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Katherine D. Black  
*Southern Utah University*

Jeffrey N. Barnes  
*Southern Utah University*

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MBA EXPENSES CAN BE DEDUCTIBLE: REVISITING THE AGED SHERMAN CASE

KATHERINE D. BLACK & JEFFREY N. BARNES
SOUTHERN UTAH UNIVERSITY

ABSTRACT

For years, the deductibility of educational expenses was a contentious area of tax law. However, over the past decade Congress has passed numerous provisions designed to allow taxpayers to deduct the cost of education. Thus, the emphasis has changed from “is the expense deductible” to “what kind of expense is it”, “who wants to take it” and “in what form do they want to take the deduction”?

It has always been more difficult to deduct the expenses of getting a graduate education and was impossible if it led to a professional degree (e.g. law, medicine, CPA). Deducting the expenses of an MBA degree, however, was a different matter. The MBA did not prepare someone to enter a new field, since anybody could own a business, thus, MBA expenses were the source of several lawsuits that tried to draw some bright line tests. However, Congress has rendered some of those tests unnecessary for some taxpayers and may have simply created new tests and new methods of deductibility for others.

However, taking the deduction under §162 results in a greater deduction and is not subject to AGI limitations. Therefore, it is still important to analyze the deduction under §162 and only rely on the other provisions, if necessary. This is especially important because the IRS has not acquiesced to the Tax Court’s positions despite the numerous cases to the contrary. Therefore, although the regulation seems clear and the cases have gone so far as to indicate they are not going to follow the IRS’s Revenue Ruling, the IRS seems entrenched in its position establishing a continuous string of ever increasing hurdles that are not on the face of the Regulation, congressional intent, or the court cases of petitioners.

1. CODE SECTIONS PROVIDING FOR DEDUCTIBILITY OF EDUCATION EXPENSES--§162

There are numerous Code and Regulation sections designed to provide a deduction for the cost of education. The most liberal is found in Regulation §162-(5)(b) which provides that an individual may deduct education expenses as ordinary
and necessary business expenses provided the expenses are incurred for either of two reasons:

1. To maintain or improve existing skills required in the present job; or
2. To meet the express requirements of the employer or the requirements imposed by law to retain his or her employment status.

Education expenses are not deductible if either of the following applies:

1. The education meets the minimum educational standards for qualification in the taxpayer's existing job; or
2. The education qualifies the taxpayer for a new trade or business.\textsuperscript{i}

If these requirements are met all of the expenses, (including travel expenses) are deductible for AGI as ordinary and necessary business expenses. However, fees incurred for professional qualification exams (the CPA or BAR exam, for example) and fees for review courses (such as a CPA or BAR review course) are not deductible.\textsuperscript{ii}

If the education maintains or improves existing skills and does not qualify a person for a new trade or business, the deduction still can be taken. Even if the education results in a promotion or raise, a change in duties does not negate the deduction if the new duties involve the same general work. For example, a practicing dentist's education expenses incurred to become an orthodontist are deductible,\textsuperscript{iii} and a teacher who got a doctoral degree and became a principal still had deductible expenses.\textsuperscript{iv}

Reg. §1.162-5(a) provides:

“General rule. --Expenditures made by an individual for education (including research undertaken as part of his educational program) which are not expenditures of a type described in paragraph (b)(2) or (3) of this section are deductible as ordinary and necessary business expenses” (for AGI).

Despite the fact that the Regulation provides that the expenses of an individual are deductible as ordinary and necessary business expenses, IRS Publication 508 provides that if that individual is not self-employed the deductions are employee business expenses deductible as itemized deductions (from AGI). Although the IRS position in Publication 508 seems to be consistent with the treatment of other business expenses of self-employed individuals vs. employees, the publication goes contrary to
the Regulation which seems to provide otherwise.

Further, the Regulation provides an exception that seems to clarify the language in subparagraph (a), it reads:

(b) Nondeductible educational expenditures

(1) In general. --Educational expenditures described in subparagraphs (2) and (3) of this paragraph are personal expenditures or constitute an inseparable aggregate of personal and capital expenditures and, therefore, are not deductible as ordinary and necessary business expenses even though the education may maintain or improve skills required by the individual in his employment or other trade or business or may meet the express requirements of the individual's employer or of applicable law or regulations.

Thus, if the expenditures are not the kind described in subparagraphs 2 and 3, (the education meets the minimum educational standards for qualification in the taxpayer's existing job or the education qualifies the taxpayer for a new trade or business) they are deductible as ordinary and necessary business expenses when they maintain or improve the skills of an employee or meet the express requirements of the employer. The regulation envisions employee deductions as ordinary and necessary business deductions not as employee business expenses as the Publication suggests. Presumably, taxpayers could argue that IRS Publication 508 contravenes the intent of Congress and the specific wording of the Regulation.

Deductible educational expenses include tuition, books, supplies, lab fees and similar items; certain transportation and travel costs; and other educational expenses, such as costs of researching and typing when writing a paper as part of an educational program (IRS Publication 508).

II. EDUCATION MUST BEAR A CLOSE RELATIONSHIP TO TAXPAYER’S FORMER DUTIES

The court in Heffernan v. Commissioner stated that in the context of Code §162(a) it must be established that the education expenses bear "a proximate and direct relationship" to the taxpayer's employment or trade or business.

The court further elaborated in Blair v. Commissioner, Docket Nos. 4715-79, 10695-79, 41 TCM 289, TC Memo. 1980-488, which related to two years of
educational expenses:

In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's present employment.

