The Deductibility of MBA Degree Expenses Under Treasury Regulation 1.162-5: Are You One of the Lucky Few Who Qualify?

Jill Kutzbach Sanchez

I. INTRODUCTION ................................................................. 660

II. BACKGROUND ..................................................................... 661

A. The Struggle with the Deductibility of Educational Expenses Prior to Regulation 1.162-5 .......................................................... 662

1. A Change in History: The Hill Case in the Tax Court......................... 663

2. A Change in History: The Hill Case on Appeal .................................. 663


1. The Objective Non-Deductibility of Educational Expenses in Fields of Study with Education and Examination Prerequisites .......... 665

2. The “Objective” Approach to Educational Expense Deductibility in Fields of Study with No Formal Education or Examination Prerequisites ................................................. 666

III. ANALYSIS: THE SHORTCOMINGS OF THE “OBJECTIVE” STANDARD OF DEDUCTIBILITY UNDER REGULATION 1.162-5 WHEN APPLIED TO MBA DEGREE EXPENSES .................................................................. 669

A. Losing Objectivity Through the Use of “Commonsense” ...................... 669

B. Qualifying for a New Trade or Business with an MBA Degree ............. 670

1. Comparing Education to Work Clothing ........................................... 671

2. MBA Degree Expenses: Not What the Code or Regulations Contemplated .. 673

C. “Commonsense” Produces Unfair Results .......................................... 674

D. “Commonsense” Leaves Room for Abuse ........................................ 675

IV. RECOMMENDATION: DENY EDUCATIONAL EXPENSE DEDUCTIONS FOR COSTS INCURRED TO OBTAIN AN MBA DEGREE IN ALL CIRCUMSTANCES .................................................... 675

A. Getting Back to an Objective Approach .......................................... 676

B. Promoting Equal Treatment Among Taxpayers .................................. 677

C. Eliminating Opportunities for Abuse of Tax System .......................... 677
I. INTRODUCTION

Individual taxpayers incurring expenses for education face a significant challenge when determining whether those expenses are deductible as trade or business expenses for income tax purposes. The Internal Revenue Code ("Code") allows taxpayers to deduct "the cost of earning a living" by taxing their "net profits [from a trade or business] rather than . . . gross receipts or gross income."\(^1\) Therefore, employees can either deduct their employment expenses from gross income if the employer reimburses the taxpayer for those expenses or as a miscellaneous itemized deduction if the employer provides no reimbursement.\(^2\) With respect to educational expenses, the threshold requirement for deductibility is that the expenses are incurred while "carrying on a[ ] trade or business."\(^3\) After meeting this threshold requirement, Treasury Regulation 1.162-5 imposes four additional tests that the education must pass to qualify for deductibility.\(^4\) Under these four tests, the education must not (1) be the "minimum educational requirements" for the taxpayer’s position or (2) "qualify[] [the taxpayer] in a new trade or business," and the education must either (3) "maintain or improve [the taxpayer’s] skills" or (4) be an "express requirement of the [taxpayer’s] employer" for retention of the position.\(^5\)

The courts employ a number of different analyses and standards when determining whether educational expenses meet these four tests.\(^6\) Thus, two different taxpayers incurring expenses for the exact same education could be subject to a different analysis and standard, depending on their unique circumstances, which could ultimately lead to contradictory outcomes. This inconsistency leaves a taxpayer hoping to get a deduction for educational expenses largely at the mercy of the judge.

One specific type of education, the Masters of Business Administration ("MBA") degree, results in taxpayers falling victim to this disparity when determining the deductibility of expenses incurred to obtain the degree. In a recent case, the Tax Court allowed an employee of an orthodontic laboratory to deduct the expenses he incurred while pursuing an MBA degree.\(^7\) The outcome of the case hinged on the "upward-bound"\(^8\) disallowance test of the current regulation, which denies a deduction where the education "qualif[ies the taxpayer] in a new trade or business."\(^9\) To determine the deductibility of the expenses, the court embarked on an in-depth analysis of the different

---

\(^2\) I.R.C. §§ 62(a)(2)(A), 63(e), 67(a), 162(a) (LexisNexis 2005).
\(^3\) I.R.C. § 162(a); see also Treas. Reg. § 1.162-5 (as amended in 1967).
\(^4\) Treas. Reg. § 1.162-5.
\(^5\) Id.
\(^6\) See infra Part II.C.
\(^7\) Allemeier v. Comm’r, 90 T.C.M. (CCH) 197 (2005).
tasks and duties the taxpayer performed at the orthodontic laboratory before and after obtaining his degree. Ultimately, the court determined that the taxpayer did not qualify for a new trade or business with an MBA degree and thus, could deduct his educational expenses because the "courses provided him with a general background to perform tasks and activities that he had performed previously."11

Conversely, in a 2002 case, the Tax Court deemed the expenses of obtaining an MBA degree non-deductible under the "upward-bound" disallowance test.12 The court found that the degree qualified the taxpayer in a new trade or business, regardless of his duties before and after obtaining the degree and regardless of whether he chose to enter those new trades or businesses.13 Therefore, the outcome of an MBA educational expense case can turn entirely on the taxpayer’s luck of the draw with respect to which of several standards of analysis the particular judge decides to apply.

This Note analyzes the deductibility of expenses incurred to obtain an MBA degree by investigating the inconsistent outcomes, illustrated by the preceding cases, which result from the courts’ varying applications of regulation 1.162-5. Part II of this Note examines the evolution of the educational expense deduction from the pre-regulation era to the current regulatory scheme. It also discusses the various approaches employed by the courts in applying the current regulation when they are considering expenses incurred for different types of education. Specifically, Part II.C.2 examines the cases involving the deductibility of MBA degree expenses and discusses the various analyses employed by the courts in those cases. Part III analyzes the effects of these various analyses and demonstrates the negative impact these approaches can have on taxpayers. Part IV suggests that the Internal Revenue Service (“IRS”) and the courts should adopt a bright-line disallowance test for MBA educational expenses as an alternative to the multiple judicial approaches currently in use and outlines the suggested rule’s likely effect on taxpayers and the tax administration system.

