The Wine Industry Audit Technique Guide

NOTE: This document is not an official pronouncement of the law or the position of the Service and cannot be used, cited, or relied upon as such. This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

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Introduction

This ATG is intended to be useful to both SB/SE and LB&I examiners in their compliance reviews of both winery and vineyard operations. In addition, it is anticipated that the Industry will utilize this guide as a resource, as were the previous renditions of the ATG. This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as sustaining a technical position.

The wine industry has changed in some significant ways over the past 20 years. The Industry has expanded substantially. Nationally, there are more than 23,000 farms that grow grapes, with about 60% of the total production going to wine grapes. The number of wineries has expanded from 2,688 in 1999 to over 5,400 by 2007. While almost 90 percent of the U.S. wine production still occurs in California, the number of vineyards and wineries in the other 49 states has increased dramatically. Another major change has been consolidation and foreign ownership.

There are a number of significant developments in tax law affecting the Industry, which will be discussed in the body of this ATG. Some of these developments have produced wholesale changes in Industry practices. For example, it was a common practice for a wine producer to hold its related vineyard assets in a separate farming entity. The cash method farmer would sell the grapes to the winery, but not receive payment until the wine was sold, sometimes 3 or 4 years later. This income deferral issue was raised in Oakcross Vineyards, Ltd v Commissioner, T.C. Memo 1996-433; where the Court determined that the cash method of accounting did not clearly reflect income. Subsequently, it has been held that when a farmer operates as a division of a winery entity, the cash method of accounting for the farming operations is permissible. Therefore, many winery entities are now operating their vineyards as a division of the winery entity in order to take advantage of the opportunities therein afforded.

The IRS has changed significantly as well. The old General Program and CEP distinctions have been replaced by SB/SE and LB&I divisions. The Technical Advisor regime was in its infancy 20 years ago and has now become a mainstay in issue development. The systems in place for requesting and receiving guidance have changed significantly.

Changes in technology have dramatically changed the way we do business, and likely will be changing the future as well. Where we used to use fax machines and snail mail, we now use e-mail, thumb-drives and the internet. The popularity of personal computers and sophisticated spreadsheets has opened the window for increasing the accuracy of LIFO computations by allowing for a more meaningful item definition. We used to work almost exclusively with hardcopy books and records. Now, we often receive the entire set of workpapers electronically. With the advent of encrypted files being shared with the taxpayers, remote audits are more feasible. Is a virtual tour of the business that far away? Even now, a winery's website has a wealth of information to assist the agent in determining the scope of the audit. The Audit

Technique Guides now make reference to these website resources rather than include the data in the guide itself. This enables the examiner to readily access the most current information.

Chapter 1 - Overview of Winery/Vineyard Operations

Farming

The initial step in the making of wine is growing grapes. Specific varieties of grapes are used in making premium wines, but any grape with sugar content can be fermented. Successful wine grape farming is dependent upon proper soil and climatic conditions. These particular geographic regions (appellations) can be conducive to the quality of a particular varietal or to wine grapes in general.

The first step in the development of a vineyard is land clearing. This may be as simple as plowing under existing vegetation to removal of trees and leveling the dirt. Vineyards planted on hillsides must be terraced. Rocks may need to be removed. Typical water sources include wells, above ground storage (ponds), or some form of irrigation district supply. The water is then delivered through sprinkler or drip systems.

In certain cases, the soil may need to be fumigated (sterilized) prior to planting. Various viral, bacterial, and soil-borne pest problems can be minimized through this process. Fumigation consists of injecting chemicals into the soil and then sealing the vineyard with a plastic cover for a few days. The cost of this process can vary significantly, depending on the type of chemicals used and the difficulty in application. In addition to fumigation, the land may need some type of soil conditioning, such as the addition of fertilizers, lime, or minerals, to correct deficiencies in the soil. With the advancing awareness of environmental concerns, soil and water conservation expenditures are increasingly part of vineyard development costs. Soil and water conservation expenditures have particular tax consequences and are addressed in the Vineyard section.

Grapevines, like most commercial plants, have a disease-resistant rootstock, with a strong fruit-bearing varietal grafted on to it. This grafting process is usually done in the nursery (bench-grafting) prior to purchase by the vineyard, but can be done out in the field (field-budding) subsequent to planting. In either case, planting the vines is the next step. A trellis system is then built for the vines to grow upon. This trellis system allows the foliage to form an "umbrella" (canopy), under which the grape clusters will grow. The type of trellis system will have a major impact on vineyard yield (and hence profits). Therefore, many wineries are spending substantial amounts of money on complex trellis systems in the newer vineyards.

It takes a period of at least three years from the time of planting for the vines to produce a "commercially harvestable crop". For tax purposes, this means when the crop is substantial enough where sales proceeds will exceed the cost of harvest. This is an important factor in that it determines how long the pre-productive period is and when the vines are "placed in service."

Once the vines are established, there are several cultural practices that occur seasonally. In the dormant season, generally December to February, the vines are pruned. In the spring, the new canes (vine growth) are trained along the trellis system. Weeding, pest control, fertilization, and mildew/mold control also occurs. Harvest time is August to October. Most premium wine grapes are hand picked, while bulk/generic wine grapes are often machine harvested. A common practice for the vineyard owner is to contract out to a farm labor manager who will supply all the laborers throughout the year. The vineyard manager will pay a flat fee, with the labor manager responsible for any and all employment tax issues. The deduction will normally be listed as "contract labor."

Another common practice is the planting of a cover crop in the first two years. In the fall an annual cover crop (bell, bean, and oat) is planted and disked in the spring. In the third year a permanent cover crop may be planted in the fall and allowed to reseed in the spring. The cover crop is then mowed once a year.

When the grapes are harvested, they must be taken to a certified weigh station. Many wineries will have a weigh station at their facility. The winery is required to keep certain information about their grape supply (whether they grow their own grapes or buy them from others). This information is captured on a "weight ticket". The weight ticket will show the tonnage of grapes, the variety of grapes and the vineyard of origin.

Audit Techniques

Weight tickets can be very useful in verifying vineyard sales. Accurate grape prices can be determined from the Grape Crush Report released by the USDA (see information sources). This information is available to independently ascertain the gross receipts of a particular vineyard operation.

See Exhibit 1-1 for an overview of the timing of events in the development of a vineyard and the tax treatment of the various costs involved. Some items are capitalized and depreciated, while some costs are currently expensed.

The University of California Cooperative Extension service provides a review of vineyard development costs. You may wish to use these estimates to verify the taxpayer's depreciable basis. You will find sample costs to establish a vineyard as well as an analysis of costs per acre. The agent may utilize the University of California Cost study, which is available under Current Cost and Returns Studies.

Winery (Manufacturing)

The process of making wine is a manufacturing process. The winery takes one product (grapes) and transforms it into another (wine). Since this is a manufacturing process, the wineries must account for their costs as a manufacturer using the Uniform Capitalization (UNICAP) rules under I.R.C. § 263A. The following discussion of the manufacturing process will also consider how UNICAP comes into play.

Generally speaking, the wine making process has four cost centers: crush/fermentation, aging/storage, general and administrative (G&A), and marketing/sales. Under UNICAP, the process of cost accounting should include the following steps. First, all costs must be assigned to the appropriate cost centers. Second, certain G&A costs must be allocated to all the other cost centers. Finally, production costs (crush, fermentation, aging, and bottling costs) must be capitalized to inventory while the balance of costs (remaining G&A and marketing) is deducted currently.

Depending on the varietal of grape, wine production can take several years when you include barrel aging and bottle aging prior to the wine's release for sale. Wineries may make several different levels of wine using different techniques, and many of the people or other costs involved in the process cross cost center boundaries. This combination of factors can make cost accounting difficult.

Wineries can make several different products. The lower end wine is made in large quantities, usually of lesser quality grapes and using less expensive techniques. This generic wine is sometimes used for related products such as brandy, wine coolers or vinegar, but usually is sold as jug or table wine. Premium varietals are the high quality, high priced wines that use the highest quality grapes. Sparkling wines, commonly known as champagne, need another step in processing to give them the effervescence. Brandy is made by distilling wine and aging it an additional 3 years.

The first step in the wine making process is the delivery of the grapes from the fields. The grapes go into a stemmer/crusher which both separates the individual grapes (berries) from the stems and leaves, and breaks open the skins. The white wine grapes are then placed in a press, and various degrees of pressure can be exerted on the grape skins/pulp to extract more juice. Generally, white wines are made from juice without the skins, while red wines are fermented with skins and seeds included.

