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Income Tax Deduction of Educational Expenses

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tunately, Florida is one of this number, as exemplified by the statement in the *Davis* case that the transfer will not be set aside unless the challenging wife was the particular one the transferor intended to defraud. It is somewhat surprising that so few of these cases have arisen in Florida in view of the ever-increasing number of retired people moving into the state. Thus, with the likelihood that many such cases lurk in the future, it is to be hoped that the Florida Court will continue its tendency toward relaxing this rule.

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INCOME TAX DEDUCTION OF EDUCATIONAL EXPENSES

Section 162(a) of the Internal Revenue Code of 1954 allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." To be deductible under this section the expense must have been "incurred" by an accrual basis taxpayer[1] or actually paid by a cash basis taxpayer[2] within the taxable year. This requirement is not a determining factor as to whether an expense is deductible; rather it determines the taxable year in which the deduction may be taken. The requirement simply refers to the accounting method employed by the taxpayer; it does not allow him an election as to the year of deductibility.

Neither the code nor the regulations attempt to define the "carrying on any trade or business" requirement of the code, and the cases lead only to the conclusion that what is meant by this phrase is dependent upon the facts of each situation.[3] It has been held that even the holding of a single piece of rental property may constitute a trade or business.[4] However, in *Higgins v. Commissioner*[5] the Su-

[1]Noxon Chemical Prod. Co. v. Commissioner, 78 F.2d 871 (3d Cir.), *cert. denied*, 296 U.S. 647 (1935).

[2]Massachusetts Mut. Life Ins. Co. v. United States, 288 U.S. 269 (1933); J. H. Martinus & Sons v. Commissioner, 116 F.2d 732 (9th Cir. 1940).

[3]Stoddard v. Commissioner, 141 F.2d 76 (2d Cir. 1944); Henry G. Owen, 23 T.C. 377 (1954); Frank B. Polachek, 22 T.C. 858 (1954).

[4]Leland Hazard, 7 T.C. 372 (1946).

[5]312 U.S. 212 (1941).

preme Court said that numerous trading activities in securities did not constitute a trade or business.

In addition to the requirement that the expense must be paid or incurred within the taxable year in carrying on any trade or business of the taxpayer, to be deductible it must also be both "ordinary and necessary." An expense is "necessary" if appropriate and helpful in developing or maintaining the taxpayer's trade or business. In *Welsh v. Helvering*[6] the United States Supreme Court merely *assumed* the expenses to be necessary. No cases have been found in which the expense determined to be ordinary has been disallowed on the ground that it was not necessary.

To be ordinary, the expenditure need only be usual in relation to the particular business of the taxpayer; it need not be habitual or normal in the sense that the taxpayer will have to make it often.[7] In the *Welsh* case the Supreme Court said that there is no "verbal formula that will supply a ready touchstone" and that the statutory standard "is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."[8]

Until recently the Treasury Department[9] and the courts[10] had held that educational expenses incurred in maintaining or increasing one's professional skill or knowledge were not deductible under the predecessors of section 162 (a).[11] In most instances these expenditures were disallowed as being either personal[12] or capital[13] in nature.

History of Educational Deduction

As early as 1921 the Treasury Department announced its basic policy as to the deductibility of educational expenses by stating: "The expenses incurred by school-teachers in attending summer school are in the nature of personal expenses incurred in advancing their education and are not deductible in computing net income."[14] In the

[6]290 U.S. 111 (1933).

[7]Western Maryland Dairy Corp. v. Commissioner, 32 B.T.A. 769 (1935).

[8]290 U.S. 111, 115 (1933).

[9]O.D. 892, 4 CUM. BULL. 209 (1921); Treas. Reg. 111, §29.23 (a)-15 (1943).

[10]*E.g.*, Robert M. Kamins, 25 T.C. 1238 (1956); Knut F. Larson, 15 T.C. 956 (1950); T. F. Driscoll, 4 B.T.A. 1008 (1926).

[11]*E.g.*, Int. Rev. Code of 1939, §23 (a).

[12]*E.g.*, Fred A. DeCain, 20 P-H Tax Ct. Mem. 535 (1951); T. F. Driscoll, 4 B.T.A. 1008 (1926). See also INT. REV. CODE OF 1954, §262.

