

# Allowable Cash Basis Taxpayers:

## I. IRC § 280E

### a. Statute<sup>1</sup>

- i. IRC § 280E provides that **no** deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business consists of trafficking in controlled substances which is prohibited by Federal law or the law of any State in which such trade or business is conducted.
- ii. To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill." S. Rep. No. 97-494 (Vol. 1), at 309 (1982).

## II. Court Case

- a. Edmondson v. Commissioner, T.C. Memo. 1981-623. allowed an illegal business to recover the cost of the controlled substances (i.e., amphetamines; cocaine; marijuana) obtained on consignment. In addition, the taxpayer was allowed to claim certain business deductions. (**a portion of his the rent on his apartment which was his sole place of business, the cost of a small scale, packaging, telephone, and automobile expenses**) Need to make decision

## III. Gross Income

- a. Treas. Reg. 1.61-3(a) provides that in manufacturing, merchandising, or mining business, "gross income" means the total sales, less cost of goods sold, plus any income from investments and from incidental or outside operation or sources.
- b. Treas. Reg. 1.61-3(a) also provides that gross income is determined without subtraction of selling of selling expenses, losses or other items not ordinarily used in computing costs of goods sold or amounts which are of a type for which a deduction would be disallowed under § 162(c).
- c. Treas. Reg. 1.61-3(a) finally provides that the cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer. Thus for example, an amount cannot be taken into account in the computation of cost of goods sold any earlier than the taxable year in which economic performance occurs with respect to the amount (see § 1.446-1(c)(1)(ii)).

## IV. Cash Method of Accounting – Gross Receipts & Deductions

### a. Cash Method of Accounting:

- i. Treas. Reg. 1.446-1(c)(1)(i) provides that under the receipts and disbursements method in the computation of taxable, all items which constitute gross income



(whether in the form of cash, property or services) are included for taxable in which actually or constructively received.

- ii. *Treas. Reg. 1.446-1(c)(1)(i)* also provides that expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipts, see § 1.451-2. For treatment of expenditure attributable to more than one taxable year, see § 461(a) and paragraph (a)(1) of § 1.461-1.

b. **Definition of Deductions**

- i. *Treas. Reg. 1.162-1(a)* provides that business expenses **are deductible from gross income** include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or credit under provisions of law other than IRC § 162.
- ii. *Treas. Reg. 1.162-1(a)* also provides that the cost of goods purchased for resale, with property adjustment for opening and closing inventory, is deducted from gross sales in computing gross income. See paragraph (a) of § 1.61-3.

V. **Rev. Proc. 2002-28**

Rev. Proc. 2002-28 (IRS RPR), 2002-18 I.R.B. 815, 2002-1 C.B. 815, 2002 WL 539014  
Internal Revenue Service (I.R.S.)

IRS RPR

Revenue Procedure

METHODS OF ACCOUNTING; INVENTORIES; SMALL BUSINESS TAXPAYERS

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**Section 162.**--Trade or Business Expenses, *26 CFR 1.162-1: Cost of materials.*

**Section 263A.**--Capitalization and Inclusion in Inventory Costs of Certain Expenses, *26 CFR 1.263A-1: Uniform capitalization of costs.*

**Section 446.**--General Rule for Methods of Accounting, *26 CFR 1.446-1: General rule for methods of accounting.*

**Section 447.**--Method of Accounting for Corporations Engaged in Farming

**Section 448.**--Limitation on Use of Cash Method of Accounting, *26 CFR 1.448-1T: Limitations on the use of the cash receipts and disbursements method of accounting.*

**Section 460.**--Special Rules for Long-Term Contracts, *26 CFR 1.460-1: Long-term contracts.*

**Section 471.**--General Rule for Inventories, *26 CFR 1.471-1: Need for inventories.*

**Section 481.**--Adjustments Required for Changes in Method of Accounting, *26 CFR 1.481-1: Adjustments in general. 26 CFR 1.481-4: Adjustments taken into account with consent.*

**Section 1001.**--Determination of Amount of and Recognition of Gain or Loss, *26 CFR 1.1001-1: Computation of gain or loss.*

*26 CFR 601.204: Changes in accounting periods and methods of accounting.*

**\*1 Methods of accounting; inventories; small business taxpayers.** This procedure provides that the Commissioner will exercise his discretion to except qualifying small business taxpayers from the





requirements to use an accrual method of accounting under [section 446](#) of the Code and to account for inventories under [section 471](#) of the Code. [Rev. Proc. 2002-9](#) modified and amplified. [Notice 2002-14](#) modified and superseded.

#### SECTION 1. PURPOSE

In order to reduce the administrative and tax compliance burdens on certain small business taxpayers and to minimize disputes between the Internal Revenue Service and small business taxpayers regarding the requirement to use an accrual method of accounting (accrual method) under [§ 446](#) of the [Internal Revenue Code](#) because of the requirement to account for inventories under [§ 471](#), this revenue procedure provides that the Commissioner of Internal Revenue will exercise his discretion to except a qualifying small business taxpayer (as defined in [section 5.01](#) of this revenue procedure) from the requirements to use an accrual method of accounting under [§ 446](#) and to account for inventories under [§ 471](#). This revenue procedure also provides the procedures by which a qualifying small business taxpayer may obtain automatic consent to change to the cash receipts and disbursements method of accounting (cash method) and/or to a method of accounting for inventoriable items as materials and supplies that are not incidental under [§ 1.162-3](#) of the [Income Tax Regulations](#).

#### SECTION 2. BACKGROUND

.01 [Section 446\(a\)](#) provides that taxable income must be determined under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books.

.02 [Section 446\(c\)](#) generally allows a taxpayer to select the method of accounting it will use to compute its taxable income. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business, including the cash method or an accrual method, subject to certain restrictions. For example, [§ 446\(b\)](#) provides that the selected method must clearly reflect income. In addition, [§ 1.446-1\(c\)\(2\)\(i\)](#) requires that a taxpayer use an accrual method with regard to purchases and sales of merchandise whenever [§ 471](#) requires the taxpayer to account for inventories, unless otherwise authorized by the Commissioner under [§ 1.446-1\(c\)\(2\)\(ii\)](#). Under [§ 1.446-1\(c\)\(2\)\(ii\)](#), the Commissioner has the authority to permit a taxpayer to use a method of accounting that clearly reflects income even though the method is not specifically authorized by the regulations.

.03 [Section 447](#) generally requires the taxable income from farming of a C corporation engaged in the trade or business of farming, or a partnership engaged in the trade or business of farming with a C corporation partner, to be determined using an accrual method, unless the C corporation meets the \$1,000,000 (\$25,000,000 for family corporations) gross receipts test.

.04 [Section 448](#) generally prohibits the use of the cash method by a C corporation (other than a farming business and a qualified personal service corporation) and a partnership with a C corporation partner (other than a farming business and a qualified personal service corporation), unless the C corporation or partnership with a C corporation partner meets a \$5,000,000 gross receipts test. [Section 448](#) also prohibits tax shelters from using the cash method.

