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Untaxingly Yours
Funemployment

Avoiding the Hobby Loss Limitations

By Brian T. Whitlock

Nearly a generation ago[1] (2007–2009) during the "Great Recession," when businesses downsized and workers were laid-off, many young people decided to relax and experience "funemployment" in order to plot their next career move. Many workers found part-time employment as the gig economy was born and "freelancing" boomed. Historically, freelancing was a term connected with the newsprint industry where full-time reporters were replaced with part-time people who specialized in "content creation and writing". Today's gig workers serve in a variety of different fields and industries, including technology and IT, software engineering and development, transportation and delivery, and even administrative and clerical work. These part-time workers complete various tasks and responsibilities previously completed by full-time employees.

During the coronavirus disease (COVID-19) shutdowns, most traditional office workers were "forced" to work from home. As workers have been "called back into the office," they have resisted, not necessarily because they fear contracting an illness, but because they fear the loss of their newfound freedom. A large number of Baby Boomers chose to retire early. Many workers of all ages chose to opt out of the traditional work environment and pursue new opportunities or start their own businesses. These new-age entrepreneurs have been joined by two large groups of individuals who are starting up new businesses. The first group consists of retail entrepreneurs who have been forced to close their urban businesses, victims of the online retail boom and abandoned by their office worker clientele. The second group consists of successful small business owners who have either sold their businesses to consolidators or decided that, in addition to their existing successful business, they now possess the financial means to pursue a life-long passion.

As tax advisors, we know that each of these new business ventures will be faced a myriad of issues ranging from the choice of entity and methods of accounting to financing and equity ownership. For many of these start-up businesses, the owners and investors may expect to incur initial losses, particularly if they start from scratch or are self-financed. In these situations, the owners may want to deduct the losses incurred against investment income, income generated by their gig or traditional employment, or income generated by other continuing

business endeavors. The income tax deductibility of losses is not guaranteed; it requires careful preparation and planning.

Trade or Business

Code Sec. 162(a) permits income tax deductions for "ordinary and necessary expenses paid or incurred … in carrying on any trade or business". Where the deductible expenses exceed the revenue generated within the same tax period, the resulting loss may be offset against all other income, if the activity is a "trade or business" and the taxpayer "materially participates"[2] in the activity. Where the loss exceeds all of the taxpayer's current year's business income, the resulting Net Operating Loss may be carried forward for up to 20 years under Code Sec. 172, subject to certain limitations and offset against future income.[3]

With funemployment on the rise, one can only expect that the number of tax controversies involving the classification of enterprises as hobbies will continue for some time to come.

The U.S. Supreme Court famously took up the definition of "trade or business" in *Commissioner v. Groetzinger*[4] in 1987 when it looked at the full-time gambling activities of a manufacturer sales representative who had lost his full-time job. The Court acknowledged that, despite the fact that the words "trade or business" appeared in over 50 sections and 800 subsections of the Internal Revenue Code and in hundreds of places in the Treasury Regulations, there was no general definition. After reviewing a litany of cases, the Court stated: "[w]e accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby[5], or an amusement diversion does not qualify." After reviewing the facts, the Supreme Court determined that Mr. Groetzinger's activity as a full-time gambler was in fact a trade or business.

Expenses for the Production of Income

Even if there is no trade or business, a deduction for expenses relating to investment activities may be allowable under Code Sec. 212.[6] It generally allows a taxpayer to deduct all the ordinary and necessary expenses paid or incurred "for the production or collection of income," and "for the management, conservation, or maintenance of property held for the production of income." The Tax Court in *Mitchell v. Commissioner*[7] held that the phrase "held for the production of income" has the same meaning under Code Sec. 212 as it does under Code Sec. 167, which relates to depreciation deductions. The question of whether the property is held for the production of income is determined by all the facts and circumstances.[8] In order for expenses to be deductible under either Code Sec. 162 or 212, the taxpayer must be able to show that they are engaged in the activity with the primary objective of making a profit.

This issue of whether a taxpayer is entitled to claim deductions for expenses was recently revisited by the Tax Court in *Wondries v. Commissioner*.[9] The taxpayer, a highly successful owner of 23 car dealerships, diversified his business interests by acquiring a cattle ranch. The Tax Court's analysis of whether Mr. and Mrs. Wondries' cattle ranching activity was "engaged in for profit" turned, in the Court's opinion, on the application of Code Sec. 183. Despite the fact that ordinary and necessary expenses might be deductible under either Code Sec. 162 or 212, the Tax Court cited numerous prior decisions which stated that taxpayers must be able to show that they are engaged in the activity with the primary objective of making a profit under Code Sec. 183.[10] The Court in *Wondries* emphasized that the expectation of a profit need not be reasonable but nevertheless held that the taxpayer must conduct the activity with the honest objective and intent of making a profit.[11]

