In FOCUS

New York Pours Tax Incentives into the Craft Brewing Industry

By Mark A. Nickerson and Linda A. Hall

In Brief

Recent years have seen governments experiment with different ways of encouraging entrepreneurs to launch new businesses, especially in new or growing industries. The expanding popularity of craft beer and brewpubs presents one such example. The authors discuss federal and state tax incentives and benefits available to craft breweries in New York State, as well as regulations and considerations to take into account when dealing with businesses in this industry.

The popularity of craft brewing in the United States is a fairly recent phenomenon; the industry has more than doubled in size over the past five years, with 186 regional craft breweries, 3,132 microbreweries, and 1,916 brewpubs as of 2016 (https://www.brewersassociation.org/statistics). While the boom may be plateauing, the industry is still experiencing double-digit growth. States have stepped up their efforts to support this industry by providing tax, marketing, and other incentives targeting the craft beverage industry; in addition, there are federal incentives for domestic production and tax credits for research and development (R&D) and capital investment. New York State is a leader in this area; no other state has done more to assist and promote the industry, as incentives originally designed for New York wineries have been expanded to encompass craft breweries, cider mills, and distilleries. Since 2012, the New York State Senate has passed legislation that provided financial incentives to establish breweries in the state, lowering fees and increasing the production cap for small breweries from 60,000 barrels to 75,000 barrels ("Senate Passes Bills to Grow Craft Brewing Industry in New York," New York State Senate Press Release, June 18, 2012, http://bit.ly/2vQ5ORB). New York has also created a farm brewery license, provided an exemption from paying the annual State Liquor Authority fee, expanded tax exemptions for tastings, and launched a grant program for marketing and promotions (https://esd.ny.gov/industries/craft-beverage). With nearly 350 breweries, New York State has the fourth largest craft beer industry in the country, with an estimated economic impact of $4 billion. With the help of competent accounting, financial, and legal pro-

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fessionals, craft breweries are taking advantage of business incentives and breaks in income, excise, property, and employment taxes.

Advising Craft Brewers

For a relatively small industry, the compliance and tax reporting for craft brewers can be daunting. Producing and distributing alcohol is a highly regulated and taxed activity, both at the federal and state levels. A critical starting point in owning and operating a brewery is to navigate the process necessary to obtain a brewery license from the Alcohol and Tobacco Trade and Tax Bureau (TTB), the agency responsible for collecting federal excise tax on alcohol and ensuring compliance with alcohol permitting, labeling, and marketing requirements. The TTB is also responsible for approving brewery recipes and labels and monitoring all aspects of operations, including intellectual property (i.e., trademarks, copyrights, patents, trade secrets).

Prior to commencing operations, breweries must submit a Brewer's Notice application and obtain approval from the TTB. A Brewer's Bond must be posted, previously set at $1,000 for breweries with an expected excise tax liability of less than $50,000. As of January 1, 2017, however, small brewers are no longer required to post any bond. Breweries should expect an on-site visit from the TTB, as well as background checks on all owners and officers. Prior to marketing any product, breweries must receive Certificates of Label Approval (COLA) for all recipes, packaging, and labels.

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These COLAs are extremely important to breweries, as the intellectual property developed may represent a significant part of a company's valuation.

The valuation of a brewery may be important to those seeking to attract investors or obtain outside capital for expansion. Many craft breweries have yet to grow beyond private, closely held companies; as in any other industry, however, brewers are making moves to raise capital, expand, form strategic alliances, or in some cases cash out.

Some small brewers have taken the more traditional path to raising capital, selling stakes in their business to holding companies or larger brewing companies; others have forged production or distribution alliances. Financial advisors should be ready to assist brewers in innovative strategies that best suit their capital or strategic needs. For example, in North Carolina, Appalachian Mountain Brewery LLC used a rare method known as a reverse merger to go public, thereby avoiding the costly and burdensome IPO process. A reverse merger occurs when a private company buys enough shares to control a publicly traded company, then uses its shares as currency to buy the public company's remaining shares. Appalachian's shareholders, led by founder Sean Spiegelman, used $3.5 million of its own stock to purchase North Carolina Natural Energy Inc., a nonoperating company on the OTC bulletin board. The company changed its symbol to HOPS and is still trading in over-the-counter markets (http://www.bizjournals.com).

