

FEBRUARY 29, 2008 | VOLUME 2, ISSUE 60

## HBS Graduate Denied A Tax Deduction For Education Expenses

The battle between the I.R.S. and Master of Business Administration (MBA) candidates seeking a tax deduction for the expenses of earning that prestigious degree rages on with no end in sight. While the I.R.S. has won the majority of the cases, the MBAs have scored some notable victories as well. However, in the most recent controversy to reach the Tax Court, the I.R.S. earned a decisive win over a decidedly overmatched (on the facts and the law) MBA candidate.

The taxpayer in this recent case, entitled *Foster v. Commissioner*, T.C. Summ. Op. 2008-22; No. 20500-06S (a case which was decided under a procedure that precludes an appeal of the decision), had earned a bachelor of engineering degree from the University of Canterbury, located in New Zealand, in 1995. After graduation, Ms. Foster worked for an engineering consulting company, named International Food and Beverage Services, in New Zealand, as a "project manager". In February, 2001, Harvard Business School (HBS) offered Ms. Foster admission to the MBA class of 2003. HBS conditioned its offer on Ms. Foster's completing certain academic requirements (in the fields of finance and accounting) before matriculating. Ms. Foster, not surprisingly, accepted HBS's offer and enrolled at the school in September, 2001. During the course of her MBA studies, Ms. Foster worked at Snapple Beverages Co. (Snapple) as a "corporate strategy consultant" **where she completed marketing projects relating to beverage consumption in the U.S. and to Snapple's strategy and profitability**. On April 8, 2003, shortly before Ms. Foster's graduation from HBS, a company engaged in the production and distribution of beverages, Refreshment Brands, (RB) offered Ms. Foster the position of Vice-President of Marketing. Ms. Foster accepted RB's offer and took up her new duties immediately after her graduation from HBS.

In a letter written to the Department of Homeland Security, in support of a petition for a H-1B visa for Ms. Foster, RB wrote the words that would sound the death knell for Ms. Foster's tax case--The letter stated "...the position of Vice-President of Marketing requires...attainment of a Bachelor's degree in business administration or its equivalent...and requires at least a Bachelor's degree in a field related to the specialty occupation..." On her 2002 federal income tax return, Ms. Foster claimed the fees and expenses she paid in 2002 for the MBA as deductible "unreimbursed employee expenses". The I.R.S. disallowed her claim and the Tax Court has now upheld the I.R.S.'s position.

### The Governing Law

Sec. 162(a) allows a deduction for all of the "ordinary and necessary" expenses paid or incurred during the taxable year in carrying on any trade or business. Within this broad category, education expenses occupy their own special niche. Thus, Reg. Sec. 1.162-5(a) provides that expenses for education are deductible if the expenditure "maintains or improves skills" required by the individual in his employment or other trade or business. If this was the only criterion that had to be met to secure a deduction, most education expenses would easily qualify. However, under Reg. Sec. 1.162-5(b)(2) and (b)(3), the general rule does not apply if the education falls within either of two categories. The first such category encompasses expenses incurred to meet the **minimum education requirement** for qualification in a taxpayer's trade or business and the second category encompasses expenditures for

education which is part of a program of study which qualify the taxpayer, incurring the expenses, for a **new trade or business**. The court ruled that Ms. Foster's situation fell within each of these unfavorable categories.

The court observed that before receiving her MBA, Ms Foster had an engineering degree but did not have any sort of business degree. Her engineering "credential" satisfied RB's general education requirement **but not the "job-specific" requirement** of a degree in Business Administration (or its equivalent). **Only her MBA qualified her for the job**. Accordingly, it followed that her MBA was necessary to satisfy, within the meaning of Reg. Sec. 1.162-5(b)(2), the minimum education requirements for her trade or business. That finding would have been sufficient to decide the case in the I.R.S.'s favor. The court, however, chose to go further and it is here where the decision may presage problems for MBA candidates who, for example, go to work "on Wall Street" after graduation but did not work in an allied field prior to the commencement of their studies.\*