* * *

We think that, under any realistic interpretation, petitioner falls within the ambit of this regulation. There was a substantial overlap in petitioner's job tasks, the only major difference being that a Sherwin Williams personnel manager makes decisions while a personnel representative only makes recommendations. Neither that difference nor the acquisition of a new title is enough to constitute being a personnel representative and being a personnel manager as separate trades or businesses. See Glenn v. Commissioner [Dec. 32,613], 62 T. C. 270, 275 (1974). We note in passing that even if "personnel manager" were in in this situation a new trade or business, the educational expenses nonetheless would be deductible unless they qualified petitioner for such new trade or business.

Respondent further suggests that the new trade or business condition is met because petitioner's program of study partially satisfies Ohio's requirements for registration as a public accountant. See Ohio Rev. Code Ann. sec. 4701.07 (Page 1977).

Ohio requires that a public accountant have an education "substantially the equivalent of an accounting concentration." Ohio Rev. Code Ann. sec. 4701.07(D) (Page 1977). Petitioner's studies at Baldwin-Wallace were far from that. Respondent's contention that petitioner's M. B. A. is "one step along the way" to qualifying her as a public accountant is simply too tenuous, in the context of this case, to merit consideration.

Our perception would have been different if the factual background herein were such that we could perceive an unfolding pattern of action by petitioner which would have qualified her as a public accountant. But, we do not believe an isolated venture into the educational world is enough to require the disallowance of an educational expense where such a pattern does not exist and the education undertaken clearly improves the taxpayer's skills in an existing trade or business.
Finally, we reach the question whether petitioner's graduate studies improved her skills as a personnel representative and personnel manager. The question is one of fact and the burden of proof is on the petitioners. *Schwartz v. Commissioner* [Dec. 35,020 ], 69 T. C. 877, 889 (1978).

Initially, we note that the fact that petitioner was reimbursed for her tuition expenses is not determinative, although it is relevant.

There are a plethora of decided cases in this area. We see no need to delve into the wide variety of nuances with which the opinions in such cases abound. Although petitioners' supporting evidence does not cross every "t" nor dot every "i," the record before us is sufficient to cause us to conclude that petitioners have carried their burden of proof. We hold that petitioners are, with the exception attributable to the expenses relating to the course in Marketing Information Systems (which they concede are not deductible), entitled to the claimed deductions.

As far as the travel expenses are concerned, respondent does not ask us to deal with these separately and disallow any portion thereof as commuting expenses. We, therefore, hold that petitioners are entitled to deduct their claimed travel expenses except with respect to one-sixth of the amount expended in 1975, attributable to the Marketing Information Systems course.

In the recent T.C. Summary Opinion 2003-58,vii(1997) the petitioner was not employed in a managerial position, prior to enrolling in his MIT MBA program. He was employed with Arthur Andersen in Beijing, China. The petitioner helped foreign companies develop joint venture strategies and financial structures for operations in China; he advised foreign companies on Chinese tax policies; and he helped companies develop marketing strategies for sale in China and was not in a managerial position. After his MIT MBA education, the petitioner joined Morgan Stanley’s investment banking division as an investment banker, again, not in a managerial position.

The distinguishing factor in this most recent case is that the petitioner went from a non-management responsibility position to an unrelated non-management-related position. The Tax Court focused on the fact that the courses did not “improve” the skills required by the taxpayer petitioner in his former line of work. Thus, going from accounting into management or vice versa is not improving skills in the same job field.
III. OTHER EDUCATION DEDUCTION FOR AGI, §222 (APPLICABLE FOR 2002 TO 2006)

Code §222 provides a deduction for AGI for qualified tuition and related expenses for individuals beginning after December 31, 2001, and before January 1, 2006. This deduction is equal to the qualified tuition and related expenses paid by the taxpayer during the taxable year and is limited by the taxpayer's adjusted gross income (AGI).

§162 relates to business expenses. The language of the regulation provides that expenditures made by an individual for education are deductible as ordinary and necessary business expenses as if part of a business. This deviates from the normal ordinary and necessary business expense deduction as there is no nexus with a business. The deduction under Code §222 parallels this same approach in that it provides a deduction for individuals as a deduction for AGI again without the requirement of a business or a business connection. Presumably since the deduction under Code §222 is not tied to a “business”, its deductibility for AGI will not be redefined by the IRS. Classification as a “for AGI” deduction avoids the 2 percent-of-AGI floor on miscellaneous itemized deductions such as employee business expenses.

Interestingly, this new code section allows the deduction for AGI and was enacted after Reg. §162-5 became effective. Reg. §1.162-5 provides that the deduction is allowable by an individual for AGI which is the same language used in the new Code §222.

If an expense is deductible under any other provision, it is not deductible under this provision. "Qualified tuition and related expenses" are tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent for whom the taxpayer is entitled to deduct a dependency exemption, at an eligible educational institution for courses of instruction.”

In years 2004 and 2005, the amount of the deduction allowed under Code §222 is limited to $4,000 and is only available to taxpayers with adjusted gross income (AGI) not exceeding $65,000 ($130,000 for joint filers). Taxpayers whose income exceeds that limit but does not exceed $80,000 ($160,000 for joint filers) in 2004 or 2005 may deduct up to $2,000 in qualified expenses.