II. BACKGROUND

Courts have struggled with the deductibility of work-related educational expenses for almost a century. To aid in determining which expenses should be deductible, the Treasury issued the original regulation 1.162-5 in 1958.15 However, when that regulation proved unsuccessful at solving the problem, the Treasury issued an amended version in 1967, which is still in effect today.16 While this new regulation provides clear guidance with respect to certain types of education, the deductibility of other classes of education remains unsettled.17

10. Allemeier, 90 T.C.M. (CCH) at 199-200.
11. Id. at 200.
14. Id.
17. See infra Part II.C.
The struggle surrounding the deductibility of educational expenses as business expenses originated in the 1920s. In 1921, the IRS expressed its first position regarding the deductibility of educational expenses in two rulings. The IRS ruled that “[t]he expenses incurred by school-teachers in attending summer school” and the “[e]xpenses incurred by doctors in taking post-graduate courses” were personal expenses. By deeming the expenses personal, the IRS automatically made educational expenditures non-deductible since the Code expressly prohibits the deduction of personal expenses.

The courts originally took a position similar to that of the IRS. In some of the earliest cases addressing this issue, the Board of Tax Appeals disallowed deductions for education expenses. In Appeal of Driscoll, the taxpayer had taken vocal lessons with the intent to begin a professional singing career. The Board agreed with the reasoning of the Commissioner that “the expenditure . . . was for educational purposes and of a personal character” and thus, the taxpayer could not take the deduction. In contrast, the Board consistently allowed taxpayers to deduct the expenses incurred to attend conventions related to their field of work. The Board ruled that a minister could deduct the expense of attending conventions, which were required for the maintenance of his status in the church. Similarly, in Silverman v. Commissioner, the Board allowed a professor to deduct the expenses he incurred to attend scientific conventions in an attempt to keep up with current issues in chemistry. A possible explanation for the apparent disconnect in these early cases is that the Board did not consider expenses incurred to attend conventions to be “purely educational” expenses; therefore, they were not personal, non-deductible expenses. Instead, they

23. See Katz, supra note 15, at 18 (discussing Darling v. Comm’r and Appeal of Driscoll); see also Darling v. Comm’r, 4 B.T.A. 499, 503 (1926) (denying professional cartoonist a deduction for expenses of sculpting classes); Appeal of Driscoll, 4 B.T.A. 1008, 1009 (1926) (disallowing deduction for voice lessons where taxpayer was an aspiring professional vocalist but eventually abandoned the career).
24. 4 B.T.A. 1008.
25. Id.
26. Id. at 1009.
28. 2 B.T.A. 23.
29. Id. at 23-24.
30. 6 B.T.A. 1328.
31. Id. at 1329.
32. Darling v. Comm’r, 4 B.T.A. 499, 503 (1926) (finding that “purely educational” expenses were not incurred in carrying on a business for profit and thus were not deductible as business expenses).
33. Kalafat, supra note 27, at 196.
qualified as business expenses for which the IRS allowed taxpayers a deduction.34

1. A Change in History: The Hill Case in the Tax Court

One of the most significant pre-regulation cases regarding the deductibility of educational expenses was Hill v. Commissioner,35 which the Tax Court first decided in 1949.36 Petitioner Nora Payne Hill taught high school in Virginia where teaching certificates expired every ten years.37 The state required its teachers to pass examinations over five educational books or acquire three college credits to obtain a renewal of their certificates.38 Ms. Hill chose to acquire three college credits to obtain her renewal, which she did by attending summer school at Columbia University.39 The Tax Court found there was no evidence to prove that most teachers chose to attend summer school and, therefore, that option was not ordinary.40 Furthermore, since Ms. Hill’s future employment depended upon the renewal of her certificate, the court found that she incurred the expenses to qualify for the position and, as such, she was not carrying on a trade or business while in summer school.41 Therefore, the expenses were personal and non-deductible.42

2. A Change in History: The Hill Case on Appeal

On appeal, the Court of Appeals for the Fourth Circuit found that Ms. Hill had incurred the expenses to “maintain her present position, not to attain a new position; to preserve not to expand or increase; to carry on, not to commence.”43 Additionally, the court found that the IRS ruling limiting the deductibility of summer school expenses for teachers did not apply in Ms. Hill’s case since “attendance at summer school was undertaken essentially to enable [Ms. Hill] to continue her . . . career in her . . . existing position.”44 Therefore, the Fourth Circuit reversed the Tax Court’s decision and allowed Ms. Hill to deduct the expenses, holding that “the expenses incurred by the taxpayer . . . were incurred in carrying on a trade or business, were ordinary and necessary, and were not personal in nature.”45

The Fourth Circuit’s holding in Hill was a turning point in the history of the tax treatment of educational expenses.46 While the Hill court limited its holding to the particular facts of that case, it marked the first time in history that a taxpayer could deduct “purely educational”47 expenses.48 Additionally, because of the Hill decision, the

34. I.R.C. § 162(a) (LexisNexis 2005).
35. 13 T.C. 291 (1949).
37. Hill, 13 T.C. at 291.
38. Id. at 292.
39. Id.
40. Id. at 294.
41. Id.; Katz, supra note 15, at 23.
42. Hill, 13 T.C. at 295.
44. Id.
45. Id. at 911.
IRS overruled one of its earlier rulings by issuing a pronouncement allowing a limited deduction for expenses incurred by public school teachers while attending summer school. However, the *Hill* decision and its corresponding IRS pronouncement did little to resolve the struggle over the deductibility of educational expenses, as evidenced by the string of inconsistent decisions following these two decisions.

**B. The IRS Releases Treasury Regulation 1.162-5 in 1958: The Subjective Standard**

After more than thirty years of conflicting cases and IRS rulings, the IRS promulgated regulation 1.162-5 in 1958 in an attempt to create a manageable standard for the deductibility of educational expenses. The 1958 regulation allowed a deduction if the education was:

undertaken *primarily for the purpose* of (1) maintaining or improving skills required by the taxpayer in his employment or other trade or business, or (2) meeting the express requirements of a taxpayer’s employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the taxpayer of his salary, status or employment.

While the 1958 regulation significantly changed the treatment of educational expenses and established that such expenses were deductible in certain circumstances, the focus on the taxpayer’s primary purpose rendered the regulation unmanageable. The determination of a taxpayer’s primary purpose was a question of fact, which resulted in another string of inconsistent cases. Therefore, the application of this new regulation proved to be almost as unmanageable as it had been to apply the conflicting case law during the pre-regulation era.


