



The Growth in the Number of Breweries and the Implications for Compliance with State Excise and Retail Taxes

Prepared for
National Beer Wholesalers Association

Alexandria, Virginia

January 2018

Washington, D.C.
Washington National Tax
kpmg.com

Foreword

This report was prepared by KPMG LLP for the National Beer Wholesalers Association. It is intended to provide an educational document that examines the potential impact of marketing and other preferences being adopted by states to foster the craft beer industry on the administration and enforcement of various taxes on beer. The report does not make public policy recommendations as to the desirable means or levels of taxation on beer or the effectiveness and impact of any of the craft beer preferences. Instead, it examines only questions related to the administration of various taxes on beer sales and distribution and the implications that certain craft beer preferences may have for the administration of those taxes. KPMG has not endorsed any particular public policy regarding state taxation of beer. This report is a holistic work and should be read in its entirety for complete context of the questions examined.

About the author

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Executive summary

Total U.S. beer consumption has remained relatively flat over the last 15 years, varying within a relatively narrow range around 205 million barrels annually. [Note: The sources for all data in the Executive Summary are contained in the text of the report.] Within this total, however, there have been two rather dramatic shifts: (a) growth in the consumption of imported beers which now account for over 30 million barrels of consumption or something in excess of 15 percent of the total; and (b) an explosion in consumption of beers produced by an increasingly large number of smaller brewers for a relatively local market, often called craft beers. By some measures, craft beer accounts for nearly 15 percent of total U.S. beer consumption. Imported beers accounted for only 5 percent of U.S. consumption as recently as 1995. Craft beers have grown even more dramatically, accounting for about 5 percent of U.S. production in 2007. It is the rise of production and consumption from smaller breweries that is the focus of this report because of the potential impact that this sector may have on the collection and administration of state excise and retail taxes on beer.

There are two aspects of the craft beer explosion that create challenges for excise and retail tax collection and administration. First, there has been a dramatic increase in the number of new, smaller brewers with responsibilities for complying with various excise and retail taxes. A substantial body of tax compliance research indicates that the larger the number of taxpayers responsible for collection of a given tax, and the less experienced those taxpayers are with tax compliance, the greater the risks of noncompliance with that particular tax. More importantly, in an effort to promote development of the craft beer industry, nearly every state has enacted one or more measures designed to ease the ability of smaller brewers to market their product. These measures have principally taken the form of creating exceptions or carve-outs from the traditional three-tier system for regulating the sale and distribution of alcoholic beverages by enabling craft brewers, under certain circumstances, to sell their product directly to consumers and to sell their product directly to various retail outlets (also known as self-distribution). With direct-to-consumer sales, the distributor and retailer components and their economic interests in the three-tier system are eliminated, while the self-distribution model supplants the distributor role in the three-tier system. Importantly, when smaller brewers take advantage of selling directly to consumers and retail outlets, they step into the shoes of those supplanted levels and become directly responsible for the excise taxes that would have been due on the beer as if it had gone through the three-tier system. That is, they are responsible for remitting the excise tax on all such beer directly to the state tax authority and collecting and remitting any retail level sales and special taxes on beer sold to consumers at the brewery.

From a tax administration standpoint, allowing direct sales to consumers and retailers increases the risk of noncompliance with state excise and retail taxes on beer. As reviewed fully in the 2009 report on state excise and retail taxes on beer prepared for the National Beer Wholesalers Association (2009 NBWA Report), there are certain attributes of the three-tier distribution system that promote compliance with state taxes on the sale and distribution of beer and reduce significantly the burden of tax compliance for both taxpayers and tax authorities, particularly as it relates to state excise taxes. Principal among these is the availability of third-party reports (e.g., on shipments from brewers to distributors and from distributors to retailers) that are provided to state authorities and enable them to monitor the flow of product through the system and to verify excise tax compliance with relatively limited resource expenditures. Coupled with certain other aspects of the regulatory system, the three-tier system creates the opportunity to monitor the flow of beer in the state, provides state regulators and tax administrators with a limited

number of points to tax or exercise control over the flow of alcoholic beverages, limits opportunities for contraband (i.e., untaxed) alcoholic beverages to enter the distribution chain, and helps ensure compliance with the various tax systems. Without the three-tier system, the level of resources necessary to achieve any given level of compliance would be greater.

The most significant impact on tax administration and compliance under both direct-to-consumer and direct-to-retailer sales results from the absence of the third-party supplier reports that can be used to verify the completeness and accuracy of the excise tax return by matching taxpayer returns with the supplier reports. The third-party report is lost as the brewer takes on the role of both supplier and distributor. Verification of excise tax returns, if it occurs, would likely need to be done through field audits at the taxpayer's premises. To the extent the state requires distributors to report on sales to retailers as an aid in tax compliance or uses purchases from distributors as a tool in the audit of retail outlets, those reports will also be unavailable in cases in which the brewer sells directly to consumers. It is hard to overstate the role that third-party reporting can play in promoting tax compliance and efficient administration. The reports provided by brewers on shipments to distributors were commonly cited as the most effective component of excise tax compliance in the work done for the 2009 NBWA Report. The importance of third-party reports to verify taxpayer compliance is also evident in the general tax compliance research. IRS research indicates that income on which there is no information reporting is understated, on average, by 63 percent, compared to just 7 percent when there is substantial information reporting.

It is not possible to estimate fully the volume of beer production that may be exposed to greater risk of noncompliance because there is no publicly available data set that accurately reflects craft beer production or consumption in the aggregate, much less the two streams of sales that are the focus of this report. In addition, the data on beer production and consumption generally that is available from the Alcohol and Tobacco Tax and Trade Bureau (TTB) of the U.S. Treasury Department which is responsible for regulating and collecting taxes on U.S. beer production contains certain gaps and inconsistencies that are difficult to reconcile. Nonetheless, we do know that TTB reports that over 75 percent of all U.S. breweries produce less than 1,000 barrels per year. In 2016, there were over 3,750 breweries producing less than 1,000 barrels, about 3.5 times more breweries than in 2007. Less than one-half of U.S. breweries have been in operation more than five years. We also know that the number of brewery permits issued by TTB in 2016 exceeded the number of breweries reporting a federal excise tax liability by about 2,000. Despite the lack of specific data, it is likely based on various estimates that as much as 3 million barrels of craft beer production was sold directly to consumers or retail outlets in 2016, a figure that is more than three times the volume sold via these channels in 2014. There appears to be little reason that the volume of direct-to-consumer sales and self-distributed beer will not continue to increase.

The primary risk to tax compliance and collections from the increase in craft beer, particularly that sold directly by brewers to consumers and retailers, comes from the loss of a reporting trail that allows tax authorities to monitor the flow of product through the distribution system. The question from a risk mitigation standpoint is whether there are measures that could be adopted that would serve to fill, at least partially, that reporting gap.

One option would be for the TTB to share with state tax authorities the information that is reported to the TTB by each brewer and on which its federal excise tax liability should be based. Receipt of these reports would provide a form of verification of the amounts reported by brewers to the state tax authorities. To the extent there are concerns about sharing of confidential or proprietary information, the Internal Revenue Service program of sharing individual and corporate income tax return information with state tax authorities for tax administration purposes provides a model for sharing information while ensuring that it is safeguarded from unauthorized disclosure.

Another risk mitigation approach would be to adopt state legislation requiring breweries to report certain information on their operations to the alcoholic beverage regulatory authority. The information could then be used to cross-check with the excise and other tax reported by the brewer. This is not a perfect substitute for an independent, third-party report, but it would be beneficial for verification and ensuring consistency in reporting. A final mitigation strategy would be to adopt a program of regular and ongoing audits or inspections of brewers to ensure appropriate tax reporting and compliance with other obligations. While this would, of course, require staffing and expenditures, it could also provide some on-going benefits by educating brewers and ensuring they understand their obligations and the proper manner for reporting as a tool for promoting future compliance.

The report does not make public policy recommendations as to the desirable means or levels of taxation of beer or as to the desirability of any measure designed to promote the specialty beer industry. It examines only questions related to the administration of various taxes on beer sales and distribution and the implications that certain measures may have for the administration of those taxes. KPMG has not endorsed any particular public policy regarding state taxation of beer.

Introduction

In addition to repealing Prohibition, the 21st Amendment to the U.S. Constitution granted states the authority to regulate the transportation, importation, delivery and use of alcoholic beverages within their borders.¹ In exercising this authority, states for the large part adopted what is known as the “three-tier system” that spells out the roles of each tier of the alcoholic beverage industry: suppliers, distributors, and retailers.² The three-tier system is generally structured such that licensed suppliers (brewers, distillers, wineries and importers) may only sell in a state to and through state-licensed distributors, the second tier. The distributors are, in turn, responsible for providing all alcoholic beverages to state-licensed *retailers* that are authorized to sell to individual consumers in the state (for both on- and off-premise consumption). Under the three-tier system, a supplier is generally not able to sell directly to a retailer or to an individual consumer.³

The original intent⁴ of the three-tier system—provide temperance, ensure orderly market conditions, and raise revenue—remains largely the same. A primary aspect of the three-tier system is the positive impact it has on compliance with and administration of various taxes imposed by states on the distribution and sale of beer. The role of the three-tier system in promoting effective compliance with state distributor-level excise taxes and retail taxes on beer was examined, in detail, in a report prepared for the National Beer Wholesalers Association in 2009.⁵ Briefly summarized, the NBWA Report found that the sale of beer through the three-tier system contributes significantly to promoting efficient compliance with state excise taxes because there are relatively few taxpayers involved in administration, and the reporting required by the various levels in the three-tier system enables the state tax authority to monitor the flow of product through the supply chain as an aid in securing tax compliance. In particular, the availability of third-party reports from suppliers (brewers and importers) to match against the excise tax reports filed by distributors generates substantial excise tax compliance without the need for an extensive field audit enforcement effort. Further, unlike with tobacco taxes, the inability of retailers to secure inventory from other than licensed distributors reduces the opportunity for tax evasion at the retail level, as do the reports that some states require distributors to file on the sales they make to individual retailers.⁶

¹ U.S. Const. amend. XXI. Sec. 2 provides specifically that “[t]he transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.” *Granholm v. Heald*, 544 U.S. 460, 484 (2005) holds that state laws pursuant to this authority may not discriminate against out of state producers, in favor of in state producers.

