A Flight of Tax Issues for the Alcohol Industry

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A FLIGHT OF TAX ISSUES FOR THE ALCOHOL INDUSTRY

DASH DEJARNATT

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1 This article was authored prior to the 2017 Tax Reform.
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Alcohol is one of the highest-taxed commodities in the United States. On top of normal income, payroll, and property taxes, among others, alcohol producers ("producers") must pay additional excise taxes at both the state and federal levels. This paper primarily addresses the past, present, and future of alcohol taxation, as a primer for those wishing to learn more about unique tax issues that producers must address. While there are many regulatory twists and turns that are particularly difficult to navigate for the uninitiated, it is important to understand that the vast majority of alcoholic beverage regulations have at least one of two main purposes: tax collection and consumer safety.3

The tax framework for alcohol confuses even seasoned tax professionals. This Article attempts to shed some light on the foundation of alcohol tax issues. The second section, after this first introductory section, provides a brief overview of the historical evolution of alcohol taxation. The third section briefly describes many of the unique and important taxes that producers must take into account. The fourth section briefly suggests improvements to alcohol-tax policies.

II. HISTORY OF ALCOHOL TAXATION

Historically, governments imposed consumption or production taxes on alcohol to generate revenue and to control the production and sale of alcoholic beverages. Regulations governing where inventory may be stored primarily address the issue of when tax liability is owed on a particular good. Laws against home distillation primarily protect the public from bad "hooch" that could result in blindness or other unfortunate side effects. Labeling requirements typically serve both purposes.

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3 For example, regulations governing where inventory may be stored primarily address the issue of when tax liability is owed on a particular good. Laws against home distillation primarily protect the public from bad "hooch" that could result in blindness or other unfortunate side effects. Labeling requirements typically serve both purposes.
taxes as an easy way to generate revenue. High excise tax rates incentivized people to commit tax fraud in order to avoid payment. To address fraud, England imposed licensing and bonding requirements as a form of financial security to guarantee tax payments. Governments have created, abolished, reinstated, increased, decreased, and otherwise modified excise taxes countless times throughout the centuries. While excise taxes were a historically efficient form of tax administration, that efficiency eroded as more progressive forms of taxation, such as the modern iteration of the federal income tax, came into prominence. The following subsections describe the evolution of the excise tax system, particularly as it pertains to alcohol excise taxes.

A. 17th and 18th Century England

The history of the modern alcohol taxation begins well before the founding of our country. Our Imperialist ancestors are to blame. During much of the 1600s, England ran a large trade deficit with France and imposed large tariffs on imported wines, intentionally sheltering domestic producers while they grew to the point that they became an alluring target to tax.\footnote{JOHN V.C. NYE, WAR, WINE, AND TAXES: THE POLITICAL ECONOMY OF ANGLO-FRENCH TRADE, 1689-1900, 46-48 (2007).} The first domestic excise tax regime was authorized in England in May of 1643, in order to support three ongoing wars with the Portuguese, Irish, and English rebels.\footnote{Act of Aug. 3, 1643, reprinted in ACTS AND ORDINANCES OF THE INTERREGNUM 1642-1660 (C.H. Firth & R.S. Rait, eds., London, His Majesty's Stationery Office, 1911), https://www.british-history.ac.uk/no-series/acts-ordinances-interregnum/pp223-241.} This regime levied excise taxes on many goods including beers and ‘‘strong waters.’’\footnote{Act of July 22, 1643, reprinted in ACTS AND ORDINANCES OF THE INTERREGNUM 1642-1660 (C.H. Firth & R.S. Rait, eds., London, His Majesty's Stationery Office, 1911), https://www.british-history.ac.uk/no-series/acts-ordinances-interregnum/pp202-214.} While the Crown permitted merchants of most commodities to pay their excise tax obligations in installments over eight months, producers of alcoholic beverages and most importers paid weekly, up front.\footnote{Id.; Non-alcoholic goods quickly moved to a quarterly system in 1645. See}
and extended excise taxes to domestic cider and perry.\textsuperscript{8}

The late 1600's followed suit:

An initial period of high imports and poor local product, followed by war and urbanization, led to the closing of foreign markets and the rise of professional domestic production. Eventually this expansion of the industry is accompanied by expansive peacetime controls to limit foreign (i.e. French) imports, while local industry is seen as a means of expanding government revenue and regulatory control.\textsuperscript{9}

Problems arose, and by February of 1645, the Crown realized that merchants were creating fraudulent books to reduce their excise tax liability.\textsuperscript{10} Consequently, new punishments were enacted for such acts of fraud.\textsuperscript{11} Fraud grew so out of control, that in September of 1645, the Crown officially required those liable for excise taxes to have a license to remove excisable goods.\textsuperscript{12} The Crown greatly expanded powers of search and seizure to assess these excise taxes.\textsuperscript{13}

The next century of British taxation revealed a paradigm shift. The 18\textsuperscript{th} century, right up until the American Revolution, witnessed

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{9} \textsuperscript{9} Id. at 315-316.
\item \textsuperscript{11} \textit{Id.}
\item \textit{Id.}
\end{enumerate}
\end{footnotesize}
excise taxes grow to an ever greater portion of revenue generation, though never equaling property, income, or wealth taxes.\textsuperscript{14} In 1733, the British mercantile class almost revolted in response to the increasingly burdensome nature of excise taxes and the proposed Excise Act of 1733.\textsuperscript{15}

While the Excise Bill of 1733 was defeated, it established the first time in history where the concept of a bonded warehouse arose, which was eventually enacted in 1803 in England and 1846 in America.\textsuperscript{16} These warehouses enabled merchants to store goods without triggering the excise tax.\textsuperscript{17} This allowed the government to investigate excise violations in centralized locations, while also allowing merchants to bide time for favorable market prices, rather than desperately sell just to raise necessary funds to pay the excise tax.\textsuperscript{18}

Similar waves of anti-excise-tax sentiment arose in the colonies. In the middle of a series of Acts that eventually set the stage for the American Revolution, Parliament enacted the Stamp Act of 1765:\textsuperscript{19} While most remember the Stamp Act as being a tax on newspapers and other paper products like magazines and playing cards, it also imposed a tax on legal documents, such as alcohol licenses.\textsuperscript{20} While the Act was quickly repealed a year later, this tax laid the groundwork for the insurrection that followed.