The grape juice is then transferred to a container in which it will be fermented. White wine is often fermented in temperature controlled, stainless steel tanks. Some premium white varietals are fermented in the 40 gallon oak barrels in which they will be aged. Red wines are similarly fermented in stainless steel tanks as the normal practice, but are occasionally fermented in large open topped wood tanks.

Wines may remain in the tanks in which they were fermented for the balance of their aging prior to bottling. In this case, the tanks see duty as both fermentation and aging tanks. In other cases, the wines, after spending time in the fermentation tank, will be transferred to smaller oak barrels for further aging. In either case, the wine in the fermentation tank will be transferred prior to the next year's harvest, so that the fermentation tank will be available again.

All wines take about the same amount of time to ferment (change from grape juice to alcoholic beverage), but the processing after this step can vary dramatically. Lower end wines are generally not aged for any considerable amount of time. However, premium wines are often stored in oak barrels (barrel aging) and then bottle aged. For white wines, this aging process can take from 9 months to 3 years. For red wines, this process can take from 18 months to 5 years. For sparkling wines, the wine must be processed again (yeast and sugar are added to produce the bubbles) and then stored (aged) for a period of time. The total period of time for some sparkling wines, from harvest to completion of the process, can take up to 5 years. The process for brandy is to distill wine into grape brandy designate (GBD) which must be aged in wood barrels for at least 3 years before it can be marketed as brandy.

The definition of "production period" is vital for UNICAP purposes. All the costs associated with the manufacturing of the product during the production period must be capitalized to inventory. Any costs incurred after the production period may be deducted as period costs. Prior to UNICAP, some wineries were taking the position, based on the *Heaven Hill* case, *Heaven Hill Distilleries, Inc. v. United States,* 476 F2.d 1327 (Ct. Cl. 1973) , that the production period for wine stopped when the grape juice was changed into wine. This process takes a matter of weeks. The Service did not agree with this treatment prior to UNICAP. UNICAP requires that the production process include aging. One national accounting firm has promoted the concept that the production period should terminate at the "release date." The release date is when the wine is officially offered to the winery's distribution chain. The Service supports this determination of the end of the production period. Prior to the release date, the winery is purposely holding the wine for aging. After the release date, the wine remains unsold only due to sales or marketing restrictions. Often, a winery will have published release dates for its wines. Barring that, the first shipping invoice for general sales may be determinative.

Wineries will often pre-release wines to wine writers or for other promotional purposes. This is done for marketing reasons and does not terminate the aging process for that lot of wine. The Service has taken the position that the production period should be determined for each vintage (year the grapes were picked) and varietal (type of wine, based on the type of grape used). For example, the production period for a 1988 Chardonnay will be determined separately from a 1988 Cabernet Sauvignon.

NOTE: TAM 9327007 is an example of the Service's position that the end of the production period is the release date.

Marketing/Sales

Once the product is ready for sale, the wineries have a variety of options on how to sell their product. Most wineries have tasting rooms where visitors can purchase the wine directly from the winery. The wineries may also sell directly to restaurants and "bottle shops." More commonly, the wineries will work through a broker or a distributor. A distributor will actually buy the product for resale. A broker, on the other hand, may take possession but not ownership of the wine. The broker is paid a commission based on sales. The wineries will still have their own sales force, even though working through a broker or a distributor. More recently, wineries are increasingly using their websites as a vehicle to sell their wines directly to the consumer. Some wineries have developed a Wine Club, where subscribers are provided periodic shipments of wine, usually at a member's discount.

With the proliferation of wineries within the U.S., as well as foreign imports, there is great competition for market share. Therefore, the key to success in the wine industry has fallen on the marketing/promotion side as much as on producing fine wines. To assist in marketing and publicizing their wines, the winemaker or owner of the winery will often host or attend tastings or other promotional events. As will be discussed in Chapter 4 (Wine Industry Issues), this can cause cost accounting problems when people “wear more than one hat.” An allocation of their salary, based on facts and circumstances, needs to be made.

Exhibit 1-1
Timing and Treatment of Vineyard Development Costs

Guidelines for capitalizing and expensing vineyard establishment costs when UNICAP does not apply. If UNICAP applies, all costs are capitalized until the vineyard starts producing a crop.

The following is an example of costs noting C for Capitalize and E for Expense.

Cultural Costs	First Year	Second Year	Third Year
Pre-Plant Tillage: Man and Tractor	C		
Fumigation	C		
Layout and Mark	C		
Distribute and Set Stakes	C		
Stakes – 7 foot Treated	C		
Rootstocks	C		
Planting Vines – Labor	C		
Planting Supervision	C		
Bud and Cover, Including Rubber Ties	C	E	E
Budwood – Certified		C	E
Uncover and Prune Rootstocks		C	E
Cut Rubbers and Tops, Place Collars		C	E
End Posts – Treated	C	C	C
End Posts Set – Labor	C	C	C
String Trellis Wire – Labor	C	C	C
Trellis Wire	C	C	C
Train and Prune – Labor		E	E
Mildew Control		E	E
Irrigation Labor – After Planting	E	E	E
Water & Pumping Power-After Planting	E	E	E

Cultural Costs	First Year	Second Year	Third Year
Repairs on Irrigation Equipment	E	E	E
Cultivation	C	E	E
Frost Protection – Labor		E	E
T-Budding – Conversion	C	C	C

Chapter 2 - Pre-Audit Information Gathering

Information Sources

There are a number of resources available electronically to assist in our initial review of a return, including the winery/vineyard website and various search engines. Larger, publicly traded companies often have a link to their financial statements. Perusing these sources can give a wealth of information, including:

- The name, address, and telephone number of the winery
- When the winery was founded
- Who the principals are, such as the owner, CFO, winemaker, etc.
- Vineyard holdings
- Crush and storage capacity
- Types of products (still wine, sparkling wine, brandy)
- Brand names (if different from the winery name)
- Recent acquisitions and dispositions
- In some cases, the type of entity (proprietorship, partnership, corporate)
- Areas and methods of distribution
- Financials, including methods of accounting for book.

Many wineries are subsidiaries of larger entities and file as part of the consolidated return. In addition, some entities may have been acquired by foreign parents. Although tracking ownership can be difficult, the ownership of the various entities can be established. Research of industry periodicals may be required to assist in determining the parent company and where they are located. For wineries that underwent a recent change in ownership, information may be obtained directly from the winery, including a copy of their tax return.

In addition to finding out information on the winery, the following factors should be evaluated for return potential:

- Who prepared the return? Some CPA firms specialize in the wine industry.
- Look for obvious omissions in the cost accounting system. Review the cost of goods sold section to see if it appears that indirect costs have been included.

Chapter 3 - Audit Considerations

This chapter provides information in conducting the pre-audit, initial interview, and comparative analysis of the balance sheet and income and expense statements.

Initial Information Document Request

The initial Information Document Request (IDR) form should include, in addition to the generic books and records, the following items:

- Schedule M adjustments
- Inventory costing workpapers
- Depreciation Schedules
- Copies of all Forms 3115, as changes in method of accounting are common

Initial Interview and Tour

As with any examination, the initial interview can be crucial. One of the most difficult aspects of UNICAP is the allocation of certain costs, especially officer's and employee's salaries. The tour/walk through of the facilities should be viewed as an opportunity to verify the overhead allocations made. Since the overhead allocations may be made asset by asset or by square footage, getting a firm understanding of the layout of the facility is essential.

The tour is an excellent time for the taxpayer to tell you about their product line, what varietals they produce, what processes they use, and what the different assets are used for.

The initial interview and tour may reveal miscellaneous issues. Find out if there are other structures on the property that they use to house their vineyard workers or if they are used for other purposes. Find out if the personal residence is on winery/vineyard property. If the residence is owned by the shareholder, and no other deductions for business use are claimed, no issue exists. However, if title is held by the corporation, depreciation and other associated deductions may have been claimed.

In addition to all your other standard questions, including those about internal control, you may wish to ask about:

Vineyard Operations:

- Do you grow your own grapes? If so, do you sell any to outside parties? How do you account for grape growing costs (deducted versus capitalized to inventory)?
- Do you purchase grapes from related parties? If so, what are the terms? FMV? Payment made in the year of sale or when the wine made from those grapes is sold?
- Did you buy any vineyard properties recently? (Purchase price allocations - placed in service dates.)

