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Who Is Going To Run Your Winery In The 21st Century?

Elaine Chan

When questions like these arise that directly affect your family or closely-held business, you need to consider them twice: the first time, ask what would be the best for your *business;* the second time, ask what would be the best for your *family.* Hopefully, the second decision will complement the first; sometimes, a reconciliation between the two is necessary. When you think about the future of your winery, first decide whether continuing the business is a good idea; if it is, then decide whether continued *family* ownership of the winery is a good idea.

If you like the idea of having your family continue to operate the winery, then you need a plan that will keep the ownership of your winery in the family. That plan, typically called a business continuation plan, includes deciding *who* should be the successor to your business. You probably need a successor for your entire business. Do you need successors for specific divisions or lines of business? Have you considered successors for your other key people?

As you can see, a major part of business continuation planning is management succession. Management succession sounds simple: just select the person who will take over. But that really is the **final** step of a very important process.

Management succession probably best starts with the selection of a number of candidates. Why a *number* of candidates? Because unless you are ready to name your successor and to let him or her actually start running and managing your company now, you need to have several potential successors to ensure that the best person is selected when it comes time to make the actual selection. You need to plan for contingencies and unforeseeable future events that may affect your winery or the lives of the candidates.

Dennis, Jack, Dolores, and Bruce Cakebread of Cakebread Cellars, a family-owned and family-run winery.

How do you select this group of individuals? You probably already have some potential candidates in mind. What do they have in common? They seem to have the same values, goals, and vision for the company that you have; they are motivated and committed; and they are intelligent and appear to have good management and decision-making abilities. In short, they all seem to have qualities that are important to you. Remember that during this process, we are dealing with a *group* of candidates. Until the final decision is made, you should feel free to make changes to the group so that the pool of candidates always consists of the best individuals.

Assuming that each of the candidates is interested in and is willing to become the new manager, then you must start to look at each one objectively. Will they be ready to manage the winery when the time comes? Will they be ready for a job in the future that cannot be specifically defined at the present time? Do they have the characteristics that will successfully lead the company forward? To answer these questions and to consider each candidate objectively, each candidate should be subject to regular reviews: both internal reviews as well as evaluations by an outside review board. Internal reviews tend to focus on past performance and monitor progress based on predetermined company guidelines. Outside review boards can provide objectivity as well as

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Should You Incorporate?

Karen Kryla

Businesses are operated through many different ownership forms such as proprietorships, partnerships, S corporations and C corporations. How do you choose the one that's right for your winery or vineyard?

Each form of ownership has unique advantages and disadvantages — both business-related and tax-related. It is important to review the appropriateness of the entity that you are using as your business moves through different stages of development. What worked in the beginning may not be the best for you now.

Many wineries and vineyards simply begin as partnerships or proprietorships. These forms of ownership are easy to set up and maintain — no corporate minutes, meetings or resolutions are needed. They are also generally easy to get into and out of without triggering adverse tax consequences.

So. . .why use a corporation?

Corporations are often formed to help limit the personal liability of the owners. Generally, businesses operating as proprietorships or partnerships expose both the business and personal assets of the owners to claims of business creditors. In most cases, the shareholder of the corporation does not expose his personal assets to the claims of the business creditors. Although insurance can be obtained for most risks, some individuals feel more comfortable keeping their personal assets legally separate from their business by using a corporation.

Corporations can also be used to separate your business operations from your realty ownership. With a separation of the activities within your business, you open up opportunities for tax planning based on transactions between these businesses (for example, setting grape prices and rental payments). This separation may also help you in the division of your assets among your heirs, succession planning and in managing your overall estate plan.

With a C corporation, tax dollars can also be saved by taking advantage of fringe benefits available to you as an employee of your corporation which are not available to you as an individual, partner or S corporation shareholder. One of the most attractive of these fringes is the ability, given the right circumstances, to deduct your housing and meal costs. Other fringe benefits available include the complete exclusion from income for amounts paid for medical and group term life insurance.

When you form a C corporation, you create a separate taxpayer. This new taxpayer pays its own taxes and has its own tax rate structure. You can save up to $ 11,000 in taxes *each* year if you are able to shift $75,000 in taxable income out of the top tax bracket in your individual return into the corporation's tax brackets. This tax rate advantage phases out between $75,000 and $210,000. However, with tax planning and the determination of the amount the corporation will pay you for grapes, rents, royalties, license fees, commissions and salaries, you can somewhat manage the amount of income that is taxed to the corporation versus the amount of income that is taxed to you as an individual. This will help you to maximize the tax savings by taking best advantage of the tax rate differential.

