

ABA Section of Taxation
2018-2019 Law Student Tax Challenge
Official JD Division Problem

You are a tax associate at one of the top law firms in New Orleans. After a busy first few months, you've finally figured out the quickest route from the coffee machine to your desk and you think you understand the firm's billing software. You're preparing for a Friday night out on Bourbon Street when you get an email from one of the senior partners.

You've heard rumors that one of the firm's biggest clients is in need of tax advice. Fingers crossed for your chance to prove yourself, you open the email:

From: Senior Partner
To: Associate
Re: IMPORTANT – Rose Riesling
Date: September 4, 2018

Associate,

One of our long-time clients, Rose Riesling, has come to us for tax advice. Before I give you your assignment, you should know a little bit about Ms. Riesling. Ms. Riesling began her career in film and appeared in a number of featured roles during her young adult life. At one point she was even nominated for an Academy Award. Since retiring from her life on screen, she has been an executive producer on a number of blockbuster movies, which she says pays the bills while still leaving time for her real interests: yoga, travel, and wine. She also receives a good amount of royalty income from the use of her likeness on movie merchandise, such as posters and T-shirts.

After rejecting the call of her name for far too long, she developed a love of wine many years ago during a trip to Italy. She has fond memories of learning about wine while basking in the Tuscan sun with her friends, and since that trip she had always dreamed of making her own wine. In 1997, Ms. Riesling was enjoying a weekend of wine tasting and on a whim purchased a small vineyard in Sonoma County, California. She chose to rename it Pienza Vineyards after an adorable town she happened upon in the Tuscan countryside during her trip to Italy. Over the years she has acquired a few adjacent vineyards and now owns a beautiful 200 acre estate, which produces approximately 12,000 cases of wine annually including cabernet sauvignon, pinot noir, merlot, sauvignon blanc, chardonnay and, of course, riesling.

Three years ago during a vacation to Hawaii Ms. Riesling had a whirlwind romance with an on-screen love interest from her early acting days, Bud Lagerale. Bud's acting career never took off, but Ms. Riesling always had fond memories of their movie. They married soon after.

While the size of Ms. Riesling's vineyard has grown, she has always maintained that her acquisition of a wine producing estate was her way of connecting with the earth and trying her hand at winemaking, not to mention a way to ensure she would always have delicious wine to drink with her friends and family. Because of her film-making history, however, Ms. Riesling's wine-making venture quickly gained attention from people across the country. Her wines regularly sell out at local farmers markets and she has distributors knocking on her door almost daily. While she does not currently allow tours of Pienza Vineyards, she is considering

changing her stance as she wants the public to be able to enjoy her winery, too. Of course, Ms. Riesling's direct involvement in the wine-making is somewhat limited, as her career as an executive producer requires frequent travel.

Despite the vineyard's growth and popularity, its profitability has been variable. In the first ten years of operation, the vineyard had significant losses--I believe around \$10 million in total. In fact, there were no profits made in any of their first ten years. The last decade has been a bit better. About five of the last ten years have seen a decent profit, but as a whole the vineyard is still in the red. 2015 and 2016 were blockbuster years, bringing in record profits for the vineyard after the release of Ms. Riesling's most recent box office hit. Last year, however, Pienza Vineyards brought in \$3,600,000 in revenue and incurred \$4,200,000 in expenses.

Ms. Riesling filed an extension to file for last year's return. She's asked us whether the vineyard's \$600,000 in losses in 2017 can offset some of the income from her royalties and role as an executive producer. We've already asked for more documentation on how many hours Ms. Riesling spent on her wine-making business, so hold off on any passive activity loss issues for now. For the time being, I just need to know whether the winery counts as a business or a hobby.

Also, last September, Ms. Riesling sold the following items:

1. A 500-liter wine tank that she purchased in October of 2016 for \$2,000. Another winery purchased the tank at its fair market value of \$1,000. At the time of the sale, Ms. Riesling's adjusted basis in the wine tank was \$1,500 (after taking a \$500 depreciation deduction).
2. A wine press that she purchased four years ago for \$6,000. After taking \$2,000 in depreciation over the last four years, she sold it to a large wine corporation, Sangria Co., for \$5,000. Sangria Co. paid \$3,000 at the time of purchase and will pay the remainder this year.
3. A necklace that she had inherited from her grandmother in November of 2016. Ms. Riesling sold the necklace at fair market value for \$15,000. Grandmother Riesling had purchased the necklace about forty years earlier for \$1,000.

Unfortunately, also last September, a small storage unit used to store some of the smaller wine-making equipment caught fire. Ms. Riesling was able to salvage the equipment, but the storage unit itself was completely destroyed in the fire. At the time Ms. Riesling's adjusted basis in the storage unit was \$2,500, and its fair market value was \$1,500. We don't know if the vineyard's insurance policy is going to cover the loss.

Ms. Riesling is unsure how to report the gains or losses from the items listed above. Focusing your analysis on section 1231, how much gain/loss should she report, and what is the character of that gain/loss? Also, do we need to be concerned about depreciation recapture under section 1245? Can Ms. Riesling report the sale of the wine press as an installment sale under section 453?

In June 2015 Ms. Riesling purchased a car from her Aunt Char for personal use. She wanted a car that she could drive around town without drawing too much attention. The car was valued at \$5,000 at the time, but Aunt Char sold Ms. Riesling the car for a discount at \$3,500. Aunt Char bought the car in 2014 for \$6,000. Ms. Riesling has barely used the car, so she is thinking about selling it to her Uncle Merl for \$2,000. How much gain or loss can Ms. Riesling expect?

Ms. Riesling also informed us that she and Bud are divorcing because during an argument he suddenly exclaimed that he's never liked wine and thinks she should open a brewery instead. She filed for divorce last October. Last December, after they began divorce negotiations, she transferred to Bud stock held as an investment and valued at \$5,000. Her basis in the stock was \$3,000, and she had held the stock for more than one year. She wants to know if she needs to report a long-term capital gain of \$2,000 because of the transfer. Note that the stock is unrelated to Ms. Riesling's winery or to her work as a producer.

Last week Ms. Riesling brought us several boxes full of documents and records, including the following:

- An appraisal dated October 28, 2016 (the date Grandmother Riesling died), stating that the fair market value of Grandmother Riesling's necklace as of that date was \$12,000.
- A document showing that Bud has owned 60% of the stock in Sangria Co. since June of 2014 (surprising, considering his feelings about wine). Does this affect the sale of the wine press to Sangria Co.?

Please address the questions presented in a memorandum not to exceed 10 pages. Please also draft a letter to Ms. Riesling not to exceed 5 pages. Focus only on the substantive federal income tax aspects. Other associates are looking into other issues, including excise and state and local tax issues. Make sure to specify any additional information we might need.

Needless to say, Ms. Riesling is one of our highest-profile clients. I expect you to complete the memorandum and letter by November 6, 2018. I trust that you will be hard at work over the next two months while I am away on a European wine tour.

Senior Partner