The negative results of the 1958 version of regulation 1.162-5 prompted the IRS to amend it in 1967. By amending the regulation, the IRS hoped to provide rules for the

---


49. I.T. 4044, 1951-1 C.B. 16.

50. See Katz, *supra* note 15, at 25-30; see also Marlor v. Comm’r, 251 F.2d 615 (1958) (allowing tutor to deduct expenses incurred to obtain doctorate degree, which was a requirement for continued employment), rev’d 27 T.C. 624, 626 (1956) (disallowing deduction for same because education was just one step on “the ladder to his ultimate goal” and thus was personal); Coughlin v. Comm’r, 203 F.2d 307, 309 (1953) (allowing a tax attorney to deduct the expense of attending the Institute on Federal Taxation), rev’d 18 T.C. 528 (1952) (disallowing a deduction for the same “because of the educational and personal nature of the object pursued by the [taxpayer]”); Kamins v. Comm’r, 25 T.C. 1238, 1240-41 (1956) (disallowing expenses of obtaining doctorate degree, which was prerequisite to taxpayer’s permanent employment); Larson v. Comm’r, 15 T.C. 956, 958 (1950) (disallowing a mechanic’s deduction for expense of obtaining engineering degree); Marshall v. Comm’r, 14 T.C.M. (CCH) 955, 957 (1955) (disallowing a deduction for music teacher’s piano lessons).


52. Treas. Reg. § 1.162-5(a) (emphasis added).


54. *Id.*

55. *Id.*

The 1967 version of regulation 1.162-5 remains the authority for educational expense deductions today. The current regulation allows a deduction if the education meets either the “skill-maintenance” or the “employer-mandate” test, which closely mirror the allowance tests in the 1958 regulation. The current regulation, like the 1958 regulation, also disallows a deduction if the education constitutes “the minimum educational requirements for qualification in [the taxpayer’s] employment or other trade or business” or if the education “is part of a program of study . . . which will lead to qualifying [the taxpayer] in a new trade or business.”

One of the most significant changes made to regulation 1.162-5 in 1967 was the elimination of the subjective primary purpose test. The IRS replaced the subjective test with an objective test, such that the taxpayer’s intent for obtaining the education was no longer a consideration when determining whether the education met the requirements of the regulation. Additionally, the IRS eliminated the provision that disallowed a deduction for expenses incurred by taxpayers to specialize within their existing trade or business.

1. The Objective Non-Deductibility of Educational Expenses in Fields of Study with Education and Examination Prerequisites

In cases where an individual must meet certain educational and examination requirements to become legally eligible to practice in a field, the courts apply a strictly objective approach to determine the deductibility of expenses incurred to obtain the requisite education. Under this strictly objective approach, the courts do not consider the facts and circumstances of each case, but rather disallow a deduction solely because the education objectively qualifies the taxpayer in a new trade or business. Thus, the expense of obtaining a law or medical degree is never deductible under the current regulation because an individual may only practice in the legal or medical professions by obtaining the requisite education and passing the requisite examinations. Therefore, regardless of whether the taxpayer ever engages in the legal or medical trade, a degree in law or medicine is never deductible.

---

59. Treas. Reg. § 1.162-5(a)(1); see BITTKER & LOKKEN, supra note 8, ¶ 22.1.2, at 22-7 to 22-8.
60. Treas. Reg. § 1.162-5(a)(2); see BITTKER & LOKKEN, supra note 8, ¶ 22.1.2, at 22-9 to 22-10.
61. See Kalafat, supra note 27, at 1999.
63. Id. § 1.162-5(b)(3).
64. Kalafat, supra note 27, at 2000.
65. Id. at 2001.
68. Id.
either of these fields automatically precludes a deduction.  

Similarly, the courts have consistently disallowed deductions under the current regulation where the taxpayer obtains a Certified Public Accountant (“C.P.A.”) license.  

Therefore, obtaining a C.P.A. license qualifies an individual in a new trade or business, which precludes deductibility of the corresponding expenses, regardless of whether the taxpayer actually practices as a C.P.A.

2. The “Objective” Approach to Educational Expense Deductibility in Fields of Study with No Formal Education or Examination Prerequisites

Conversely, where the education in question is an advanced degree other than a law or medical degree, such as a masters or doctorate degree, the decisions are often inconsistent because the courts use varying approaches and standards. In cases specifically involving the deductibility of an MBA degree, the courts often have various standards they could apply with respect to each of the four tests under the current regulation. In many cases the courts resort to considering the unique facts and circumstances of each case, as opposed to applying a strictly objective test to determine whether deductibility is appropriate, which leads to great inconsistency.

In some of the cases concerning the deductibility of an MBA degree, the court’s decision has turned on whether the MBA degree maintains or improves the taxpayer’s skills. For example, in one of the first cases to consider the deductibility of MBA degree expenses under the current regulation, the Tax Court denied a deduction where the taxpayer was a revenue agent for the IRS prior to entering an MBA program. In
support of its holding, the court found that there was no “direct and substantial relationship between examining tax returns” and the taxpayer’s MBA courses.\(^79\) Therefore, the court found that the education did not maintain or improve the taxpayer’s skills as an IRS revenue agent.\(^80\)

In other cases, the court never reaches a consideration of whether the education meets the four tests of the current regulation because the decision turns solely on whether the taxpayer was “carrying on”\(^81\) a trade or business while obtaining the MBA degree.\(^82\) For example, in *Schneider v. Commissioner*,\(^83\) the Tax Court denied a deduction where the taxpayer resigned from his position in the United States Army, with no intent to return, before beginning his MBA studies and took a position as a consultant after finishing his education.\(^84\) Conversely, in *Sherman v. Commissioner*,\(^85\) the Tax Court allowed a military officer to deduct the expense of obtaining an MBA degree because “he was engaged in business administration before [obtaining the degree] and stayed in the field after his graduation,” even though he took a different position after completing his degree.\(^86\) The court reasoned that temporarily ceasing employment solely to attend college does not constitute failing to carry on a trade or business where the tasks performed before and after the education are similar and the taxpayer intends to return to his previous employment.\(^87\)