- Did you plant or convert (t-bud) any vineyards recently? (T-budding is the grafting in of a different type of wine grape to the trunk of an existing vine. The issues involve the capitalization of development costs, including fumigation, cost of vines and trellises, labor, etc.)See Exhibit 1-1.
- How do you keep track of vineyard expenses? (Deducted versus Capitalized)
- Did you have any losses due to phylloxera or other disease? Phylloxera is a root louse that feeds on the roots of vines. The disease kills the vines and the only effective treatment is to replace the vineyard.
- What election have you made concerning I.R.C. § 263A and preproductive costs?
- If this is a single entity vineyard and winery, how do you account for grapes transferred to the winery operation?

Manufacturing Operations:

- Where are the production facilities? (Some wineries may have several crushing, bottling/ warehousing locations.) There are different sourcing relationships with resulting cost differences to consider.
- Are the grapes grown and bottled on the winemaker's property? These would be Estate grown.
  - Are the grapes grown by someone other than the winemaker-bottler and sold to him directly or in an open market? These are called Open Market Grapes.
  - Are the grapes that are grown on leased land on a share-profit basis with the land owner? Commonly referred to as Leased Vineyards.
- How do you account for winery production costs? (How do they keep track of capitalized vs. deducted costs?)
- What facilities are used for crush/ferment versus barrel/bottle aging versus post-production warehousing? (Some wineries have limited storage space and may use a coop of some sort for bottle aging - these costs should be capitalized.)
- Do you do any custom crush or have any custom crush work done? (Custom crush refers to a winery, which has the idle production capacity doing the crush/ferment and even bottling/aging for someone who has grapes but not the equipment available. This should be reflected in other income, with an offsetting allocation of costs, by the winery doing the work. The amounts paid would be capitalized as part of the cost of the wine by the owner of the grapes.)
- What exactly are the tasks of the highly compensated employees? (Since UNICAP requires officers' salaries to be capitalized if related to production, it seems that more and more of their time is accounted for in marketing!)

Cost Accounting System:

- What method do you use? (Are they on UNICAP? Have they tried to avoid UNICAP by using lower of cost or market? Some wineries have used bulk wine spot prices or other estimates of fair market value.)
- Did you have any write-downs of your inventory? (Sometimes a particular tank of wine might in fact go wrong, and the actual sales price might drop below cost. In other

situations, a particular varietal may not be well received, but the sales price may not be reduced. It just takes longer to move the product.)

- Is there a narrative, manual or other documentation available that discusses how the cost accounting system works? (Often the larger wineries, who have adopted UNICAP will have a detailed analysis of how they implemented UNICAP - how they allocated the various costs between the cost centers.)
- How do you account for interest expense? (UNICAP requires that interest expense be allocated to inventory having a production period in excess of 2 years, such as most red wines, sparkling wines and brandy.

Marketing/Sales

- Do you do direct sales; use a broker or a distributor or a combination thereof? Are sales limited to your state or do you sell nationwide or export?
- Do you maintain your own sales force? Are shareholder/employees or owners involved? (Again, as it relates to UNICAP, the costs involved in marketing and sales are currently deductible. A principal shareholder/owner might wear the title of "winemaker" when in reality he or she spends a significant amount of time on the road promoting the wine, leaving the actual production process in the hands of an assistant. Conversely, a guest appearance at a promotional event does not turn a winemaker into a Vice President of Marketing.)
- Do you sell any of your wines on futures or sell gift cards?

Balance Sheet Accounts

Inventories

Compare the balance sheet amounts with prior and subsequent year returns; Schedule A (Computation of Cost of Goods Sold) and the financial statements if available. Are there any discrepancies? In one examination, tasting room inventory was included per the financial statements but excluded from the tax returns. Has the taxpayer changed the inventory calculations between returns without making the necessary amendments? Compare the balance sheet amounts with the inventory workpapers. They do not always agree.

Other Assets

Does the taxpayer have construction in progress? This can be an indication that vineyards in the development stage are being properly accounted for.

Buildings and Other Depreciable Assets (Fixed Assets)

This industry is one of the most capital intensive industries in the United States. The assets to sales ratios normally run about 2 to 1. A lack of assets could be an indication that the taxpayer is renting assets from a related party. If production assets are being rented, this rent should be capitalized to inventory. The depreciation schedule should be scrutinized for (1) adequate capitalization of depreciation to inventory, (2) useful lives on buildings (sometimes claimed to be essentially equipment), (3) personal residences being depreciated, (4) all development costs being capitalized, and (5) placed in service dates. (Are the vineyards producing a crop?)

Land

Review the land/depreciable assets in the vineyard allocation. Did the taxpayer purchase the land with the vineyard already planted? Was the allocation made pursuant to an appraisal? See the following Emerging Issue on Amortization of Appellation Value in Chapter 4.

Interest Bearing Debt in General

Compare the amount of debt with the amount of interest expense. Is it reasonable? If the taxpayer produces products with a long production period (most red wines, sparkling wines and brandy), is a portion of the interest being capitalized? Under UNICAP, interest should be capitalized under the avoided cost method.

Other Liabilities

Sometimes the breakdown of this amount will indicate that there is an amount “due to affiliates” or “due on grape purchases” or some similar description. This should be investigated to determine if an accrual basis winery is purchasing grapes from a related cash basis vineyard. Often, the terms will state that the winery will voluntarily withhold payment to the vineyard until the wine produced from those grapes is sold. This can result in an unwarranted deferral of the recognition of income (at the vineyard level) for a period of up to 5 years. See Recognition of Income in Chapter 4 for further discussion.

Other Liabilities should also be reviewed for any improper deferrals of advance payments or any other types of deferred revenues.

Other Liabilities also may reflect certain Reserves or Accrued Expenses which should be reviewed to determine if the all events and economic performance tests of I.R.C. §§ 446 and 461 have been met.

A common transaction of this type in the wine industry is called Programming Expense. This expense occurs where a winery is selling to a distributor. If the winery is behind on their sales, they may enter into an arrangement with the distributor to have the distributor more aggressively market a particular product. If the distributor is successful in meeting certain pre-arranged volumes within a specified timeframe, the distributor is due a payment. At year-end, the winery may forecast the success of the distributor in the “programming” and set up a reserve to estimate the amount of the expense. To the extent that the reserve is based on forecasts of sales that would occur past year-end, the reserve would not meet the tests.

Income and Expense Accounts

Other Income

Does the taxpayer do any custom crushing? Does the taxpayer sell any by-products? Some of the larger producers will sell their solid waste (skins, seeds, stems, and leaves) as a soil conditioner. Are there other crops on the property?

Deferred Revenue

Gift card revenue is a common example of deferred revenue. Generally, unless taxpayers elect the deferral rules under Treas. Reg. § 1.451-5, gift card income must be reported when received. (Rev. Proc. 2004-34, allowing a one year deferral, may also apply in certain circumstances). To the extent a taxpayer is using the deferral rules of Treas. Reg. § 1.451-5, unredeemed gift card income may be deferred to the last day of the second taxable year following the year of the sale. Deferral for tax purposes cannot be later than it is for financial accounting purposes, and the taxpayer must have on hand enough goods to satisfy the outstanding gift cards. The regulations generally provide deferral related to goods and not services.

Another similar advance payment transaction is that of Futures sales. A customer may make an advance payment towards the future delivery of a specific allotment of wine.

Compensation of Officers

Is any amount capitalized to inventory? Particularly in smaller wineries, owner/operators are involved in many aspects of the winery operations. Some allocation of their salary should be made to production activities; to the extent they are involved.

Salaries and Wages

All directly related production costs should be capitalized to inventory. In addition, UNICAP requires an allocation of certain other overhead costs to inventory.

Repairs

Under UNICAP, repairs to production assets must be capitalized to inventory.

Rent

Under UNICAP or full-absorption, rent on production assets must be capitalized to inventory.

Taxes

There are four main categories of taxes for wineries. They are: (1) Payroll taxes; (2) Real estate taxes; (3) Wine (excise) taxes; and (4) Income and miscellaneous other taxes.

Payroll taxes should be capitalized to inventory in the same ratio as the wages to which they relate.

Real estate taxes on production assets should be capitalized to inventory per UNICAP.

The wine excise tax is paid when the wine is transferred "out-of-bond." The term "bonded facility" means a specific geographic location that is under bond. When alcoholic beverages are produced, excise tax must be paid when the product is transferred from that location, unless the new location is also a bonded facility. Generally, the wine is not transferred until the year of sale. Therefore, whether it is treated as an expense item or directly attached to the wine sold, the effect would be an allowance in the year of sale. However, if the wine is transferred in years prior to sale, and the excise tax is paid upon transfer, the tax should be included in the ending inventory calculation for UNICAP.