If the taxpayer takes a Hope Scholarship Credit or Lifetime Learning credit with respect to a student, the qualified tuition and related expenses of that student...
which qualify for the credit are not deductible under Code §222. A taxpayer must reduce the total amount of qualified tuition and related expenses by the amount excluded for distributions from a qualified tuition plan, educational IRA or interest on U.S. savings bonds used to pay for higher education. In addition, taxpayers may not take a deduction for amounts excluded from income (i.e., GI benefits).

An individual who can be claimed as a dependent by another taxpayer cannot take a deduction under this section. If a taxpayer is married, Code §222 applies only if the taxpayer and his or her spouse file a joint return. However, if the person elects not to claim the dependent, the dependent may claim the deduction himself.

Obviously, the restrictions on the use of the deduction under Code §222 and the limitations for AGI make reliance on Code §222 for the educational benefits less desirable than under Code §162.

IV. HOPE AND LIFETIME LEARNING CREDITS—CODE §25A

The education credits (HOPE Scholarship Credit and the Lifetime Learning Credit) under Code §25A, provide other tax benefits to individuals in connection with their educational expenses. The HOPE scholarship credit and the Lifetime Learning credit are both nonrefundable credits. They are available for qualifying tuition and related expenses incurred by students pursuing undergraduate or graduate degrees. Unlike the deductions allowed under §162, the credits do not allow any deduction for room, board, and book costs.

The HOPE Scholarship Credit permits a maximum credit of $1,500 per year (100 percent of the first $1,000 of tuition expenses plus 50 percent of the next $1,000 of tuition expenses) for the first two years of postsecondary education. The HOPE Scholarship credit is available per eligible student. The Lifetime Learning credit permits a credit of 20 percent of qualifying expenses (up to $10,000) incurred. The Lifetime Learning credit is calculated per taxpayer. The credits may not be claimed concurrently. Generally, the HOPE Scholarship Credit is used for the first two years of post secondary education and the Lifetime Learning credit is used by individuals who are beyond the first two years. Both credits are taken based on qualified expenses incurred by a taxpayer, taxpayer's spouse, or taxpayer's dependent.

To be eligible for the HOPE credit, a student must take at least one-half the full-time course load for at least one academic term at a qualifying educational institution. There is no time and load requirement for the Lifetime Learning credit. The Lifetime Learning credit may be used by taxpayers who are seeking new job skills or maintaining existing skills through graduate training or continuing education.
Taxpayers with modified adjusted gross income above $50,000 ($100,000 for married filing jointly) cannot claim an education credit. The credit is phased out ratably for taxpayers that have modified adjusted gross income between $42,000 and $52,000 ($83,000 and $103,000 for married filing jointly). An education credit cannot be claimed if a married taxpayer files a separate return. The AGI and use limitations make the credits less desirable than the §162 expense deduction.

V. OTHER EDUCATIONAL BENEFITS

Other educational benefits include the deduction of interest on student loans under Code §221, tax-free distributions from a Coverdell education savings account under Code §530, early withdrawals from traditional and Roth IRAs for educational expenses, state tuition programs under Code §529, exclusion of interest from educational savings bonds, and employer education assistance programs.

An employee who receives employer-provided educational assistance may exclude up to $5,250 per year for amounts paid for tuition, including graduate school tuition for expenses related to courses, fees and related expenses under Code §127. Under Code §127, as long as an employer maintains a qualified educational assistance program, the cost of education provided through the program is eligible for exclusion and there is no need to distinguish between job related education and education taken for personal purposes.xi

No double benefits are allowed, so if a taxpayer claims a deduction for higher education expenses under any Code section, a credit or deduction for the same expenses under another Code section cannot be claimed.

VI. MBA EXPENSES

IRC §162(a)xii states:

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business…”

Treasury Regulation 1.162-5(a)(1) and (2),xiii states:

(a) General rule. Expenditures made by an individual for education (including research undertaken as part of his educational program) which are not expenditures of a type described in paragraph (b)(2) or (3) of this section are deductible as ordinary
and necessary business expenses (even though the education may lead to a degree) if the education—

Maintains or improves skills required by the individual in his employment or other trade or business, or

Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation.

In the definition of the phrase, “ordinary and necessary,” the word "necessary," as used by Congress, has been construed to mean "appropriate" or "helpful" rather than "indispensable" or "required." Because earning an MBA is both “appropriate” and “helpful” for certain taxpayers, there are circumstances in which MBA expenses might be allowed. However, the courts have now begun to weigh in on what other attributes must be present in order for graduate MBA expenses to be deductible.

The court in Johnson v. United States of America, the court explained:

As is apparent, the regulations treat educational expenses from two points of view. Paragraphs (a)(1) and (2) give the requirements which must be met before deduction can be allowed. Paragraphs (b)(2) and (3) on the other hand list instances wherein deduction will not be allowed. It is clear that in order for an educational expense to be deductible it must escape the prohibitions contained in (b)(2) and (3) as well as fulfill the express requirements of (a)(1) and (2).* * *

In order for plaintiff to fulfill the requirements of (a)(1) and (2) it is necessary that he either be employed or engaged in carrying on a trade or business. Rev. Rul. 60-97 1960-1 Cum. Bull. 69. Canter v. U. S. [66-1 USTC ¶9118], 354 F. 2d 352 (Ct. Cl. 1965).

