Applying § 1.471-11 to the Cannabis Industry

A practical approach
for cannabis cultivators and
processors

Michigan Association of CPAs

Cannabis Summit

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Presenter:

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Attendees should consult tax, accounting, legal, regulatory or other professional advisor(s) for advice appropriate to their situations. This presentation is not sufficient to rely on and the information presented is not complete - many other matters affecting your business and tax structuring needs are also applicable.

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Learning Objectives

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- Review Internal Revenue Code 471 and Treasury Regulation 1.471-11, and why these apply to the cannabis industry;
- Discuss best practices for accommodating § 1.471-11 rules within your client's accounting system, following the accrual tax-basis of accounting (modified);
- Review a practical example of accounting for inventory following § 1.471-11;
- Review example financial statement footnotes for preparation engagements under SSARS.

Overview

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- How many in the room currently work with one or more cannabis cultivators or processors?
- IRC 471 - General rule for inventories.
- Reg 1.471-11 - Inventories of manufacturers.
- This presentation will focus on applying 1.471-11(b) and 1.471-11(c), covering accounting for direct and indirect production costs, and assumes the audience is already familiar with the limitations imposed by 280E.

IRC 471

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- Cannabis producers and retailers are required to follow the rules and allowable inventory valuation methods described under IRC 471. Use of 471 has been consistently upheld by Tax Court decisions and IRS publications.
- While other valuation methods may be permissible under 471 regulations, this presentation will focus on applying the full absorption method described under § 1.471-11. **This is applicable to cultivators and processors only (manufacturers).** <u>**This regulation is not applicable to retailers (provisioning centers).**</u>

Reg. 1.471-11

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(a) *Use of full absorption method of inventory costing.* **In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income** (as required by section 471 of the Code), **both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the "full absorption" method of inventory costing. Under the full absorption method of inventory costing production costs must be allocated to goods produced during the taxable year, whether sold during the taxable year or in inventory at the close of the taxable year determined in accordance with the taxpayer's method of identifying goods in inventory.** Thus, the taxpayer must include as inventoriable costs all direct production costs and, to the extent provided by paragraphs (c) and (d) of this section, all indirect production costs.

Reg. 1.471-11

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- (b) Production costs—(1) In general. Costs are considered to be production costs to the extent that they are **incident to and necessary for production or manufacturing operations or processes.** Production costs include direct production costs and fixed and variable indirect production costs.
- (2) Direct production costs.
- (3) Indirect production costs.

Where do we start? **With the chart of accounts!**

Direct Production Costs (DPC)

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- **Direct material costs** include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product
  - Supplies and materials
    - Grow medium, nutrients, pest management supplies
    - Purchased biomass (raw material), distillate, terpenes
    - Packaging and labels
  - Mindset: Expenditures are not expenses or COGS; Expenditures are purchases (consider Form 1125-A, lines 2, 3, and 5 application)

Direct Production Costs (DPC)

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- **Direct labor costs** include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. [...] costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments [under] a wage continuation plan per 105(d)), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.
    - Direct labor costs
        - Wages
        - Employer taxes
        - Trim and harvest contract labor

DPC → Chart of Accounts

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13000 Inventory on hand
- 13100 Cultivation inventory on hand
  - 13101 Supplies and materials
    - 13101.1 Grow medium
    - 13101.2 Nutrients
  - 13104 Production labor
    - 13104.1 Direct labor wages
    - 13104.2 Employer taxes - direct labor

For clients who want to track further detail for management reporting and cost consideration needs.

More detail = more time and attention!

Direct Production Costs → The 'easy' part!

Tip: Work with your client(s) to determine the level of detail that is important to them when building their COA. Some clients may prefer to keep things simple, while others may require significant detail in order to support their management reporting needs. Most cannabis ERP systems do not have a sufficient method to track both direct and indirect costs. Keep in mind that the more detailed the COA, the more time and effort that will be required to later account for cost of goods sold and ending inventory value. Your client may prefer the detail, but may not understand the level of effort maintenance of such requires.

Indirect Production Costs (IPC)

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- 1.471-11(b)(3)
  - (i) In general. The term "indirect production costs" includes all costs which are incident to and necessary for production or manufacturing operations or processes other than direct production costs (as defined [..]).