### A New Trade or Business?

The Tax Court observed that when education qualifies a taxpayer to perform "substantially different tasks and activities" from those she could perform before, then, in that case, the education is deemed to qualify the taxpayer for a new trade or business. Here, in applying this test, the court framed the issue in the following manner--"...the petitioner must prove that the education did not qualify her to perform significantly different tasks from those she performed in New Zealand while working as an engineer..." In other words, the tasks and activities with which her new tasks and activities would be compared **would be those that she undertook prior to her matriculation at HBS and not those tasks and activities she performed for Snapple during the course of her studies at HBS**. In short, the trade or business in which she was engaged prior to becoming RB's Vice-President of Marketing **was not** as a corporate strategy consultant in the beverage industry whose job encompassed the undertaking of marketing projects but was, instead, as an engineer. The court's approach guaranteed that the taxpayer's education expenses would fall within the second of the two unfavorable categories. Thus, before embarking on her MBA, Ms. Foster worked in New Zealand as an engineer. While pursuing her MBA, she worked for Snapple in the marketing area and after graduating from HBS Ms. Foster joined RB as Vice-President of Marketing. From these undisputed facts, the court reached the following judgment: Because the petitioner has not demonstrated that she was qualified to work in marketing **before she began studying at HBS** we find that the MBA qualified Ms. Foster for a new trade or business. The fact that Ms. Foster was employed, while at HBS, in the same field in which she began working upon her graduation was one to which the court accorded no weight at all.\*\*

The Tax Court, in ruling against Ms. Foster, chose to distinguish other cases in which the taxpayers had prevailed. Thus, here, unlike the taxpayer in *Sherman v. Commissioner*, T.C. Memo. 1977-301, Ms. Foster had not demonstrated that her trade or business was "business administration" before she enrolled at HBS. In addition, the Tax Court distinguished the most favorable "MBA case" ever decided, the decision in *Allemeier v. Commissioner*, T.C. Memo. 2005-207, because, there, the taxpayer was already performing sales, management and marketing functions **before receiving her MBA and continued to do so while studying for it and after receiving it**.

### Penalties Imposed

To add insult to injury, the Tax Court agreed with the I.R.S.'s imposition of penalties. Thus, the I.R.S. asserted and the court agreed that the taxpayer's underpayment of taxes was attributable to negligence or disregard of rules or regulations. The court agreed that Ms. Foster had not shown that she "acted in good faith" or that she had "reasonable cause" for the position that she took in her 2002 tax return: Her

position, the court agreed, was an untenable one because, by her employer's own admission, only her MBA met the "specialty education requirements" of such employer and, therefore, it should have been apparent that the education expenses were not deductible because such education met the minimum education requirements for qualification in her new trade or business.

\*It seems clear that the MBA is not a minimum requirement for qualification for the position of *associate* at an Investment Bank. Many occupants of that position do not possess that degree with the result that only a bachelor's degree constitutes the minimum education requirement for this position that many MBAs gravitate towards following graduation.

\*\*Does this mean that an MBA candidate who secures summer employment (during the interregnum between the candidate's first and second year of study) with an investment bank to which she returns after graduation has not established herself in the trade or business of investment banking as a result of such summer employment? If it does, the expenses and fees incurred with respect to the candidate's second year of study might not be deductible. Instead, they would fall within the non-deductible basket since the education would, vis a vis the trade or business in which the candidate was engaged prior to matriculation, qualify the candidate for a new trade or business.

**By Robert Willens**

**DISCLAIMER:**

"Robert Willens LLC is neither a registered investment advisor nor a broker/dealer. Subscribers and/or readers are advised that the information contained in The Willens Report is not to be construed or relied upon as investment, tax planning, accounting and/or legal advice, nor is it to be construed in any way as a recommendation to buy, hold or sell (short or otherwise) any security or any other form of investment. All opinions, analyses and information contained herein is based upon sources believed to be reliable and is written in good faith, but no representation or warranty of any kind, express or implied, is made herein concerning any investment, tax, accounting and/or legal matter or the accuracy, completeness, correctness, timeliness and/or appropriateness of any of the information contained herein. Subscribers and/or readers are further advised that the Company does not necessarily update the information and/or opinions set forth in this and/or any subsequent edition of The Willens Report or any version thereof. Readers are urged to consult with their own independent professional advisors with respect to any matter analyzed herein. All information contained herein and/or this website should be independently verified."