.05 The cash method generally requires an item of income to be included in income when actually or constructively received and permits a deduction for an expense when paid. [Section 1.446-1\(c\)\(1\)\(i\)](#). Other provisions of the Code or regulations applicable to cash method taxpayers may change these general rules, including, for example, [§ 263](#) (requiring the capitalization of expenses paid out for a new building or for permanent improvements or betterments made to increase the value of any property or estate, or for restoring property or making good the exhaustion of property for which an allowance is or has been made); [§ 263A](#) (requiring capitalization of direct and allocable indirect costs of real or tangible personal property produced by a taxpayer or real or personal property that is acquired by a taxpayer for resale); [§ 460](#) (requiring the use of the percentage-of-completion method for certain long-term contracts); and [§ 475](#) (requiring dealers in securities to mark securities to market).

.06 [Section 471](#) provides that whenever, in the opinion of the Secretary, the use of inventories is



necessary to clearly determine the income of the taxpayer, inventories must be taken by the taxpayer. Section 1.471-1 generally requires a taxpayer to account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business.

.07 Section 1.162-3 requires taxpayers carrying materials and supplies (other than incidental materials and supplies) on hand to deduct the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the taxable year. In the case of incidental materials and supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, taxpayers may include in their expenses and deduct from gross income the total cost of such incidental supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method.

.08 Section 263A generally requires direct costs and an allocable portion of indirect costs of certain property produced or acquired for resale by a taxpayer to be included in inventory costs, in the case of property that is inventory, or to be capitalized, in the case of other property. However, resellers with gross receipts of \$10,000,000 or less are not required to capitalize costs under § 263A, and certain producers with \$200,000 or less of indirect costs are not required to capitalize certain costs under § 263A. See § 263A (b)(2)(B) and 1.263A-2(b)(3)(iv).

.09 Sections 446(e) and 1.446-1(e) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e).

.10 Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is determined under a method of accounting different from the method used to determine taxable income for the preceding taxable year.

### SECTION 3. SCOPE

.01 *Applicability.* This revenue procedure applies to a qualifying small business taxpayer as defined in section 5.01.

.02 *Taxpayers Not within the Scope of this Revenue Procedure.*

Notwithstanding section 3.01 of this revenue procedure, this revenue procedure does not apply to a farming business (within the meaning of § 263A(e)(4)) of a qualifying small business taxpayer. If a qualifying small business taxpayer is engaged in the trade or business of farming, this revenue procedure may apply to the taxpayer's non-farming trades or businesses, if any. A taxpayer engaged in the trade or business of farming generally is allowed to use the cash method for any farming business, unless the taxpayer is required to use an accrual method under § 447 or is prohibited from using the cash method under § 448.

### SECTION 4. QUALIFYING SMALL BUSINESS TAXPAYER EXCEPTION

.01 Pursuant to his discretion under §§ 446 and 471, and to simplify the recordkeeping requirements of a qualifying small business taxpayer, the Commissioner, as a matter of administrative convenience, will allow a qualifying small business taxpayer to use the cash method as described in this revenue procedure for a trade or business described in this section 4.01 (eligible trade or business).

(1) A qualifying small business taxpayer may use the cash method as described in this revenue procedure for all of its trades or businesses if the taxpayer satisfies any one of the following three tests and did not previously change (and was not previously required to have changed) from the cash method to an accrual method for any trade or business as a result of becoming ineligible to use the cash method under this revenue procedure.



(a) The taxpayer reasonably determines that its principal business activity (as defined in section 5.04, below) is described in a North American Industry Classification System (“NAICS”) code other than one of the ineligible codes listed below. The ineligible NAICS codes are as follows:

- (i) mining activities within the meaning of NAICS codes 211 and 212;
- (ii) manufacturing within the meaning of NAICS codes 31-33;
- (iii) wholesale trade within the meaning of NAICS code 42;
- (iv) retail trade within the meaning of NAICS codes 44 and 45; and,
- (v) information industries within the meaning of NAICS codes 5111 and 5122.

Information regarding the NAICS codes can be found at [www.census.gov](http://www.census.gov). Visitors to the site should select “Subjects A to Z,” followed by “N,” and then should select “North American Industry Classification System.” Taxpayers also may find a partial list of NAICS codes, described as “Principal Business Activity Codes,” in the instructions to their tax return forms.

(b) Notwithstanding that a taxpayer’s principal business activity is described in one of the ineligible NAICS codes listed above in section 4.01(1)(a), the taxpayer reasonably determines that its principal business activity is the provision of services, including the provision of property incident to those services.

(c) Notwithstanding that a taxpayer’s principal business activity is described in one of the ineligible NAICS codes listed above in section 4.01(1)(a), the taxpayer reasonably determines that its principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications. For purposes of this rule, tangible personal property is not fabricated or modified in accordance with customer design or specifications if the customer merely chooses among pre-selected options (such as size, color, or materials) offered by the taxpayer or if the taxpayer must make only minor modifications to its basic design to meet the customer’s specifications. Moreover, a taxpayer that manufactures an item in quantities for a customer is not treated as fabricating or modifying tangible personal property in accordance with customer design or specifications.

(2) Under current law, a taxpayer with two or more trades or businesses that has a trade or business that is permitted to use the cash method may use such method for such trade or business. Therefore, notwithstanding that a taxpayer’s principal business activity is not described above in section 4.01(1) and thus the taxpayer can not use the cash method for all of its trades or businesses, a taxpayer may use the cash method with respect to any separate and distinct trade or business if the principal business activity of the trade or business is not described in an ineligible NAICS code in section 4.01(1)(a)(i) through (v) or is described in either section 4.01(1)(b) or section 4.01(1)(c). No trade or business will be considered separate and distinct unless a complete and separable set of books and records is kept for such trade or business. See § 1.446-1(d)(2).

.02 A taxpayer who satisfies the qualifying small business taxpayer exception described in section 4.01 and chooses not to use an overall accrual method with inventories being accounted for under § 471 has the following three options for an eligible trade or business under this revenue procedure:

- (1) The taxpayer can use the overall cash method and account for inventories under § 471;
- (2) The taxpayer can use an overall accrual method and account for inventorable items, as defined in section 5.09 below, in the same manner as materials and supplies that are not incidental under § 1.162-3 (see sections 4.04 and 4.05 below); or
- (3) The taxpayer can use the overall cash method and account for inventorable items in the same manner





as materials and supplies that are not incidental under § 1.162-3 (see sections 4.04 and 4.05 below).

.03 Notwithstanding § 1001 and the regulations thereunder, qualifying small business taxpayers that use the cash method for an eligible trade or business under section 4.01 of this revenue procedure shall include amounts attributable to “open accounts receivable” (as defined in section 5.10) in income as such amounts are actually or constructively received. However, § 1001 may be applicable to other transactions.