A Hobby—An Activity not Engaged in for Profit

Controversies involving the classification of activities as hobbies have long been a part of the Internal Revenue Code. Under Code Sec. 270 of the 1954 Code, taxpayers were required to have a reasonable expectation of making a profit. In 1969, Congress repealed Code Sec. 270 and replaced it with Code Sec. 183. The goal of the new provision was to replace the subjective intention of the taxpayer

with a set of objective tests. Under Code Sec. 183(b) if an activity is not engaged in for profit, the allowable deductions under Code Secs. 162 and 212 are limited to gross income derived from the activity.

Code Sec. 183(d) creates a presumption in favor of the taxpayer where the activity produces gross income in excess of deductions attributable to the activity in any three out of five consecutive years. In the case of the breeding, training, showing, or racing of horses, the presumption is broadened to any two out of the last seven years.

In 1972, the Treasury promulgated Reg. §1.183-2, which clearly lays out the Service's objective standards for determining whether an activity is engaged in for profit.[12] The regulation lays out the following nine relevant factors, and no one factor is determinative:

(1) **The manner in which the taxpayer carries on the activity.** In other words, does the taxpayer carry on the activity in a businesslike manner and maintain complete and accurate books and records?
(2) **The expertise of the taxpayer or his advisors.** Meaning, does the taxpayer procure expert advice, and does the taxpayer carry on the activity in accordance with such advice?
(3) **The time and effort expended by the taxpayer in carrying on the activity.** Primarily, is this a full-time or a part-time activity?
(4) **Expectation that assets used in the activity may appreciate in value.** In other words, the term profit encompasses appreciation in the value of assets, not just operations.
(5) **The success of the taxpayer in carrying on other similar or dissimilar activities.** The regulation stresses the fact that if the taxpayer has successfully engaged in similar activities or turned around similar activities, that can overcome current negative assumptions.
(6) **The taxpayer's history of income or losses with respect to the activity.**
(7) **The amounts of occasional profits earned, if any, relative to the losses claimed.**
(8) **The financial status of the taxpayer.** Thus, the fact that the taxpayer does or does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit.
(9) **Elements of personal pleasure or recreation.**

Over the last 10 years, there have generally been two or three cases each year dealing with the issue of whether an activity is conducted as either a "trade or business" or a "hobby". In nearly every written opinion, the Tax Court has rigorously applied the nine-factor test of the regulations in their analysis. The Seventh Circuit Court of Appeals in *Roberts v. Commissioner* highly criticized the Tax Court's nearly blind application of the nine-factor test,[13] a case involving a horse-racing business. The Court of Appeals reversed the Tax Court and stated: "Considering that most commercial enterprises are not hobbies, the Tax Court would be better off if rather than wading through the nine factors it said simply that a business that is in an industry known to attract hobbyists (and horse racing is that business par excellence), and that loses large sums of money year after year that the owner of the business deducts from a very large income that he derives from other (and genuine) businesses or from trusts or other conventional sources of income, is presumptively a hobby, though before deciding for sure the court must listen to the owner's protestations of business motive." The Court of Appeals was much more lenient in its interpretation of Roberts' involvement in its horse-racing enterprise, and it permitted the deductibility of the losses.[14]

Hobby Expense Limitation

If the taxpayer's new activity is conducted as a sole proprietorship, and it is treated as a *bona fide* trade or business, then the taxpayer will be permitted to deduct the expenses on Internal Revenue Service (IRS) Form 1040, Schedule C. This method of reporting the income will reduce not only the taxpayer's federal taxable income, but it would reduce the taxpayer's state taxable income and its exposure to self-employment tax.

Failing to plan ahead and "going on the cheap" will likely be met with the failure of the business and worse yet the limitation of the taxpayer's deductions.

If the taxpayer's activity is determined under Code Sec. 183 to be a hobby, then the deductible expenses will be limited to the amount of the gross income that is derived from the same activity, and the deductible expenses must be reported as miscellaneous itemized deductions on Form 1040, Schedule A. Itemized deductions do not generally reduce state taxable income, nor do they

reduce the taxpayer's exposure to self-employment tax. Since the enactment of the Tax Cut and Jobs Act (TCJA) in 2017, the apparent benefit of miscellaneous itemized deductions may also be limited. Since 2017, taxpayers have been limited to $10,000 of state and local income tax deductions, but they have received a larger standard deduction. Where the taxpayer has no other medical, charitable, or interest deductions, the result is that the taxpayer will lose the effective benefit of those itemized deductions that are necessary to push the taxpayer above the standard deduction floor.

