BURR ALERT 2018

Toasting Tax Reform's Impact on Brewers, Vintners, Distillers and Distributors

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In addition to the more publicized portions of the recent tax legislation, certain provisions also positively impact your favorite local craft brew, regional small batch wine or even a locally distilled alcoholic beverage. While the producers of craft beverages receive extra relief with the enactment of the Tax Cuts and Jobs Act of 2017 (the "TCJA"), others in the industry are discovering that some changes negatively impact the way they historically conducted business. The following is a brief overview of the provisions of the TCJA which impact brewers, vintners, distillers and their distributors.

A Brief Summary of the TCJA Provisions Affecting All Businesses

Many businesses hold the opinion that tax reform is mostly a positive development for the U.S. economy and thus U.S. businesses. While certain expenses may no longer be deductible, most corporations are willing to trade the loss of those deductions in exchange for a maximum corporate tax rate of 21% (down from 35%). If the business is a *pass-through* tax entity (where the tax on business income is paid by the owners and not the operating company), trading the loss of deductions in exchange for a reduction in the effective Federal income tax rate imposed on the business income of approximately 10% to 12% (from a maximum rate of nearly 40% to something closer to 30%, perhaps even less) is likewise seen as quite favorable. Most of the rate reduction for pass-through entities is a result of the new 20% qualified business income deduction. Before even considering those provisions of the TCJA specifically targeting craft brewers, small vintners and artisan distillers, the good news is the alcohol beverage industry benefits just like other businesses from the tax rate reductions.

Industry Specific Tax Reform

With respect to producers of craft beers, wine and distilled spirits, the TCJA addresses complaints voiced by industry trade associations by lowering the excise taxes levied on the production of beer and other beverages containing alcohol. Excise tax relief is not the only extra tax benefit included in the TCJA for small producers of beer, wine or distilled spirits. These taxpayers benefit from a change in accounting methods for such producers. As of January 1st and so long as the fermentation process takes less than two (2) years, producers of beer, wine and distilled spirits are no longer required to capitalize certain interest payments into their inventory. Prior law effectively delayed the deduction of such interest until the sale of the product. Accordingly,whether the taxpayer is a craft brewery, a family winery or an artisan distiller and if the fermentation process for their product is less than two (2) years, the prior rules which required the allocation of certain interest costs to the product being sold (usually referred to as the "UNICAP rules" or IRC Section 263A), no longer apply. This change allows the producers of such beverages to currently deduct such costs (subject, of course, to any other limitation(s) which might apply) instead of waiting until the sale of the beverage.

Federal Excise Tax Rate Reductions Under TCJA

Further, the TCJA also significantly reduces the amount of the Federal excise tax due from certain producers and importers of beer, wine and distilled spirits.

a) **The Excise Tax Rate on Beer**. The excise tax obligation resulting from the production of beer arises once beer is produced. However, the tax is not payable until the product is removed from the brewery for consumption or sale. There are a few exceptions to this rule with the primary exception that beer can be and often is transferred between commonly owned breweries which does not trigger the excise tax. Prior to the enactment of the new law, the excise tax rate on beer was $18 per barrel (with a reduced rate of $7 per barrel applying to small domestic brewers (i.e., those producing less than 2 million barrels annually), on the first 60,000 barrels of beer produced and sold. The TCJA lowers the Federal excise tax rate on beer to $16 per barrel for the first 6 million barrels brewed or imported with that rate applied and apportioned at a controlled group level. Beer brewed or imported in excess of 6 million barrels continues to be taxed at a rate of $18 per barrel. For small brewers (producing not more than 2 million barrels annually), the excise tax rate is only $3.50 per barrel on the first 60,000 barrels of domestically produced product. With regard to importers, the reduced tax rate is assignable by the brewer to the importer pursuant to rules set forth by Treasury (the Alcohol and Tobacco Tax and Trade Bureau; the "TTB"), HHS and Homeland Security. Please take note, this reduced rate is temporary as it sunsets on December 31, 2019.