² These three-tier laws and regulations are sometimes discussed in coordination with “tied house” laws and generally prohibit suppliers and distributors from having any financial or ownership interest in other tiers such as a retail establishment. *See, e.g.*, Or. Rev. Stat. §§ 471.392 to 471.402.

³ In 17 states and certain local jurisdictions, the state or local government itself is a participant in the wholesale and/or off-premise retail level for distilled spirits and, in some cases, wine or strong beer. These are commonly referred to as “control” states; the others are known as “license” states since all parties are private sector entities that are licensed and regulated by the state.

⁴ *See, e.g.*, Ala. Code § 28-9-1 and Ark. Code Ann. § 3-5-1101 (the legislative intent of the chapter is “to maintain stability and healthy competition in the beer industry in this state; to promote and maintain a sound, stable, and viable three-tier system of distribution of beer to the public; and to promote the public health, safety, and welfare”).

⁵ Harley Duncan and Bobby Bui, Washington National Tax, KPMG, LLP, *An Analysis of the Structure and Administration of State and Local Taxes Imposed on the Distribution and Sale of Beer* (March 2009) [hereinafter *NBWA Report*].

⁶ *Id.* at 26-33.

In recent years, the beer industry in the U.S. has gone through some seismic changes, and certain of these trends could pose challenges for administration and collection of excise and retail taxes. The increasing popularity of specialty or craft beers among the consuming public is generating a significant increase in the number of smaller specialty or craft brewers.⁷ In addition, to foster the growth of the craft beer industry, many states are adopting measures that allow some brewers, in certain instances, to bypass specific aspects of the three-tier system and sell their product directly to consumers (for both on-premise and off-premise consumption in some cases) or directly to retailers for further on-sale to consumers. Such preferences raise potential issues for the administration and enforcement of excise and retail taxes on beer because the number of excise taxpayers reporting to the state may increase substantially, and most importantly, the ability to monitor the flow of product through the system by relying on reports filed by the different tiers is reduced. By circumventing the distribution tier of the three-tier system, these measures reduce the ability to rely on supplier reports to verify excise tax obligations, and to monitor sales into the retail tier – both of which can present challenges for the administration of taxes on beer.

The purpose of this report is to examine the potential impact that these deviations from the three-tier structure may have on the administration and enforcement of excise and retail-level taxes on beer. The evaluation is qualitative in nature, i.e., it does not quantify the actual or potential impact on state revenue collections. Instead, it highlights the manner in which the measures being adopted may affect the administration of taxes on beer by comparing them to the characteristics of the three-tier system that were found in the 2009 NBWA Report to support effective tax administration. It does not evaluate the efficacy or economic impact of the preferences being accorded craft brewers, but is instead intended to identify the potential tax administration challenges associated with their adoption.

The report contains four parts: (a) a review of data and trends regarding beer production and sales with an emphasis on the growing number of brewers and rise in the proportion of consumption represented by craft beers; (b) an overview of the types of marketing and other preferences being adopted by states to foster the craft beer industry based on a review of certain preferences in 10 large states; (c) an evaluation of the qualitative impact these preferential measures may have on the administration of various taxes on beer; and (d) an identification of measures that could potentially address certain of the tax administration impacts identified in the report.

The report does not make public policy recommendations as to the desirable means or levels of taxation of beer or as to the desirability of any measure designed to promote the specialty beer industry. It examines only questions related to the administration of various taxes on beer sales and distribution and the implications that certain measures may have for the administration of those taxes. KPMG has not endorsed any particular public policy regarding state taxation of beer.

⁷ TTB has defined “small brewers” as those with an excise tax liability of less than \$50,000 annually which translates to 7,140 barrels of production. There is no generally accepted definition of the term “craft brewer” or “craft beer,” and it is the continued source of controversy. See Kevin Short, *Sorry, Hipsters: These Mainstream Beers Will Soon Be ‘Craft’ Too*, HUFFINGTON POST (Dec. 6, 2017), https://www.huffingtonpost.com/2014/06/18/craft-beer-definition_n_5405757.html. The Brewers Association, a trade association of small brewers, uses the following definition of craft brewer and produces an annual data compilation on craft beer production and consumption. As defined by the Association, “craft brewer” means a brewery that is small (annual production of 6 million barrels or less), independent (less than 25 percent owned or controlled by a non-craft brewer), and traditional (a majority of the total beverage volume has flavors that derive from traditional or innovative brewing ingredients and their fermentation). See *Craft Brewer Defined*, BREWERS ASSOCIATION, <https://www.brewersassociation.org/statistics/craft-brewer-defined/>. In this report, the terms specialty and craft beer or brewer should be considered to be used generically, unless the reference is to specific data from the Brewers Association in which case the Association’s definition will apply.

A snapshot of the beer industry

In 2016, total taxable consumption of beer in the U.S. amounted to an estimated 207.3 million barrels, consisting of about 173.9 million barrels produced in the U.S., and 33.4 million barrels of imported product.⁸ Over the last 15 years, total domestic consumption of beer has fluctuated within a fairly narrow range. Total consumption was about 203 million barrels in 2002, before reaching a peak of about 213 million barrels in 2009 before the Great Recession; it has been fairly stable at about 207 million barrels since 2012.⁹

Within this consumption total, however, there has been a marked shift over time in the source of the beer consumed – away from domestic beer produced by a relatively small number of large, national brewers to imported beer and beer brewed by smaller, more local, domestic brewers, i.e., craft brewers. Imported beer constituted 16.1 percent of domestic consumption in 2016, up from slightly less than 12 percent in 2002; the volume of imports increased from roughly 24 million barrels to over 33 million barrels in that period, while total consumption remained relatively flat. Going back further in time, imported beer comprised only about 5 percent of domestic consumption in 1995.¹⁰

The recent rise in consumption of craft beer is even more dramatic. As noted, there is no single definition of craft beer, and no single public data set on craft beer production and consumption. The Brewers Association does collect a range of production and sales data annually from its members based on its definition of craft beer.¹¹ According to data from the Association, craft beer production amounted to 24.6 million barrels in 2016.¹² This is up less than 1 percent from the 24.4 million barrels produced in 2015, but is more than 3 times the 8.0 million barrels produced in 2007 and more than twice the 11.1 million barrels produced in 2011.¹³ Craft beers represented about 13 percent of the total production of the domestic beer industry in 2016, which is more than triple the production share of 4 percent by the craft

⁸ Domestic production data obtained from the Department of Treasury, Alcohol, Tobacco Tax and Trade Bureau (TTB), *Statistical Report – Beer (December 2016)*, Report TTB S 5130-12-2016, (revised September 28, 2017), available at <https://ttb.gov/beer/beer-stats.shtml>. The import data are from data compiled by the Beer Institute from U.S. Department of Commerce, Bureau of the Census data (available at <http://www.beerindustryinsights/import-export-data/>). See also TTB, *Number of Brewers by Production Size – CY 2016* (Revised October 25, 2017) (indicating a domestic tax paid production volume that is roughly 1 million barrels less than the Statistical Report, possibly due to revised reports by brewers that do not get reflected in the Production Size report). Data in this report is taken from the Statistical Report series unless otherwise noted. A barrel is equal to 31 gallons which translates into 13.8 standard cases of 24 containers holding 12 ounces each (24/12 cases), meaning total taxable consumption in 2016 of about 2.9 billion 24/12 cases. The September 2017 revision to the Statistical Report added about 600,000 barrels of production compared to the May 2017 revision. Domestic consumption was increased by only 100,000 barrels with the bulk of the change being reflected in increased inventory. The October revision to the Brewers by Production Size report, by contrast, added only about 100,000 barrels compared to the May report, still leaving a discrepancy of about 1 million barrels of taxable production between the two reports.

⁹ Based on data from sources cited in note 8.

¹⁰ *Id.*

¹¹ See Note 7.

¹² Brewers Association, *The New Brewer: The Journal of the Brewers Association*, Vol. 34, No. 3 (May-June 2017), 127 [hereinafter *The New Brewer*].