Income taxes are specifically excluded from capitalization under UNICAP.

Interest Expense

Again, per UNICAP, interest expense needs to be capitalized to inventory if the production period exceeds 2 years. Most premium red wines have a production period exceeding 2 years.

Depreciation

Depreciation on production assets must be capitalized to inventory.

Advertising and Marketing

Generally, amounts expended for advertising and promotion are currently deductible. However, in closely held entities, look for personal expenses.

Pension/Profit Sharing Plans and Employee Benefits

These costs should be capitalized in the same ratio as the wages from which they came.

Other Deductions

Some preparers use this section to show the total capitalization of expenses to inventory, including amounts capitalized on the expenses listed above. In some cases, the amount of capitalization exceeds the total of "other expenses," resulting in a negative amount. Since this total amount of capitalization cannot be traced to any specific account, it is difficult to isolate any expenses in the pre-audit that appears to warrant attention. If that is the case, you will need to wait until you receive a breakdown from the taxpayer. Some preparers provide a schedule of capitalized costs, as an attachment to the return. This schedule shows the total amount of an expense, and an individual breakdown of the amount capitalized and the amount expensed. This type of schedule can be very helpful in your pre-audit to determine the scope of your review of the taxpayer's application of UNICAP.

In addition, this account should be reviewed for other items that should be capitalized to inventory, such as supplies, utilities, insurance, contract labor; production related consulting/professional fees, storage or warehousing costs, and other indirect production costs.

Chapter 4 - Capitalization & Tax Accounting

Capitalized Costs Under I.R.C. § 263A "Unicap"

UNICAP has been around for 20 years. It requires the capitalization of many costs for property either produced by the taxpayer, or acquired for resale. The costs that must be capitalized are direct costs and a portion of indirect costs attributable to property produced or property acquired for resale. Costs that are not required to be capitalized include pre-productive costs, as discussed in detail below.

Direct Costs

Direct costs that must be capitalized include direct material costs and direct labor costs. Treas. Reg. § 1.263A-1(e)(2).

Indirect Costs

Indirect costs that must be capitalized include certain labor costs, officer's compensation, pension expenses, employee benefits, indirect material costs, purchasing costs, handling and storage costs, cost recovery (depreciation), depletion, rent, taxes, insurance, utilities, repairs and maintenance, engineering and design, spoilage, tools and equipment, quality control, bidding costs, licensing and franchise costs, interest, and capitalizable service costs. Treas. Reg. § 1.263A-1(e)(3).

Pre-Productive Costs

Costs incurred so that the plant's growing process can begin, such as costs of seed or plants, and the costs of planting, cultivating, developing the plant during the pre-productive period must be capitalized. Treas. Reg. § 1.263A-4(b)(1)(i).

The pre-productive period refers to the period before the first marketable crop or yield, for plants that will have more than one crop or yield. Treas. Reg. § 1.263A-4(b)(2)(i)(D), Example 7 (ii) addresses how preproductive period costs are accounted for between the disposal of one grape crop and the appearance of the next grape crop.

Non-Field Costs

Non-field costs that are incurred during the field cost period are capitalized to the harvested grape crop. Non-field costs incurred during the pre-bud period are deducted as a cost of the vine. Non-field costs include all other costs such as administration, tax depreciation and repairs on farm buildings, farm overhead and taxes (other than state and Federal income taxes) are not field costs because they directly benefit, or are incurred by reason of, the production of the crop.

Self-Use

CCA 200713023 determined in the case of grapes grown for self use, the onset of the crush is the equivalent of the sale & disposal of the grapes for purposes of I.R.C. § 263A .

Exceptions From I.R.C. § 263A Capitalization

Certain expenses are not capitalized under I.R.C. § 263A, including inventories valued at market under either the market or lower of cost or market methods, and certain farming businesses, such as field costs. A farmer who is not a partnership or corporation, and required to use the accrual method of accounting, is not required to capitalize the costs of producing plants with a pre-productive period of 2 years or less. I.R.C. § 263A(d)(1). Also, a taxpayer can elect to have I.R.C. § 263A not apply. I.R.C. § 263A(d)(3).

Field Costs

Field costs (fertilizer, spraying, irrigation, & pruning) incurred during the field cost period and the pre-bud period are deducted as a cost of the vine. Examples of field costs include irrigation, fertilization, spraying or pruning of the vines because they do not directly benefit, and are not incurred by reason of, the production of a grape crop that has already been severed from the vines. Treas. Reg. § 1.263A-4(b)(2)(i)(C)(2).

This period following harvest of the grapes but before the vine produces its first bud can be thought of as two separate periods:

(1) Field cost period; and (2) Pre-bud period. The field cost period is the period of time after the grapes are harvested but before the sale & disposal of the grapes. The pre-bud period is the period of time after the sale & disposal of the grapes but before the vines produce the first buds.

Vineyard Operations: Cash And Accrual Methods Of Accounting

With a few exceptions, vineyard operations are allowed to use the cash method of accounting. I.R.C. § 446(c).

The exceptions include:

Per I.R.C. § 447, certain corporations and partnerships must use the accrual method of accounting. First, corporations which are not family corporations, and have gross receipts in excess of $1,000,000, are required to be on the accrual method. Partnerships with a C corporation partner fall into the same exception. Second, corporations which are family corporations, and have gross receipts in excess of $25,000,000 must use the accrual method. I.R.C. § 447(d)(2) provides the special rules for and definitions of family corporations. Finally, I.R.C. § 448 requires that certain partnerships and S-corporations, which come within the definition of a tax shelter, must use the accrual method of accounting. I.R.C. § 448(d)(2) provides the definition of a tax shelter. Generally, this provision is quite broad, and includes not only registered tax shelters but also entities which have 35% or more of its losses allocable to certain limited partners (not active participants or family members).

In the particular circumstance where an accrual method vineyard and winery are operating as a single entity and treating the grape-growing and wine-making activities as a single trade or business, CCA 200713023 addresses what grape growing costs need to be capitalized to inventory at the winery level.

The following analysis assumes the preproduction period of the vines has ended & grapes are being produced in marketable quantities.

Vineyard Development Costs

There are a number of categories of costs incurred in the development (or replacement) of a vineyard. These costs include land clearing, soil and water conservation, direct and indirect costs of vine, trellis, and irrigation systems, and preproductive costs.

Land Clearing Costs

Generally, land clearing costs, which include removal of rocks, trees, stumps, and brush, are capitalized as part of the land and are not depreciable.

Soil and Water Conservation

Soil and Water Conservation costs have their own definitions under I.R.C. §175. In certain cases, the costs of earth movement (leveling, shaping, terracing, etc.) and earthen reservoirs and ponds may qualify for a deduction to the extent of 25% of gross income from farming. Soil and Water Conservation costs not deducted are capitalized to land and are not depreciable.

Preproductive Costs

Preproductive period costs include all cultural costs (training, suckering, pruning, tying, mowing, weed spray, etc.), depreciation on vineyard improvements and farming equipment, certain interest expense (under the avoided cost method) and a prorated portion of other expenses.

The general rule under I.R.C. § 263A is that all preproductive costs incurred during the preproductive period of vines must be capitalized into the cost of the vines. Depreciation on those capitalized costs would begin when the vines have experienced their first commercially harvestable crop.

Certain taxpayers are eligible to elect out of these I.R.C. § 263A capitalization requirements. TAM 199946003 addresses a number of issues related to electing out of the I.R.C. § 263A capitalization requirements. First, the election may be made by an express statement to that effect on the return for the tax year of the election. Alternately, a taxpayer may make an implicit election by failing to capitalize the preproductive costs. Second, it established that vineyards have a preproductive period exceeding two years. Third, it discussed the definition of a marketable crop. This election is not available to taxpayers required to use the accrual method of accounting pursuant to I.R.C. § 447 or 448(a)(3).

Note: Per I.R.C. § 263A(e)(2), one of the consequences of electing to deduct preproductive costs is a requirement to use the ADS depreciation method on all assets used in farming activities so long as the election is in effect. Failure to use the ADS method will invalidate the election.

