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RETHINKING TREASURY REGULATION § 1.162-5
AND SLAYING THE MONSTER IN THE
EDUCATION TAX MAZE

*Vincent G. Kalafat**

INTRODUCTION

Among the many heroic tales told by the ancient Greeks is that of Theseus and the Minotaur. The story begins in Athens with the untimely death of Androgeus, the son of Minos, King of Crete. To punish the Athenians for his son's death, Minos demanded a grisly tribute of them. Each year, seven young men and seven maidens fair were to be sent from Athens to Crete. Soon after their arrival, Minos would place them in an elaborate and deadly maze known as the Labyrinth. The Labyrinth had been constructed to confine the Minotaur, a ferocious monster, half man and half bull. As the nature of the Labyrinth prevented escape, the Athenians were doomed to death either by starvation in the depths of the maze or at the hands of the Minotaur. In time, Theseus, son of the King of Athens, was numbered among these unlucky ones and, although he had already performed many valiant deeds, there was little hope for his return when he set sail for Crete. Upon his arrival in Crete, however, the daughter of Minos immediately fell in love with Theseus. The princess secretly gave Theseus a magic ball of thread to guide him through the maze and told him how to defeat the Minotaur. Armed thus, Theseus bravely entered the maze, slew the monster, and escaped Crete with the princess.¹

Throughout the years, Congress has created its own daunting tax maze in the Internal Revenue Code (the Code)² relating to higher

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1 See ROBERT GRAVES, *THE GREEK MYTHS* 336-39 (Michel W. Pharand ed., 2001). There are, of course, variations among the accounts of Theseus and the Minotaur.

2 All citations to the Code refer to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

education. Without considering the direct financial aid through government grants and subsidized loans, the various tax incentives³ for higher education fall into three broad categories: (1) tax benefits for future expenses, (2) tax benefits for past expenses, and (3) tax benefits for current expenses.⁴ The first category, tax benefits for future educational expenses, provides favorable tax treatment of qualified distributions from Coverdell Education Savings Accounts⁵ and from Qualified Tuition Programs (also known as "529 Plans"),⁶ avoidance of the ten percent penalty for certain early distributions from Individual Retirement Accounts (IRAs),⁷ as well as an exclusion from gross income for interest earned on certain qualified U.S. savings bonds.⁸ Tax benefits for past educational expenses include an above-the-line deduction for interest paid on student loans⁹ and an exclusion from gross income for the cancellation of certain student loans.¹⁰ The final category, tax benefits for current educational expenses, encompasses an exclusion from gross income for certain scholarships and fellowships¹¹ and qualified employer-provided assistance under an educa-

3 The loss of tax revenues when the Code provides for a special exclusion, deduction, or credit, preferential tax rates, or a deferral of tax liability is commonly referred to as a tax expenditure. Essentially, one can view the revenue losses from special tax relief as the functional equivalent of a spending program—the government simultaneously collects the revenue and makes a direct budget outlay of equal amount to the taxpayer. Deductions for business expenses, on the other hand, are not tax expenditures because an income tax necessarily requires a deduction for expenses. See ALAN GUNN & LARRY D. WARD, *CASES, TEXT AND PROBLEMS ON FEDERAL INCOME TAXATION* 163–70 (5th ed. 2002). Thus, the Hope and Lifetime Learning Credits and the § 222 deduction for qualified tuition and related expenses are tax expenditures, while a deduction under Treasury Regulation § 1.162-5 for educational expenses is not. The staff of the Joint Committee on Taxation project that 2005 tax expenditures for the Hope and Lifetime Learning Credits and § 222 deduction for qualified tuition and related expenses will total \$5.2 billion and \$2.8 billion, respectively. STAFF OF THE JOINT COMM. ON TAXATION, 109TH CONG., *ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2005–2009*, at 35 (Joint Comm. Print 2005), available at <http://www.house.gov/jct/s-1-05.pdf>.

4 See generally STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., *PRESENT LAW AND ANALYSIS RELATING TO TAX BENEFITS FOR HIGHER EDUCATION* (Joint Comm. Print 2004), available at <http://www.house.gov/jct/x-52-04.pdf>; INTERNAL REVENUE SERV., PUB. 970, *TAX BENEFITS FOR EDUCATION* (2004).