- 1.471-11(c) Certain indirect and production costs. **Where the fun begins!**
  - Not to be confused with 471(c)

Indirect Production Costs (IPC)

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- 1.471-11(c)(2)(i) Indirect production costs:
  - (a) Repair expenses
  - (b) Maintenance
  - (c) Utilities, such as heat, power and light
  - (d) Rent
  - (e) Indirect labor and production supervisory wages, [generally including similar costs as direct labor costs on earlier slide]
  - (f) Indirect materials and supplies
  - (g) Tools and equipment not capitalized
  - (h) Costs of quality control and inspection

[..] Only to the extent such costs are incident to and necessary for production or manufacturing operations or processes.

IPC → Chart of Accounts

13100 Cultivation inventory on hand

...

- 13105 Repairs
- 13106 Maintenance
- 13107 Equipment rent
- 13108 Testing and quality control
- 13109 Environmental management
- 13110 Building rent

Building rent? Utilities?

Need to allocate based on an appropriate method → see example later in presentation and § 1.471-11(d).

Allocating Facility Wide Indirect Costs

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… 65110 Building rent

… 65120 Utilities

65120.1 Electricity

65120.2 Gas

65120.3 Waste

Appropriate allocation methods might include reasonable burden rates:

- Percentage of square footage devoted to production areas
- Equipment usage time

See §1.471-11(d)

IPC - Includible Depending Upon Accounting Treatment

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1.471-11(c)(2)(iii) Indirect production costs includible in inventoriable costs depending upon treatment in taxpayer's financial reports.

(a) Taxes (generally, property taxes)

(b) Depreciation and depletion (but, remember §167 and §168 are disallowed as deductions!)

(c) Employee benefits

(d) Costs attributable to strikes, rework labor, scrap and spoilage

(e) Factory administrative expenses incident and necessary for the production process

(f) Officer salaries attributable to the production process

(g) Insurance costs incident and necessary to the production process

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All expenditures that are considered direct or indirect purchases, that can be attributed to inventory without the need to allocate (such as is the case with rent and utilities) → 'categorize' directly to inventory accounts. This practice increases the inventory value.

Do not categorize costs to 'expense' accounts, except for those that need to be allocated.

Beginning inventory + purchases - ending inventory = COGS

Example

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- Beginning inventory = $0
- Expenditures during the period:
  - $10,000 in direct supplies and materials
  - $2,000 in testing fees
  - $5,000 in payroll expenses, with $4,000 related to direct production wages and $1,000 related to sales wages
- Other costs:
  - $4,000 in building rent
  - $3,000 in utilities
  - $1,000 general liability insurance (facility wide)
  - $1,000 crop insurance

Example (continued)

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- Additionally:
  - The client has determined, based on the square footage of their facility, that 90% of the facility is used for production activities, including:
    - ‘Mother’ plant room
    - Clone and seedling room
    - Vegetative rooms
    - Flower rooms
    - Shared facility space only used by production employees
    - Storage of biomass not yet packaged and ready for sale
    - Water tank and RO system storage room
    - Production area with trimming and pre-roll machines

The Accounting..

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- Beginning inventory = $0; After incurring the following purchases and expenses however, the accounts look like this:
    - 13101 Supplies and materials: $10,000
    - 13104 Production labor: $4,000
    - 13108 Testing and quality control: $2,000
    - 13113 Insurance: $1,000

No 'expenses' or COGS have been recognized yet.

- **65110 Building Rent: $4,000**
- **65120: Utilities: $3,000**
- **65130 Insurance: $1,000**
- 66000 Payroll: $1,000

Bolded overhead expenses need to be allocated to inventory

The Accounting (cont.)..

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In order to allocate overhead expenses to inventory, the following journal entry is made, using 90% as the allocation percentage:

JE: 123123InvOvh:

	Debit	Credit
13110 Building rent	$3,600	
65110 Building rent		$3,600
13112 Utilities	$2,700	
65120 Utilities		$2,700
13113 Insurance	$900	
65130 Insurance		$900

The Accounting (cont.)..

Now our accounts look like this:

- 13101 Supplies and materials: $10,000
- 13104 Production labor: $4,000
- 13108 Testing and quality control: $2,000
- 13110 Building rent: $3,600
- 13112 Utilities: $2,700
- 13113 Insurance: $1,900

....

- 65110 Building Rent: $400
- 65120: Utilities: $300
- 65130 Insurance: $100
- 66000 Payroll: $1,000

Beginning inventory + purchases = **$24,200**

This is the available inventory value.