I.R.C. § 263A(d)(2) provides for an exception to certain capitalization rules when a vineyard is being replaced due to disease. In TAM 9547002, the Service clarified which costs could be deducted and which must be capitalized. While not discussed in the TAM, the costs of removing the diseased vineyard would be allowed as an abandonment loss. Then, the direct and indirect costs to replace the vineyard would be capitalized under I.R.C. § 263A(a) to the various asset types, and the certain preproductive costs would be allowable as period costs under the I.R.C. § 263A(d)(2) exception. Further, if a taxpayer is not applying I.R.C. § 263A solely because of replacement due to disease, the requirements to use ADS depreciation methods will not apply.

Grape Growing Costs And Recognition Of Income – Choice Of Entity

Brother/Sister Entities

Prior to the Oakcross Vineyards Ltd. v. Commissioner, T.C. Memo. 1996-433, aff'd 142 F.3d 444 (9th Cir. 1998) case, a common form of vineyard and winery operations was brother/sister entities. The entities could be partnerships, corporations, or individuals. For cash method vineyards, grape growing costs would be deducted in the year paid. Recognition of the gross receipts from the related party sale would be postponed until the wine was sold by the winery. In some cases, the payments would be postponed for several years after the wine was sold. The Tax Court's decision held that this type of deferral did not clearly reflect income and required the farmer to adopt the accrual method of accounting. The case was appealed and the verdict stood. The Appellate Court seemed to indicate that, had other legal arguments been raised in the original case, a different result may have been reached. As a result of the Court's holdings, this form of related, but separate, entity structure became less popular in the mid-1990's.

Corporations in a Consolidated Group

A similar structure is the cash method farmer and accrual method winery placed in a consolidated group. The cash method farmer would sell its grapes to the winery as a deferred intercompany transaction, expensing its farming costs in the year paid, and postponing recognition of the grape sales until the year the wine was sold. In essence, the same result occurs if a single entity holds the farming and winery operations as separate divisions. The farmer deducts the grape growing costs and has no gross receipts. The winery takes the grapes into inventory at zero basis and reflects a much smaller cost of goods sold when the wine is eventually sold. In both cases, there is a deferral until the wine is sold.

Prior to 1997, both those positions were challenged by the Service. However, the new regulations at Treas. Reg. § 1.263A-4(a) were published 8/22/1997, making it clear that farmers, eligible to use to cash method, could do so in a consolidated setting or single entity with different operating divisions.

Since the publication of those regulations, the single entity concept has become very popular.

Depreciation Methods and Lives

Depreciation begins when the assets are placed into service. For trellis and irrigation systems, depreciation begins when they are installed and the vines are planted. Vines, however, are not deemed to be placed in service until such time as there is a first commercial crop. See the discussion in TAM 199946003 for the definition of a marketable crop.

Depreciation on vineyard assets, such as the trellis and irrigation systems, is capitalized as part of the preproductive costs, unless the taxpayer has made a valid election out of I.R.C. § 263A. All capitalized preproductive period costs are added to the cost basis of the vines. Depreciation on all capitalized vine costs would begin at the time of the first marketable crop.

One common error at the vineyard level is an inconsistent treatment of the election out of I.R.C. § 263A. If preproductive costs have been deducted, the longer useful lives and more restrictive methods under ADS must be used for all farm assets.

Methods and Lives – (Post 1988)

Land, Land Clearing and non-deductible Soil and Water Conservation costs are not subject to depreciation. Fumigation of the land, prior to vineyard development, is considered part of the cost of the vines.

All assets used in the trade or business of farming are limited to a maximum of 150% declining balance method. Vines and residential buildings are further limited to straight line depreciation. If use of ADS is required, only straight line is allowed.

Farm Buildings	(20 year life, 25 for ADS)
Residential Buildings	(27.5 year life, 40 for ADS)
Land Improvements - Fences, Landscaping, Sidewalks, Roads and Sewers	(15 year life, 20 for ADS)
Vineyard Equipment - Tractors, Sprayers, Mowers, Gondolas, Mechanical Harvesters, etc	(7 year life, 10 for ADS)
Trellis System*	(7 year life, 10 for ADS)
Irrigation System* - Drip Irrigation, Drainage, non-earthen Reservoirs, Wells, etc.	(15 year life, 20 for ADS)
Vines - Fumigation, layout, vines, and planting costs	(10 year life, 20 for ADS)

* Useful lives of trellis and irrigation systems were recently argued in Trentadue v. Commissioner, 128 T.C. 91 (2007), in which the Tax Court determined that the drip irrigation system was not depreciable. Prior to this decision coming out in 2007, it was an industry practice to use a 7 year life on irrigation systems.

Vineyard Emerging Issue

Amortization of Appellation Values

This issue might arise in conjunction with the purchase of a vineyard. The taxpayer would hire an appraiser to make purchase price allocations between land and other depreciable assets (vines, trellis systems, irrigation systems, etc.). Apparently, some appraisers have allocated a portion of the purchase price to a premium being paid for the vineyard, based on its location (appellation). This appellation value is then treated similarly to goodwill and is amortized over 15 years. Please contact the Agriculture Technical Advisor if this issue is present on your case.

Vineyards qualifying as property under I.R.C. §179

In Kimmelman vs. Commissioner, 72 T.C. 294 (1979), it was held that grapevines are not "tangible personal property" within the meaning of I.R.C. §179(d). Prior to 1981, I.R.C. §179(d)(1), in part, defined I.R.C. §179 property as tangible personal property of a character subject to depreciation under I.R.C. §167, used in a trade or business, with a useful life of 6 years or more.

Current tax services reference pre-1981 cites to maintain that vines do not qualify as Section 179 property. Section 179 was amended in 1981 and later. The definition of qualifying property was substantially changed. The definition now references I.R.C. §1245(a)(3), to include (in part) any property of a character subject to the allowance for depreciation in §167, and is used as an integral part of manufacturing, production, or extraction. See CCA 201234024.

Winery Operations

Inventory Costing

The basic steps of the wine making process are fairly simple and straightforward. Grapes are brought into the winery, crushed, and juice fermented into wine. The wine is then aged, bottled, aged some more in the bottle, and then released for sale. The subtle complexities of operating a modern winery make inventory costing a complex conundrum. Wineries will typically be working on several vintages of wine, all in different stages of production. Further, most wineries produce a number of varietals of wine, each with its distinct production stages, activities and timeframes. Many wineries produce more than one class of varietal, with each level of quality having its own specific costs and timeframes. For example, the lower level Cabernet will be made from less expensive grapes, barrel aged in used American oak, and aged overall for a shorter period of time. A higher end Cabernet might be produced from the best grapes available, aged in new French oak, and aged for a longer period of time. The overall goal of any costing system should be to differentiate between deductible period costs (unrelated to production) and those direct and indirect costs that should be capitalized to a specific lot of inventory, only to be released through Cost of Goods Sold when that lot of wine is eventually sold.

To further complicate matters, there are a number of differences between typical book costing and tax costing. There are the standard differences such as book and tax depreciation. However, there are many subtle differences where book and tax may vary. For example, UNICAP requires an additional allocation of indirect costs. Similarly, UNICAP requires an allocation of interest expense to inventory where the production period is in excess of two years. The Service has taken the position that the production period starts at crush and ends after bottle aging when the wine is released for sale. Premium red varietals are often in production in excess of two years under this definition. The additional bottle aging period may cause the total production period to exceed two years (therefore, allocated interest would need to be capitalized) and any storage costs incurred during the bottle aging period would be capitalized. Many costing methods for book will end the production period when the wine is bottled. Another major difference is the costing of grapes grown by the winery. For book, these grapes are often taken into inventory at the cost of growing the grapes. For tax, the farming costs for those grapes are treated as period costs. The winery would have no basis in those grapes and would start accumulating production costs from that point.

Generally, the goal of most wineries is to sell off any given vintage of wine within 12 months of the release date, making room in the sales program for the following year's vintage. However, some wineries do keep back a percentage of their wines for further aging (for which they would charge a higher price). Storage costs incurred after the initial release date would be considered period costs, but the capitalized production costs wouldn't be released from inventory until these “library” wines are sold.

Any comprehensive wine costing system should start with keeping wines separate by vintage and varietal as the wines move from bulk to bottle. Most direct costs are often easy to identify and assign (the cost of purchased grapes, the cost of bottles, labels and corks used in bottling). Other direct costs may be easy to identify but more difficult to assign. For example, on any given day, the activities in the cooperage (bulk aging) may include transferring wine from the fermenting tanks to oak barrels for aging, topping off the barrels, filtering or fining wines, racking the barrels, or blending different lots of wine. Since these activities are not done in the same measure to each varietal, a simple allocation by volume won't do. Employee timecards are not kept in the detail sufficient to make these allocations either. Therefore, an allocation based on reasonable estimates must be built into the costing system.

