

AUGUST 20, 2008 | VOLUME 2, ISSUE 242

## Deducting an MBA Candidate's Education Expenses

Can a candidate for a Masters of Business Administration (MBA) degree deduct, for Federal income tax purposes, her educational expenses? This is a question that has vexed MBA students for decades and, after all these years, is still no closer to a satisfactory resolution than it was when the question first arose. Anecdotal evidence strongly suggests that the Internal Revenue Service is, if anything, stepping up its efforts to deny students the benefit of a tax deduction, even in cases where the "law" in the area seems clearly, at least to this observer, to favor the students' claims. From what we can gather, the principal issue is not whether the program of study "maintains or improves" skills required in the student's employment or other trade or business but, more fundamentally, whether, in fact, the student is "carrying on" a trade or business during his or her tenure at school. If the answer to that fundamental question is no, the deduction cannot be enjoyed because the expense would not be described in Sec. 162(a) of the Internal Revenue Code. That section only allows a tax deduction for those "ordinary and necessary" expenses which are paid or incurred **in carrying on any trade or business** during the taxable year. Whether the student is carrying on a trade or business at the time the education expenses are incurred, in turn, depends upon whether his or her "sojourn" at school represents a "temporary hiatus" in his or her professional career or whether such sojourn removed him from his previous trade or business and placed him in the unfavorable (for this purpose) category of a student for an indefinite period of time.

### The Standard for Deductibility

The income tax regulations provide that expenses made by an individual for education are, generally, deductible as ordinary and necessary business expenses, even though the education may lead to a degree. Thus, the expenses are deductible so long as the education (i) maintains or improves skills required by the individual in his employment or other trade or business or (ii) 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. See Reg. Sec. 1.162-5(a)(1) and (2). However, even where the education fits comfortably within one or both of the foregoing categories, the expenses will not be deductible if (i) they are made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business or (ii) they are made by an individual for education which is part of a program of study being pursued by him which will lead to qualification in a new trade or business. See Reg. Sec. 1.162-5(b)(2) and (3).

In most cases, the MBA candidate will not run afoul of either of these two prohibitions regarding the deductibility of education expenses. Most notably, in the case of those candidates who will be working at investment banks, hedge funds, or private equity firms, it seems clear beyond cavil that the MBA degree is not a minimum educational requirement for securing a position at any of these organizations. In fact, every investment bank has, at any one time, scores of employees functioning as associates--the position the MBA candidate will occupy upon graduation--who do not possess the MBA credential. Moreover, it seems intuitive, and the I.R.S. has not pursued the argument in any meaningful way, that the M.B.A. degree does not, in and of itself, the way a law school degree or a medical school degree does, qualify the student to engage in a new trade or business. Why then is the issue of deducting a

candidate's education expenses so contentious? Because the I.R.S. has long contended that the M.B.A. does not, in the first instance, have access to the benefits of Sec. 162(a) because, as indicated, the candidate is not, at the time the expenses are incurred, carrying on a trade or business.

#### Furner and its progeny

It is generally conceded that the seminal decision in this area is *Furner v. Commissioner*, 393 F.2d 292 (7th Cir. 1968). There, the taxpayer received her bachelor's degree in 1957 and taught social studies, in Minnesota, during the school years 1957 through 1960. She resigned her position in June, 1960 because she desired to attend Northwestern University (NU), as a full-time graduate student, during the 1960-1961 school year. In fact, she attended NU from September, 1960 until she received her M.A. degree in August, 1961. She performed no teaching duties during the period she attended NU. Upon graduation, Ms. Furner signed a contract to teach in a junior high school in Illinois beginning in September, 1961. She taught social studies in Illinois. Ms. Furner sought to deduct her education expenses but the I.R.S. contended, and the Tax Court agreed, that the deduction was not proper because the taxpayer was not engaged in carrying on a trade or business of teaching during the time she attended NU. The fact that Ms. Furner was not "on leave" from a school system employer while studying was a key factor in the Tax Court's thinking. **(1)** However, the Seventh Circuit Court of Appeals reversed the Tax Court's decision and permitted Ms. Furner her tax deduction. The Seventh Circuit observed that "...The Commissioner and the Tax Court placed too much emphasis on whether the taxpayer's studies displaced performance of teaching activities and gave insufficient consideration to the question whether the relationship of the course of study to intended future performance as a teacher is such that the expenses thereof can reasonably be considered ordinary and necessary in carrying on the trade or business of teaching..." **(2)** The court then observed that a year of graduate study, under the circumstances described here, is a **normal incident** of carrying on the business of teaching and, therefore, the expenses were deductible because, in fact, these expenses were incurred by Ms. Furner in **carrying on** the trade or business of teaching. In reaching its now famous "normal incident" conclusion, the court observed that (i) it is not unusual for teachers to enroll in full-time graduate study for an academic year and (ii) many school systems require teachers to earn additional academic credits.