VII. ESTABLISHED IN A TRADE OR BUSINESS

Implicit in both IRC §162 and the related regulations is that the taxpayer must be established in a trade or business or employed before any expenses are deductible as “trade and business” expenses. The question of whether a taxpayer is established in a trade or business is one of fact. Can a taxpayer be both employed, currently unemployed, or running a trade or business, and enrolled in a graduate program and still be considered “established in a trade or business?”
There are several court cases that carefully looked at the definition of “established” in a trade or business. In 1981, the Tax Court (Memorandum Decision) in Reisine v. Commissioner\textsuperscript{xvi} held that limited business experience before earning an MBA was not sufficient to be allowed a deduction. Specifically, the taxpayer was an engineer who was employed by Bendix for one year prior to attending Coleville University to obtain both a master’s and an Ph.D. degree in engineering. The expenses in that case were disallowed because the taxpayer was not sufficiently established in a trade or business. The court held that since taxpayer worked only one year and was not a manager, he was not “sufficiently established”.

However, in Ruehmann v. Commissioner\textsuperscript{xvii}, one of the distinguishing aspects was that taxpayer obtained an official “leave of absence” from an employer after only three and one-half months of on-the-job employment. Taxpayer had passed the Georgia bar and had obtained his law degree prior to commencing employment with a law firm in June of 1967. The law firm had accepted him as a permanent associate, and it was the firm's policy to permit leaves of absence to pursue graduate legal studies. Prior to graduation from law school taxpayer had been accepted into a Master of Laws (LLM) program at Harvard University. He worked for the law firm from June until September of 1967 and then commenced the one-year LLM program. The taxpayer was allowed to deduct the expenses of attending Harvard based on a finding that he was “engaged in a trade or business.”

In Sherman v. Commissioner,\textsuperscript{xviii} an individual left his position as a manager to pursue a full-time graduate course in business administration. He was allowed a deduction for the cost of attending school, even though he was not on “leave of absence” status while attending school and he had accepted another position from a different company upon graduation. The Tax Court (Memorandum Decision) held he had merely suspended active participation in the management responsibilities field while at school for two years and had returned to the field of employment with management responsibility upon graduation.

In the Sherman case, the taxpayer had worked as a military officer for three years and then an additional two years as Chief of Plans and Programs Office in Viet Nam. After acting as an enlisted officer for three years, he received managerial responsibility for two years and then entered into Harvard’s MBA program.

Whether a taxpayer is engaged in carrying on a trade or business is a question of fact. Corbett v. Commissioner [Dec. 30,669 ], 55 T. C. 884, 887 (1971).
For the two years immediately preceding petitioner's matriculation in the Harvard Graduate Business School petitioner was employed by the Army and Air Force Exchange Service (AAFES) as Chief, Plans and Programs Office, in Viet Nam. We conclude on the facts that this was a sufficient period of time for petitioner to have established himself in the business of being an employee who was an administrator and planner (i.e., business manager). \footnote{xix}

Respondent's second contention is that petitioner has not proved that he was "carrying on" a trade or business at the time he incurred the educational expenses in issue. Petitioner was not employed while he was enrolled full time for two years in the Harvard Graduate School of Business.

We have held that a taxpayer who temporarily ceases active participation in a trade or business during a transition period between leaving one position and obtaining another may be "carrying on" a trade or business during the transition period. *Haft v. Commissioner* [Dec. 26,049 ], 40 T. C. 2 (1963). Likewise, a taxpayer who leaves his position temporarily to attend school full time may be "carrying on" a trade or business while in school. The Seventh Circuit in *Furner v. Commissioner* [68-1 USTC ¶9234 ], 393 F. 2d 292 (1968), rev'g [Dec. 28,182 ], 47 T. C. 165 (1966), held that a school teacher, who resigned from her teaching position when she could not get a leave of absence to attend graduate school full time for a year, and who after finishing graduate work took a different teaching job in another school district\footnote{xx} was "carrying on" her trade or business of being a teacher while in graduate school. And we held in a reviewed decision, *Ford v. Commissioner* [Dec. 30,986 ], 56 T. C. 1300 (1971), aff'd per curiam [73-2 USTC ¶9798 ] 487 F. 2d 1025 (9th Cir. 1973), that another teacher was in the trade or business of teaching while attending the University of Oslo in Norway full time for one year after leaving a teaching job in one school district (without a leave of absence) and before returning to another teaching job in another district. These cases establish that a leave of absence is not essential to carry on a trade or business while attending school, nor is it essential to return to the same position after completing the course of study undertaken.

However, when a taxpayer leaves his trade or business for a prolonged period of study with no apparent continuing connection with either his former job or any clear indication of an intention to actively carry on the same trade or business upon completion of study, the taxpayer is not
"carrying on" his trade or business while attending school. *Canter v. United States* [66-1 USTC ¶9118], 354 F. 2d 352 (Ct. Cls. 1965) (a nurse discontinued nursing activities for more than four years while obtaining Bachelor's and Master's degrees in nursing); *Corbett v. Commissioner* [Dec. 30,669], 55 T. C. 884 (1971) (a teacher discontinued teaching and commenced full time study leading to a Ph.D., and four years later at time of trial was still a full time student).