Indirect costs also have their own levels of simplicity and complexity. The depreciation on the crush equipment, for example, can be allocated to the new year's wines based on the number of total gallons of wine produced that year. Depreciation on the winery building can be allocated to the different cost centers (production, barrel storage, bottling, G&A, marketing, tasting room) on a square footage basis. These relatively simple methods attach a particular cost to a stage of production or a particular activity. Conversely, trying to allocate and apportion an annual utility bill may be difficult. Spikes of electrical use are common during crush and the initial stages of cold fermentation in stainless steel tanks. But often, only white grapes are pressed and cold fermented. It may not be reasonable or material to go beyond allocation of the utility bill by square footage of the facility.

Again, the overall goal of any costing system should be to differentiate between deductible period costs (unrelated to production) and those direct and indirect costs that should be capitalized to a specific lot of inventory, only to be released through Cost of Goods Sold when that lot of wine is eventually sold. It is important to have the Taxpayer walk you through the costing methodology. If you see material amounts of direct or indirect production costs being written off as period costs rather than capitalized, you have an issue. Similarly, if wines with a short production life (generally, white wines) are receiving an inordinately high allocation of costs, these costs will be released through Cost of Goods Sold earlier than should be.

Overhead Costs

Most wineries have systems in place to capture the required additional overhead costs. One area that needs to be checked is that of the Taxpayer's definition of production period. This has two areas of impact. The first is interest capitalization. Another area is the capitalization of storage costs. Treas. Reg. § 1.263A-12(d)(1) provides guidance for when the production period ends, stating, "In the case of property that is customarily aged (such as tobacco, wine, or whiskey) before it is sold, the production period includes the aging period. Since bottle aging is customarily done prior to the wine's release for sale, the tax definition of production period should include bottle aging. This can add a year or more to the production period, especially for premium red wines.

For their book definition of production period, many wineries will truncate the definition of production period at the time the wine is bottled. In that case, for book purposes, storage costs for the post bottling period are deducted as period costs. If there is no adjustment to capitalize bottle aging storage costs for tax, ending inventory will be understated and Cost of Goods Sold will be overstated. Further, by not including the bottle aging period, some wines which have a production period in excess of 2 years will not be considered for interest capitalization. For example, if a Taxpayer ages their cabernet for 20 months in oak barrels, then ages that wine for another 12 months in the bottle prior to release for sale, the production period would exceed 24 months and interest should be capitalized. Most wineries have a fairly stable, programmed aging and release cycle, so the production period should be transparent in the first year in which the wine is made.

LIFO

Many wineries have elected LIFO under I.R.C. § 472 to enjoy the tax benefits associated with increasing inventory costs. As long as inventory costs increase and inventory quantities do not decrease, a deferral of income tax occurs. This is because the items most recently purchased at the higher cost are matched against current revenues.

Most taxpayers elect to determine the cost of their LIFO inventories under the dollar-value method. The dollar-value method determines cost by using base-year cost expressed in terms of total dollars rather than the quantity and price of specific goods as the unit of measurement.

The dollar-value regulations offer taxpayers three alternative approaches to computing an internal price index under LIFO - (1) the double-extension method; (2) the index method; and (3) the link-chain method. These methods measure inflation in a taxpayer's inventory by reference to the taxpayer's own cost data. While each of these methods is available to taxpayers, the regulations prefer the use of the double-extension method and describe the limited circumstances in which either of the other two methods may be employed. In lieu of the three foregoing alternative methods of constructing a price index using internal information, a taxpayer may elect to use the IPIC method in order to construct a price index based on external pricing information developed through industry surveys by the Commerce Department's Bureau of Labor Statistics ("BLS").

The objective of the dollar-value LIFO method is to enable a taxpayer to price its inventories at the beginning and end of each year in constant dollars in order to ascertain whether there has been an increment or liquidation in the quantity of items within a pool. To accomplish this objective, the dollar-value method undertakes to cost the items within a pool in a taxpayer's ending inventory at current-year cost and base-year cost in order to develop an index of price change. The development of such a price index is essential in order to restate the beginning and ending inventories to a common dollar basis, so that changes in inventory quantities can be measured. Schneider, Federal Taxation of Inventories, § 14.01[1].

Item Definition

The starting point under the dollar-value methods of pricing LIFO inventories is to determine what constitutes an "item" within each LIFO pool. The dollar-value regulations do not define what an inventory item is; however, the Tax Court has established some basic principles. In order to clearly reflect income, the grouping of like goods and the separation of dissimilar goods must be accomplished. Because the change in the price of an item determines the price index and the index affects the computation of increments or decrements in the LIFO inventory, the definition and scope of an item are extremely important to the clear reflection of income. A narrower definition of an item within a pool will generally lead to a more accurate measure of inflation (i.e., price index) and thereby lead to a clearer reflection of income. Amity Leather Products Co. v. Commissioner, 82 T.C. 726, 733-734 (1984). If factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed. Amity Leather Products, 82 T.C. at 733.

The appropriate definition of a wine item of inventory has recently attracted significant attention. Industry practice has been to define items of wine inventory into very few categories. Most commonly, wineries place all of their products into a single pool that includes only two items, for example, bulk wine and bottled wine. Yet wineries produce several different wine varietals and/or varietal-blends, each with varying cost characteristics and production processes. Wineries may produce wines under different "labels" or trade names as a way to reach consumers at multiple market segments. The cost differentials of the various wines are typically traced for financial accounting purposes and can be substantial.

Wine products may be added or eliminated and production levels may be expanded or contracted for various reasons. When a taxpayer changes its mix of product over the years and does not differentiate between low and high cost items, distortions will occur. Since wine generally takes several years to produce, wineries will have several vintages in inventory at any one time, each at different stages of production. Grouping multiple vintages into one item of inventory will cause a distortion if there is a change in the vintage mix from one year to the next.

A Non-Docketed Significant Advice Review ("NSAR") 20064301F addressed the weaknesses of the wine industry's "two-item" LIFO methodology. In order for inflation to be correctly and consistently measured, the cost differences associated with the various wines must be identified and measured at the item level. The taxpayer in the FSA produced a significant number of wines with cost differences due to the type of grape, the location where the grapes were grown, the grape grower, the storage containers used, aging requirements of the wine, and the bottling materials used. However, the taxpayer defined inventory items in just two categories: bulk wine and case goods. This broad item definition allowed product mix variations to intermingle with actual inflationary elements, thereby rendering an inaccurate index computation. The FAA concluded that since the taxpayer has defined their items too broadly, the taxpayer had not properly determined its LIFO index, and its LIFO method did not clearly reflect income.

While the above mentioned FSA concluded that two items were not sufficient, it did not describe a suitable definition of an "item" of wine inventory. At the time this ATG is being written, published guidance is in process and should be issued in 2010.

The determination of how a Winery would define an "item" for purposes of a LIFO Dollar Value, Internal index Inventory calculation is a very factually intensive decision. How one Winery defines their items may be very different from how another Winery defines their items. Following are the criteria that an agent should consider in determining the item definition for a Winery:

- The taxpayer will maintain a natural business unit pool for the wines it produces. In addition, the taxpayer will maintain a separate resale pool for the wines, if any, that it purchases for resale.
- The taxpayer will divide the bulk wines that it produces into LIFO inventory items based on the following criteria: (1) type of wine (i.e., varietal, appellation, blends of two or more varietals); (2) source of grapes (i.e., purchase or grown); (3) process, recipe, or formula used, or the program followed, to make the wine; and (4) length of time the wine has been aging at the end of the tax year(e.g., 3 months; 15 months; 27 months). For this purpose, "process," "recipe," "formula," and "program mean a set of directions, techniques, or procedures regularly followed, as well as set of ingredients regularly used, to produce a distinct product (i.e., wine with specific taste; quality or grade; cost; and price point). For example if the taxpayer uses a high quality grape to produce a high quality wine and a medium quality grape to produce a medium quality wine of the same varietal, the two wines will be treated as separate items. On the other hand, if the taxpayer uses the same quality grapes and some of the resulting wine has a higher quality than, or will be marketed as a different wine from, the remainder of the wine produced using those grapes, the taxpayer will not treat that wine as two items bases solely on the process, recipe, formula, or program criteria.

