

Refresher Course on Wine Taxes



By Sara Schorske

WHEN YOU'RE busy making wine or fighting for shelf space, you may easily fail to notice how many new wineries are still being established. Certainly, the practice of two distinct wineries sharing space and equipment, which has become very popular since it was first allowed in 1989, has drastically reduced the cost of entering the industry. It has also flooded the industry with inexperienced proprietors who rely on others to handle their record keeping for them, or teach them the minimal knowledge they need to manage. No wonder an ATF inspector recently complained that many small winery owners don't understand the small producer credit.

It has now been over seven years since Congress increased wine excise taxes more than 600 percent, and simultaneously established the small producer's credit. Initially, the credit was seen as controversial—and many people, myself included, expected it to be repealed after a few years. But experience has proved the pessimists wrong; the small producer's credit appears to be here to stay. And it is such an important factor in the economics of the small or startup winery that it behooves every proprietor to understand its basics.

Tax Basics

The federal excise tax on table wine

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is currently \$1.07/gallon (\$2.54/case). However, qualifying small wineries are entitled to a credit that reduces their tax payments by up to \$0.90/gallon on the first 100,000 gallons of wine they remove from bond each year. This brings the effective tax rate back to the pre-1991 levels of \$0.17/gallon or \$0.40/case.

This tax saving is a significant pricing advantage for new and small wineries when you consider that every increment of pricing is doubled by the

time the wine reaches the consumer. It also significantly reduces the size of the required winery bond. If the small producer credit were not available, I am convinced that many small wineries would be forced out of business by the inability to get sufficient bond coverage.

Production Thresholds

Wineries producing in excess of 250,000 gallons are considered 'large producers' not eligible for the credit.



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Wineries producing 150,999.9 gallons or less in a given year are entitled to a \$0.90 credit on the first 100,000 gallons of still wine they taxably remove from bond during that year. Wineries producing between 151,000 and 249,999.9 gallons are still entitled to a tax credit on the first 100,000 gallons of wine removed, but they must reduce their credit in proportion to their production. All producers must pay the full excise tax rate for any still wine removed after the first 100,000 gallons.

Controlled Groups

Under the federal tax law, two or more wineries with more than 50% common ownership are considered a controlled group, even if some members are located outside of the U.S. Thus, controlled groups are considered one winery for tax purposes, and their production and removals are added together to determine their eligibility for the credit, and also to calculate its amount. BATF adds the

production of the foreign winery or wineries to the production of the domestic winery or wineries for purposes of the credit. There is only one exception to this rule: if the foreign corporation is subject to tax under Section 881 of the Internal Revenue Code, it is excluded from the controlled group. I will leave it to your accountant to explain the implications of this exception and if it applies to you.

Mid-Year Acquisitions

When the small producer credit was first established, many of its ramifications were unclear or undreamed of. Regulation and policy have evolved as real life circumstances arose. In the Fall of 1992, the BATF answered a question crucial to many winery purchasers: when one small winery purchases another during the calendar year, will the wineries be considered a controlled group for the entire year?

Applying precedents from other tax cases involving statutory exceptions

to the definition of controlled groups, the BATF determined that the answer would differ depending upon the date of acquisition. The BATF decided the wineries would be treated as separate entities for the entire year for purposes of the credit if the acquisition takes place during the last half of the year. However, if one winery acquires another during the first half of the year, the two wineries will be considered a controlled group for the entire year and their production and removals must be added together for purposes of the credit. Because both the removals and production of the two wineries must be added together, this could have the unpleasant effect of retroactively reducing or eliminating some or all of the small producer credit that has already been taken by one or both wineries. It could also cause an immediate and steep increase in the bond requirements for both wineries.

Taking the Credit

The credit is available only to eligible proprietors engaged in wine production operations during the current calendar year. BATF's definition of 'production activities' includes primary fermentation, secondary fermentation (sparkling wine production), sweetening, wine spirits addition and the blending of a formula wine.

Wineries must not only produce in each calendar year, but they must also report production during the year on monthly reports. Even if fermentation is completed, BATF does not recognize production until wine is reported 'produced' on the front of Form 702.

Because wineries generally do not produce a new vintage until the third or fourth quarter of each calendar year, BATF allows proprietors of bonded wine premises which produced wine and were eligible for the wine credit in prior years to take the wine credit from the beginning of a new calendar year based on estimated production. Taxes are then adjusted up or down (if necessary) when actual production levels are determined. Very small wineries are relatively safe from the gut wrenching experience of retroactively recalculating their taxes for an entire year. But wineries whose annual production is near 150,000 gallons will see their tax burden more than double if they increase their production just 20,000 gallons.

