Beyond Brewing–Business Basics Bulletin

MARCH 2015 EDITION

TAX SEASON FEATURE:

Pre-Opening Expenses Every Brewery Should Know and Be Aware Of

By Troy Faris, CPA Partner
Considine & Considine

As a CPA one of the most common questions I get is "Can I deduct the cost of _______?" And if the Internal Revenue Code (which we will refer to as simply the code from here on out), related regulations, revenue rulings, explanatory material, etc. was not over 70,000 pages it might be an easy question to answer. The general rule is that the expense will be deductible if it has a legitimate business purposes.

Of course, there are always exceptions to the general rule.

One of those many exceptions includes costs the brewery incurs prior to opening its doors. Unfortunately just because you incurred expenses related to opening your brewery doesn't mean you get to deduct those expenses when paid. The IRS code classifies pre-opening costs into one of two categories, which are generally not favorable to the business owner.

First, there are the organizational costs which are the costs you would incur to form your brewery. These would include the legal fees for drafting the articles of organization (if an LLC), founder's agreements, operating agreement, etc. It may also include accounting and consulting fees related to the choice of entity and initial meetings.

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Second, are the start-up costs. These are the costs that are incurred after the business has been formed but before it begins its "activity trade or business." Start-up costs could include (but are not limited to) initial marketing and advertising, rent, training or educational costs, salaries, and benefits incurred prior to the business being open and actively engaged in its primary trade or business.

The code limits the deductibility of both organizational costs and start-up costs to $5,000 each (phased out for each dollar that the costs exceed $50,000) in the year in which the business begins its "active trade or business;" the remaining costs must be amortized or expensed over 15 years. Please note these costs cannot be deducted or expensed until the "business begins" which is a separate and distinct date from when the business is formed. For example….

ABC (no pun intended) LLC pays $8,000 in legal and accounting fees to form its business. It pays an additional $20,000 in rent, marketing, and employee wages prior to the brewery opening for business. All expenses were paid in the 2014 tax year and the brewery opened its doors for business in 2014. On the 2014 tax return ABC LLC could deduct $5,000 of organizational costs and $5,000 of start-up costs. The remaining $3,000 of organizational costs and $15,000 of start-up costs must be expensed over 15 years!

In a new example, assume the same facts and circumstances as above except that the brewery does not open its doors until the following tax year of 2015. In this case ABC LLC <u>would not</u> be able to deduct any expenses in 2014, as according to the IRS it has not started its "active trade or business". ABC LLC would be allowed to deduct the $5,000 of organizational and start-up costs in 2015 (the year it started its active trade or business) with the remaining costs amortized over 15 years.

If you have the option it is always better to delay costs until after opening your doors as these will generally be deductible as ordinary and necessary business expenses in the year paid. If you incur expenses prior to the business opening they may be limited or even non-deductible in the year paid.

Have questions, need help, and just want to get back to brewing? Call or email us. We are here to help.

Troy Faris, CPA Partner
ttf@cccpa.com
Considine & Considine
Certified Public Accountants
Phone: 619.231.1977

Craft Beer Distribution Part II: *Where to Begin*

By Laura Lodge,

bigbeersfestival@hotmail.com

www.distributioninsight.com

Craft Beer Distribution: Where to Begin (Part II)

Our previous article covered the importance of establishing an outstanding line of consistent, quality products and the benefits of self-distribution. In this edition we move forward to the questions of *when* and *why* you would consider working with a distributor. The answers to both questions are as unique as breweries themselves; no two are exactly alike. Each issue should be considered separately in the order appropriate for your business.

Why

Contracting with an outside distributor can alleviate a substantial number of stressors on a brewing operation. Consider the ownership and maintenance of delivery vehicles, storage space for product in a growing brewery, availability of brewery staff for brewing, the administrative responsibilities of invoicing and collections with customers, and the focus of the brewery team on (only) brewing.

In addition to alleviating these financial and operational burdens on the brewery, distributors can streamline several key areas that can be a self-distribution challenge.