The I.R.S. reacted swiftly to the *Furner* decision. Thus, in Rev. Rul. 68-591, 1968-2 C.B. 73, the Service said that it would follow the decision but only to the extent that a student's facts were "substantially the same" as those confronting Ms. Furner. Thus, the scenario that the I.R.S. grudgingly endorsed encompasses the case where a taxpayer, in order to maintain or improve the skills required in her employment, **temporarily ceases to engage, actively, in employment**. Ordinarily, the I.R.S. went on to say, a suspension for a period of one year or less after which the taxpayer resumes the same employment or trade or business will be considered temporary. **(3)** Moreover, the ruling states in no uncertain terms, the I.R.S. **does not agree** with any construction of *Furner* under which an expense could be considered incurred while carrying on a trade or business merely because the study may be a normal incident of carrying on a trade or business and the taxpayer subjectively intends to resume the business at some indefinite time in the future. Thus, the I.R.S.'s acceptance of the Seventh Circuit's *Furner* decision was quite limited: The fact that the study may be a normal incident of carrying on the taxpayer's trade or business was dismissed by the I.R.S. as irrelevant. What mattered, instead, was that the cessation of active participation in the trade or business was no more than temporary. Moreover, for this purpose, a suspension for a period of one year or less, would, ordinarily, be considered temporary. A hiatus of more than one year, presumably, would render the cessation indefinite (rather than temporary) with the result that the taxpayer would not be viewed as having incurred the education expenses while *carrying on* the abandoned trade or business. **(4)**

## Tax Court sees the error of its ways

The Tax Court decided that its prior approach to the problem was erroneous and it moved quickly to embrace the reasoning employed by the Seventh Circuit in *Furner*. Thus, in *Ford v. Commissioner*, 56 T.C. 1300 (1971), the taxpayer had received a bachelor's degree in 1962 and by 1963 had completed the 24 credit units required for a regular teaching certificate. Nevertheless, the taxpayer taught under a provisional teaching certificate. In 1967, the taxpayer, pursuant to his provisional teaching certificate, was employed as a regular, full-time teacher at Compton Union High School for the spring semester. In August of 1967, Mr. Ford traveled to Norway and in December of 1967 registered at the University of Oslo under a program leading to a Ph.D. in Anthropology. He ceased his studies at the University of Oslo in June, 1968 and returned to the United States. In September, 1968 the taxpayer accepted employment as a regular teacher of English and social studies at San Gabriel High School. Were the expenses he incurred while in Oslo deductible? The answer turned on whether, while abroad, he was carrying on the trade or business of being a teacher. The I.R.S. contended that Mr. Ford was not actively carrying on his trade or business as a teacher when the expenses were incurred. Instead, at that time, Mr. Ford was unemployed. The I.R.S. concluded that in June, 1967 Mr. Ford had "voluntarily and indefinitely" abandoned any active pursuit of the teaching profession. The court, however, in response to this assertion, noted the following salient facts (i) upon Mr. Ford's arrival in Oslo he applied for appointment as a substitute teacher with a U.S. government agency responsible for educating the children of government officials stationed in Norway, (ii) in November or December of 1967, Mr. Ford wrote a letter to the principal of a California high school seeking employment for the fall of 1968 and (iii) in September, 1968 Mr. Ford returned to California to teach at San Gabriel High School. In ruling for Mr. Ford, the Tax Court cited *Furner* with approval and indicated that "we will follow the reversal". In the instant case, as in the *Furner* case, the taxpayer attended school **for one year** taking courses which the court believed were directly related to improving his skills as a teacher. Since Mr. Ford's situation was not substantively different from Ms. Furner's, the court found that Mr. Ford was engaged in the trade or business of being a teacher throughout 1967 and, therefore, his expenses were deductible because they were incurred in carrying on a trade or business. Nevertheless, the nagging question of whether a suspension of active participation in the trade or business for more than the one year interval approved by the I.R.S. in Rev. Rul. 68-591 still loomed. After all, a taxpayer pursuing the M.B.A. degree makes a two year commitment to the process. **(5)** That the one year interval referred to in the ruling was nothing more than a guideline, as opposed to an absolute ceiling beyond which a taxpayer could not venture without forfeiting the ability to secure a tax deduction, was proven, beyond a reasonable doubt, by the Tax Court's decision in *Sherman v. Commissioner*, T.C. Memo. 1977-301.

