

# Wineries Could Realize Significant Savings with R&D Tax Credits

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**THE RESEARCH AND DEVELOPMENT** (R&D) tax credit is one of the largest tax incentives available—offering businesses more than \$12 billion a year. For wineries and grape growers, the potential tax savings could be significant. Yet these businesses often miss out on savings, either because they aren't aware of the credit or don't realize they're eligible.

The following outlines key information—from what activities and expenses qualify to documentation requirements—to help wineries and grape growers benefit from this savings opportunity.

## Qualifying Activities

Any company that encounters and resolves technological challenges may be eligible for the R&D credit. Winemaking and grape-growing companies often aren't aware that many of the activities they perform—potentially at each stage of the winemaking and grape growing process—could meet this qualification.

**TABLE 1** is just a partial list of activities that could qualify.

### CASE STUDIES

While many wineries overlook the R&D credit, those that do pursue it often see promising results. A Napa Valley winery worth nearly \$3 million identified qualifying activities they performed, including:

- Evaluating the effects of staves, as barrel inserts, to improve flavor and save on the cost of new barrels
- Removing smoke-tainted grapes to reduce the aroma and taste of smoke from the wine
- Flash processing.

With careful documentation and planning, this winery was able to apply and successfully qualify for approximately \$200,000 in combined credits.

A family-owned winery in the heart of Washington took a similar approach. They reviewed the work they were already doing and realized it included several qualifying activities:

- Experimenting with new blends
- Bacteria removal
- Barrel fermentation.

The business successfully claimed approximately \$50,000 in combined credits.

**TABLE 1**

Process	Examples of Winery or Vineyard Activities that could qualify
<b>Grape Growing</b>	Development or testing of new or improved strains of grapes
	Development of new systems, structures, or techniques to improve harvesting processes
	Design or development of irrigation systems
	Evaluation of geological plot characteristics, including grade, soil, and water conditions
<b>Crushing &amp; Pressing</b>	Development of automated sorting and crushing processes or equipment
	Development of new methods or systems to manage wastewater generated from the crushing, de-stemming, and pressing processes
<b>Fermentation</b>	Development of new or improved fermentation methods, processes, or techniques
	Testing and evaluation of various fermentation methods to improve wine quality, flavor profiles, or economic efficiencies
<b>Post-fermentation</b>	Development of new clarification methods or technique, including improvements to fining and filtration processes
	Evaluation of various filtration methods to improve wine quality
	Development of new or improved product formulations for desired flavor or aroma profiles
<b>Aging &amp; Bottling</b>	Experimentation with various blends of wine to produce new or improved products
	Design and development of subterranean wine cave improvements
	Development of new or improved bottling and packaging processes



### FOUR-PART TEST

Eligibility ultimately depends on whether research meets the tax code's four-part test. Once a company has identified potential qualifying activities, it can check them against the test criteria.

### ELIMINATION OF UNCERTAINTY

A company must demonstrate that it has attempted to eliminate uncertainty about the development or improvement of a product or process. The scope of the research should answer questions at the project onset, such as is this doable, what is the best design to achieve the desired result or what is the best method for creating a successful design.

### PROCESS OF EXPERIMENTATION

A company must demonstrate—through modeling, simulation, systematic trial and error, or other methods—that it has evaluated alternatives for achieving the desired result.

### TECHNOLOGICAL IN NATURE

The process of experimentation must rely on the hard sciences, such as engineering, physics, chemistry, biology or computer science.

### QUALIFIED PURPOSE

The purpose of the research must be to create a new or improved product or process, resulting in increased performance, function, reliability or quality. Improvements must be measurable, but they don't need to be entirely unique.

## Expenses

If a company determines the work it's conducting likely qualifies, identifying related expenses is the next consideration. Most expenses fall into three categories—employee wages, supplies and contractor expenses.

### EMPLOYEE WAGES

Qualifying employee wages can include the following:

- Form W-2, Box 1 wages, including bonuses and stock options, for those directly supporting, as well as first-level supervisors of those involved in research
- Pass-through income subject to self-employment tax.

The rules allow if an employee is 80 percent qualified, 100 percent of their wage can be included to calculate the credit.

### SUPPLIES

Qualifying equipment and materials related to the research process can include the following:

- Tangible property—other than land or depreciable property—that's used in qualified research
- Some large-scale prototypes and pilot models
- Extraordinary utilities expended for research processes and activities.

Here are some wine-specific examples:

- Grapes
- Fining agents
- Corks
- Bottles
- Barrels
- Barrel staves
- Testing supplies
- Batches of wine used in experimental blends.

Indirect general administrative supplies don't qualify.

### CONTRACTOR EXPENSES

Payments to contractors can be eligible, contingent on rules, including:

- Expenses paid would be eligible if the same services were performed in-house
- Contractors must be performing an activity that would've qualified if performed by employees
- Taxpayer must be at risk in the sense that their payment isn't contingent on the contractors' results
- Taxpayer must retain substantial rights—shared rights or greater—in the results

Wine-related examples include contractors, such as engineers and architects for the design and construction of a new winemaking facility, or engineers hired to design new processes for harvesting, irrigation, bottling or storage.



## Documentation

It's critical to accurately document the activities and demonstrate a connection between qualified activities and their related eligible expenses. Taxpayers must evaluate and document their research activities contemporaneously to establish the amount of qualified research expenses paid for each qualified research activity and show how activities meet the four-part test.

Certain elections must be made on tax returns, and it's much easier to collect documentation and support for credits identified and claimed at the same time the expenses are being incurred, rather than looking back and doing so historically.

The consequences of failing to keep sufficient records substantiating a claimed credit may be denial of the credit, as outlined in the Research Credit Audit Techniques Guideline.

Examples of contemporaneous documentation include the following:

- Payroll records
- General ledger expense details
- Old tax returns
- Contracts with customers or vendors
- Project lists
- Project notes
- Design documents
- Email communications
- Photographs of improvements to projects and processes.

Wine-specific examples include materials, such as:

- Lab analysis results
- Test methods
- Variability analyses
- Blend analyses
- Acidity adjustment analyses
- Tasting panel notes
- Harvest records
- Fermentation procedures
- Tank fermentation
- Barrel fermentation.

These records, combined with credible employee testimony, can form the basis of a successful R&D credit claim. While taxpayers may estimate some research expenses, they must have a factual basis for the assumptions used to create the estimates.

If a company is already documenting its R&D efforts, it may just need to improve them or make adjustments to ensure they capture the records necessary to properly support the tax credit.

## Opportunities for Companies That Haven't Claimed Before

The amount of R&D tax credit that wineries and growers can claim depends on many factors, but the potential tax savings could make it well worth the time it takes to investigate. The savings potential is particularly significant for companies that haven't previously benefited from the credit, as they have the option to look back at all open tax years—typically three to four, depending on when tax returns were filed—to claim credits for a refund on taxes paid in earlier years.

### COMPANIES THAT AREN'T TAXABLE

Companies that aren't currently taxable should still consider pursuing the credit. If a company doesn't currently have taxable income or is otherwise limited in how much tax credit it can use, the federal tax credit can be carried forward for 20 years or potentially applied to offset the company's federal payroll tax under the newly expanded rules. State credits may also be carried forward for a length of time determined by the state.

Recently, the R&D credit was enhanced and made permanent. One enhancement allows eligible small businesses to use their credits to offset the alternative minimum tax, and another allows qualified small businesses to use up to \$250,000 in credits against their payroll taxes. Both enhancements are a potential windfall for companies and their owners who haven't been able to use their credits in the past. **WBM**

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