¹³ *Id.*

sector in 2011.¹⁴ When examined on the basis of beer consumption in the U.S., the breakdown among traditional brewers, craft brewers and imports in 2016, is roughly 12 percent craft beer, 16 percent imported and 72 percent beer from traditional, national brewers.¹⁵

Within the craft beer sector, there is a substantial concentration of production in the “regional craft brewery”¹⁶ category which accounted for over 70 percent of the total craft production of 24.6 million barrels in 2016, up from just over 60 percent in 2007.¹⁷ [See Table 1 below for a breakdown of production by type of craft brewery in 2007 and 2016.] Over this period, the share of craft beer production accounted for by contract brewers has declined sharply, while the share represented by microbreweries has risen significantly, an important trend for this report as microbreweries are more likely to be involved in selling directly to retailers and consumers. [All terms are defined in the Glossary.]

Table 1

Craft Brewery Production, by Type of Brewery, 2007 and 2016

Type of brewery	2007		2016	
	Barrels (000's)	Percent of total	Barrels (000's)	Percent of total
Contract Brewer	1,381	17.3%	268	1.1%
Regional Craft Brewer	4,910	61.5%	17,938	73.0%
Microbreweries	969	12.1%	5,012	20.4%
Brewpubs	719	9.0%	1,353	5.5%
Total	7,978		24,570	

Source: *The New Brewer*, May-June 2017, p. 127.

Along with the dramatic increase in the production and consumption of craft beers, there has been a substantial increase in the number of breweries operating in the U.S. over the last 10 years as shown in the table below.

¹⁴ Calculated based on craft beer production from *The New Brewer*, *supra* note 12, and data on total U.S. domestic beer production as reported by the TTB, *supra* note 8. Note these statistics are based on domestic production, and do not reflect amounts of beer imported or exported.

¹⁵ Based on data presented in *The New Brewer*, *supra* note 12, at 97.

¹⁶ Defined by the Brewers Association as an independent regional brewery (less than 25 percent ownership by a non-craft brewer) with a production between 15,000 and 6 million barrels annually. See *Craft Beer Industry Market Segments*, BREWERS ASSOCIATION, <https://www.brewersassociation.org/statistics/market-segments/>.

¹⁷ *The New Brewer*, *supra* note 12, at 127.

Table 2

Number of Breweries by Production Size, 2007 and 2016

Brewery size (barrels)	2007			2016		
	No. of breweries	Taxable removals in barrels (000's)	Percent of total	No. of breweries	Taxable removals in barrels (000's)	Percent of total
Over 6 million barrels	17	153,687	84.8%	14	119,775	69.3%
1 million - 6 million	3	12,706	7.0%	11	30,142	17.4%
500,001 - 1 million	10	6,362	3.5%	6	4,015	2.3%
100,001 - 500,000	24	3,920	2.2%	45	8,618	5.0%
60,001 - 100,000	20	1,230	0.7%	38	2,395	1.4%
30,001 - 60,000	34	1,220	0.7%	53	2,069	1.2%
15,001 - 30,000	26	508	0.3%	75	1,341	0.8%
7,501 - 15,000	41	435	0.2%	148	1,352	0.8%
1,001 - 7,500	356	749	0.4%	935	2,283	1.3%
Less than 1,000	1,088	344	0.2%	3,771	987	0.6%
Total	1,619	181,162		5,096	172,957	

Source: TTB, Number of Brewers by Production Size (various calendar years) available at <https://www.ttb.gov/beer/beer-stats.shtml>. Taxable removals is the volume of production removed from the brewery into the distribution/retail levels. The difference between taxable removals and total production is product that is exported and production remaining at the brewery in inventory.

Two observations are evident from the table. First, while the largest breweries (over 6 million barrels of production annually) still account for the largest proportion of U.S. beer production – nearly 70 percent in 2016 – both the volume and the share of production from this category has declined significantly over this period. The share of total production has declined from about 85 percent to just under 70 percent from 2007 to 2016. The volume produced by the largest breweries has declined by roughly 34 million barrels, or about 22 percent. The bulk of the production share has been picked up by breweries in the 1 million to 6 million barrel capacity range, which increased from 7 percent of the total to 17.4 percent, as the volume produced by that group of brewers increased by 2.5 times from 12 million barrels to 30 million barrels. For each category below 500,000 barrels of annual production (with one exception), the share of total production more than doubled from 2007-2016. In total, the share of U.S. production accounted for by breweries producing less than 500,000 barrels annually increased from 4.7 percent in 2007 to 10.8 percent in 2016; among those producing 60,000 barrels or less, the share of production increased from 1.8 percent to 4.7 percent (or nearly 8 million barrels in 2016).

The second trend evident from Table 2 is the explosion in the number of breweries operating in the U.S., particularly the large and growing number of relatively small-volume breweries. The number of breweries operating in the U.S. more than tripled from 2007-2016, increasing from 1,691 to 5,096.¹⁸ The number of breweries producing less than 1,000 barrels annually jumped from 1,088 to 3,771 in 2016,¹⁹ and the number with production of 1,000-7,500 barrels more than doubled from 356 in 2007 to 935 in 2016. Breweries with less than 7,500 barrels of annual production comprise 92 percent of all breweries in the U.S. in 2016, and those with less than 1,000 barrels of production account for 74 percent of all breweries. With the exception of two categories – over 6 million barrels and 500,000-1 million barrels – all other categories showed an increase in the number of breweries operating from 2007 to 2016.

Every state in the country has brewing operations within its borders. The District of Columbia (smallest geographically) has the fewest (13), while California has the most (927) as of the end of 2016.²⁰ After California, the five states with the greatest number of breweries are (in descending order) Washington State, New York, Colorado, Michigan, and Pennsylvania. In ascending order, the five states (other than D.C.) with the smallest number of breweries are Mississippi, North Dakota, Rhode Island, South Dakota, and Hawaii.²¹ If the comparison is normalized to population, the top five states in terms of the number of permitted breweries per 100,000 population in 2016 are (in descending order) Vermont, Maine, Montana, Oregon, and Colorado.²²

The growing popularity of craft beers is, of course, reflective of trends in consumer preferences for local products and for what is sometimes termed “premiumization,” or the offering of a product that is viewed as above the norm for the market in quality and price as a means of creating some exclusivity for the consumer.²³ Some observers trace the general premiumization trend to the alcoholic beverage industry where spirits manufacturers worked at redefining “top shelf” offerings with specialty products,²⁴ and others argue that the beer industry is in a second wave of “premiumization” with an earlier one having occurred 1960-1980 when some of today’s national brands grew by acquiring some of the older regional value brands.²⁵ The willingness of some consumers to increase the price they pay for beer is clear. A comparison of the proportionate share of the dollar value of beer sales represented by three groups of products from 2011 to 2016 – the leading four brands, those brands with a price below the leading four, and those with a price above the leading four – showed that those brands priced above the leading four brands increased their share of the dollar value of beer sales from 31.4 percent to 44.5 percent, while the share of the four leading brands fell from about 45 percent to 37 percent and those with prices below the

¹⁸ This is the number of brewers reporting to TTB with the primary purpose of the report being to remit tax owed on production at the brewery. Other sources produce different numbers of breweries, some of which are reviewed later in this report.

¹⁹ TTB reports its data on the basis of breweries producing 1-1,000 barrels and those producing less than 1 barrel. The volume of removals they report for the less than 1 barrel are more than could be produced by the number of brewers they place in that stratum. To make the data meaningful, these two categories are collapsed into a less than 1,000 barrels group for this report.

²⁰ National Beer Wholesalers Association, “Permitted Breweries Hit Another Record in 2016 at 7,190,” available at <https://www.nbwa.org/resources/permitted-breweries-hit-another-record-2016-7190> (hereinafter NBWA, Permitted Breweries). These counts represent the number of breweries in each state that have obtained a permit from the TTB to operate a brewery as of December 31, 2016.

²¹ *Id.*

²² *Id.*

²³ Milly Stilianovic, *Premiumization: The Most Affluent Retail Trend of 2016*, FORBES (June 16, 2016), <https://www.forbes.com/sites/millystilianovic/2016/06/16/premiumisation-the-most-affluent-retail-trend-of-2016/#467d25714416>. Even Starbucks, which would seem to define the “premiumization” of a market, is planning a premiumization of its own product and planning to offer a \$12 per cup Starbucks Reserve coffee. See James Lynch, *Starbucks’ \$12 Curious Cup of Coffee*, ADVERTISING AGE (Dec. 9, 2016), <http://adage.com/article/agency-viewpoint/starbucks-12-curious-cup-coffee/307069/>.

²⁴ *Id.* (noting that when consumers look for premium products, they are generally looking for brand authenticity, “the embodiment of a luxurious life,” and experimentation).

²⁵ Bart Watson, *Premiumization, Prices and Positioning*, BREWERS ASSOCIATION (Dec. 6, 2016), <https://www.brewersassociation.org/insights/premiumization-prices-and-positioning/>.

leading brands fell from 24 percent to 18.5 percent.²⁶ In short, consumer preferences are shifting to a beer that is produced in smaller volumes with a higher price point. From 2014 to 2015, sales of craft beer grew by 18.8 percent even though the price per case of craft beer was 60 percent greater than the average case price of beer. Total beer sales increased by 2.1 percent that year.²⁷

²⁶ *Id.*

²⁷ Data obtained from National Beer Wholesalers Association.

