The Deductibility Of Work-Related Higher Education Costs: The Saga Continues

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ABSTRACT

Whether a taxpayer's work-related higher education costs are deductible under IRC (Internal Revenue Code) Section 162 is an issue highly dependent upon facts and circumstances. The regulations pursuant to IRC Section 162 and the emergence of case law on this topic constitute important elements to consider in making this determination.

Keywords: IRC Section 162; Educational Expenses; Work-Related Educational Expenses; Deductibility of Obtaining Advanced Degrees

INTRODUCTION

The deductibility of certain education-related costs under IRC Section 162, particularly those associated with pursuing a college or advanced degree, has, over the years, resulted in numerous disputes between taxpayers and the Internal Revenue Service. The value of a deduction for education-related costs depends primarily upon worker status, the taxpayer's marginal tax rate, and whether the education is pursued in the locale in which the taxpayer lives and works or is pursued away from home. This article will examine these aspects of this dispute, with emphasis being placed upon applicable regulations and case law. For purposes of our analysis, in order to focus upon IRC Section 162, we will assume that the educational costs at issue do not also qualify for American Opportunity Tax Credit, the Lifetime Learning Credit, or the deduction for adjusted gross income relating to qualified educational expenses under IRC Section 222.

GENERAL REQUIREMENTS OF IRC SECTION 162

In order to deduct education related expenses under the general provisions of IRC Section 162 --and, in particular, Treas. Reg. Sec. 1.162-5 -- the education must be related to the taxpayer's work. In essence, it is critical that the education be associated with, and relevant to, a taxpayer's existing trade or business. If the taxpayer is self employed, deductible costs will generally qualify as a deduction for adjusted gross income. This status is particularly advantageous for a self- employed person in that deductible costs reported on Schedule C reduce both income tax and self employment tax.

In contrast, if the worker is an employee, unreimbursed education-related costs will generally be treated as a Schedule A itemized deduction subject to a 2%-of AGI floor.

Example 1: Taxpayer is employed as an auditor in the audit department of a regional accounting firm. The taxpayer attends a nearby college in order to take courses relevant to the development of his skills as an auditor. Each weekday evening, the taxpayer goes from his place of employment to the nearby college. The cost of books, transportation, fees and tuition each qualify as a deductible education-related cost. Assuming that these costs constitute unreimbursed employee business expenses of $3,500 and that the employee has an adjusted gross income of $35,000, he can claim $2,800 of the education-related expenses on his Schedule A. This is determined by subtracting 2% of his adjusted gross income of $35,000 from the $3,500 in otherwise allowable education-related costs ($3,500 - $700 = $2,800).

If the taxpayer is self-employed, his deduction for education-related costs presumably will be $3,500. Most likely this will appear on Schedule C and will reduce his federal income tax, Social Security tax and Medicare tax.

Example 2: The facts are the same as in Example 1, except that the taxpayer is reimbursed for his expenses under an accountable plan. In this instance, the taxpayer's costs will not appear as a deduction on the return because the qualified expenses will be offset by the reimbursement. (This is sometimes referred to as a "wash").

Example 3: Assume that a taxpayer lives in North Carolina but travels away from home on a regular overnight basis to take coursework. The costs associated with his education may include, if certain requisites are met, lodging, meals, dry cleaning, mileage, etc. . . The taxpayer may do even better financially if his employer has a reimbursement plan pursuant to which certain categories of cost (e.g., meals and lodging) are reimbursed pursuant to a per diem arrangement. This can enable the taxpayer to potentially derive additional tax-free income while the employer is able to obtain a deduction for such amount. Note that where amounts are paid pursuant to a recognized per diem arrangement (as a form of reimbursement of employee business related expenses under the deemed substantiation rules), the employer gets a deduction, the employee gets an exclusion, and each avoid subjection to FICA and FUTA taxes on such amount.

