Current Federal Tax Developments

Week of October 4, 2021

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CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF OCTOBER 4, 2021

Published in 2021 by Kaplan Financial Education.

Printed in the United States of America.

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Kaplan Financial Education

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SECTION: 183
HOBBY LOSS EXPENSES CAN ONLY BE DEDUCTED AS MISCELLANEOUS ITEMIZED DEDUCTIONS

Citation: Gregory v. Commissioner, TC Memo 2021-115, 9/29/21

In the case of *Gregory v. Commissioner*, TC Memo 2021-115,[1] the taxpayer asked the Tax Court to rule that expenses incurred for a "hobby" under Section 183 are not miscellaneous itemized deductions facing the limitations of IRC §67(a), the 2% floor on miscellaneous itemized deductions that was in place before all such deductions were eliminated in the Tax Cuts and Jobs Act. The Tax Court found just the opposite—that, aside from taxes allowed as a deduction under IRC §183(b)(1), the expenses are treated as miscellaneous itemized deductions.

IRC §183 is often referred to as the hobby loss rule, and most court cases dealing with this section spend time trying to determine if the activity is or is not an "activity not engaged in for profit" under IRC §183(a). But this case looks at a different issue—assuming the activity is found as not being engaged in for a profit, are the expenses allowed under IRC §183(b) subject to the limitations imposed on miscellaneous itemized deductions found at IRC §67.

IRC §183(b) reads as follows:

> (b) Deductions allowable
>
> In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed--
>
> > (1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and
> >
> > (2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

While the taxpayer asked for a ruling on the entirety of the expenses under IRC §183(b), the IRS had already moved taxes paid by the business to a tax deduction on Schedule A, so the Court found that the only issue was whether IRC §183(b)(2)'s allowed deductions (what would have been allowed had it been conducted for a profit,

[1] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/boat-chartering-activity-deductions-subject-to-2-percent-floor/79gy0 (retrieved October 1, 2021)

limited to gross income from the activity reduced by the §183(b)(1) deductions that would have been allowed regardless) were subject to the rules of IRC §67.

Facts of the Case

The opinion provides the following summary of the facts of the case:

> The Gregorys jointly filed tax returns for the years at issue and reported the income and expenses from their CLC activity on Schedules C, Profit or Loss From Business. Upon selection for examination and subsequent audit, the IRS issued a notice of deficiency dated March 1, 2018, determining deficiencies in Federal income tax for taxable years 2014 and 2015 of $139,268 and $127,953, respectively. Among other things, the IRS recharacterized the gross receipts and "other income" (totaling $342,173 and $313,825 for the respective years at issue) the Gregorys had reported on their Schedules C as non-Schedule C "other income", after concluding they lacked a profit motive with respect to their CLC activity. The IRS also recharacterized the reported Schedule C expenses as miscellaneous itemized deductions to the extent allowable under section 183, with the exception of expenses reported for "taxes and licenses". These expenses, totaling $750 and $126 for the respective years at issue, were recharacterized as non-miscellaneous itemized deductions for taxes. The Gregorys' total miscellaneous itemized deductions for the respective years at issue were adjusted upwards by $341,423 and $313,699 pursuant to section 183(b)(2). However, because the Gregorys' total miscellaneous itemized deductions for both years at issue were less than 2 percent of their adjusted gross income (AGI), no deductions for the CLC expenses (with the exception of the tax expenses) were ultimately permitted pursuant to section 67(a).[2]

What is a Miscellaneous Itemized Deduction?

Since the question is whether the deductions are subject to the limits of IRC §67(a), ultimately the question will be decided by determining if the deductions are miscellaneous itemized deductions. But what makes a deduction a miscellaneous itemized deduction under the IRC?

To understand this issue, the reader must first understand how deductions are divided between "itemized deductions" and just plain old deductions under the IRC. The Tax Court explains that process as follows:

> Section 63(d) defines itemized deductions as deductions other than (i) those allowable in computing AGI and (ii) the deduction for personal exemptions allowed under section 151.[3]

IRC §62 defines adjusted gross income. That section has a list of deductions that are to be allowed in computing adjusted gross income and, as was noted above, if a deduction

[2] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

[3] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

is not in this list it will be an itemized deduction for an individual—the first hurdle to be cleared for an item to be treated as a miscellaneous itemized deduction.