\section*{B. 18\textsuperscript{th} and 19\textsuperscript{th} Century America}

After the Revolutionary War, the federal government imposed the

\textsuperscript{14} NYE, supra note 3, at 69-70.
\textsuperscript{15} This near-revolt has been coined the “Excise Crisis.” See Historical Outline of Restoration and 18th-Century British Literature, Excise Crisis (1733), https://mason.gmu.edu/~ayadav/historical\%20outline/excise\%20crisis.htm (last visited May 11, 2017).
\textsuperscript{16} Warehousing Act of 1803, 43 Geo. 3 c. 132; \textit{id.} at ch. 84, 9 Stat. 53 (1846). While temporarily repealed in 1861 under the Morrill Tariff Act, the warehousing system was brought back in 1930 under Smoot-Hawley Tariff Act, ch. 497, 46 Stat. 590 (1930).
\textsuperscript{17} \textit{Id.}
\textsuperscript{18} NYE, supra note 3, at 69-70.
\textsuperscript{19} Stamp Act of 1765, 5 Geo. 3 c. 12.
\textsuperscript{20} 1770, 42 Geo. 3.
excise tax on whiskey, which led to the infamous Whiskey Rebellion.\textsuperscript{21} Taxpayers did not use the tax-return system that is used today. As in England, the new American government imposed a stamp-system to collect liquor taxes.\textsuperscript{22} The stamp tax generally required merchants to pay tax at the time of a transaction.\textsuperscript{23} As an alternative to paying the tax immediately, importers of goods such as tea and wine were allowed to initially defer payment for up to two years if they submitted “bonds” valued at twice the excise tax, due as a guaranty of payment.\textsuperscript{24} In contrast, domestic producers had six months to pay their debt upon the bond.\textsuperscript{25} This is the American origin of the bonding requirement, and the ability for alcohol producers to defer taxes.

In 1794, the federal government required domestic alcohol producers to obtain licenses from revenue agents, who stamped the businesses’ paperwork to show that each business was in good standing and all duties had been paid.\textsuperscript{26} The government could not impose an income tax to generate revenue because the Constitution prohibited direct taxes until the 16\textsuperscript{th} Amendment was ratified over a century later.\textsuperscript{27} The Department of the Treasury acquired the initial authority and discretion to create such rules, in order to enforce this Congressional law.\textsuperscript{28}

In 1802, President Thomas Jefferson abolished the domestic excise taxes, including the infamous whiskey tax, amid strong anti-
excise sentiment and relatively low levels of success. President Madison briefly revived the excise tax system, to help pay off debts from the War of 1812, with some minor modifications. After only a short period of time, federal excise duties were not collected again until the Civil War.

The lack of federal excise taxation led to a boom in the alcohol industry before the Civil War. Costs were so low that "previous to 1860[,] a man could undoubtedly get drunk in the United States with [ ] less expenditure of money than in any part of the civilized world." In 1861, the U.S. government needed to raise more funds, and imposed taxes and bonding requirements on imported goods. In 1862, the U.S. government again imposed tax and bonding requirements on various domestic products, including beer and spirits, but not wine.

The domestic excise tax generated greatly varying amounts of revenue year-by-year. Another war predictably brought another wave of excise taxes, after the United States needed to raise additional funds to pay off debts from the Civil War in 1868. The 1868 laws reformed the liquor taxes by reducing the excise tax rate per proof gallon to a point estimated to optimize revenue generation while minimizing incentives for fraud. From 1868 to 1913, aside from increasing rates, the laws stayed relatively static; fraud decreased, and alcohol and tobacco taxes comprised 90% of federal tax revenues.

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30 Act of July 24, 1813, ch. 26, 3 Stat. 42-44.
31 HU, supra note 28, at 35.
32 DAVID AMES WELLS, PRACTICAL ECONOMICS 163 (1885).
33 See Act of 1861, 12 Stat. 178.
35 See HU, supra note 28, at 40.
36 Act of July 20, 1868, Ch. 185, 15 Stat. 125-151.
37 HU, supra note 28, at 44-45.
38 INTERNAL REVENUE SERV., HISTORICAL HIGHLIGHTS OF THE IRS, (2015), https://www.irs.gov/uac/Historical-Highlights-of-the-IRS; HU, supra note 28, at 46-47. Also of note, in 1906, the Denatured Alcohol Act was passed to provide for the tax-free removal of alcohol that was rendered undrinkable by mixing it with
C.20th Century America

The dawn of the 20th century witnessed the first shift to the tax-return system under the new excise tax on corporate income. After the Great War, the United States yet again needed to raise revenues. In response, Congress passed the Revenue Act of 1918, which imposed the American income tax requirement, essentially as we know it today. Like excise tax bonds, income tax bonds were initially required in double the amount of expected tax liability.