I.R.C. SECTION 162 AND THE REGULATIONS THERETO

Although I.R.C. Section 162 relates to "ordinary and necessary trade or business expenses", the Section does not directly mention education expense. Instead, the treatment of such costs is addressed elsewhere. According to Treasury Regulations Section 1.162-5 entitled "Expenses for Education", the following general criteria must be met in order for education costs to be eligible for deduction as ordinary and necessary business expenses (even though the education may lead to a degree):

1) The education must either improve or maintain skills required by the individual in his employment or other trade or business" or
2) The education must meet requirements imposed by either "the individual's employer, or requirements set by applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation."

Treasury Regulations Section 1.162-5(b) further provides that even if either of the above two requirements are satisfied, educational expenses are not deductible under IRC Section 162 if they are personal expenditures. Such nondeductible educational expenditures are those: 1) required of the taxpayer in order to meet the minimum educational requirements to be qualified to work in the taxpayer's present employment, trade, or business; or 2) qualify the taxpayer for a new trade or business.

The regulations indicate that, in an educational setting, where there is no strict criteria (i.e. "normal" requirements), a worker will be assumed to meet the minimum qualifications for a given job. For example, evidence of a worker being considered a faculty member include: a) possession of tenure or years of service that can be included in the computation of tenure; b) the institution making contributions to the individual's retirement plan, or c) the individual having the right to vote in faculty affairs. However, an individual will normally not qualify as a member of the faculty at an institution where the education is taken in order to qualify the individual to either: a) meet the minimum qualifications for the profession or position, or b) enable the individual to qualify for a change in their type of work or duties.

Likewise, there is little dispute over the general notion that review courses taken to prepare for licensing examinations are generally not deductible due to qualifying the individual for a new trade or business.

Note that the scenarios mentioned above differ from those in which there has been a change in the criteria set by the employer, or a change in the law that the worker must meet in order to either maintain an existing job or maintain a job for which the worker had originally qualified. In these situations, where certain conditions are satisfied, it may be possible for a deduction for education-related costs to be claimed.

A QUESTION OF BALANCE

Taxpayers and the Internal Revenue Service have long battled over the deductibility of costs for advanced graduate degrees. In some respects, the dispute has centered upon whether the degree allows the taxpayer to enter a new trade or business or simply enhances the education and skills of whatever the taxpayer is already qualified to do. For example, the education costs associated with attaining a Juris Doctorate (J.D.) or Medical Doctorate (M.D.) are not deductible due to enabling entry into a new trade or business, while arguably the costs of an LL.M., or an MBA may be deductible depending on the circumstances. Note that where a person is a working CPA or a person that qualifies to become a CPA without the need for a masters degree, it is conceivable that the costs of an MACC degree may be deductible. Insight into the approach taken by courts on these matters are reflected by the cases of Ruehman and Singleton.

Ruehman

In Ruehman, the taxpayer sought to deduct costs associated with attaining both a J.D. and LL.M. degrees. The Court disallowed the costs related to the J.D. degree due to finding that it qualified the taxpayer for a new trade or business, e.g., the practice of law. The court however ruled in favor of the taxpayer with regard to deduction of the costs for the LL.M. degree. According to the court, the LL.M. degree did not qualify the taxpayer for a new trade or business. The court indicated that the taxpayer was already considered to be in the business of law due to having worked in a law firm--albeit for a summer or two after getting the J.D degree--and being admitted as a member of the bar.

Consider whether this treatment would be justified if either:

a) The taxpayer is not already considered to be engaged in the practice of law due to not having worked in the law firm, or
b) The taxpayer is hired for a position for which the minimum required credential is an LL.M. degree.

These arguments are evident in MBA cases, as the MBA --unlike the M.D., CPA or JD-- does not entail getting an education as a minimum requirement for getting the license to practice a particular profession. In general, it would appear that there is a greater likelihood of being able to deduct the cost of pursuing an MBA where the taxpayer is a part-time student, rather than a full time student, due to the need to establish that the student has remained in the trade or business.