Preferences favoring smaller breweries

To promote the craft brewing industry, nearly every state has taken some action aimed at increasing the ability of such brewers to market their products. In some cases, the measures that have been adopted are targeted specifically to smaller-volume brewers below some production cap. In others, the laws may apply to all or a wider range of in-state brewers, but they tend to be most beneficial to smaller brewers because of the local or regional nature of their market as contrasted with a brewer serving a national or international market that requires large volume production and extensive distribution systems. Of importance to this report, the effect of many of the preferences is that they deviate from the traditional three-tier distribution and sales system by allowing direct sales by brewers to consumers and/or distribution by brewers directly to licensed retail premises. As a result, these types of preferences create potential challenges for the administration and collection of state excise taxes on beer by disrupting the reporting system inherent in the three-tier system and eliminating some of the separation of roles among the levels – both of which facilitate excise tax compliance.

The research conducted for this report²⁸ found three general types of carve-outs from the three-tier system that are aimed at increasing the ability of craft brewers to market their product and that, at the same time, create challenges for excise tax administration. These include: (a) allowing sales by brewers directly to consumers for on-premise consumption; (b) allowing sales by brewers directly to consumers for off-premise consumption; and (c) allowing brewers to “self-distribute” or sell and distribute their product directly to licensed retail premises. Of these, the most common is to allow certain brewers to sell their product directly to consumers for on-premise consumption. A large number of states have laws governing what are commonly referred to as “brewpubs” that allow certain breweries, often limited by size, to sell beer brewed on the premises directly to retail consumers at the brewer’s location; often there is a state law requirement that a brewpub have some restaurant or food-serving establishment on site. In New York State, for example, a restaurant-brewer licensee may sell beer brewed on the premises as long as there is a “bona fide” restaurant at the site. The licensee may have up to five separate locations and may produce up to 5,000 barrels of beer per location, not to exceed 20,000 barrels total each year.²⁹ In Texas, a brewer with a capacity not exceeding 225,000 barrels may sell directly to the consumer (without a food requirement), provided that direct sales to consumers do not exceed 5,000

²⁸ The research included a review of state tax preferences available to craft or specialty brewers in ten states: California, Florida, Georgia, Illinois, New York, Ohio, Oregon, Pennsylvania, Texas, and Vermont. The research was intended to provide examples of the types of preferences available in these states, thus enabling an identification of trends and potential issues; the research was not intended to provide a complete listing of all available preferences. The results of the research are available upon request. For general information on state tax preferences available to brewers, see the Brewers Association database of brewery laws at www.brewersassociation.org/government-affairs/laws/.

²⁹ N.Y. Alco. Bev. Cont. Law § 64-c; New York State Liquor Authority Division of Alcoholic Beverage Control, *Definition of License Classes*, available at <https://www.sla.ny.gov/definition-of-license-classes>.

barrels per year.³⁰ A Texas brewpub licensee is limited to 10,000 barrels of production annually, with no food requirement and no limit on the proportion sold directly to consumers.³¹ In Illinois, a brewpub licensee may not produce more than 5,000 barrels per year,³² the same production limit as is imposed in Florida.³³ In Georgia, brewpubs are limited to facilities producing fewer than 10,000 barrels annually.³⁴

Allowing the sale of beer directly to consumers for off-premise consumption is a somewhat less common, but growing, type of preference accorded specialty brewers. A popular form for this type of sale is by the “growler” which is generally a reusable, sealable container in which draft beer can be sold for off-premise consumption, i.e., it remains “fresh” for some period of time.³⁵ Here again, the requirements as to which brewers can sell for off-premise consumption vary. For example, in California³⁶ and Florida,³⁷ brewpubs may not sell for off-premise consumption, but in Georgia³⁸ and Texas,³⁹ only brewpubs are allowed to sell for off-premise consumption. In New York, a restaurant-brewer licensee must be granted a supplemental license to sell up to 250 barrels per license, or 1,000 barrels total, for off-premise consumption.⁴⁰ In Illinois⁴¹ and Oregon,⁴² on the other hand, both breweries and brewpubs may sell for off-premise consumption, although sales for off-premise consumption in Illinois must be made in-person at the brewer’s premises.

Finally, with respect to the ability of certain brewers to distribute beer that they have brewed directly to licensed retail outlets, the states again exhibit a mixed pattern, but most appear to allow self-distribution in some form.⁴³ For example, brewers regardless of size may not sell their product directly to a licensed retailer in Florida⁴⁴ and Georgia,⁴⁵ but in New York, a brewery or microbrewery (classified as producing not more than 60,000 barrels annually) may sell directly to retailers.⁴⁶ In Texas, brewers with less than

³⁰ Tex. Alco. Bev. Code § 62.122. Texas brewpub licensees are permitted, but not required, to sell food on the premises of the brewery.

³¹ Tex. Alco. Bev. Code §§ 74.01, 74.03.

³² 235 ILCS 5/5-1(n).

³³ Fla. Stat. Ann. §§ 561.221(3), 563.02(2); Florida Division of Alcoholic Beverages and Tobacco, *Licenses and Permits for Alcoholic Beverages*, available at <http://www.myfloridalicense.com/Dbpr/abt/documents/ABTLicenses.pdf>. Neither Florida nor Illinois require brewpubs to serve food.

³⁴ Ga. Code Ann. § 3-5-36(2)(A).

³⁵ Sale for off-premise consumption is not limited only to sale of draft beer. It may also include, depending on state law, the sale of product in bottles or cans.

³⁶ Cal Bus & Prof Code § 23396.3(a).

³⁷ Fla. Stat. Ann. § 561.221(3)(a)(2).

³⁸ Georgia SB 85 (effective Sept. 1, 2017) (amending Ga. Code Ann. § 3-5-36(4)).

³⁹ Tex. Alco. Bev. Code Ann. §§ 62.01(a)(2), 74.01(a)(2).

⁴⁰ N.Y. Alco. Bev. Cont. Law § 64-c(12); New York State Liquor Authority Division of Alcoholic Beverage Control, *Definition of License Classes*.

⁴¹ 235 ILCS 5/5-1(n), 5/6-4(e).

⁴² Or. Rev. Stat. Ann. § 471.200; Oregon Liquor Control Commission, *Annual and Multi-Year License Types*, available at http://www.oregon.gov/olcc/LIC/docs/license_types.pdf.

⁴³ According to one analysis, 33 states allow self-distribution. Three states have a limited form of self-distribution, and 14 states and the District of Columbia do not allow self-distribution. See Bart Watson, *Dr. Statelaws: Or How I Learned to Stop Worrying and Love Self Distribution*, BREWERS ASSOCIATION (Apr. 22, 2014), <https://www.brewersassociation.org/insights/dr-statelaws-or-how-i-learned-to-stop-worrying-and-love-self-distribution/>. The recent Justice Department litigation related to the ABInBev and SABMiller merger placed a 10 percent cap on ABI’s ownership of distribution. See Proposed Final Judgment, *United States v. Anheuser-Busch InBev SA/NV*, No. 1:16-cv-01483 (D.D.C. July 20, 2016), available at <https://www.justice.gov/atr/file/877596/download>.

⁴⁴ Fla. Stat. Ann. § 563.022(14)(b).

⁴⁵ Ga. Code Ann. § 3-5-32.

⁴⁶ N.Y. Alco. Bev. Cont. Law § 51(2).

125,000 barrels of annual production may self-distribute not more than 40,000 barrels.⁴⁷ In Oregon, all brewers may self-distribute their product to retailers, but a brewery-public house may self-distribute no more than 7,500 barrels of its own product.⁴⁸

The focus of this report is not whether measures such as those outlined above are economically efficient or achieve an intended policy goal. Rather, the focus is on the potential impact they could have on the administration of and compliance with state excise and retail taxes on beer. As discussed in greater detail below, the current excise tax system is generally seen as imposing modest burdens on the taxpayers involved, being economically efficient, and generating a high level of compliance with limited administrative and enforcement effort – in large part because it was designed around the three-tier distribution system. As such, the current excise tax system relies on reporting of the amount of product moving at each tier of the distribution system to monitor the production and flow of product in the state, provide an independent verification of the amounts of product and tax that are reported on returns filed at the various levels (especially distributor-level excise tax returns), and provide a separation of roles in the distribution system that minimizes the incentives and opportunities for noncompliance with the excise tax. Direct sales of beer by brewers to consumers and self-distribution by brewers to retailers deviate from the three-tier system and disrupt that flow of information.

It is important to note that there is no difference in the total tax imposed on the distribution and sale of beer under the traditional three-tier system as opposed to that sold under any of the measures described above. Texas, for example, imposes an excise tax on the first sale of beer manufactured in the state. The definition of “first sale” includes both sales by a distributor and direct sales by a brewpub.⁴⁹ As a result, brewpub sales that bypass the distributor are subject to the same tax as sales made through the traditional three-tier system. Vermont imposes an excise tax on malt beverages sold by a wholesaler or bottler to a retailer. However, the manufacturer of malt beverages is required to pay the tax for any malt beverages it sells at retail.⁵⁰ Put another way, any tax imposed at the distributor level or at the retail level under the three-tier system is also imposed on beer that is sold directly from brewer to consumer or directly from brewer to retailer. What changes is the entity on which the burden of collecting, reporting and remitting the tax falls and the various mechanisms in place to ensure compliance with those tax obligations. It is those differences that raise implications for the administration of excise and retail taxes on beer. They are examined in the next section.

⁴⁷ Tex. Alco. Bev. Code Ann. § 62A.02(a).

⁴⁸ Or. Rev. Stat. Ann. § 471.200(2); Oregon Liquor Control Commission, *Annual and Multi-Year License Types*.

⁴⁹ Tex. Alco. Bev. Code §§ 203.01, 203.02.

