**Tax Team Enterprises, LLC**

Cleveland, OH

March 29, 2020

**Facts**

Mr. David Johnson is a practicing lawyer. He owns and operates a small winery in Napa Valley, CA in his free time. When starting the business Mr. Johnson paid $2,000,000 (adjusted basis $600,000) for the land, the winery building, and related equipment. To help with the initial purchase, he arranged for a loan of $1,000,000. The winery generates yearly revenues of $240,000. However, the business has never been profitable. Mr. Johnson has been operating the winery as a sole proprietorship. He has reported losses from the first four years on his personal tax return (Schedule C), reducing his tax liability from his work as a lawyer. Mr. Johnson is interested in incorporating the business as Grapes-of-Joy, Inc.

**Issue(s)**

1. Are the winery-related losses that Mr. Johnson took on his personal tax return in prior years proper?
2. Is incorporating the winery tax-free?
3. Is the transfer of the winery-related debt ($1,000,000) to the corporation tax free?

**Conclusion**

1. The winery-related losses that Mr. Johnson took on his personal tax return in prior years are not proper. Such a position is, given the facts above, frivolous.
2. Incorporating the winery should be tax free.
3. The transfer of the liability to Grapes-of-Joy, Inc. will more likely than not result in a taxable gain.

**Authorities**

**Issue 1:**

Reg §1.183-2(b)

IRC §162

IRC §183

IRC §212

*Theodore James Zalesiak*, T.C. Summary Opinion 2019-16.

*Keanini*, 94 T.C. 41

*Hulter*, 91 T.C. 371

Young, P. 2018. Avoiding the hobby loss trap after the TCJA.

<https://www.thetaxadviser.com/issues/2018/nov/avoiding-hobby-loss-trap-after-tcja.html>.

**Issue 2:**

IRC §351

**Issue 3:**

IRC §357

Reg. § 1.357-1(c)

*Lessinger v. Comm.*, 872 F.2d 519

# *Seggerman Farms, Inc.*, 308 F.3d 803

**Analysis and Summary**

Issue 1:

The challenge with regard to the deduction of losses is whether or not a profit motive exists for the winery. Regulation 1.183-2(b) enumerates the criteria used to determine whether a business is engaged in for profit, noting that this is a matter of “facts and circumstances” rather than a brightline distinction. The summary opinion of *Zalesiak v. Commissioner* cites cases where the profit motive for a business was struck down by the courts. Since the winery has never made a profit and the client already has a full-time job that sustains him, establishing a profit motive may be a challenge. The deductions on previous years’ tax returns seem frivolous.

Issue 2:

Under IRC §351, the formation of a corporation is tax free. The formation of Grapes-of-Joy, Inc. should be tax free.

Issue 3:

The tax rule for a transfer of a liability to a corporation is governed by IRC §357(a). Under this section, liabilities assumed by a corporation that exceed the asset basis of the corporation result in a taxable gain. This code section has been litigated. While *Lessinger v. Commissioner* would indicate a favorable tax treatment, the more recent ruling in *Seggerman Farms, Inc. v. Commissioner* indicates differently. *Seggerman Farms* is more recent and seems to align better with the Internal Revenue Code. Therefore, we will rely on that ruling. Unfortunately, Mr. Johnson’s debt of $1,000,000 exceeds his adjusted basis of $600,000. As a result, there will more likely than not be a taxable gain on the transfer of the liability.

**Actions to Be Taken**

Prepare the client letter.

Review the results with the client.

Suggest that the client file amended returns to avoid fines and penalties on underpayment of taxes.

Preparer: NAME 1

Preparer: NAME 2