Singleton-Clarke

The 2009 case of Singleton-Clarke reflects issues involving the deductibility of certain costs associated with the pursuit of an MBA degree. The case concerned whether a nurse could deduct the expenses incurred in order to attain an MBA degree with a specialization in management. The taxpayer possessed a bachelor degree in nursing and had worked for some 24 years at different hospitals in various capacities as a registered nurse. In carrying out these duties, she had worked in various capacities including as: 1) an acute bedside clinical nurse, 2) a team leader (which entailed "supervising nurses providing acute bedside care"), and 3) a director of a 150 bed facility (which entailed responsibility for some 110 nurses and technicians).

For the 4 year period preceding her furthering her education by seeking an MBA/HCM, the taxpayer had returned to a nonsupervisory role. The taxpayer pursued her degree at the University of Phoenix. She sought the degree there in order to:

a) enable her to pursue her studies online;
b) enhance her skills for her current position and duties; and
c) increase her credibility and make her more "effective in her current position" (i.e., as a quality control coordinator).

The taxpayer attempted to deduct the cost of pursuing her degree as an unreimbursed employee business expense. The deduction was challenged by the IRS which asserted that without the degree the taxpayer would not have been qualified for her job. According to the Service, this resulted because such position required an RN license (which she already possessed) as well as a degree of at least a "bachelor's degree in health care administration".

The Court ruled in favor of the taxpayer based upon finding that the MBA is a general degree that is distinguishable from a degree leading up to a professional license. The court held that the taxpayer had been sufficiently established in her profession so as to make acquisition of the MBA degree unnecessary to do the tasks that she had already performed.

The Singleton-Clarke decision has received significant attention in the media. According to an article appearing in the Wall Street Journal, this decision may benefit "thousands of students." While the potential of qualifying for substantial write-offs is arguably enhanced with a more general degree such as an MBA, it should be borne in mind that there are circumstances where such degree is not deductible. The education should improve skills applicable to a position already held by the taxpayer, but must not qualify the taxpayer for a new type job or position.

OTHER DECISIONS OF NOTE

There are several decisions in which deductions have been denied for educational costs associated with pursuit of an advanced degree. In Schneider, the court rejected allowance of deductions based on the degree pursued being insufficiently related to the individual's previous line of work (e.g., military service). In McEuen, the court denied a deduction for MBA expenses that, under the circumstances, qualified the taxpayer for a new trade or business. In contrast, a deduction was permitted to a used car salesman in Allemeier who retained his position while attending an MBA program. The MBA program arguably helped the taxpayer in his current occupation.

More recently, in the January 2010 decision of Andrew Shah, T.C. Summary Opinion 2010-6, deductions were denied in large part for expenses which were considered to qualify the taxpayer for a new trade or business. Similarly, in the 2009 case of Ortega, TC Summary 2009-120, the court denied the deduction of costs incurred by the taxpayer in pursuing a doctorate degree in psychology.

The decision was largely based on such degree being needed in order to qualify for the trade or business of being a psychologist. Further the court noted that receipt of the degree allowed the taxpayer to: a) meet the minimum qualifications to be a staff psychologist; b) qualify to perform tasks and services significantly different from those she could perform prior to receipt of the additional education; and c) meet the statutory requirements to become licensed as a psychologist.

CONCLUSION

Whether a taxpayer can deduct the cost of obtaining an education is an issue of high financial stakes. The regulations pursuant to I.R.C. Section 162 and the emergence of case law on the topic constitute important elements to consider in making this determination. Examination of the regulations and emergent case law constitute good places to start in analyzing the deductibility of educational costs already incurred and in planning for educational costs to be pursed in the future.

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6. Schneider, TC Memo 1983-753
7. Shah, Andrew, T.C. Sum. Opn. 2010-6
8. Singleton-Clarke, TC Sum. Opn. 2009-182
9. Treasury Regulation Section 1.162-5
10. Treasury Regulation Section 1.162-5(b)
11. Woody, TC Memo 2009-93, Note that the Court denied a deduction for educational expenses incurred concerning a training class to prepare for a career in real estate investment and sales and not to maintain or improve skills in an ongoing career.

NOTES

