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"DEDUCTIBILITY OF EDUCATIONAL EXPENSES"
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To determine whether an education expense is deductible, taxpayers must examine a series of tests. The first test determines whether the education qualifies under Section 162 as a trade or business expense. To pass this test, the taxpayer must be engaged in a trade or business and the education must have a direct and proximate relationship to the individual’s skills required in his or her profession. If the taxpayer does not satisfy both criteria, then the education is considered personal in nature and is not deductible. If the individual satisfies both criteria, then another set of tests are analyzed.

The second test is often referred to as the disqualifying test. Under this test, if the education is required to meet the minimum educational requirements or if it is part of a program of study that qualifies the taxpayer for a new trade or business, then the education expense is never deductible.

Educational expenses that survive the disqualifying test are then analyzed using the third and final test often referred to as the qualifying test. The two criteria of the qualifying test allow an expenditure to be deductible provided the education maintains or improves the skills required in the taxpayer’s business or is required to maintain the individual’s current employment status.
One reason many taxpayers have trouble understanding and interpreting the current income tax laws is because numerous regulations are written in general, broad nonspecific language. The deduction for educational expenses is one of these areas. An individual who is an employee may have educational expenditures that qualify as a 2% miscellaneous itemized deduction on Schedule A via Form 2106. Self-employed taxpayers can deduct qualified educational expenses on Schedule C as a trade or business expense.

To determine whether an education expense is deductible, taxpayers must examine a series of tests. The first test determines whether the education qualifies under Section 162 as a trade or business expense. To pass this test, the taxpayer must be engaged in a trade or business and the education must have a direct and proximate relationship to the individual's skills required in his or her profession. If the taxpayer does not satisfy both criteria, then the education is considered personal in nature and is not deductible. If the individual satisfies both criteria, then another set of tests are analyzed.

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allow an expenditure to be deductible provided the education maintains or improves the skills required in the taxpayer’s business or is required to maintain the individual’s current employment status.

In essence, the taxpayer must first establish that the education expense qualifies as a trade or business expense under Sec. 162; second, avoid both criteria of the disqualifying test; and third, establish that the education satisfies one of the criteria of the qualifying test. Only when all three tests are satisfied, is the education expense deductible. Thus, even when the expenditure meets the requirements under Section 162 and also one of the qualifying test criteria, if the education falls under one of the disqualifying criteria, it will be ruled nondeductible since the expenditure must avoid both criteria under the disqualifying test.

The remainder of the paper contains a detailed analysis of these three tests, giving special attention to IRS and judicial interpretations. Additionally, a hypothetical case is presented to demonstrate application of the tests and how to report the deduction on the tax return.

**Section 162 Trade or Business Expense**

Before education expenses can be deducted, they must first meet the requirements of a Section 162 trade or business expense.
The regulations under Sec. 162 require that the taxpayer meet the following test, otherwise the expenditure is not deductible:

(1) The taxpayer must be engaged in carrying on a trade or business during the period the courses are taken, and

(2) The course of study must have a direct and proximate relationship to the taxpayer's employment.¹

Engaged in a Trade or Business

The first criteria requires the taxpayer to be engaged in a trade or business, either as an employee or self-employed. While this criteria may appear to be straightforward, it has caused much debate between the courts and the IRS. The controversy surrounds instances where the taxpayer ceases working, becomes a full-time student, and then returns to work. The IRS's original position is stated in Revenue Ruling 60-97:

A taxpayer will not be considered to have ceased to engage his employment or other business during an off-duty season, when he is on vacation, or when he is on temporary leave of absence.²

Thus, the only time full-time students qualify for a deduction is when they are on a temporary leave of absence. Consequently, individuals who quit their job, enroll as a full-time students, and then returned to a similar job, cannot claim a

¹ Reg. Sec. 1.162-5(e)(2).
deduction because according to the IRS, they had ceased to be engaged in a trade or business.

The IRS's position was first challenged in the landmark case Furner. The taxpayer, a teacher at a school whose policy was not to grant leaves of absence, resigned her position and enrolled in graduate courses for one academic year. Upon graduation, she accepted a teaching position at a different school. The Tax Court agreed with the IRS that since the taxpayer had resigned from her position and was not working in her profession at the time she incurred the education expenditure, she was not engaged in a trade or business. However, the Seventh Circuit overruled the Tax Court's decision and allowed the taxpayer to deduct the graduate educational expenses. The court listed the following reasons for justifying the deduction:

(1) Teachers frequently take graduate courses in order to update and improve their knowledge and skills.

(2) The courses were not offered at night or during the summer.

(3) Even though she did not have a leave of absence, the taxpayer planned to return to teaching after completing her graduate education.

