



The Education of The Taxpayer from a Business Perspective

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I. Education as a Business Expense

As we are all likely very aware, the Internal Revenue Code contains now a plethora of tax incentives regarding education of various sorts. But this week we are going to look at an old favorite, one that existed long before Congress discovered HOPE, Lifetime Learnings, and all of those other special programs and credits—the issue of taking a deduction for education related to your trade or business. In one sense it's a subject near and dear to our hearts, since all Circular 230 qualified tax professionals face some sort of continuing education obligation to stay in the profession—expenses that virtually always are valid business deductions so long as we have a valid tax related business.

But in other cases, the matter isn't quite so clear, as many of us likely remember from our first introductory income tax coursework. Dealing with the limitations of education expense in a business context has been standard fare in such courses going back as long as we have all been in practice. But it's an area that, quite honestly, we may overlook and/or delegate to a “simple checklist” system to determine the deductible status.

This week we look at a case that shows us the answer may be a bit more nuanced.

This week's case is the recent case of *Ray v. Commissioner*, TC Summary 2009-71 where a taxpayer was teaching under one type of certificate, and his education ended up qualifying him for a second type of certificate that did not have to be renewed annually. The taxpayer claimed a deduction for his educational expenses, the IRS argued that he did not qualify and, in the end, the Tax Court agreed with the taxpayer.

II. Business Educational Expenses

As we are generally aware, business expenses generally are governed by Section 162(a)'s initial provision, which provides:

(a) In general

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, ...

However, the deduction is limited by §262(a) which provides:

(a) General rule

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

As well, expenses of a capital nature are not currently deductible, by reference to §263.

The IRS, in regulations under §162, takes the position that certain educational expenses, even though useful in a taxpayer's trade or business, are more in the nature of personal expenses and/or capital expenses and therefore nondeductible. This position is one the courts have agreed with, and which will be applied in today's case.

The tests are outlined in Reg. §1.162-5, a regulation we've had with us since 1967. The regulation starts out in Reg. §1.162-5(a) with a general description of what will represent deductible educational expenses in a business context:

(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--

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

(2) 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.

A couple of interesting issues should be noted. First, despite the “rule” that many professionals seem to believe exists, the regulation makes clear that merely obtaining a degree does not, by itself, render the educational expense a nondeductible personal expense. However, the wording should be a clue that being in a degree program may still be a factor to be considered.

Second, note that we are warned right off that clearing this hurdle is not the exclusive test. After clearing this hurdle, the taxpayer must show the expense does not run afoul of Reg. §1.162-5(b)(2) or (3). So we need to turn to Reg. § 1.162-5(b) itself.

That portion of Reg. §1.162-5 starts out by defining why these two types of educational expenses, even if meeting the general requirements of Reg. §1.162-5(a), still will be held to be nondeductible:

(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.

The first of these two prohibited types of educational expenditures relates to expenditures that meet the minimum educational requirements for his employment or other trade or business. The regulation goes on:

(2) Minimum educational requirements.

(i) The first category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures 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. The minimum education necessary to qualify for a position or other trade or business must be determined from a consideration of such factors as the requirements of the employer, the applicable law and regulations, and the standards of the profession, trade, or business involved. The fact that an individual is already performing service in an employment status does not establish that he has met the minimum educational requirements for qualification in that employment. Once an individual has met the minimum educational requirements for qualification in his employment or other trade or

business (as in effect when he enters the employment or trade or business), he shall be treated as continuing to meet those requirements even though they are changed.

(ii) The minimum educational requirements for qualification of a particular individual in a position in an educational institution is the minimum level of education (in terms of aggregate college hours or degree) which under the applicable laws or regulations, in effect at the time this individual is first employed in such position, is normally required of an individual initially being employed in such a position. If there are no normal requirements as to the minimum level of education required for a position in an educational institution, then an individual in such a position shall be considered to have met the minimum educational requirements for qualification in that position when he becomes a member of the faculty of the educational institution. The determination of whether an individual is a member of the faculty of an educational institution must be made on the basis of the particular practices of the institution. However, an individual will ordinarily be considered to be a member of the faculty of an institution if (a) he has tenure or his years of service are being counted toward obtaining tenure; (b) the institution is making contributions to a retirement plan (other than Social Security or a similar program) in respect of his employment; or (c) he has a vote in faculty affairs.

The regulation then goes on to give a number of examples of applying this provision.

The second prohibited type of expenditure relates to education that qualifies a taxpayer for a new trade or business. The emphasis is not on whether a taxpayer actually intends to enter the trade or business, but rather whether the taxpayer simply qualifies to do so. As such, in theory this issue could be triggered even if the taxpayer might be aware of the new opportunities open to him/her.

(3) Qualification for new trade or business.

(i) The second category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business. 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. For this purpose, all teaching and related duties shall be considered to involve the same general type of work. The following are examples of changes in duties which do not constitute new trades or businesses:

(a) Elementary to secondary school classroom teacher.

(b) Classroom teacher in one subject (such as mathematics) to classroom teacher in another subject (such as science).

(c) Classroom teacher to guidance counselor.

(d) Classroom teacher to principal.

The test here revolves around the duties that a taxpayer would be performing in a new position, not just the existence of a new position. These nuances are what would come into play in the *Ray* case we'll look at.