⁵⁰ Vt. Stat. Ann. tit. 7, § 421(a).

Administration of taxes on beer

Background

There are two types of state and local taxes on the distribution and sale of beer as a commodity: (a) excise taxes imposed on a volumetric basis similar to the federal beer excise tax;⁵¹ and (b) retail-level taxes consisting of either the general retail sales tax and/or a special retail sales tax (at a higher rate) that are applied to sales of beer to the final consumer and are based on the price of the product.⁵²

Under the three-tier system, the legal liability for the state excise tax is generally imposed on the beer distributor – the middle level of the system. The distributor, in turn, includes the tax in the price charged to the retailers to which it sells. The distributor is responsible for remitting the tax collected to the state tax authority on a monthly basis, along with a return showing its beginning and ending inventory and the volume of product received from its brewers/suppliers. With the beginning and ending inventory as well as the volume of product received, the state tax authority can accurately compute the amount of tax owed by the distributor. In most states, brewers/suppliers are also required to file reports with the state tax authority on the volume of product they ship to each distributor. This third-party reporting enables the tax authority to match supplier and distributor reports and verify the accuracy of the excise tax return.⁵³

Any retail-level tax is charged by the retailer to the customer and remitted by the retailer to the state tax authority. Retailers are responsible for filing returns with the tax authority, and any special retail tax is generally submitted on a separate return from the general retail sales tax. State compliance efforts are generally of two types: (a) programs to monitor the receipt of returns and remittances in a timely manner with follow up, as necessary, to ensure that taxpayers are not delinquent; and (b) field audits at the location of the retailer to verify sales reports and tax remittances based on the books and records of the retailer. Additionally, some states require distributors to report to the tax authority on the volume of sales to each retailer as a means of identifying retailers with substantial differences between the amounts reported on their returns and the volume of product they received from distributors.⁵⁴

⁵¹ Every state and the District of Columbia imposes an excise tax on beer. In 2017, the rates range from \$.02 per gallon in Wyoming to \$1.07 per gallon in Alaska with a median state excise tax rate of \$.20 per gallon. See Federation of Tax Administrators, *State Tax Rates on Beer* (Jan. 1, 2017), available at <https://taxadmin.memberclicks.net/assets/docs/Research/Rates/beer.pdf>. Some localities also impose an excise tax on beer distributed in the jurisdiction. The federal beer excise tax rate, through December 31, 2017, was \$18 per 31-gallon barrel (\$.581 per gallon). A reduced rate of \$7 per barrel applied to the first 60,000 barrels of production for brewers that produce less than 2 million barrels annually. Effective January 1, 2018, the federal excise tax rate is \$3.50 per barrel for the first 60,000 barrels of production for brewers that produce less than 2 million barrels annually, \$16 per barrel for the first 6 million barrels of production by all other brewers, and \$18 per barrel for production in excess of 6 million barrels per year. The new rates will expire December 31, 2019.

⁵² For a consolidated summary of the special retail taxes applied to beer sales as they existed in 2009, see *NBWA Report, supra* note 5, Appendix A. In addition, some states have other special taxes applied to beer as shown in Appendix A.

⁵³ For more complete description, see *NBWA Report, supra* note 5, at 14-17.

⁵⁴ For a complete discussion, see *NBWA Report, supra* note 5, at 21-23.

Evaluation criteria

The purpose of the 2009 NBWA Report was to evaluate the structure and operation of various taxes on the sale and distribution of beer against a set of criteria that are commonly considered important in determining the level of compliance with a tax that can be expected and the level of resources needed to administer the tax. The characteristics against which the taxes were evaluated included:⁵⁵

- **Number of taxpayers** – The number of taxpayers is a key determinant of the resources the state must expend to control the risk of noncompliance and the degree to which the state can approach universal coverage with its various compliance efforts. The number of taxpayers is also an indicator of the relative size and sophistication of the taxpayers.
- **Simplicity of tax** – Compliance tends to be more complex and prone to error for taxes that have numerous exemptions or other features applicable to a limited class of taxpayers or transactions because of the recordkeeping involved and the opportunity for error or evasion.
- **Availability of data** – Taxes that rely on data that is not readily available from a taxpayer’s books and records or that must be computed and obtained from multiple sources are more complex for taxpayers. This complicates compliance and increases the burden associated with audits for both the taxpayer and the tax authority.
- **Return filing burdens** – Taxes that require multiple filings impose greater burdens on taxpayers, are more prone to error, and impose increased costs on the state.
- **Third-party reports** – The availability of third-party reports that can be used to verify a taxpayer’s return or identify potential noncompliance is a significant aid in ensuring compliance. The reports can reduce the compliance burden on both taxpayers and tax authorities.
- **Field audits** – Field audits are burdensome and consume resources of both taxpayers and tax authorities. To the extent that states must rely on audits, some noncompliance must be expected as 100 percent audit coverage is unlikely.
- **Opportunities for evasion** – A general concern in tax administration is the degree to which the nature of the tax creates opportunities for evasion. When taxes on particular commodities are involved, the potential for consumers to shift purchases to out-of-state sellers and for illegal sales of untaxed products in the state must be considered.
- **Enforcement mechanisms** – The effectiveness of the enforcement mechanisms available to the tax authority can ultimately determine the ability to achieve compliance. Ineffective or cumbersome mechanisms can increase the burden on the state and on taxpayers and leave compliance gaps.

Key findings

The key findings of the 2009 evaluation of the excise and retail taxes imposed on beer that are relevant to this discussion included:⁵⁶

- State beer excise taxes, when administered through the three-tier system, are most closely aligned with the characteristics that are considered to promote tax compliance. Several features, including the number of taxpayers, simplicity of the tax, and the availability of third-party reports to verify compliance, contribute significantly to ensuring compliance with excise taxes without an excessive burden on taxpayers. Of these, the most important are the limited number of taxpayers and the use of third-party reports from suppliers.

⁵⁵ NBWA Report, *supra* note 5, at 26-27.

⁵⁶ See NBWA Report, *supra* note 5, at 33-34.

- The persons interviewed for the 2009 Report (which included distributors and state tax administration officials) did not consider complying with or administering excise taxes to be a significant burden. Similarly, no one interviewed considered noncompliance with the excise tax to be a significant issue. They considered compliance to be straightforward and relatively simple. Retail and special sales taxes, on the other hand, necessarily involve more compliance and administrative issues because of the large number of sellers involved, many of whom are smaller.
- Other features of the regulatory system governing alcoholic beverages, including the three-tier distribution system, exclusive territories for beer wholesaling, and various controls on the retailing of beer, significantly contribute to compliance with various taxes on beer. These regulations, taken together, create the opportunity to monitor the flow of beer in the state, provide state authorities with a limited number of points to tax and exercise control over alcoholic beverages, limit opportunities for contraband (i.e., untaxed) alcoholic beverages to enter the distribution chain, and ensure compliance with the various taxes. In particular, requirements that suppliers must sell only to licensed wholesalers and that retailers may purchase product only from certain licensed wholesalers are fundamental to ensuring compliance in an efficient manner. Without these controls, the level of resources necessary to achieve any given level of compliance would be greater.
- Taxes imposed on the sale of beer, at either the wholesale or the retail level, are not subject to the level of noncompliance and evasion that exists with respect to cigarette taxes. The principal reasons for this are: (a) The three-tier system effectively limits the sources from which beer may enter the retail market; (b) Federal law provides that the sale of beer and other alcoholic beverages on Indian tribal lands (when authorized by the tribal government) is subject to both state and tribal regulation and taxation; and (c) The bulk associated with large quantities of beer makes it a less likely product for contraband sales.
- Information available from beer wholesalers as part of the excise tax administration process has proved helpful in promoting compliance with other beer-related taxes. The Texas program for reporting sales to off-premise retailers, for example, has allowed the tax administration agency to model off-premise retailer sales and improve compliance significantly among such entities.⁵⁷

In short, the 2009 NBWA Report found that the three-tier distribution system, along with other factors, contributed significantly to compliance with taxes of all types on the sale of beer. This was especially true for excise taxes, in large part because of the limited number of taxpayers involved and the availability of third-party supplier reports on beer delivered to distributors. In addition, other features of the system minimized opportunities for untaxed or contraband product entering the state, and distributor reports on sales to retailers had proven valuable. Retail taxes on the sale of beer were susceptible to a greater level of noncompliance than excise taxes because of (as with, for example, retail sales taxes generally) the greater number of taxpayers and limited third-party reporting.

Implications of direct sales

As discussed, many states have adopted measures designed to help the specialty beer industry market its product. A common feature of these measures is to collapse the three-tier distribution system and allow brewers, in certain instances, to sell their product directly to consumers (for on- and off-premise consumption) and to sell their product directly to licensed retail outlets for ultimate sale to individual consumers. Based on the findings of the 2009 NBWA Report, such measures hold significant implications for the administration of and compliance with both excise and retail-level taxes imposed on beer.

⁵⁷ See Texas Comptroller of Public Accounts, Hearing No. 110,730, STAR Doc. 201710022H (Oct. 30, 2017) for an example of the use of the retailer reports in upholding a finding of fraudulent sales tax reporting against a retailer.

