

Cannabis Taxpayers Find Flaws in New Accounting Method Rules

March 11, 2021, 1:00 AM PST

Andrew Gradman of the Law Office of Andrew L. Gradman, and Abraham Finberg and Rachel Wright of AB FinWright LLP argue that new final regulations—stating that tax code Section 471(c) cannot be used to capitalize non-deductible amounts—are subject to challenge by cannabis taxpayers.

With cannabis clients, normal tax planning is reversed: the goal is to capitalize as many costs as possible, rather than to seek deductions.

This is thanks to tax code Section 280E, which bars cannabis businesses and other “drug traffickers” from reducing gross income by deductions. On the other hand, when a cannabis business sells property, it can still reduce amount realized by adjusted basis, and can still reduce gross receipts by cost of goods sold, in calculating gross income. Better to capitalize a cost and recover it later, than never to recover it at all.

Until recently, Section 280E’s exception for capitalized basis was more useful to some cannabis companies than to others. Under Section 471(a), retailers and distributors could not capitalize costs as aggressively as producers. However, Congress seemed to expand this exception in 2017, when it added Section 471(c) as part of the TCJA. This new provision seemed to say that a qualifying taxpayer can choose any method of accounting for inventory—including one which allocates additional expenses to inventory—so long as it “conforms to ... the books and records ... prepared in accordance with the taxpayer’s accounting procedures.” If so, retailers and distributors could elect to be treated like producers.

In proposed and final regs, Treasury has challenged the idea that Section 471(c) removes existing limits on capitalization. REG-132766-18 (Aug. 5, 2020); TD 9942 (Jan. 5, 2021). We would paraphrase Treasury’s reasoning as follows:

- Section 471 is in Subchapter E of Chapter 1, “Accounting Periods and Methods of Accounting,” and not in Subchapter B of Chapter 1, “Computation of Taxable Income.”
- Therefore, it is a timing provision, not a substantive tax provision.
- A timing provision cannot be used to turn a non-recoverable cost into a recoverable cost.
- Thus, it cannot be used to capitalize a cost which is otherwise non-capitalizable and non-deductible.

If Treasury is right, then this new technique can join its friends in the burgeoning Section 280E scrap heap. However, we don’t think Treasury is right.

Rule is inconsistent with Section 471(a)

Of course, Section 471 can be used to capitalize otherwise non-deductible and non-capitalizable costs. It is uncontroversial that producers can capitalize costs which retailers cannot, including costs which are non-deductible under Section 280E. In both cases, this disparate treatment is caused by 471(a)'s requirements.

Since retailers are denied the treatment given to producers by Section 471(a), and since Section 471(c) suspends that provision's requirements, it follows that Section 471(c) does what we think it does: it eliminates the obstacle that was preventing retailers from capitalizing costs like producers can.

Rule is inconsistent with Section 280E

Even if Treasury is correct that Section 471 denies capitalization wherever a deduction is denied, there should be an exception where the deduction is denied because of Section 280E. When Congress enacted Section 280E, it understood that taxpayers could circumvent the provision by capitalizing costs. The legislative history confirms that, instead of challenging this behavior, it expressly approved it. S. Rept. 97-494 (Vol.1), at 309 (1982).

Even Treasury acknowledges this. In the words of the U.S. Tax Court, Treasury has acknowledged "that the disallowance of sec. 280E does not apply to costs of goods sold, a concession that is consistent with the caselaw on that subject and the legislative history underlying sec. 280E." *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r*. Treasury has also implicitly conceded the point in prior regs: Outside of Section 471(c), Treasury denies capitalization only to illegal bribes, penalties, and treble antitrust damages, confirming that it is fine with capitalization in other cases. Treasury Regulation Section 1.471-3(f).

Rule is inconsistent with preamble

The final rule is also inconsistent with Treasury's statement in a preamble that Section 471(c) is "an exemption from taking an inventory." If so, we would expect the final rule to bar retailers from using Section 471(c) to capitalize otherwise *deductible* costs. But nothing in the preamble suggests why that should be, and it's not in the final rule.

Rule invents timing vs. substance distinction

Unlike other tax code provisions, Section 471 does not expressly disallow capitalization of non-deductible amounts. To read such a disallowance rule into Section 471, Treasury asserts that it is a "timing provision."

However, Treasury doesn't offer valid evidence to support this idea. It points to Section 471(c)'s placement in the tax code, but Section 7806 provides that "No inference, implication, or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular Section or provision or portion of this title." This makes sense; Congress cannot always codify new laws in the right places, particularly when, as Boris Bittker noted, many accounting rules "have both accounting and substantive aspects."

Furthermore, the distinction between “timing” and “substantive” rules does not have accepted significance. Again, quoting Bittker: it is “far from clear” whether the specialized provisions which we refer to as accounting methods constitute “mini-methods of accounting or should be viewed instead as rules of substantive tax law.” For example, there are many provisions which Treasury would characterize as substantive, yet which affect timing. These include:

- Section 280B (transferring basis from a demolished structure into land); Section 280F (limiting depreciation of certain automobiles);
- Section 179 (permitting deduction of certain costs that would otherwise have been capitalized);
- Section 174 (permitting deduction of research and experimental expenditures that would otherwise have been capitalized); and
- Section 83 (permitting delayed inclusion of property received as compensation for services).

Conversely, there are provisions that Treasury would characterize as timing rules, yet which have substantive effect. For example:

- If a business expense is capitalized into a capital asset, its tax-shield value will be impaired.
- If a corporation sells a capital asset for a loss, that loss will be disallowed under tax code Section 1212 unless used within five years.
- The business loss limitation in Section 461(l) is a method of accounting, yet it generates net operating losses (NOLs), which in Treasury’s analysis are substantive. Section 461(l) became law in the TCJA, alongside Section 471(c), suggesting that Congress felt the same indifference to the distinction when it passed Section 471(c).
- The installment method of accounting in Section 453 is basically a nonrecognition provision. Although the exchanged property (the note) doesn’t get a step-up at death, the taxpayer may defray the tax using long-term balloon payments. A lot of tax controversies are about efforts to defer tax in this way. Both sides would be surprised to learn that these issues are not “substantive.”

Conclusion

If cannabis taxpayers persist in using Section 471(c) to skirt Section 280E, they must disclose this on Form 8275-R when the new regulation becomes effective, i.e. for taxable years beginning on or after January 5, 2021. Reg. Section 1.471-1(c). This disclosure will invite an audit. If the law in 2022 is like the law today, the audit will end in a deficiency.

Still, if the taxpayer challenges that deficiency in court, she might use these points to argue that the regulations violate the APA. Specifically, under Section 553(c) of the APA, the rule may be struck down if it lacks a statement of the rule’s basis and purpose which provides a reasonable connection between the rule and the promotion of the objectives of the underlying statute. Similarly, Section 706 of the APA provides that a court may hold unlawful and set aside agency action, findings, and conclusions found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law or without observance of procedure required by law.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information

Andrew Gradman is a tax attorney. Abraham Finberg and Rachel Wright are principals at AB FinWright LLP.

Bloomberg Tax Insights articles are written by experienced practitioners, academics, and policy experts discussing developments and current issues in taxation. To contribute, please contact us at TaxInsights@bloombergindustry.com.

© 2026 Bloomberg Industry Group, Inc. All Rights Reserved