Tax and Non-Tax Planning for Winery Owners and Investors

ABA Tax Section Joint Fall Meeting
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BUSINESS & REGULATION OF WINE PRODUCTION AND SALES

ABA TAX LAW SECTION
OCTOBER 2019
Agenda

1. **Background on Wine Law**
   - Concurrent Regulation
   - Licensing

2. **Overview of Wine Industry**
   - Grape Growing
   - Winemaking
   - Sales

3. **Federal Excise Tax**
Background & Philosophy: Three Points

**Point 1**
Alcohol is Not Like Any Other Good

**Point 2**
Alcohol has a Peculiar History in the U.S.

**Point 3**
Concurrent State / Federal Power Makes Wine Law Particularly Complex
Background & Philosophy:
Point 1 - Alcohol Differs from Other Goods

Goods Covered in U.S. Constitutional Amendments
“Alcohol occupies a complicated place in this country’s history.” Justice Neil Gorsuch, U.S. Supreme Court, Dissent in TN Wine & Spirits Retailers (2019)

“A nation of drunkards”

- “But by 1830, the average American over fifteen years old consumes nearly seven gallons of pure alcohol a year, three times as much as we drink today. Alcohol abuse, mostly perpetrated by men, wreaks havoc on the lives of many families, and women, with few legal rights or protection, are utterly dependent on their husbands for sustenance and support.”
  – Website for Ken Burns’ Prohibition Documentary
Background & Philosophy:
Point 2 - Peculiar History in the U.S.

Postcard, c. 1910, illustrating the common prohibitionist charge that the brewing industry harmed the American home. PIKE MICROBREWWERY MUSEUM, SEATTLE, WA
“The manufacture, sale or transportation of intoxicating liquors within, the importation thereof into, or the exportation thereof from the United States for beverage purposes is hereby prohibited.”
The transportation or importation into any state territory or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.
Regulatory Structure:
Concurrent Federal & State Power

**Federal Power**

Commerce Clause grants Congress the power to regulate commerce "among the several states."

Dormant Commerce Clause: states cannot discriminate against interstate commerce.

**State Power**

General Police Powers re health and welfare.

PLUS – any powers granted under 21st Amendment
Regulatory Structure: Common Objectives of Alcoholic Beverage Laws Post Prohibition

1. Promote temperance
2. Control vertical and horizontal integration which in Pre-Prohibition era allowed large liquor trusts to monopolize the production and distribution of alcoholic beverages
3. Generate tax revenue
4. Exclude criminals from the industry
5. Encourage local agriculture / economy
Concurrent Federal & State Regulations: Licensing

The federal and state alcoholic beverage licensing systems overlap.

1. Each government has its own permitting and licensing system.
2. **Federal law** only requires licenses (called basic permits) for producers, importers and wholesalers who engage in business in the United States.
   - Retailers not required to hold a federal permit.
3. **State law** generally licenses all three tiers of the alcoholic beverage distribution and sales system: producer/importer, wholesaler and retailer.
4. The licensing system also determines the focus of alcoholic beverage law enforcement.
   - An alcoholic beverage agency’s primary – often exclusive – enforcement mechanism is an action (suspension or revocation) against the license of the person violating the law.
Licensing and Permits: The Specifics Matter

Specific to the person

Specific to the place

Specific to the type of alcoholic beverage

Specific to the type of sale (on-sale or off-sale)

The application process includes qualifying the **person** and the **place** (i.e., **licensed premises**), including criminal record and source of funds.

Because license is specific to the person, transfers of interests in a licensed entity trigger reporting obligations.
Wine Law Overview

Grapes

Wine

Sales
Wine Law Overview

Grapes
- Employment
- Organic Standards

Wine
- Federal Permits
- Employment
- Organic Standards
- Federal Production regs
- TTB Reporting
- FDA Requirements

Sales
- Labeling / Advertising
- Tied-House Laws
- Taxes

Federal
- Employment
- Organic Standards

State
- Employment
- Environmental / Pest Regulations
- Contracts: Grapes sales, vineyard leases
- State Licenses (ABC, CDFA)
- Employment
- State production regs
- State Reporting
- Contracts: AP Agreements, Custom Crush Agreements
- Labeling / Advertising
- Tied-House Laws
- Taxes
- DTC Shipping
- DTR Sales / Shipping
- Contracts: Distribution Agreements

Local
- Zoning / Land Use re Vineyards
- Zoning / Land Use re Winery Facility
- Zoning / Land Use re Tasting Room
Components of Wine Industry