.04 Qualifying small business taxpayers that are permitted to use the cash method for an eligible trade or business under section 4.01 of this revenue procedure and that do not want to account for inventories under § 471 must treat all inventoriable items in such trade or business in the same manner as materials and supplies that are not incidental under § 1.162-3. For purposes of this revenue procedure, taxpayers are not required to apply § 263A to inventoriable items that are treated as materials and supplies that are not incidental. Items that would be accounted for as incidental materials and supplies for purposes of § 1.162-3 may still be accounted for in that manner. Whether an item is purchased for resale or use (and thus accounted for as a non-incidental material and supply) or is purchased to provide to customers incident to services (and thus may be accounted for as either an incidental or a non-incidental material and supply depending on the facts and circumstances) must be determined under general tax principles.

.05 Under § 1.162-3, materials and supplies that are not incidental are deductible only in the year in which they are actually consumed and used in the taxpayer’s business. For purposes of this revenue procedure, inventoriable items that are treated as materials and supplies that are not incidental are consumed and used in the year the qualifying small business taxpayer provides the items to a customer. Thus, the cost of such inventoriable items are deductible only in that year, or in the year in which the taxpayer actually pays for the goods, whichever is later. A qualifying small business taxpayer may determine the amount of the allowable deduction for non-incidental materials and supplies by using either a specific identification method, a first in, first out (FIFO) method, or an average cost method, provided that method is used consistently. See § 1.471-2(d). A taxpayer may not use the last in, first out (LIFO) method described in § 472 and the regulations thereunder to determine the amount of the allowable deduction for non-incidental materials and supplies.

.06 The method of accounting used by a qualifying small business taxpayer for financial accounting (“book”) purposes will not affect the taxpayer’s eligibility under this revenue procedure to use the cash method or the method of accounting for inventoriable items as non-incidental materials and supplies under § 1.162-3. However, taxpayers must still comply with the requirements under § 446(a) and the regulations thereunder to maintain adequate books and records, which may include a reconciliation of any differences between such books and records and their return. See § 1.446-1(a)(4).

## SECTION 5. DEFINITIONS

.01 *Qualifying Small Business Taxpayer.* A qualifying small business taxpayer is any taxpayer with “average annual gross receipts” of \$10,000,000 or less that is not prohibited from using the cash method under § 448.

.02 *Average Annual Gross Receipts.* A taxpayer has average annual gross receipts of \$10,000,000 or less if, for each prior taxable year ending on or after December 31, 2000, the taxpayer’s average annual gross receipts for the three taxable-year period ending with the applicable prior taxable year do not exceed \$10,000,000. If a taxpayer has not been in existence for three prior taxable years, the taxpayer must determine its average annual gross receipts for the number of years (including short taxable years) that the taxpayer has been in existence. See § 448(c)(3)(A).

.03 *Business Activity.* A taxpayer may use any reasonable method of applying the relevant facts and circumstances to determine what is a business activity. For example, for some taxpayers, the provision of services, the sale of goods, and the production of goods each will be treated as a different business activity. However, if a taxpayer sells or produces goods incident to the performance of services, the different activities may be treated as one business activity--the provision of services.



.04 *Principal Business Activity.* A principal business activity is determined by the sources of gross receipts. Under sections 4.01(1)(a), (b), and (c), a taxpayer must apply the tests in this section to all the taxpayer's trades or businesses in the aggregate. Under section 4.01(2), a taxpayer must apply the tests in such section separately to each trade or business for which the taxpayer keeps a complete and separable set of books and records. A taxpayer may use either of the following tests to determine the principal business activity of the taxpayer or of the taxpayer's trades or businesses.

(1) *Principal business activity prior year test.* Under the principal business activity prior year test, the principal business activity is the activity from which the largest percentage of gross receipts was derived during the prior taxable year (even if this amount is less than 50 percent of the aggregate gross receipts of the taxpayer or the trade or business). If a taxpayer or a trade or business is in its first taxable year, the principal business activity is the activity from which the largest percentage of gross receipts is derived for that taxable year.

(2) *Principal business activity three-year average test.* Under the principal business activity three-year average test, the principal business activity is the activity from which the largest percentage of average annual gross receipts was derived over the three taxable-year period ending with the prior taxable year. If a taxpayer or a trade or business has not been in existence for three prior taxable years, the taxpayer must determine average annual gross receipts for the number of years (including short taxable years) that the taxpayer or the trade or business has been in existence. See § 448(c)(3)(A).

.05 *Gross Receipts.* Gross receipts is defined consistent with § 1.448-1T(f)(2)(iv) of the Temporary Income Tax Regulations. Thus, gross receipts for a taxable year equal all receipts that must be recognized under the method of accounting actually used by the taxpayer for that taxable year for federal income tax purposes. For example, gross receipts include total sales (net of returns and allowances), all amounts received from services, interest, dividends, and rents. However, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. See also § 448(c)(3)(C).

.06 *Aggregation of Gross Receipts.* For purposes of computing gross receipts under section 5.02, all taxpayers treated as a single employer under subsection (a) or (b) of § 52 or subsection (m) or (o) of § 414 (or that would be treated as a single employer under these sections if the taxpayers had employees) will be treated as a single taxpayer. However, when transactions occur between taxpayers that are treated as a single taxpayer by the previous sentence, gross receipts arising from these transactions will not be treated as gross receipts for purposes of the average annual gross receipts limitation. See §§ 448(c)(2) and 1.448-1T(f)(2)(ii).

.07 *Treatment of Short Taxable Years.* In the case of a short taxable year, a taxpayer's gross receipts must be annualized by multiplying the gross receipts for the short taxable year by 12 and then dividing the result by the number of months in the short taxable year. See §§ 448(c)(3)(B) and 1.448-1T(f)(2)(iii).

.08 *Treatment of Predecessors.* Any reference to a taxpayer in this section 5 includes a reference to any predecessor of that taxpayer. See § 448(c)(3)(D).

.09 *Inventoriable Item Defined.* An inventoriable item is any item either purchased for resale to customers or used as a raw material in producing finished goods.

.10 *Open Accounts Receivable Defined.* For purposes of this revenue procedure, open accounts receivable is defined as any receivable due in full in 120 days or less.

## Marijuana Cash Basis Taxpayers

### I. IRC § 280E

#### Statute<sup>1</sup>

- IRC § 280E provides that **no** deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business consists of trafficking in controlled substances which is prohibited by Federal law or the law of any State in which such trade or business is conducted.
- To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill." S. Rep. No. 97-494 (Vol. 1), at 309 (1982).