[13]*E.g.*, James M. Osborn, 3 T.C. 603 (1944).

[14]O.D. 892, 4 CUM. BULL. 209 (1921).

same year the Government also announced that "expenses incurred by doctors in taking post-graduate courses are deemed to be in the nature of personal expenses and not deductible."[15] The Board of Tax Appeals in 1926 followed this policy by denying a loss deduction for expenses incurred in preparation for a career as a singer, which the taxpayer had to abandon on the advice of a physician.[16] The Commissioner had held the expenses to be educational and therefore personal in nature.

It was not until 1950, in *Hill v. Commissioner*,[17] that the first deviation from this long-established policy occurred. In this landmark decision a public school teacher holding the highest certificate issued by the State Board of Education was required to have a certificate in full force to maintain her teaching position. To keep this certificate in force, she was required either to pass an examination on five books selected from a reading list or to present evidence of college credit earned. When she followed the latter course and deducted the expense incurred in obtaining these college credits at summer school, the court held that this expense was a deductible business expense. The basic treasury ruling, O.D. 892,[18] was expressly not overruled but was held to be not applicable when summer school attendance was necessary for "carrying on" and "preserving" the present position of the taxpayer.

The Treasury Department accepted the holding and modified O.D. 892 in the light of that decision. Its reluctance to open the gates to a flood of educational expense deductions is evidenced, however, by its seizing upon the limitations of the *Hill* case to rule that not "all teachers attending summer school may deduct their expenses as 'ordinary and necessary business expenses.' "[19] The expenses incurred in obtaining a teaching position; qualifying for permanent status, a higher position, or an advance in salary; or fulfilling the teacher's general cultural aspirations were still deemed to be personal expenses and not deductible in determining taxable income.

The Tax Court seemed to share the reluctance of the Treasury Department to expand the area of allowable educational expense deductions. Immediately after the *Hill* case, the Tax Court in *Knut F.*

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[15]O.D. 984, 5 CUM. BULL. 171 (1921).
[16]T. F. Driscoll, 4 B.T.A. 1008 (1926).
[17]181 F.2d 906 (4th Cir. 1950).
[18]4 CUM. BULL. 209 (1921).
[19]I.T. 4044, 1951-1 CUM. BULL. 16, 17.

Larson[20] refused to allow deduction of a mechanic's expenses of attending night school to acquire an engineering degree. The court called "learning" a capital asset and held that it was not an ordinary business expense. The case, however, was distinguished from *Hill v. Commissioner* in that the education was for the purpose of commencing a new vocation and obtaining a new position rather than for continuing a career in an existing position. In another case[21] a college professor deducted expenses incurred in connection with his doctor's dissertation, although the degree was not required in order to hold his current position. The Tax Court disallowed the expense as not "necessary."

The Tax Court seemingly took a step back from the *Hill* decision in disallowing the educational expenses of obtaining a doctorate degree when a taxpayer was temporarily employed as a research associate and was required to obtain the degree for permanent employment.[22] Such expenses were held to be clearly for "commencing" and "increasing," not for "carrying on" and "preserving," a profession. In *Marlor v. Commissioner*[23] the court of appeals reversed a similar Tax Court decision involving substantially the same circumstances. The appellate court accepted the dissent in the Tax Court opinion, which contended that even though the expense may have been incurred for a dual purpose, the immediate objective was to retain the taxpayer's current position.[24]

At the time that *Hill v. Commissioner* was decided, it was considered a great stride forward in allowing the deduction of educational expenses. A careful examination shows that in actuality the decision was accepted narrowly and with great reluctance to expand it in any direction. The Tax Court continued to show a strong distaste for educational expense deductions by holding them to be personal[25] or capital[26] in nature, and never hesitated to distinguish the *Hill* case or to limit its rule to the facts of that situation.[27] Also it freely applied the distinction between "commencing" or "increasing"

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[20]15 T.C. 956 (1950).

[21]Richard Henry Lamkin, 21 P-H Tax Ct. Mem. 507 (1952).

[22]Robert M. Kamins, 25 T.C. 1238 (1956).