In yet another group of cases concerning the deductibility of an MBA degree, the outcome depends solely on whether an MBA degree qualifies the taxpayer in a new trade or business.\(^88\) In these cases, the courts often use the “commonsense approach,” \^[which requires \(\ldots\) a comparison \(\ldots\) between the types of activities \(\ldots\) the taxpayer was qualified to perform before acquiring a particular title or degree with those that he or she was qualified to perform afterwards.\(^3\)](\ref{footnote:89}) For example, in *Blair v. Commissioner*,\(^90\) the

\begin{footnotesize}
\begin{enumerate}
\item Id.
\item Id.
\item I.R.C. § 162(a) (LexisNexis 2006).
\item See Link v. Comm’r, 90 T.C. 460, 463-64 (1988) (disallowing a deduction for MBA degree expenses where the court found the taxpayer was not established in any trade or business, but rather was a career student); Schneider v. Comm’r, 47 T.C.M. (CCH) 675, 680 (1983) (disallowing a deduction for MBA degree expenses where taxpayer was an Army officer but terminated his employment before commencing studies and failed to return to a similar position afterwards); Sherman v. Comm’r, 36 T.C.M. (CCH) 1191, 1193-94 (1977) (allowing resigned Army officer a deduction for expenses incurred to obtain an MBA degree where the taxpayer worked in the same general field upon obtaining the degree).
\item 47 T.C.M. (CCH) 675.
\item Id. at 680.
\item 36 T.C.M. (CCH) 1191.
\item Id. at 1193.
\item Id.
\item See, e.g., Blair v. Comm’r, 41 T.C.M. (CCH) 289, 291 (1980) (allowing deduction for MBA degree expenses because of the substantial overlap in the taxpayer’s duties before and after she obtained the degree); Lewis v. Comm’r, No. 538-01S, 2002 Tax Ct. Summary LEXIS 48, at *9-11 (May 7, 2002) (disallowing a deduction for MBA degree expenses even though the taxpayer did not pursue a different career after obtaining the degree).
\item Allemeier v. Comm’r, 90 T.C.M. (CCH) 197, 199 (2005) (emphasis added); see also Reisinger v. Comm’r, 71 T.C. 568, 574 (1979) (denying a nurse a deduction for expenses incurred in physician’s assistant program); Davis v. Comm’r, 65 T.C. 1014, 1019 (1976) (denying a teacher’s aid with an undergraduate degree in social work to deduct the expense of a doctorate degree in social work).
\item 41 T.C.M. (CCH) 289.
\end{enumerate}
\end{footnotesize}
Tax Court allowed a deduction where the taxpayer was a personnel representative for Sherwin Williams prior to obtaining her MBA degree and held the position of personnel manager for the same company after completing the degree. The court found that the “substantial overlap in petitioner’s job tasks” before and after obtaining the degree supported a finding that the degree did not qualify her for a new trade or business. The court also found that neither a change in duties from merely making recommendations to actually making decisions, nor “the acquisition of a new title” required a finding that the education qualified petitioner in a new trade or business.

Similarly, in Allemeier v. Commissioner, the Tax Court applied the “commonsense approach” and determined that the taxpayer performed substantially similar tasks before and after obtaining his MBA degree. Therefore, the taxpayer was entitled to a deduction, regardless of whether the MBA degree objectively qualified him in other positions in which he chose not to engage. Conversely, in Lewis v. Commissioner, the court denied a deduction based upon its finding that an MBA degree qualified the taxpayer in a new trade or business. The taxpayer was an employee in the telecommunications industry prior to commencing his MBA studies and felt he needed additional business skills to perform his duties adequately. The court applied a strictly objective approach to determining deductibility, finding:

[Even if the taxpayer does not intend to enter into a new field of endeavor, or even if the taxpayer’s duties are not significantly different after the education from what they were before, the expenditures are not deductible if the education qualifies the taxpayer for a new trade or business.]

Therefore, since an MBA degree qualified the taxpayer for “a wider variety of positions,” the expenses incurred to obtain the degree were not deductible.

Overall, the current regulation has produced consistency for the deductibility of educational expenses where the degree sought by the taxpayer is part of an educational requirement for practice in the respective trade or business, such as law or medical degrees. However, there continue to be many contradictory cases regarding educational expenses because taxpayers and courts remain uncertain as to the correct application of regulation 1.162-5 when it comes to education that is not part of a formal requirement to practice in the respective trade or business. One such class of education is the MBA degree.

91. Id. at 291.
92. Id.
93. Id.
94. 90 T.C.M. (CCH) 197.
95. Id. at 200.
96. Id.
98. Id. at *10-11.
99. Id. at *7.
100. Id. at *10.
101. Id.
III. ANALYSIS: THE SHORTCOMINGS OF THE "OBJECTIVE" STANDARD OF DEDUCTIBILITY UNDER REGULATION 1.162-5 WHEN APPLIED TO MBA DEGREE EXPENSES

The Treasury Department’s very reason for amending regulation 1.162-5 in 1967 was to create an objective standard that the courts could apply with more ease and consistency.\(^{103}\) However, it is evident that the goal of amending the regulation has been somewhat frustrated in cases concerning the expense of MBA degrees because the results continue to be inconsistent and imprecise.\(^{104}\) These results lead to undesired consequences, such as disparate treatment among taxpayers and tax avoidance schemes.\(^{105}\) Additionally, the current approach to these cases creates unnecessary administrative costs because the lack of objective guidelines causes disputes between individuals and IRS agents as to what qualifies for deductibility and, ultimately, continually requires taxpayers to go through the judicial system for a determination of the deductibility of their expenses.\(^{106}\)

A. Losing Objectivity Through the Use of “Commonsense”

The “commonsense approach” involves a comparison of the tasks the taxpayer “was qualified to perform before acquiring a particular title or degree with those that he or she was qualified to perform afterwards” to determine whether a taxpayer is qualified for a new trade or business.\(^{107}\) Read literally, this approach seems to require an objective examination of the tasks and duties the taxpayer was qualified to perform \(\text{in any employment setting}^{108}\) before and after acquiring the education. In fact, that is exactly the way the courts examine cases where the education is a law degree. In \textit{Bodley v. Commissioner},\(^{109}\) the Tax Court found “[e]ven if an individual taking a course[,] which both qualifies him for a new profession and improves his skills . . . in his current field of endeavor[,] does not intend to enter the new profession, his purpose and intention may change. He may later decide to enter the new profession.”\(^{110}\) Therefore, the court disallowed the taxpayer’s deduction because it found that he was objectively qualified in the trade of law, even though he did not engage in the profession of law after completing the degree.\(^{111}\)

However, when the courts have applied the “commonsense approach” to situations where the taxpayer has obtained an MBA degree, they have generally narrowed their focus to examining the tasks the taxpayers were qualified to perform \(\text{in their specific employment setting}^{112}\) before and after obtaining the education.\(^{113}\) For example, in

\(^{103}\) See supra Part II.C.

