

Deductibility of Expenses for Studying Abroad

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Introduction

In this paper we examine the tax treatment of study abroad expenses for students who engage in study abroad activities. Study abroad activity has increased dramatically at U.S. universities. The Institute of International Education (IIE) reports that 289,408 U.S. students studied abroad in 2013 up 2.1% from 2012 (IIE 2014). Over the past decade, the number of U.S. students studying abroad has increased by over 160%, despite consistently increasing costs.

The Institute of International Education's 2013 study (as cited by Stansbury, 2013) reports that the average cost of studying abroad for one semester is currently \$17,785 for the 2012-2013 academic year. The cost of an international study abroad educational experience may include expenses such as airfare, short-term housing, day-trips, and cultural activities in the host country. But not all study abroad trips are created equally. Study abroad trips run the gamut from seven day excursions to full semester trips to multiple year, multiple country trips. While both students and faculty participate in study abroad opportunities, the tax consequences of study abroad expenses are dependent upon the type of trip chosen, the duration of the visit, and the role of the participants involved.

Students participating in a study abroad trip have multiple options when it comes to deducting their study abroad expenses. Students need to consider whether their study abroad educational expenses are personal educational expenses or work related educational expenses. Qualified personal educational expenses may be deducted through tax credits such as the American Opportunity Tax Credit or the Lifetime Learning Credit, while qualified work related educational expenses are generally deducted either on Schedule A as an itemized deduction or on Schedule C. Qualifying educational expenses, whether work related or personal, may also be used to reduce taxable income by utilizing the tuition and fees deduction or the student loan interest deduction. Students need to understand each of these alternative tax treatments and the expenses which are considered qualified for each one. The internal revenue service does not allow double counting of educational expenses. Taxpayers are responsible for determining which option is most beneficial to them.

It is important for students to understand the nuances of the US tax code when considering costs incurred while studying abroad. In the remainder of this paper, we will discuss and provide examples of the alternative tax treatments of study abroad expenses for students.

Tax Considerations for Students

Students generally decide to study abroad for either career and/or personal benefits. When deciding to enroll in a study abroad course, students often have to weigh the benefits of their travel with associated financial costs. Understanding how expenses related to international education can be

handled from a tax perspective may help inform students regarding potential tax benefits that may lower the overall costs of studying abroad. The tax treatment of educational expenses and, consequently, the extent to which students may benefit financially, are primarily dependent upon two factors: (1) classification of the expenses as either business expenses or personal educational expenses; (2) employment status of the taxpayer as either a full-time student, an employee-student, or a self-employed student. Unfortunately, there are no shortcuts in determining which tax treatment will yield the greatest benefit. For example, a student who is classified as an employee may realize a tax benefit by treating the study abroad expenses as personal educational expenses. Another student, with the same income and expenses, who is self-employed, may realize a greater tax savings by classifying the study abroad expenses as a business deduction. However, taxpayers are not permitted to double dip when it comes to educational expenses; allowable educational or work related expenses must be reduced by any reimbursement or tax-free income. Remaining out-of-pocket expenses must be reported as either business expenses or as personal educational expenses. In the following subsections we discuss students' tax treatment for both business and personal study abroad educational expenses.