Congress made other important modifications to excise taxes before Prohibition. In 1916, the federal government imposed excise tax brackets for wine, based on varying levels of alcohol content by volume. Then, just before the modern income tax arose, the federal government bifurcated the treatment of alcoholic beverages and alcoholic non-beverages. The excise taxes on alcoholic beverages remained in force, though Prohibition banned the sale of liquor, and the tax was, in fact, expanded in order to address fraudulent claims on the lower non-beverage rates. Additionally, the Treasury was authorized to provide civil tax penalties for those who engaged in illegal alcohol activities.

Post-Prohibition, the federal government created a system that would generate revenue, but also discourage diversion into illegal markets, in large part to combat “tied house” economics. In 1934, Congress created the Federal Alcohol Administration, replacing the Federal Alcohol Control Administration. As a separate

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41 See id. at 1059.
44 Hu, supra note 28, at 57-58.
45 Id. at 60.
administrative measure, the government required stamps to be affixed to individual containers of distilled spirits. This provided a simple means for both government agents and consumers to ascertain whether the product was legal, and afforded some assurance that it was not mixed with illegally-produced spirits. Alcohol taxes made virtually no revenue during Prohibition, but went on to account for roughly 3% of federal tax revenue during the Great Depression up until World War II.

The rest of the 20th century saw further development, but little that is notable within the scope of this paper. In 1954, the Treasury allowed alcohol producers to destroy their product and avoid any tax on that product where it would otherwise remain taxed with little offsetting revenue. In 1958, the Internal Revenue Code recodified and restructured the legislative authority for excise taxes. In 1972, the Department of the Treasury reorganized and created the Bureau of Alcohol, Tobacco, and Firearms. In 2002, the Homeland Security Act again reorganized the excise tax collecting function, and placed it with the Alcohol and Tobacco Tax and Trade Bureau.

III. UNIQUE AND IMPORTANT TAX ISSUES FOR THE ALCOHOL INDUSTRY

Producers must pay an additional excise tax based on production levels at both state and federal levels. The industry is so heavily reliant

48 See Hu, supra note 28, at 83.
49 Id.
52 See id. at i.
on goodwill, trade secrets, and patents, in particular, that it is worthwhile to discuss the tax treatment of intellectual property. This section describes the basic principles for alcohol excise tax and intellectual property tax issues.

A. Excise Taxes

1. Federal Excise Taxes

a. Rates, Fees, and Reporting Requirements

The tax base for alcohol excise tax is typically determined by the quantity or volume of products transferred out of bond. In contrast, property taxes are usually based on the value of the property held; income taxes are based on a person’s accrual of wealth; and, sales and use taxes are based on the total price of each sale. For example, excise-tax liability will remain the same on the sale of a gallon of wine, regardless of price, while sales-tax liability will remain the same on a sale at a certain price, regardless of the amount of wine sold.

Many items are subject to federal excise taxes, including tires, gas, and tobacco. Excise taxes are generally considered to be an efficient means of revenue generation, due to the taxed products’ inelasticity and general economic stability. However, alcohol and tobacco are the only industries that are also subject to certain "bonding" requirements at the federal level.

This section will primarily explain the following table of rates and fees. The subsequent text will explain how to use the appropriate tax rate, measuring unit, and resolve other specialized issues for the various categories of alcohol.

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57 Fuel and other commodities are subject to bonding requirements in many states. See, e.g., WASH. REV. CODE § 82.01-82.98 (2016).
Alcohol excise taxes are complex in a variety of ways. First, consider the timing. Excise tax attaches to alcohol as soon as it comes into existence.\(^{58}\) Tax becomes determined once the alcoholic product is withdrawn from bond.\(^{59}\) Product may be removed from bond, without paying tax, in only a few circumstances and when properly documented, such as losses or destructions.\(^{60}\) Tax rates must be determined based on a variety of factors including volume, concentration, and credits for overall production levels. Taxes are generally paid on an excise tax return, either quarterly or bi-monthly, depending on the producer’s expected excise tax liability for the year.\(^{61}\)

\(^{58}\) See e.g., 26 U.S.C. §§ 5001(b) (distilled spirits), 5054(a) (beer), 5041(a) (wine).

\(^{59}\) See id. §§ 5001(b) (distilled spirits), 5054(a) (beer), 5041(a) (wine).


Beer excise taxes are simple. Beer is defined as beer, and other similar fermented beverages of any name or description, containing one-half of one percent or more of alcohol by volume ("ABV"), brewed or produced from malt, wholly or in part, or from any substitute for malt.\(^{62}\) Beer is measured in barrels, which is the equivalent of 31 gallons, where a gallon is equivalent to 231 cubic inches of liquid.\(^{63}\) Beer is taxed at a rate of $18 per barrel at the regular rate.\(^{64}\) For those that produce less than two million barrels per year, the tax rate on the first 60,000 barrels is $7 per barrel, increasing to the regular rate thereafter.\(^{65}\)

Determining the appropriate tax rate for distilled spirits is a little more complex. Distilled spirits are ethyl alcohol, ethanol, or spirits of wine in any form (including all dilutions and mixtures thereof, from whatever source or by whatever process produced); but, not denatured spirits, unless specifically stated.\(^{66}\) Distilled spirits are measured in proof gallons, i.e. gallons of liquid at 60 degrees Fahrenheit, that contain 50 percent by volume of ethyl alcohol, having a specific gravity of 0.7939 as referred to water at 60 degrees Fahrenheit, or the alcoholic equivalent thereof.\(^{67}\) Once the volume has been appropriately determined, the producer is liable for $13.50 per proof gallon, less credits for wine and flavor content.\(^{68}\)