- First, their sales representatives are able to efficiently visit far more retail accounts in a larger territory than would realistically make sense for a self-distributing brewery.
- Second, their sales reps will have already established relationships with each account in their territory and be familiar with the protocol for sales and delivery at each. The distribution team can likely accommodate changes and last minute requests more easily than most breweries as well.
- Third, over time the distributor will earn credibility with the

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INDUSTRY UPDATES

2015 Minimum Wage Increases for Bay Area Brewers

City of Richmond: $9.60 on 1/1/2015

City of San Jose: $10.30/hr. on 1/1/2015

City of Sunnyvale: $10.30/hr. on 1/1/2015

City of Oakland: $12.25/hr. on 3/1/2015

City of San Francisco: $11.05/hr., increasing to $12.25/hr. on 5/1/2015

City of Berkeley: $10.00/hr., increasing to $11.00/hr. on 10/1/2015

All other cities in California: $9.00/hr. (at least for now…)

A New Bill Would Allow Beer Vendors to Offer Tastes of their Products at Farmers Markets in CA

Assembly Bill 774 extends the terms of the permit which allows breweries to get licenses to sell products at farmers markets, to also allow tastings as long as the brewery is located in the same county as the market or an adjacent one.

Money Well Spent?

Grading the Brewery Insurance Carriers

With the rise of the craft brewing industry, there has been an inevitable rise in the number of insurance companies offering to insure them as well. The increase in carriers has kept premiums competitive, but which carriers offer the best liability and property protection for your brewery?

Insurance carriers that also specialize in wineries have made a strong entry into the market by offering some of the broadest coverage available for breweries. And with their experience in the wine business, their premiums are typically the most competitive. Other carriers that insure manufacturers have also entered the market; but while many offer competitive pricing, these carriers often lack the basic protections that are essential to a *brewery* operation.

Ultimately, it all boils down to two very specific brewery risks: selling price endorsement and leakage coverage. If a carrier covers these two risks correctly, it typically has a well-tailored brewery policy.

The selling price endorsement protects your profits. If your product gets damaged or destroyed in the process of being made or packaged to sell, the insurance company will pay the price you would have sold the beer for instead of what it cost to produce (replacement cost). The difference in the claim payout is your profit margin. Accidents happen all the time and having the selling price endorsement could mean the difference between making money and barely breaking even.

Leakage coverage is exactly what it sounds like: coverage against beer leaking from damaged tanks, barrels, and other containers. You would think any insurance company offering coverage to a brewery would include this provision; but you would be surprised. Leakage is a common occurrence in the brewing industry so it is ill advised to have an insurance policy that does not cover this risk.

By John Hoefer,
Brewery Insurance Program
Milestone Risk Management & Insurance Services

For your time and convenience, we have evaluated a few of the policies from leading brewery insurers to see if their coverage passes muster.

Companies with the Broadest Coverage Available

BreweryPlus – As the only insurance company endorsed by the California Craft Brewers Association, BreweryPlus has the broadest coverage of all the carriers in the market.

Spawned from WineryPlus, the largest insurer of wineries in the country, the BreweryPlus policy offers wide profit protection. Their selling price endorsement covers all of a given breweries stock, from raw materials to finished goods. In addition, leakage coverage is endorsed on every policy up to any limit the brewery chooses or the broker recommends.

BreweryPAK – Started by WineryPAK, the second largest insurer of wineries in the US, BreweryPAK automatically includes a leakage endorsement that sets the limit at the brewery's choosing or the broker's recommendation. The

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Craft Beer Distribution Continued…

retail accounts based on their entire portfolio and performance, and can have considerable negotiation ability to improve shelf spots, promotions, floor displays, and other marketing strategies in off-premise accounts, and secure draft line or bottle placements on premise in restaurants and bars.

- Lastly, hiring, training, and managing the sales and delivery teams, as well as handling orders and collections, are the very definition of distribution, not brewing. They will have established systems for everything already in place.

When

Planning is important. Distribution is a topic that should be considered at the very inception of your brewery. It may not take the form of a definite timeframe, but should at least be specifically included or excluded as part of your business plan for the brewery.

If it will be included as part of the evolution of the brewery's growth, there should be general criteria set as to when self-distribution will start and when it should be handed off to an outside business.

If it is specifically excluded (perhaps due to state law), there should be growth, quality, consistency, and financial benchmarks established to create a timeline. At critical points along the timeline, preparation for distribution can begin to take place.

The worst-case scenario is deciding to go with an outside distributor because the brewery is failing at self-distribution. This happens because of customer complaints, retail outages, retail complaints, the need to service more accounts than possible, vehicle issues, sales and delivery staff issues, and other similar situations. Be cautious about avoiding this kind of crisis, as thorough research takes time and finding the right distributor is the essential result of this research process.

Looking ahead to the when and why of distribution can take the guesswork out of brewery growth and development. This will provide your team with the confidence and guidance to lay the groundwork for distribution in the best way possible for your brewery.