In response to the appellate court's decision in Furner, the IRS softened its position and issued Revenue Ruling 68-591, which now allows taxpayers to claim a deduction if they "temporarily ceased" to be engaged in their trade or business. Taxpayers who were full-time students no longer had to obtain leaves of

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3Furner, 393 F2d 292 (7th cir. 1968).
absence to be eligible for a deduction. In its ruling, the IRS defined "temporarily ceased" as a period of not more than one year. Thus, an individual was allowed to stop working for up to one year and still be considered actively engaged in a trade or business. It appears the IRS has "backed down"; however, many full-time educational programs such as a M.S. or an MBA often take up to two years to complete. The IRS's post-Furner ruling does not allow deductions for taxpayers in such programs, since the IRS imposes a one year time limit.

An additional consideration is that the IRS will not allow a deduction in cases where taxpayers subjectively intend to resume their trade or business at an "indefinite" future date. In such instances, taxpayers must find a job or demonstrate that they are actively seeking employment.

The IRS's arbitrary one-year limitation was challenged in Sherman, where the taxpayer left a management position for a two-year MBA program at Harvard University. After completing the program, the taxpayer obtained a management position with a different employer. The IRS denied the deduction since the absence from employment was longer than one year as specified in Revenue Ruling 68-591. However, the Tax Court allowed the deduction asserting that there is no "magic" one year time limit as endorsed by the IRS. The court ruled that "we find nothing in Section 162 justifying us in following an arbitrary one-year limit as endorsed by the IRS." The court concluded that instead

5Sherman, TC Memo 1977-301.
of using a mechanical one year limit test, an arbitrary evaluation of the facts and circumstances is appropriate to determine if an absence is deemed to be temporary or permanent. The court allowed Sherman the deduction for the following reasons:

(1) he was established in a trade of business before attending Harvard,

(2) his period of study was temporary and for a definite time period, and

(3) upon completion of his degree, he returned to the same field of employment.\(^6\)

The Tax Court also disagreed with the IRS in Picknally,\(^7\) where the taxpayer was employed as an educator for ten years before resigning to return to school for a graduate degree. The taxpayer was a full-time graduate student for three years and after graduation did not return to his previous position. Except for a one-month position as a temporary lecturer at the University of Maine and some part-time instruction in the Air Force reserve, the taxpayer virtually remained unemployed. The IRS argued that Picknally was not engaged in a trade or business at the time the expenses were incurred, since the educational period extended beyond the one-year time limit specified in Revenue Ruling 68-591. The Tax Court disagreed with using an artificial time limit as a basis in deciding whether the taxpayer was temporarily employed at the time of the expenditure. Instead,


\(^7\)Picknally, TC Memo 1977-321.
the court looked at the facts and circumstances of the case and concluded that the expenses were deductible because:

(1) of Picknally's prior employment record,

(2) the period of study was of a definite duration, and

(3) even though Picknally did not directly return to a full-time position as an educator, he displayed intent to do so and he demonstrated an active search for a position.8

These two Tax Court decisions are important because they establish precedence for deducting education expenses when a taxpayer ceases employment for more than one year for educational purposes. However, the IRS does not agree with the Tax Court's decisions in Sherman, Picknally, or similar cases.9 Therefore, the IRS still may challenge taxpayers who cease employment for longer than one year. A conservative rule to follow for an individual who quits working and whose educational period extends beyond one year, is to make sure that the following three criteria are satisfied:

(1) he or she is firmly established in a trade or business prior to entering the educational program,

(2) the program is for a temporary and definite time period (conservatively not to exceed three years), and

(3) the taxpayer returns to the trade or business or demonstrates an active attempt to return to the trade or business (interviews, workshops, etc).

8Ibid.

9See IRS Letter Rulings 8538068 (6/26/85) and 8714064 (1/8/87).
These three criteria should be adhered to, since on some occasions the Tax Court has ruled in favor of the IRS. For example, in Schneider,\textsuperscript{10} the taxpayer was denied a deduction when the Tax Court ruled that the expenses were incurred for the preparation for the resumption of employment at some "indefinite" future time. The taxpayer did not return to work and was not able to prove that he actively sought employment. Failure to such has resulted in the education being deemed to be related to some indefinite future employment and thus ruled nondeductible.

Another area of controversy and uncertainty involves how long must a taxpayer be employed to be considered engaged in a trade or business? Is it one day, one year, two years? There is no absolute answer to this question since no authoritative body has stated a specific time period. If one looks at the historical court record, a good rule of thumb to use would be at least one year of full-time employment. Individuals with less than one year of experience will have a hard time convincing the IRS or the courts that they are entitled to a deduction.