5 See I.R.C. § 530 (Lexis 2005).

6 See *id.* § 529.

7 See *id.* § 72(t)(2)(E) (2000).

8 See *id.* § 135 (Lexis 2005).

9 See *id.* § 221; *id.* § 62(a)(17) (2000).

10 See *id.* § 108(f) (Lexis 2005).

11 See *id.* § 117 (2000 & Supp. I 2001).

tional assistance program,¹² the nonrefundable Hope and Lifetime Learning Credits,¹³ a limited above-the-line deduction for tuition and related expenses under § 222,¹⁴ and, the focus of this Note, a deduction for work-related education under § 162.¹⁵

Based on § 162, the Department of the Treasury¹⁶ promulgated Treasury Regulation § 1.162-5 (the "Education Regulation"). Today, the regulation looms as a monster within the education tax maze. As this Note explores in greater detail, the regulation allows certain individuals engaged in carrying on a trade or a business a deduction for educational expenses, provided that the education meets the tests articulated by the regulation.

The staff of the Joint Committee on Taxation has recently urged Congress to simplify the education tax maze that currently paralyzes taxpayers.¹⁷ More specifically, the staff proposed combining the Hope and Lifetime Learning Credits¹⁸ and the § 222 deduction for tuition and related expenses¹⁹ into a single credit.²⁰ While commend-

12 See *id.* § 127.

13 See *id.* § 25A.

14 See *id.* § 222 (Lexis 2005); *id.* § 62(a)(18) (Supp. I 2001).

15 See *id.* § 162(a) (2000); Treas. Reg. § 1.162-5 (as amended in 1967). Employees may treat such amounts as a miscellaneous itemized deductions subject to the two percent floor in § 67. Self-employed taxpayers, on the other hand, may qualify for an above-the-line deduction under § 62(a)(1).

16 The Office of the Chief Counsel of the Internal Revenue Service or the Office of Tax Policy of the Treasury largely write the Treasury Regulations, the second principal source of tax rules. The Treasury issues most regulations as "interpretative regulations" under § 7805(a) and courts defer to such regulations as long as they reasonably implement the statute. If Congress expressly authorizes the Treasury to write regulations, the regulations are referred to as "legislative regulations" and the courts afford them even greater deference, overturning such regulations only if they are plainly inconsistent with the statute. I STAFF OF THE JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 49-50 (Joint Comm. Print 2001), available at <http://www.house.gov/jct/s-3-01vol1.pdf>.

17 See STAFF OF THE JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 42 (Joint Comm. Print 2005), available at <http://www.house.gov/jct/s-2-05.pdf>. Congress has introduced legislation to simplify the education tax maze. See, e.g., Education Tax Credit Simplification Act of 2004, H.R. 4136, 108th Cong. (proposing an amendment to the Code to combine the Hope and Lifetime Learning Credits and to provide a uniform definition of "qualifying higher education expenses"). As of the date of this Note, however, Congress's attempts have been unsuccessful.

18 See *infra* notes 22-39 and accompanying text.

19 See *infra* notes 40-52 and accompanying text.

20 See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 17, at 42.

ing the staff's proposal to simplify these parts of the maze, this Note focuses on the dangers of the forgotten Education Regulation monster.

In an effort to provide the magic ball of thread, Part I examines the three tax provisions the staff of the Joint Committee on Taxation proposed collapsing and highlights the evolution of the Code's treatment of educational expenses under § 162, resulting in the Treasury eventually issuing and later amending the regulation. Part II critiques the regulation as applied by the courts and the Internal Revenue Service (IRS). In particular, § 162's requirement that taxpayers engage in "carrying on" a trade or business and the regulation's "upward-bound" test that disallows a deduction for education that "leads to qualifying" the taxpayer for a new trade or business impose overly confusing and complicated limitations. In turn, the confusion and complexities create difficulties for courts applying these standards, and, combined with the intense fact-based inquiry the regulation requires, generate considerable uncertainty for taxpayers considering deducting their educational expenses under § 162. As one might suspect, this landscape provides a climate ripe for aggressive tax positions and even tax evasion. In sum, the regulation represents an unworkable tax incentive for higher education in the twenty-first century.