Wine is likely the most complex excise tax to compute, due to the many tax brackets a producer’s line of products may fall in. “Wine” is every kind of product produced on bonded wine premises from grapes, other fruit, or other suitable agricultural products, and containing not more than 24 percent ABV, and not less than one-half of one percent ABV.\(^{69}\) Wine is measured by the gallon, which is 231 cubic inches of liquid.\(^{70}\) There are generally six different tax brackets, each depending

\(^{63}\) See id; 27 C.F.R. § 25.156 (2005).
\(^{65}\) Id. § 5051(a)(2)(A).
\(^{67}\) 7 C.F.R. § 19.1 (2016).
\(^{68}\) 26 U.S.C. §§ 5001, 5010.
\(^{69}\) 27 C.F.R. § 24.10.
\(^{70}\) Id.
on ABV, carbonation levels and processes, and whether the product qualifies as a hard cider.\textsuperscript{71} Five of those brackets are also subject to a $0.90 per gallon tax credit for the first 100,000 gallons, subject to a credit phase out.\textsuperscript{72} Producers commonly have products that fall into multiple tax brackets and each must be accounted for separately.

2. Tax Bonds

Alcohol categories and tax rates directly impact the requisite tax bond. Alcohol producers are categorized in various ways by the federal authorities for the purpose of excise taxation.\textsuperscript{73} Before producers may begin operations, they must obtain the proper licensing from both state and federal authorities.\textsuperscript{74} In order to obtain federal licenses, producers must provide a sufficient bond that insures payment of their federal excise taxes.\textsuperscript{75} Many states have similar requirements.\textsuperscript{76} Bond requirements differ by category of alcohol, and are authorized to varying extents by statutes and regulations.\textsuperscript{77}

The bond requires either the producer to put up sufficient collateral themselves or to persuade a third-party insurer to guarantee all excise taxes on behalf of the producer, should the producer fail to pay the full tax liability to the IRS.\textsuperscript{78} Essentially, it is a bond to pay tax obligations. Generally speaking, there do not appear to be many industries that are similarly treated at the federal level. Tobacco has similar bonding requirements.\textsuperscript{79} In the construction industry, contractors are often required to file a bond with the state that guarantees payment for taxes, but also for wages and breach of contract claims, among others.\textsuperscript{80} Fuel suppliers also require bonding in many

\textsuperscript{71} 26 U.S.C. §5041(b).
\textsuperscript{72} Id. § 5041(c).
\textsuperscript{73} 26 U.S.C. §§ 5002(a)(8) (distilled spirits), 5041 (wine), 5051 (beer) (2012).
\textsuperscript{76} E.g., OR. REV. CODE § 475.155 (2015).
\textsuperscript{77} See infra Part III.A.1.b.i-iv.
\textsuperscript{80} See e.g., WASH. REV. CODE § 18.27.040(1) (2016).
states, but not at the federal level.81 The basic bonding requirements for alcohol sound relatively simple. A producer must determine its total expected tax liability in order to know what level of bond coverage it needs, both per year and by tax period.82 The total tax liability is determined by taking the total volume of wine-gallons, barrels, or proof-gallons83 that may be stored on site at any given time.84 The producer then multiplies the volume in each tax class by the applicable excise tax rates and sums the totals to arrive at a predictive total tax liability.85 The producer uses its predicted yearly gallonage total to determine its tax periods.86 Generally, the producer then determines how much product it will have in inventory during the appropriate tax period, in order to determine the required bond coverage.87 One thing common to all bonds is that they expire and must be renewed every four years after the effective date.88

In the following subsections, this article will describe the particular bonding requirements for producers of the three main categories of alcoholic beverages.

a. Wine Bond

To apply for an application to become a bonded winery, a wine producer must fill out Form 5120.36, which requires the provision of a bond.89 The total "penal sum" for bond coverage includes the wine

81 See id. § 82.38.060.
82 See infra Part III.A.1-3.
84 See supra Part III.A.1.
85 See id.
86 See id.
87 See id.
operations bond and a tax deferral bond.\textsuperscript{90} Wine operations bonds are a minimum of $1,000 and a maximum of $100,000, depending on circumstances.\textsuperscript{91} The bond covers the inventory that a producer has stored at any given time.\textsuperscript{92} The bond can either be covered by a third party or by sufficient collateral.\textsuperscript{93} Tax deferral bonds cover unpaid tax amounts that have been determined, but not paid, up to a maximum penal sum of $250,000.\textsuperscript{94} This is the amount that the winery must have in bond to cover what has been taken out, but not reported, and paid during each semi-monthly or quarterly tax period.\textsuperscript{95} Deferral bonds can be avoided or mitigated by transferring in bond to an offsite bond warehouse, or by prepaying taxes.\textsuperscript{96} Combined, the total penal sum that the TTB may require for bond coverage is $350,000.