Also, with a C corporation you may choose a tax reporting year that will more closely mirror the way you look at your business — perhaps from release to release or from harvest to harvest. Proprietorships, partnerships and S corporations are restricted in the reporting year that they can use. Generally, these entities are required to use a calendar year. With special additional reporting and tax payment agreements, some may be eligible to use a September, October or November year end. A C corporation may choose any reporting year they wish to have.

Sound interesting? Well, don't leap at the idea of changing your organizational structure without examining the specifics of your situation and comparing all of the various advantages and disadvantages.

Quite possibly the best answer for your winery or vineyard is not a single entity but a combination of entities that work together to avail you of the advantages while avoiding or minimizing the disadvantages that specific entities bring.

Here is a checklist for you to use in your initial review of your ownership structure. Use this as a starting point to see if a change might be warranted, then head out from there to look at all of the angles. . . the advantages, the disadvantages, where you are now and where you are going. ♦

WINERY and VINEYARD ENTITY ADVANTAGE CHECKLIST	Proprietor / Partnership	S Corporation	C Corporation
Protect personal assets from business claims		X	X
Current tax losses	X	X	
Flexibility to give some owners preferential tax treatment, distributions, or return	X		
Taxable income primarily reinvested in business			X
Taxable income in amounts substantially larger than needed for growth	X	X	
Taxable income can be kept below $100,000 by payment of salaries, rents, royalties, grape payments and residence expenses			X
Owner's home on or adjacent to winery/vineyard, and has business purpose			X
Owners participate in Company fringe benefits			X
Wines released in a cycle other than periods ending in September through December			X
Plan to eventually sell winery/vineyard	X	X	

How Many Businesses Are You Operating?

Debra S. Sasser

The wine business is a complex, vertically-integrated business. Some of the many activities that are often integrated into that one business include:

1. The agriculture business of growing the grapes,
2. The manufacturing business of producing the wine, and
3. The business of marketing the wine in a highly regulated and complex distribution system.

How do you measure success and reconcile the needs of these very different activities if they are all in one entity? How can you determine what should be changed if the result is not satisfactory? Perhaps the answer is to separate your activities into separate entities.

Separating your activities into separate entities gives you the flexibility to analyze these activities individually. Profitability and cash flow can be determined and management decisions can be influenced with this information.

The activities may operate on different business years, the vineyard from harvest to harvest and the winery from release to release. These years may not coincide. With different entities, you can use different year-ends.

Having separate entities will also allow you to choose a different type of entity for each activity. The types of entity generally include proprietorships, partnerships, S corporations and C corporations. There are advantages and disadvantages to each type. The choice will depend on the activity and where your business is in the development process.

Separating your activities can offer you numerous opportunities for tax planning. The best opportunity would be to avoid taxes, but there are only limited ways to avoid taxes. With certain planning techniques, you may be able to minimize or defer your taxes.

Another major business reason to separate your activities into different entities is succession planning. Having different entities allows you the flexibility of gifting or bequeathing the appropriate assets to the appropriate people. Management control can also be more easily divided among the appropriate people when the activities are separated.

As an example, let's say that you personally own the vineyard and winery real estate. You can lease the real estate to a farming company and a wine producing company. The farming company can sell grapes on a contract basis to the wine producing company. And a marketing company can sell on a commission basis the wine that the wine company produces.

By separating these activities, a cash basis partnership might be established for the farming company. Net losses would flow out to the partners, and income could be delayed until received by using deferred grape contracts. On the other hand, an accrual basis corporation could be set up for the winemaking activity to limit the personal liability of the owners.

Further, individual family members may be interested in different areas of the business, some in farming, others in winemaking or marketing. With separate entities, each family member could more easily focus on, and help lead the business in, their area of interest.

With the benefits of separating entities, however, come requirements, some of which are:

1. The separate entities must be run separately,
2. Contracts and debt instruments must be documented and adhered to, and
3. Separate books and records must be maintained.

To be effective, the plan must be well thought out. If it is, there can be many rewards!

If understanding your various activities, having planning flexibility for future ownership and management, and taking advantage of tax opportunities appeal to you, then you should take advantage of separating your many activities into different entities. ♦

Estate Freezes

Brad Harland

Wouldn't it be nice if you could transfer the **future appreciation** in your winery and/or vineyard to your heirs without subjecting it to the 55% estate tax? If it would, then you may want to use an estate freeze. An estate freeze is an estate planning technique where the value of your family business is frozen at its current value, and any future appreciation is automatically transferred to your heirs, tax-free.

While an estate freeze can be structured in many ways, the basic theory is quite simple. The family business is split into two forms of ownership, a preferred interest and a common interest. The preferred interest is retained by the older generation and pays the holder a fixed annual amount. The common interest, the value of which appreciates as the business grows and prospers, is transferred to the younger generation by gift, sale or a combination of the two.