With the potential to break down socioeconomic and racial barriers, to fulfill individual dreams, and to unleash waves of innovation even greater than those of the last century, higher education clearly provides lasting benefits both to individuals and society. Considering the critical importance of higher education in the modern world, federal tax incentives for current higher education expenses should not force students or their parents to enter a daunting tax maze or to confront a monster.²¹ Accordingly, this Note recommends that Con-

21 Individuals personally benefit from higher education. As one example, college graduates typically earn significantly higher income over their working lives. SANDY BAUM & KATHLEEN PAYEA, COLL. BD., EDUCATION PAYS 2004, at 9, available at http://www.collegeboard.com/prod_downloads/press/cost04/EducationPays2004.pdf. One commentator, however, appropriately states that "[t]o derive any justification at all for governmental financial support from taxes compulsorily levied on all citizens, we must be able to show, at least conceptually, just what *general* benefits the taxpayer who secures no purely private consumption benefits receives from the outlays to higher education." JAMES M. BUCHANAN, WHAT SHOULD ECONOMISTS DO? 257 (1979). Recent studies establish that higher education provides significant societal benefits as well. For example, higher education generally increases productivity, generates higher tax payments from the additional earnings, reduces dependence on public income transfer programs, improves quality of life, reduces unemployment and poverty, and increases civic participation. BAUM & PAYEA, *supra*, at 9. Moreover, higher education helps to fuel the economy and to maintain the United States' global com-

gress legislatively slay the monster by disallowing a deduction under § 162 for educational expenses paid or incurred by a degree-seeking taxpayer at an eligible educational institution and dismantle parts of the maze by implementing the staff of the Joint Committee's proposal to collapse § 25A and § 222 into one unified education tax credit for higher education.

I. SURVEYING THE MAZE AND THE MONSTER

While the birth of the Education Regulation monster dates back to 1958, the Hope and Lifetime Learning Credits and the above-the-line deduction for qualified tuition and related expenses are relatively recent statutory creations found within § 25A and § 222 respectively. Accordingly, Part I.A briefly analyzes § 25A and § 222, the parts of the tax maze the staff of the Joint Committee proposed simplifying, describes their interplay, and, most importantly, offers a glimpse of their collective complexity. Part I.B focuses on the Education Regulation monster to provide a foundation for critiquing the weaknesses of the regulation.

A. *The Construction of the Maze*

1. The Hope Scholarship Credit and the Lifetime Learning Credit

The Taxpayer Relief Act of 1997²² contains several of Congress's most significant tax incentives for higher education, including two important nonrefundable tax credits, the Hope Scholarship Credit and the Lifetime Learning Credit.²³ At the same time, these tax provisions have generated significant criticism because of their considerable complexity.²⁴

petitiveness in the twenty-first century. Accordingly, this Note accepts the premise that higher education provides significant societal benefit, justifying a simple and effective unified education tax credit.

22 Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 26 U.S.C.).

23 I.R.C. § 25A (2000 & Supp. I 2001); see also GUNN & WARD, *supra* note 3, at 171 n.d. ("For reasons not explained in the committee reports, the names 'Hope Scholarship Credit' and 'Lifetime Learning Credit' are capitalized, unlike the names of other credits. This may reflect the profound importance of these credits, in comparison with all the others. Or it may not.")

24 See, e.g., Glenn E. Coven, *Bad Drafting—A Case Study of the Design and Implementation of the Income Tax Subsidies for Education*, 54 TAX LAW. 1, 2 (2001) (arguing that the legislation creating the Hope Scholarship Credit, the Lifetime Learning Credit, and the Educational Individual Retirement Accounts are "really poorly drafted and the resulting deterioration in the quality of the taxation statute results in unacceptable costs").

The Hope Credit, codified at § 25A(b), is a nonrefundable credit *per student* per year equal to 100% of the first \$1000 of qualified tuition and related expenses and fifty percent of the next \$1000 paid for a student's education for the first two years of postsecondary education (i.e., first two years of undergraduate studies).²⁵ The sister credit found in § 25A(c), the Lifetime Learning Credit, is a nonrefundable credit as well, but calculated *per taxpayer* (i.e., family wide) per year for an unlimited number of years (i.e., both undergraduate and graduate studies) and equals twenty percent of qualified tuition and related expenses not exceeding \$10,000.²⁶ Both credits are phased out for higher-income taxpayers with modified adjusted gross incomes between \$43,000 and \$53,000 (\$87,000 and \$107,000 for married taxpayers filing a joint return) for 2005.²⁷

To be eligible for the Hope Credit, a student must enroll in a "degree, certificate, or other program . . . leading to a recognized educational credential at an [eligible] institution of higher education . . . and not be enrolled in an elementary or secondary school,"²⁸ and carry at least one half the normal full-time workload for at least one academic period.²⁹ Moreover, students convicted of a felony drug offense cannot claim the Hope Credit.³⁰ For both credits, neither mar-

25 I.R.C. § 25A(b) (2000). Beginning in 2001, each of the \$1000 amounts are adjusted as a result of inflation and rounded to the next lowest multiple of \$100. *Id.* § 25A(h).

