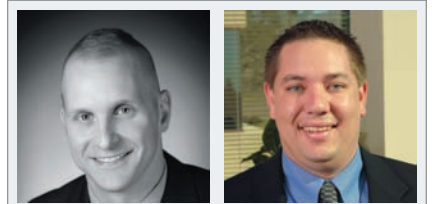


# New Depreciation Incentives: Does Your Winery Qualify?

Recent legislation has enhanced the tax incentives associated with depreciation.

*Craig Anderson and Michael Ricioli*



**Craig Anderson** (left) is a partner in the Yakima, Washington office of Moss Adams LLP. **Michael Ricioli** (right) is a senior manager in the Santa Rosa, California office of Moss Adams. Both specialize in taxation issues specific to the wine industry.

**MAINTAINING PROFITABILITY** in the face of today's constantly changing and often volatile economy is a balancing act requiring a delicate touch and a strong constitution. Managing cash flow and servicing current debt obligations are no longer the only basic functions companies must perform to survive in a globally dynamic wine industry. Among many other factors, an ability to maintain flexibility while maximizing the return on assets and equity is essential for a winery to position itself for long-term financial success.

There are many strategies a winery can implement to maximize the return on its investments. One step toward this goal is being knowledgeable about current tax-related provisions—in particular, one that allows a company to accelerate one of the most important deductions allowed in today's tax law: depreciation.

The term certainly isn't new to the wine industry or to the business world in general. Anyone who has ever purchased, expensed or decided to capitalize a fixed asset is likely familiar with depreciation and the income tax deduction it represents. Essentially, depreciation is recovering the cost of an asset placed into service over time via deductions against revenue for income tax purposes. While depreciating an asset is a non-cash transaction, taking depreciation can affect a business's bottom line in immediate and often sizable ways.

Recent legislation has enhanced the tax incentives associated with depreciation. In February 2009, Congress enacted the **American Recovery and**

**Reinvestment Act** (ARRA), which contains several incentives aimed at providing businesses with increased depreciation deductions, including expanded Section 179 expensing and the extension of bonus depreciation.

## **SECTION 179**

One of the most common methods of maximizing depreciation deductions is Section 179 expensing. This gives business taxpayers the option of writing off the cost of certain capital expenses (purchased fixed assets, such as equipment or machinery) in the year of acquisition rather than depreciating the asset and recovering the cost over time. Eligible property must be purchased by the taxpayer, be considered tangible recovery property (most depreciable property except buildings and certain longer-lived assets) and be placed in service during the current year. For a winery, this might include production equipment and office or tasting room furniture.

Because of the phase-out limitations discussed below, the Section 179 incentive is typically thought to benefit only small businesses, helping them quickly recover costs associated with large purchases (the thinking being that a deduction today is more valuable than a deduction five to seven years from now).

Prior to the increased Section 179 expense amount outlined in ARRA, business taxpayers were typically allowed to write off up to \$125,000 in capital expenditures incurred during the year (subject to phase-out once total capital expenditures exceed

\$500,000). With ARRA, Congress has temporarily increased the amount small businesses can write off for capital expenditures incurred in 2009 to \$250,000, with the phase-out threshold rising to \$800,000. There is no requirement that the equipment purchased be new assets (more on this below).

Lastly, generally speaking, Section 179 cannot create a loss for the business.

## **BONUS DEPRECIATION**

In addition to enhanced Section 179 expensing, ARRA provides expanded depreciation deductions available to all businesses by extending bonus depreciation, which allows companies to more quickly recover the cost of capital expenditures.

Ordinarily, tax law requires a company to recover the cost of all capital expenditures over time according to a depreciation schedule. Different schedules and depreciation methods are available depending on the type of asset purchased as well as the type of business involved. Bonus depreciation permits a business to immediately write off 50 percent of the cost of qualifying depreciable property as a tax deduction. The remainder of the basis is recovered over the normal depreciation schedule.

To qualify for bonus depreciation for 2009, a business must make sure the following criteria are met:

- The asset must be new. The original use of the asset must commence with the taxpayer claiming the bonus depreciation.

- It must be acquired during 2009, provided no binding contract for acquisition was in effect prior to January 1, 2008.
- It must be placed into service during 2009.
- The property must have a recovery period of 20 years or less.
- The property must not fall under the Alternative Depreciation System (ADS). ADS is generally found in farming operations in which the taxpayer has made an election to expense preproduction costs. This may apply to a winery if the winery also farms grapes.