### II. Court Case

- Edmondson v. Commissioner, T.C. Memo. 1981-623.
  - Allowed an illegal business to recover the cost of the controlled substances (i.e., amphetamines; cocaine; marijuana) obtained on consignment.
  - In addition, the taxpayer was allowed to claim certain business deductions.
  - The deductions that were allowed were:
    - A portion of his the rent on his apartment which was his sole place of business,

### I. Non-IRC § 280E Taxpayers

#### Taxable Income Computation<sup>2</sup>:

#### Non § 280E

Total Sales  
(Cost of Goods Sold)  
 Gross Income  
(Deductions)  
Taxable Income

Tax Liability  
(Tax Credits)  
**Tax Due**

#### IRC § 280E

Total Sales  
(Cost of Goods Sold)  
Taxable Income

Tax Liability  
**Tax Due**

<sup>1</sup>

<sup>2</sup> Treas. Reg. 1.61-3: Total Sales – CGS = Gross Income. Gross Income – Deductions = Taxable Income



- the cost of a small scale,
- packaging,
- telephone, and
- automobile expenses)

III. Rev. Proc. 2002-28

A. Use of Cash Method: Rev. Proc. 2002-28, Sec. 4.02

- Rev. Proc. 2002-28, Sec. 4.02 provides that a taxpayer who satisfies the **qualifying small business taxpayer exception** described in section 4.01 and
- **chooses not to use** an overall accrual method with inventories being accounted for under § 471 has the following three options for an eligible trade or business under this revenue procedure:

(1) The taxpayer **can use** the overall cash method and account for inventories under § 471;

(2) The taxpayer can use an overall accrual method and account for inventorable items, as defined in section 5.09 below, in the same manner as materials and supplies that are not incidental under § 1.162-3 (see sections 4.04 and 4.05 below); or

(3) The taxpayer can use the overall cash method and account for inventorable items in the same manner as materials and supplies that are not incidental under § 1.162-3 (see sections 4.04 and 4.05 below).

**Capitalizable Costs**

IRC § 471 – Identification of Capitalizable Costs

**Capitalizable Inventory Costs**

II. **Cash Method Explanation**: Treas. Reg. 1.446-1(c)(1)(i)

A. Total Sales

Under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property or services) are to be included for the taxable year in which actually or constructively received.

B. Cost of Goods Sold

Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipts, see § 1.451-2. For treatment of an expenditure attributable to more than one taxable year, see § 461(a) and paragraph (a)(1) of § 1.461-1.

**Not Capitalizable**

IRC § 471 & § 263A

**Not Capitalizable as Inventory Costs in Cost of Goods Sold**

I. IRC § 263A General Provision – Treas. Reg. 1.263A-1(e)(3)(i)

- Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale).
- Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale.
- Indirect costs are properly allocable to property produced or property

(b)(3) 26 U.S.C.  
§ 6103



I. General Provision – Treas. Reg. 1.471-11(b)(1)

- Costs must be incident to and necessary for production or manufacturing operations or process
- Production costs include:
  - Direct production costs
  - Fixed indirect production costs
  - Indirect production costs
- Manufacturing Scope: Only costs that are incurred during the production process are required to be capitalized

II. Direct Costs – Treas. Reg. 1.471-11(b)(2)(i)

- Direct Materials
  - Treas. Reg. 1.471-3(b)
- Direct Labor

III. Indirect Costs – Treas. Reg. 1.471-11(c)(3)

- Impermissible Inventory Methods Treas. Reg. 1.471-11-2(f)(1)-(7)
  - Prime Costs – Treating all or substantially all indirect costs as a current period deduction – Does not provide for a clear reflection of income
- Treas. Reg. 1.471-11(c)(3)(i) provides that for inventory methods that do not provide for a clear reflection of income, the following costs are required to be included in inventoriable costs:
  - Repair expense Treas. Reg. 1.471-11(c)(3)(i)(a)
  - Maintenance Treas. Reg. 1.471-11(c)(3)(i)(b)
  - Utilities Treas. Reg. 1.471-11(c)(3)(i)(c)
  - Rent Treas. Reg. 1.471-11(c)(3)(i)(d)
  - Indirect Labor Treas. Reg. 1.471-11(c)(3)(i)(e)
  - Indirect Materials and Supplies Treas. Reg. 1.471-11(c)(3)(i)(f)
  - Tools & equipment Treas. Reg. 1.471-11(c)(3)(i)(g)
  - Quality Control Treas. Reg. 1.471-11(c)(3)(i)(h)
  - Taxes: Other than income taxes Treas. Reg. 1.471-11(c)(3)(i)(i)
  - Book depreciation/amortization Treas. Reg. 1.471-11(c)(3)(i)(j)
  - Administrative costs Treas. Reg. 1.471-11(c)(3)(i)(k)
  - Officers' salaries Treas. Reg. 1.471-11(c)(3)(i)(l)
  - Insurance Costs Treas. Reg. 1.471-11(c)(3)(i)(m)

D. Full Absorption Inventory Capitalization Method

acquired for resale

- When the costs directly benefit or
- Are incurred by reason of the performance of production or resale activities.
- Manufacturing Scope:
  - Costs incurred during the production process
  - General costs for producers Treas. Reg. 1.263A-2(a)(3)(i)
    - Pre-Production Costs Treas. Reg. 1.263A-2(a)(3)(ii)
    - Post production Costs Treas. Reg. 1.263A-2(a)(3)(iii)

II. Costs That Are Not Capitalizable

A. IRC § 471 – Category II Costs – Treas. 1.471-11(c)(2)(ii)

- Marketing Expenses Treas. Reg. 1.471-11(c)(2)(ii)(a)
- Advertising expenses Treas. Reg. 1.471-11(c)(2)(ii)(b)
- Selling expenses Treas. Reg. 1.471-11(c)(2)(ii)(c)
- Other distribution expense Treas. Reg. 1.471-11(c)(2)(ii)(d)
- Interest Treas. Reg. 1.471-11(c)(2)(ii)(e)
- Research/Experimental expenses Treas. Reg. 1.471-11(c)(2)(ii)(f)
- Losses under § 165 Treas. Reg. 1.471-11(c)(2)(ii)(g)
- Percentage depletion in excess of cost depletion Treas. Reg. 1.471-11(c)(2)(ii)(h)
- Depreciation and amortization Treas. Reg. 1.471-11(c)(2)(ii)(i)
- Incomes taxes attributable to the sale of inventory Treas. Reg. 1.471-11(c)(2)(ii)(j)
- Pension contributions: past services Treas. Reg. 1.471-11(c)(2)(ii)(k)
- Certain general/administrative costs Treas. Reg. 1.471-11(c)(2)(ii)(l)
- Certain salaries paid to officers Treas. Reg. 1.471-11(c)(2)(ii)(m)

B. IRC Section 263A Costs

- Pension and Related Costs Treas. Reg. 1.263A-1(e)(3)(ii)(C)
- Purchasing Costs Treas. Reg. 1.263A-1(e)(3)(ii)(F)
- Handling Costs Treas. Reg. 1.263A-1(e)(3)(ii)(G)
- Storage Costs Treas. Reg. 1.263A-1(e)(3)(ii)(H)
- Tax Over Book Depreciation Treas. Reg. 1.263A-1(e)(3)(ii)(I)
- Engineering and Design Treas. Reg. 1.263A-1(e)(3)(ii)(P)



- Cost Allocated to Goods      Treas. Reg. 1.471-11(d)(1)
- Burden Rate Allocations      Treas. Reg. 1.471-11(d)(2)(i)
- Developing Burden Rates      Treas. Reg. 1.471-11(d)(2)(ii)
- Operation of Burden Rates      Treas. Reg. 1.471-11(d)(2)(iii)
- Standard Cost Rates      Treas. Reg. 1.471-11(d)(3)(i)
  - Treatment of variances      Treas. Reg. 1.471-11(d)(3)(ii)

