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PROFESSIONAL AND EDUCATIONAL EXPENSES

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I would like to talk to you today concerning recent important developments in the tax treatment of professional and educational expenses. My remarks will be largely focused on the subject of deductible treatment of educational expenses of professional persons. The spring from which all the law on this subject flows is Section 162 of the Internal Revenue Code of 1954. That section does not mention the term "educational expenses." To best understand recent developments, an awareness of the early history of the treatment of educational expenses is helpful.

Prior to 1950, the Revenue Service and the courts were almost unanimous in regarding collegiate training as being beyond the scope of deductibility under Section 162. Cases during this period, however, did allow deductions for expenses of attending institutes and special programs in one's field. The dominant theme in this period was that expenses of collegiate training were personal or capital in nature and therefore non-deductible.

The first major break favoring the taxpayer relative to the treatment of the expenses of collegiate training was *Hill* vs. *Commissioner,* 181 Fed. 2d 906, (4th Cir. 1950). This circuit court decision involved a Virginia school teacher who had attended summer session at a college in order to improve her skills as a teacher. Reversing the Tax Court, the circuit court held that her expenses in attending summer session of a college were deductible because ordinary and necessary in her trade or business. Although the revenue service by a ruling in 1951 accepted the doctrine developed in the Hill case, it was 1958 before regulations under Section 162 dealing with the treatment of educational expenses were finalized.

These regulations, adopted in 1958, in large measure covered the treatment of educational expenses until 1967, when they were substantially revised through the issuance of new regulations. The 1958 regulations covered the subject with a double thrust. First, they provided for allowance of deductions for educational expenses incurred to maintain or improve skills or to meet employment requirements prescribed as a condition to retention of employment status. Secondly, they provided express disallowance of deductions for educational expenses incurred for the purpose of pursuing a new trade or business,

obtaining a new position, gaining a substantial advancement in position, or acquiring a specialty, within one's profession.

It is important in understanding the inadequacy of the 1958 regulations to understand that these regulations, in their administration, were geared in large part to a determination of subjective intention of the taxpayer. For example, the taxpayer, in order to prevail in litigation under these regulations, had the burden of proving that his purpose in incurring the expenses in question was to maintain or improve skills or to meet standards prescribed by his employer. The presence of a purpose to obtain a new position or to advance general knowledge for personal reasons would result in disallowance of the deductions.

The 1958 regulations, being based in large measure on subjective tests and criteria, invited litigation and dispute and it was forthcoming in tremendous volume. Because of the relatively small amounts of money involved in the disallowance of claims deductions, a pattern developed of *pro se* representation by taxpayers in settlement procedures within the Revenue Service and before the Tax Court, with all of the attendant difficulties inherent in situations where laymen represent themselves in complex legal proceedings.

Because the volume of litigation was heavy as a consequence of the impreciseness of the 1958 regulations and because of development in the case law which expanded and contradicted the rules in these regulations, it was fitting that they be reconsidered. On July 7, 1966, new proposed regulations pertaining to the deductibility of educational expenses were issued. These proposals were restrictive in tone and explicit in denying deductions in a number of situations not covered in the 1958 regulations. The hue and cry that followed the publications of the July 7, 1966, proposals was sufficient to bring about their withdrawal and the issuance of revised proposed regulations on October 1, 1966. With some changes, these proposals were finalized as treasury regulations on May 1, 1967.

By way of general comparison between the 1967 regulations and the 1958 regulations, the 1967 regulations were less restrictive in tone and application than their predecessor's provisions and employ the device of objective relationship rather than subjective intent in determining deductibility. Accordingly, it would appear that the present regulations should be easier to administer. Whether they have the effect of curtailing litigation under the deduction of educational expenses remains to be seen, and it is probable that certain key provisions in the 1967 regulations will soon be challenged in the courts.

Before turning to the treatment of specific classes and types of expenses, it is well to note that the 1958 regulations are still with us. The revenue service ruled in May of 1968 (Rev. Ruling 68-97) that the 1967 regulations need not be used to dispose of cases and claims

for refunds and in assessing deficiencies for years beginning prior to January 1, 1968. Accordingly, for a year beginning prior to January 1, 1968, a taxpayer may rely upon either the old or the new regulations. If he has a strong case on subjective intention to improve skills, he may prefer to rely on the earlier regulations. If the more liberal treatment in some areas of the 1967 regulations is advantageous to him, he may rely on these.

Although the general tone of the 1967 regulations is liberal and less restrictive, there is one change of major proportions that is quite restrictive in nature. Under a prior law the expenses that qualify one for a new trade or business were deductible, in the view of the courts, if not in the view of the Service, if the taxpayer's purpose in incurring those expenses was to improve or maintain needed skills in existing employment or trade or business. Under the 1958 regulations a number of courts held that accountants and revenue agents could properly deduct the cost of a legal education. As revised, the regulations are no longer vague concerning deductibility of expenses that both qualify for a new trade or business and yet are appropriate to the maintenance or improvement of skills in present employment. The regulations flatly provide that no deductions shall be allowed for expenses of education that qualify a person for a new trade or business. Thus, it appears that one's intention to use his education in existing employment or business is of no consequence under the revised regulations. The deduction will be disallowed notwithstanding the taxpayers intent.