III. The Teacher and the Certificates

The case started out with many more issues than finally ended up being handled at trial—and the IRS did not appear to fare well with the issues that were cleared up before trial, suggesting that the proposed assessment had a number of issues when the agent pushed it forward. The court noted that the original report had ended up denying \$800 more in charitable contributions than what the taxpayer had actually claimed on the return—again, not an indicator of a high level of “quality control” on this examination.

But nevertheless, the IRS did decide that one of the issues uncovered was worth holding fast to and taking to court—the issue of education expenses incurred by one of the taxpayers (the IRS conceded that the taxpayer's spouse did have the right to take a deduction for her education expenses).

However, Mr. Ray is our concern today. His basic situation is outlined by the Tax Court as noted below:

Mr. Ray is a teacher who received his bachelor of arts degree with a major in history during 2004. Mr. Ray was teaching under a so-called emergency credential, which in effect meant that he did not have tenure in the school system. He began teaching on February 14, 2005, under the emergency credential, which would expire in 1 year. There were educational requirements for the extension of the emergency credential, which could be extended for 1 additional year. The next level of teaching status was a so-called preliminary credential, which also was not a tenured position.

The difference in the two credentials is next examined by the Tax Court as it continues:

In all other respects Mr. Ray had the obligations, rights, and privileges of a tenured teacher. He had a voice (vote) in all faculty decisions; the school system made contributions to his retirement plan; and there were continuing education requirements to maintain his emergency credentials and his teaching position for a second year. During 2005 Mr. Ray incurred expenses for educational courses to maintain his teaching status for 2005 or 2006. Mr. Ray's courses might also have qualified him to obtain a preliminary credential which,

although not a tenured position, was a more permanent position in the school system. Once Mr. Ray obtained a preliminary credential, he had 5 years to obtain a permanent teaching certificate. Mr. Ray's courses did not lead to a master's or other advanced educational degree. There were also educational requirements, on a 5-year cycle, for all teachers, irrespective of whether their teaching position was permanent.

Given this background, the question becomes whether Mr. Ray had qualified for a new trade or business.

IV. Applying the Law to Mr. Ray

The Tax Court had dealt with the matter before in an earlier case, *Orr v. Commissioner*, T.C. Memo. 1992-566, but the issue was now back because the IRS believed changes in California law would change the result.

Respondent agrees that Ms. Johnson is entitled to claim her educational expenses, so there is no need to address her circumstances. With respect to Mr. Ray, however, respondent contends that his educational expenditures were to meet the minimum requirements for a job and, therefore, are not deductible. Mr. Ray contends, however, that he had met the requirements to teach on an emergency credential. Petitioner did not know at the end of 2005 whether he had qualified for a preliminary credential. Accordingly, at the end of 2005 Mr. Ray was merely able to show that he was attempting to seek a preliminary credential and that he was attempting not to lose his teaching status under the emergency credential.

The court summarizes the earlier holding, noting that the taxpayer had met the minimum requirements already:

In a substantially similar case involving a California teacher with emergency credentials, we held that the taxpayer's educational expenses were deductible. *Orr v. Commissioner*, T.C. Memo. 1992-566. In that case we held that the taxpayer:

who has already obtained a baccalaureate degree, has met the minimum educational requirements for qualification as an elementary or secondary school teacher in the State of California. Therefore, the educational costs incurred to meet additional requirements of the employer are deductible.

That holding was in view of a thorough analysis of Federal tax statutes and regulations and California law governing teaching positions.

The IRS argues, though, that a change in California law now means that the temporary credential truly qualifies the taxpayer for a new trade or business. The court summarizes:

Sec. 1.162-5(b)(2)(ii), Income Tax Regs., states that

The minimum educational requirements for qualification of a particular individual in a position in an educational institution is the minimum level of education (in terms of aggregate college hours or degree) which under the applicable laws or regulations * * * is normally required of an individual initially being employed in such a position. * * *

Respondent argues that a change in California law since *Orr v. Commissioner*, supra, was decided would change the application of the above-quoted regulation in this case. The change referenced by respondent is that at the time of *Orr*, to acquire a teaching credential California law required a bachelor's degree and completion of 5 years of total study within 5 years from the date of issuance of an emergency credential. See Cal. Educ. Code sec. 44259 (West 1978). Current California law does not allow a 5-year period to complete the postbachelor professional education courses. See Cal. Educ. Code sec. 44259(a) (West 1990). Instead the current law provides for a staging process, beginning with an emergency credential for 1 and up to 2 years, and then a preliminary credential leading to a permanent credential. With respect to preliminary and permanent credentials, California requires continuing education in order to remain certified to teach in either category.

The Court, however, was not convinced:

The difference cited by respondent is without a distinction. It merely changes the form (reduces the 5-year period to a 2-year period) and not the substance or effect of the prior California requirements. Under either the 1978 or the 1990 version of the California statute, a bachelor's degree is the threshold for a teaching credential. See sec. 1.162-5(b)(2)(iii), Example (1), Income Tax Regs. Mr. Ray had a teaching credential and he had therefore met the minimum educational requirements for qualification so that his educational expenditures were for the purpose of maintaining and improving his skills and not for qualification. There is no actual or rational difference between a teacher on an emergency or regular credential being required to take educational courses in order to be retained, even though the interval may be different. Accordingly, we hold that Mr. Ray and Ms. Johnson are entitled to deduct \$24,883 in educational expenses and related expenses for 2005