Craft brewers are not usually accountants by trade and may not have an accountant on staff, especially in startups. While basic accounting and payroll services are easily contracted out, recordkeeping specific to brewers is complicated and time-consuming. The TTB requires brewers to maintain daily detailed records of raw materials placed in production; amounts produced, transferred from, or returned to the brewery, lost to waste, or consumed at the brewery; and the total amount removed for sale or consumption. These amounts are reported quarterly to determine federal excise tax owed, with larger brewers filing and remitting more frequently. Estimates are not allowed, and fines can be imposed if proper records are not kept. In New York, state excise taxes are also levied on alcohol sold or used in the state, and monthly or annual filings are required reporting the amounts purchased, produced, lost to waste, and sold. CPAs can help by setting up accounting information systems or arranging for the outsourcing of accounting and TTB reporting, which for smaller operations could cost more than the benefit derived.

> Craft brewing entrepreneurs may not realize that a number of activities necessary to starting, operating and growing their business qualify for federal R&D credits.

Most craft breweries are not public companies and therefore are not required to produce GAAP financial statements. Inventory valuation and cost of goods sold are, however, used for internal financials, lender reports, and income tax reporting. Calculating the cost of goods sold can be a challenge for craft brewers, and it is suggested that small brewers use a simplified variable costing method, treating all materials and excise taxes as variable product costs, and all labor and overhead as period costs (http://www.craftbrewingbusiness.com). This method is easy to apply and lends itself to breakeven analysis. At tax time, a full-absorption uniform capitalization (Unicap) cost of ending inventory and cost of goods sold can be calculated to satisfy IRS regulations.

Federal R&D Credits

Craft brewing entrepreneurs may not realize that a number of activities necessary to starting, operating and growing their business qualify for federal R&D credits. While R&D credits have benefited craft breweries in the past, the Protecting Americans from Tax Hikes (PATH) Act of 2015 made them considerably more attractive. In particular, for years beginning after December 31, 2015, the R&D credit is permanent, and for those claiming the alternative simplified method, the credit will increase from 14% to 20%. Many small businesses also have a new opportunity to reduce their taxes by offsetting their Alternative Minimum Tax (AMT) with R&D tax credits. In addition, certain small businesses can elect to take up to $250,000 annually in credits against the employer portion of FICA payroll taxes for up to five years. Qualified small businesses include corporations (including S corporations) or partnerships that 1) have gross receipts of less than $5 million for the credit-claiming year and 2) did not have gross receipts in the current year and the prior four tax years. Since the R&D credit is nonrefundable, this allows startup companies to monetize credits where they previously could not (if lacking federal income tax liability).

Craft brewers spend time and money developing appealing brews and innovative processes in order to compete. Various costs, including supplies, wages, and contract labor costs incurred in developing and testing these products, can be claimed as qualified

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research expenditures (QRE). As these breweries grow and expand, costs associated with developing new or improved bottling or canning processes, hopping techniques, fermentation processes, water recycling or waste management processes, product designs, and bottle or can designs also qualify for R&D credits.

Financial advisors will want to closely examine each company's individual circumstances when planning for R&D credits. Under Internal Revenue Code (IRC) section 280C(c)(3), taxpayers may elect to take a reduced credit without disallowing the deduction for tax purposes. Individual circumstances, including the new provisions under the PATH Act, may make this election more advantageous for some while effectively increasing tax costs for others.

Tangible Property Regulations

Breweries usually need fairly large spaces to operate within, and growth requires expanding current facilities or purchasing or building new facilities. Tangible Property Regulations issued on September 17, 2013, under Treasury Decision 9636 and covered under IRC section 162 made significant changes that simplify how expenditures related to tangible property are treated as either deductible business expenses or depreciable capital expenditures. A simplification provision that applies to microbreweries and brewpubs in particular is the de minimis safe harbor provision. In the past, a brewpub that bought 100 bar stools for $200 each would almost undoubtedly capitalize the $20,000 as furniture and depreciate accordingly. Under the de minimis safe harbor provision, a taxpayer may elect to deduct up to $2,500 *per item*, not per invoice; therefore, a brewery with a signed and documented capitalization policy stating that it adheres to the de minimis standard could deduct the amount in the year purchased. If these materials or supplies were also utilized for R&D purposes, they would also qualify for the R&D credit.

These updated regulations also provide a potential benefit for companies that build, expand, or remodel facilities. Cost segregation studies can yield tax benefits by classifying buildings and components into different, shorter asset class lives and depreciation periods, as well as by allowing certain items to be expensed immediately. If applicable, accelerating these deductions can increase cash flow and allow growing businesses to put their working capital to good use.

