

Precious Privilege in Jeopardy: ATF Re-examines Alternating Proprietorships

Part One



By Sara Schorske
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MORE THAN a decade ago, we had the privilege of helping establish the first shared premises wineries,

more properly known as "alternating proprietorships" (AP's). At the time, we enthusiastically predicted: "In five or ten years from now, we are sure that decision [to allow alternating proprietorships] will prove to have saved the wine industry as we know it—the industry with a large number of small and medium sized brands."

In those early days, we also cautioned each of the small wineries we helped to establish: "Alternating proprietors can expect to be scrutinized for a while, at least until they completely satisfy the regulators (1) that alternating with one or more other proprietors doesn't cause administrative difficulty and (2) the alternating proprietors are operating as bona fide small wineries. If the regulators have serious misgivings about either of these questions, it could cause them to re-evaluate their policies about alternating proprietors in general, or to

question the status of specific proprietors. It is important that this way of operating be viewed by everyone who reviews it as a completely bona fide way of doing business, and not just an easy way to get some important advantages by merely manipulating semantics."

Happily, our first prediction—about the importance of AP's to the growth of the industry—has now come true. The combination of the tax savings provided by the small producer credit, with the reduced set up costs available to wineries that share premises and equipment, has allowed a healthy diversity of small operators to successfully enter the business in the last decade.

But unhappily, we now find ourselves in danger of seeing the second prediction also come true, although it is long after we thought regulatory uncasiness about the AP privilege was well behind us. This article is written to help make sure our old warning DOESN'T come true; this is one case in which we'd rather be remembered as being WRONG!

Why has a shadow fallen over the AP privilege, and what can we do about it? To best understand, let's start at the beginning . . .

The Post-partum Blues of It

The birth of the AP style of doing business wasn't an easy one. We know; we played midwife to the first AP in California. Although the revolutionary rule allowing control of a wine pre-

mises to alternate between permittees was added to the wine regulations in 1990, the provision laid dormant until 1992. Part of the long gestation period was needed to convince state regulators to accept the radical new concept. But surprisingly, federal regulators needed convincing too, even though the enabling regulation was their own, and it simply extended to the wine industry a similar privilege already available to distilled spirits producers.

As it often happens, when government relaxes its regulations and restrictions to promote business, regulators fear that the expanded benefits will be misused. When alternating proprietorships were born, these fears were sharply accentuated by a coincidence of history. In 1990, the same year the new wine regulations were issued, Congress passed a substantial increase in wine excise taxes, and enacted a small producer tax credit at the same time. The purpose of the business-friendly credit was to shelter small wineries from the new, higher excise rates. As fate would have it, the tax benefit introduced a new incentive to operate as a small winery, and simultaneously, the availability of the AP regulation erased most of the traditional start-up expenses of doing so.

Looking from ATF's Shoes at It

All you have to do is think like a regulator for a minute to see the problem. ATF* (see note at end of story) was concerned for a number of reasons. It envisioned AP's established solely for the

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purpose of splitting off part of the production of a single large or medium producer, and allocating it among several of its custom crush customers. Each of the customers, whose wine would formerly have been removed from bond at the producing winery's higher tax rate, could then take advantage of the small producer credit—to Uncle Sam's financial detriment. Regulators were also nervous about the additional record keeping complications necessitated by the alternation of proprietors, fearing that mistakes or sloppiness could result in mislabeling, additional revenue loss, and, of course, more work for ATF Inspectors in untangling it all.

In an article published in 1994 about alternating proprietorships, we described the mood of the times:

"A palpable apprehension surrounded the birth of alternating proprietorships. Government agents feared that every wholesaler in the country might hang out a winery shingle to take advantage of the tax benefits—without good intentions. Compliance Specialists [our company's name at the time] was concerned that the new and unfamiliar

arrangement might strain the record keeping ability of some who tried it. If compliance problems resulted, the regulation would be repealed, or the criteria for approval would be raised sky high. . . ."

In 1994, the regulators were still skeptical, even after two years of approving AP's, and we were still working on building their confidence, by making sure all our AP clients legitimately deserved the privilege they had been granted, and exemplified a high standard of responsibility in their winery operations. Our strategy apparently worked! We reported in our compliance newsletter: "We like to think we get a little credit for starting them off on the right foot but, in reality, the alternating proprietors themselves are doing an exceptional job keeping on top of the requirements on their own steam. They realize that the government has given them some trust, and they are taking special care not to abuse it."

Today, however, the struggle to establish the credibility of the AP method of operating has faded from the industry's memory, and that special care invested to validate the privilege

has also faded. Now, what was once a treasured and protected opportunity has become taken for granted. Understandably, regulatory confidence in the privilege has been shaken.

Misuse It and Lose It

Over time, the industry seems to have forgotten that being an alternating winery is inherently different from being a custom crush client. An alternating proprietor is a separate winery in every sense of the word EXCEPT having its own "bricks and mortar." Clearly, the proprietor must exercise control over its winemaking process and act in every way as an independent producer. Although alternators share space and equipment with the host winery, and almost always rely on the host's cellar workers to perform wine movements, each winery must ferment wine in their own premises each year, maintain separate records of all winery operations, and accept full responsibility for winemaking decisions, standards, and results.

However, some of the alternating proprietors established in recent years seem to be unclear about these concepts. Perhaps the new breed of AP's rely too heavily on the host winery, not only to handle certain services for them, but also to "understand it all" for them. Even ATF has unwittingly contributed to the problem, by sometimes approving premises and arrangements that failed to insure each winery would act as a separate permittee. Not surprisingly, many in the industry have taken advantage of the agency's permissiveness.