We hold on the facts that petitioner was "carrying on" his trade or business of being a business manager while attending Harvard Graduate Business School for two years. He sought, but was refused, a leave of absence from his job with AAFES in order to attend school and study for an MBA. The MBA would not equip him for a different career. He was engaged in business administration before he went to Harvard, and stayed in the field after his graduation. The MBA rather was expected to equip him to be a better manager than he had been. He sought to return to his job with AAFES after obtaining his degree, but was not re-employed because AAFES was cutting back in Viet Nam. Therefore he took another job, utilizing his management, administrative and planning skills, with Radix Corporation in the Orient. These facts bring petitioner within the scope of *Furner and Ford*, and his temporary cessation of active participation in the business of being a managerial employee did not prevent him from "carrying on" a trade or business within the meaning of section 162, while attending Harvard.

A taxpayer who temporarily ceases active participation in a trade or business during a transition period between leaving one position and obtaining another may still be "carrying on" a trade or business during the transition period. Likewise, a taxpayer who leaves his position temporarily to attend school full time may be "carrying on" a trade or business while in school.

However, if taxpayer has quit his job prior to going to school and has no intention of returning, he is not “engaged” in the field.

As indicated by the express language of section 162(a), referred to above, in order for educational expenses to be deductible, the taxpayer must be engaged in a trade or business during the period the education is undertaken. In other words, the "expenditure must relate to activities which amount to the present carrying on of an existing business."

*Corbett v. Commissioner* [Dec. 30,669], 55 T. C. 884, 887 (1971); see *Canter v. United States* [66-1 USTC ¶9118], 354 F. 2d 352, 173 Ct. Cl.
723 (1965). The cessation of a trade or business by a taxpayer in order to undertake full-time study will disqualify the deduction if the cessation is indefinite rather than temporary. *Furner v. Commissioner* [68-1 USTC ¶9234], 393 F. 2d 292, 294 (7th Cir. 1968), revg. [Dec. 28,182 ] 47 T. C. 165 (1966); *Corbett v. Commissioner*, *supra*.xxii

In *Wassenaar v. Commissioner*xxiii a law school graduate who was not yet admitted to the bar sought to deduct the cost of a masters program in taxation as a business educational expense. The court denied the deduction on the grounds that at the time the taxpayer took the masters courses he was not yet in the trade or business of being an attorney; consequently, the courses did not maintain or improve his skills in an existing trade or business and were part of a program of study leading to his entering a new trade or business.

In order to constitute maintenance or improvement of business skills, a taxpayer must be engaged in the trade or business at the time he incurs the educational expenses. *Jungreis v. Commissioner* [Dec. 30,600 ], 55 T. C. 581, 588 (1970). It is well established that membership in good standing in a profession is not equivalent to carrying on the profession for purposes of section 162(a) . *Ford v. Commissioner* [Dec. 30,986 ], 56 T. C. 1300, 1304 (1971), affd. per curiam, 487 F. 2d 1025 (9th Cir. 1973). In the case of a lawyer, mere admission to a bar does not place a taxpayer in the trade or business of practicing law. *Wassenaar v. Commissioner* [Dec. 36,359 ], 72 T. C. 1195, 1199-1200 (1979).xxiv

The Seventh Circuit, in *Furner v. Commissioner*xxv held that a school teacher, who resigned from her teaching position when she could not get a leave of absence to attend graduate school full time for a year, and who after finishing graduate work took a different teaching job in another school district, was "carrying on" her trade or business of being a teacher while in graduate school.

The taxpayer’s establishment in the business must immediately precede the education.xxvi Further, when the time is short in duration, the court looks at the taxpayer’s entire employment history to establish a pattern.

There are a number of factors indicating that petitioner's employment at Xerox was merely a temporary hiatus in a continuing series of academic endeavors. The first is the period of time of employment, both in absolute and relative terms. Petitioner worked only 3 months at Xerox before leaving to attend graduate school. While we decline to set a minimum period of time that one must be employed, such a short period
of time is relevant evidence. In addition, viewing petitioner's post-high school activities as a continuum, he was employed in his field only 3 months out of a total 6 years. Moreover, he effectively ceased employment when he returned to school. The job at Xerox was but another summer position in an otherwise continuous pattern of schooling which petitioner decided he needed prior to establishing himself in a trade or business.xxvii

In Rance v. Commissioner, 45 TCM 956, TC Memo. 1983-129, Rance, who had been an investigator for the state of California went to law school. He tried to take a deduction for the expenses, but they were denied. The court held:

Petitioners argue that the legal courses Rance took in 1977 are not "part of a program of study * * * which will lead to qualifying him in a new trade or business" because Rance did not complete the whole law school curriculum in 1977. In addition, petitioners contend that admission to the bar alone qualifies one for practicing law and that Rance was not admitted to the bar until later years.

There is absolutely no merit to petitioners' arguments. This Court has consistently disallowed education deductions taken by non-lawyers for attending law school. See, e.g., Bodley v. Commissioner [Dec. 30,989], 56 T. C. 1357 (1971); Weiler v. Commissioner [Dec. 29,989 ], 54 T. C. 398 (1970); Bradley v. Commissioner [Dec. 29,952 ], 54 T. C. 216 (1970); Weiszmann v. Commissioner [Dec. 29,765 ] 52 T. C. 1106 (1969), affd. per curiam [71-1 USTC ¶9312] 443 F. 2d 29 (9th Cir. 1971). In each of the above-cited cases, the taxable year before the Court was a year prior to the taxpayer's graduating from law school and prior to the taxpayer's passing the bar. Nevertheless, we held that the early years of law school were part of a course of study which would lead to qualification in a new trade or business. For the reasons stated in the above-cited cases, we hold that Rance's courses were part of a program which would lead to qualifying him in a new trade or business.

