LAW360

Portfolio Media. Inc. | 230 Park Avenue, 7th Floor | New York, NY 10169 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Pot Rescheduling Could Spur Inventory Accounting Change

By **David van den Berg**

Law360 (February 23, 2024, 11:51 AM EST) -- If cannabis is reclassified to a lower tier under the Controlled Substances Act, it would unlock significant tax benefits for cannabis companies, such as allowing them to take standard business deductions, but they may need to account for their inventories differently to take full advantage.

Internal Revenue Code Section 280E, which bars tax deductions for businesses that traffic in Schedule I or II controlled substances, **prohibits cannabis companies** from taking ordinary business deductions since the drug is classified as a Schedule I substance under the CSA, the law's most restrictive tier.

However, the U.S. Department of Health and Human Services last month **publicly released** a recommendation for the U.S. Drug Enforcement Administration to reclassify cannabis to Schedule III. The DEA has the final word on whether to reschedule the drug and if it follows the recommendation, Section 280E would no longer apply to cannabis businesses. There is **no timetable** for the DEA's decision.

Under current law, while cannabis companies cannot deduct business expenses, they can **deduct their cost of goods sold**, essentially their inventory costs, according to a 2021 Internal Revenue Service article. Because of that, cannabis businesses are motivated to use expansive inventory methods, Jennifer Benda of Holland & Hart LLP said.

However, rescheduling cannabis may make using expansive inventory methods less advantageous.

"For that reason, a cannabis company may want to change its inventory accounting method after Section 280E no longer applies," she said.

Businesses generally have to keep an inventory when generating income is a factor in making, buying or selling merchandise, according to the IRS. Calculating taxable income requires methods for both valuing and identifying inventory items, and the rules for valuing inventory aren't uniform for all businesses, according to the agency.

In the event cannabis is reclassified as recommended, cannabis companies will need to reevaluate their accounting methods and decide whether changes are needed, Benda said.

"A company in a loss position may want to continue to use more expansive inventory methods, and a company in an income position may want to change to a permissible method that minimizes inventory costs," she said.

Businesses can generally deduct expenses such as salaries and rent in the current taxable year provided the expenses are ordinary and necessary under IRC Section 162 and meet timing rules under Section 461, according to an IRS Office of Chief Counsel memo issued in 2015. However, inventory cost rules can force producers to capitalize a cost that would otherwise qualify for a Section 162 deduction and keep that cost in their inventory until selling the merchandise, the memo said. The producer then includes the cost in their cost of goods sold, according to the memo.

Most businesses prefer deducting expenses right away rather than capitalizing their costs into inventory, according to James B. Mann, a tax attorney who works with cannabis companies. Because of that, non-cannabis companies typically seek to minimize their cost of goods sold, Mann said. Cannabis businesses, on the other hand, try to maximize costs of goods sold in order to deduct them, he said. In the event the drug is reclassified to Schedule III, those motivations will shift, according to Mann.

To the extent they can, cannabis companies "may well want to change their accounting methods to move items of expense from cost of goods sold to below the line to be deductible items of expense," he said.

Cannabis retailers and producers are affected differently by capitalizing costs into their inventories, said Les Schneider of Ivins Phillips & Barker. Retailers get deductions quicker since they have fewer costs to defer in inventory, he said.

Should cannabis be moved to Schedule III, the IRS could make life simpler for cannabis businesses by specifying which inventory accounting method changes they will have automatic consent to make. Under IRC Section 446(e), taxpayers **must get IRS consent** before changing an accounting method for federal income tax purposes. The agency periodically **releases updates** on accounting method changes it will automatically consent to.

There will be a lot of companies reevaluating their inventory accounting methods in the event of rescheduling, Mark A. Loyd of Dentons said. Without guidance from the IRS detailing what accounting method changes it will automatically consent to, companies will have to spend a lot of time and money applying for a nonautomatic change, Loyd said.

"It just makes sense for the IRS to make it as administratively streamlined as possible," he said.

There wouldn't be any question that the IRS has authority to provide cannabis companies with automatic consent for inventory accounting method changes in the event the rescheduling recommendation is followed, Mann said.

"This is totally within IRS powers, as it has great discretion in the tax accounting area," he said.

Section 280E contributes to making tax payments a struggle for nearly all licensed companies in the industry, said Marc Claybon of Crowe LLP. If the recommended rescheduling occurs and 280E is no longer applicable, tax doors will open for cannabis businesses, he said.

"Cannabis businesses will finally be able to take advantage of all the tax opportunities and benefits every other business is afforded," he said.

--Additional reporting by Sam Reisman, Katryna Perera and Emlyn Cameron. Editing by Tim Ruel and Neil Cohen.