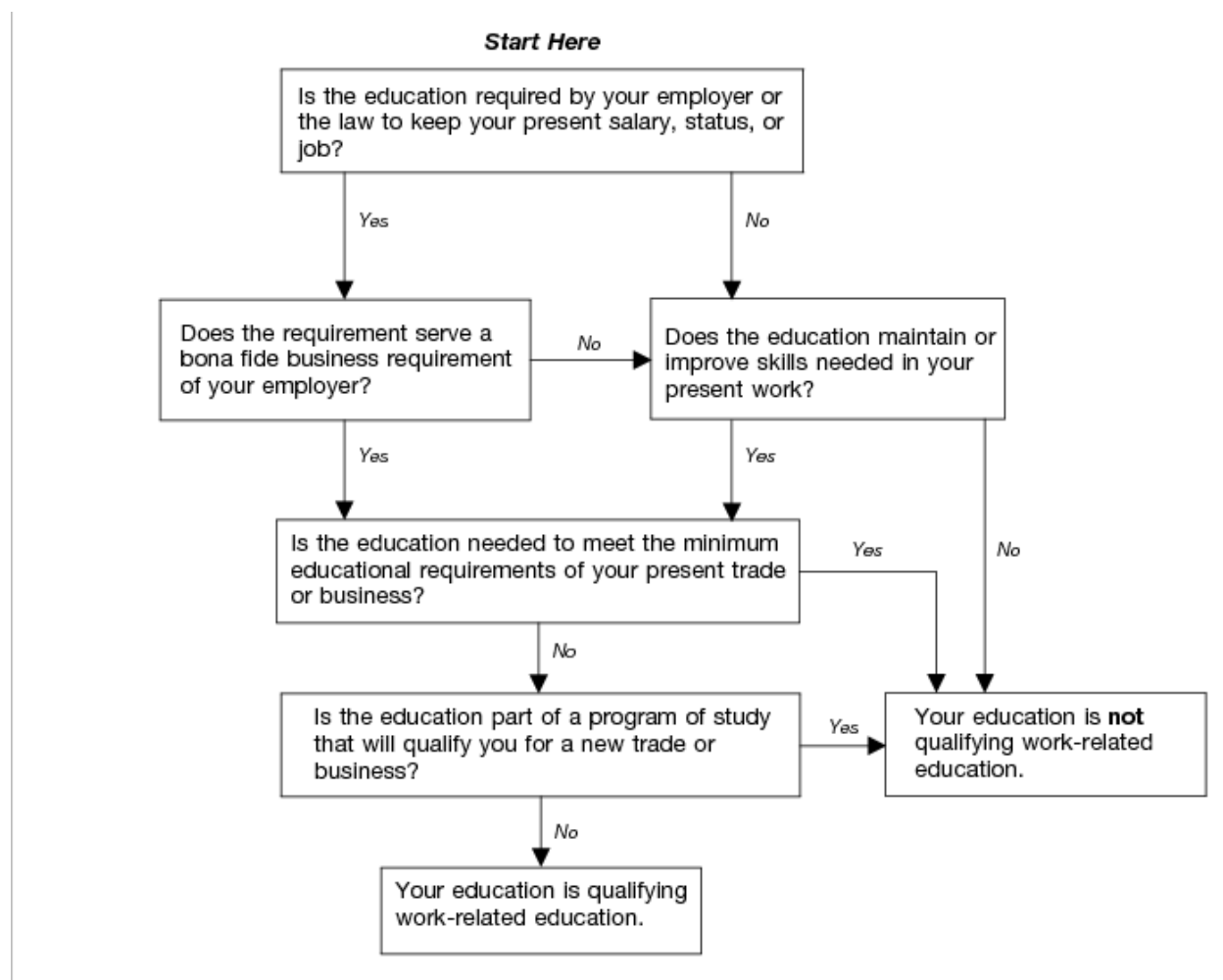
Work Related Educational Expenses for Students

Some students may be able to deduct study abroad costs as business related expenses. Business expenses are defined by the Internal Revenue Service (26 USC §162, 2015) as those ordinary and necessary expenses incurred in carrying on any trade or business. Although educational expenses are not explicitly mentioned in IRC Section 162 (2015), guidance for the deductibility of business expenses is given in 26 CFR 1.162-5 (2015) and IRS Publication 970, Chapter 12 (2014). According to these sources, educational expenses incurred to study abroad are considered business expenses if they meet specific criteria. As illustrated in Figure 1, if the education is obtained because it is expressly required by the student's employer or if the education maintains or improves skills required by the student in his current employment, the costs of such education may be deductible as a business expense. However, if the educational expenses are incurred to meet the minimum requirements for qualification in the student's employment or to acquire education which will qualify the student for a new trade or business, they are not deductible as business expenses but may qualify as personal educational expenses.

Educational expenses which qualify as business related expenses, in general, include tuition, books, supplies, lab fees, costs of research, and typing for a program related paper, as well as certain transportation and travel costs (IRS Pub 970, 2014). Of particular interest to students studying abroad, is the fact that qualifying business related travel expenses, incurred primarily to obtain education, include travel while away from home, one-half of the cost of meals, and lodging (IRC §162(a), 2015).

Often during the course of a study abroad experience, faculty will take students on one or more "side" trips to nearby towns, attend cultural or educational facilities, such as a library or museum, or even visit culinary facilities, such as a winery or restaurant. If scheduled activities are directly related to the study abroad course, the expenses associated with each, including transportation, meals and lodging, would be considered ordinary and necessary, as required by the tax code for costs to be deductible as business expenses.