**VIII. IS AN EMPLOYEE ACTIVELY ENGAGED IN A TRADE OR BUSINESS?**

Can a taxpayer who is employed for two years with managerial responsibilities, such as a supervisor, after his first year of non-managerial responsibility, have sufficient experience to arguably be engaged in a "trade or business?" In Primuth v. Commissionerxxviii, the court held a taxpayer may be in the trade or business of being
an employee, such as a corporate executive or manager.

IX. INTENTION TO RETURN

Taxpayer must have the intention to return to the same job field. A nuclear engineer was denied a deduction for educational expenses. He had no apparent intention of returning to his former job or job field and, therefore, was not involved in a trade or business. In addition, the intention cannot be general. It must be specific. A taxpayer who was employed as an engineer resigned this position to take up graduate studies in engineering. The education was undertaken to pursue his general educational aspirations and with the intention of resuming a trade or business at some future date. He was denied the deduction.

X. THE IRS POSITION

After the Furner v Commissioner case (pre-Sherman) the Treasury Department issued Rev. Rul. 68-591, 1968-2 C. B. 73, in which they stated that they would follow Furner under certain circumstances, and in which they stated:

"Ordinarily a suspension for a period of a year or less, after which the taxpayer resumes the same employment or trade or business, will be considered temporary."

The IRS issued Letter Ruling 8538068, on June 26, 1985. The letter ruling provided some light on whether a 2-year MBA course of instruction could be construed as temporary and not indefinite. The letter ruling stated, ordinarily, a suspension for a period of a year or less, after which the taxpayer resumes the same employment or trade or business, will be considered temporary.

The letter ruling also stipulated the following (rearranged for emphasis):

In support of your position that the educational expenses you have incurred are deductible under section 162(a) of the Code, you rely on Sherman v. Commissioner, T.C. Memo. 1977-301, where the court held that an individual who

1. left his position as a manager,
2. to pursue a full-time graduate course in business administration could deduct the cost of attending school. Although the taxpayer was not on
leave status while attending school, and

3. he accepted another [managerial] position upon graduation, he had merely suspended active participation in the management field while at school for two years and had returned to the field upon graduation.

Even though the government lost the Sherman case, Rev. Ruls. 60-97 and 68-591 remain the position of the Internal Revenue Service. Therefore, since you suspended your employment for a period of two years while pursuing an MBA degree, the expenses incurred in obtaining that degree are not deductible under section 162(a) of the Code.

Thus, despite the case law which looks for a pattern of prior establishment in a business, leave for a period of time and intent to return to the line of business, the IRS has taken an arbitrary position, possibly for administrative convenience. It is interesting to note, that this position was not taken in the Regulation, and was not reiterated in Publication 508.

The IRS’s position is, at best, capricious and ill-reasoned. Suppose taxpayer goes to school for nine months and returns to work for three. After the three months, he goes back and finishes the final nine months of school. Has he had two one year or less periods of time? If the program is a two-year program, what length of time is necessary back on the job before he can complete his program? According to the Tax court these expenses should be deductible without having to go through this charade. According to the IRS they will not be deductible, but they have not ruled under what conditions the taxpayer may resume his education. This is not only silliness, but it is arbitrary. Further, it could result in additional cost to the Treasury. Suppose the program is in another state. If the first year’s expenses are covered, that will include moving expenses and the expenses of starting up a household. If the taxpayer must return to work and then move again after a period of time this is costly in dollars as well as effort and time. Surely, it would be better to let the taxpayer finish the program. Perhaps a rule that taxpayer must be continuously working on the program with the intent to return to the job field in a reasonable period of time, would be more appropriate.

Respondent's third contention is that petitioner's suspension from his established trade or business was not temporary and definite. After the Furner decision respondent issued Rev. Rul. 68-591 , 1968-2 C. B. 73, in which he stated that he would follow Furner under certain circumstances, and in which he further stated: "Ordinarily a suspension for a period of a year or less, after which the taxpayer resumes the same employment or trade or business, will be considered temporary."
As this Court has frequently noted, a revenue ruling is no more than the opinion of one of the litigants in the case. E.g., *Estate of Lang v. Commissioner* [Dec. 33,258], 64 T. C. 404, 406-407 (1975), on appeal (9th Cir. January 6, 1976). There is no magic in a one year limit on "temporary" (other than possible ease of administration), and we believe a facts and circumstances test is the appropriate test for determining whether a hiatus is temporary rather than indefinite.xxxiii The course of instruction for the MBA was quite definite in length--two years. We find nothing in section 162 justifying us in following an arbitrary one-year limit on self-improvement progress. Under the facts of this case we hold that petitioner's two-year suspension of active participation in his business was temporary and definite.xxxiv

In Letter Ruling 9112003, (Dec. 18, 1990), the IRS provided an interesting analysis of their mix of the one year rule with the analysis in Sherman:

Rev. Rul. 68-591, 1968-2 C.B. 73, which follows *Furner v. Commissioner*, 393 F.2d 292 (7th Cir. 1968), provides that amounts spent by a teacher who left her position to pursue a graduate degree as a full-time student for one academic year were deductible as educational expenses under section 1.162-5 of the regulations, even though the petitioner temporarily ceased to engage actively in her employment. During the course of her studies, the petitioner accepted a teaching position beginning immediately after graduation from the master's program. The Service stated in Rev. Rul. 68-591 that ordinarily, a suspension of a year or less, after which the taxpayer resumes the same employment or trade or business, will be considered temporary.

