THE MKF ADVISOR

WINE BUSINESS UPDATE

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Wine Exports May Bring Tax Savings

By Carol Stevens

A profitable wine export business may yield even more cash flow thanks to a new tax provision recently enacted by Congress. If you qualify, the benefit is a reduction in the effective tax rate and the reduction is permanent with no recapture provisions.

BACKGROUND

The new export tax code provision is called "The Extraterritorial Income Regime" (ETI). All entities that export products outside the United States are eligible for ETI. This includes corporations, LLCs, partnerships – even individuals.

Claiming the ETI benefit entails less effort than the implementation of some other international tax-minimizing strategies. There is no requirement for a separate legal entity as the ETI calculation is made within the entity that generates the export income.

HOW IT WORKS

There are two key issues that largely determine eligibility for ETI. The first is profitability of the export business. The second is the amount of gross receipts from products sold to international markets.

Is the entity profitable? The determination of ETI is based on an allocation between income from sales in the U.S. versus international markets. You are more likely to qualify for ETI if your entity has an overall profit. Claiming ETI with an overall taxable loss is usually not possible.

Are your export gross receipts less than $5 million? This is an important threshold. Entities with export gross receipts of more than $5 million face more difficult qualifications, such as foreign economic process requirements. On the other hand, the cost of documentation and process may yield significant tax savings if you have a large amount of taxable income and export gross receipts.

For example, an entity with $2 million in export gross receipts and an average 50% gross margin on goods sold might be able to exclude about $60,000 from the taxable income. The federal tax savings could be about $20,000 (see example on page 3).

THE FINE PRINT

As usual, there are a few caveats to claiming ETI. U.S. entities that claim foreign tax credits must analyze the effects of ETI on foreign tax credit limitations. Claiming ETI might reduce your ability to use foreign tax credits.

There also is a legal battle brewing with the European Union, which is challenging ETI. The E.U. has asked the World Trade Organization to disallow ETI, claiming it's unfair because it creates subsidies to U.S. companies.

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—Carol Stevens, CPA, MA, MBA-Tax

Ms. Stevens provides tax planning, advisory and compliance services. She specializes in maximizing tax benefits for wineries with international operations.

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MOTTO KRYLA FISHER LLP

John Heymann, CEO

Mr. Heymann has over 25 years experience in business and organizational development.

CEO Comment

There has been much hand-wringing on Capitol Hill and in the media lately on the subject of business ethics and the need for unambiguous standards of financial disclosure. Apparently, some people have just discovered how important these pursuits are for the health and well-being of our country and its economy.

The philosopher Immanuel Kant said: "In law a man is guilty when he violates the rights of others. In ethics he is guilty if he only thinks of doing so."

Since its beginnings 20 years ago, MKF has been guided by principles of the highest ethical standards and best business practices. Doing so is not a response to the latest scandal, or the need to be seen to do the right thing – it is a fundamental part of MKF's culture and approach to our relationships with clients.

Retroactive Federal Tax Breaks For Businesses

By Amy Smith, CPA

On March 9, 2002, President Bush signed into law the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). The new law provides several important tax law changes that may benefit your business. Two important changes are the additional 30% first year depreciation deduction on qualified property and the increase in the net operating loss (NOL) carryback period. These tax law changes are effective retroactively to 2001 and may affect returns that have already been filed. This article outlines some of the important details and mechanics relating to these tax law changes.

ADDITIONAL 30% FIRST YEAR DEPRECIATION DEDUCTION

The new tax law provides an additional ***30% first year depreciation deduction*** for qualified property acquired after September 10, 2001 and generally before September 11, 2004. The following are some of the definitions, rules, mechanics, and key points of this provision:

Qualified Property Defined

- Newly acquired property with a recovery period of 20 years or less
- Certain computer software
- Certain qualified interior leasehold improvements

Property Acquisition Rules

- Acquired for original use after 9/10/01 and generally before 9/11/04
- Placed in service after 9/10/01 and generally before 9/11/04
- Can not have a binding purchase contract entered into before 9/11/01

Calculation Mechanics

- Cost basis is reduced first by the 30% bonus, then other permanent provisions apply
- No limits to the total acquisition costs
- 30% bonus valid for alternative minimum tax purposes

Key Points

- 30% is a deduction and not a tax credit
- Subject to normal capitalization rules
- Not available for vineyard property subject to the Alternative Depreciation System

NET OPERATING LOSS (NOL) CARRYBACK PERIOD EXTENDED

The new tax law provides a temporary extension of the NOL carryback period for losses occurring in tax years ending in 2001 and 2002. The following are some of the key points of this provision:

Key Points

- The general 2 year NOL carryback period is extended to five years
- The 3 year NOL carryback period is extended to five years
- Election is available to forego the five year carryback
- NOL deductions can reduce alternative minimum taxable income up to 100%

Please contact Amy Smith, CPA at 707-963-9222 for more details on how your business can benefit from the Job Creation and Worker Assistance Act of 2002.

—Amy Smith, CPA, MS-Tax

Ms. Smith specializes in income and estate taxation. She provides tax planning, advisory and compliance services specific to the wine industry. Ms. Smith has a Master of Science in Taxation.

How Does My Winery Compare?

By Burt Thompson

This question is asked with increasing frequency as winery managers search for methods to measure success. Increased competition, a changing economy, and consolidated distribution underscore the importance of understanding how well your winery is performing against its peers.

Today's competitive environment dictates that savvy managers utilize solid business practices to achieve the double-digit growth that, in recent years, was more easily won. MKF has developed a unique peer group analysis, or benchmark, that compares wineries to their peers without compromising confidentiality.