26 *Id.* § 25A(c). Unlike the Hope Credit, these amounts are not adjusted for inflation. *See supra* note 25.

27 I.R.C. § 25A(d). The phase-out calculation itself is rather daunting:

The amount which would (but for this subsection) be taken into account . . . shall be reduced (but not below zero) by . . . the amount which bears the same ratio to the amount which would be so taken into account as . . . the excess of the taxpayer's modified adjusted gross income for such taxable year, over \$40,000 (\$80,000 in the case of a joint return), bears to . . . \$10,000 (\$20,000 in the case of a joint return).

Id. Therefore, during 2005 taxpayers with modified adjusted gross income in excess of \$53,000 (\$107,000 in the case of joint returns) may not claim the Hope Credit or Lifetime Learning Credit. Treas. Reg. § 1.25A-1(c)(1) (2002). Note that these phase-out amounts are indexed for inflation beginning after 2001 and the 2005 amounts are referred to in the text. I.R.C. § 25A(h)(2).

28 I.R.C. § 25A(b)(3)(A); *see also* Higher Education Act of 1965 § 484(a)(1), 20 U.S.C. § 1091(a)(1) (2000).

29 I.R.C. § 25A(b)(3)(B).

30 For reasons Congress did not explain, the strict "no drug" policy applies only to the Hope Credit. Query why Congress adopted this policy for the Hope Credit, a credit targeted to community college students, but not for the Lifetime Learning Credit. Furthermore, Congress failed to explain why offering an education incentive for students with a history of drug abuse would be a bad policy, while students con-

ried taxpayers who do not file a joint tax return nor nonresident aliens can claim the credits.³¹

The Code defines “qualified tuition and related expenses” as tuition and fees required for enrollment or attendance by the taxpayer, spouse, or any dependent at an eligible educational institution.³² This definition, however, excludes not only expenses for any course involving sports, games, or hobbies (unless part of the student’s degree program), but also student activity fees, athletic fees, insurance, and other expenses unrelated to the student’s academic studies.³³ Qualified tuition and related expenses paid by dependents are treated as paid by the taxpayer claiming the personal exemption for the dependent.³⁴ Accordingly, determining who can claim the student as a dependent, and thus claim the credit, adds even further complexity.³⁵ Because only if the taxpayer actually claims the personal exemption for a student does the taxpayer receive the credit, the taxpayer must determine whether the taxpayer or the dependent-student would receive the greatest tax benefit from the Hope or Lifetime Learning Credit to decide whether to claim the personal exemption.³⁶

Section 25A contains special provisions dealing with the interaction of other educational tax incentives. Taxpayers must reduce qualified tuition and related expenses by the amount of qualified scholarships and fellowships or employer-provided educational assistance excluded from gross income.³⁷ In addition, if a taxpayer claims a Hope Credit with respect to a student, then amounts paid to educate that student are ineligible for the Lifetime Learning Credit.³⁸ Finally, taxpayers cannot claim the Hope or Lifetime Learning Credits for any educational expenses for which the taxpayer claims a deduction under any other section of the Code.³⁹

victed of other crimes, such as murder, should receive a tax benefit. *See Coven, supra* note 24, at 33.

31 *Id.* § 25A(b)(2)(D), (g)(6)–(7).

32 *Id.* § 25A(f)(1)(A).

33 *Id.* § 25A(f)(1)(B)–(C).

34 *Id.* § 25A(g)(3).

35 *See id.* § 25A(f)(A), (g)(3).

36 *See id.* § 25A(g)(3).

37 *Id.* § 25A(g)(2).

38 *Id.* § 25A(c)(2)(A).

39 *Id.* § 25A(g)(5).