The taxpayer may forgo bonus depreciation, and businesses can make this choice on a class-of-property basis. For example, a winery could decide to take bonus depreciation on all assets in the seven-year class life but forgo bonus depreciation on all other asset classes in 2009.

## **QUALIFIED LEASEHOLD IMPROVEMENT PROPERTY**

Does leasehold improvement property qualify for bonus depreciation when one taxpayer leases that property to another? For example, what if a landlord makes significant tasting room improvements for a winery tenant? Is the property eligible for bonus depreciation? Generally, in order to qualify, the property must meet the following requirements:

- It must be real property (part of the building).
- The improvements must be made to nonresidential property.

- The improvements must be done to the interior of the building and not enlarge the building's footprint.
- The improvements must be placed into service more than three years after the date the building was first placed into service.
- The improvements must be made under or pursuant to a lease by the lessee, sublessee or lessor of the building.
- The interior of the building must be occupied exclusively by lessee or sublessee.
- The lease may not be between related persons.
- The improvements otherwise qualify as bonus-eligible—they were new assets placed into service during 2009, and no contract for construction of such improvements existed prior to January 1, 2008.

## CAPITALIZED COSTS OR CURRENT DEDUCTION

Once a winery has determined what its depreciation for the year is—including bonus depreciation and Section 179 if applicable—it must determine how to treat such depreciation under its adopted method of accounting. Most wineries capitalize the costs of producing their wines into inventory. This includes the obvious direct costs of wine production as well as a share of indirect costs.

Section 179 need not be capitalized to inventory, which results in an immediate benefit to the taxpayer. Bonus depreciation does, however. So purchasing barrels (or production equipment) for the 2009 vintage in which bonus depreciation is taken will not result in an immediate (2009) tax savings since this additional depreciation will generally be capitalized into the inventory to be stored in the barrels. However, when this inventory is sold, its basis is recovered, and the deduction is realized for tax purposes.

Thus, although wineries can defer the ultimate tax benefit with bonus depreciation (waiting until the wine is sold), in most cases the bonus depreciation will result in faster recovery than traditional depreciation. For assets not included in the production process (for example, a computer used by a sales representative), the winery will generally not be required to capitalize such costs to inventory. For depreciation related to overhead or mixed-type costs, an allocation to inventory may be

required based on the winery's current method of accounting.

Lastly, some wineries make allocations of depreciation to inventory based on other methods, as opposed to a specific identification of an asset, as we've alluded to here. In theory, though, the heightened bonus depreciation from a new barrel acquired for the 2009 vintage should have this additional depreciation captured in the 2009 vintage inventory.

Granted, based on adopted methods of accounting and prior practices, it may not always be quite as easy as we've described here. Some other tax planning thoughts to consider when choosing between bonus and Section 179 include considering taking Section 179 on production-type assets (thus excluding such expense from inventory as noted above), taking Section 179 on used assets first (used assets are ineligible for bonus depreciation) and taking Section 179 on longer-lived qualifying assets before shorter-lived ones.

## A FEW THINGS TO NOTE

The guidance in this article is intended to promote general awareness and wasn't written with any specific set of facts or existing methods of accounting in mind. For example, we haven't attempted to address state law or state income tax deductions related to Section 179 or bonus depreciation. Nor have we attempted to address certain asset acquisitions such as automobiles or trucks. There are myriad other details, exceptions and requirements for both bonus depreciation and Section 179. As a result, any winery considering taking Section 179 and/or bonus depreciation should consult with its tax advisor.

It's also worth noting that enhanced bonus depreciation and increased Section 179 expensing were slated to expire on December 31, 2009. After that date, Section 179 deductions will revert to \$125,000. Congress may or may not extend these ARRA provisions into future years.

## STRATEGIC PLANNING

In the face of today's challenging financial landscape, wineries must focus on the details of their business operations. They can use enhanced Section 179 expensing and bonus depreciation to accelerate deductions and hence increase cash flow via income tax

deferral. Some wineries may decide to take advantage of both provisions, and some may elect to forgo the incentives altogether.

Although the increased bonus and Section 179 deductions may be advantageous for some wineries, it may not be for all. Wineries should consider these choices carefully, taking into account current income tax rates, expected future tax rates and related use of the deductions. (For example, a winery might not want to load up its deductions now if it's in a low tax bracket anyway and is expecting higher brackets in future years.)

Whether or not a winery takes advantage of these options, the decision should be made as part of an overall strategic plan that takes many factors into consideration. **wbm**