*Ruehmann v. Commissioner*, T.C.M. 1971-157, holds that the petitioner, an attorney, was entitled to deduct the cost of obtaining an LL.M. degree. Upon graduating from law school in June 1967, and having already passed the bar, the petitioner was engaged in the trade or business of practicing law from June to September 1967. The petitioner then entered into a graduate law program to obtain his LL.M. degree. Following graduation from the LL.M. program the petitioner was employed by a law firm for a three month period after which he entered into the office of the judge Advocate General of the Department of the Army, where he performed legal services. The court opined that the courses taken by the petitioner improved upon skills required in the practice of law, rather than qualify the petitioner in a new trade or
business or were necessary to meet the minimum educational requirements of a legal position or the legal profession.

Kohen v. Commissioner, T.C.M. 1982-625, holds that the petitioner was not entitled to deduct, as trade or business expenses, amounts incurred in the procurement of a master's degree in taxation. In the months between graduation from law school and enrollment in the graduate law program, the petitioner did not hold himself out as an attorney, nor did he perform legal services. Noting that section 162 requires one to be engaged in a trade or business at the time an expense is incurred, the court stated that the petitioner was a full time student during the time in question and not engaged in the practice of law prior to enrolling in the LL.M. program, therefore, the expenses were personal and nondeductible.

Based upon the submitted facts, the issue presented by X is analogous to that of the petitioners in both Rev. Rul. 68-591 and Ruehmann. Prior to undertaking graduate studies at Y, X was engaged in the full-time practice of law for approximately four years. X anticipates that he will temporarily cease to practice law on a full-time basis for approximately nine months. During the course of his studies, X will continue to perform legal services for his clients on limited basis and will make reasonable efforts to resume the practice of law after completing his graduate work. In other words, X is taking a suspension of less than a year from the full-time trade or business of practicing law. X's studies are supplemental to the minimum educational requirements of the legal profession and improve upon skills required in the practice of law, rather than qualify him in a new trade or business. Accordingly, amounts incurred by X in the pursuit of obtaining a master's degree in taxation are deductible as business expenses under section 162 of the Code. This ruling is based on X's representation that he intends to return to the practice of law upon completion of the master's program and that he makes a good faith attempt to obtain such a position.

Longer periods of time have been allowed in several cases.xxxv

XI. MINIMUM EDUCATION REQUIREMENTS

Reg § 1.162-5 provides that no business deduction will be allowed if the education qualifies the taxpayer for another trade or business. A taxpayer getting an MBA is obtaining additional coursework that better enables him to be a manager. However, does an MBA qualify the taxpayer for another trade or business?
Unlike the graduate student pursuing a medical degree, JD degree, MAcc degree, or other specialized graduate professional degree, the MBA graduate presumably has not qualified taxpayer for a new trade or business. When the earned degree helps qualify the taxpayer for another professional career, the education deductions are not deductible. The unique aspect of the MBA is that there are no state licensing requirements for MBAs. Thus, non-MBAs can act as business managers.

Expenses for education are deductible if the education is undertaken primarily for the purpose of maintaining or improving skills required by the taxpayer in his trade or business. These expenses, however, are not deductible if they are for education undertaken for the purposes of obtaining a new position or substantial advancement in position, or in order to meet the minimum requirements for qualification in his intended trade or business (or specialty therein) (Prior 1967 language). The regulations indicate that, if educational expenses either qualify one to meet the minimum educational requirements of one's employment or qualify one for a new trade or business they are not deductible even though the education has the incidental effect of maintaining or improving skills required in the existing employment, trade or practice. §1.162-5(b)(1).

**XII. CAN THE SHERMAN CASE STAND?**

The courts have taken the stand that MBA expenses or any educational expenses that do not lead to a new profession, may be deductible under Reg.§ 162-5 if the taxpayer was established in the job field before going for his education, got education that was definite in duration and improved his job skills, and had the intent of returning to the job field. The IRS has taken the position that those expenses must be incurred in less than one year. *The courts have said that is ridiculous and a facts and circumstances test is more appropriate.* The IRS has also stated in its Publication 508 that the expenses, if deductible, must be deductible from AGI unless the taxpayer is a sole proprietor. Although not specifically on point, the courts have quoted the language of the Regulation that the deduction is for AGI.

Thus, taxpayers desiring to take deductible educational expenses for an MBA degree need to be aware that the IRS has drawn battle lines. Taxpayers will probably win if they come within the court’s parameters, but not without a court battle.

**XIII. ALTERNATIVES**

In the alternative, if taxpayer’s expenses do not come under the definition of Code §162 expenses, they may still be deductible under one of the other code
sections. For the next few years the expenses may be deductible under Code §222. Taxpayers may also qualify for a combination of deduction and credits if the expenses exceed the limits in either category. Unfortunately, most of these deductions have AGI limitations, or other limitations regarding who can take the expenses that may make this alternative unavailable.

However, with a little pre-planning, taxpayers may be able to qualify for deductions under other code sections such as the deduction of interest on student loans, tax-free distributions from a Coverdell education savings accounts, early withdrawals from traditional and Roth IRAs for educational expenses, state tuition programs, exclusion of interest from educational savings bonds, and employer education assistance programs.