Grapes
Grape Growing: Players

- Vineyard Owner (Landowner)
- Vineyard Manager (Person making farming decisions)
- Vineyard Labor (Boots on the ground)
California winery blames 'smoke taint' from wildfires in canceling Rogue Valley grape contracts
But this new crop is different. In June, Joseph learned that the fungicide she has been spraying on her grapes for decades could be drifting onto the cannabis. Unlike food crops, cannabis can't be sold if there's any trace of fungicide or pesticide in it, according to state law. So while the county investigates, she's using a more expensive and far less effective spray on the grapevines that are nearest to the cannabis farm.
Components of Wine Industry
Wine Making: Process

1. Harvest Grapes
2. Extract Juice
3. Fermentation
4. Pressure
5. Filtration
6. Aging
7. Bottling
8. Consumption
Wine Making: Players

- Vintner / Winery Owner
  - May or may not own any vineyard property
- Winemaker
  - Could be Vintner, could be employee, could be contractor
Wine Making: Issues

- Deciding what federal / state licenses you need to become a winery (or wine supplier) depends on the type of business model you want to adopt.
Licensing and Permits: The Specifics Matter

Specific to the person
Specific to the place
Specific to the type of alcoholic beverage
Specific to the type of sale (on-sale or off-sale)

The application process includes qualifying the person and the place (i.e., licensed premises), including criminal record and source of funds.

Because license is specific to the person, transfers of interests in a licensed entity trigger reporting obligations.
## “Winery” Business Models

<table>
<thead>
<tr>
<th>Model</th>
<th>CA License</th>
<th>Federal Permit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stand Alone Winery</td>
<td>Type 02 (winegrower)</td>
<td>Basic Permit; Bonded Winery</td>
</tr>
<tr>
<td>Alternating Proprietor</td>
<td>Type 02 (winegrower)</td>
<td>Basic Permit; Bonded Winery</td>
</tr>
<tr>
<td>“Virtual Winery” / Custom Crush Client (Typical)</td>
<td>Type 17/20 (wholesale / retail)</td>
<td>Wholesaler’s Permit</td>
</tr>
</tbody>
</table>
Stand Alone Winery

- Winery A leases or owns facility
- Winery A holds CA Type 02 License / Federal Bonded Winery Permit
- Winery A crushes, ferments, bottles its own grapes (grown or purchased) to make its own wine for it to sell at wholesale or retail
AP Arrangement

Alternating Proprietorship: Two or more wineries (each holding their own bond) enter into an AP agreement that permits “alternate” use of shared space and equipment.

- Winery A leases space and use of equipment to Winery X and Y.
- Parties rotate use of “alternating premises.”
- Each winery makes its own wine in the alternating premises under its own bond.
## AP Arrangements

<table>
<thead>
<tr>
<th>Alternating Proprietor Agreements</th>
<th>Parties to Agreement</th>
<th>Nature of Agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Host Winery:</strong> Entity that owns or holds lease to a facility, holds federal &amp; state permits.</td>
<td>Sublease relationship Services agreement (if host provides any services to AP tenant)</td>
</tr>
<tr>
<td></td>
<td><strong>Alternating Proprietor:</strong> Winery that holds its own fed &amp; state permits to produce wine under its own bond at Winery A's facility.</td>
<td></td>
</tr>
</tbody>
</table>
Custom Crush Arrangement

- Winery A leases or owns facility
- Winery A holds Type 02 License / Bonded Winery Permit
- Winery A offers custom crush services to clients (such as a Type 17/20) based on Custom Crush Agreement
# Custom Crush Arrangements

<table>
<thead>
<tr>
<th>Parties to Agreement</th>
<th>Nature of Agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Custom Crush Agreements</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Winery:</strong> The entity licensed to produce wine at the facility (Service Provider).</td>
<td>Services Agreement</td>
</tr>
<tr>
<td><strong>Custom Crush Client:</strong> Third party wishing to have its grapes made into wine by Winery at Winery’s facility.</td>
<td></td>
</tr>
</tbody>
</table>
## Privileges of Different Business Models

<table>
<thead>
<tr>
<th>Type</th>
<th>Wine Production?</th>
<th>Tasting Room?</th>
<th>Consumer Tastings?</th>
<th>DTC Shipping</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type 02 – Winegrower (Incl. APs)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes (45 States)</td>
</tr>
<tr>
<td>Type 17/20 – Wholesale / Limited Retail</td>
<td>No</td>
<td>No</td>
<td>No (except non-profit events)</td>
<td>Yes (limited)</td>
</tr>
<tr>
<td>Type 85 – Special Retail</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes (limited)</td>
</tr>
</tbody>
</table>
Components of Wine Industry
Sales: Issues

- Like any other agricultural product, the key issue for any supplier / producer is “How do I get my product to market?”