\(^{104}\) See supra Part II.C.2.

\(^{105}\) See infra Parts III.C, III.D.

\(^{106}\) Pevsner v. Comm’r, 628 F.2d 467, 470-71 (5th Cir. 1980) (denying manager of clothing boutique a deduction for cost of required work clothing because it could be worn as ordinary clothing even though taxpayer did not do so).


\(^{108}\) 56 T.C. 1357 (1971) (denying school teacher a deduction for law school expenses).

\(^{109}\) Id. at 1361.

\(^{110}\) Id.

\(^{111}\) See, e.g., Allemeier, 90 T.C.M. (CCH) at 200 (2005) (allowing a deduction where the court found an MBA degree merely provided the taxpayer with a “general background to perform tasks and activities that he
Allemeier the court declined to even analyze the case under the strictly objective approach. Instead, the court applied the “commonsense approach,” concluding that the “basic nature of [the taxpayer’s] duties did not significantly change” because he performed the same general activities at the orthodontics laboratory before and after obtaining his MBA degree. Therefore, the education did not qualify him in a new trade or business and thus he could deduct the educational expenses. However, it is very likely that the taxpayer would not have been qualified to perform these same tasks for a different employer in the very same line of business. Therefore, applying the test the way the court did in Allemeier defeats the objective purpose of the current regulation because it submits the analysis to one particular employer’s subjective opinion of what he or she considers necessary skills for employees to qualify for certain positions or titles.

B. Qualifying for a New Trade or Business with an MBA Degree

The difficulty of determining whether a taxpayer qualifies for a new trade or business by holding an MBA degree ultimately stems from the fact that the law does not require individuals to obtain a license or certificate to engage in the profession of an MBA as it does for the medical, legal, and accounting professions. This difficulty is evidenced by the court’s refusal in Allemeier to apply a strictly objective test based on the fact that “[p]etitioner’s MBA was not a course of study leading him to qualify for a professional certification or license.” However, the definition of “qualified” includes not only “holding appropriate documentation . . . to perform a specified function or practice a specified skill” but also “meeting the proper standards and requirements and training for an office or position or task.” Therefore, obtaining a license or certificate is not the only way to qualify for a new trade or business.

Under the second definition of qualify, an MBA degree absolutely qualifies an individual for many new trades or businesses. An MBA degree qualifies an individual for an investment banking career because “[a]t associate level, the usual minimum entry requirement is an MBA.” Additionally, “most upper-level international management positions require an MBA.”

Furthermore, because an MBA degree qualifies individuals in several trades—such as accounting, marketing, general management, operations management, and finance—it
The Deductibility of MBA Degree Expenses

is significantly different than other masters degrees that only qualify individuals for one specific trade. For example,

[w]hile both a master's degree [in finance] and an MBA concentration [in finance] will prepare you to hold management positions within the field of finance at some point in your career, an MBA degree may also qualify you to hold management positions in other fields, should you become interested in a different career.

Therefore, even if the taxpayer can argue that he or she was qualified to practice in one or more of these trades before obtaining an MBA degree, it is extremely unlikely that any MBA graduate was previously qualified to practice in all of these fields. Thus, the MBA degree qualifies the taxpayer in new trades and businesses.

It is evident that an MBA degree objectively qualifies individuals in new trades and businesses even though there are no specific educational or examination requirements an individual must meet to legally practice as an MBA. Additionally, the degree objectively qualifies graduates in those new trades or businesses even if they choose to remain in their previous field and never enter those new fields. Because the taxpayer “may later decide to enter the new profession,” the expenses incurred to obtain an MBA degree should not be deductible under the current objective regulation.

1. Comparing Education to Work Clothing

The reasons for making educational expenses incurred to obtain an MBA degree non-deductible are similar to those for making certain types of required work clothing non-deductible. Certain types of required work clothing, such as nursing and police uniforms, are not useful to the taxpayer outside of his or her current trade and therefore are deductible. However, other types of required work clothing, such as business suits, are useful outside of the taxpayer’s current trade because he or she can wear the clothing in many other contexts. The courts only allow a business expense deduction for clothing if “(1) the clothing is of a type specifically required as a condition of employment, (2) it is not adaptable to general usage, and (3) it is not so worn.”

In comparison, regulation 1.162-5 provides a similar test for deductibility. An educational expense is deductible if the expenditure is an express requirement of the taxpayer’s employer, which is similar to requirement (1) for the deductibility of work

121. Id.
123. Harsaghy v. Comm’r, 2 T.C. 484, 486 (1943) (allowing nurse to deduct the cost of uniforms), acq. 1945 C.B. 3; Benson v. Comm’r, 2 T.C. 12, 14-15 (1943) (allowing traffic officer a deduction for uniform costs), acq. 1949-2 C.B. 1, aff’d, 146 F.2d 191 (1944); see also ALAN GUNN & LARRY D. WARD, CASES, TEXT AND PROBLEMS ON FEDERAL INCOME TAXATION 319-23 (5th ed. 2002) (discussing the difficult distinction between business, investment, and personal expenses).
Furthermore, the regulation only allows a deduction if the education does not qualify the taxpayer for a new trade or business or meet the minimum educational requirements for the position. This standard is similar to requirement (2) for the deductibility of work clothing in that it prevents a taxpayer from deducting expenses incurred for items that the taxpayer could make use of outside of his or her current field of employment.

Like business suits, an MBA degree is “adaptable to general usage” because it qualifies the taxpayer in trades or businesses outside of his or her current employment and thus the taxpayer can take that education and make use of it in an entirely new field. The taxpayer’s current employment setting is not the only field where the MBA degree would be useful. Conversely, if the education is simply continuing education required for the taxpayer’s current job, the education is not “adaptable to general usage” because it is unlikely that the taxpayer could put that education on a résumé to obtain a job in a new field.