Figure 1. Deductibility of Work Related Expenses



If cultural or travel-related activities, such as the ones described above, are undertaken for both personal and business purposes, an allocation between deductible business expenses and non-deductible personal expenses may be necessary for students whose education is work related. No such allocation is necessary for expenses of foreign travel away from home when the entire duration of the trip is one week or less, or where the time spent on personal pursuits is less than 25% of the total time away from home (26 CFR §1.274-4(b), ¶2294E, 2015). However, assuming that the duration of the study abroad trip is longer than one week and that more than 25% of the total time spent abroad is devoted to personal activities, the taxpayer must allocate travel expenses, lodging and one-half of the cost of meals between business days and personal days as described in a previous section.

In applying the foreign travel allocation rule, the student traveler must determine which days are business days and which days are personal days. Cab fares, tips, hotels, meals (subject to the 50% limitation for business meals) and other incidental travel expenses are fully deductible expenses when incurred on days which are deemed to be “business” days. The same expenses would be non-deductible on “personal” days. According to 26 CFR §1.274-4(d)(2) (2015), “business” days include

days spent traveling to or returning from the business location; days when the taxpayer's presence is required at a meeting; days primarily devoted to the business activity; Saturdays, Sundays, legal holidays or other reasonably necessary intervening days; and days when the taxpayer intends to engage in his or her business activities but is prevented from doing so by circumstances beyond his or her control.

Self-Employed vs Employee

When making a determination as to the most favorable tax treatment for students' travel related education expenses, it is important to consider the employment status of the student. Employee students will deduct unreimbursed study abroad costs incurred as miscellaneous itemized deductions on IRS Form 1040, Schedule A. In contrast, self-employed students will deduct study abroad costs incurred as a business deduction on IRS Form 1040, Schedule C. The tax consequence differs significantly between these two alternative treatments. Next we will discuss the tax treatment of study abroad costs for employee students versus self-employed students. Examples will be provided to demonstrate differences between the two treatments.

Employee Students

Taxpayers who are classified as employees and who deduct their study abroad educational expenses as an unreimbursed business expense are severely limited in the amount of allowable deductions and in the reduction of their overall tax burden. Out-of-pocket expenses are deducted as miscellaneous itemized deductions and, as such, are subject to a 2% of Adjusted Gross Income (AGI) reduction. In other words, to qualify as miscellaneous itemized deductions, the expenses must not be reimbursed by the employer and the amount of the ultimate deduction is limited to qualifying expenses above 2% of the taxpayer's adjusted gross income. In addition, the taxpayer must have enough total deductions to warrant claiming itemized deductions rather than taking a standard deduction. For example, using estimated costs for a semester study abroad in English with total expenses of \$9,921,¹ including personal educational expenses of \$5,018 (tuition and books) and business related educational expenses of \$4,903 (\$1,645 meals, \$791 transportation, and \$2,467 lodging) a taxpayer with an adjusted gross income of \$36,000 (with enough deductions to itemize) would have his or her miscellaneous itemized deduction reduced by \$720 (2% of their adjusted gross income). The \$720 deduction would reduce the taxpayer's overall tax burden by \$108 ($\$720 \times$ their marginal tax rate of 15%).² This deduction would be taken after calculation of the taxpayer's adjusted gross income and these expenses would be included on Schedule A of the taxpayer's individual tax return.

Self-Employed Students

Self-employed students are able to deduct 100% of their qualifying study abroad costs on Form 1040, Schedule C as a business expense. This business expense directly reduces adjusted gross income which results in a reduced federal income tax burden as well as a lower self-employment tax burden (Social Security and Medicare taxes). Reducing adjusted gross income may also lower the taxpayer's marginal tax bracket and possibly increase the amount of allowable itemized deductions. For example,

¹ Estimated study abroad costs were adapted from a 2014-2015 semester long study abroad trip to the University of Hertfordshire in Hatfield, English. A study abroad budget is published annually at <http://www.unf.edu/coggin/abroad/semester/English-Hertfordshire.aspx>.

² Marginal Tax Rate – the tax rate which applies to the taxpayer based on adjusted gross income. This is often described as the tax rate applied to the next dollar of income.

consider a self-employed taxpayer with \$36,000 of self-employment income³ and no study abroad expenses versus a self-employed taxpayer with study abroad education expenses. The taxpayer with no study abroad expenses and self-employment income of \$36,000 would have an adjusted gross income of \$33,456 after deducting $\frac{1}{2}$ of the self-employment tax for a tax liability of \$3,045. Assuming study abroad educational expenses of \$5,018 (tuition and books) in qualified personal educational expenses and \$4,903 (\$1,645 meals, \$791 transportation, and \$2,67 lodging) in business related educational expenses, the same taxpayer would report adjusted gross income of \$25,000 (down from \$33,456). This reduction in adjusted gross income is the combined effect of business expenses of \$5,018, personal expenses of \$4,081 (\$4,903 less non-deductible portions of meals of \$822), and the self-employment tax deduction of \$1,901⁴. This would reduce the federal tax liability of the taxpayer by \$1,267 (to \$1,778) and reduce the self-employment taxes (Social Security and Medicare) by \$1,286 for an overall reduction in tax liability of \$2,553. Self-employed taxpayers wishing to deduct business related expenses for studying abroad may do so directly on Form 1040, Schedule C which is used to report business income and expenses.