- The taxpayer will divide bottled wines and cased goods into LIFO inventory items based on the following criteria: (1) type of wine (i.e., varietal, appellation, blends of two or more varietals); (2) source of grapes (i.e., purchased or grown); (3) process, recipe, or formula used, or the program followed, to make the wine; (4) length of time the wine has been aging when bottled; (5) type of container, if a significant cost difference exists between cases of containers; and (6) length of time the wine has been stored after bottling. The taxpayer will not divide wines into separate LIFO inventory items based on the type of barrel or container used for fermenting and aging wine because the taxpayer does not specifically allocate the cost attributable to a particular type of barrel or container to any particular LIFO inventory item for purposes of determining the inventory cost or current-year cost of that item for tax or financial accounting purposes. Finally, the taxpayer will use the specific identification method to determine current-year cost.

Taxpayers should be using the above described method to define their wine items and to value their LIFO inventories. Any change in the definition of an item (either expanding or contracting the scope of an item) constitutes a change in method of accounting that requires the Commissioner's advance consent. If an item definition change is proposed per audit, all of the taxpayer's prior LIFO layers must be restated. This can be accomplished through the use of a simplified allocation method.

Glossary

Acid - A component of grape juice and wines. The most important acids present are malic, tartaric, succinic, lactic, and citric.

Aging - The final process in winemaking of holding wines for a period of time to allow some of the components to mature and change beneficially.

Alcohol by Volume - The percentage of alcohol contained in a wine by volume, declared by law on the label. Table wines cannot contain more than 14 percent; dessert and fortified wines (legally the same) contain more than 14 percent but not more than 24 percent, although wines of more than 21 percent are not normally found on the market.

Amelioration - The legal addition of sugar, water, and/or acid to balance deficiencies in wine.

Appellation of Origin - In the United States, a general term for the label designations that indicate geographic origins of bottled wines that meet specific requirements. Any wine, at least 75 percent of which is made of grapes grown in the area designated on its label and conforms to the laws and regulations relevant there, is entitled to a country, state, or county appellation.

BATF - The Bureau of Alcohol, Tobacco, and Firearms (also ATF).

Balling - A system for measuring the sugar content of juice or wine, expressed as degrees balling. Called after the man who devised it, the name is pronounced as in “balance.” For all purposes, the same as Brix.

Barrel-Fermented - Wine that has undergone fermentation in small casks as opposed to very large tanks.

Bench-Grafted - Vines grafted to rootstock, then developed in greenhouses and field nurseries, and planted while still dormant.

Binning - Storing premium bottled wine (before its release for sale) for 6 months to several years to obtain the benefits of aging in the bottle.

Blanc de Blancs - Usually sparkling wine made entirely of Chardonnay (occasionally of other whites) rather than the more traditional blend of black and white grapes.

Blanc de Noirs - A white wine made from black grapes, with a blush, or deeper tone than a white wine from white grapes. Frequently used for sparkling wines.

Blend - To combine wines of different varieties or lots to add interest or harmony to the finished product; or a wine so made.

Bonded - Legal winemaking or warehousing facilities under bond to the Government for payment of taxes on the wine made or stored there.

Bottle Age - The mature characteristics of a wine attributable to the length of its stay in the bottle.

Bottle-Aging - Keeping bottled wines for a period of time to allow some of the components to mature.

Bottle-Fermented - A champagne or sparkling wine made either by the method champenoise or the transfer method.

Boutique Wineries - Those making premium, generally expensive, varietal wines, often from designated vineyards, on a relatively small scale of production.

Brix - A measure of the sugar content. See Balling.

Brut - Champagne or sparkling wine that is very dry but may still contain a trace of sweetness.

Budwood - Well-developed canes bearing buds suitable for use in grafting or budding.

Bulk Process - In making sparkling wine, a technique (also called “Charmat process”) that uses large covered containers for the secondary fermentation, a less expensive method for production of large quantities.

Bulk Wine - Generally, less expensive wines sold in large containers or jugs. Some large producers buy bulk wines from other wineries and blend, bottle, and distribute them under their own labels.

Bung - A plug for stoppering a wine cask.

Bung Hole - A small opening in a cask through which wine can be put in or taken out.

Butt - A wine barrel or cask of moderately large capacity.

Candle - To test the clarity of wine by looking at it with a candle or other light held behind the bottle.

Cane - The woody, mature state of the shoot (new growth) of the vine.

Canopy - The "umbrella" formed by the foliage of the vine.

Cap - The crust consisting of skins that forms on top of the juice during fermentation. To extract the color and prevent spoilage, the cap must frequently be submerged by punching down or by covering with juice pumped from the bottom.

Carbonated - Wines infused with carbon dioxide to make them bubbly.

Carbonic Maceration - The fermentation of uncrushed whole grapes, which takes place partly inside the berries, some of which break down by their own weight, others by the action of the internal fermentation. The resulting light, intensely fruity, low tannin wines are mildly effervescent, an effect of the carbon dioxide produced in the process, and are meant for early drinking. Nouveau-style wines are made by this process.

Centrifuge - A machine used to clarify wine or must.

Chai(s) - A French term for above ground areas for wine storage.

Chapitalization - The addition of sugar to must, legal in such areas as Burgundy (France), but not permitted in California.

Charmat Process - The same as bulk process for making sparkling wines.

Clone - (1) The propagation of a group of plants from a single source to perpetuate selected characteristics or special attributes; (2) the variety so produced.

Cold-Fermented - White wines fermented in containers whose temperatures are controlled internally or with jackets.

Cold Stabilization - A technique of chilling wine before bottling to cause the precipitation of harmless potassium acid crystals or other sediment that might later cause haziness or deposits.

Concentrate - A reduction of grape juice by evaporation often used in home winemaking or in areas where fresh grapes are not obtainable.

Controlled-Fermentation - A fermentation whose progress is altered by adjustment of temperature or pressure.

Cooperage - Containers for storing wine, usually barrels, casks, and tanks of wood or steel.

Crush - The specific process of breaking the grape skins to begin fermentation. Used generally, as “the crush,” it designates the total procedure of winemaking steps preceding fermentation.

Crusher - Usually a stemmer-crusher, a machine that macerates the grapes after destemming them.

Culture - A growth of organisms such as yeast that may be used to inoculate crushed grapes to aid fermentation.

Cutting - A segment of a cane or shoot that will develop into a new plant when grown under favorable conditions.

Cuvee - A specific blend of wines, often of different varieties, combined in the final lot; generally used in making sparkling wine but occasionally also in producing table wine.

Dessert Wine - Wine of more than 14 percent but not more than 24 percent alcohol.

Diatomaceous Earth - A light, friable material derived from fossilized microscopic algae (diatoms) used as a filter in clarifying wine.

Disgorge - In the making of sparkling wine, to eliminate the accumulated sediment in the neck of the bottle by freezing it, uncorking the bottle, and using the pressure of the gas in the wine to eject the sediment.

Dosage - In the making of sparkling wine, usually brandy and wine, mixed with sugar, used to replace the wine lost in the disgorging of sediment.

Enology - The science of viniculture or winemaking.

Estate Bottled - A wine produced solely from grapes grown on land owned or controlled by and in the same viticultural area as the winery making it, as well as being made entirely on the premises.

Extraction - In winemaking, drawing out and dissolving the pigments and other solubles in the skins, seeds, pulp, and occasionally stems, which are kept in continuous contact with the juice.

Fermentation - The conversion by yeast enzymes of the grape sugar in the must or juice into alcohol and carbon dioxide.

Fermentor - A large container in which fermentation takes place.

Field-Budded - See Field-grafted.

Field-Grafted - Budwood grafted to rootstock in the vineyard in late summer or early fall. Also called field-budded.

Filter - To clarify wine after fermentation by removing suspended matter such as yeast cells with the aid of porous membranes; also, the porous material used in the process. Filtration is the process of clarifying wine with filters.

Fining - The process of clarifying wine by employing such agents as gelatin, egg whites, bentonite (clay), or isinglass, that absorb or carry along most of the other suspended matter with them as they settle to the bottom.

Finishing - The processes involved in clarifying wine before it is bottled.

Foil - The molded plastic or metallic material that fits over the cork and part of the neck of a wine bottle.

Fortified - Any wine, but most frequently sherry, port, and so-called dessert wine, in which, by the addition of spirits or brandy, the alcohol content has been increased to more than 14 percent and not more than 24 percent and the fermentation halted before all of the sugar has been converted. Normally, wines on the retail market are well below 24 percent.