As with the test for educational expenses, courts can apply the test for work clothing subjectively or objectively. A subjective examination entails a consideration of whether the clothing is “adaptable to general usage” based on each individual taxpayer’s socio-economic level and clothing preferences outside of work. This inquiry is similar to the “commonsense approach,” which looks at the taxpayer’s qualifications in comparison to the required qualifications in his particular employment setting. Conversely, an objective examination involves an investigation into whether or not the clothing is “adaptable to general usage” based on standards of the general public. This inquiry is similar to the approach taken in the educational expense context with respect to law or medical degrees where the courts examine the taxpayer’s qualifications in comparison to the general qualifications for those trades and businesses. Although the courts examining work-related clothing expenses have not adopted a uniform approach, several courts do apply the test objectively. The Court of Appeals for the Fifth Circuit asserted two compelling goals that the objective test achieves, including administrative ease and

---

127. Id.
128. Fontanilla, 77 T.C.M. (CCH) at 1978.
129. Id.
130. GUNN & WARD, supra note 123, at 321-22; Pevsner v. Comm’r, 628 F.2d 467, 470-71 (5th Cir. 1980) (declining to apply the subjective approach and instead applied the objective approach to deny a clothing boutique manager a deduction for the cost of required work clothing because it could be worn as ordinary clothing even though the taxpayer did not do so).
131. GUNN & WARD, supra note 123, at 322; Pevsner, 628 F.2d at 470-71.
132. See Pevsner, 628 F.2d at 470-71; Stiner v. United States, 524 F.2d 640, 641 (10th Cir. 1975) (disallowing a deduction for certain items, including shoes, boots, gloves, a handbag, and cosmetics that the taxpayer was required to purchase as part of her employment as an airline stewardess while allowing a deduction for other items, including uniform skirts and jackets, that were not “adaptable to general usage”); Donnelly v. Comm’r, 262 F.2d 411, 412 (2d Cir. 1959) (disallowing a deduction for the cost of aprons and strong clothing worn by taxpayer in his employment as a buffer and polisher of rough plastics); Drill v. Comm’r, 8 T.C. 902, 904 (1947) (denying a deduction for work clothing worn by construction company superintendent); Christey v. United States, No. 3-77 Civ. 68, 1981 U.S. Dist. LEXIS 14551, at *7-8 (D. Minn. Aug. 19, 1981) (denying a deduction for expense of black shoes and maroon socks worn by taxpayer for work because they were “usable as ordinary clothing”).
“substantial fairness among . . . taxpayers.” These goals are equally compelling in the realm of educational expense deductions and, therefore, the courts should also apply a strictly objective test with respect to MBA degree expenses.

2. MBA Degree Expenses: Not What the Code or Regulations Contemplated

Code section 162 allows a deduction for the “cost of earning [income]” so that taxpayers are taxed on their net business income. A simple reading of current regulation 1.162-5 makes it evident that the type of educational expenses contemplated as deductible to arrive at net business income are those required by an employer, such that an employee has no choice regarding the education, and those that make the employee better at his or her current job. However, those expenses for education that will allow a taxpayer to leave his current field of employment and take on a completely new endeavor were not the type contemplated as deductible expenses by the drafters of the regulation.

The deduction of expenses incurred with respect to several types of education—such as continuing education classes, courses taken to obtain a specialty within a certain field, and training courses required by an employer (i.e. computer software training courses)—would be in line with the intent of section 162 and the current regulation. A taxpayer incurs all of these types of education while he or she is engaged in a trade or business and the education works to maintain or improve the individual’s skills and may be an express requirement of the employer. However, the education does not qualify a taxpayer in a new trade or business and is not the minimum education required for the position. An example of this type of education is the Master of Laws (“LL.M.”) degree. If an individual obtains an LL.M., completion of the degree does not qualify the taxpayer in a new trade or business because “[a]n LL.M. degree by itself generally does not qualify graduates to practice law” and “lawyers are not required to hold an LL.M. degree” to practice law. Therefore, deductibility is correct under the statute in this situation as long as the education meets all of the other prerequisites.

Conversely, an MBA degree qualifies an individual in several new trades and businesses. Therefore, regardless of whether the taxpayer engages in those new trades, the expenses do not directly relate to carrying on his or her previous trade or business. Rather, under the strictly objective approach, the taxpayer incurs the expenses in direct relation to the new trades for which he or she is now qualified. Therefore, they are

---

133. Pevsner, 628 F.2d at 471.
134. BITTKER & MCMAHON, supra note 1, ¶ 11.1[1], at 11-4.
138. Id.
140. See supra Part III.B.
non-deductible because they are not a “cost of earning [income]”\(^\text{143}\) since the taxpayer is not earning income from those new trades when the costs are incurred.\(^\text{144}\) Thus, allowing a deduction for these educational expenses, which qualify taxpayers in new trades and businesses, frustrates the intent of Code section 162 and the current regulation.

C. “Commonsense” Produces Unfair Results

One of the major drawbacks of the “commonsense approach” is that it results in “disparate treatment among taxpayers.”\(^\text{145}\) Application of the “commonsense approach” allows taxpayers who further their business-related careers by obtaining an MBA degree to deduct their educational expenses while, at the same time, prevents taxpayers who leave a non-business career and enter the business world by obtaining an MBA degree from deducting their expenses.\(^\text{146}\) Both types of taxpayers likely had the same motive for obtaining the MBA degree, which was to advance their career. Additionally, both of these taxpayers are now qualified for the same new trades and businesses, most of which they were likely not previously qualified for because the MBA degree provides graduates with qualifications in several fields.\(^\text{147}\) However, the “commonsense approach” leads to disparate treatment of these two taxpayers simply because of their previous employment position.