- Also, in a crowded market, how do I differentiate my product from my competitors?
Sales: Channels

- Distributor / Wholesaler (in state or out of state)
- Retailer (in state if permitted, out of state (in certain DTR states))
- Direct to Consumer
- Other (Third Party Providers)
- Export market
Entering other state via Three Tier System

Tier 1
CA Winery

Tier 2
CA Distributor

Tier 3
CA Retailer

Tier 1
NY Winery

Tier 2
NY Distributor

Tier 3
NY Retailer
Three Tier System in Practice

Tier 1
Winery

Tier 2
Distributor

Tier 3
Retailer

In limited # of states

In large # of states, pursuant to permit
Components of a Wine Label: Mandatory and Additional Information

- **Brand Name**: Wine producer
- **Special Designation**: Unusual qualities of the wine
- **Wine Type**: Grape variety
- **Vineyard Designation**: 95% of grapes must come from named vineyard
- **Alcohol Content**: Alcohol content by volume
- **Vintage**: Year grapes were harvested
- **Estate Bottled**: 100% of grapes grown, crushed, fermented, finished and bottled on the same property
- **Fanciful Name**: Marketing term used by some wineries to differentiate a brand
- **Appellations of Origin**: Where the wine comes from

Circled component = Required components of wine labeling
# U.S. Appellations of Wine Origin

**U.S. Appellations can be divided into two categories: Political and Petitioned**

## Political
- A country;
- A state;
- A listing of up to 3 contiguous states (multi-state appellation);
- A county; or
- A listing of up to 3 counties (multi-county appellation).
  - 27 C.F.R. 4.25(a)(1)

## Petitioned
- American Viticultural Areas (AVAs)
  - “A recognized delimited grape-growing area having distinguishing features … and a name and a delineated boundary established by TTB…”
- 27 C.F.R. 4.25(e)(1)
# Appellation Labeling Requirements

<table>
<thead>
<tr>
<th>(1) Grape Sourcing</th>
<th>POLITICAL</th>
<th>PETITIONED</th>
</tr>
</thead>
<tbody>
<tr>
<td>75% of grapes from identified area.</td>
<td>27 C.F.R. 4.25(b)(1)(i)</td>
<td>85% of grapes from identified area.</td>
</tr>
<tr>
<td>85% of grapes from identified area.</td>
<td>27 C.F.R. 4.25(e)(3)(ii)</td>
<td></td>
</tr>
</tbody>
</table>

| (2) Place of Production |  | |
|-------------------------|  | |
| - If county, fully finished in state in which county is located. |  | - If single state AVA, fully finished in state in which AVA is located. |
| - If state, fully finished in that state or adjacent state. |  | - If multi-state AVA, fully finished in any of those states. |
Importance of appellations

Grape Pricing Comparison
Prices paid for grapes from different regions can vary dramatically. In the cabernet sauvignon grape pricing chart, we can see that in district four, which is Napa County, the median price of cabernet sauvignon grapes was approximately $4,000 per ton. This can be compared to the median of district 10, which includes the Sierra Nevada Foothills counties such as El Dorado and Amador, where the median price for cabernet grapes was $1,600 per ton.

Recent Federal Excise Tax Changes

Craft Beverage Modernization and Tax Reform Act significantly changed laws governing wine excise taxes.

1. New Tax Rates and ABV Limits
2. Suspension of Small Producer Tax Credit
3. Applicability of New Excise Tax Credit
4. Changes to **Eligibility** for Excise Tax Credit
5. Changes to **Transferability** of Excise Tax Credit
1. New Tax Rates

<table>
<thead>
<tr>
<th>Tax Rate (w/o credit)</th>
<th>Removals prior to 1/1/2018</th>
<th>Removals in 2018/2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1.07</td>
<td>Still wines not more than 14% ABV</td>
<td>Still wines not more than 16% ABV</td>
</tr>
<tr>
<td>$1.57</td>
<td>Still wines more than 14% ABV, but not more than 21% ABV</td>
<td>Still wines more than 16% ABV, but not more than 21% ABV</td>
</tr>
<tr>
<td>$3.15</td>
<td>Still wines more than 21%ABV, but not more than 24% ABV</td>
<td></td>
</tr>
<tr>
<td>$3.30</td>
<td>Artificially Carbonated Wine</td>
<td></td>
</tr>
<tr>
<td>$3.40</td>
<td>Champagne and other sparkling wine</td>
<td></td>
</tr>
</tbody>
</table>
2. Small Producer Tax Credit