Under TCJA, the Code Sec. 67(a) the 2% floor imposed on miscellaneous itemized deduction was eliminated. This is helpful for potential hobby enterprises; however, if this provision sunsets in 2025, then taxpayers will need to be aware of the 11th Circuit Court of Appeals decision in *Gregory v. Commissioner*,[15] which affirmed the Tax Court decision and stated that pre-2017 hobby expenses were miscellaneous itemized deductions subject to the 2% floor.

IRS Audit Technique Guide (IRS Publication 5558)

The IRS periodically publishes aids for its field auditors. The Service recently updated its Audit Guide dealing with Code Sec. 183 on September 7, 2021. The guide estimates that Code Sec. 183 non-compliance probably accounts for a sizable portion of the $30 billion annual tax gap. The Treasury Inspector General for Tax Administration (TIGTA) in 2016 estimated that 88% of Form 1040, Schedule Cs in its statistical sample reflected indications that the losses reflected may have involved activities that were not engaged in for profit. TIGTA recommended focusing on high-income individuals with multiyear Schedule C losses.[16]

Publication 5558 fully embraces the nine-factor test of Reg. §1.183-2(b)(2) and it suggests examination techniques designed at highlighting taxpayers' deficiencies in operating the activities in a manner that were indicating that they were regularly attempting to reverse losses and grow the revenues of the business. The guide constantly reminds examiners not to lose sight of the big picture or get lost in the details by focusing on only one of the nine factors. At the conclusion of each factor, the guide reminds the examiner that all of the factors together must be used to fully develop a facts and circumstances approach.[17]

Much More Is Likely to Be Written

With funemployment on the rise, one can only expect that the number of tax controversies involving the classification of enterprises as hobbies will continue for some time to come. The bottom line with the regulations and the analysis of the Tax Court is that the preparation and application of a solid business plan, the use of experts to assist taxpayers with management and operations, and the amount of time devoted by the taxpayer will generally carry the day and permit the taxpayer to fully deduct its losses. Failing to plan ahead and "going on the cheap" will likely be met with the failure of the business and worse yet the limitation of the taxpayer's deductions.

ENDNOTES

1 Generations of people are typically measured in 15 to 20-year increments: The Greatest Generation (born before 1928); the Silent Generation (1928–1945); Baby Boomers (1946–1964); Generation X (1965–1980); Millennials (1981–1996); and Generation Z (1997–2012).

2 A more detailed discussion of Code Sec. 172 and the limitations on Net Operating Loss is beyond this scope of this article.

3 Code Sec. 469, Code Sec. 1411, and the regulations thereunder that generally define "material participation" and are beyond the scope of this article.

4 *Robert P. Groetzinger*, SCt, 87-1 USTC ¶9191, 480 US 23, 107 SCt 980.

5 It is particularly curious that despite the fact that the opinion refers to a "hobby" as a non-qualifying activity, the Court does not refer to Code Sec. 183, which was enacted in 1969 (its predecessor under the Internal Revenue Code of 1954, Code Sec. 270), or Reg. §1.183-2, which was promulgated in 1972.

6 *H.E. Thomason*, 74 TCM 1012, Dec. 52,317(M), TC Memo. 1997-480 (1997).

7 *G.W. Mitchell*, 47 TC 120, 129, Dec. 28,177 (1966).

8 *J.W. Johnson*, 59 TC 791, Dec. 31,886, *aff'd* CA-6, 74-1 USTC ¶9355, 495 F2d 1079 (1974).

9 Dec. 62,147(M), TC Memo. 2023-5 (January 9, 2023).

10 *Westbrook*, CA-5, 95-2 USTC ¶50,587 68 F3d 868 (1995).

11 *Keating*, CA-8, 2008-2 USTC ¶50,604, 544 F3d 900, 904 (2008).

12 Reg. §1.183-2(b)(2), T.D. 7198, 37 FR 13683 (July 13, 1972).

13 CA-7, 2016-1 USTC ¶50,260 (2016).

14 This was the second horse-related hobby case to come before the 7th Circuit Court of Appeals within four months, the other case being *Estate of Stuller*, CA-7, 2016-1 USTC ¶50,165, 811 F3d 890 (2016). In *Stuller*, the Court of Appeals affirmed the U.S. District Court's decision issued in the year prior, when it ruled in favor of the IRS in connection with the taxpayers' horse-breeding enterprise.

15 CA-11, 2023-1 USTC ¶50,183 (2023).

16 IRS Publication 5558, *Activities Not Engaged in for Profit—Audit Technique Guide Internal Revenue Code Section 183*, page 8 (September 7, 2021).

17 *Ibid*.