The bond can take several forms. It can be a corporate surety, cash, or a treasury bond.\textsuperscript{97} When an old bond is no longer sufficient, a producer must strengthen their bond to cover the new level of liability.\textsuperscript{98} The bonds may be combined into one bond, often called a unit bond.\textsuperscript{99}

\textit{b. Brewer’s Bond}

A brewer must submit a bond with his Brewer’s Notice before he may brew.\textsuperscript{100} The bond is submitted with Form 5130.22.\textsuperscript{101} The brewer’s bond is very similar to a wine bond. Taxation on beer is

\begin{itemize}
  \item \textsuperscript{90} 27 C.F.R. §24.146; TTB WINE BOND F5120.36.
  \item \textsuperscript{91} 27 C.F.R. §24.148 (2017).
  \item \textsuperscript{92} \textit{Id.} § 24.146.
  \item \textsuperscript{93} \textit{Id.} §§ 24.149, -.151.
  \item \textsuperscript{94} \textit{Id.} § 24.148.
  \item \textsuperscript{95} 26 U.S.C. § 5061.
  \item \textsuperscript{96} 27 C.F.R. § 24.275, .280 (2017); see also Sara Schorske, BOND BASICS, COMPLIANCE SERVICE OF AMERICA, https://archive.is/4FiUu (last visited Nov 14, 2017).
  \item \textsuperscript{97} 27 C.F.R. §§ 24.149, -.151 (2017).
  \item \textsuperscript{98} \textit{Id.} § 24.153.
  \item \textsuperscript{99} 26 U.S.C. § 7102 (2012).
  \item \textsuperscript{100} 26 U.S.C. § 5401(b) (2012).
  \item \textsuperscript{101} 27 C.F.R. § 25.91; TTB BREWER’S BOND, F5130.22 available at http://www.ttb.gov/forms/f513022.pdf
\end{itemize}
typically $7 per barrel for small producers. Each brewer must submit a bond that will cover at least 10% of the brewer’s predicted yearly excise tax liability if filing semi-monthly, or 29% if filing quarterly. At minimum, most brewers need to submit at least a $1,000 bond and, at most, $500,000. Contrast this with the wine bond, which must cover 100% of prospective excise tax liability, has different maximum amounts, and apparently requires no deferral bonds.

c. Distilled-Spirits Bond

A distilled spirits plant must submit a distilled spirits bond covering operations and withdrawals before beginning distillation. Distilled spirits are taxed at $13.50 per proof-gallon. Like wine bonds, distilled spirits bonds come in two flavors: operations and withdrawal bonds, which may be combined into a unit bond. Operations and withdrawal bonds follow the same formula as the wine bond. Operations bonds cover the amount of distilled spirits currently in inventory. Withdrawal bonds, like deferral bonds, cover excise tax due to the federal government, because the distilled spirits have been removed, but not yet paid. Like the other bonds, distilled spirits bonds can be covered either by corporate sureties or sufficient collateral. Most distilled spirits operations will need a minimum of $15,000 of operations-bond coverage and maximum of $250,000. The withdrawal bond must cover at least $1,000 and up to $1,000,000. Fifteen thousand dollars would be the equivalent of the

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104 Id. § 25.93(c).
107 Id. §§ 5173(a), (d).
108 Id. § 5173(b).
109 Id. § 5173(c).
111 Id. § 19.166(a)(8).
112 Id. § 19.166(c).
excise taxes on roughly 1,100 proof-gallons.

*d. Impacts of the Bonding Requirement*

The bonding requirements do have their consequences. First, they restrict cash flow in an industry where some members may not be able to generate revenue for several years. Quality wine and spirits take years to mature. Second, they create an excessive administrative burden, particularly on small producers. Third, they make wine and spirits producers less competitive compared to substitutes for alcoholic beverages and other faster-maturing alcoholic beverages such as beer and cider. Fourth, they cause somewhat inequitable tax penalties where producers fail to expand their bond coverage as described below.

Alcohol producers frequently run into bonding issues during the first few years of production. They begin as small facilities with low production capacities. These startups acquire bond coverage for that low capacity. In time, production grows. However, many forget to review the bond coverage. This can become an issue.

Consider the following example of how the bond-coverage math plays out. Jessica loves wine. She loves it so much that she began to make her own homemade wine several years ago. Many of her friends tell her she should try to sell her delicious merlot. Jessica is exploring her options and wants to know how much it will cost her. Among her many, many concerns, she wants to know what her tax liability and bond coverage will look like.

She says she wants to start small, only 30,000 gallons of tax-paid wine that year, with a maximum storage capacity of 25,000 gallons.\[113\] Her particular method creates a final product best described as having bold notes of currant and subtle hints of vanilla and coffee. Her method results in an ABV of roughly 14.1%. Wines containing between 14%
and 21% are taxed at a rate of $1.57 per gallon.114 However, small producers are provided a credit of $0.90 per gallon on the first 100,000 gallons produced.115 This reduces Jessica’s rate down to $0.67 per gallon. Now, if the ABV is slightly higher than Jessica intends, she could be liable for unexpected taxes. In this example, Jessica could face an excise tax liability of $16,750. This sum is not particularly debilitating.

But consider this: a few years later, Jessica has successfully expanded to a 60,000-gallon winery with a 50,000-gallon capacity, where 50,000 gallons are dedicated to her merlot and 10,000 gallons dedicated to a sparkling wine.116 Sparkling wine is taxed at a rate of $3.40 per gallon.117 She still fully qualifies for the credit. Here, she would owe $33,500 in excise taxes on the merlot, and $25,000 on the sparkling wine. While her total excise tax liability is over $50,000, she would only need to provide a bond covering $50,000 if it is essentially all stored in inventory at the same time.118 Also, she would need to transition from a quarterly excise tax return to a semi-monthly excise tax return.119 Again, the consequences are not severe, thus far.

The problem is that many forget to strengthen their bond coverage. People like Jessica would start out by asking for a bond that covered her $16,750 liability, but may easily forget about increasing coverage as operations expand. There are so many regulatory hoops to jump through, it is easy to forget a step. There are consequences when production exceeds the bond coverage amount. Technically, the producer is no longer conducting legal operations. While minor excess will likely not be punished by more than minor tax penalties, major differences may result in revocation of the producer’s operating license.

