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Federal Tax Reform: Burgeoning The Bottom Line for the Bourbon Industry

May 19, 2018

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Participants in Kentucky's signature bourbon industry are poised to save millions in federal tax liabilities as a result of the recent amendments to the 1986 Internal Revenue Code.^[2] Formerly-labeled the Tax Cuts and Jobs Act, the legislation temporarily reduces the excise tax rate applicable to the first 100,000 proof gallons of alcohol produced by distillers in 2018 and 2019, respectively.^[3] Although the lower tax rate affects distilleries nationwide, Kentucky is certain to experience economic benefits as bourbon represents a substantial segment of the state's total exports.^[4]

Bourbon whiskey is subject to federal quality standards, which strictly prescribe which spirits can and cannot be labeled "bourbon."^[5] There are no legal requirements that Bourbon Whiskey must be distilled in the Commonwealth. However, Kentucky-based distilleries produce roughly 95 percent of the world's supply.^[6] For a whiskey to be called bourbon, it must be "(1) made in the United States; (2) aged in new, charred oak barrels; (3) produced from a grain mixture containing at least 51% corn; (4) distilled at or below 160 proof, or 80% alcohol; (5) bottled at or above 80 proof, or 40% alcohol; and (6) it must not be barreled for aging at more than 125 proof, or 62.5% alcohol."^[7] For the spirit to be labeled "straight" bourbon, it must age for a minimum of two years before being bottled.^[8]

The federal government currently levies excise taxes related to the production, importation, and sale of alcohol. The current tax regime covers distilled spirits, beer, and wine.^[9] Bourbon and other distilled spirits are taxed at a standard rate per "proof gallon" produced.^[10] A "proof gallon" is one liquid gallon of spirits that is 50% alcohol at 60 degrees Fahrenheit.^[11] Before the Tax Cuts and Jobs Act became effective on January 1, 2018, the federal excise tax on distilled spirits was \$13.50 per proof gallon regardless of the total volume produced by a single taxpayer.^[12] For calendar years 2018 and 2019, all distillers will be subject to a reduced federal excise tax rate of \$2.70 per proof gallon on the first 100,000 proof gallons of alcohol produced.^[13] The rate applicable to the next 22,130,000 proof gallons produced is \$13.34 per proof gallon,^[14] while the traditional rate of \$13.50 per proof gallon remains in effect for any proof gallons produced thereafter.^[15] Smaller distilleries are thus uniquely positioned to realize the largest proportional benefits as the tax savings attributable to the first 100,000 proof gallons of alcohol produced will undoubtedly facilitate opportunities for growth and expansion.

Overall, the new tax laws have been viewed as positive for businesses engaged in distilling spirits.^[16] In addition to the cost-saving excise tax cuts, amendments to 26 U.S.C § 179 will likely incentivize some distillers to expand production by investing in qualified equipment.^[17] As a general rule, taxpayers must capitalize the cost of acquiring long-term assets and are allowed to gradually deduct depreciation



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expenses from adjusted gross income over a number of taxable years.^[18] Section 179 of the Internal Revenue Code, by contrast, affords taxpayers the opportunity to purchase qualified business equipment, place the equipment into service in the same year, and immediately deduct the purchase price from gross income on the taxpayer's federal income tax return.^[19]

Before The Tax Cuts and Jobs Act, taxpayers could elect to deduct a maximum of \$500,000 for the aggregate amount of purchases of qualified property under Section 179.^[20] The recent tax reform doubles the total allowable deduction amount to \$1,000,000,^[21] which creates a huge benefit for smaller businesses wishing to invest in operating equipment. Although section 179 allows taxpayers to capture the time value of tax savings, the code essentially creates an investment limit, whereby the total amount allowable as a deduction is "phased out" dollar-for-dollar by any aggregate amount of qualified property placed in service exceeding \$2,500,000.^[22] The phase out provision is arguably aimed at limiting the applicability of Section 179 to those taxpayers whom do not typically expend considerable amounts on long-term assets in a single taxable year.

Despite the significant reduction in tax liabilities associated with the production of alcohol, it remains to be seen whether industry participants will pour the extra savings into a larger workforce. Given the short two-year term of the lower excise tax rate^[23] and increased income tax deductions available to businesses with qualifying capital expenditures under Section 179,^[24] it seems likely that any short-term cash infusions will be reinvested in equipment in order to expand production. Ultimately, the tax reform should alleviate barriers to market entry and spur competition in Kentucky's thriving bourbon industry.^[25] If the lower excise tax rate is subsequently etched as a permanent measure, industry leaders may become further incentivized to create more jobs and pass savings on to consumers in the form of lower prices.