XIV. HOW SHOULD THE CLAIMED DEDUCTIONS BE REPORTED ON THE INDIVIDUAL’S TAX RETURN?

Because these educational expenses have been deemed “trade or business” expenses, they are deemed to be deductions “for AGI.” IRC §62(a)(1) states the following:

“For the purposes of this subtitle, the term “adjusted gross income” means, in the case of an individual, gross income minus the following deduction:

(1) TRADE AND BUSINESS DEDUCTIONS. — The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.”

Because these expenses are not paid by the taxpayer in connection with his employment, but after his employment, and before his accepting another managerial position upon graduation, these expenses are not in connection with his being an employee. Rather, these expenses are in connection with his “trade or business” as being an employee for hire, in the direct past and in the direct future, but not as instantly present, which is construed to be an acceptable, at least arguable, per the Sherman Case, a “temporary absence” from employment. And being a taxpayer for hire as an employee is construed to be the taxpayer’s “trade or business.”

Therefore, the deduction should be listed as a deduction “for AGI” and not as a miscellaneous deduction, as a deduction “from AGI”, as suggested by Code
§62(a)(2)(A) and found not supportable in the T.C. Summary Opinion 2003-58, Petitioner Yuanqiang Zhang, Petitioner v. commissioner, Respondent Case. If you list the item as an “unreimbursed employee expense” and the taxpayer is not currently employed, the IRS knocks this tax position right out of the ballpark as a de facto non-compliance statutory position.

ENDNOTES

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i Reg. §§1.162-5(b)(2) and (3).


iii Rev.Rul. 74-78, 1974-1 C.B. 44.

iv Reg. §1.162-5 provides specifically for a deduction for the educational expenses of teacher’s going for additional education. “In this respect plaintiff’s reliance on the recent case of Mary O. Furner v. Comm. [68-1 USTC ¶9234], 393 F. 2d 292 (7th CCA 1968) is misplaced. In that case the Court held that graduate training by a high school teacher was a normal incident of carrying on the profession of teaching. The distinguishing factor between that case and the instant one can be found in the following language of the Court: "Expert testimony in the record before the tax court leads to two conclusions, nowhere rebutted. One is that it is not unusual, and is becoming more usual, for teachers to enroll in full time graduate study for an academic year in order to keep up with expanding knowledge and improve their understanding of the subjects they teach. It also appears, as is common knowledge, that many school systems require teachers to earn additional academic credits from time to time." Johnson v. United States of America 71-1 USTC ¶9347 U. S. District Court, East. Dist. La., New Orleans Div.

v Reg. §§1.162-5(b)(2) and (3).


viii Code §25A(g)(2), Code Sec. 117.

ix Code §222(d)(1).

x Code §222(d)(4).


xii Internal Revenue Code of 1986, as amended, Section 162.
Treas. Reg. § 1.162-5.


Respondent relies on two cases here: Houston v. Commissioner [Dec. 32,034(M) ], 32 T. C. M. 686 (1973), 42 P-H Memo. T. C. par. 73, 142 (1973) (taxpayer graduated from VMI with a B.S. in civil engineering then attended the University of Virginia Graduate Business School for one year before entering the Air Force where he served as a pilot for five years; upon discharge from the Air Force he attended Michigan State University Graduate School of Business; held, he had not established himself in the trade or business of being an engineer); and Reisine v. Commissioner [Dec. 30,415(M) ], 29 T. C. M. 1429 (1970), 39 P-H Memo. T. C. par. 70,310 (1970) (after graduating from college with an engineering degree, taxpayer was employed for one year, whereupon he resigned to take up graduate study in engineering; held, the taxpayer had not established himself in the trade or business of being an engineer). In neither case were the facts even closely analogous to those presented here.

See King v. Commissioner [Dec. 25,463(M) ], 21 T. C. M. 495 (1962), 31 P-H Memo. T. C. par. 62,093 (1962) (taxpayer, a teacher was granted a leave of absence in 1958 by the school board to attend Stanford University to obtain a Ph.D. in education; as of 1961 she was still at Stanford and still on a leave of absence; held, her education expenses for 1958 were deductible).


Schneider v. Commissioner, Docket No. 6981-81, 47 TCM 675, TC Memo. 1983-753.


Martin S. Frankel v. Commissioner, Docket No. 8260-80, 47 TCM 1208, TC Memo. 1984-103.


Taxpayer had not been engaged in the trade or business for three years prior to enrolling in the courses, and, although he intended to go back to work in the field, he had worked in several unrelated fields immediately preceding his education. His absence from his field was for an indefinite rather than a temporary duration, and the deduction was disallowed. C.C. Damron,


xxx B. Reisine, 29 TCM 1429, Dec. 30,415(M), TC Memo. 1970-211

xxoi Furner v. Commissioner, 68-1 USTC ¶9234, 393 F. 2d 292 (1968).


xxoi See Cornish v. Commissioner [Dec. 29,984(M )], 29 T. C. M. 235 (1970), 39 P-H Memo. T. C. par. 70,051 (1970) (taxpayer, an assistant analyst engaged in developing safety aspects of the "Minuteman", left his job to study at a university where he obtained a B.S. in physics, a B.A. in mathematics, and an M.S. in physics; held, taxpayer's studies were indefinite rather than temporary for purposes of improving skills).


xxv A nurse who went to school to earn a doctor's degree in nursing education was entitled to a deduction for the cost of the education even though it lasted three years. D.C. Hitt, 37 TCM 333, Dec. 34,987(M), TC Memo. 1978-66

xxvi Internal Revenue Code, of 1986, Section 62.