## Temporary suspension vs. interruption

The result in *Sherman* seems to be largely predicated on the decision rendered by the Tax Court in a case entitled *Haft v. Commissioner*, 40 T.C. 2 (1963). There, during the period January 1, 1932 through December 31, 1956, the taxpayer (H) was employed as a salesman by C Corporation, a manufacturer of costume jewelry. H's customers were, largely, department stores and specialty stores located in the South. On January 1, 1957, H was hired as a salesman and sales manager by K Corporation. While employed by K Corporation, H continued to deal with most of the same customers that he had dealt with on behalf of C Corporation. H terminated his employment with K Corporation in September, 1957. Throughout 1958, H sought employment as a sales manager by canvassing companies throughout the U.S. which were engaged in the sale of costume jewelry. His efforts, however, did not meet with success. Finally, in 1962, H founded a company to engage in the manufacture and sale of costume jewelry. While H was employed by both C Corporation and K Corporation he entertained both buyers and merchandise managers of the stores with which he did business and H continued this practice during the year 1958, a year in which he was not gainfully employed. At issue was whether those entertainment expenses, incurred in 1958, were deductible by

H. The answer turned on whether H was, during the period the expenses were incurred, carrying on a trade or business. The Service contended that the expenses were not deductible but the Tax Court disagreed. It found that H did not cease to be in the costume jewelry business in 1957 and 1958 merely because, **temporarily**, he had no merchandise to sell. That period was, the court observed, a "period of transition" in which H actively sought another connection that would enable him to serve the same customers with whom he had previously dealt. The court concluded that "...Respondent's position that petitioner was not carrying on a trade or business gives an unduly narrow interpretation to the statute...his failure to make sales in 1958 is not controlling..." In fact, the court ruled, one's trade or business **does not cease** during a "reasonable period of transition" and, here, petitioner was actively seeking a "suitable connection" commensurate with his standing in the costume jewelry field. In this case, the court concluded, the period of transition was an eminently reasonable one. Thus, the *Haft* case stands for the proposition that a taxpayer can be seen as carrying on the trade or business in which she has previously established herself during a period of transition in which she is not engaged in "remunerative activity".

The Tax Court's decision in *Sherman* is, by far, the most helpful with respect to the M.B.A. candidate's quest to secure a tax deduction for his or her educational outlays. To fall within the ambit of *Sherman* it is essential that the student has established himself in a trade or business prior to the time he or she matriculates. In this instance, assuming one's facts are similar to those the court was called upon to analyze in *Sherman*, the clear implication of the decision is that the student, during the period in which she is a full-time student, is, concurrently, carrying on, within the meaning of Sec. 162(a), a trade or business. In *Sherman*, the taxpayer (S) graduated from Tufts University in 1965. After a stint in the Army, on July 25, 1969, he secured employment with the Army and Air Force Exchange Service as Chief, Plans and Programs Office, in Vietnam. Once his tenure with the Army and Air Force Exchange Service was completed, S enrolled at Harvard Business School. While at Harvard, S, who did not receive any salary during his time as a student, applied for re-employment with the Exchange Service but, due to budgetary restraints, his application was denied. On August 15, 1973, shortly after graduating from Harvard Business School, S accepted employment with R Corporation as Director of Planning and Research. The sole question before the court was whether S was carrying on a trade or business at the time he incurred the education expenses. The I.R.S. advanced three separate arguments any or all of which would, if accepted by the court, have led to the denial of a tax deduction for S's education expenses. However, the court rejected each of them.