Recall, the total tax imposed on sales of beer remains the same if the brewer sells through the three-tier system or directly to consumers and retailers; the excise tax imposed at the distributor level is still owed on the total volume of product sold, and the retail taxes are still owed based on the price for which they are sold. What does change, however, is the entity on which the responsibility for collecting, reporting and remitting the tax falls, with greater responsibility falling on the brewers.⁵⁸ Specifically, in instances in which the brewer sells directly to the consumer, the brewer is stepping into the shoes of both the distributor and retailer. The brewer becomes responsible for determining the volume of beer sold directly to consumers and self-reporting and paying the excise tax due directly to the tax authority as well as collecting any retail level tax due from the customers and remitting it to the tax authority. Where the brewer self-distributes its product, the brewer once again steps into the shoes of the distributor and is responsible for reporting the volume of product sold to retailers and self-assessing the tax due.

The implications of this shift in responsibility can be seen by comparing the administration of the excise and retail taxes under these scenarios to the evaluation criteria used in the 2009 NBWA Report that were identified above.

- **Number of taxpayers** – With both direct-to-consumer and direct-to-retailer sales, the number of taxpayers responsible for remitting excise taxes is likely to increase substantially. There are roughly 2,000 beer wholesalers operating in the U.S., compared to 7,190 brewers.⁵⁹ There were a dozen states with more than 200 brewers in 2016.⁶⁰ The number of taxpayers affects the resources required of tax authorities to monitor compliance and increases the likelihood of delinquencies, errors and noncompliance. In addition, the increase in the number of brewers responsible for reporting excise tax will bring in a number of newer, smaller brewers that may not have the compliance resources that a larger distributor would. Over 90 percent of the 7,190 brewers produced fewer than 7,500 barrels each in 2016.⁶¹

The 2009 NBWA Report looked at several reviews of tax compliance that had been conducted by state tax administration agencies.⁶² The reports generally found that compliance with retail-level taxes on beer was less than was generally considered to be the case for excise taxes collected at the beer distributor level in part due to the increased number of taxpayers at the retail level. Similar results are still evident in newer studies. A 2016 study by the Washington Department of Revenue found an overall noncompliance level among registered taxpayers for all excise taxes of about 2.5 percent. The study found that the noncompliance rate for newer firms (those open two years or less before the audit) had a noncompliance rate of 4.7 percent, compared to a rate of 2.3 percent for “older” firms.⁶³ Another interesting aspect of the Washington study was that noncompliance with “use tax” obligations was 21.9 percent, compared to 2.5 percent for all excise taxes.⁶⁴ In the context of the Washington State study, use tax is the amount owed by a purchaser on items the purchaser brought into Washington where sales tax was not paid to the seller at the time of the purchase. The Washington study dealt only with registered excise taxpayers (not individuals), meaning that registered businesses in Washington underreported the amount of tax on their purchases that they were to self-report to the state by 22 percent. By increasing the “self-reporting” required by brewers, preferences allowing direct-to-consumer and direct-to-retailer sales could pose risk for beer

⁵⁸ See, e.g., Tex. Alco. Bev. Code §§ 203.01, 203.02 and Vt. Stat. Ann. tit. 7, § 421(a) (generally imposing a tax on sales by distributors, but requiring brewpubs or manufacturers to pay the tax on any sales that bypass the distributor).

⁵⁹ NBWA, Permitted Breweries, *supra* note 20.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² NBWA Report, *supra* note 5, at 23.

⁶³ Washington Department of Revenue, 2016 Compliance Study, 11 (June 1, 2016), https://dor.wa.gov/sites/default/files/legacy/Docs/Reports/Compliance_Study/compliance_study_2016.pdf.

⁶⁴ *Id.* at 4.

excise tax compliance. Adding brewers to the number of taxpayers responsible for collecting and remitting retail taxes on beer is unlikely to have a substantial impact in any one state.

- **Simplicity of tax** – The shift of responsibility to brewers for certain excise and retail taxes does not alter the structure of the tax.
- **Availability of data** – If a brewer becomes responsible for self-reporting state beer excise taxes, it will be required to accurately monitor and report the volume of product that it sells through various channels, and the tax authority will potentially need to verify those amounts. Where the product is bottled or kegged and distributed by third parties, there are likely reasonable means for measuring the volume produced and distributed. However, for beer brewed and sold on premises without bottling, the volumetric measures may not be as precise, and the ability of the tax authority to review and verify the measurements is likely to be limited. TTB does not impose requirements for flow meters or measurement devices in breweries. If accurate measurements are not available, the brewer will likely be required to estimate the volume of beer that should be reported for excise tax purposes. For retail taxes that are based on price, information should be available to the brewer to compute retail taxes, presuming a point of sale system is used.
- **Return filing burdens** – Individual brewers will be required to file a monthly excise tax return. The number of retail returns is dependent on the types of retail taxes in the state and the current operations of the brewer.
- **Third-party reports** – The most significant impact on tax administration and compliance under both direct-to-consumer and direct-to-retailer sales will be the absence of the third-party supplier reports that can be used to verify the excise tax return by matching supplier reports to the return.⁶⁵ The third-party report is lost as the brewer takes on the role of both supplier and distributor. Verification of excise tax returns would likely need to be done through field audits at the taxpayer’s premises, if at all. To the extent the state requires distributors to report on sales to retailers, those reports would also be unavailable in cases where the brewer sells directly to consumers.

It is hard to overstate the role that third-party reporting can play in promoting tax compliance and efficient administration. The reports provided by brewers on shipments to distributors were commonly cited as the most effective component of excise tax compliance in the 2009 NBWA Report.⁶⁶ General tax compliance research also bears witness to their importance. The latest estimates by the Internal Revenue Service of the U.S. tax gap (i.e., the difference between the tax paid and the tax owed) show that income on which there is little or no information reporting is understated on final tax returns by a staggering 63 percent.⁶⁷ Income on which there is substantial information reporting is understated by 7 percent, and income on which there is “some” third-party reporting is misreported by 19 percent. Income on which there is tax withholding (as opposed to just reporting) is underreported by only 1 percent.⁶⁸

- **Field audits** – The absence of third-party reports would likely require field audits of brewer records to verify the amounts reported for excise tax purposes. Such audits are resource-intensive for both tax authorities and taxpayers. In addition, depending on the nature of the records maintained, effective compliance may also require what are termed “indirect audits,” i.e., audits of inputs into the brewing process to evaluate if they are in line with the reported output. The changes in

⁶⁵ See, e.g., Texas Comptroller of Public Accounts, *Alcohol Reporting*, <https://comptroller.texas.gov/taxes/alcohol/> (noting that the Comptroller’s office compares information reported by beer wholesalers and distributors to the sales reported by retailers to support and enhance its audit programs).

⁶⁶ *NBWA Report*, *supra* note 5, at 34.

⁶⁷ I.R.S. Publication 1415, at 12 (May 2016).

⁶⁸ *Id.*

distribution would have minimal impact on the need for field audits of retail taxes which is where they are most commonly used at present.

- **Opportunities for evasion** – Given that all participants in the beer distribution and sales system would still be subject to state licensing requirements, there should not be an opportunity for untaxed product to enter the distribution system as is now the case with cigarettes and tobacco products.
- **Enforcement mechanisms** – As under the current system, the state regulatory authority would still retain an effective enforcement mechanism over noncompliant taxpayers, i.e., withdrawal of the ability to manufacture, distribute or sell beer. Identifying the noncompliance, however, becomes more difficult.

In short, measures that allow brewers in certain instances to sell directly to consumers or to retail licensees clearly have implications for administration and compliance with excise and retail taxes on beer as compared to the traditional three-tier system. Compliance with excise taxes could be affected as the number of taxpayers increases and their sophistication, in terms of systems and information availability, potentially decreases. The most significant impact, however, is the loss of third-party supplier reporting that can be used to verify excise tax compliance.

A further look at the data

It is not possible to estimate precisely the volume of beer production that moves outside the three-tier system directly from brewers to consumers or retail outlets. Therefore, the amount of excise and other tax that may be at risk because of the loss of third-party reporting is not known. There is no publicly available data set that sufficiently breaks out these two product flows, and certain discrepancies in the beer production reporting system make quantifying the volume of beer that is directly sold to consumers or retailers difficult. Several things are, however, known about these areas, particularly the direct-to-consumer sales by brewers.

Regardless of which data one examines, it seems clear that the volume of beer being sold or used at the premises on which it is brewed is rising rapidly, the growth is primarily among craft brewers, and on-premise sales at the brewery are vitally important to certain segments of the craft beer industry. The one item of publicly available data that hones in on the volume of on-premise sales at the brewery is an entry on the TTB Statistical Report termed “Tax Determined, Premises Use,” which is defined by TTB as the volume of beer produced at the brewery and sold in a ‘tap room’ (on-premise location) at the brewery.⁶⁹ Federal and state excise taxes are required to be paid on this volume. In 2016, the volume of “Tax Determined, Premises Use” reported by TTB was 2.0 million barrels, amounting to 1.1 percent of total taxable removals.⁷⁰ The 2016 volume of “Tax Determined, Premises Use” was up about 55 percent from the 1.2 million barrels reported to TTB in 2015, and is nearly three times the reported volume in 2014.⁷¹ Some portion of the “Tax Determined, Premises Use” production is attributable to larger breweries which also sell beer on premises. The vast majority of the production, however, is from small brewers as over 95 percent of the total volume of “Tax Determined, Premises Use” is reported by brewers reporting to TTB on a quarterly basis.⁷² Quarterly reporting is permissible only for brewers with less than \$50,000 in federal excise tax liability in the prior calendar year (equivalent to 7,140 barrels of production).⁷³

The TTB data may understate on-premise brewery sales because some craft brewers likely report beer that they produce, place in kegs, and sell to consumers at the on-premise location under the “In kegs” category of the TTB report (which is supposed to be used only if the beer is kegged and distributed to a retail outlet through a distributor or directly).⁷⁴ Adjusting for this reporting issue (and using other data sources), the Brewers Association estimated about 1.75 million barrels of beer sold on-premise at breweries in 2015, as opposed to the 1.2 million barrels of “Tax Determined, Premises Use” reported by

⁶⁹ TTB Form 5130.9 and accompanying instructions. This is distinguished from beer that is otherwise consumed on the brewery premises which is not considered as “removed” and is not subject to excise tax.