Let's look at how an estate freeze could work for a couple who owns a family-run winery. The winery has been profitable for the last few years, has completed its major investments in assets and inventory, and has enough cash flow to service its debt and to continue investing in the business or begin distributing cash to the owners. It is estimated that the winery is worth about $5,000,000 in today's economy, *after* all of the creditors have been paid off. The owners are concerned that the value of the winery could really take off once the economy turns around and their children would have a hard time paying the estate tax on the value of the winery, without selling the winery. The owners would like to do some estate planning, but are concerned about giving up control over the business they founded and retaining the income generated by the winery for their retirement.

With an estate freeze, the owners can maintain control of the winery by

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input regarding the qualifications of managers and manager-candidates in other businesses and other companies. Because of their independence, this outside board is in a good position to review not only the candidates, but also any key person or family member in the company.

What if the reviews indicate that the candidates need additional preparation in order to become ready and able? Do they need to acquire technical information? Or do they need to improve or acquire certain skills? If technical information is required, the solution may be formal education, industry seminars or simply informal reading and discussions to keep abreast of changes and new developments.

To improve or acquire certain skills, the best preparation is usually experience. Many times experience outside of the family business is appropriate and important. The candidates have an opportunity to gain insight into various operational and management techniques and strategies. They gain confidence in themselves; credibility in the business community; and competence in specific technical areas. They learn the importance of discipline, and they learn efficient managerial and administrative skills.

While outside experience is important, internal experience is always necessary. Every winery is different in philosophy and in its method of operation. By working in the family business, the candidates become familiar with the various functions and special characteristics of *your* business. They gain specific skills that they need and can readily apply them to your winery.

While you are preparing this group of candidates, keep in mind that probably only one of them will succeed you. What will happen to the rest of the group when you announce your final decision? Unless you are planning on co-managers (can they peacefully co-exist?), they need to understand that only one person will succeed you. But no one should be considered **the** winner or else a loser. While you are preparing these individuals, they should also be preparing themselves for other roles and leadership positions. They need to decide whether they would be willing to continue in the family business and in what capacity. A flexible business and organizational structure is beneficial in the vertically-integrated wine business. There can be many advantages to using separate "autonomous" companies or businesses within the business. Different family members can be given primary responsibility for different activities and their related entities, while maintaining unity with one manager for all of the operations.

Once you have a group of well-prepared and motivated candidates, how do you make the actual selection? How do you know exactly when the transition and the turning over of the reins should occur? What else do you need to consider? These are the some of the questions we will discuss in our next issue. ♦

Estate Freezes
continued

assigning greater voting rights to the preferred interest, which they would retain. Further, because the company *must* pay a fixed annual amount to the holders of the preferred interest, a certain level of cash flow can be maintained. Of course in determining the amount of the preferred payment, the owners must balance the anticipated cash needs of the winery with their own cash needs during retirement.

If the common interest is transferred to the children by gift, a gift tax may be imposed on the value of the common interest. Generally, the value of the common interest is determined by taking the value of the winery as a whole and subtracting the value of the preferred interest; the greater the preferred payments, the greater the value of the preferred interest and the lower the value of the common interest. Continuing our example, let's assume that the value of the preferred interest is $4,000,000, requiring annual 8 percent payments of $320,000. The value of the common interest would be $1,000,000 (= $5,000,000-$4,000,000). Since a married couple is allowed to gift up to $1,200,000 ($600,000 each) during their lifetime, they could gift the common interest in the winery to their children without paying any gift tax. Once the transfer of the common interest is made, the value of the winery is frozen, and any appreciation in the winery will affect only the value of the common interest.

The rules regulating the use of estate freezes are complex and have changed dramatically over the last few years. Due to perceived abuses during the go-go eighties, the IRS virtually eliminated their use a few years ago. But the IRS was forced to retreat and reinstate their use in 1990 when the uproar from taxpayers and estate planners became too loud. Of course when the use of estate freezes was reinstated, more restrictions were added. While we may all long for the good old days, the current estate freeze rules still allow a good opportunity for real tax savings. ♦

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AGENDA

Business Continuation Planning
Management Succession
Ownership Succession
Identification and Separation of Family and Business Goals
Estate Planning
Estate Taxes
Retirement Planning
Financing and Funding Issues
Business Valuations

MOTTO, KRYLA & FISHER
Wine Industry Accountants and Consultants

NAPA VALLEY:
999 Adams Street
St. Helena, CA 94574
(707) 963-9222

SONOMA COUNTY:
North & Vine, P.O. Box 1524
Healdsburg, CA 95448
(707) 431-2200

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