Conversely, one can see how it would be reasonable for the courts to allow a taxpayer employed in the business field to deduct the cost of continuing education business classes while, at the same time, disallowing a taxpayer in a non-business career a deduction for the very same education. Those classes would most likely improve or maintain the skills of the taxpayer employed in the field of business and may even be an express requirement of the taxpayer’s employer. However, the classes would not be enough to qualify the taxpayer for a new trade or business. On the other hand, the business courses would not improve or maintain a taxpayer’s skills if he or she does not practice in the field of business. Additionally, business courses would most likely not be an express requirement of a non-business taxpayer’s employer. Therefore, the expenses would not be a “cost of earning a living”\(^\text{148}\) from the non-business trade. The taxpayers in this situation would not be receiving disparate treatment because the expense for the education completed by the taxpayer employed in the field of business clearly falls within the type of expenses contemplated by the statute while the expenses for the same education completed by the taxpayer employed in a non-business career do not.

This result is in contrast to the one where both taxpayers receive an MBA degree and thus both taxpayers fall within the 1.162-5(b)(2) disallowance test and yet the business taxpayer is still allowed the deduction solely because of his or her previous employment. One of the very purposes of objective tax standards is to reduce disparate

\(^{143}\) BITTKER & MCMAHON, supra note 1, ¶ 11.1[1], at 11-4.
\(^{144}\) I.R.C. § 162(a).
\(^{146}\) Hamish P.M. Hume, The Business of Learning: When and How the Cost of Education Should Be Recognized, 81 VA. L. REV. 887, 888 (1995) (proposing a different set of categories for determining the deductibility of educational expenses to replace those in the current regulation, arguing they would be more in line with the rationale behind the current categories).
\(^{147}\) See supra Part III.B.
\(^{148}\) BITTKER & MCMAHON, supra note 1, ¶ 11.1[1], at 11-3.
The Deductibility of MBA Degree Expenses

2007] 675

The disparate treatment among taxpayers. In Commissioner v. Idaho Power, the Supreme Court confirmed this objective when it reversed the lower court’s holding because it would result in “disparate treatment among taxpayers.” Therefore, the current approach to MBA degree expenses produces unacceptable results by promoting disparate treatment among taxpayers.

D. “Commonsense” Leaves Room for Abuse

The disparate treatment among taxpayers resulting from the application of the “commonsense approach” in MBA cases leaves room for abuse by taxpayers and their employers. By merely looking at the tasks and duties the taxpayer “was qualified to perform before acquiring a particular title or degree with those that he or she was qualified to perform afterwards” in his or her specific employment setting, the courts are providing an opportunity for taxpayers to abuse the tax system to obtain deductions. A taxpayer and his or her employer could accomplish this circumvention by effecting a promotion of the taxpayer shortly before he or she enters an MBA program to the type of managerial position the parties intend the employee to hold after obtaining an MBA degree. While the taxpayer normally would not be qualified for such a position in the company prior to obtaining the degree, the employer could easily make an exception and allow the taxpayer to enter that position before completing the degree requirements since there are no legal requirements for practicing in the MBA field.

This arrangement would benefit both the taxpayer employee and the employer. The taxpayer would receive a deduction for the MBA degree expenses because the court’s examination would reveal that he or she was qualified to perform the same duties and tasks before and after obtaining the degree in his or her particular employment setting. Therefore, the employer has the ability to offer the employee an additional incentive—a significant tax deduction—when trying to induce the employee to further his or her education. In the end, the employer receives the benefit of having an employee with additional education and greater capabilities who now meets the actual job qualifications.

IV. RECOMMENDATION: DENY EDUCATIONAL EXPENSE DEDUCTIONS FOR COSTS INCURRED TO OBTAIN AN MBA DEGREE IN ALL CIRCUMSTANCES

The courts and the IRS should not allow taxpayers to deduct educational expenses incurred to obtain an MBA degree under any circumstances. When applying the current regulation, courts have the choice between starting with the allowance or disallowance provisions to determine whether a taxpayer can deduct his or her educational expenses. However, since taxpayers cannot deduct expenses that fall into one of the two disallowance tests, even if the expenses do fall into one of the two allowance tests, the disallowance tests are primary and should apply first. The language of the current regulation supports this contention by allowing a deduction under the allowance tests

---

149. Pevsner v. Comm’r, 628 F.2d 467, 471 (5th Cir. 1980).
151. Id. at 14.
only if the expenditures are not “of a type described in” the disallowance tests.\textsuperscript{155} Therefore, if a certain educational expense either meets “minimum educational requirements” or qualifies the taxpayer “in a new trade or business” there is no reason to consider whether the education “maintains or improves skills” of the taxpayer or “meets the express requirements of the [taxpayer’s] employer” because the expenses are automatically non-deductible.\textsuperscript{156}

When a taxpayer obtains an MBA degree, he or she is qualified to enter many new trades and businesses.\textsuperscript{157} Therefore, the deductibility of expenses incurred to obtain an MBA degree should turn entirely on the second disallowance test, which considers whether the education qualifies the taxpayer “in a new trade or business.”\textsuperscript{158} Based on this test, the courts should break from their current approach of allowing the deduction in some circumstances and disallowing the deduction in others and simply disallow the deduction of all expenses incurred to obtain an MBA degree in all cases.

The following contentions support disallowing the deduction of all MBA expenses. First, this bright-line test would give effect to the objective standard contemplated by the current regulation, which is currently defeated through use of the “commonsense approach.”\textsuperscript{159} Second, denying a deduction under all circumstances would cure the disparate treatment problem of the “commonsense approach.”\textsuperscript{160} Third, employers and employees would no longer have the ability to take advantage of the tax system.\textsuperscript{161} Fourth, a bright-line test would significantly reduce administrative costs associated with the deduction in these cases.\textsuperscript{162} Last, the argument for amortization of educational expenses with respect to an MBA degree as business start-up expenses would no longer be viable.