[23]251 F.2d 615 (2d Cir. 1958).

[24]Clark S. Marlor, 27 T.C. 624, 626 (1956) (dissenting opinion).

[25]Manoel Cardozo, 17 T.C. 3 (1951); Samuel W. Marshall, 24 P-H Tax Ct. Mem. 797 (1955).

[26]Knut F. Larson, 15 T.C. 956 (1950).

[27]*Ibid.*

and "carrying on" or "preserving."[28] Similarly, the Treasury Department's caution in the field was probably due to its fear of what a broad acceptance of the case might lead to.

A more lenient attitude toward educational deductions was indicated in 1957 when the Tax Court in a memorandum decision[29] allowed the deduction of expenses incurred by a taxpayer whose school attendance was required in order to renew her teaching certificate. Similar expenses incurred by the taxpayer's husband were held to be for the purpose of obtaining a new position and therefore not allowed.

A further liberalization was evidenced by the Tax Court when the fact that the courses taken could be used as credit toward the earning of a graduate degree was held to be only incidental.[30] Here the teacher attended summer school at the direction of her employer for the purpose of maintaining her senior salary position.

Shortly after these two 1957 Tax Court cases were decided, the Court of Appeals for the Second Circuit decided *Marlor v. Commissioner,* discussed above. This case further illustrates the more lenient attitude of the courts toward deductions of educational expenses.

Regulations

The proposed regulations under the 1954 code[31] promulgated by the Treasury Department in July, 1956, were little more than a summary statement of prior decisions and rulings on the deduction for educational expense. The general proposition set forth was that such expenditures are personal and not deductible.[32]

An exception was made for situations in which the degree of business necessity clearly outweighed any personal aspect of the expenditure and the expenses were ordinary and necessary for the maintenance of the taxpayer's employment, trade, or business. This provision covered the expenses of "refresher" or similar courses necessary to maintain, but not advance, the skills possessed by the taxpayer in his trade or business. The fact that a course carried academic credit, was of long duration, or was designed for persons preparing to enter a trade or business weighed against its being of the "refresher"

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[28]Robert M. Kamins, 25 T.C. 1238 (1956).
[29]William E. Thompson, 26 P-H Tax Ct. Mem. 229 (1957).
[30]Robert S. Green, 28 T.C. 1155 (1957).
[31]21 Fed. Reg. 5091 (1956).
[32]Proposed Treas. Reg. §1.162-5 (a) (1).

type. Expenses incurred for education undertaken as a requisite to retention of the taxpayer's position or salary under an express requirement of his employer were recognized as being deductible. However, expenses were not deductible if in more than an incidental or minor manner[33] they would aid the taxpayer to obtain a different position, to qualify for employment, to enhance his business reputation, or otherwise to advance substantially in salary, status, or position.

When the final regulations were published in April, 1958,[34] a major change of Treasury Department policy and a broadening of the deductibility of educational expense became evident. The general tenor of the final regulations is that educational expenses are deductible under certain circumstances, as compared with the tenor of the proposed regulations, under which such expenses were personal and not deductible except under certain conditions.

Under the final regulations the deduction is allowed if the expense is incurred in "maintaining or improving skills required by the taxpayer in his employment or other trade or business."[35] A deduction will be allowed under this section if it is customary for established members of the trade or business to undertake such education.

An expense is also deductible if incurred to meet the express requirements of the taxpayer's employer when training is imposed as a condition for retention of the taxpayer's salary level, status, or employment. This deduction is limited to the expenses necessary for the minimum education required by the employer. However, any excess may be deducted under the "maintaining or improving skills" section if the requirements of that provision are met.

The final regulations, as well as the proposed, disallow a deduction for educational expenses undertaken primarily for the purpose of obtaining a new position, or for a substantial advancement in position, or for fulfilling the general educational aspirations of the taxpayer. Expenditures for travel as a form of education are considered primarily personal in nature and therefore are not deductible, but expenses for travel, meals, and lodging incurred while away from home primarily to obtain an education may qualify for a deduction on the same basis as any other expense of the education.

On the other hand, if the travel is primarily personal, with the

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[33]Proposed Treas. Reg. §1.162-5 (d).