Spillage is one example of a tax penalty for those producing out

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114 I.R.C. § 5041(b)(2).
115 ld. § 5041(c)(1).
116 An effervescent wine containing more than 0.392 gram of carbon dioxide per 100 milliliters of wine resulting solely from the secondary fermentation of the wine within a closed container. 27 C.F.R. § 24.10.
117 I.R.C. § 5041(b)(4).
118 ld. § 5354.
119 ld. § 5061(d)(1).
of bond. If finished wine is lost due to spillage or some other reason, a winery would generally file a claim to the Alcohol and Tobacco Tax and Trade Bureau (TTB) to explain the discrepancy in their physical inventory. If the winery had inadequate coverage, the TTB may claim the loss was not covered. Thus, the winery would be liable for the taxes due on the lost wine even though it produced no revenue.

Overall, the bonding requirement is an additional administrative burden on an industry that is already highly regulated. Ideally, the bonding requirement would be eliminated, or softened, so that alcohol could be treated like most other industries without tax-bond requirements. However, either way, the industry has flourished and will continue to flourish with or without bonding requirements.

IV. STATE AND LOCAL TAXES

Federal excise taxes are a large portion of a producer’s overall tax liability and generally cannot be deducted. In contrast, state and local taxes can be deducted on a federal tax return, as ordinary and necessary business expenses, under I.R.C. §162. Because state and local taxes may be deducted at the federal level, and do not significantly affect a business’s bottom line, these taxes do not receive much fanfare. Nonetheless, not paying the appropriate state or local taxing authority may result in tax penalties that are not deductible. Thus, it is important for producers to understand, and, most importantly, pay their state and local taxes.

This section will not detail issues involving typical state and local taxes, such as sales and use taxes, or state income or gross receipts taxes, as these are typically deductible. However, it is important to note that all states have some additional revenue-generating framework for alcoholic beverages, whether it is additional sales or manufacturing...

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122 See id.
123 See id. at 151.
taxes, or even markups in state-run liquor stores.124 Tax rates and taxing authorities also vary greatly by state. States also vary on whether tax bonds are required.125

As an example of how complicated state and local taxes can be beyond the state income or gross receipts tax, consider Washington State. There are varying excise taxes on production for all alcoholic beverages, and also for distributions of distilled spirits.126 Consumers must also pay the state and local sales taxes for beer and wine127 and a special sales tax for distilled spirits.128

It is important to also briefly discuss multi-state tax issues. Shipments of alcoholic beverages in and out of a state, when permitted, complicate tax matters even further. Imagine a Washington State winery wishing to ship wine to customers or retailers in Minnesota. Initially, Washington will want to capture as much in sales taxes as possible, claiming rights to such tax as the production and distribution originate from Washington. Similarly, Minnesota will want to capture sales taxes on the inbound transaction that are paid by a resident consumer or business. But allowing both states to fully tax the transaction would chill similar transactions to the point that it could unconstitutionally impede interstate commerce.129 Similar issues exist in the rare case where an alcohol business attempts to have employees or production in multiple states. Thus, most states have adopted, in some form, a system of taxation that will mitigate, but not eliminate, double taxation.130

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130 See e.g., Uniform Division of Income for Tax Purposes Act, NAT. CONF. OF COMM’RS ON UNIF. STATE LAWS (1957),
But double taxation will carry on. The problem is that states logically adopt systems of taxation that favor their state’s economy in such a way that they will be able to capture an optimal amount of taxes within constitutionally permissible guidelines. For example, states with economies primarily based on services may favor a system that heavily weighs payroll as a dominant factor in apportioning outcome. In contrast, a state with more imports than exports may want to give a sales factor more weight. Finally, a state with more exports than imports may desire to assign more weight to a manufacturing factor. The difficulty comes when, for example, a state that apportions manufacturing more heavily sells to a state that apportions sales more heavily. In such cases, there will be a great likelihood of double taxation as both states have orchestrated a constitutionally permissible system of taxation, and the taxpayer will need to pay higher-than-average taxes on both manufacturing and sales. Other important state and local tax issues such as nexus, tax remittance, and separate, combined, and consolidated returns are beyond the scope of this paper, but should be discussed when determining multi-state tax liability.

V. TAXATION OF INTELLECTUAL PROPERTY

Intellectual property is particularly important to the alcohol industry. Trademarks, patents, trade secrets, and, to a growing extent, copyrights along with other forms of intangible property, are becoming stronger points of emphasis for alcohol-industry members. Branding and effective (and potentially copyrighted) images can influence and even manipulate taste perceptions. Patents and trade secrets speak less to the final product and more to the processes that lead to the final product.

Tax consequences are often overlooked by those engaging in


intellectual property transactions. Whether intellectual property is being assigned, leased, or simply held, alcohol-industry members should pay attention to the tax treatment of its intellectual property portfolio. The rest of this section will briefly describe the American tax consequences for intellectual property and assume that there are no international taxation issues. This section will briefly address tax issues involving tax characterizations of transactions, cost recovery, and multi-state issues as they relate to intellectual property portfolios.

A. Characterization

Characterization of intellectual property revenue is critical. It is the difference between ordinary and capital tax treatment. Generally, if an intellectual property holder relinquishes legal title and substantially all of the rights to the intellectual property, the transaction will be considered a sale, not a license and potentially eligible for long-term capital gains treatment. Alternatively, royalty income from licenses will be treated as ordinary income, regardless of whether the intangible property is considered a capital asset.