Regardless of the taxpayer's status (self-employed vs. employee), if the study abroad educational expenses incurred qualify the student for entry into a new occupation or if the educational expenses are required for the student to meet the minimum educational requirements in their field, the expenses are not deductible as a business expense. These expenses would be categorized as nondeductible personal expenses. Fortunately, there are special provisions within the tax code which offer potential tax savings to students with personal educational expenses.

Personal Educational Expenses for Students

Non-work related study abroad expenses may qualify as personal educational expenses. Personal educational expenses, although not deductible as a business expense, may render a significant tax benefit in the form of a dollar for dollar reduction in the amount of taxes owed through tax credits or a direct reduction in taxable income. Tax credits, such as the American Opportunity Tax Credit and the Lifetime Learning Credit, can directly reduce the amount of tax owed for students, regardless of whether the educational expenses are personal or work-related. Both of these education credits are subject to income limitations and both have unique guidelines for eligibility. The Tuition and Fees Deduction may be another option for taxpayers with personal education expense. The Tuition and Fees Deduction directly reduces adjusted gross income. Next, we will discuss each of the tax credits and the tuition and fees deduction in more detail.

Tax Credits for Personal Educational Expenses

³ In addition to income tax, self-employed individuals must also pay self-employment taxes, at the rate of 15.3%, which consists of Social Security and Medicare taxes. This 15.3% is applied to the Social Security wage base, which is 92.35% of the self-employment income. One-half of the self-employment tax is deductible in arriving at adjusted gross income. In this example, the calculation of a self-employment tax deduction for a taxpayer with no educational expenses is as follows: $[(\$36,000 \times .9235) \times 15.3] = \$5,086.64$ SE tax. $\frac{1}{2}$ of this amount = \$2,543.32 which is the SE tax deduction.

⁴ $\$36,000 - \$5,018 - \$4,081 = \$26,901$ AGI before self-employment tax deduction. $[\$26,901 \times .9235] \times 15.3 = \$3,801$ SE tax. $\frac{1}{2}$ of this amount = \$1,901 which is the SE tax deduction.

The Lifetime Learning Credit and the American Opportunity Tax Credit are two tax credits that may benefit students with eligible study abroad education expenses. Each credit has unique benefits and limitations.

The Lifetime Learning Credit is available for students who pay for a course at an eligible educational institution, regardless of whether the course is part of a postsecondary degree program or taken to acquire or improve job skills (26 CFR §1.25A-4, 2015). The credit may be claimed for each year the student is enrolled in undergraduate, graduate or professional degree courses, including courses to acquire or improve job skills. Eligible expenses for The Lifetime Learning Credit include only amounts *required* for enrollment in the course. While tuition and fees are considered qualified expenses, other common education costs such as student-activity fees and course-related expenses (books, supplies, and equipment) are considered qualified education expenses only if the fees and expenses are required to be paid directly to the institution for enrollment or attendance.

The Lifetime Learning Credit provides taxpayers a dollar for dollar reduction of their tax liability. However, the Lifetime Learning credit is subject to both benefit limitations and income limitations. With respect to the benefit limitation, there are two factors which determine the total tax savings provided by the Lifetime Learning Credit. First, the maximum annual benefit for the Lifetime Learning Credit is \$2,000 per taxpayer or 20% of the first \$10,000 of qualified educational expenses. For example, a taxpayer with \$5,018 of qualifying expenses, adjusted gross income of \$36,000 and a tax liability of \$3,428 would be able to use the Lifetime Learning Credit to reduce their tax liability by \$1,004 (20% of the \$5,018 of qualifying expenses).

Second, the Lifetime Learning Credit is a non-refundable credit, meaning that it can only reduce the taxpayer's tax liability to zero; it cannot generate a tax refund for the taxpayer. For example, a taxpayer with a \$1,500 tax liability and \$2,000 Lifetime Learning Credit would only be able to reduce their tax liability to zero. The unused portion of the Lifetime Learning Credit cannot be carried forward to benefit future tax periods.