- Spoilage      Treas. Reg. 1.263A-1(e)(3)(ii)(Q)
- Bidding Costs      Treas. Reg. 1.263A-1(e)(3)(ii)(T)
- Licensing & Franchise Fees      Treas. Reg. 1.263A-1(e)(3)(ii)(U)
- Interest – IRC § 263A(f)      Treas. Reg. 1.263A-1(e)(3)(ii)(V)
- Capitalizable service costs      Treas. Reg. 1.263A-1(e)(3)(ii)(W)

C. Purchasing, Storage and Handling Costs

- Definition of purchasing costs      Treas. Reg. 1.263A-3(c)(3)
- Definition of handling cost      Treas. Reg. 1.263A-3(c)(4)
- Definition of storage costs      Treas. Reg. 1.263A-3(c)(5)
- Pick and pack not capitalizable      Treas. Reg. 1.263A-3(c)(4)

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## Marijuana Inventory Capitalization Rules Manufacture with Financial Statements

### Capitalizable

#### IRC § 471 – Identification of Capitalizable Costs

- I. General Provision – Treas. Reg. 1.471-11(b)(1)
- Costs must be incident to and necessary for production or manufacturing operations or process
  - Production costs include:
    - Direct production costs
    - Fixed indirect production costs
    - Indirect production costs
  - Only cost incurred during the production period are capitalizable
- II. Direct Costs – Treas. Reg. 1.471-11(b)(2)(i)
- Direct Materials
    - Treas. Reg. 1.471-3(b)
  - Direct Labor
- III. Indirect Costs – Treas. Reg. 1.471-11(c)(3)
- Category I – Treas. Reg. 1.471-11(c)(2)(i) - Inventory Costs Required to be Capitalized:
- |                                   |                                  |
|-----------------------------------|----------------------------------|
| • Repair expense                  | Treas. Reg. 1.471-11(c)(2)(i)(a) |
| • Maintenance                     | Treas. Reg. 1.471-11(c)(2)(i)(b) |
| • Utilities                       | Treas. Reg. 1.471-11(c)(2)(i)(c) |
| • Rent                            | Treas. Reg. 1.471-11(c)(2)(i)(d) |
| • Indirect Labor                  | Treas. Reg. 1.471-11(c)(2)(i)(e) |
| • Indirect Materials and Supplies | Treas. Reg. 1.471-11(c)(2)(i)(f) |
| • Tools & equipment               | Treas. Reg. 1.471-11(c)(2)(i)(g) |
| • Quality Control                 | Treas. Reg. 1.471-11(c)(2)(i)(h) |

Category III – Treas. Reg. 1.471-11(c)(2)(iii) – Indirect costs includible in

### Not Capitalizable

#### IRC § 471 & § 263A

- I. IRC § 263A General Provision – Treas. Reg. 1.263A-1(e)(3)(i)
- Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale).
  - Generally, taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Indirect costs are properly allocable to property produced or property acquired for resale. However, costs disallowed under section 280E cannot be capitalized under section 263A
    - When the costs directly benefit
    - or
    - Are incurred by reason of the performance of production or resale activities.
  - General costs for producers Treas. Reg. 1.263A-2(a)(3)(i)
    - Pre-Production Costs Treas. Reg. 1.263A-2(a)(3)(ii)
    - Post production costs Treas. Reg. 1.263A-2(a)(3)(iii)
- II. Costs That Are Not Capitalizable
- A. IRC § 471 – Category II Costs – Treas. 1.471-11(c)(2)(ii)
- |                                  |                                   |
|----------------------------------|-----------------------------------|
| • Marketing Expenses             | Treas. Reg. 1.471-11(c)(2)(ii)(a) |
| • Advertising expenses           | Treas. Reg. 1.471-11(c)(2)(ii)(b) |
| • Selling expenses               | Treas. Reg. 1.471-11(c)(2)(ii)(c) |
| • Other distribution expense     | Treas. Reg. 1.471-11(c)(2)(ii)(d) |
| • Interest                       | Treas. Reg. 1.471-11(c)(2)(ii)(e) |
| • Research/Experimental expenses | Treas. Reg. 1.471-11(c)(2)(ii)(f) |

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inventory if included for book purposes

- Taxes/Per § 164 on Manufacturing Assets Treas. Reg. 1.471-11(c)(2)(iii)(a)
- Depreciation/Depletion Treas. Reg. 1.471-11(c)(2)(iii)(b)
- Employee Benefits Treas. Reg. 1.471-11(c)(2)(iii)(c)
- Strike, rework labor, scrap & spoilage Treas. Reg. 1.471-11(c)(2)(iii)(d)
- Factory Admin Expenses Treas. Reg. 1.471-11(c)(2)(iii)(e)
- Officers' Salaries Treas. Reg. 1.471-11(c)(2)(iii)(f)
- Insurance Costs Treas. Reg. 1.471-11(c)(2)(iii)(g)

III. Full Absorption Inventory Capitalization Methods

- Cost Allocated to Goods Treas. Reg. 1.471-11(d)(1)
- Burden Rate Allocations Treas. Reg. 1.471-11(d)(2)(i)
- Developing Burden Rates Treas. Reg. 1.471-11(d)(2)(ii)
- Operation of Burden Rates Treas. Reg. 1.471-11(d)(2)(iii)
- Standard Cost Rates Treas. Reg. 1.471-11(d)(3)(i)
  - Treatment of variances Treas. Reg. 1.471-11(d)(3)(ii)

- Losses under § 165 Treas. Reg. 1.471-11(c)(2)(ii)(g)
- Percentage depletion in excess of cost depletion Treas. Reg. 1.471-11(c)(2)(ii)(h)
- Depreciation and amortization Treas. Reg. 1.471-11(c)(2)(ii)(i)
- Incomes taxes attributable to the sale of inventory Treas. Reg. 1.471-11(c)(2)(ii)(j)
- Pension contributions: past services Treas. Reg. 1.471-11(c)(2)(ii)(k)
- Certain general/administrative costs Treas. Reg. 1.471-11(c)(2)(ii)(l)
- Certain salaries paid to officers Treas. Reg. 1.471-11(c)(2)(ii)(m)

B. IRC Section 263A Costs

- Pension and Related Costs Treas. Reg. 1.263A-1(e)(3)(ii)(C)
- Purchasing Costs Treas. Reg. 1.263A-1(e)(3)(ii)(F)
- Handling Costs Treas. Reg. 1.263A-1(e)(3)(ii)(G)
- Storage Costs Treas. Reg. 1.263A-1(e)(3)(ii)(H)
- Tax Over Book Depreciation Treas. Reg. 1.263A-1(e)(3)(ii)(I)
- Engineering and Design Treas. Reg. 1.263A-1(e)(3)(ii)(P)
- Spoilage Treas. Reg. 1.263A-1(e)(3)(ii)(Q)
- Bidding Costs Treas. Reg. 1.263A-1(e)(3)(ii)(T)
- Licensing & Franchise Fees Treas. Reg. 1.263A-1(e)(3)(ii)(U)
- Interest – IRC § 263A(f) Treas. Reg. 1.263A-1(e)(3)(ii)(V)
- Capitalizable service costs Treas. Reg. 1.263A-1(e)(3)(ii)(W)