⁷⁰ TTB, *Statistical Report – Beer (December 2016)*, Report TTB S 5130-12-2016, (revised September 28, 2017).

⁷¹ TTB, *Statistical Report – Beer*, December of relevant years. These data undoubtedly reflect an increase in brewery on-premise sales, but they may also be influenced by changes in reporting behavior. From 2010 – 2014, “Tax Determined, Premises Use” reported volumes were generally steady at about 500,000 barrels per year.

⁷² Based on review of monthly TTB, *Statistical Report – Beer* in 2016.

⁷³ TTB, Instructions for Form 5130.26, Quarterly Report of Brewer’s Operations. Based on an excise tax of \$7 per barrel for small brewers, this report is available only to brewers with less than about 7,140 barrels of production annually.

⁷⁴ Bart Watson, *Breweries: A New Epicenter of On-Premise Growth?*, BREWERS ASSOCIATION (Sept. 15, 2016).

TTB.⁷⁵ If that same differential occurred in 2016, the volume of brewery on-premise sales would be approximately 2.5 million barrels.

Putting aside the actual volume, on-premise sales at the brewery are vital to many craft brewers, a factor that would suggest continued growth. Over 90 percent of the beer produced by breweries with annual production of less than 1,000 barrels (of which there were about 3,800 in 2016)⁷⁶ was draft beer intended primarily for on-premise sale in 2015.⁷⁷ Brewpub production (as defined by the Brewers Association) accounts for over 5.5 percent of all craft beer production, and it is intended almost entirely for on-premise sale. Overall, one observer estimates that brewery on-premise sales could reach 7 percent of all on-premise sales (i.e., of all types of beer in all types of retail on-premise outlets) and account for as much as 25 percent of all craft beer sold in on-premise outlets.⁷⁸ The popularity of consumption at the brewery is even changing some business models. Microbreweries (see Glossary) which traditionally refrained from offering food at the brewery, have begun offering food service through restaurant delivery or food trucks to respond to customer preferences, increase their on-premise sales, and avoid the investment necessary to prepare their own food. This is resulting in an increasing number of microbreweries and increasing on-premise sales by such establishments.⁷⁹ In short, several factors make it difficult to see an end to the increasing volume of on-premise sales at breweries which will result in an increasing volume of beer moving outside the three-tier system where there is no system of third-party reporting to help ensure excise tax compliance.⁸⁰

The potential for reporting discrepancies can be seen when state-reported data is compared to TTB data. For example, in Maryland, the Office of the Comptroller is responsible for state excise tax collection. A recent report from the Comptroller's Office on the economic impact of the brewing industry notes that Maryland's 74 breweries produced 247,000 barrels of beer in 2016.⁸¹ However, data published by TTB shows Maryland breweries with a total of 201,747 barrels for 2016.⁸² The 45,250 barrel discrepancy (over 20 percent) is the equivalent of over \$125,000 in state beer excise tax at the Maryland rate of \$2.79 per barrel and nearly \$340,000 in federal taxes at the 2016 reduced rate of \$7.50 per barrel. A similar issue was raised in the North Carolina legislature in 2017 with the Department of Revenue noting that 23 percent of breweries were not in compliance with their tax obligations.⁸³

We have been unable to identify data sources that would allow any estimate of the volume of beer that is self-distributed. As noted, however, some form of self-distribution is allowed in 35 states. This, too, creates risk for excise tax collection because of the loss of third-party supplier reports.

⁷⁵ *Id.*

⁷⁶ TTB, *Number of Brewers by Production Size – CY 2016*, *supra* note 8.

⁷⁷ Bart Watson, *On-Premise Beer Data and Craft*, BREWERS ASSOCIATION (June 15, 2016), <https://www.brewersassociation.org/insights/importance-on-premise-craft-brewers/>.

⁷⁸ Watson, *Epicenter*, *supra* note 76.

⁷⁹ Bart Watson, *The Rise of the Microbrewery Tap Room*, BREWERS ASSOCIATION (Sept. 16, 2014), <https://www.brewersassociation.org/insights/importance-on-premise-craft-brewers/>.

⁸⁰ The discussion of any tax issues arising from closures of traditional alcohol retailers due to increased brewery taproom competition is beyond the scope of this report. See, for example, Tara Nurin, *Bars Lash Out Vs. Craft Beers*, NEW JERSEY MONTHLY (August 30, 2017), <https://njmonthly.com/articles/just-for-the-web/bars-lash-vs-craft-beers/>.

⁸¹ Maryland Bureau of Revenue Estimates, *Economic Impact of the Craft Beer Industry in Maryland* (October 25, 2017), p. 11, http://comptroller.marylandtaxes.gov/Public_Services/Agency_Information/Office_of_the_Comptroller/Comptroller_Initiatives/Craft_Beer_Economic_Impact_Study.pdf.

⁸² TTB, *Yearly Statistical - Beer Summary by State (2007-2016)* available at <https://www.ttb.gov/beer/beer-stats.shtml>.

⁸³ Laura Leslie, *Tax compliance flap shakes up craft beer debate*, WRAL (Apr. 6, 2017), available at <http://www.wral.com/tax-compliance-flap-shakes-up-craft-beer-debate/16630154/>.

A second feature of the increased popularity of craft beers that creates some risk exposure for excise taxes is the explosion in the number of brewers, particularly smaller ones, responsible for reporting excise tax. As noted, studies examining tax compliance tend to find higher rates of noncompliance for taxes with a large number of taxpayers as well as among smaller, newer (i.e., without significant tax compliance history, experience and systems) businesses. At the end of calendar year 2016, there were 7,190 brewery premises with a permit to produce beer issued by TTB.⁸⁴ This is an increase of about 1,100 permits from 2015 and over three times the number of permits in place at the end of 2010. Another way of looking at the data would be to say that less than one-half of brewery permittees have been in operation for more than five years and have never been through an economic downturn. Given that the requirements to capitalize a small brewery are sometimes estimated to be at least \$1 million for even a modest amount of commercial production,⁸⁵ many of these brewers are likely to be thinly capitalized and tax compliance risks may well exist.⁸⁶

Beyond the lack of data that focuses on on-premise consumption at breweries and direct to retailer distribution, there are other anomalies in the data surrounding beer production and sales that make it difficult to gauge the potential impact of craft beer marketing preferences on excise tax administration. Among these are:

- It is difficult to reconcile the two main TTB reports regarding beer production – the monthly Statistical Report and the Number of Brewers by Production Size. While the total production entry in both reports for calendar year 2016 is within 30,000 barrels of one another, the taxable removals total (i.e., the volume of beer reported for excise tax purposes) is about 900,000 barrels higher in the Statistical Report, despite the reports having been revised in September 2017 and October 2017, respectively. A similar discrepancy of just over 1 million barrels in total taxable removals is evident in the 2015 data.⁸⁷
- The Number of Brewers by Production Size report for 2016 (as revised in October 2017) contains a reporting stratum for breweries with less than 1 barrel of production. The report shows 488 such breweries, reporting virtually no total production, but nearly 103,000 barrels of “taxable removals,” i.e., sales into the retail sector on which excise tax was reported.⁸⁸ The May version of this data set showed 1,000 breweries with nearly 500,000 barrels of taxable removals in this stratum. In the October revision of the Production Size report (as compared to the May revision), the largest change in the number of breweries was in the 1-1,000 barrels of production category (adding 472), but the largest change in production volume was in the 1,001-7,500 stratum (nearly 400,000 additional barrels or a 20 percent increase in this stratum). Fluctuations such as these raise questions about the quality of the reporting for small-volume producers.
- There is a large discrepancy between the Number of Brewers by Production Size report and the number of TTB Permitted Brewery Premises.⁸⁹ The 2016 Production Size report shows 5,096 breweries, whereas TTB reports a total of 7,190 brewery permits issued as of the end of 2016. Since

⁸⁴ NBWA, Permitted Breweries, *supra* note 20. Note this is permitted locations as opposed to the 5,096 breweries reporting to TTB that are captured in the TTB “Production Size” report referenced elsewhere in the report. The difference may be attributable to brewers that produce, but do not report to TTB and permittees that have not begun production.

⁸⁵ Reiser Legal, *How Much Does it Cost to Start a Brewery?*, BREWERY LAW BLOG (Oct. 28, 2014), <http://brewerylaw.com/2014/10/how-much-does-it-cost-to-start-a-brewery>.

⁸⁶ Certain of these new breweries are also likely to be quite leveraged in their financial structure. The Small Business Administration has provided over \$450 million in loan guarantees to brewers since 2014.