Small Producer Tax Credit

- Applicable to removals prior to 1/1/2018, and on and after 1/1/2020
- Wineries Eligible: only those that produce 250,000 gallons or less in a calendar year.
- Amount of Credit: 90 cents per gallon on 1st 100K gallons removed; Credit reduced by 1% for each 1,000 gallons produced over 150K in calendar year.
- Eligible Wines: Wines other than sparkling wine/champagne, “produced at qualified facility.”
NEW EXCISE TAX CREDIT

• Wines removed in 2018 or 2019

• Wineries Eligible: All wineries, regardless of production level.

• Amount of Credit:
  – $1 per gallon on the first 30K gallons;
  – 90 cents per wine gallon on the next 100K gallons; and
  – 53.5 cents per wine gallon on next 620,000 wine gallons.

• Eligible Wines: All wines removed from bond, including sparkling wine/champagne, produced by the winery claiming the credit and removed from that winery’s bond.
4. Eligible Wine

Per TTB:

“Wine eligible for the new tax credits must be produced by the producer and removed by that producer.”
4. Eligible Wine

Under Small Producer Tax Credit (removals prior to 1/1/2018)

If Winery A is a small producer and actually produced wine at its own facility in year of removal, Winery A could claim SPTC on eligible wine produced at another facility for Winery A and removed directly from Winery A’s bond.
Winery A cannot claim excise tax credit on wines that were made for it at Custom Crush Winery.

Removed from Bond
What constitutes **production**?
- Wine produced by fermentation.
- Wine that has undergone the following activities at winery’s facility:
  a. Sweetening
  b. Addition of wine spirits
  c. Amelioration
  d. Production of formula wine
  e. Turning bulk wine produced at another facility into sparkling or artificially carbonated wine.
4. Eligible Wine

What does not constitute production?

• Bottling of bulk wine
• Blending

a. If winery blends wine it produced with wine produced by another winery and removes that wine from its bond, it may claim the new excise tax credit only on the portion of wine it produced and not on the portion produced by the other winery.
5. Transferability of Credit

Under Small Producer Tax Credit (removals prior to 1/1/2018)

• If its a small producer, Winery A can transfer wine produced at Winery A to a Bonded Warehouse in bond and transfer its SPTC to Bonded Warehouse.
• Warehouse could claim credit upon removal from its bond.
5. Transferability of Credit

Under New Excise Tax Credit (removals in 2018/2019)

• New excise tax credit only applies if tax is paid when the wine is removed from producing Winery’s own bond.

• New excise tax is not transferable.
Estate and Business Succession Planning for Winery and Vineyard Owners

Presenter: Lauren A. Galbraith, Esq.
Common Pitfalls to Avoid

• Lack of capable new leaders
• Disagreement regarding direction of business
• Liquidity crunch
• Sale below optimized value
• Reassessment for California property tax purposes
Planning Overview

- Basic estate planning
- Transfer restrictions in entity governing documents
- Planning to minimize and defer estate tax
- Other legal and non-legal topics:
  - Management structure
  - Talent recruitment and development
  - Education in technique and tradition
  - Leadership transition
  - Conflict resolution
Motivation for Basic Estate Planning

- Avoid Disruption to Business
- Avoid Probate
- Achieve Personal Creditor Protection for Beneficiaries
- Benefit Multiple Generations
- Distribute Family Business in Tailored Manner
Estate Tax Strategies

- **Reduce tax:**
  - Wealth transfer during life
  - Valuation discounts
  - Conservation easements
  - Section 2032A special use valuation

- **Defer tax:**
  - Transfers to spouse
  - Section 6166 deferral
Wealth Transfer During Life

- **Why not wait until death?**
  - Remove future appreciation from estate
  - Exemption amount may shrink
  - Leveraged gifts
  - Discounts for fractional interests
  - Pay income taxes of “grantor trusts”

- **But..**
  - Avoid jeopardizing lifestyle
  - Foregone basis adjustment
Valuation Discounts

2016

• **August 2016**: Proposed 2704 Regulations raise concerns that discounts will be severely curtailed
• **December 2016**: Hearing and comments

2017

• **April 2017**: Executive Order directs Treasury to identify Tax Regulations issued January 1, 2016 or later which impose undue financial burden on U.S. taxpayers, add undue complexity, or exceed IRS statutory authority
• **June 2017**: Proposed 2704 Regulations identified as such
• **October 2017**: Proposed 2704 Regulations withdrawn
Conservation Easements

• **What is it?** Legal agreement between a landowner and a land trust or government agency that permanently limits uses of the land in order to protect its conservation values.