Next, we need to determine the ending inventory value

Determining Ending Inventory

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This part can get tricky.. Work with your client to determine the best approach for calculating ending inventory value. For a cultivator, a simple method may be:

- From METRC, run:
  - Monthly Plants Inventory Report for the period
  - Inventory Point in Time Report for the period
  - Use the above reports (or other method) to determine the amount of inventory remaining on hand as a percentage of the total inventory available during the period.
    - To keep it simple, I like comparing 'harvested' plants on hand per the Inventory Point in Time report with the total plants harvested and destroyed for the period on the Monthly Plants Inventory report.

Determining Ending Inventory (cont.)

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- **The prior slide is a very simple method that relies on external data (from METRC); if using this approach, make sure the client understands the limitations** of considering harvested plants (that are not yet ready for sale) and the exclusion of active packages on hand (considered finished and available for sale). This method may not be appropriate for your client, if for example they maintain a finished goods inventory.
- The method does not need to be perfect. But it does need to be consistently applied.
- Processors with different product lines may require a much different approach. For example, inventory on hand related solely to making vape cartridges vs. pre-rolls may have vastly different costs and value associated.

Determining Ending Inventory

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Your client has determined that of the total inventory produced during the period, 30% remains on hand at period end, and makes the following journal entry:

JE: 123123EndInv:

	Debit	Credit
13101 Supplies and materials		$7,000
13104 Production labor		$2,800
13108 Testing and quality control		$1,400
13110 Building rent		$2,520
13112 Utilities		$1,890
13113 Insurance		$1,330
50000 Cost of Goods Sold	$16,940	

And the statement of revenues and expenses looks something like this...

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40000 Revenue	$20,000
50000 Cost of Goods Sold	(16,940)
Gross Profit	**3,060**
65110 Building rent	$400
65120 Utilities	300
65130 Insurance	100
66000 Payroll	1,000
Total expenses:	(1,800)
Net income	$1,260

Considerations Under SSARS

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- The accrual tax-basis of accounting is a basis of accounting other than GAAP;
- Tax-basis accounting methods, generally, must follow the same rules as GAAP if the rules are applicable → disclosures;
- When applying a tax-basis accounting method, the financial statements have a different naming convention: See AICPA Practice Aid: Accounting and Financial Reporting Guidelines for Cash- and Tax-Basis Financial Statements

Considerations Under SSARS:

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Sample Footnote

The financial statements within this packet and accompanying note are unaudited. No assurance is provided on these financial statements. Entity management is responsible for the preparation and fair presentation of these financial statements in accordance with the accrual tax-basis of accounting, modified, and as described in the note following these statements. All other disclosures that may be required by the financial reporting framework have been omitted. **The company must comply with Internal Revenue Code § 280E, which disallows the deduction of expenses when computing federal taxable income.**

This last sentence is added, as the average FS reader would not be aware that taxable income is based on gross profit, and may generally assume it is based on net income otherwise.

Considerations Under SSARS:

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Sample Endnote

Basis of Accounting

The accompanying financial statements have been prepared in accordance with the accrual tax-basis of accounting, modified. The accrual tax-basis of accounting is the basis of accounting the entity uses for federal income tax purposes, and is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). Departure, or modification to the accrual tax-basis of accounting used in the preparation of the Financial Statements includes the presentation of expense items that are disallowed for federal income tax purposes, such as for meals and entertainment and deductions disallowed pursuant to Internal Revenue Code § 280E. Additional departure from, and modification to, the accrual tax-basis of accounting includes the omission of certain disclosures that may otherwise be required by the financial reporting framework.

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Sample Endnote Continued..

Significant Accounting Policies

Accrual tax-basis of accounting

The accompanying financial statements have been prepared in accordance with the accrual tax-basis of accounting, modified. The Company records accounts receivable, accounts payable, prepaid expenses, and inventory on hand, under the accrual tax-basis of accounting, modified.

Internal Revenue Code 280E and Internal Revenue Code 471

See the attachment for more...

What else?

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§ 1.471-11(c)(2)(ii)?

471(c)?

263A?

Retailers → See §§ 1.471-3; 1.471-4 & 1.471-8 may also be worth considering

Other approaches to determining ending inventory and cost of goods sold

Physical inventory still needed at year end

Questions?

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Please feel free to reach out after the presentation with questions or feedback!

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About the Presenter

Kareyna Miller, CPA, CRISC is a founding member of the MICPA Cannabis Industry Expert Panel, and has been working with businesses in Michigan's cannabis industry since 2017. Her industry experience is well rounded and includes both client service in the areas of accounting, tax, consulting, and assurance, as well as in firm management in organically growing and managing a practice servicing this unique niche. Currently, her practice focuses primarily on providing fractional CFO and controller services to cultivators and processors, and their retail locations.