C. Purchasing, Storage and Handling Costs

- Definition of purchasing costs Treas. Reg. 1.263A-3(c)(3)
- Definition of handling cost Treas. Reg. 1.263A-3(c)(4)
- Definition of storage costs Treas. Reg. 1.263A-3(c)(5)
- Pick and pack not capitalizable Treas. Reg. 1.263A-3(c)(4)

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## Marijuana Inventory Capitalization Rules Manufacture without Financial Statements

### Capitalizable

#### IRC § 471 – Identification of Capitalizable Costs

- I. General Provision – Treas. Reg. 1.471-11(b)(1)
- Costs must be incident to and necessary for production or manufacturing operations or process
  - Production costs include:
    - Direct production costs
    - Fixed indirect production costs
    - Indirect production costs
  - Only costs that are incurred during the production process are required to be capitalized
- II. Direct Costs – Treas. Reg. 1.471-11(b)(2)(i)
- Direct Materials
  - Direct Labor
- III. Indirect Costs – Treas. Reg. 1.471-11(c)(3)
- Impermissible Inventory Methods Treas. Reg. 1.471-11-2(f)(1)-(7)
    - Prime Costs – Treating all or substantially all indirect costs as a current period deduction – Does not provide for a clear reflection of income
  - Treas. Reg. 1.471-11(c)(3)(i) provides that for inventory methods that do not provide for a clear reflection of income, the following costs are required to be included in inventoriable costs:
 

○ Repair expense	Treas. Reg. 1.471-11(c)(3)(i)(a)
○ Maintenance	Treas. Reg. 1.471-11(c)(3)(i)(b)
○ Utilities	Treas. Reg. 1.471-11(c)(3)(i)(c)

### Not Capitalizable

#### IRC § 471 & § 263A

- I. IRC § 263A General Provision – Treas. Reg. 1.263A-1(e)(3)(i)
- Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale).
  - Generally, taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Indirect costs are properly allocable to property produced or property acquired for resale. However, costs disallowed under section 280E cannot be capitalized under section 263A.
    - - When the costs directly benefit
      - or
      - Are incurred by reason of the performance of production or resale activities.
  - Manufacturing Scope:
    - Costs incurred during the production process
    - General costs for producers Treas. Reg. 1.263A-2(a)(3)(i)
      - Pre-Production Costs Treas. Reg. 1.263A-2(a)(3)(ii)
      - Post production costs Treas. Reg. 1.263A-2(a)(3)(iii)
- II. Costs That Are Not Capitalizable
- A. IRC § 471 – Category II Costs – Treas. 1.471-11(c)(2)(ii)
- Marketing Expenses Treas. Reg. 1.471-11(c)(2)(ii)(a)
  - Advertising expenses Treas. Reg. 1.471-11(c)(2)(ii)(b)

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o Rent	Treas. Reg. 1.471-11(c)(3)(i)(d)
o Indirect Labor	Treas. Reg. 1.471-11(c)(3)(i)(e)
o Indirect Materials and Supplies	Treas. Reg. 1.471-11(c)(3)(i)(f)
o Tools & equipment	Treas. Reg. 1.471-11(c)(3)(i)(g)
o Quality Control	Treas. Reg. 1.471-11(c)(3)(i)(h)
o Taxes: Other than income taxes	Treas. Reg. 1.471-11(c)(3)(i)(i)
o Book depreciation/amortization	Treas. Reg. 1.471-11(c)(3)(i)(j)
o Administrative costs	Treas. Reg. 1.471-11(c)(3)(i)(k)
o Officers' salaries	Treas. Reg. 1.471-11(c)(3)(i)(l)
o Insurance Costs	Treas. Reg. 1.471-11(c)(3)(i)(m)

III. Full Absorption Inventory Capitalization Method

• Cost Allocated to Goods	Treas. Reg. 1.471-11(d)(1)
• Burden Rate Allocations	Treas. Reg. 1.471-11(d)(2)(i)
• Developing Burden Rates	Treas. Reg. 1.471-11(d)(2)(ii)
• Operation of Burden Rates	Treas. Reg. 1.471-11(d)(2)(iii)
• Standard Cost Rates	Treas. Reg. 1.471-11(d)(3)(i)
o Treatment of variances	Treas. Reg. 1.471-11(d)(3)(ii)

• Selling expenses	Treas. Reg. 1.471-11(c)(2)(ii)(c)
• Other distribution expense	Treas. Reg. 1.471-11(c)(2)(ii)(d)
• Interest	Treas. Reg. 1.471-11(c)(2)(ii)(e)
• Research/Experimental expenses	Treas. Reg. 1.471-11(c)(2)(ii)(f)
• Losses under § 165	Treas. Reg. 1.471-11(c)(2)(ii)(g)
• Percentage depletion in excess of cost depletion	Treas. Reg. 1.471-11(c)(2)(ii)(h)
• Depreciation and amortization	Treas. Reg. 1.471-11(c)(2)(ii)(i)
• Incomes taxes attributable to the sale of inventory	Treas. Reg. 1.471-11(c)(2)(ii)(j)
• Pension contributions: past services	Treas. Reg. 1.471-11(c)(2)(ii)(k)
• Certain general/administrative costs	Treas. Reg. 1.471-11(c)(2)(ii)(l)
• Certain salaries paid to officers	Treas. Reg. 1.471-11(c)(2)(ii)(m)

B. IRC Section 263A Costs

• Pension and Related Costs	Treas. Reg. 1.263A-1(e)(3)(ii)(C)
• Purchasing Costs	Treas. Reg. 1.263A-1(e)(3)(ii)(F)
• Handling Costs	Treas. Reg. 1.263A-1(e)(3)(ii)(G)
• Storage Costs	Treas. Reg. 1.263A-1(e)(3)(ii)(H)
• Tax Over Book Depreciation	Treas. Reg. 1.263A-1(e)(3)(ii)(I)
• Engineering and Design	Treas. Reg. 1.263A-1(e)(3)(ii)(P)
• Spoilage	Treas. Reg. 1.263A-1(e)(3)(ii)(Q)
• Bidding Costs	Treas. Reg. 1.263A-1(e)(3)(ii)(T)
• Licensing & Franchise Fees	Treas. Reg. 1.263A-1(e)(3)(ii)(U)
• Interest – IRC § 263A(f)	Treas. Reg. 1.263A-1(e)(3)(ii)(V)
• Capitalizable service costs	Treas. Reg. 1.263A-1(e)(3)(ii)(W)

C. Purchasing, Storage and Handling Costs

• Definition of purchasing costs	Treas. Reg. 1.263A-3(c)(3)
• Definition of handling cost	Treas. Reg. 1.263A-3(c)(4)
• Definition of storage costs	Treas. Reg. 1.263A-3(c)(5)
• Pick and pack not capitalizable	Treas. Reg. 1.263A-3(c)(4)

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## Marijuana Inventory Capitalization Rules Resellers