In addition, any small winery may retroactively lose its small producer's



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credit for any calendar year in which it does not produce. Previously eligible wineries which take the credit during a calendar year based on anticipated production, but then fail to produce during that year, are considered to have underpaid their taxes and the balance due for each tax period underpaid (plus interest) must be paid on the next tax return. This could happen due to a reporting oversight, a delay in declaring the new wine past the end of the year, a problem that prevents the winery from crushing at all or a mid-year change of ownership.

I highly recommend that all small producers get themselves 'free insurance' against this unwanted surprise. The way to insure the winery against this risk is to always declare some wine before the end of the year and keep some wine in fermenters until the January following crush. That way, the winery has established its eligibility for the small producer credit for the coming year from the start.

New Permittees

New wineries must produce their first vintage before taking the credit for the first time. This has no serious implications for a winery that has no inventory until it makes its own. These days, many start-up wineries have wine custom crushed for them before their own first harvest. Such wineries are required to calculate their bond coverage and taxable removals at the \$1.07/gallon rate for all wine stored in and removed from their winery prior to production.

The production-under-the-new-permit prerequisite can affect not only new wineries but also, according to BATF interpretation, any existing pro-

prietor who is issued a new permit. This second group includes proprietors who undergo a change in business structure (such as incorporation of a sole proprietorship or partnership), wineries that have a change in 'control' (when an entity which did not have 50% or more of the stock of a corporation acquires 50% or more), and new owners who purchase existing small wineries.

Re-issuance or discontinuance of a winery's permit for any reason before the winery produces in that calendar year results in the old permittee's loss of eligibility for the credit, retroactively to the first of the year! This means that a bona fide small winery which happens to change hands, say in February, has to pay taxes as a large producer until it re-qualifies as a small producer by its own production. Fortunately, BATF regulations allow the new proprietor to apply for a refund once the winery re-qualifies for the credit, but cash flow can feel a severe crimp until then.

If a change of structure, control, or ownership catches you without your 'free insurance' program in place, you can 'produce by sweetening' if faced with a possible loss of the small producer's credit. (The increase in wine inventory caused by adding concentrate counts as production.) While production by sweetening may not be considered sufficient to establish a brand new winery's eligibility for the credit, BATF accepts this solution when an ongoing operation finds itself in a tax bind.

Transfer of Credits

In late 1996, a change in the tax law finally made it possible for commercial wine warehouses to taxpay wine at the customer's rate. Currently, the law

is being enforced through temporary regulations—permanent regulations are due out later this year.

The regulations require that at the time of taxable removal, the following information must be provided to the transferee by the producer, in writing (or by electronic transmission), and the producer and transferee shall each retain a copy with the record of tax-paid removal from bond: (a) the names of the producer and transferee; (b) the quantity and tax class of the wines to be shipped; (c) the date of removal from bond for consumption or sale; (d) a confirmation that the producer is eligible for credit, with the credit rate to which the wines are entitled; and (e) a confirmation that the subject shipment is within the first 100,000 gallons of eligible wine removed by (or on behalf of) the producer for the calendar year.

Production Eligibility

The regulations technically restrict the privilege of tax credit transfer to wine that was owned by its actual producer at the time of removal from bond. However, BATF is still debating how to define 'production' for purposes of transfer of small producer credits.

Under accepted practice, an eligible winery may remove any wine from its own bonded premises with benefit of the small producer tax credit, as long as the wine belongs to the small producer, it is labeled with the small producer's label at the time of removal, and it is within the first 100,000 gallons removed that year. The small winery may have obtained the wine, either in bulk or in bottles, from a producer of any size.

The standard for transferring wine to another bonded premises for removal at the small winery's tax rate will be a little more restrictive. Wine custom produced and bottled for a small producer will not qualify. ATF is still considering the question of whether blending or bottling activities will qualify a wine as 'produced' by the small winery transferee.

Whoever coined the saying, "Only death and taxes are certain" never heard of the small producer credit. There are still some uncertainties about its interpretation and enforcement. Only by keeping current with regulatory changes and reinterpretation in wine taxation can a winery proprietor avoid costly surprises in the area of wine taxation. ❁

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