Thus, the I.R.S.'s first contention was that S had not proved that he had established himself in a trade or business prior to attending Harvard Business School. The court rejected this assertion. It noted that, for the two years prior to matriculation, S was employed by the Army and Air Force Exchange Service as Chief, Plans and Programs Office, Vietnam. We conclude, the court said, that *this was a sufficient period of time for petitioner to have established himself in the business of being an employee*. Since virtually every M.B.A. program requires that its students have at least two years of work experience prior to enrollment, the *Sherman* court's certification of that length of time as meaningful should enable an M.B.A. candidate to reach the conclusion that, prior to enrollment, he has firmly established himself in the trade or business of being an employee.

The I.R.S.'s second contention, also summarily rejected, is that S had not proved that he was carrying on a trade or business at the time the expenses were incurred. This, of course, was the I.R.S.'s principal argument and the one on which it continues to rely in denying an M.B.A. candidate's entitlement to a tax deduction. The court, in rejecting the I.R.S.'s assertion, concluded that a taxpayer who **temporarily ceases active participation in a trade or business during a "transition period" between leaving one position and obtaining another position may be carrying on a trade or business during the transition period**. By contrast, where a taxpayer leaves his trade or business **for a prolonged period of study** with no apparent connection with his former job or any clear indication of

an intention to actively carry on the same trade or business upon completion of his studies, the taxpayer is not carrying on his trade or business while attending school. **(6)** Here, the court found, S was carrying on his trade or business while at Harvard Business School. This conclusion was based primarily on the following facts--

--S sought, but was refused, a leave of absence from his former employer,  
--the M.B.A. degree would not equip him for a different career, and,  
--S was engaged in "business administration" before he attended Harvard and stayed in that same "field" after he graduated.

In short, S's temporary cessation of active participation in the business of being a "managerial employee" **did not prevent him from carrying on a trade or business while at Harvard Business School**. What about the I.R.S.'s third contention, the one that was based upon the principles the I.R.S. had articulated in Rev. Rul. 68-591? Its third contention was that S's suspension from his established trade or business (of being a managerial employee) was not **temporary and definite**--only a suspension of one year or less can fall within that prescription. The court summarily rejected the notion of a "one year rule". Instead, it concluded that a "facts and circumstances test" is appropriate for determining whether a hiatus is temporary or indefinite and, here, S's two-year suspension of active participation (in the field of management) was both temporary as well as definite. Thus, based on the court's cogent reasoning in the *Sherman* case, it is difficult to envision a situation where, in the case of a "typical" M.B.A. candidate, the Service could successfully argue that the candidate is not, at the time his or her education expenses are incurred, carrying on a trade or business. In most cases, the candidate will, as Mr. Sherman did, have established himself, prior to matriculation, in a trade or business and will return to that field of endeavor upon graduation. In these instances, the *Sherman* case stands clearly for the proposition that the taxpayer is, while attending school, carrying on, because the hiatus is both temporary and definite, a trade or business. Accordingly, with that issue out of the way, the student, in order to secure a deduction, need only demonstrate that the education does not run afoul of Reg. Sec. 1.162-5(b)(2) and (3), a relatively simple task. Accordingly, it seems that, as a matter of settled law, an M.B.A. candidate's education expenses ought to be deductible: They seem to fall within the intent of the statute in their capacity as ordinary and necessary expenses paid or incurred **in carrying on a trade or business** during the taxable year.

**(1)** See in this regard *Canter v. United States*, 354 F.2d 352 (Ct. Cl. 1966); "...Before a person can qualify for a deduction he must either (i) be engaged in remunerative activity or (ii) have a direct connection, such as a leave of absence, with a position..." Here, by 1960, the ties between the petitioner and her former job had been severed. By 1960, in light of the fact that the taxpayer had resigned her position and was not operating under a temporary leave of absence, petitioner's status was, simply, that of a former employee who had transmogrified into a full-time student.

**(2)** The court debunked the notion that a leave of absence was critical to the finding that a student was, during the period of study, carrying on a trade or business. The court observed that leave status has "little meaning" as a criterion of whether or not a teacher's graduate study is a normal incident of carrying on a trade or business. Accordingly, the court concluded, the Tax Court's finding, "based as it was on the fact that petitioner was not on leave, is clearly erroneous".