^[1] J.D. Expected 2019.

^[2] See Amendment of 1986 Code, Pub. L. No. 115-97, 131 Stat. 2054 (codified as amended in scattered sections of 26 U.S.C.) (formerly known as the Tax Cuts and Jobs Act of 2017).

^[3] See *id.*

^[4] See *Bourbon Facts*, KENTUCKY DISTILLERS ASSOCIATION, http://kybourbon.com/bourbon_culture-2/key_bourbon_facts/ (last visited March 4, 2018).

^[5] 27 C.F.R. § 5.22(b)(1)(i) (2014).

^[6] See KENTUCKY DISTILLERS ASSOCIATION, *supra* note 4.

^[7] See Wesley Abrams, *Note: Bourbon Distillation & Its Collision With The Clean Air Act & Tort Law: Is the Angel's Share Actually a Devil to Kentucky Residents?*, 42 N. KY. L. REV. 129, 131 (2015); 27 C.F.R. § 5.22 (b)(1)(i) (2014).

^[8] See 27 C.F.R. § 5.22(b)(1)(iii) (2014).

^[9] See 26 U.S.C.S. § 5001 (LexisNexis, Lexis Advance through PL 115-128, approved 2/22/18) (imposing a tax on production of distilled spirits); 26 U.S.C. § 5041 (2014) (imposing a tax on production of wine); 26 U.S.C. § 5051 (2014) (imposing a tax on production of beer); See also 27 C.F.R. §1.10 (2014) (defining the terms listed in the Federal Alcohol Administration Act); 27 U.S.C. § 211(5) (2014) ("The term 'distilled spirits' means ethyl alcohol, hydrated oxide of ethyl, spirits of wine, whiskey, rum, brandy, gin, and other distilled spirits, including all dilutions and mixtures thereof, for non-industrial use"); 27 U.S.C. § 211(6) (2014) (providing the federal definition of wine); 26 U.S.C. § 5052 (2014) (providing the federal definition of beer).

^[10] See 26 U.S.C.S. § 5001 (LexisNexis, Lexis Advance through PL 115-128, approved 2/22/18).

^[11] *Id.* §§ 5002(10)–(11).

^[12] See Amendment of 1986 Code, Pub. L. No. 115-97, 131 Stat. 2054 (codified as amended in scattered sections of 26 U.S.C.) (formerly known as the Tax Cuts and Jobs Act of 2017); 26 U.S.C.S. § 5001

(LexisNexis, Lexis Advance through PL 115-128, approved 2/22/18).

^[13] See 26 U.S.C.S. § 5001 (c)(1)(A) (LexisNexis, Lexis Advance through PL 115-128, approved 2/22/18).

^[14] *Id.* § 5001 (c)(1)(B).

^[15] *Id.* § 5001 (a)(1).

^[16] See Lizzy Alfs, *Craft beer, whiskey producers hail giant excise tax cut*, USA TODAY, (Feb. 19, 2018, 2:57 p.m.), <https://www.usatoday.com/story/money/cars/2018/02/19/craft-beer-whiskey-producers-hail-giant-excise-tax-cut/331232002/>.

^[17] See 26 U.S.C.S. § 179 (LexisNexis, Lexis Advance through PL 115-128, approved 2/22/18).

^[18] See *id.* § 263(a); *id.* § 167(allowing depreciation deductions); *id.* §168 (providing the available depreciation methods); See *also*, 26 C.F.R. § 1.263(a)–1(a).

^[19] See 26 U.S.C.S. § 179 (LexisNexis, Lexis Advance through PL 115-128, approved 2/22/18); *id.* § 62(a)(1).

^[20] See Amendment of 1986 Code, Pub. L. No. 115-97, 131 Stat. 2054 (codified as amended in scattered sections of 26 U.S.C.) (formerly known as the Tax Cuts and Jobs Act of 2017); 26 U.S.C.S. § 179(b)(1) (LexisNexis, Lexis Advance through PL 115-128, approved 2/22/18).

^[21] 26 U.S.C.S. § 179(b)(1) (LexisNexis, Lexis Advance through PL 115-128, approved 2/22/18).

^[22] *Id.* § 179(b)(2).

^[23] *Id.* § 5001(c).

^[24] *Id.* § 179(b)(1).

^[25] See KENTUCKY DISTILLERS ASSOCIATION, *supra* note 4.

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