Imagine a company such as WA Brewery ("WA") that is looking to expand its chain of brew pubs, overall production, and store-based retail sales from its humble origins in Washington to the rest of the west coast. WA comes across OR Brewery ("OR") in Oregon. WA is considering its options. Preferably, WA wants to buy OR via an asset purchase agreement primarily focused on hard assets, but also wants some of OR's intellectual property. However, if a purchase agreement fails, WA might be willing to license some of the intellectual property, if the terms are favorable. First, consider the transactions primarily from OR's perspective.

WA wants to acquire some very imaginative label artwork from

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133 Facebook was recently slapped for a potential undervaluation of intangible property transferred to an Irish subsidiary. See Dolores W. Gregory, Facebook Estimates Tax Bill of up to $5 Billion from IRS Audit, BLOOMBERG BNA (Jul. 29, 2016), http://www.bna.com/facebook-estimates-tax-n73014445592/.


135 See id.
OR. This falls under the purview of copyrights. Copyrights are generally considered capital assets when not held by their authors.\(^{136}\) In contrast, if a copyright was retained by the author, perhaps by a sole proprietor or independent contractor that retained the copyrights and sold separately, such revenue would be treated as ordinary gain or loss.\(^{137}\) The characterization of a sale or license is also important. If the copyright is merely licensed to WA, all of it would be treated as ordinary income, while if it is sold, OR would be able to reduce the gain by any basis in the copyright.\(^{138}\)

WA also wants to acquire some patents on brewing devices. If OR is a pass-through entity, the individual partners may be able to qualify for capital gains treatment, but, a separately-taxed entity may need to treat the sale as ordinary income outside of I.R.C. §1235.\(^{139}\)

WA is particularly interested in acquiring some of the trademarks on OR brands such as Dead Duck IPA, Evergreen ESB, and Beaver Butte Pale Ale. If OR retains rights such as quality control, termination at will, or payments contingent on productivity or use, the transaction will likely be characterized as a license with profits treated as ordinary income.\(^{140}\)

Finally, WA wants to purchase OR’s secret recipe for creating the beers connected with their brands. Trade secrets, such as this one, are analyzed using essentially the same common law as used for patent transactions falling outside of I.R.C. § 1235.\(^{141}\) However, there are special considerations. For example, if the transaction involves a definite term of years, then the transaction will likely be considered a license subject to ordinary tax treatment.\(^{142}\) Similarly, the transferor must transfer the rights, to prevent and ensure against unauthorized disclosures of the trade secrets, in order for the transaction to be

\(^{137}\) See id.
\(^{138}\) See id. § 1001.
\(^{139}\) See id. § 1235.
\(^{140}\) See id. § 1253.
\(^{141}\) See generally Graham v. United States, No. CA-3-77-0928-G, 1979 WL 1312 (N.D. Tex. 1979).
considered a sale.\textsuperscript{143}

\textbf{B. Cost Recovery}

Cost recovery for intellectual property in the alcohol industry is also particularly important, given the long period of time some producers must wait between creating and selling their products. WA will likely need to capitalize its cost of acquiring OR's intellectual property, rather than deducting it as ordinary losses all in the same year. Patents and copyrights acquired in connection with the acquisition of a trade or business, not developed in house or separate from a business, as well as any trademark or goodwill acquisitions, are amortized over a period of 180 months.\textsuperscript{144} Alternatively, self-developed patents and copyrights falling outside of this scope may be amortized under either the life of the intellectual property or the income forecast method.\textsuperscript{145} For purchased patents and copyrights falling outside of this scope, the taxpayer may be able to deduct the costs incurred, during that year, if certain conditions are met.\textsuperscript{146} Research and experimental expenditures may be deducted in the tax year incurred, or amortized over a period not less than 60 months.\textsuperscript{147}

Given these cost recovery considerations, WA would want to carefully consider whether it is more cost effective to purchase the entire OR business, or just some of the intellectual property rights, and how to recover the costs of such an acquisition. The tax impacts would heavily influence these intellectual property transactions.

\textbf{C. Multi-State Issues}

Multi-state intellectual property tax issues have many similarities to their multi-national counterparts. States tax intangibles differently.

\textsuperscript{144} 26 U.S.C.A. § 197.
\textsuperscript{145} See id. § 167.
\textsuperscript{146} See id.
For example, Nevada and Delaware are frequently used to incorporate intellectual property holding companies within a complex business structure from which the intellectual property will be licensed out to affiliated companies. Affiliated companies will be able to deduct the expense of the license while the holding company will be credited with the income on that transaction, which in Nevada and Delaware are not subject to tax. Thus the affiliated group reduces its overall tax rate by gaining a deduction while not being taxed on any additional income. However, these holding company strategies are coming under more frequent attack, and are becoming less popular in multi-state tax planning.

Thus ends a brief summary of the taxation of intellectual property. Alcohol producers should carefully consider tax consequences when buying, selling, or developing its intellectual property, as tax considerations may influence the fundamental character of what rights it wishes to acquire, relinquish, or retain. The designated home of the intellectual property, by nation and state, also become important factors in the tax calculus.

VI. IMPROVEMENTS FOR THE FUTURE

Thus far, this article has explored some particularly unique and important tax issues that alcohol producers must address. From federal and state excise taxes to intellectual property considerations, taxes influence the daily operations of alcohol producers more than most industries. The system of taxation we have in place is understandable, given the history of the industry. However, progress can and should be made. This Section attempts to address areas of improvement, primarily by beginning with some currently proposed legislation and building from there.