<u>Capitalizable</u>	<u>Not Capitalizable</u>																																				
<p><u>IRC § 471 – Identification of Capitalizable Costs</u></p> <p>I. <u>Reseller Capitalizable Costs</u> – Treas. Reg. 1.471- 3(b)</p> <p>In the case of merchandise purchased since the beginning of the taxable year:</p> <ul style="list-style-type: none"> <li>• The invoice price less trade or other discounts, except strictly which may be deducted or not at the option of the taxpayer, provided a consistent course is followed.</li> <li>• To this net invoice price should be added transportation or other necessary charges incurred in acquiring possess of the goods.</li> </ul> <p>II. <u>Reseller Court Cases – IRC § 471</u></p> <p>McIntosh Mills<sup>1</sup> – The Taxpayer had raw cotton inventory. The taxpayer stored the cotton in warehouses after acquiring physical position. The Commission made an adjustment and capitalized the storage costs to the taxpayer's ending inventory.</p> <p><b>Holding:</b> Warehousing costs <b>do not</b> constitute additional costs of the cotton for inventory purposes, but are business expenses and proper deductions from income. The warehousing add no capital value to the cotton.</p>	<p><u>IRC § 471 &amp; § 263A</u></p> <p>I. <u>Manufacturer Costs not Capitalizable by Retailers</u></p> <p>The following costs although capitalizable for manufactures are not capitalizable for retailer or wholesalers:</p> <p>A. <u>Category I – Treas. Reg. 1.471-11(c)(2)(i):</u></p> <table style="width: 100%; border: none;"> <tr><td style="width: 50%;">• Repair expense</td><td style="width: 50%;">Treas. Reg. 1.471-11(c)(2)(i)(a)</td></tr> <tr><td>• Maintenance</td><td>Treas. Reg. 1.471-11(c)(2)(i)(b)</td></tr> <tr><td>• Utilities</td><td>Treas. Reg. 1.471-11(c)(2)(i)(c)</td></tr> <tr><td>• Rent</td><td>Treas. Reg. 1.471-11(c)(2)(i)(d)</td></tr> <tr><td>• Indirect Labor</td><td>Treas. Reg. 1.471-11(c)(2)(i)(e)</td></tr> <tr><td>• Indirect Materials and Supplies</td><td>Treas. Reg. 1.471-11(c)(2)(i)(f)</td></tr> <tr><td>• Tools &amp; equipment</td><td>Treas. Reg. 1.471-11(c)(2)(i)(g)</td></tr> <tr><td>• Quality Control</td><td>Treas. Reg. 1.471-11(c)(2)(i)(h)</td></tr> </table> <p>B. <u>Category II Costs – Treas. 1.471-11(c)(2)(ii)</u></p> <table style="width: 100%; border: none;"> <tr><td style="width: 50%;">• Marketing Expenses</td><td style="width: 50%;">Treas. Reg. 1.471-11(c)(2)(ii)(a)</td></tr> <tr><td>• Advertising expenses</td><td>Treas. Reg. 1.471-11(c)(2)(ii)(b)</td></tr> <tr><td>• Selling expenses</td><td>Treas. Reg. 1.471-11(c)(2)(ii)(c)</td></tr> <tr><td>• Other distribution expense</td><td>Treas. Reg. 1.471-11(c)(2)(ii)(d)</td></tr> <tr><td>• Interest</td><td>Treas. Reg. 1.471-11(c)(2)(ii)(e)</td></tr> <tr><td>• Research/Experimental expenses</td><td>Treas. Reg. 1.471-11(c)(2)(ii)(f)</td></tr> <tr><td>• Losses under § 165</td><td>Treas. Reg. 1.471-11(c)(2)(ii)(g)</td></tr> <tr><td>• Percentage depletion in excess of cost depletion</td><td>Treas. Reg. 1.471-11(c)(2)(ii)(h)</td></tr> <tr><td>• Depreciation and amortization</td><td>Treas. Reg. 1.471-11(c)(2)(ii)(i)</td></tr> <tr><td>• Incomes taxes attributable</td><td>Treas. Reg. 1.471-11(c)(2)(ii)(j)</td></tr> </table>	• Repair expense	Treas. Reg. 1.471-11(c)(2)(i)(a)	• Maintenance	Treas. Reg. 1.471-11(c)(2)(i)(b)	• Utilities	Treas. Reg. 1.471-11(c)(2)(i)(c)	• Rent	Treas. Reg. 1.471-11(c)(2)(i)(d)	• Indirect Labor	Treas. Reg. 1.471-11(c)(2)(i)(e)	• Indirect Materials and Supplies	Treas. Reg. 1.471-11(c)(2)(i)(f)	• Tools & equipment	Treas. Reg. 1.471-11(c)(2)(i)(g)	• Quality Control	Treas. Reg. 1.471-11(c)(2)(i)(h)	• Marketing Expenses	Treas. Reg. 1.471-11(c)(2)(ii)(a)	• Advertising expenses	Treas. Reg. 1.471-11(c)(2)(ii)(b)	• Selling expenses	Treas. Reg. 1.471-11(c)(2)(ii)(c)	• Other distribution expense	Treas. Reg. 1.471-11(c)(2)(ii)(d)	• Interest	Treas. Reg. 1.471-11(c)(2)(ii)(e)	• Research/Experimental expenses	Treas. Reg. 1.471-11(c)(2)(ii)(f)	• Losses under § 165	Treas. Reg. 1.471-11(c)(2)(ii)(g)	• Percentage depletion in excess of cost depletion	Treas. Reg. 1.471-11(c)(2)(ii)(h)	• Depreciation and amortization	Treas. Reg. 1.471-11(c)(2)(ii)(i)	• Incomes taxes attributable	Treas. Reg. 1.471-11(c)(2)(ii)(j)
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• Maintenance	Treas. Reg. 1.471-11(c)(2)(i)(b)																																				
• Utilities	Treas. Reg. 1.471-11(c)(2)(i)(c)																																				
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<sup>1</sup>Linkage to McIntosh

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- to the sale of inventory
- Pension contributions: past services Treas. Reg. 1.471-11(c)(2)(ii)(k)
- Certain general/administrative costs Treas. Reg. 1.471-11(c)(2)(ii)(l)
- Certain salaries paid to officers Treas. Reg. 1.471-11(c)(2)(ii)(m)

C. Category III – Treas. Reg. 1.471-11(c)(2)(iii)

- Taxes/Per § 164 on Manufacturing Assets Treas. Reg. 1.471-11(c)(2)(iii)(a)
- Depreciation/Depletion Treas. Reg. 1.471-11(c)(2)(iii)(b)
- Employee Benefits Treas. Reg. 1.471-11(c)(2)(iii)(c)
- Strike, rework labor, scrap & spoilage Treas. Reg. 1.471-11(c)(2)(iii)(d)
- Factory Admin Expenses Treas. Reg. 1.471-11(c)(2)(iii)(e)
- Officers' Salaries Treas. Reg. 1.471-11(c)(2)(iii)(f)
- Insurance Costs Treas. Reg. 1.471-11(c)(2)(iii)(g)

III. Full Absorption Inventory Capitalization Methods

- Cost Allocated to Goods Treas. Reg. 1.471-11(d)(1)
- Burden Rate Allocations Treas. Reg. 1.471-11(d)(2)(i)
- Developing Burden Rates Treas. Reg. 1.471-11(d)(2)(ii)
- Operation of Burden Rates Treas. Reg. 1.471-11(d)(2)(iii)
- Standard Cost Rates Treas. Reg. 1.471-11(d)(3)(i)
- Treatment of variances Treas. Reg. 1.471-11(d)(3)(ii)

II. IRC § 263A General Provision – Treas. Reg. 1.263A-1(e)(3)(i)

- Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale).
- Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale.
- Indirect costs are properly allocable to property produced or property acquired for resale
  - When the costs directly benefit
  - or
  - Are incurred by reason of the performance of production or resale activities.