For example, in Link,\textsuperscript{11} the taxpayer completed a four year undergraduate degree and then took a position as a summer intern. At the same time, the taxpayer applied to graduate school for the upcoming fall semester. After completing the internship in August, the taxpayer immediately began graduate school earned an

\textsuperscript{10} Schneider, 71 TC 568 (1977).

\textsuperscript{11} Link, 90 TC 460 (1988).
MBA degree two years later. Link deducted his MBA expenses assuming his summer internship qualified him as being actively engaged in a trade of business.

The Tax Court, however, concluded Link was not engaged in a trade or business because:

1. his internship resembles a step in his educational career, rather than a permanent position where he was engaged in a trade or business,
2. he had applied to and been accepted into the MBA program prior to his employment as an intern, and
3. when his post high school activities are examined as a continuum, he was employed for only three months out of a total of six years.\(^\text{12}\)

As in Sherman, the Tax Court does not want to establish artificial time requirements as a standard to judge cases. Instead it judges each case based on its facts and circumstances. To be safe, it is suggested that the taxpayer not attempt to claim an educational deduction if he or she has been working for less than one year and then ceases employment to pursue education as a full-time student.

Proximate and Direct Relationship

To qualify as a trade or business expense under Section 162, the second requirement is that the education must have a direct and proximate relationship to the taxpayer’s employment. The Tax

Court first defined this criteria in Cohn. In this case, the taxpayer was a physical education teacher who took handball and racquetball lessons to improve his teaching skills. The Tax Court allowed the deduction stating that:

A precise correlation is not necessary and the education expense need not be for training which is identical to [the taxpayer's] prior training so long as the education enhances [the taxpayer's] existing skills.

Therefore, under this rule, any education which improves one's skills required in an existing trade or business may be qualify the taxpayer for a deduction. For example, in Beatty, an engineer who had administrative and managerial duties was allowed to deduct costs of an MBA degree. Besides meeting the other tests, he established the education was directly related to his managerial duties as an engineer.

The Tax Court has also decided that the education does not necessarily have to be connected with a traditional formal educational program. In McCulloch, the taxpayer was an elementary school teacher who took a leave of absence. She traveled to Ireland to conduct research on improving teaching skills for elementary education. The taxpayer did not attend any classes but instead conducted independent library and field research.

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13Cohn, TC Memo 1985-480.
14Ibid.
15Beatty, TC Memo 1990-438.
16McCulloch, TC Memo 1988-84.
She was able to demonstrate that her research produced a professional benefit to her teaching skills. Thus, the Tax Court found that the independent research project had a direct and proximate relationship to her skills as a teacher. Since a direct relationship had been established, the fact that her education qualified under the other tests, coupled with the fact that the trip was primarily business, the Tax Court allowed the deduction.

Though it appears that the Tax Court is fairly liberal in applying the direct and proximate relationship test, taxpayers should be careful to make sure they can demonstrate a direct relationship. Since the burden of proof is on the taxpayer, failure to do so has resulted in education expenses being declared nondeductible. For example, Duffey, a commercial pilot, could not deduct costs of maintaining an acrobatic airplane as an educational expense. The taxpayer failed to establish a direct and proximate relationship between the skills needed to fly an acrobatic airplane and the skills needed to fly a commercial airplane.

Lewis, a power company dispatcher who took various courses at a local community college, was denied a deduction because the court could not find any direct relationship between the courses he took and his duties as a dispatcher.

To be safe taxpayers should be able to demonstrate a direct relationship between the education and the skills required in

\[17\text{Duffey, TC Memo 1977-143.}\]

[18\text{Lewis, TC Memo 1981-49.}\]
their profession. For example, a manager in an insurance firm probably would have an easy time demonstrating a relationship between his skills as a manager and any skills acquired in pursuit of an MBA degree. However, that same manager probably would have extreme difficulty in establishing a relationship if the courses taken were either in ancient history or astronomy.

In conclusion, the first step in determining whether a deduction is allowed is to determine whether the educational expenditures will be considered a Section 162 trade or business expense. The two key criteria under Section 162 are whether (1) the taxpayer is actively engaged in a trade or business and (2) the education bears a direct relationship to skills required in the individual’s trade or business. A conservative rule to follow is that the taxpayer should have a least one year’s experience in the trade or business before ceasing employment to pursue an education as a full-time student. Ideally, the leave of absence should not be longer than three years because in many cases the Tax Court has ruled such a time period as "indefinite" and disallowed the deduction. Also, the taxpayer should make sure that the education is connected to the skills in his or her profession.