Finally, the results of this laxity have taken a toll on regulatory confidence, and change is in the wind. The stricter requirements we feared might be imposed ten years ago may now be just around the corner.

Regulators Accuse It

At every industry seminar we have attended in the last year, every ATF speaker has voiced the agency's concerns about AP's and the potential for abuse of the small producer tax credit by alternators. In addition, we have noticed that during the licensing process for new AP's, ATF inspectors are beginning to ask our clients tough and pointed questions about their proposed operations, to determine if each of them is really going to act as a winery or just be a custom crush client.

As this article is written, ATF has been circulating for informal comment



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a draft Industry Circular announcing stricter policies on qualification of AP's and ATF's intention to review and clarify the application of the small producer's wine tax credit. By the time this column appears, ATF may have issued the final version of the Industry Circular.

In its draft document, ATF raised three questions or concerns. The first question is whether a prospective alternating proprietor really needs to qualify as a wine producer. For example, ATF notes that many applicants for an AP winery had been custom crush customers at the host winery premises, and there appears to have been no substantial change in the arrangements between the owner of the wine premises and the applicant. ATF notes that in some cases, the proposed alternating proprietor doesn't even have access to the wine premises, and all production will be done by employees of the host winery.

The second question is whether the proposed alternating proprietor is legitimately eligible for the small producer tax credit, noting that some applications for AP's appear to be merely attempts to split production of one proprietor among several businesses—the same concern we described earlier.

The third question is whether the physical premises are suitable for sharing, and whether both proprietors understand the importance of keeping their respective wine separated and identified. The draft circular notes that difficulties have arisen from "poorly defined physical and record keeping separation of operations."

Clues How Not to Confuse It

ATF's third point is certainly a valid one. Alternating proprietor arrangements and operations often look so much like custom crush situations that the two seem indistinguishable—even to the employees of the host winery who are dragging the hoses. Although many alternators have their own winemaker, very few employ their own "cellar rats" or record keeping staff, so these essential functions are fulfilled by host winery personnel—just as they would be if the host winery were providing custom crush services. But an alternating proprietorship arrangement is a collaboration of independent wineries, each with separate records and sovereign responsibility for its own winemaking prac-

tices. To actually implement this crucial difference, the personnel working in the wine premises need cues to remind them that they are working for two or more wineries.

The maintenance of physical barriers or separations between the various AP operations is one way to insure that the personnel understand these distinctions and the delineations of the various premises. While in the past regulators may have allowed the separations and segregation of the premises to be shown only on premise diagrams, we have now seen a return to the concept that the barriers between distinct areas must be substantial enough to differentiate the various premises. Given the complexity of AP's this may be the best way to deal with the fact that human beings need physical reminders that they have moved from one "premise" to another.

How to know "What Is Whose" in It

Placards are also essential to prevent confusion. Remember that many areas in the winery building alternate between the control of the various alternating proprietors involved. Who's to

know who's in charge, without a sign? So, in addition to barriers and physical separations, when the alternator temporarily "takes over" control of an alternating area—such as a bottling room or outdoor area where a mobile bottling line parks, any tanks in which its wine is placed, or alternating barrel work areas—the area under the alternator's control must be readily identified by placards showing its bonded winery registry number (BW#).

More Don'ts and Do's for It

Also, it is essential for everyone involved to think, speak, and act very clearly and consistently about the alternator as an independent winery—especially when the alternator used to be a custom crush client—to help prevent otherwise inevitable confusion in the cellar. In order to clearly demonstrate that they are operating as bona fide wineries—not just doing the minimum to get the tax credit—we have always recommended to our clients that each AP winery maximize its use of its alternating privileges by actually bottling under its own permit, storing bulk wines in its own premises, and

when possible, making taxable removals from their own premises.

Finally, we always advise alternators to structure their legal contracts and fee agreements differently than for custom crush situations. For example, most custom crush contracts clearly make the larger winery responsible for winemaking and wine quality. Also, custom crush customers usually pay by the gallon or case, and never see an itemized bill of services and expenses. It is more appropriate for a separate alternating winery to pay directly for its floor space, equipment use, personnel time, and materials consumed. Granted, such predictable costs may be reducible to a standard per gallon or per case charge in standard situations, but to simply apply the same rate structure to alternators as to custom crush clients is an ill-advised short-cut, in our opinion, and is certainly liable to raise regulators' suspicions.

Eliminating the Boos for It

We feel strongly, as much as we did a decade ago, that every existing or prospective alternating proprietor owes it to himself and to the industry to do it right. Do not abuse the privilege by obtaining winery status while continuing to operate as a custom crush customer in all essential regards. Do not misuse the privilege through fuzzy thinking, sloppy records, and inadequate attention to regulatory requirements. Not only could your permit be in jeopardy, which is bad enough, but the entire industry could suffer if access to this important method of operating gets restricted or operating requirements are tightened to the point where they are prohibitively difficult.

In the second article in this series on alternating proprietorships, we will give you more details about exactly how to "do it right." ❀

**Note: As you know, the Bureau of Alcohol, Tobacco and Firearms (ATF) has now been split into two agencies. The name "ATF" now properly belongs to the branch that was transferred to the Justice Department and will focus on regulating firearms and explosives. The successor agency that now supervises wineries, which has remained under the jurisdiction of the Department of the Treasury, is called the Alcohol and Tobacco Tax and Trade Bureau, or "TTB." However, to keep things simple, we refer to the federal wine regulatory agency by its historic name of "ATF" in this article.*