CALIFORNIA ASSOCIATION of WINEGRAPE GROWERS

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Dear Doctors Allen-Diaz and Frost:

I want to call your attention to the pressing need to fill two UC Grape & Viticulture Farm Advisors positions for the southern San Joaquin Valley. Grape growers in the south valley area, between Merced and the Tehachapi Mountains, farm 60-70% of California's vineyard acreage. This area is responsible for the lion's share of California grape tonnage annually crushed into wine and concentrate.

South San Joaquin Valley winegrape growers are confronted by an array of challenges, including the ongoing threat of Pierce's disease and glassy winged sharpshooter, labor shortages and foreign bulk wine imports. These issues, combined with the heavy burden of government regulation, recordkeeping and reporting requirements, have prompted many growers to shift acreage away from winegrapes toward almonds and other nut crops. This shift in production is a serious threat to California's long-term capacity to satisfy U.S. demand for California wine.

The University of California system is a leader in agricultural research and extension, and is recognized for research in entomology, plant health, soil science, and viticulture. However, the full benefits of this research will not be realized for South San Joaquin Valley growers until viticultural advisors are hired to serve Fresno and Madera Counties.

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The University of California research and extension system is vital to ensuring the competitive position of California agriculture, especially our winegrape growers in Fresno and Madera counties. On behalf of the growers in the San Joaquin Valley and the wineries who depend upon their grapes, I strongly encourage the prompt and timely search and hire of Viticultural Advisors to serve Fresno and Madera Counties.

Sincerely,

John Aguirre
President

CC: Heidi Scheid, Chair, CAWG Board of Directors and Sr. VP, Scheid Vineyards
Nat DiBuduo, President CEO, Allied Grape Growers
Peter Vallis, Executive Director, San Joaquin Valley Winegrowers Association

Accrual Accounting Is Bad For the Wine Industry

Timing of Income Recognition is Key to Winegrape Grower Operations

Throughout North America, winegrape harvests occur in the latter part of the calendar year. While payment terms vary among wineries, payments to winegrape growers often span two calendar years. For example, a grower may receive payment of 25% - 50% of the proceeds from a crop thirty days after delivering winegrapes on October 15. The remaining payment of 75% to 50% for that delivery may not be received until sometime within the next four months, well into the following calendar year.

Under the cash method of accounting, growers can expense all of their farming costs during the calendar year in which they are incurred and recognize income related to those harvest costs in the years in which the cash proceeds are actually received. Such a policy is sensible for growers because they incur costs and spend money in the vineyard throughout the year, but often receive only a partial cash payment before year end for the sale of their grapes.

Pre-productive Costs are Significant

The cash method of accounting better reflects the unique realities of many vineyard operations. Under the cash method of accounting, growers can expense pre-productive costs incurred during the course of vineyard establishment, from the time the vine is planted until the vineyard yields a commercially viable crop.

The expenses incurred when buying a vine and planting it would be capitalized into the vine and depreciated once the vine begins producing a commercial crop. However, expenses relating to the vine after it has been acquired and planted and before it produces a commercial crop are categorized as pre-productive expenses. These costs, over the course of a three year period, are substantial and, under the cash method of accounting, the grower benefits by recognizing cash outflow as an expense in the period it occurs.

Typical pre-productive costs for a Central Valley grower average $7,200 per acre during the three years until a vineyard produces a commercially marketable crop ($1,900 in year 1, $2,400 in year 2, and $2,900 in year 3, including harvest costs). Based on these numbers, pre-productive expenses for a newly established 750-acre winegrape vineyard would amount to $5.4 million, which is a very substantial cost.

Growers who rely on the cash method of accounting would be hard hit if forced to capitalize these pre-productive expenses into the vines, which would then be depreciated over a ten-year timeframe.