Considering that a body of case law has developed permitting taxpayers who demonstrate an intention of using legal education in present employment, rather than in pursuing a new trade or business, to deduct the expenses of such education, it requires no prophetic skills to anticipate that this change in the 1967 regulations will be challenged and that there will be some time before the law in this area is settled.

An apparent liberalization in the 1967 regulations relates to expenditures which qualify a person for a new position or for substantial advancement in present position. The 1958 regulations provided that expenses incurred for the purpose of attaining a new position or gaining substantial advancement in position were *not* deductible. This restrictive language in the 1958 regulations is omitted from the 1967 regulations. However, there is no substitute language in the 1967 regulations. It is possible to infer an intention to retreat from the 1958 position but difficult to determine how far the retreat has gone. It is clear, however, that if the new position or advanced position takes one into a new trade or business, that the expenses are not deductible under the Regulations. Fortunately for the taxpayer, the 1967 regulations employ an expanded concept of what constitutes one's present trade or business. For example, a high school English teacher that takes courses

for the purpose of becoming a history teacher, a principal, or a guidance counselor, is regarded under the regulations as being within his original trade or business and the expenditures may be deducted.

Another area where changes were made is in the provision dealing with improvement of skills. Under the 1958 regulations, educational expense deductions were allowed where the purpose of the education was to maintain or improve skills within one's trade, business or employment. The 1958 regulations limited the deductions to cases where the expenditures are "customary." The same basic provisions in the 1958 regulations are carried forward but the limitation of "customary" expenditures is deleted. Seemingly, the taxpayer no longer need show convincingly that his decision to take courses to improve his skills is one customarily made within his calling by persons similarly situated. By way of clarification, but without changing the law, the regulations expressly provide that "refresher" courses in one's area of business or professional interest and "current development" courses in such areas are courses the expenses of which are deductible.

The thrust of the new regulations is to downgrade the element of "purpose" in pursuing education that improves one's skills and to focus on the question of whether or not the education in fact improves one's skills. However, a taxpayer can not be assured that the expenses incurred in courses which improve his skills will be deductible where such courses also advance his general knowledge. In *James A. Carroll,* 51 TC, No. 22, Filed October 31, 1968, the taxpayer was a policeman who enrolled in a baccalaureate degree program at DePaul University. The police department encouraged him to do so and arranged for him to be excused from rotation duty assignments which would have conflicted with his class attendance. The taxpayer attempted to show that an educated police officer is a more effective and valuable police officer and that his purpose was to improve his skills as a policeman. The Tax Court, in disallowing his claimed deductions had the benefit of knowing his later activities, including completion of the B.A. degree with a concentration in philosophy, resignation from the police department and enrollment in law school. Finding that the taxpayer lacked the requisite purpose to improve skills under the 1958 regulations, and acknowledging the applicability of the 1967 regulations, the court examined the taxpayer's case in the light of the latter regulations. It observed:

> "By their terms, they do not require the taxpayer to establish his primary purpose in undertaking the education. However, in our opinion, the new regulations do not allow a deduction for educational expenses when the education is inherently personal and not proximate to the job activities of the taxpayer. Having previously discussed these issues and found that the education undertaken by

> the petitioner was of an inherently personal nature and only tenuously related to his employment, we find that the 1967 regulations do not allow the deduction claimed by the petitioner."

The essence of the majority holding appears to be that even if the general studies in a B.A. program improved his skills as a policeman, that such expenses were inherently personal and therefore not deductible. Four judges dissented rather strongly. In a dissent by Judge Hoyt with Judges Faye and Maroney concurring, the following conclusion was drawn:

> "Even if the expense was of a sort generally regarded as personal, it was for education which improved petitioner's skills in his then existing employment as a police officer and not within the exceptions spelled out by the regulations making only certain specific expenses of this type non-deductible."

Because of the division in the Tax Court, it is likely that the case will be appealed. Under the improvement and maintenance of skills tests as contained in the new regulations, *James A. Carroll* focuses on the central weakness; namely, what degree of direct relationship to employment is necessary for education expenses to be deducted and what degree of personal, non-business benefit associated with the education obtained is sufficient to foreclose deductible treatment?