With respect to income limitations, for 2014, the Lifetime Learning Credit is completely phased out for single taxpayers with modified adjusted gross income above \$64,000 and for married taxpayers filing a joint return with adjusted gross income above \$128,000. Married taxpayers who file a separate return are not allowed to claim the credit (IRC §25A(g)(6), 2015). For example, a single taxpayer with \$1,000 of qualifying expenses, adjusted gross income of \$65,000 and a tax liability of \$9,595 would not be able to use the Lifetime Learning Credit to reduce their tax liability.

The American Opportunity Tax Credit (26 USC §25A(i), 2015) is another option for study abroad educational expenses. This credit is slightly less stringent with respect to allowable deductions and income limitations but is only available for students in degree seeking programs and only for the first four years of postsecondary education. The American Opportunity Tax Credit provides a maximum benefit of \$2,500 based on a percentage of eligible expenses; 100% of the first \$2,000 of education expenses and 25% of the next \$2,000 of education expenses. Unlike the Lifetime Learning Credit, the American Opportunity Credit can result in a refund of up to a maximum of \$1,000. Qualifying expenses for this credit include tuition and related fees required for enrollment, as well as other course-related expenses (books, supplies, and equipment), regardless of whether these supplementary materials are required for enrollment or purchased directly from the school. This credit

is available to students with modified adjusted gross income below \$90,000 if the student is single or \$180,000 if the student files a joint return with a spouse. For example, let us consider a taxpayer with the same level of income and expenses we used to evaluate the benefit of the Lifetime Learning Credit: \$5,018 of qualifying expenses, adjusted gross income of \$36,000 and a tax liability of \$3,428. Since this taxpayer has adjusted gross income far below the limits specified for the American Opportunity Credit, he would realize a tax credit equal to the maximum benefit of \$2,500. Although his adjusted gross income will not be affected, his tax liability will be reduced to \$928. Additionally, if the taxpayer's tax liability had been less than \$1,500, any amount of the credit in excess of liability would be refunded to the taxpayer since 40% of the total \$2,500 credit is refundable.

Tuition and Fees Deduction for Personal Educational Expenses

A third option for students with personal educational expenses, regardless of employment status, is the Tuition and Fees Deduction (26 USC §222, 2015). This deduction can reduce taxable income up to a maximum of \$4,000 for single students with income less than \$65,000. Similar to the Lifetime Learning Credit, eligible expenses for the Tuition and Fees Deduction include only amounts *required* for enrollment in the course. The Tuition and Fees Deduction defines qualified expenses as required tuition and fees and other common education costs such as student-activity fees and course-related expenses (books, supplies, and equipment) only if the fees and expenses are required to be paid directly to the institution for enrollment or attendance.

Regardless of which tax treatment students select for their personal educational expenses, certain expenses are always ineligible with respect to either of the education credits and the Tuition and Fees Deduction. The cost of insurance, medical expenses (such as student health fees), room and board, transportation, or other personal expenses are not qualifying expenses for any of these tax benefits (IRS Publication 970, 2014). Students need to carefully consider which of these tax treatments is most beneficial for their individual situation.

Student Loan Interest Deduction

Students who pay their educational expenses with borrowed funds may be allowed to reduce their adjusted gross income for interest incurred on student loans. For a single taxpayer, adjusted gross income must be less than \$80,000 before the deduction and the borrowed funds must have been used to pay qualified educational expenses. Fortunately, students need not itemize to take advantage of the student loan interest deduction. The amount of educational interest expense is deducted directly from gross income on the face of the tax return. The maximum amount of interest which can be deducted annually is \$2,500. However, the deduction may be claimed every year for as long as the educational loan is outstanding. This deduction is available as an educational benefit regardless of any other credits or deductions claimed.

Conclusion

Ultimately, full-time students who travel abroad may utilize the American Opportunity Credit, the Lifetime Learning Credit or the Tuition and Fees Deduction to gain a tax benefit. The student need not itemize to take advantage of these provisions, however, qualifying expenses are limited to tuition, fees, books, supplies and other costs required for enrollment.

Students who work and go to school, whether employees or self-employed individuals, have

more flexibility in their reporting of study abroad expenses. Working students have the same opportunities to claim education credits or the tuition and fees deduction as non-working students. However, working students' qualifying educational expenses may also include travel, meals, lodging, and other work-related expenses for education while they are away from home. Students who are employees will need to itemize to benefit from these additional expenses and students who are self-employed will need to deduct the expenses from business income.

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