[34]T.D. 6291, 1958 INT. REV. BULL. No. 16 at 8.

[35]Treas. Reg. §1.162-5 (a) (1) (1958).

deductible educational activity only incidental, the taxpayer is allowed to deduct only the expenses of meals and lodging during the time spent in such allowable educational activities, and no portion of his travel expenses is deductible. This provision is a change from the proposed regulations, which disallowed all meals and lodging expense regardless of the fact that some time was spent in otherwise allowable educational pursuits. Expenses incurred while engaging in personal activities, such as sightseeing, social visiting, entertaining, or other recreation, are nondeductible personal or living expenses. In accordance with long-established principle, expenses incurred in the nature of commuter's fares are nondeductible personal expense.[36]

EMPLOYEE VERSUS SELF-EMPLOYED

In a letter to the Department of Health, Education and Welfare, Secretary of the Treasury Anderson said that the new regulations remove differences in treatment of educational expenses between employed and self-employed teachers.[37] This is true to the extent that both classes of taxpayers are now allowed to deduct expenses that carry academic credit or result in salary increases or promotion if they otherwise meet the requirements as to deductibility.

There does remain, however, a distinction between these two classes. It arises not from the allowance of the educational deduction but from the different methods of deducting expenses to arrive at taxable income. In computing adjusted gross income, a taxpayer is allowed to deduct expenses only to the extent that they fall within one of the enumerated categories of section 62 of the Internal Revenue Code. For this purpose a deduction is allowed for all expenses attributable to a trade or business if the taxpayer is self-employed or if the taxpayer is an employee and the expenses incurred are reimbursed.[38] This section allows to a self-employed professional person a deduction for arriving at adjusted gross income of all allowable educational expense but expressly denies such a deduction to an employee. The trade or business deductions of an employee are allowed in computing adjusted gross income only to the extent that they are reimbursed by his employer (of little use to most educators), or for expenses of travel while away from home, such as transportation,

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[36]Treas. Reg. §1.162-5 (d) (1958).
[37]P-H FED. TAX SERV. ¶54,846.
[38]INT. REV. CODE OF 1954, §62 (a) (1).

meals, and lodging. Any expenses incurred for books, tuition, supplies, and the like would have to be utilized as a deduction *from* adjusted gross income.[39]

On a theoretical plane this distinction hardly seems to be of major significance. But in practice it means that a self-employed taxpayer will be allowed to deduct *all* of his educational expenses in addition to taking the optional standard deduction. For an employee who is not reimbursed to deduct all of his allowable educational expenses, however, he will have to itemize his deductions in lieu of taking the optional standard deduction. This simply means that unless an employee can profit by not taking the standard deduction, *without* taking into consideration his educational expenses, which are not allowed in arriving at adjusted gross income, he is not receiving the same tax-saving benefit as the self-employed taxpayer.

Professions Other Than Teaching

Although the cases dealing with educational expense deductions have primarily involved teachers and educators, and most of the publicity given the new regulations has been aimed at informing the teaching profession of the advantages that are now available for expenditures incurred for educational purposes, the regulations and the accompanying advantages are by no means limited to that profession. The regulations themselves give examples involving an accountant,[40] a physician,[41] and a tax consultant.[42]

As early as 1953 an appellate court allowed a deduction for tuition, travel, board, and lodging expenses incurred by an established lawyer while attending the Fifth Annual Institute on Federal Taxation sponsored by New York University.[43] The Tax Court had disallowed the deduction because of the educational and personal nature of the object of the taxpayer. In a 1956 decision, a deduction was also allowed for educational expenses incurred by a lawyer while attending the Practicing Law Institute.[44]

Cases arose prior to the Treasury's shift in policy in which the

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[39]William E. Thompson, 26 P-H Tax Ct. Mem. 229 (1957).
[40]Treas. Reg. §1.162-5 (e), *Example* (1) (1958).
[41]*Id. Example* (2).
[42]*Id. Example* (8).
[43]Coughlin v. Commissioner, 203 F.2d 307 (2d Cir. 1953).
[44]Bistline v. United States, 145 F. Supp. 802 (E.D. Idaho 1956).