Free-Run - In pressing, the crush juice that runs free from the press before force is used.

Fumigation - Chemically sterilizing the soil prior to planting.

Generic - Wines named after general categories (red or while table wine) and place-names (Burgundy, Rhine, Champagne

Graft - To splice a varietal vine to a rootstock of another type, usually one that is resistant to particular predators or diseases; sometimes used to change the variety. Also, the union or splice portion of a plant so treated.

Hardening - When applied to canes, the state of dormancy.

Hybrid - A new grape variety developed by crossing two or more varieties or species.

Hydrometer - An instrument used to measure the amount of sugar in grape juice.

Inoculation - The addition of yeast starter to wine must to begin fermentation; or of a bacterium to cause a malolactic fermentation.

Jug Wines - Generally less expensive, generic wines sold in large containers, although varietals are more and more frequently included.

Lees - The yeast residue that settles to the bottom during fermentation. Wines that are left too long before racking can pick up the odor of lees

Made and Bottled By - Legally only designates that at least 10 percent of the wine in the bottle was fermented at the winery.

Magnum – A large wine bottle that holds the same as two normal bottles. The larger the bottle, the slower the wine ages.

Malic Acid - The acid in wine that converts to lactic acid during a secondary, or malolactic fermentation.

Malolactic Fermentation -A secondary fermentation, often occurring naturally, that converts malic to lactic acid and carbon dioxide, adding complexity to red wines and to some Chardonnays; undesirable if it occurs or continues in the bottle, trapping gas and off-odors.

Marriage - A blending, or marrying, of two or more lots of still wine.

Meritage – Red or white wines solely from specific noble Bordeaux grape varieties and are considered to be the very best wines of the vintage.

Methode Champenoise - The classic method of making Champagne by completing the second fermentation, clarification, and other processes in the same bottle in which it is marketed.

Microclimate - The climate within a small area that differs from the climate in the larger area around it.

Mildew - A fungus that is a major problem in quality vineyard control. The odor from heavily mildewed grapes is often transmitted to the wine.

Mold - A fungus growth usually detrimental to grapes.

Must - The juice and pulp produced by crushing or pressing grapes before fermentation.

Negociant - A shipper of wine.

Nematodes - Vineyard pests that in their larval form attack vine roots, stunting the growth of the plant. See Fumigation.

Overcropping - In viticulture, encouraging too large a yield per acre, thereby having a detrimental effect on quality.

Oxidation - The changes in wine caused by exposure to air, sometimes beneficial, but often undesirable, especially when excessive.

Phylloxera - A highly destructive root louse that infests Vitis Vinifera, but not some of the native American stock, most of which is resistant to it.

Pomace - The solid residue after pressing.

Press - To exert pressure on crushed grapes to extract their juices. Also, a hand-operated or mechanical device used in the process. The four common types are: 1) a vertical, hand-operated, wooden basket press; 2) a horizontal, mechanical, metal basket press; 3) a horizontal, pneumatic air-pressure (or bladder) press, including a tank press; and 4) a continuous press that allows uninterrupted feeding and juice removal.

Press Wine - The wine obtained by pressing in a machine.

Private Reserve - Because there is no legal definition, this term on a label generally, but not necessarily, indicates that the wine is of special quality, above the ordinary run. Same as Special Select or Proprietor's Reserve.

Produced and Bottle By - Legally designates that 75 percent or more of the wine was fermented and clarified at the winery named on the label

Proprietary Wines - Those bearing fanciful names such as Rhine Castle, Rubion, or Ripple, usually registered as a trademark by the brand owner.

Pruning - Cutting back the vegetative part of the vine after it has become dormant, a process that affects the size, and, therefore, the quality of the next year's crop. In California, the three most frequently used systems are head training (with spurs), cane pruning, and cordon pruning.

Pulp - The flesh of the grape or other fruit.

Puncheon - A large wooden cask for storing wine.

Punt - The indentation in the bottom of some wine bottles. Also called the kick.

Racking - Siphoning or pumping wine from one container to another to clarify it by leaving the sediment behind.

Residual Sugar - Sugar that remains unconverted in the wine after fermentation.

Riddling - A method used at the end of the bottle fermentation of sparkling wine to encourage the yeast sediment toward the cork for later disgorgement. The process, which can take between a week and a month, consists of placing the bottles neck down in special racks and rotating them individually about one-eighth of a turn daily. This historically has been done by hand, but now is often done mechanically.

Rootstock - The part of the grapevine that is planted directly in the soil. A different bearing variety is often later grafted to rootstock resistant to disease.

Scion - A cutting used in grafting, containing a bud of the desired vine.

Secondary-Fermentation - A fermentation that takes place either spontaneously or by design after the completion of the primary fermentation. In the making of sparkling wine, the gas produced gives the wine its bubbles.

Sediment - Particulates that form deposits in some wines stored in containers, or, with age, in some bottled wines.

Select - Generally implying something special about a wine, but meaningless since there is no precise legal definition.

Settling - The natural precipitation of the solid matter in wine.

Shoot - A new growth of the vine.

Skin Contact - The process of holding grapes and juice together for a period of time before pressing to obtain an extraction of color.

Sommelier - A wine steward.

Sparkling Wines - Wines whose effervescence is produced by carbon dioxide captured during a second fermentation in the bottle or container in which it is made. The term applies to all champagne-style wines made outside the Champagne district in France.

Split - A wine bottle containing 6.4 ounces.

Starter - Yeast used to start or ensure fermentation.

Stemmer - A machine that separates the stems from the grapes; when combined with a crusher, it is called a stemmer-crusher.

Still Wines - All wines made without effervescence.

Stuck Fermentation - An incomplete fermentation that stops before all the sugar has been converted to alcohol.

Sulfur - Used to dust vineyards as a control for powdery mildew.

Table Wine - In general, still, dry wine meant to accompany food, as opposed to special wines such as sparkling, appetizer, or dessert wines.

Tannin - A polyphenolic compound derived from the skins, seeds, and stems of grapes which gives young red wine an astringent, puckery quality, but contributes to its longevity and normally ameliorates as the wine ages. In excess, it causes a bitter taste.

T-Budding - A method of grafting a new variety to an existing plant.

Tirage - In making sparkling wine, the mixture of still or cuvee wine, yeast culture, and sugar drawn off into bottles or larger containers to undergo the secondary fermentation and allow the spent yeasts to settle out.

Topping - A technique to control oxidation in containers by replacing wine lost through evaporation.

Transfer Process - A champagne and sparkling wine process that removes the wine from the bottle after fermentation for filtering in pressurized tanks before rebottling. Such wines are labeled "bottle fermented" or "fermented in the bottle" as opposed to "fermented in this bottle," often used on the more expensive methode champenoise wines.

Ullage - Leakage or evaporation of wine from its container, resulting in oxidation and often spoilage.

Varietal Wine - Since January 1, 1983, any wine named after and containing 75 percent or more of a Vitis vinifera grape variety, and grown in the appellation of origin appearing on the label.

Vigneron - A French term for a vineyardist.

Vintage - Applied in the United States to wine in which at least 95 percent of the grapes come from the harvest of the year designated on the label. A vintage year is also one worthy of being specified on the label.

Vintner - A person who makes or sells wine.

Viticultural Area - Since January 1, 1983, a region described as having distinguishable geographic features and governmentally recognized and defined boundaries. Wines bearing a viticultural area designation on their labels must contain 85 percent grapes grown from that area.

Viticulture - The science of growing grapes.

Vitis Vinifera - The European-Middle Eastern grapevine from which most of the world's fine table wine are made.

Information Sources

The following is a non-inclusive listing of various sources of information found useful by the Sacramento Wine Industry Study group in conducting wine industry examinations. Consult with the state and local agencies/resources in your area for assistance.

Government Agencies

- BATF - Bureau of Alcohol, Tobacco and Firearms

- ABC - Department of Alcoholic Beverage Control
- California Department of Food and Agriculture
- Napa County Agricultural Commissioner
- Napa County Agriculture Resources
- University Extension - University of California - Davis
- UC Davis - Department of Viticulture & Enology, University of California
- USDA - United States Department of Agriculture

Industry Publications

- Wines & Vines' Directory/Buyer's Guide

Magazines

- Wines & Vines
- The Wine Spectator
- Wine & Spirits

Books

- Book of California Wine
  Authors - Muscatine, Amerine & Thompson
  Publisher - University of California Press/Sotheby