**Disqualifying Test**

After the taxpayer has established that the educational expenditures qualify under Section 162 as a trade or business
expense, the next step is the disqualifying test. According to
the regulations, if the educational expenses are classified under
either of the following two criteria, then the education will be
deemed to be a personal expenditure and will never be deductible.
The two disqualifying criteria are:

(1) the education is required to meet the
minimum educational requirements in the
taxpayer's trade or business, and

(2) the education is part of a program of
study that will qualify the taxpayer
in a new trade or business.  

It is important to note that only one (not both) of the
above criteria needs to apply for the expenses to be nondeduct-
able. For the expense to be deductible, the education must not
fall under either of these two criteria.

Minimum Educational Requirements

The first disqualifying criteria states that if the educa-
tion is needed to meet the minimum requirements of employment
then the expenditure is nondeductible. The minimum educational
requirements are determined by:

(1) Applicable laws and regulations,

(2) Standards of the taxpayers profession, and

(3) Requirements of the employer.  

Reg. Secs. 1.162-5(b)(2) and (3).

To become a high school teacher, to fly a plane, or become a police officer, there are regulations and qualifications that an individual must meet. Any educational expenditures the taxpayer incurs to meet these requirements would be nondeductible since the expense is for the minimum educational requirements of the profession. Therefore, the expense of a college degree for a teacher, the cost of flying lessons to become a pilot, or the cost of attending a police academy are not deductible since the education is required by applicable laws and regulations to be member of the particular profession.

In the business world, employers often require their employees to obtain a college education. However, if a position requires a bachelor's degree, then the costs of such a degree would be nondeductible since a degree is deemed to be the minimum educational requirement for the position. In Murphy, college expenses of an insurance company trainee were declared nondeductible since a college degree was a requirement of employment.

Even if the taxpayer is employed, it does not establish the fact that the minimum educational requirements have been met. In Davidson, the taxpayer attended a university to earn an undergraduate degree. While completing the degree, the taxpayer was employed by a corporation as an "Accountant I." The Tax Court ruled that the expenses were nondeductible since it was determined that "the employer required a college degree or prior

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21Murphy, TC Memo 1963-162.

22Davidson, TC Memo 1982-119.
experience in order to be employed as an Accountant I."²³ Davidson possessed neither. Therefore, the Tax Court held that even though the taxpayer was employed, the college degree was necessary to meet the minimum requirements of employment. Thus the expenditure was ruled nondeductible.

Qualify For A New Trade Or Business

Most educational expenses are ruled nondeductible because they qualify the taxpayer for a new trade or business. The Regulations disallow educational expenditures that are part of a program of study that qualify the taxpayer in a new trade of business. Before continuing the terms "a program of study" and "a new trade or business" should be defined. A "program of study" is one which leads to a formal degree, certification, or provides the taxpayer with skills that would be considered a new trade or business. Examples include most college undergraduate programs, law school, medical school, and a C.P.A. license.

²³Taxation for Accountants, February 1986, Page 89.
The term "new trade or business" was defined in Schwernn.\textsuperscript{24} where the Tax Court stated that:

...if the education provides [the individual] with the ability to perform significantly different tasks and activities, than [the individual] could perform prior to education, then it [the individual] will be considered to have qualified for a new trade or business.

In determining whether the individual qualifies for a new trade or business, the types of activities and duties the taxpayer performs are compared with any significant new capabilities gained through the education. If any new capabilities are discovered, then the deduction is disallowed.

In Brandt,\textsuperscript{25} an air force pilot was disallowed the expenses of taking a course to prepare for the FAA flight engineer's examination. The test was part of a program of study which allowed the taxpayer to enter the new trade or business of being a flight engineer.

For similar reasons, in Stroope,\textsuperscript{26} an engineer was disallowed deductions for expenses relating to real estate courses he took. The courses were part of a program that would allow the taxpayer to become a real estate salesman, thus qualify him for a new trade or business.

\textsuperscript{24}Schwernn, TC Memo 1986-16.

\textsuperscript{25}Brandt, TC Memo 1963-162.

\textsuperscript{26}Stroope, TC Memo 1975-348.
These examples seem straightforward; however, the IRS sometimes creates confusion and controversy in what it considers to be a new trade or business. For instance, the IRS views the business of being an accountant different from the business of being a C.P.A. In 1969, the IRS issued Revenue Ruling 69-292,\(^7\) which states that any educational expenses incurred for preparation of taking the C.P.A. exam are nondeductible because, in the IRS's eyes, becoming a C.P.A. is entering a new trade or business.