**(3)** See, for example, LTR 9112003, December 18, 1990; in September, 1986, the taxpayer (X) became employed as an "associate attorney" at a law firm. In June, 1988, X accepted employment as an associate attorney with another law firm. In the spring of 1990, X was accepted for admission to Y (a law school) as a full-time candidate for a master's degree in tax law. In June, 1990, X resigned his position and began full-time studies at Y. Upon graduation from Y, X intends to resume the full-time practice of law. The ruling concludes that X's education expenses are deductible. Prior to undertaking graduate study, 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 and X will make "reasonable efforts" to resume the practice of law after completing his studies. On this basis, given the brevity of the suspension (it will last for less than one year), the I.R.S. concluded that the expenses were deductible because, in

addition to the temporary nature of X's suspension of active participation in his established trade or business, X's studies improve upon skills required in the practice of law (rather than qualify him for a new trade or business) and were "supplemental" to the minimum educational requirements of the legal profession.

(4) See Rev. Rul. 77-32, 1977-1 C.B. 38; the taxpayer (T) who had been engaged in the practice of medicine stopped practicing in large part because of recent increases in premium rates for malpractice insurance. While the practice is suspended, T intends to attend educational seminars, medical meetings, and conferences in order to "maintain knowledge and expertise". The expenses at issue, the ruling concludes, will not be deductible. T has ceased to practice medicine. The expenses that T will incur to attend educational sessions will be incurred only "in preparation" for a return to medical practice at some indefinite future date and are not related to an **existing business**. Thus, a suspension of activities which is indefinite, rather than temporary and definite, will result in a finding that the taxpayer has abandoned the trade or business in which he or she was previously engaged with the result that expenses incurred during the period of inactivity are not incurred while carrying on a trade or business.

(5) See LTR 8714064, January 8, 1986; Taxpayer (T) resigned his position with X Corporation (X) as a Manufacturing Sales Representative to pursue an M.B.A. T was unable to garner a leave of absence from X. During the summer between his first and second years of study, T worked for Z Corporation (Z) as a Marketing Assistant and, upon graduation, T started working for Y Corporation (Y) as a Marketing Representative. The ruling concludes that T's education expenses are not deductible. This conclusion was based on the following facts (i) there is no indication that X either required or advised T to obtain an M.B.A. in order to maintain or improve the skills required by T's position as a Manufacturing Sales Representative, (ii) there is no indication that T decided to leave his position (with X) with the expectation to resume his employment with X at a definite time in the future and (iii) the summer job with Z and T's present job (with Y) are not related except to the extent that "they involve duties related to marketing". Accordingly, the I.R.S. viewed T's period of study as an *interruption* of his trade or business rather than a *temporary suspension* of such trade or business and, accordingly, T could not, during the period of study, be considered to have been carrying on a trade or business.

(6) See, for example, *Cornish v. Commissioner*, T.C. Memo. 1970-51; the taxpayer (C) resigned his position with Boeing Corp. in June, 1963. In September, 1963, C received a B.S. degree from the University of Washington (UW). In August, 1964, C received a B.A. degree, awarded by UW, in mathematics. In September, 1964 C commenced studies towards a Master's degree in mathematics but, in March, 1965, C withdrew from UW without receiving the degree. While C was enrolled at UW, he was not employed. Between March, 1965 and July, 1966, C sought employment but no offers were forthcoming. The I.R.S.'s position was that C's education expenses were not deductible because C was not engaged in any trade or business during the years in which the expenses were incurred. The court found for the I.R.S. We are not satisfied, the court said, that C was merely engaging in a temporary effort to improve his skills. We think, the court went on to say, that C was simply a student indefinitely pursuing his "educational aspirations" and, therefore, the rationale of the *Haft* case and the *Furner* decision does not apply. The fact that C had withdrawn from graduate school in March, 1965 and sought employment in 1965 and 1966 (albeit unsuccessfully) did not sway the court's judgment. Although, the court said, "such activity" (seeking employment) tends to indicate that one's educational interlude may well have been temporary, in the instant case we view such activity more as an aberration in C's educational pursuits than as proof of a trade or business.

**By Robert Willens**

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