• For example, restriction on ability to develop property or engage in farming; runs with the land.

• Landowner qualifies for charitable income tax deduction for difference between value “at highest and best use” and value once encumbered by easement; possible state income tax credit.
Conservation Easements (cont’d)

- **Estate Tax Savings**: (1) value of land is reduced due to easement; (2) estate tax exclusion of up to 40% of encumbered value of land protected by a “qualified” conservation easement, capped at $500,000, § 2031(c)

- **Careful Drafting and Execution Required**
  - Easement must comply with state and federal law
  - Must be in perpetuity
  - Requires appraisal from a qualified appraiser
  - Requires contemporaneous acknowledgement from donee
Special Use Valuation

• §2032A: May be able to utilize special valuation method to reduce value of farmland for estate tax purposes if certain technical requirements are met:
  • U.S. citizen or resident
  • “Qualified use” and “Qualified heir”
  • Satisfy 50 percent test
  • Satisfy 25 percent test for 5 of past 8 years
• Relevant only if current use is not “highest and best use”
• Reduction in value may not exceed $1,160,000
• Recapture if interest is disposed of within 10 years
Deferral of Payment of Estate Tax

• §6166: May be able to defer payment of estate tax attributable to interest in closely held business, and pay in installments, if certain technical requirements are met:
  • U.S. citizen or resident
  • 45 or fewer shareholders or partners, or decedent owned in excess of 20% voting stock or capital interest
  • Carrying on a trade or business – not passive
  • Satisfy 35 percent test
  • Election made on timely-filed return
Deferral of Payment of Estate Tax (cont’d)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Estate</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Debts and Expenses</td>
<td>($2,000,000)</td>
</tr>
<tr>
<td>Adjusted Gross Estate</td>
<td>$18,000,000</td>
</tr>
<tr>
<td>Family Business</td>
<td>$6,500,000</td>
</tr>
<tr>
<td>Qualifies: 36.1%</td>
<td>($6.5M/$18M)</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
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<tbody>
<tr>
<td>Gross Estate</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Debts and Expenses</td>
<td>($500,000)</td>
</tr>
<tr>
<td>Adjusted Gross Estate</td>
<td>$19,500,000</td>
</tr>
<tr>
<td>Family Business</td>
<td>$6,750,000</td>
</tr>
<tr>
<td>Does Not Qualify: 34.6%</td>
<td>($6.75M/$19.5M)</td>
</tr>
</tbody>
</table>
Deferral of Payment of Estate Tax (cont’d)

• **Nature of Deferral**
  - 4 annual payments of interest only
  - Followed by 10 annual payments of principal and interest

• **Interest Rate**
  - 2% for first $1,550,000 of business value
  - 45% of underpayment rate (currently, 5%) (so, 2.25%) for balance

• **Loss of Deferral**
  - Distribution, sale, exchange or other disposition of 50% or more of decedent’s interest in business
  - Failure to make a payment within 6 months of due date
Calculation of Deferred Amount

- $36,400,000 Adjusted Gross Estate
- $25,000,000 Family Business
  - Satisfies 35% test: 68.68% ($25M/$36.4M)
- $10,000,000 Estate Tax Due
  - Equals ($36.4M less $11.4M exemption) x 40%
- $3,132,000 Due Immediately
- $6,868,000 Subject to Deferral
  - Equals ($10M x 68.68%)
  - 4 Annual Payments of roughly $155,000
  - 10 Annual Payments of $700,000 - $850,000
  - Total Amount of Installments: $8,337,000
Basics of California Property Tax

General Principles

- Annual tax equal to 1% of “base year value” plus special assessments
- Base year value = purchase price + improvements + annual increases
- Increases limited to 2% annually, until reassessment
- Property is reassessed (i.e., reset to fair market value), when it is transferred; more specifically, upon “change in ownership” or “change in control”

Certain Exceptions to Reassessment

- Transfers to spouse
- Transfers to children of primary residence and additional $1 million
- Transfers to legal entities in proportion to ownership interests
Contact Information

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