> Brewers in New York may be eligible for the investment tax credit on any equipment, building, and structural components of those buildings used in production within the state.

Domestic Production Activities Deduction

At a federal tax level, most profitable breweries qualify for the Domestic Production Activities Deduction (DPAD). The deduction, covered under IRC section 199 (enacted as part of the American Jobs Creation Act of 2004), gives all manufacturers a tax deduction for producing goods and paying wages in the United States. The deduction is equal to 9% of the lesser of taxable income or qualified production activity income (QPAI), not to exceed 50% of the domestic wages paid.

While R&D credits and the accelerated depreciation benefit apply to companies in the startup phase, as well as those established entities with taxable income, the DPAD requires that companies have QPAI in order to take the deduction. QPAI is defined as the excess of Domestic Production Gross Receipts (DPGR) over the total of cost of goods sold and other expenses, losses or deductions properly allocable to DPGR. While DPGR for breweries will most likely come from the sale of beer produced in whole or in significant part within the United States, some entities will need to be careful when calculating their QPAI that qualifies for the credit. For example, brewpubs serving food along with the beer they manufacture will need to break out these respective income and expense areas, as the QPAI will only be the result of sales derived from beer, not food.

FICA Tip Credit

Brewpubs serve their beer on-site and may also have restaurant components. If so, any tipped staff must report those tips and subject them to FICA through payroll reporting. The brewery employer must match this FICA amount for each tipped dollar reported. The FICA tip credit, often overlooked by small restaurants or startup brewpubs, is intended to allow employers to recapture some of this additional FICA expense. Employers should file Form 8846 to claim the tip credit if they meet two conditions: 1) they have employees who received tips from serving food or beverages if tipping is customary, and 2) they paid employer Social Security and Medicare taxes on those tips. The credit is generally equal

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to the amount of employer FICA paid during the year on wages in excess of the federal minimum wage rate in effect.

Craft Beverage Modernization and Tax Reform Act

Commercial brewers pay a federal excise tax on each barrel produced. Small breweries that produce fewer than 2 million barrels a year pay $7 per barrel on their first 60,000 barrels and $18 per barrel for production over 60,000. Larger brewers pay $18 for every barrel. Proposed federal legislation, the Small Brew Act (or Craft Beverage and Modernization and Tax Reform Act), would reduce the tax on the first 60,000 barrels to $3.50. For each barrel beyond 60,000 but before 2 million, the tax would be $16; after 2 million, breweries would pay the full $18 tax. Any brewery that produces fewer than 6 million barrels per year would be eligible for the tax reduction. If this bill is passed and signed into law, eligible craft brewers stand to save more than $4 million per year in federal excise taxes.

New York Investment Tax Credit

Brewers in New York may be eligible for the investment tax credit on any equipment, buildings, and structural components of those buildings used in production within the state. This credit is particularly attractive to startup breweries, as the credit is refundable for a company's first five tax years. Under current regulations, the credit is equal to 4% of the total investment credit base, which is generally the cost basis for federal income tax purposes, less the amount of nonqualified nonrecourse financing with respect to the specific property. In computing the base available for credit, taxpayers also must reduce the basis by any amount of the IRC section 179 depreciation taken on such property.

New York Alcoholic Beverage Production Credit

Formerly the Beer Production Credit, this credit was expanded in 2016 to include production of cider, wine, and liquor. For brewers, the credit is equal to 14 cents per gallon for the first 500,000 gallons of beer, cider, wine, or liquor produced in New York in a tax year, plus 4.5 cents per gallon for each additional gallon (up to 15 million additional gallons for beer, cider and wine, and up to 300,000 additional gallons for liquor). Therefore, the maximum beer production credit is $745,000. Brewers must be registered distributors subject to excise tax and produce fewer than 60 million gallons of beer in the year the credit is claimed to be eligible. It is no coincidence that the credit is equal to the state excise tax imposed on alcohol production; the credit began in 2012 to allow New York breweries a tax credit to offset the excise taxes they were forced to pay when a court ruling ended the previous tax and fee exemption for small brewers. There are special rules for partnerships and S corporations—for example, the aggregate amount allowed to all partners or shareholders is $745,000 in any tax year. The credit is refundable for individuals with pass-through ownership; however, as with most states, New York corporate entities are subject to a fixed-dollar minimum that cannot be completely eliminated by the credit.