\textit{A. Getting Back to an Objective Approach}

The promulgation of the current regulation was an attempt to eliminate the difficulty surrounding the application of the previous regulation’s subjective “primary purpose test” and the inconsistent outcomes that resulted from its application.\textsuperscript{163} Therefore, the current regulation requires an objective examination of whether the education in question falls within the statutory provision. Inherent in the purpose of the current regulation, which was to simplify and clarify the rules for deductibility, is a requirement that the courts disregard the particular circumstances of each individual taxpayer and focus the examination solely on the type of education pursued by the taxpayer.\textsuperscript{164} By employing a bright-line non-deductibility rule for educational costs incurred to obtain an MBA degree, the courts would achieve the objective nature and purpose of the current regulation.

\begin{itemize}
\item \textsuperscript{155} Treas. Reg. § 1.162-5(a).
\item \textsuperscript{156} Treas. Reg. § 1.162-5.
\item \textsuperscript{157} See supra Part III.B.
\item \textsuperscript{158} Treas. Reg. § 1.162-5(b)(3).
\item \textsuperscript{159} See supra Part III.A.
\item \textsuperscript{160} See supra Part III.C.
\item \textsuperscript{161} See supra Part III.D.
\item \textsuperscript{162} See supra Part III.B.1.
\item \textsuperscript{163} See Katz, supra note 15, at 36-37.
\item \textsuperscript{164} Id.
\end{itemize}
B. Promoting Equal Treatment Among Taxpayers

The proposed non-deductibility of MBA expenses puts all taxpayers back on equal footing, as they are when the education obtained is a law or medical degree. Before entering into an MBA program, every taxpayer—regardless of their current employment position and plans for employment after obtaining the MBA degree—will be aware that their expenses will not be deductible. Additionally, just as the Fifth Circuit’s objective test for deducting work clothing eliminated the unfair consequences of subjectively examining each taxpayer’s lifestyle and socio-economic level when all taxpayers could use the clothing in the same manner, the proposed rule would eliminate the unfair consequences of subjectively examining each taxpayer’s particular tasks and duties before and after obtaining the MBA degree when all taxpayers qualify for the same trades and businesses with the degree. In effect, the courts will no longer unfairly reward taxpayers holding managerial roles prior to commencing their education while effectively punishing other taxpayers for holding a non-managerial role even though all individuals obtaining an MBA degree are in the same position and become qualified in the same new trades and businesses. 165

C. Eliminating Opportunities for Abuse of Tax System

With a broad disallowance rule, employers and employees will no longer have the opportunity to take actions based solely on the objective of avoiding taxes. 166 Because the deduction for MBA expenses will no longer depend on the taxpayer’s position before and after commencing studies, employers will no longer have the ability to provide the employee with a tax-saving incentive to undertake the MBA degree. Therefore, the proposed rule would eliminate the potential “promotions” of employees into managerial roles simply to avoid the payment of taxes and would promote the deduction of only those educational expenses contemplated under the Code and current regulation.

D. Reduction of Administrative Costs

A bright-line disallowance of MBA degree expenses would provide a significant reduction in the costs of administering the current regulation. “The principal argument in support of an objective test is . . . administrative necessity.” 167 Focusing on subjective factors, like those considered under the “commonsense approach,” “provides no concrete guidelines in determining the deductibility” 168 of educational expenses incurred while obtaining an MBA degree. Conversely, the proposed purely objective rule will allow “a taxpayer or revenue agent to look only to objective facts in determining whether” 169 educational expenses incurred for an MBA degree fall within the realm of deductibility under the current regulation. Ultimately, the proposed rule will eliminate the need to inquire into whether MBA expenses are deductible and will eliminate the costs of challenging the deduction in court because the expenses will be disallowed under all

165. See supra Parts III.B, III.C.
166. See supra Part III.D.
167. Pevsner v. Comm’r, 628 F.2d 467, 470 (5th Cir. 1980).
168. Id.
169. Id.
circumstances because they fall within the second disallowance test of the current regulation.

E. Eliminating the Business Start-Up Expense Argument

Lastly, the proposed bright-line rule will also negate, with respect to MBA degrees, the argument asserted by several academics that, as an alternative to deductibility under section 162, these educational expenses should be amortizable under section 195 as business start-up expenses. Many educational expenses are not deductible under section 162 because the taxpayer is not “carrying on” a trade or business before commencing or while obtaining the education. However, business expenditures are amortizable under section 195 if they are “incurred in connection with creating an active trade or business” and they are the types of expenses that would be deductible if the taxpayer had incurred them while operating “an existing active trade or business.” The argument for amortization of educational expenses is that expenditures qualifying an individual in a new trade or business are expenditures the taxpayer incurred to start that trade or business. Additionally, since the current cases do allow a deduction in some circumstances, the argument continues that the taxpayer would have been able to deduct the expenses had he or she been engaged in business when the expenses were incurred, so they should be amortizable as business start-up expenses.

The proposed rule would make expenses incurred to obtain an MBA degree non-deductible and non-amortizable under all circumstances. The previous argument would no longer work because the educational expenditure for obtaining an MBA degree would no longer be the type that a taxpayer would be able to deduct if engaged in the trade or business. Therefore, the courts could also eliminate the question of whether MBA expenses are amortizable because they would no longer fall within the constraints of the statute.

V. CONCLUSION

Currently, taxpayers who earn an MBA degree have no clear standard for determining whether their expenses are deductible. If a taxpayer wants to get a deduction, he or she will likely have to rely on the judge’s determination. As this Note discussed, the courts have applied several different analyses to these cases and have reached contradictory results thus far. Therefore, taxpayers have no way of knowing whether they can get a deduction for their education and must spend significant time and money to get a determination from the court. Furthermore, the taxpayer’s success in court depends heavily on what standard the judge decides to apply and on the taxpayer’s occupation before and after obtaining the MBA degree. If a taxpayer is lucky enough to: be in a business occupation with some sort of managerial role before commencing studies, hold a

170. See Katz, supra note 15, at 83-85 (arguing that students’ education expenses should be amortizable “start-up expenditures” under section 195(c)); I.R.C. §§ 162, 195 (LexisNexis 2005).
171. I.R.C. § 162(a).
175. Id. at 83-85.
similar position after obtaining the degree, and have the court apply the “commonsense approach,” the taxpayer has a good chance of getting the deduction. However, if a taxpayer is simply not so lucky, the court will likely disallow the deduction. There is a need to reconcile the current conflicting standards and results found in cases concerning the deductibility of MBA educational expenses. An MBA degree qualifies all individuals in the same trades and businesses, regardless of their previous occupation. Therefore, a bright-line rule providing for non-deductibility of expenses incurred to obtain an MBA degree in all cases, because it fails the “upward-bound test,”176 would produce substantial fairness among taxpayers and provide for easier and cheaper administration of the current regulation.

176. BUTTKER & LOKKEN, supra note 8, ¶ 22.1.3, at 22-12.