b) **The Tax-Free Transfers of Beer Between Bonded Facilities**. As noted above, it is not uncommon for brewers to transfer beer between commonly owned breweries and, because the transfer is not one for consumption or sale, payment of the excise tax is not required. The TCJA relaxes the shared ownership requirement of Section 5414 even further. The new *shared ownership* requirements are as follows: (i) the breweries are owned by the same person; (ii) one brewery owns a controlling interest in the other; (iii) the same person or persons hold a controlling interest in both breweries; or (iv) the proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the beer so transferred while the transferee formally accepts responsibility for the payment of tax. This provision also sunsets on December 31, 2019

c) **The Excise Tax on Certain Wines is Reduced**. The amount of the excise tax imposed by prior law for wine differed based on two factors: (i) alcohol content; and (ii) carbonation. While still true, the new law changes the tiers. Like beer, the excise tax on wine arises when wine is produced. However, excise tax is not due and payable until the wine moves from a bonded wine cellar, winery or warehouse for consumption or sale. Rules similar to the common ownership transfers for beer also apply. Previously, wineries with an aggregate annual production not exceeding 250,000 gallons were exclusively entitled to a credit against the wine excise tax (credit of $.90 per gallon). The new law expands the credit to ***all*** wine producers and importers by removing the 250,000 gallon limitation. Additionally, the credit now applies to sparkling wine products as well. Finally, the new law changes the amount of credit. The credit now starts at $1 per gallon of wine for the first 30,000 gallons, reducing to 90 cents per gallon on the next 100,000 gallons of wine produced, and further reducing to 53.5 cents per gallon on the next 620,000 gallons of wine produced. If wine produced outside of the United States (similar to the discussion above regarding the production of beer) is imported, the excise tax credit is assignable by the person who produces the wine to the importer if that assignment meets the requirements established by the TTB, HHS and Homeland Security. This provision also sunsets on December 31, 2019.

d) **Further Reducing the Excise Tax on Wine**. The TCJA further modifies the treatment of certain wines by increasing the alcohol-by-volume level of the first two tiers of the wine production excise tax. This change effectively reduces the per gallon rate of the tax. For example, as long as the alcohol-by-volume level of a certain wine is 16% or less, the resulting excise tax is calculated at the lowest rate (currently $1.07 per gallon).

e) **The Definition of Mead and Low Alcohol-by-Volume Wine**. The new law treatment of mead and certain sparkling wines results in tax on these beverages at the lowest rate applicable to traditional wines. Additionally, the new law provides specific definitions associated with the terms *mead* and *sparkling wine.* This tax reduction also sunsets on December 31, 2019.

f) **The Excise Tax Rate on Certain Distilled Spirits is Reduced**. The TCJA changes the excise tax applicable to distilled spirits by creating a new tiered rate structure. This change results in an excise tax rate of $2.70 per proof gallon on the first 100,000 proof gallons of distilled spirits, $13.34 for all proof gallons in excess of 100,000 but below 22,130,000 proof gallons, and $13.50 for all amounts produced or imported in excess of 22,130,000 proof gallons. As with most alcohol-based excise taxes, the rules apply at a controlled group level, and sunset on December 31, 2019.

g) **The Excise Tax on Bulk Distilled Spirits.** Prior to the changes in the law, taxation for distilled spirits was a flat rate of $13.50 per proof gallon. While the tax rate stays the same, the new law allows distillers to more easily transfer product between locations without triggering the payment of the excise tax so long as the product transfers occur "in approved containers other than bulk containers," and the spirits remain subject to bond. Like the other excise tax provisions, this provision also sunsets on December 31, 2019.

A Negative Change for Distributors

While producers of beer, wine and distilled spirits generally benefit from the new law, the same is not true for their supply chain partners, i.e. the distributors which wholesale the products to retailers. Pursuant to the new law, distributors no longer are able to exchange their distribution rights on a tax-free basis as a result of a change to Section 1031 limiting the definition of "like-kind property." Unfortunately beginning January 1, 2018, the non-recognition of gain through the use of like-kind exchanges is limited to exchanges of **real property** held for productive use in a trade or business or for investment; like-kind exchanges of tangible and intangible property (including distribution rights) are no longer eligible for Section 1031 non-recognition treatment.

The Industry Verdict

Overall, it appears that brewers, vintners and distillers of spirits for the most part fare favorably under 2017's tax reform; for distributors, however, the verdict is uncertain as to whether the reduced income tax rates outweigh the loss of like-kind exchange treatment on exchanges of distributorship rights. As always, the usual caveats apply to our discussion of the impact of tax reform on this industry. Any taxpayer should consult with its own tax advisor/professional in order to insure that management properly understands these new rules, their applicability to the particular circumstances of a specific company, and formulates action plans specific to their company's unique circumstances. This is especially true when considering the need to re-evaluate what structure is the most tax effective for any company.

If you would like more information on these proposed regulations, their impact on buy-sell agreements or any other tax matter, please contact:

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