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income**
 - **Accrual/GAAP**

Getting the client the best deduction

IRC §471-3 General Rules for Retail Inventories

- **§471-3(b) – Purchased Goods**
 - Invoice price less trade or other discounts **plus transportation** or other necessary charges incurred in acquiring possession of the goods



IRC §471-3 General Rules for Produced/Manufactured Inventories

- **§471-3(c) – Produced Goods**
 - Direct materials and supplies
 - Direct labor
 - Indirect **production costs...**



...incident to and necessary for production or manufacturing...

IRC §471-11

Inventories of Producers/Manufacturers

IRC §471-11 Inventories of Producers/Growers

- **§471-11(a)** – Full absorption method... **production costs must be allocated** to goods produced during the year
- **§471-11(b)(1)** – ...incident to and necessary for production or manufacturing...
 - Direct production costs
 - Fixed and variable indirect production costs

IRC 471-11(b)(2)(i) Direct Production Costs

Direct material costs

- Those that become an integral part of the specific product

Direct labor costs

- Basic compensation
- Overtime pay
- Vacation and holiday pay
- Sick leave pay
- Shift differential
- Payroll taxes
- Workers' compensation

§IRC 471-11(b)(3) Indirect Production Costs (IPCs)

- **§471-11(b)(3)(i)** – includes all costs which are incident to and necessary for production or manufacturing operations or processes **other than direct production costs**
- **§471-11(b)(3)(ii)** – fixed and variable classifications

§IRC 471-11(b)(3)(ii) Fixed and Variable IPC Classifications

Fixed IPCs

- Do not vary significantly with amount of goods produced
 - Rent
 - Property taxes

Variable IPCs

- Do vary significantly with amount of goods produced
 - Indirect materials
 - Factory janitorial supplies
 - Utilities

“Incident to and necessary for manufacturing operations and processes”

§IRC 471-11(c)(2)(i) - Indirect Production Costs

(Must enter into inventory computation)

- Repair expenses
- Maintenance
- Utilities such as heat, power, light
- Rent
- Indirect materials and supplies
- Tools/equipment not capitalized
- Quality control and inspection costs
- Indirect labor and production supervisory wages
 - Basic compensation
 - Overtime pay
 - Vacation and holiday pay
 - Sick leave pay
 - Shift differential
 - Payroll taxes
 - Workers' compensation

§IRC 471-11(c)(2)(ii) - Costs Not Included in Inventoriable Costs

(Regardless of their treatment in the financial statements)

- Marketing expenses
- Advertising expenses
- Selling expenses
- Other distribution expenses
- Interest
- Research/experimental expenses
- Losses under §165
- Percentage depletion in excess of cost depletion
- Depreciation/amortization reported for federal income tax in excess of what's reported in the financials
- Income taxes received on the sale of inventory
- Pension contributions for past services cost
- General/admin expenses not related to production/manufacturing
- Salaries paid to officers for activities not related to production or manufacturing

§IRC 471-11(c)(2)(iii) - Costs Included in Inventoriable Costs

(Depending on their treatment in the financial records)

- Taxes otherwise allowable under §164, other than state and local and foreign income taxes
- Depreciation and depletion
- Costs attributable to strikes, rework labor, scrap and spoilage
- Factory administrative expenses
- Officers' salaries
- Insurance costs
- Employee benefits
 - Pension/profit-sharing contributions allowable under §404
 - Workmen's compensation expense
 - Payments under a pay contribution plan described in §105(d)
 - Profit sharing/stock bonus plans
 - Life/health insurance premiums
 - Miscellaneous benefits such as
 - Cafeteria
 - Recreational facilities

Tax Cuts & Jobs Act of 2017

Small Business Exception

Tax Cuts & Jobs Act of 2017

- Increased the gross receipts test to \$25 million
- Exempted taxpayers from the requirement to take inventories under 471(a) if...

TCJA – Small Business Election

- **Election** – non-incidental materials & supplies (NIMS)
 - Direct material cost
 - No direct labor
 - No indirect production costs

If you don't make this election, then...



§471(c) Small Business Exception, Cont.

- Applicable financial statements (AFS)
 - Whether financial statements given to bank or shareholders, that is your AFS
 - Tax and accounting **must** be the same
 - Do inventory and figure out COGS
- No AFS = books and records
 - How you keep books and records is how you account for your inventory for tax

Resources

- Sixteenth Amendment
- U.S. Code §61
- IRC 162-1(a)
- IRC §471 General Rules for Inventories
- *Controlled Substance Act*
- IRC §280E. Expenditures in connection with the illegal sale of drugs
- IRC §263A Capitalization and Inclusion in Inventory Costs of Certain Expenses