Sharing Less Profits With Your "Partners"; IRS & Others

By Gary Burkel

There is a well-worn saying around Napa and Sonoma County, California, "if you want to make a small fortune in the wine business start with a large one and start a winery". With California vineyards in popular appellations selling anywhere from $60,000 to $300,000 a planted acre it is hard to project profitability when such a large capital investment needs to be recovered. Recently, one Sonoma County based vineyard broker predicted that by 2050 someone will pay $1.million for a vineyard acre in Napa! While we know there are 'lifestyle buyers" that will never get a return on their investment, for the rest of us who struggle, beg, borrow and dream about our business and the capital it consumes, losing money is not an option. Grape growers, winemakers and banks want to get paid on time in cash.

Let's assume you are an entrepreneur and therefore an optimist *(the glass is always half full, right, especially after five o'clock?)* and you will eventually make money. But, to your dismay the "profit" (money) is not in the bank. You ask yourself what's wrong with my bookkeeping, can this be right? Well this is when most business owners really start to distrust the bean counters. So you call your trusted CPA and he starts with a simple question. How much has your inventory increased during the year? To which you respond with an intelligent sounding "uh, not sure". Your CPA then says to check your balance sheet and so begins your love-hate relationship with bookkeeping.

If you have a good accountant and banker who understand the wine business (a rare combination) they will have chatted with you about how to deal with the financing of inventory, equipment, barrels and receivables from customers. This process (called cash flow management) involves an understanding of the difference between profit and cash receipts. Which means you probably should not pay cash for the purchase of assets like inventory, barrels or any asset that does not convert to cash for a couple of years. This is where the large fortune will come in handy, if you have still have it. If you don't, it will probably be the first thing your banker points out to you. Second, he will get into the risks of leverage, collateral, borrowing base and other bank talk, and remind you for the first time (but not the last) that if the bank lends you money they will become your "partner". At this point you are now so happy that you invited your friendly banker to lunch and a bottle of your best wine, right?

Then there is your other "partner", the IRS, who is typically not sympathetic with the poor winery owner who owes them money. So, your plan also needs to address the cash needed for income taxes. An accountant that knows the wine industry will suggest ways to minimize your tax liability by using legal tax planning strategies to minimize Uncle Sam's share. Below is an overview of some of these strategies, if they all sound like "Greek" to you, you need to learn a new language or get a new tax accountant.

Before listing the strategies we need to start with an assumption. This breaks my rule of never assuming anything (if you have children you get this) which is: that you have good bookkeeping records that are designed for the winemaking business. A winery is a manufacturing business, so your chart of accounts should be set up to capture the cost of manufacturing. This is actually a good thing, because our representatives in D.C. tend to favor manufacturing when writing tax law. In the wine industry accounting process, costs are tracked from the farming or purchase of grapes (or juice or bulk wine), through bulk wine inventory, to cased goods, to cost of goods sold (when it is sold). Like any business it makes sense to understand the cost of your product so you know how much you are making (or losing) on each bottle you sell. To state the obvious, if you lose money on every bottle of wine you sell you will not be in business long. Your chart of accounts and financial reports should include accounts like bulk wine inventory, cased goods inventory, grapes payable, facilities costs, cellar and bottling costs.

If your winery financial statements don't include these accounts then forget about strategies for now and start looking for a different bookkeeper. After all, how are you going to plan to make and price your wines if you don't know how much each bottle or case cost to make? If your answer is "I price my wine at what the market will bear "or" I look at my competition", that's good, but what if you are losing money on every bottle you sell? Do you then make it up by increasing volume? That reminds me of the investment manager who when asked by his client, "How long will you be managing my money?" To which he/she responds, "Until you run out!" So, here is the overview of some ideas that wineries use to minimize their tax bite. We will discuss each of them, and others, in more detail in future articles.

1. Can you be on a cash basis for tax purposes? In the beginning there was a little old winemaker who sold enough wine to be in business, which means that individuals other than his family bought his wine. Maybe he/she expects to sell 700 cases this year. Fortunately, for tax purposes small wineries may qualify to use a simplified method of inventory accounting. This method can reduce taxable income and income tax for small profitable wineries.

2. Are your wines made from your estate vineyard? If so, are you using the "single entity" method of accounting for inventory costs? This method essentially allows you to expense the cost of growing your grapes transferred to your winery at the time the costs are incurred instead of when the wine is sold.

3. Are you maximizing deductions on capital expenditures in the vineyard and winery? Proper planning of elections to expense pre-productive period costs of vines and the cost of equipment is essential to maximize the tax benefit of the deduction.

4. If your costs of wine making are increasing every year, the LIFO (last-in-first out) method of valuing inventory should be considered. This method assigns the most recent wine making costs incurred to the wine sold in the current year. The method reduces ending inventory, increases the cost of wine sold, and reduces taxable income.

5. If you are selling wine outside the United States, you should consider establishing an IC-DISC which allows an exporter to defer income tax on a portion of the profit of exported wine.

A famous Tax Court Judge named Learned Hand (seriously) once said, "Anyone may arrange his affairs so that his taxes shall be as low as possible. He is not bound to choose that pattern which best pays the Treasury." I agree with the Judge and work with my winery clients to help them pay the least amount of tax possible.