Vineyard and Winery Operations

For the wine industry as a whole, there is an added layer of complexity. Currently, a winery owner who is also a grower can elect two different methods of accounting, cash for the vineyard and accrual for the winery. This flexibility allows the vineyard side of a winegrowing operation to expense farming costs inthe year in which they occur, thus the winery side of the operation does not have to roll those same grape growing costs into the cost of the wine carried on its books.

A winery may hold onto its wine inventory for several years either because the winery is ageing or storing wine in barrels, bottles or tanks, or holding back inventory due to market conditions. For example, a vineyard-winery operator can expense the farming costs of grapes grown and crushed in 2013, while the wine may not be sold until 2017. In this case, the wine sold in 2017 would have relatively lower costs associated with it than under the accrual method of accounting, which means a greater share of the sale proceeds would be recognized as income.

Finally, vineyard-winery operators forced to convert to the accrual method of accounting would face significant administrative burdens in recalculating the cost of their current inventory, and in refiguring their income for the years in which they expensed grapes using the cash method. Moreover, the acceleration of tax due for these operations would be substantial and entail difficult calculations.

Transition from Cash to Accrual Accounting

If winegrape growers are forced to switch from the cash method of accounting to accrual, it isn't entirely clear how the acceleration of tax would show up on grower's returns. However, it's reasonable to assume that prior years' tax returns would have to be recalculated on the accrual method through the current year.

The deductions and deferrals of income taken under the cash method of accounting will likely have occurred at lower tax rates (old tax law), so growers forced to switch to the accrual method of accounting would have to recognize this income at a higher tax rate which may also be subject to an increased self-employment/passive income tax under the Affordable Care Act.

Even if the deferred income and resulting change in tax payable is spread out over a three year period, the tax burden for many growers will be substantial. Moreover, the cost of accounting fees required to calculate the tax will entail an additional significant financial burden.

Ten-Million Dollar Threshold is Inadequate

If Chairman Camp's proposed $10 million threshold and aggregation rules, that require combining gross receipts among operations with greater than 50% shared ownership, were in effect, then the past two years of strong winegrape prices would have forced many growers into the accrual method of accounting. With a resurgence of grape prices in 2012 and 2013, California winegrape growers benefited from large crops and higher revenue. These past two grape harvests illustrate the volatility of winegrape markets and prices.

The statewide average price paid per ton of winegrapes in 2012 was 32.6% higher than 2010. Such years, following several years of depressed market conditions, represent critically important opportunities for growers to shore up their balance sheets. If forced to change to the accrual method of accounting, growers would face a big tax hit and a missed opportunity to regain their financial footing.

Admittedly, gross receipts fall far short of the proposed $10 million limit for a substantial majority of CAWG growers, but over time the march of inflation will erode the value of the $10 million threshold. Consider that the inflation adjusted value of $10 million in 1983 is today worth $4.25 million, and with predictions for a future resurgence in inflation, we believe the proposal is highly detrimental to the long term viability of family winegrape growing operations.

Conclusion

The loss of the cash method of accounting for agricultural producers will mean new burdens for winegrape growers. CAWG strongly opposes proposed changes to the use of cash method of accounting for winegrape growers and other agricultural producers for the following reasons:

- Accounting for farming activities and costs on the cash method simplifies recordkeeping and accounting. Farmers forced into the accrual method of accounting will need additional accounting sophistication and higher costs to ensure proper recording of accruals.
- The cash method of accounting provides flexibility in managing taxable income, as expenses are recorded when paid and income is recorded when received (or constructively received).
- Significant expenses, known as pre-productive costs, are associated with bringing newly established or redeveloped winegrape vineyards into commercial production. Capitalizing these expenses will result in a substantial tax burden.
- Farming is a cyclical business and winegrape prices are volatile, and use of the cash method of accounting allows farmers to even out their tax burden.
- Inflation will erode the value of the $10 million threshold, forcing more growers over time into the accrual method of accounting.

CAWG strongly opposes proposals to limit current usage of the cash method of accounting for agricultural operators. The proposed changes under consideration in both the U.S. House of Representatives and the Senate would result in dire consequences for many California winegrape growers.