The bad news is that IRC §183(b)(2) is not included in the list of deductions found in IRC §62:

> Section 183(b)(2) is not identified as a deduction allowable in computing AGI. See sec. 62(a). Consequently, section 183(b)(2) is properly viewed as an itemized deduction. The broader statutory scheme confirms as much; section 183(b)(2) is enumerated under Part VI, Itemized Deductions for Individuals and Corporations, of Subchapter B, Computation of Taxable Income. As the title of Part VI suggests, section 183(b)(2) is by default an itemized deduction, and nothing in the text of section 183 or another provision of the Code suggests otherwise.[4]

But even if it is an itemized deduction, how do we determine if it is a miscellaneous itemized deduction? The answer to that is found at IRC §67(b) which contains a list of itemized deductions that are *not* miscellaneous itemized deductions:

> In turn, section 67(a) provides that "[i]n the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." Miscellaneous itemized deductions are defined as itemized deductions other than those described in section 67(b). See sec. 67(b). Thus, if an itemized deduction, such as section 183(b)(2), is not identified on the list provided under section 67(b), it is a miscellaneous itemized deduction and therefore subject to the restriction provided under section 67(a).[5]

One interesting item to note is that some may protest that there are miscellaneous itemized deductions that aren't subject to the 2% floor. Well, actually there aren't, but the IRS labeled certain deductions that didn't have a special line on Schedule A as "Other Miscellaneous Deductions" on Schedule A up through 2017, with the ones limited to 2% of adjusted gross income in a section labeled "Job Expenses and Certain Miscellaneous Deductions."

Job Expenses and Certain Miscellaneous Deductions	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. See instructions. ▶	21		
	22	Tax preparation fees	22		
	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶	23		
	24	Add lines 21 through 23	24		
	25	Enter amount from Form 1040, line 38	25		
	26	Multiply line 25 by 2% (0.02)	26		
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27
Other Miscellaneous Deductions	28	Other—from list in instructions. List type and amount ▶			28

[4] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

[5] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

However, the current version of Schedule A more properly labels such items as "Other Itemized Deductions." This is just one example of when not looking at the IRC, but rather only reading forms, publications and the, like can lead you down a very misleading path.

Other Itemized Deductions	**16** Other—from list in instructions. List type and amount ▶	**16**

The opinion notes that the finding that these hobby loss expenses are a miscellaneous itemized deduction is consistent with prior statements of the Tax Court (though in *dicta*):[6]

> This holding is consistent with earlier statements made by this Court in *dicta*. See, e.g., *Strode v. Commissioner*, T.C. Memo. 2015-117, at *32 n.12 (stating in a footnote that deductions claimed under section 183(b)(2) are subject to section 67(a)'s 2-percent floor for miscellaneous itemized deduction); see also *Bailey v. Commissioner*, T.C. Memo. 2012-96, 2012 Tax Ct. Memo LEXIS 99, at *102; *Baldwin v. Commissioner*, T.C. Memo. 2002-162, 2002 Tax Ct. Memo LEXIS 168, at *67 n.24.[7]

As well, the Court cites a Court of Federal Claims decision that agrees with this position:

> Furthermore, this holding is also consistent with the view of at least one other court. See *Purdey v. United States*, 39 Fed. Cl. 413, 417 (1997) ("[D]eductions solely permitted pursuant to § 183(b)(2) are miscellaneous itemized deductions.").[8]

Taxpayer Argues This Can't Be Correct

The taxpayers did not agree with this view. In their view the deductions under IRC §183(b) should be deductible in computing adjusted gross income, which would make them no longer itemized deductions and, thus, by extension not miscellaneous itemized deductions.

The taxpayers advance three arguments:

- The plain language of IRC §183 provides that it is an above-the-line deduction,
- Under the rules of statutory construction, a general statute such as IRC §67 cannot supersede a previously enacted specific statute such as IRC §183(b), and

[6] *Dicta* generally refers to a position stated in an opinion that does not ultimately have a bearing on the result of the case. Effectively, the comment could be stricken from the case and the result would not change or be less well supported.

[7] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

[8] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

- Regulation §1.67-1T, Temporary Income Tax Regs., which provides that IRC §183(b) deductions are subject to the 2-percent floor on miscellaneous itemized deductions, is invalid.[9]

Does the Plain Language of IRC §183(b)(2) Require the Expenses Be Deducted in Computing Adjusted Gross Income?

The taxpayer argues that a plain text reading of IRC §183(b) requires the deductions allowed by it be used in computing adjusted gross income. Or, to put in the form many advisers would state, that it is an "above the line deduction."

As we have noted before, if the plain text of the statute unambiguously leads to a certain result, that result *must* control the treatment of the item, regardless of other items, including regulations or Congressional intent.[10] But in this case the problem is that the statute says absolutely nothing about whether this deduction is or is not used in calculating adjusted gross income. As the opinion notes:

> The language they point to in support of their argument concerns only the maximum permissible amount of the deduction. It does not instruct taxpayers to apply the deduction itself against gross income for purposes of calculating AGI. Moreover, the plain language of section 62(a) makes clear which deductions are to be applied against gross income in calculating AGI (i.e., above-the-line), none of which are section 183(b)(2).[11]

The fact a statute doesn't say something isn't really an unambiguous statement regarding anything. So the fact the language of §183 didn't say the expenses *would* be subject to the 2% limitation wasn't an issue—IRC §67 had the unambiguous language to cover that situation:

> To the extent the Gregorys make the ancillary argument that nothing in the plain language of section 183 subjects the deductions permitted thereunder to the 2-percent floor on miscellaneous itemized deductions, we refer them to the plain language of section 67, which defines the scope of its applicability in subsection (b). See discussion supra part II.A; see also *In re Shek*, 947 F.3d 770, 776-777 (11th Cir. 2020) ("Statutory provisions are not written in isolation and do not operate in isolation, so we cannot read them in isolation.").[12]

Rather than finding the plain text of the IRC required that expenses under IRC §183(b)(2) must be taken into account in computing adjusted gross income, the Court

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[9] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

[10] See Ed Zollars, "Plain Text Unambiguous Meaning of a Statute vs. Congressional Intent: A Quick Primer," *Current Federal Tax Developments* website, September 2, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/9/2/plain-text-unambiguous-meaning-of-a-statute-vs-congressional-intent-a-quick-primer

[11] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

[12] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

found that the plain text reading of the IRC required these expenses be treated as miscellaneous itemized deductions subject to the 2% floor.

Is There a Conflict Between §§67 and 183?

The taxpayers next turn to a general rule of statutory construction they argue applies in this case when two statutes are in conflict, which they argue IRC §§67 and 183 are.

> The Gregorys also argue that under the rules of statutory construction, a general statute such as section 67 may not supersede a previously enacted specific statute such as section 183(b), citing Eleventh Circuit precedent as set forth in *United States v. Jim*, 891 F.3d 1242, 1250-1251 (11th Cir. 2018) (finding no implicit repeal of a provision of the Indian Gaming Revenue Act, subjecting tribal distributions of gaming revenue to Federal taxation, by a subsequently enacted provision of the Tribal General Welfare Exclusion Act, exempting payments made through tribal government programs to its members from Federal taxation).[13]

While the taxpayers, again, correctly stated how statutes are interpreted by courts, the Court again found that the issue did not favor the taxpayers in this case. The Court found no conflict between the provisions, thus no need to base the treatment on the more specific provision:

> Without determining the veracity of the Gregorys' respective characterizations of sections 67 and 183(b) as general and specific statutes, we find this line of argument similarly unpersuasive; it assumes there is conflict between these two provisions of the Code when in fact each provision may be given effect without precluding or otherwise undermining application of the other. See discussion supra part II.A. In the absence of a conflict between sections 67 and 183(b), we find the Gregorys' reliance on Jim misplaced. See also *Williams v. Commissioner*, 151 T.C. 1, 8 (2018) ("If * * * two statutes can coexist, it is the duty of the courts to give effect to both.").[14]

Not Relevant if Reg. §1.67-1T Isn't Valid

Since the Court had already concluded a plain reading of the statute required that the deduction be treated as a miscellaneous itemized deduction subject to the 2% floor, the Court found it didn't need to look into whether or not this particular regulation is valid:

> As to the Gregorys' claim that section 1.67-1T, Temporary Income Tax Regs., supra, is invalid, we decline to further address this line of argument, as the Court's holding in this opinion does not rely on the validity of the regulation. The relevant statutory language alone establishes that section 183(b)(2) is a miscellaneous itemized deduction

[13] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

[14] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

subject to section 67(a)'s 2-percent floor. See discussion supra part II.A.[15]

Hobby Losses – Now Even Worse Following Tax Cuts and Jobs Act

Although it may seem to "make sense" to offset the deductions from a hobby directly against the income from that hobby up to the amount of that income above the line, to just "zero out" the impact on adjusted gross income, that is not the proper treatment. If the IRS prevails in a position that the activity was not undertaken to make a profit, the income is fully included in adjusted gross income and deductions cannot be taken to reduce adjusted gross income.

While before 2018 taxpayers were adversely affected by this treatment, the addition of IRC §67(g) by the Tax Cuts and Jobs Act has made matters even worse. That provision bars the deduction of any miscellaneous itemized deduction, thus even if the expenses are more than 2% of adjusted gross income and the taxpayer does not run into the alternative minimum tax, there will be no benefit to expenses incurred as part of a hobby.

[15] *Gregory v. Commissioner*, TC Memo 2021-115, September 29, 2021

SECTION: 9701
USER FEE OF $67 FOR ESTATE TAX CLOSING LETTER TO TAKE EFFECT ON OCTOBER 28, 2021

Citation: T.D. 9957; 86 F.R. 53539-53542, 9/28/21

The IRS has adopted final regulations setting a $67 dollar fee[16] for a closing letter for a decedent's estate.[17]

The person liable for the fee is the "the estate of the decedent or other person requesting, in accordance with applicable procedures and policies, an estate tax closing letter to be issued with respect to the estate."[18]

The new fee applies to requests received by the IRS on or after October 28, 2021.[19]

[16] Treasury Reg. §300.13(b)

[17] TD 9957, September 28, 2021, https://www.taxnotes.com/research/federal/treasury-decisions/final-regs-establish-user-fee-for-estate-tax-closing-letters/79gkb (retrieved October 1, 2021)

[18] Treasury Reg. §300.13(c)

[19] Treasury Reg. §300.13(d)