The Excise Tax Credit for Wine and Flavor Content

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Internal Revenue Code (IRC) Section 5010 (26 U.S.C. §5010) provides a credit against excise tax for wine and flavors content in distilled spirits. Under current law, there is a federal excise tax levied on distilled spirits. The tax rate varies from $2.70 to $13.50 per proof gallon of distilled spirits depending upon the producer or importer and the amount of distilled spirits that have already been removed or imported during the year. The Section 5010 credit can reduce tax owed because wine and flavors are generally taxed at lower rates than distilled spirits. There has, at times, been interest in repealing the credit, as some argue it distorts production by creating an incentive for producers to use wine and flavors to reduce their tax burden.

Legislative History

Section 5010 was created by P.L. 96-598. That law was enacted on December 24, 1980, and Section 5010 took effect retroactively, as of January 1, 1980.

Section 5010 has been amended several times since enactment, although those amendments have not significantly changed the tax credit. The Deficit Reduction Act of 1984 (P.L. 98-369) increased the distilled spirits excise tax and amended the Section 5010 credit accordingly. The Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647) added "alcohol derived from flavors distilled at a distilled spirits plant" as an exception to (i.e., ineligible for) the tax credit for flavors content. The Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) increased the distilled spirits excise tax and amended the Section 5010 credit accordingly.

Subpart A of Part IX of P.L. 115-97 (those provisions are commonly referred to as the Craft Beverage Modernization Act, CBMA) made several temporary changes to federal excise taxes on alcohol products. Among those changes were lower rates for certain alcohol products, depending on the amount that the producer or importer has removed or imported already during the year. Those changes were generally extended by the Further Consolidated Appropriations Act, 2020 (P.L. 116-94) and generally made permanent by the Consolidated Appropriations Act, 2021 (P.L. 116-260).

Specifically for distilled spirits, CBMA provides for a reduced tax rate of $2.70 per proof gallon on the first 100,000 proof gallons of distilled spirits and $13.34 per proof gallon for the next 22,130,000 proof

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gallons of distilled spirits, with the $13.50 rate applying to all proof gallons after that. Although these changes did not amend Section 5010 directly, they may limit the amount of the tax credit allowed because the Alcohol and Tobacco Tax and Trade Bureau's (TTB's) interpretation is that the tax credit is nonrefundable and applies only to the specific distilled spirits product that the wine or flavors are combined with. (See TR-D2 and TR-D4 on the TTB's FAQ page.)

Legislative Intent

A Government Accountability Office (GAO) report addressed some of the potential motivations for the tax credit. According to that report:

> Before 1980, all ingredients (including wine, flavors, and distilled spirits) were taxed individually before being combined into a final product. The Distilled Spirits Tax Revision Act of 1979 changed the taxes so they are levied on the final product. To compensate distilled spirits producers who used lower-taxed ingredients (i.e., wine and flavors), Congress amended the Internal Revenue Code to provide a tax credit. Products such as cordials, liqueurs, blended whiskeys, vodka, and gin are eligible for this tax credit. [...] Section 5010 reduces the effective tax rate for distilled spirits products containing wine and flavors substantially below the $12.50 per proof-gallon tax rate for distilled spirits.

Proposals to Repeal the Credit

The Obama Administration proposed to repeal Section 5010 in its revenue proposals for FY2014, FY2015, FY2016, and FY2017. The explanation and reasons provided for the change by the Department of the Treasury were largely the same in all four years. Treasury argued that the tax credit led producers to add more wine and flavor content than they otherwise would have. According to Treasury data, in 1981, producers mixed about 1 million proof gallons of wines and flavors with 300 million proof gallons of spirits. In 2013, 12.6 million proof gallons of wines and flavors were mixed with 330 million proof gallons of spirits.

Treasury argued that the tax credit is difficult for TTB to administer because the wine and flavor content of a mixed drink generally cannot be determined by lab testing the mixed drink. Verification requires inspection of the producer's production records or onsite inspections. This may create an advantage for foreign producers over domestic producers, Treasury argued, because TTB does not have authority to conduct onsite audits of foreign producers but does for domestic producers.

In the above-cited revenue proposals, Treasury estimated an increase of $109 million-$112 million in federal revenue per fiscal year from repealing the Section 5010 tax credit. For context, according to IRS data, federal excise tax collections from distilled spirits have generally been increasing in recent years, from $4.8 billion in FY2009 to $6.9 billion in FY2021 (figures are not adjusted for inflation).

Potential Impact for Producers

GAO argued that the Section 5010 credit creates an incentive for producers to use wine and flavors in their distilled spirits to receive a lower tax rate. During their investigation, GAO heard from government and industry officials that spirits manufacturers changed their production processes to qualify for the credit. **Table 1** provides an example from GAO (using 1989 data) of the potential total cost advantage of using a higher wine content. Materials to produce a drink with 50% wine content cost three times more than a drink with only distilled spirits; however, the total cost is 32% ($1.74) less because of the tax savings.

Table 1. Hypothetical Total Production Costs by Level of Wine Content

Comparative Costs Per Gallon of a 42-Proof Cordial Containing Various Levels of Wine, Costs in 1989

	Distilled Spirits	25% Wine	50% Wine
Cost of Spirits	$0.27	$0.20	$0.13
Cost of Wine	$0.00	$0.34	$0.68
Total Cost of Materials	**$0.27**	**$0.54**	**$0.81**
Tax Expense	$5.25	$4.11	$2.97
Total Cost Per Gallon	**$5.52**	**$4.65**	**$3.78**

Source: Reproduced from U.S. Government Accountability Office, "Alcohol Excise Taxes: Simplifying Rates Can Enhance Economic and Administrative Efficiency," September 1990, GAO/GGD-90-123, https://www.gao.gov/assets/ggd-90-123.pdf; using data from U.S. Bureau of Alcohol, Tobacco, and Firearms.

GAO concluded that

> This incentive provided by the tax credit distorts the production process because it encourages an inefficient allocation of resources to make these products. Taxing the ingredients differently leads to an inefficient combination of ingredients because production decisions are based on tax rates, not on which ingredients are less costly.

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