Benchmarking is a powerful tool for understanding your marketing, administration, and operations efforts by comparing them to other wine businesses of similar size and complexity. A typical benchmarking study will first look at key client statistics and annual results such as:

- Number of cases sold
- Wine Sales Revenue
- Gross Profit
- Marketing Expenses
- Operating Expenses
- Operating Income

In addition, to create a meaningful comparison, a benchmarking study should consider:

- Is there an established brand or brands?
- What percentage of grapes are grown vs. purchased?
- From which appellation(s) do the grapes come?
- What varietals are sold?
- What portion of sales comes from wine club/ tasting room vs. restaurant vs. regional/national distributor?
- At what price points do the wines sell at retail?
- Is the company family-owned or part of an international beverage company?
- What is the company's growth plan?

Once these parameters are established, they are compared with the profiles of 3 to 6 businesses of similar size, quality, and product mix, whose identities are not revealed. This type of in-depth benchmarking analysis can tell you how well you have met (or not met) your current goals, and allow you to confidently set meaningful long-term objectives. Benchmarking can also be performed for specific areas of your business, such as comparing the price point and quantity of each wine you sell. In either case, the value of comparing your results to the actual results of a peer is tremendous.

Burt Thompson, CPA, MA, MBA-Tax

Mr. Thompson, the Director of Assurance Services, specializes in advisory and compliance services.

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This is a continuation of a 30-year-old battle started in 1971, when Congress first enacted legislation to benefit U.S. companies doing international export. Professional consensus is that ETI, or some version thereof, will remain.

ACTION PLAN

MKF recommends all wineries with exports include ETI calculations in the tax planning process. An MKF tax professional will be happy to review your 2001 financial data to determine if you qualify for this permanent tax-saving opportunity.

HYPOTHETICAL CALCULATION FOR ETI TAX BENEFIT

Foreign Trading Gross Receipts	$2,000,000
Cost of Goods Sold	– 1,000,000
Gross Margin	1,000,000
Allocated and Apportioned Expenses	– 600,000
Foreign Trade Income	$400,000
ETI excluded income (assuming use of 15% method)	$60,000
Federal Tax Savings (assuming 34% rate)	$20,400

Source: MKF

MKF in the News:

Excerpts from *The Press Democrat* by Ted Appel, *January 25, 2002*

California wineries lost $75 million in potential revenues as a direct result of the Sept. 11 terrorist attacks, but sales have already started to bounce back and wineries will enjoy continued gains in 2002, according to a report issued Thursday.

However, the California wine industry saw its growth slow to a crawl last year as the recession took hold nationwide. Overall, California wineries boosted revenues by 3 percent in the United States last year to $6.5 billion while case shipments remained flat, according to preliminary figures reported by St. Helena wine consultant Motto Kryla Fisher.

"Sturdy growth in sales of mid- and high-priced wines was offset by continued erosion in sales of low-priced wines under $8 a bottle," said MKF partner Vic Motto, who presented the "State of the California Wine Industry" report.

"The low end of the market was hit pretty hard," Motto said. "The categories that Sonoma County produces in are doing well."

"The Sept. 11 attacks cut into wine sales almost immediately as Americans temporarily stopped traveling and dining out," Motto said.

"It changed very quickly," Motto said. "But it started to recover almost as quickly. October was better than September, and November was better than October."

"While wine sales fell in restaurants, hotels and airlines in the aftermath of 9/11, Americans increased their purchases of wine in retail stores," Motto said. Overall, the California wine industry lost just over 1 percent of its annual sales as a result of the attacks, he estimated. "The industry, on balance, wasn't that hard hit," Motto said.

"The financial performances of individual wineries varied much more widely in 2001 than in previous years. Half of California's wineries saw shipments decline last year, while half experienced growth," he said.

"In addition, winery profits leveled off last year, though 90 percent of California wineries were profitable. By comparison, less than half of California wineries were profitable a decade ago. The wine industry is in pretty solid financial condition right now," Motto said.

As in the past, premium wineries on the North Coast are faring much better than producers of jug wine in the Central Valley. Shipments of low-priced wine under $8 a bottle fell 3 percent last year.

"But shipments of mid-priced wines, from $8 to $15 a bottle, increased 7% last year," he said. And shipments of wines priced over $15 a bottle jumped 13%.

Sales of luxury wines priced at $50 a bottle and above came screeching to a halt last year. Motto forecast a rebound in the luxury segment this year, as consumer confidence grows and retailers deplete the lackluster 1998 vintage.

Overall, Americans continue to spend more on wines of better quality.

Two New Wine Trends Conferences Coming in May!

May 15th - The Wine Trends Forum 2002: A half-day program with MKF experts featuring a Varietal and Pricing Overview, 2001 in Review, Macro Trends and Outlook, and Using Wine Trends to Generate Results. Includes a special presentation by IRI on Retailer Margins.

May 16th - The Luxury Wine Trends Annual Conference 2002: A full-day program with MKF analysts and guest panelists presenting information on the fastest growing wine market segment—luxury wines. Topics include affluent consumer buying habits, how to reach the luxury consumer, the role of restaurants and luxury retailers and the high-end market in warehouse clubs.

For further information or to register on-line, go to www.mkf.com or call 707-963-9222.

MKF is the leading firm of wine business advisors, providing business consulting, industry research, and CPA services to the owners and managers of hundreds of wineries and thousands of vineyard acres. MKF serves the premium wine industry exclusively.

For more information, please call Lisa Anthony, Director of Marketing: 707-967-5322 or e-mail lanthony@mkf.com

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