> New breweries seeking to open in New York should consider locating where they can take advantage of the START-UP NY program.

New York Manufacturers Income Tax Credit

Since 2014, qualified New York manufacturers taxed as C corporations are subject to a 0% New York income tax rate. Qualified companies must be principally engaged in manufacturing, have all of their real and personal property located in New York, and have a fair market value and adjusted federal income tax basis of said property of at least $1 million at the end of the taxable year. When examining the potential tax benefits of this credit when coupled with others, advisors must often weigh the merits of advising taxpayers to treat corporate entities as either S or C corporations for state tax purposes. To best manage carryovers of unused credits versus current income tax reductions for individuals, these circumstances should be revisited annually.

New York Manufacturers Real Property Tax Credit

Qualified New York manufacturers can also receive a credit of 20% of real property taxes paid. This credit also applies to taxes on property leased from unrelated parties and paid directly to the taxing authority. The credit is refundable for individuals, partners, and S-corporation shareholders, and can reduce the corporate property tax to $25. For brewers to qualify as a manufacturer for the income and property tax credits, 50% or more of the beverages produced must be sold at wholesale or at retail off-premises—so restaurants and brewpubs might not qualify. These types of establishments must be very diligent in tracking sales and operations in order to ensure qualification for these credits.

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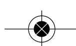

START-UP NY

New breweries seeking to open in New York should consider locating where they can take advantage of the START-UP NY program, which offers companies multiple tax incentives for up to 10 years. START-UP NY credits encompass many taxes, including license and maintenance fees, sales and use taxes, real estate/real property transfer taxes, and personal income taxes for New York State, New York City, and Yonkers. For some, this program means no taxes at all.

While the program's benefits may be significant, proving eligibility may not be easy. In order to be eligible, a company must not be operating within the state currently. If a company is operating within New York, it may still qualify if it is able to prove expansion while creating new jobs, not just moving jobs from one location to a tax-free area under the program. The tax-free zones where businesses in the program must be located are limited and are aligned with colleges or universities sponsoring the area. The business must be able to prove that its mission and activities align with or further the academic mission of the campus, while maintaining or exceeding net new jobs from the year preceding its application. There are also additional eligibility requirements, including not locating near industry competitors already in business within the state. Two breweries have already managed to qualify within New York.

Farm Brewing Law

Since 2013, New York farm brewery licenses are restricted to those farmers whose beer is made primarily from locally grown farm products. Currently, farm brewers must source at least 20% of hops and other ingredients from New York. Beginning in 2019, the bar raises to 60% New York sources, and from 2024 forward, 90%. Beer from licensed farm breweries is designated as New York–labeled beer, and the brewery is exempt from the additional permit necessary to serve beer by the glass. Farm brewers can also hold tastings, serve samples, make and serve cider, sell other New York beer, wine, and spirits by the bottle, and run retail stores and restaurants in up to five branch locations in the state. While this may not be a direct tax benefit, the ability to obtain this type of license has a significant direct and indirect economic impact (http://newyorkcraftbeer.com/farm-brewery).

> Empire State Development has issued grants for the promotion of craft beverages, financial assistance and incentives are also available for building and expansion.

Other Incentives

There are many intricacies associated with operating a craft brewing company, but also many tax incentives available to entrepreneurs and small businesses. In addition to tax incentives, other sources of federal and state support are available. For example, the federal U.S. Small Business Administration (SBA) provides helpful resources. Through the SBA, several incentives for small businesses are funded, including one particularly relevant to brewers: the Small Business Innovative Research Grant Program (SBIR). This program helps fund R&D through contracts and grants, awarding nearly $2.5 billion annually (https://www.sba.gov).

In New York, Empire State Development (https://esd.ny.gov) has issued grants for the promotion of craft beverages, including $250,000 to each of the four beverage segments to help conduct targeted advertising and marketing campaigns. Financial assistance and incentives are also available for building and expansion. To encourage new start-ups, the state awarded nearly $743,000 in New Farmers Grant Fund awards to 25 projects in 2016.

Of course, New York is not the only state to make major investments to attract startups and small businesses; states and municipalities nationwide offer a variety of tax credits and incentives to complement those provided at the federal level. Given their ready availability, these incentives should be a critical part of planning for anyone thinking about opening a brewery or related establishment. Businesses are encouraged to consult their tax advisors and reach out to their local SBA offices or state and local economic development agencies to determine which incentives will yield the greatest benefit. ❑

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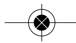

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