To be continued…stay tuned for "Craft Beer Distribution: Laying the Groundwork"

Brewery Insurance Continued...

selling price endorsement is automatically included in this policy and it covers any beer aging in barrels or beer that has been kegged, bottled, or canned.

Hanover – Like BreweryPlus and BreweryPAK, Hanover initially started with the Hanover Winery Program and have since evolved to meet the needs of brewers as well. Hanover offers leakage and selling price endorsement coverage comparable to BreweryPAK. Unlike BreweryPlus and BreweryPAK's policies, however, these coverages are not automatically included and must be requested by you or your broker.

When using Hanover, make sure the broker has endorsed the policy with these two important coverages.

Companies Lacking Important Brewery Coverages

Liberty Mutual – Although Liberty Mutual is one of the more popular insurance carriers for manufacturers in California, their policies often lack the protection that a brewery requires. Unfortunately, their winery program is no longer available and this has meant that they will seldom offer leakage coverage or the selling price endorsement to any but the largest breweries. Even then, to add these endorsements requires approval from the home office in Boston.

If you are a Liberty Mutual customer, your policy likely lacks the two most important coverages for the brewing industry.

Allied/Nationwide Insurance – Allied, also known as Nationwide Insurance, does offer brewery coverage; however, the leakage and selling price endorsements are significantly limited. Allied/Nationwide has great restaurant policies and their brewery coverage is geared towards brewpubs as they often have a smaller brewing system and a greater need for restaurant specific coverages. Allied/Nationwide insurance is not recommended for production breweries.

The Hartford – Several years ago, Hartford insurance was one of the best brewery insurers in

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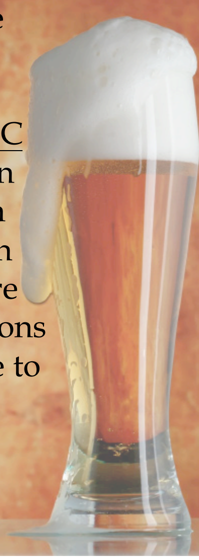
EDITOR'S NOTE:

Here at B5 we strive to provide craft breweries with the business tools necessary to run a successful business. We bring the odds and ends to you so that your focus can stay where it belongs: with the beer. We love those hoppy brews as much as you do and we want the art of brewing to stay front and center. This quarterly newsletter comes to you from the offices of The Craft Beer Attorney, APC in San Diego, California. We hope that the information contained in these pages is helpful to you and your team. While the information provided in this newsletter is not designed to be legal advice, each and every one of our providers serve the craft beer industry and are available for your questions. Should you have more general questions about this publication or the providers listed herein please feel free to contact me at:



Stacy Allura Hostetter
Craft Beer Attorney, APC
866.290.5553
stacy@craftbeerattorney.com

the country; but in recent years they have stopped offering coverage to breweries due to the increased liquor liability exposure in tasting rooms. That being said, Hartford still offers solid Workers Compensation for breweries.

If you have a liability and property policy with Hartford that's been grandfathered in, it is recommended that you consider one of the other stronger brewery insurance companies.

Getting Value for Your Insurance Dollars

The best insurance policy takes into account your brewery's unique operations and tailors the policy to cover them. Marketing your brewery to the right insurance carriers and making them compete to insure your brewery is how a brewery owner properly protects their business and ensures that hard earned dollars are spent purchasing the right coverage. I hope the above information assists all brewery owners in making the right decision in protecting their business.

INDUSTRY UPDATES

California's Paid Sick Leave Law effective July 1, 2015

In late 2014, Governor Brown signed the "Healthy Workplaces, Healthy Families Act of 2014"which requires California Employers to provide employees with one hour of paid sick leave for every 30 hours worked starting on July 1, 2015.

An employer only needs to have *one* employee who works 30 or more days in California within a year from the commencement of their employment.

Any employee who, on or after July 1, 2015, works in California for 30 or more days within a year from the start of employment is eligible for paid sick leave. However, employees must have been employed for 90 days before they can begin using their accrued sick leave.

- Employers may cap an employee's total sick leave accrual at a maximum of 48 hours or 6 days.
- Employers may limit an employee's use of paid sick days to 24 hours or 3 days in each year of employment
- Employers may set a minimum increment use not to exceed two hours
- Employers are NOT required to pay out accrued unused sick leave at time of termination.

If current Paid Time Off/Vacation time exceeds three days, no additional time has to be provided, but you may need to update your policy or offer letter to state the policy is.

NOTE: Oakland (effective March 2015) and San Francisco (effective 2007) have additional (more generous) requirements which already exist.