⁸⁷ Comparison of TTB reports. The difference between the two reports seems to be chronic in that the discrepancy – with the Statistical Report being higher than the By Production Size report – was 1.5 million barrels in 2007.

⁸⁸ See TTB, *Number of Brewery By Production Size – Calendar Year 2016*. The report indicates that the data are obtained from various reports of brewery operations filed with TTB reporting production subject to tax.

⁸⁹ See sources for Notes 8 and 20, respectively.

the Brewers by Production Size report contains data provided by all breweries that filed an excise tax report, this means that there are over 2,000 permits issued for premises that are reporting no production subject to excise tax. In 2015, there was also a 2,000 permit discrepancy – 3,920 captured in the Production Size report and over 6,000 permittees. The non-reporting premises could be start-ups that have not reached commercial production or “abandoned” permits that ceased production. Still, the fact that 40 percent of permittees are not filing excise tax reports seems large.

Risk mitigation options

The primary increase in risk of excise tax noncompliance is the growing volume of beer production that flows outside the three-tier system directly from brewers to consumers or retailers, resulting in a loss of supplier reports to tax authorities on shipments to licensed distributors. Instead, brewers will be self-assessing and self-reporting the excise tax on the volume of beer they sell to consumers and retailers directly to the tax authority. The question from a risk mitigation standpoint is whether there are measures that could be adopted that would, at least partially, fill the reporting gap.

- **Information Sharing by TTB** – The TTB receives a “Brewer’s Report of Operations” monthly from larger brewers and quarterly from the large number of brewers with less than about 7,140 barrels of annual production.⁹⁰ The Brewer’s Report provides a complete accounting of the beer produced and received as well as its distribution outside the brewery and consumption at the brewery. The Brewer’s Report is then used to compute the federal excise tax due. If the Brewer’s Report of Operations (or an extract of relevant data) was shared with state tax authorities, it would provide a form of verification of the amounts reported by brewers to the state. While both the TTB Brewer’s Report and the state excise tax return would contain data provided by the brewery, sharing with the state tax authority would enable a check as to consistency in reporting to the various tax authorities. To the extent there are concerns about sharing of confidential or proprietary information, the Internal Revenue Service program for exchanging individual and corporate income tax return information with state tax authorities provides a model for ensuring such information is safeguarded from unauthorized disclosure.⁹¹
- **State Reporting** – Another risk mitigation approach would be to adopt state legislation requiring each brewery to report information on their operations to the state regulatory authority. The information could then be used to cross-check with the excise and other tax reported by the brewer. Again, while not a perfect substitute for an independent, third-party report, it would be beneficial for verification purposes. The information reported could include total production as well as the disposition of the beer produced, i.e., amounts bottled, kegged, sold on premises, distributed to retailers, and sold to distributors. The report, as does the TTB Brewer’s Report, might also include information on inputs as a way of comparing reported inputs with reported outputs. The 2017 North Carolina Legislature considered legislation⁹² that would have required each brewery with a beer wholesaler permit to file an annual report with the regulatory authority detailing the production of the brewer as well as the volume and dollar value of the beer produced by the brewer that was sold to retailers, sold on-premise to consumers, sold off-premise to consumers and at special events. It would also have required the state regulatory authority to receive confirmation from the state tax agency that each brewer was in compliance with all tax obligations before renewing the brewer’s

⁹⁰ See TTB, Form 5130.90 and accompanying instructions for the monthly report and Form 5130.26 and accompanying instructions for the quarterly report of smaller brewers.

⁹¹ See I.R.C. § 6103 and I.R.S. Publication 1075 (Sept. 2016).

⁹² H.B. 480, 2017 Gen. Assemb, Reg. Sess. (N.C. 2017).

permit to operate. Beyond providing a source for verifying excise tax reports, gathering such information would be helpful in understanding trends and developments in the brewing industry.

- **Audits and Inspections** – A final mitigation strategy would be to adopt a program of regular and ongoing audits or inspections of brewers to ensure appropriate tax reporting and compliance with other obligations. While this would require staffing and expenditures, it could also promote on-going compliance by educating brewers and ensuring they understand their obligations.

Conclusion

A shift in consumer preferences to beers that are produced by smaller, more local craft breweries has led nearly every state to enact regulatory changes designed to promote such breweries. Many states now allow certain breweries to sell their product directly to consumers at the brewery premises and to sell their product directly to retail outlets, thus bypassing certain aspects of the traditional three-tier system. While a precise estimate of the volume of beer sold through these channels is not possible, it is a growing proportion of all beer sales and probably approaching 3 million barrels per year, or about 1.5 percent of total U.S. beer consumption.

One effect of these regulatory changes supporting the craft beer industry is to increase the risk of noncompliance with the excise and retail tax obligations associated with beer sales by eliminating the independent reports that flow to state tax authorities on the volume of beer sold by brewers to distributors and from distributors to retailers. These reports have historically enabled state tax authorities to expend minimal resources in ensuring compliance with the excise tax. The reports can also assist in retail tax compliance. In addition, allowing certain breweries to sell directly to consumers and retailers substantially increases the number of smaller, less experienced taxpayers with excise tax responsibilities, which also increases the compliance risk. While there are options available to states that could mitigate the increased noncompliance risk, they cannot replace fully the current flow of information through the three-tier distribution system and are likely to be less effective and more costly.

Disclaimer

In preparing this advice, we considered tax authorities that are subject to change, retroactively, prospectively, or both, and any such changes could affect the conclusions stated herein. This advice is based on the completeness and accuracy of any one or more of the facts, assumptions, and client representations on which we relied, relating to the matters to which this advice is addressed. Unless separately agreed in writing, we will not update our advice for subsequent changes or modifications to the law, regulations, or to the judicial and administrative interpretations thereof, nor to take into account your correcting, updating, or providing new or additional facts or information you supplied or any assumptions on which we relied in preparing our advice.

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Appendix A

Glossary

Distribution system

Control state – A state in which the state government itself is a participant in the wholesale and/or off-premise retail level for some types of alcoholic beverages.

Distributor (Wholesaler) – The second tier of the three-tier distribution system. Distributors must be licensed to distribute beer in the state. They may generally purchase beer only from licensed suppliers and sell beer only to licensed retailers.

Growler – A reusable, sealable container in which draught beer can be sold for off-premise consumption.

License state – A state that uses the three-tier distribution system. In license states, the participants at each level are private sector entities licensed and regulated by the state.

Retailer – The third tier of the three-tier distribution system. Retailers must be licensed to sell beer to individual consumers in the state and may generally purchase beer only from licensed distributors. The retail level consists of establishments that sell for “off-premise” consumption (e.g., package liquor stores, grocery stores, or convenience stores) and for “on-premise” consumption (e.g., bars, taverns, and restaurants).

Self-distribution – The ability of a brewery to sell and deliver beer directly to retailers.

Supplier (Brewer or Manufacturer) – The first tier of the three-tier distribution system. Suppliers must be licensed to manufacture or sell their beer into the state, and may generally only distribute beer through licensed distributors within the state.

Three-tier Distribution System – A distribution system that requires a legal separation in the ownership and operation of the various levels of the system and requires licensing of all participants in the alcoholic beverage distribution system. The three-tier distribution system generally requires that all sales into a state from licensed suppliers (brewers, vintners, distillers and importers) must be made to licensed distributors in the state, and licensed retailers may purchase their product only from these licensed distributors.

Types of brewers

There are no commonly accepted definitions for the various types of brewers or the establishments in which they operate, e.g., brewpub or microbrewery. State laws define various types of brewers differently and have different thresholds of production for their classification and different privileges for each class of brewer. The Brewers Association, a trade group representing many brewers considered to be craft brewers, has developed specific definitions that it uses to compile data annually on craft beer production and consumption. These definitions are reasonably representative and are presented below.⁹³

Brewpub – A restaurant-brewery that brews beer primarily for sale in the restaurant and bar and sells at least 25 percent of its beer on-site.

Craft Brewery – A brewery that is small (annual production of 6 million barrels or less), independent (less than 25 percent owned or controlled by a non-craft brewer), and traditional (a majority of the total beverage volume has flavors that derive from traditional or innovative brewing ingredients and their fermentation). Craft breweries may include brewpubs, microbreweries, regional craft breweries, and contract brewing companies.

Contract Brewing Company – A business that handles marketing, sales, and distribution of its beer, but contracts with another brewery to brew and package some or all of its beer.

Microbrewery – A brewery that produces no more than 15,000 barrels annually and sells at least 75 percent of its beer off-site. Microbreweries may sell beer to the public through the traditional three-tier system or sell directly to consumers or retailers, depending on state law where they operate.

Regional Brewery – A brewery that produces between 15,000 and 6,000,000 barrels of beer each year.

Regional Craft Brewery – An independent regional brewery (annual production between 15,000 and 6,000,000 barrels per year) with a majority of its production volume in “traditional” or “innovative” beers.

Small Brewer – Defined differently by state laws and industry practice. The TTB recently undertook rulemaking to reduce paperwork for “small brewers” and settled on those paying less than \$50,000 in excise tax which translates to 7,140 barrels (221,340 gallons) of beer.

Traditional Brewery – A brewery that produces multiple brands for national or regional distribution.

⁹³ See *Craft Beer Industry Market Segments*, BREWERS ASSOCIATION, <https://www.brewersassociation.org/statistics/market-segments/>.

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