II. Reseller General Provision – Treas. Reg. 1.263A-3(c)(1)

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- Generally, § 1.263A-1(e) the types of costs that must be capitalized by taxpayers. Resellers must capitalize the acquisition cost of property acquired for resale, as well as indirect costs described in § 1.263A-1(e)(3) which are properly allocable to property acquired for resale.
- The indirect costs most often incurred by resellers are [purchasing, handling, and storage costs](#). This paragraph (c) provides additional guidance regarding each of these categories of costs.

III: [Costs attributable to purchasing, handling, and storage](#) – Treas. Reg. 1.263A-3(c)(2)

The costs attributable to purchasing, handling, and storage [activities](#) generally consist of :

- Direct and indirect labor costs (including the costs of pension plans and other fringe benefits);
- Occupancy expenses including rent, depreciation, insurance, security, taxes, utilities and maintenance;
- Materials and supplies;
- Rent,
- Maintenance,
- Depreciation, and insurance of vehicles and equipment;
- Tools;
- Telephone;
- Travel; and
- The general and administrative costs that directly benefit or are incurred by reason of the taxpayer's activities.

IV. [Purchasing Costs \(Activities\)](#) – Treas. Reg. 1.263A-3(c)(3)(i)

- Purchasing costs are costs associated with operating a purchasing department or office within a trade or business, including personnel costs (e.g., of buyers, assistant buyers, and clerical workers), relating to—
  - (A) The selection of merchandise;
  - (B) The maintenance of stock assortment and volume;
  - (C) The placement of purchase orders;
  - (D) The establishment and maintenance of vendor contacts; and
  - (E) The comparison and testing of merchandise.



- **Purchasing Activity Determination – Treas. Reg. 1.263A-3(c)(3)(ii)**
  - The determination of whether a person is engaged in purchasing activities is based upon the activities performed by that person and not upon the person's title or job classification.
  - Thus, for example, although an employee's job function may be described in such a way as to indicate activities outside the area of purchasing (e.g., a marketing representative), such activities must be analyzed on the basis of the activities performed by that employee.
  - If a person performs both purchasing and non-purchasing activities, the taxpayer must reasonably allocate the person's labor costs between these activities. For example, a reasonable allocation is one based on the amount of time the person spends on each activity.

V. **Handling Costs (Activities) – Treas. Reg. 1.263A-3(c)(4)(i)**

Handling costs are generally required to be capitalized under § 263A. Along with processing, assembling, repackaging and transportation costs, handling costs include other similar activities, with respect to property acquired for resale, provided the activities do not come within the meaning of the term produce as defined in § 1.263A-2(a)(1)

Handling costs include costs attributable to:

- **Processing costs** – Treas. Reg. 1.263A-3(c)(4)(ii). Processing costs are the costs a reseller incurs in making minor changes or alterations to the nature or form of a product acquired for resale. Minor changes to a product include, for example, monogramming a sweater, altering a pair of pants, and other similar activities.
- **Assembling costs** – Treas. Reg. 1.263A-3(c)(4)(iii). Generally, assembling costs are costs associated with incidental activities that are necessary in readying property for resale (e.g., attaching wheels and handlebars to a bicycle acquired for resale).
- **Repackaging costs** – Treas. Reg. 1.263A-3(c)(4)(iv). Repackaging costs are the costs a taxpayer incurs to package property for sale to its customers.
- **Transportation costs** – Treas. Reg. 1.263A-3(c)(4)(v). Transportation costs are the costs a taxpayer incurs moving or shipping property acquired for resale. These costs include the cost of:

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- Dispatching trucks; loading and unloading shipments; and sorting, tagging, and marking property.
- Transportation costs may consist of depreciation on trucks and equipment and the costs of fuel, insurance, labor, and similar costs. Generally, transportation costs required to be capitalized include costs incurred in transporting property—
  - (B) From one of the taxpayer's storage facilities to another of its storage facilities;
  - (C) From the taxpayer's storage facility to its retail sales facility;
  - (D) From the taxpayer's retail sales facility to its storage facility; and
  - (E) From one of the taxpayer's retail sales facilities to another of its retail sales facilities.

- Under this paragraph (c)(4)(i), however, handling costs incurred at a retail sales facility (as defined in paragraph (c)(5)(ii)(B) of this section) with respect to property sold to retail customers at the facility are not required to be capitalized.
  - Thus, for example, handling costs incurred at a retail sales facility to unload, unpack, mark, and tag goods sold to retail customers at the facility are not required to be capitalized.
  - In addition, handling costs incurred at a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) with respect to property sold to customers from the facility are not required to be capitalized to the extent that the costs are incurred with respect to property sold in on-site sales.

VI. Storage Costs (Activities) – Treas. Reg. 1.263A-3(c)(5)(i) storage costs are capitalized under IRC § 263A to the extent they are attributable to the operation of an off-site storage or warehousing facility (an off-site storage facility).

- However, storage costs attributable to the operation of an on-site storage facility (as defined in paragraph (c)(5)(ii)(A) of this section) are not required to be capitalized under § 263A.
- Storage costs attributable to a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) must be capitalized to the extent that the

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facility's costs are allocable to off-site storage.

VII. Pick and Pack Costs (Activities) - Treas. Reg. 1.263A-3(c)(4)(vi)(C)(1) handling costs incurred inside a storage or warehousing facility must be capitalized.

- However, costs attributable to pick and pack activities inside a storage or warehousing facility are not required to be capitalized.
- Pick and pack activities are activities undertaken in preparation for imminent shipment to a particular customer after the customer has ordered the specific goods in question.
- Treas. Reg. 1.263A-3(c)(4)(C)(1) - Examples of pick and pack activities include:
  - (i) Moving specific goods from a storage location in preparation for shipment to the customer;
  - (ii) Packing or repacking those goods for shipment to the customer; and
  - (iii) Staging those goods for shipment to the customer.
- Activities that are not pick and pack activities but not capitalizable – Treas. Reg. 1.263A-3(c)(4)(vi)(C)(2)(i) – (v).
  - Pick and pack activities do not include:
    - (i) Unloading goods that are received for storage;
    - (ii) Checking the quantity and quality of goods received;
    - (iii) Comparing the quantity of goods received to the amounts ordered and preparing the receiving documents;
    - (iv) Moving the goods to their storage location, e.g., bins, racks, containers, etc.; and
    - (v) Storing the goods.

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