The Tax Court has upheld the IRS's opinion. In Cooper,\(^28\) a practicing accountant who was not a licensed C.P.A., took various accounting courses and was disallowed a deduction. The Tax Court concluded that the accounting courses contributed to Cooper qualifying to take the C.P.A. exam. The court also stated that the business of being a public accountant was different from the business of being a C.P.A., since a C.P.A. can "certify financial statements."

The intentions of the taxpayer have no bearing on whether the education qualifies the individual for a new trade or business. Even if the taxpayer has no intention of changing jobs or entering a new profession, the educational expenditures are still deemed to be nondeductible. In Hinton,\(^29\) the taxpayer was employed by the FAA as an air traffic controller. To improve his

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\(^7\)Rev. Rul. 69-292, 1969-1 CB 84.

\(^28\)Cooper, TC Memo 1979-241.

skills as a air traffic controller, Hinton enrolled in two commercial pilot courses. These courses, however were part of a program of study which could eventually allow him to become a commercial pilot, which to Hinton would be a new trade or business. Hinton had no intention of becoming a pilot, but the court found this fact to be irrelevant. The Tax Court even recognized and stated that although the taxpayer would probably not pursue the trade of becoming a pilot, his intentions did not matter. Regardless of intent, simply being enrolled in a program that could lead to a new trade or business was enough cause to disallow the deduction. In many cases, the Tax Court has concluded that the taxpayer's intentions are irrelevant in determining whether the education qualifies the individual in a new trade or business.

Though a deduction is disallowed for "a new trade or business," the taxpayer can qualify for a "new position" or "specialty" and still be allowed a deduction as long as the taxpayer is not performing "significantly different tasks." For example, a psychiatrist can deduct the costs of becoming a psychoanalyst, and a dentist is allowed to deduct expenses of becoming an orthodontist. Two areas where taxpayers have found success in overcoming the new trade or business hurdle is education associated with obtaining an M.B.A. degree and additional education taken by members of the teaching profession.

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31Rev. Rul. 74-78, 1974-3 CB 44.
Numerous taxpayers who have held managerial positions and then earned M.B.A. degrees have been allowed a deduction. The Tax Court has held that an M.B.A. education presents a broad study of management and that there are "no specialized programs which would qualify a graduate for any particular trade or business."\(^{32}\)

Another area favorable to the taxpayer is the profession of education, where the regulations give teachers special treatment. For purposes of qualifying for a new trade or business, "all teaching and related duties shall be considered the same type of general work."\(^{33}\) The following are examples of changes that do not constitute a new trade or business:

1. Elementary to secondary school teacher.
2. Teacher in one subject (such as math) to another subject (such as literature).
3. Classroom teacher to guidance counselor.
4. Classroom teacher to school administrator (such as principal).\(^{34}\)

Thus, once an individual has met the requirements of being a teacher, he or she can enter into a number of different positions and still be viewed as being in the same trade or business.

\(^{32}\)Beatty, TC Memo 1980-196.

\(^{33}\)Reg. Sec. 1.162-5(b)(3).

\(^{34}\)Ibid.
Deductions are also allowed for costs of education which would qualify a teacher to teach in another state or country.

At the collegiate level, a professor was allowed to deduct the costs of obtaining a doctorate in order to become a Junior College president.\(^{35}\) It appears, however, that the same degree of flexibility in allowing a deduction is not given in cases where an elementary or secondary school teacher earns education to become a college professor. In Bouchard,\(^ {36}\) the Tax Court stated in dictum that a move from an elementary teacher to a college professor would not constitute the same trade or business.

The IRS is the most restrictive in allowing deductions for education in the profession of law. Even if the law school courses provide clear benefits in the taxpayer's profession, they are deemed to be part of a program that will qualify the individual for a new trade or business - the profession of practicing law. Many taxpayers have challenged the IRS on this issue, but the IRS has prevailed in every case.

In Burton,\(^ {37}\) the individual was a supervisor at a hospital supply company whose duties included making decisions which could effect company liability. To improve his skills in this capacity, the taxpayer enrolled in law courses that were part of a Juris Doctor degree program at a local university. Burton stated


\(^{36}\)Bouchard, TC Memo 1977-1100.

\(^{37}\)Burton, TC Memo 1979-353.
he took the courses only to improve his skills and did not plan on completing a law degree. The Tax Court agreed that the courses probably did improve his the skills, but that fact as well as Burton's intentions were irrelevant, since the program of study could lead to the taxpayer qualifying for the new trade of practicing law. Similar conclusions were reached in O'Donnell and in Melnik.