149 Id.

150 Id.
Legislation has recently been introduced to address some long-standing issues. Companion bills SB 1562 and HR 2903 were introduced in May of 2015, and intended to reform the taxation of alcohol.151 The bills, among other things, attempted to simplify the rules for reporting, reduce excise taxes for all categories of alcohol, modify the definition of hard cider, and exempt certain home distillers from taxation.152

The bonding portion of the bill was added to the PATH Act of 2015, which has already been passed.153 On one hand, “[e]nforcement experience also indicates that there is criminality in the alcohol trade, with non-tax paid product removals...”154 But alcohol producers are not evading taxes at a relatively high rate. Voluntary compliance among large producers has averaged over 90% since Fiscal Year 010, with a “dramatic” low of 88% in Fiscal Year 2015.155 When compared to the 83.1% overall compliance rate for other taxpayers,156 it seems unequitable to construe alcohol producers of today as the bootleggers of yesteryear. Rather, they appear to be (at least 88%) model citizens.

Fortunately, the PATH Act eliminated the bonding requirement for producers who estimate their yearly excise tax liability will be less than $50,000.157 Given the new excise tax rates proposed by the bill, this would be the equivalent of roughly 14,300 barrels of beer, between 20,800 and 159,000 gallons of wine, or 18,500 proof-gallons of distilled spirits.158

One nuanced benefit of the enacted legislation is that it allows

152 Id.
157 Id.
producers to take greater advantage of the 2005 bill that modified the reporting requirements so that small producers could move to quarterly tax periods. The rub is that in order to take advantage of the less frequent tax periods, producers will need to acquire larger bond coverage to cover the longer tax period. It is reasonable that a producer might prefer the more frequent return periods, in order to avoid the larger coverage requirements. In 2015, only 25% of eligible producers were taking advantage of the quarterly option. Fewer tax returns. Fewer accounting and administrative costs. Fewer opportunities for compliance issues. Better for business. This legislation is a step in the right direction. It reduces the bonding requirements for those that need the change the most. However, the changes would render the bonding requirements effectively obsolete as only 10% of producers would be subject to the requirements.

Beyond the bonding requirements, other changes should be made. For example, the tax definition for hard cider should be further modified to allow for fruit additives. While the Act would slightly modify the definition of hard cider, the definition should be more significantly changed to allow for at least some percentage of fruit that is neither apples nor pears, say 10%. This would allow for cideries to bring more innovation to the marketplace. However, it would be important not to allow for too large of a percentage, where producers could effectively dilute the cider with an otherwise higher-taxed fruit wine for the sole purpose of mitigating tax liability.

Tax-administrative issues involving economies of scale must be addressed. TTB is not equipped to handle the expansion of the alcohol industry without extreme changes. The Bureau needs to either be provided with more funding, in order to have more people performing the same functions, or needs to make the processes more efficient. TTB issued over 5,450 Federal permits, primarily to new alcohol beverage

159 See id.
161 See id.
162 Id.
producers, importers, and wholesalers, and dealt with over 100,000 labeling issues in 2016.163 These numbers will likely continue to grow. With only 470 people on staff, the TTB is currently too shorthanded to regulate both the licensing and labeling side of the alcohol industry.164

Another more radical option would be to abolish excise taxes altogether. Excise taxes are among the least progressive forms of taxes in that they tend to affect those with fewer resources. Converting the excise taxes to a sales tax on alcohol, determined by price rather than volume, would redistribute the tax burden to those who tend to buy top-shelf alcohol. Currently, a gallon of Coors receives the same excise tax rate as a gallon of any craft beer. Coors drinkers are paying more excise tax relative to the price they pay compared to drinkers of craft beers. Thus, excise taxes based on volume effectively become a tax on the poor.

Alternatively, the government could transform the excise tax into higher income tax rates for “sin” producers. If this is the chosen method, there are some special concerns. For example, pass-through taxed entities will likely be required to submit an entity level tax return, regarding the specially-assessed tax. To avoid this, the government could require all producers subject to these taxes to form separate corporate entities for tax purposes, though this would likely be an ill-received option.

VII. CONCLUSION

In this world of alcohol, nothing can be said to be certain but death, taxes, and more taxes. While excise taxes were, at one point, a dominant way of generating tax revenue, that time is gone. Domestic alcohol producers are no longer the gun-toting bootleggers from a century ago. Today, federal and state tax rates vary, to a degree, based on the type of alcoholic beverage involved, but tax administration remains largely the same. One important difference among the state

and federal governments involves the bonding requirement, which a producer may be subject to based on its territory and its production capacity. Much of a producer's business value is attributable to intellectual property, which must be properly accounted for with regards to potential transactions, cost recovery issues, and multi-state production or sales.

While the system of alcohol taxation is relatively stable, improvements can still be made. The Craft Modernization Act is one such example in a variety of ways. Further, tax administration issues will need to be addressed if the alcohol industry continues to grow. Finally, economists and Congressmen should take a hard look at creating some alternative tax in lieu of the alcohol excise tax system, in order to shift the cost burdens from the poorer to the wealthier consumers.

The alcohol industry is a phenomenal industry full of artists, craftsman, sanitation engineers, and entrepreneurs, often all rolled up in the same individual. Anyone wishing to join or serve the alcohol industry needs to always consider the tax issues that may arise, whether those issues involve initially brainstorming a product to overall production capacities, or to the creation and eventual sales or acquisitions of intellectual property. To make a small fortune in the alcohol industry, one must start with a very large fortune, but with the right tax knowledge and planning, industry members can be set up for long-term success.