Somewhat related to questions involved in the provision relating to maintenance of skills is the question of whether expenses of education which qualify one to be a specialist within his profession are deductible. Under the 1958 regulations, the tenor of the rules was to deny deductions for expenses which tended to qualify a person for a specialty within his profession. For example, the 1968 regulations contained an illustration which expressly provided that a physician could not deduct expenses of taking a course in pediatrics. The 1967 regulations omitted that example, leaving the inference that a liberalization is intended. Further evidence of liberalization for expenses of specialty training is found in the new example which provides that the expenses of a psychiatrist in taking courses that qualify him to be a psychoanalyst are deductible. While the regulations do not expressly provide that expenses of training for a specialty are deductible, the deletion of a hostile example contained in the 1958 regulations, coupled with the addition of the generous example in the 1967 regulations, enables one to argue that this is intended.

More than any other professional class, the teaching profession is singled out for specific treatment in the 1967 regulations. The treatment accorded is generally favorable. The principle in the 1967 regulations that minimum educational expenses for employment are not deductible is rather specifically defined in relation to the teaching

profession. For teachers in higher education, a person is deemed to have met minimum education requirements for his position when he becomes a member of the faculty. A person for the purpose of this rule, is regarded as becoming a faculty member, if one of three things occurs:

(1) he has tenure or his service counts toward tenure,
(2) the institution contributes to his retirement fund, or
(3) he can vote at faculty meetings.

These rules are alternative, not cumulative. If the taxpayer is employed by an institution as a teacher and can vote in faculty meetings, he is regarded as having met minimum education requirements even though he lacks tenure. If the obtaining of a doctorate is required for tenure, his expenses of education to obtain the doctorate, incurred after his faculty appointment, are deductible. It would appear that the examples in the regulations providing deductibility when an elementary school teacher takes courses permitting her to become a secondary school teacher, high school counselor, or principal are equally applicable to the college teacher who desires to change his field of teaching competence or seek a position in college administration.

As to public school teachers, the minimum educational requirement rules are less clear in application. The regulations provide, for example, that where a taxpayer has a bachelor's degree and both a bachelor's degree and 30 hours of educational courses are required to be a secondary school teacher, one with a degree but lacking the additional 30 hours of education courses who is permitted to teach will be regarded as having met minimum requirements and the cost of obtaining the additional educational courses required will be deductible. However, in a similar situation, if one is hired without a bachelor's degree where rules require the teacher to hold a bachelor's degree, the taxpayer will be regarded as not having met minimum requirements.

The 1958 regulations took the position, particularly for teachers, that travel expenditures are generally personal in nature and are nondeductible. The rules of the 1958 regulations were liberalized somewhat in Revenue Ruling 64-176 and the 1967 regulations reflect generally the less restrictive approach of the ruling. The thrust of the 1967 regulations is that travel expenditures are deductible if directly related to duties of one's trade, business, or employment. The test of the relationship is whether a major portion of the travel period was directly related to maintaining or improving the taxpayer's skills. If so, the travel expenses are deductible except to the extent reflected in travel for personal convenience. For example, if a teacher were to travel from the East Coast to California to take summer courses, and dedicated a major portion of her activities to improving her skills as a teacher through course work in California, the round trip to and from California

would be deductible. However, the expenses of weekend excursions undertaken for the purpose of sunbathing or relaxation while in California would not be deductible. If only a small portion of the summer spent in California was related to course work directly related to improvement of skills, none of the travel expenditures, including the round trip to California, would be deductible.

The problem of deductibility of educational expenses in the context of the "carrying on of trade or business" requirement in Section 162 received no attention in the 1958 regulations and no attention in the 1967 regulations. However, Revenue Ruling 60-97 provides that when the taxpayer is not actively engaged in his trade, business or employment at the time the educational expenses are incurred, they are not expenses ordinary and necessary to the carrying on of any trade or business. Implicit in this ruling is the requirement that the taxpayer have active trade, business or employment status at the time the expenses are incurred in order for them to be deductible. This position apparently continues to be the position of the Revenue Service under the 1967 regulations, and was argued in the case of *Furner vs. Commissioner,* 7th Circuit, February, 1968, reversing 47 TC 165. The 7th Circuit rejected the government's position that educational expenses are deductible only if employment status is continuing. In *Furner,* the taxpayer, a junior high school teacher with a bachelor's degree, resigned her position with the local school system in order to attend Northwestern University as a full-time graduate student. She deducted her graduate expenses and on receiving her Master's degree took employment in a different school system in another locality. The 7th Circuit said:

> "The Commissioner and Tax Court put too much emphasis, we think, on whether the course of study displaces performance of teaching activity during the period of the year when it is traditional for teachers to teach, and give insufficient consideration to the broader question whether the relationship of the course of study to intended future performance as a teacher is such that the expenses thereof can reasonably be considered ordinary and necessary in carrying on the business of teaching."

This approach, if adopted in other circuits, could result in substantial tax savings to a large sector of the teaching profession and perhaps other professions as well.

In conclusion, because of the significant changes in treatment effected by the new educational expense regulations, they merit close attention and study. While they generally reflect the development of case law since 1958, they are, in several aspects, more restrictive. It remains to be seen whether they substantially reduce litigation in the educational expense area.