To demonstrate how strictly the IRS applies the regulation to the profession of law, one need only examine Sharon. Sharon was an attorney who had established a law practice in New York. He accepted a position as an attorney for the IRS in California and subsequently moved there. The taxpayer thought it would be beneficial to learn California law, so he took a bar review course in preparation for the exam which he subsequently took. The district court disallowed the deduction, stating that even though Sharon was already a lawyer established in New York, he was now qualified to practice in California. The court ruled that being a lawyer in New York was a different trade or business from being a lawyer in California.

Besides courses connected with the profession of law, the IRS is very restrictive in allowing any deduction for costs associated with a bachelor's degree, since it will almost always qualify the taxpayer for a new trade or business.

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3Melnik, 521 F2d 1065 (9th Cir. 1975).
4Sharon, 591 F2d 1273 (9th Cir. 1978).
Therefore, for the education to be deductible, it must avoid both criteria of the disqualifying test. The first criteria disallows education expenditures which are needed to meet the minimum educational requirements of that trade or business as dictated by law, the profession, or the employer. Even though the taxpayer is engaged in the profession, it does not necessarily mean that he or she has met the minimum educational requirements of that position. Any expenditure incurred to meet those requirements is nondeductible. Second, the education will be disallowed if it qualifies the taxpayer for a new trade or business. In application of this criteria, the IRS is the most lenient for teachers attaining a different teaching or administrative status and for managers earning an M.B.A. The IRS is the most restrictive to taxpayers taking law courses or earning a bachelor’s degree. Furthermore, the IRS and the courts have established that the taxpayer’s intent is irrelevant in determining whether the education qualifies the individual for a new trade or business.

**Qualifying Test**

If the taxpayer’s expenditures are not disallowed due to the disqualifying test, the next step is to determine whether the education meets the criteria of the qualifying test. According
to Reg. Sec. 1.162-5(a), educational expenses are only deductible if the education:

(1) maintains or improves skills required in the taxpayer's trade or business, or

(2) is required by the taxpayer's employer or law to keep present status, salary, or job.

These are the only two criteria where educational expenses will be allowed deductible. Avoiding the disqualifying test alone does not guarantee a deduction. The taxpayer has the burden of establishing that the education satisfies one of the criteria of the qualifying test. Failure to demonstrate a connection has resulted in expenses being declared nondeductible. In Barboza, a fire-fighter took algebra and physics courses at a local college and claimed an education deduction. The expenses qualified under Section 162 as a trade or business expense and survived the criteria of the disqualifying test. However, the education was not required to maintain the taxpayer’s job and he could not demonstrate that the courses improved his skills as a fire-fighter. Therefore the court disallowed the deduction due to lack of evidence that the courses improved his skills, or were required by law or his employer.

Maintain or Improve Skills Required in Trade or Business

The first criteria of the qualifying test states that the education must maintain or improve skills that are required in

\footnote{Barboza, TC Memo 1991-379.}
the taxpayer's trade or business. The process of determining whether the education maintains or improves required skills relies heavily on the taxpayer producing evidence that such a relationship exists. Usually if the education satisfies the "direct and proximate relationship" criteria under Section 162, the education will also satisfy the "maintain or improve required skills" criteria of the qualifying test.

The best way to accomplish the task of establishing a relationship between the education and the skills is the use of expert testimony and legal precedence. Many taxpayers have used these two methods to win cases against the IRS. In Stoddard, a flight manager was required to obtain a DC-9 pilot's license as a requirement of employment. The taxpayer had the license and decided to purchase a private plane in order to improve and maintain his skills as a pilot. Stoddard deducted the maintenance and operating costs of the plane as an educational expense claiming that flying his plane improved his skills as a pilot. Expert testimony was given that flying a plane with the similar basic instruments as a DC-9 would undoubtedly improve one's skills as a pilot. Relying on this evidence, the Tax Court ruled that the cost of operating the plane, maintenance costs, depreciation, state property taxes and registration fees would all qualify as an educational expense.

\footnote{Stoddard, TC Memo 1982-720.}
In Porter, the taxpayer used both expert testimony and legal precedence as a method to establish that the education improved the individual's skills. Porter was a practicing psychiatrist who deducted costs of psychotherapy education. The taxpayer produced expert testimony which stated that studying psychotherapy does improve one's skills as a psychiatrist. Additionally, the taxpayer cited two similar cases where taxpayers were allowed to deduct costs of psychotherapy.

In instances where the taxpayer is unable show a relationship, the expense has been deemed nondeductible. For example, the following taxpayers could not establish a relationship between their education and the skills of their professions: a hockey player who took leadership courses, an engineer who took philosophy courses, and a science teacher who researched a solar eclipse.

