Tax Insights & Commentary
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Gregory Impacts Miscellaneous Itemized Deductions Beyond Hobbies

The Gregory v. Commissioner decision could have profound tax consequences considering the IRS's frequent attempts in audits to characterize business activities as "not engaged in for profit," says Marcum's Michael D'Addio.

The recent decision in *Gregory v. Commissioner* has brought new scrutiny and interpretation surrounding the deduction of expenses related to activities "not engaged in for profit."

By affirming a previous Tax Court decision, the US Court of Appeals for the Eleventh Circuit's decision will affect a broad spectrum of income-producing activities beyond mere hobbies.

Both decisions effectively eliminate the ability to take related miscellaneous itemized deductions through 2025. For later years, these expenses will be treated as miscellaneous itemized deductions that provide a benefit only if they exceed a certain adjusted gross income threshold and are subject to add-back for alternative minimum tax purposes.

The *Gregory* case involved a charter boat operation that generated about $300,000 of gross income and had slightly more than $300,000 of related expenses. The IRS argued that the charter boat operation wasn't entered into for profit purposes. While most cases involve the issue of whether a particular business is entered into for profit, the taxpayers conceded this issue. The expenses were about the same as the gross income, so the taxpayers thought this concession would produce a small tax increase.

Under Section 183(a) of the tax code, an individual taxpayer can't claim deductions attributable to an activity not engaged in for profit except as provided in this code section. Section 183(b) states that the taxpayer shall be allowed:

1. Deductions that would be allowable under this chapter of the tax code without regard to whether such activity is engaged in for profit (such as interest and taxes); and
2. An amount of deduction allowable as a business deduction if the activity were entered into for profit—but only to the extent gross income derived from the activity exceeds the deductions allowed by the item above.

The taxpayer in *Gregory* believed that, under the statute, he would be allowed deductions that would offset the $300,000 of gross income. That's where things got interesting.

Both courts held that because the expenses weren't business-related, items besides interest and taxes should be treated as miscellaneous itemized deductions. These items aren't shown above the line in determining adjusted gross income, but they are itemized deductions.

Because the year involved in the case predated the Tax Cuts and Jobs Act, these expenses generate a benefit only to the extent they exceed 2% of adjusted gross income limitation and are a required add-back in determining alternative minimum taxable income. The taxpayer earned significant other income during the tax year, so the 2% limit reduced the deductions to zero.

The consequences for TCJA-affected tax years—2018 to 2025—are more significant, as no deduction is generally allowed for miscellaneous itemized deductions.

Characterizing an activity as not engaged in for profit produces drastic consequences. This treatment can cause the gross income to be taxed in full without any deduction for these expenses.

Could this be the intent of the law? The Eleventh Circuit notes that other circuit courts haven't decided on this issue but points to support for this result in several lower court opinions. It rejected the taxpayers' argument that Section 183(b) creates an above the line deduction for hobbies that produce gross income.

Furthermore, one judge on the court looked to the conference report for the TCJA to support the court's conclusion. It includes "hobby expenses, but generally not more than hobby income" in a list of items treated as miscellaneous itemized deductions.

Gregory points to the importance of qualifying one's activities as for-profit. While the Section 183 rules are referred to as "hobby loss" rules, they can impact activities that are broader than typical hobbies.

In audits, the IRS often attempts to recharacterize certain reported business activities as being not engaged in for profit. This is particularly true where the operations generate tax losses over multiple years. This threshold determination has more significance than one might have thought pre-*Gregory*.

Taxpayers can take steps to show an intent to profit from a particular activity. These include conducting the activity in a business-like manner, using personnel with expertise and experience in business operations, maintaining a professional and accurate set of books and records, and considering asset appreciation in the expectation to generate a profit.

Gregory's outcome demonstrates the potential consequences of characterizing activities as not engaged in for profit. While previously deemed trivial by many, these hobby loss rules now hold greater weight than ever. Individuals and businesses must heed the court's decision, ensuring their profit-seeking endeavors are conducted and recorded precisely.

Navigating the post-*Gregory* landscape requires diligence, expert guidance, and a laser-like focus on compliance. When the definition of a hobby can significantly impact your bottom line, understanding and responding to the implications of *Gregory* is not just a legal necessity, but a strategic imperative.

The case is Gregory v. Commissioner, 11th Cir., No. 22-10707, 5/30/23.

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