Requirement of Law or Employer to Maintain Current Status

The second criteria of the qualifying test allows a deduction if the education is required by law or an employer to maintain a certain status, salary, or job. The required education must be expressly and precisely stated by the employer,
applicable law, or regulations. For example, many professions (C.P.A.s, lawyers, and doctors) require members to take continuing professional education requirements. Professionals attending courses or seminars to meet these requirements would qualify for a deduction, since the education is necessary to improve or maintain their present positions.

A distinction should be made between the qualifying test criteria of a taxpayer maintaining a current status and the disqualifying test criteria of meeting the minimum educational requirements. The disqualifying criteria applies to a taxpayer who has not yet met the minimum educational requirements of the trade or business, while the qualifying test criteria applies to individuals who have already met the minimum requirements but must now meet additional requirements to maintain that status. For example, licensed C.P.A.s have already met the requirements of being a C.P.A. but to retain their license, they must receive continuing professional education credit. Because such credit is necessary to maintain their status as C.P.A.s, it is deductible.

The following cases illustrate deductions under this criteria. In *Lund*, a flight engineer was allowed to deduct expenses related to training for an instruments rating proficiency qualification. The employer specifically stated that the requirement was necessary for flight engineers to return to their status as flight crew members.

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*Lund*, 46 TC 321 December 27, 896 (Acq.).
Hill was a school teacher who attended summer school in order to allow her to renew her teacher's certificate. The Tax Court allowed the deduction since the education was necessary for the taxpayer to continue her position as a teacher.

In Sumner, a welder was allowed to deduct expenses associated with a heliarc welding course which was required by his employer as a condition of continued employment. The taxpayer had already met the minimum requirements of being a welder, but new regulations required welders to be certified in heliarc welding.

In conclusion, the third step in determining the deductibility of educational expenses is to establish that they satisfy one of the criteria of the qualifying test. Only education expenses that enhance taxpayers' skills or are needed to maintain their position will be deductible.

Example of Reporting the Deduction

The following is an example which incorporates all the concepts discussed thus far:

Jack Fan is a quality control manager at XYZ corporation in Cleveland, Ohio. Jack has worked at XYZ for the past five years. In November 1991, Jack took a seven day trip to Detroit, Michigan

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4Hill, (CA -4) 50-1 USTC 9310, 181 F.2d 906.

Sumner, TC Memo 1979-513.
to attend a five day quality control conference. The conference featured seminars and workshops related to the field of quality control. The conference is not part of any educational program that would lead to any new trade of business. Additionally, Jack has met the educational requirements to be employed as a quality control manager. XYZ corporation did not reimburse Jack for any of the costs. Jack's receipts show the following expenses:

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airfare</td>
<td>$400</td>
</tr>
<tr>
<td>Hotel Accommodations</td>
<td>1300</td>
</tr>
<tr>
<td>Meals</td>
<td>300</td>
</tr>
<tr>
<td>Taxi Fares</td>
<td>25</td>
</tr>
<tr>
<td>Conference Fee</td>
<td>800</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$2825</td>
</tr>
</tbody>
</table>

In applying the tests to Jack's educational expenses, one must first determine whether Jack's expenditures qualify as a trade or business expenses under Section 162. The two criteria under Section 162 require that the taxpayer be engaged in a trade or business and that the education has a direct and proximate relationship to skills required in the taxpayer's trade or business. Jack meets these tests since being employed for the past five years constitutes being engaged in a trade or business. In addition, the conference relates to his skills as a quality control manager.

The next step is to examine whether Jack's education falls under the criteria of the disqualifying test. The two criteria are if the taxpayer is qualified for a new trade or business or is meeting the minimum educational requirements of the trade or business Jack's education survives these criteria since it was
stated that the conference is not part of a study program that will qualify Jack for a new trade of business, together with the fact that Jack has met the requirements of being a quality control manager.

After verifying that the expenses are not disallowed due to the disqualifying tests, Jack must establish that the education meets one of the criteria in the qualifying test. Although it is not stated in the example, the seminar would be deductible if it satisfies any requirements of continuing professional education credit. Even if the seminar does not meet the requirements of continuing professional education credit, Jack could probably establish that the seminar maintained or improved his skills as a quality control manager. For evidence, Jack could use expert testimony or previous cases as legal precedence, where a deduction was granted to a quality control manager or similar professional. Since we have established that Jack’s education fulfills the "maintain or improve skills" qualifying criteria, the education is deductible.

Once it has been determined that the education expense is deductible, it is necessary to examine what specific educational items comprise deductible education. The IRS defines items of educational expenses as amounts spent for tuition, books, supplies, laboratory fees, correspondence courses, research, tutoring and any formal training.\(^\text{50}\) Sometimes education requires travel. These expenses may be deductible and the taxpayer should

\(^{50}\)The CPA Journal, February 1990, Page 33-34.
use the "primarily personal" or "primarily business" rules in
determining to what extent travel expenses are deductible. Using
this information, all of Jack's items are deductible except 20
percent of the costs of his meals.

Taxpayers who are employees may be reimbursed by their
employer. Any reimbursement, even if it exceeds the deduction,
is reported as income. The deduction for employees is reported
as a 2% miscellaneous itemized deduction on Schedule A via Form
2106. There are two instances where the taxpayer may be able to
exclude amounts of the reimbursement. Exclusions exist under
Section 132 if the payment qualifies as a working condition
fringe benefit. An exclusion is also available if the reimburse-
ment qualifies as a scholarship under Section 117. The taxpayer
should consult these two Code sections to determine whether
either exclusion is available.

Self-employed taxpayers report the deduction on Schedule C.
Since Jack is an employee, he will use Form 2106 to determine the
amount of his deduction (before applying the 2% floor for miscel-
naneous itemized deductions). Jack's Form 2106 appears on the
following page. The taxi fares would be reported on line 2.
Line 3 would include costs of airfare and hotel accommodations.
The cost of the conference fee would be reported on line 4, while
meals are recorded on line 5. The columns are then totaled.
Since the example stated that Jack did not receive any reimburse-
ment from his employer, no amount will be entered on line 7.
Therefore line 8 will equal line 6. Since the IRS only allows 80
# Employee Business Expenses

**Part I: Employee Business Expenses and Reimbursements**

### STEP 1 Enter Your Expenses

<table>
<thead>
<tr>
<th>Column A</th>
<th>Column B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Other Than Meals and Entertainment</strong></td>
<td><strong>Meals and Entertainment</strong></td>
</tr>
<tr>
<td>1 Vehicle expense from line 22 or line 29</td>
<td>4 0 0 0</td>
</tr>
<tr>
<td>2 Parking fees, tolls, and local transportation, including train, bus, etc.</td>
<td>2 5 0 0</td>
</tr>
<tr>
<td>3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. <strong>Do not</strong> include meals and entertainment</td>
<td>1 7 0 0 0 0</td>
</tr>
<tr>
<td>4 Business expenses not included on lines 1 through 3. <strong>Do not</strong> include meals and entertainment</td>
<td>8 0 0 0</td>
</tr>
<tr>
<td>5 Meals and entertainment expenses (see instructions)</td>
<td>3 0 0 0 0</td>
</tr>
<tr>
<td><strong>Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5</strong></td>
<td>2 5 2 5 0 0</td>
</tr>
</tbody>
</table>

**Note:** If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.

### STEP 2 Enter Amounts Your Employer Gave You for Expenses Listed in STEP 1

| 7 | 0 0 0 |

### STEP 3 Figure Expenses To Deduct on Schedule A (Form 1040)

| 8 | 2 5 2 5 0 0 |

**Note:** If both columns of line 8 are zero, stop here. If Column A is less than zero, report the amount as income and enter -0- on line 10, Column A. See the instructions for how to report.

| 9 | 2 5 2 5 0 0 |

| 10 | 2 4 0 0 0 |

| 11 | 2 7 6 5 0 0 |

**For Paperwork Reduction Act Notice, see instructions.**

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**Social security number:** 111-11-1111

**Occupation in which expenses were incurred:** Quality Control Manager
percent of expenses for meals and entertainment to be deductible, 20 percent of these costs are subtracted to arrive at line 10. The two columns are added together to compute line 11 which will be entered on Schedule A as a miscellaneous 2% deduction. Assuming Jack is single with AGI of $30,000 and other itemized deductions consisting of $1000 in charitable contributions and $3000 of mortgage interest, Jack's itemized deduction computation appears below:

<table>
<thead>
<tr>
<th>Charitable contribution</th>
<th>$1000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage Interest</td>
<td>5000</td>
</tr>
<tr>
<td>Educational Expense</td>
<td>$2765</td>
</tr>
<tr>
<td>Less 2% of AGI($30,000 X 2%)</td>
<td>600</td>
</tr>
<tr>
<td></td>
<td>----- 2165</td>
</tr>
</tbody>
</table>

Total Itemized Deduction $8165

This example illustrates how a taxpayer reports his or her deduction on the tax Return

**Conclusion**

To be deductible, the education expense must first qualify under Section 162 as a trade or business expense. The education then must survive both pitfalls of the disqualifying test. If the education survives, then it must satisfy one of the criteria of the qualifying test to be deductible. It is important to note that even if the education satisfies the qualifying test, if it falls under one of the criteria of the disqualifying test then it
is always a nondeductible personal expenditure.