2. The § 222 Deduction for Qualified Tuition and Related Expenses

Section 222, enacted in 2001, represents the latest addition to Congress's educational tax incentive family. This provision allows a taxpayer to claim an above-the-line deduction for qualified tuition and related expenses paid during the year.⁴⁰ This new education deduction incorporates § 25A's definition of qualified tuition and related expenses, which generally includes required tuition and fees for the taxpayer, spouse, or any dependents.⁴¹ Section 222 operates only as a temporary provision and will expire after 2005.⁴²

The education deduction contains an interesting three-step limitation mechanism for higher-income taxpayers. For 2004 and 2005, if the taxpayer's adjusted gross income⁴³ does not exceed \$65,000 (or \$130,000 for married taxpayers filing a joint return), the maximum deduction is \$4000. If the taxpayer's adjusted gross income does not exceed \$80,000 (or \$160,000 for married taxpayers filing a joint return), the maximum deduction is \$2000. Taxpayers with adjusted gross income in excess of \$80,000 (or \$160,000 for married taxpayers filing a joint return) cannot claim a deduction.⁴⁴ Because a single taxpayer who has adjusted gross income of \$80,000 may deduct up to \$2000 while a single taxpayer who has adjusted gross income of \$80,001 cannot deduct anything, the § 222 provides an extreme example of the "cliff effect."⁴⁵

Like the educational tax provisions discussed previously, § 222 provides detailed rules to coordinate the deduction with other Code sections. In particular, the taxpayer must reduce qualified tuition and related expenses by scholarships or employer-provided educational assistance excluded from the taxpayer's gross income.⁴⁶ Moreover, § 222 requires taxpayers to reduce qualified tuition and related expenses by funds from various other tax preferred educational savings vehicles, including income from U.S. savings bonds used to pay qualified higher education expenses and certain distributions from 529 Plans and Coverdell Education Savings Accounts.⁴⁷ Section 222 also prohibits a taxpayer from claiming the education deduction for a stu-

40 *Id.* § 222(b) (Supp. I 2001).

41 *See id.* § 222(d); *see also id.* § 25A(f), (g)(2) (2000).

42 *Id.* § 222(e) (Supp. I 2001).

43 As defined exclusively for this provision by *id.* § 222(b)(2)(C) (Lexis 2005).

44 *Id.* § 222(b)(2)(B) (Supp. I 2001).

45 Ira B. Shepard & Martin J. McMahon, Jr., *Recent Developments in Federal Income Taxation: The Year 2001*, 5 FLA. TAX REV. 627, 701 (2002).

46 I.R.C. § 222(d)(1).

47 *Id.* § 222(c)(2)(B).

dent if the taxpayer elects to claim the Hope Credit or Lifetime Learning Credit.⁴⁸ Lastly, § 222 contains a general provision denying a deduction under § 222 for any educational expenses the taxpayer deducts under other Code provisions, including § 162.⁴⁹

Similar to the education tax credits, § 222 denies the deduction for educational expenses to taxpayers married and filing separate tax returns,⁵⁰ and nonresident aliens.⁵¹ Unlike the Hope and Lifetime Learning Credits, however, § 222 denies a deduction for any individual if his or her personal exemption is allowable to another taxpayer, whether or not the taxpayer actually claims the personal exemption.⁵²

The brief discussion above only begins to describe the ghastly details and inordinate complexities of § 25A and § 222. If the individual Code provisions do not overwhelm taxpayers enough, they need only consider the collective complexities of the various tax incentives. Indeed, taxpayers should calculate the tax benefit for the educational expenses under § 25A, § 222 and, as discussed below, the Education Regulation to determine which section, or combination of sections, affords the greatest tax savings.⁵³ Consider the confusion when taxpayers have more than one qualified student or, for purposes of § 25A, must determine who receives the greatest tax benefit from the Hope or Lifetime Learning Credit to decide whether to claim the personal exemption for a dependent-student. Moreover, the various adjusted gross income phase-outs and the lack of any uniform definition of qualified educational expenditures within the Code⁵⁴ makes navigating the maze even more difficult for taxpayers attempting to compare various tax benefits. Consequently, § 25A and § 222 collectively form complex parts of the education tax maze.

48 *Id.* § 222(c)(2)(A).

49 *Id.* § 222(c)(1).

50 *Id.* § 222(d)(4).

51 *Id.* § 222(d)(5).

52 *Id.* § 222(c)(3).

53 See INTERNAL REVENUE SERV., *supra* note 4, at 60 (instructing taxpayers to “[f]irst, figure your taxes using the expenses as business deductions. Then, figure your taxes again using any of the other deductions and credits for which you qualify. You may find that a combination of credit(s) and deduction(s) gives you the lowest tax.”).

54 For a helpful table comparing the Code’s various definitions of educational expenses, see STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 4, at 46–47. For further analysis of the inconsistent Code definitions in the education context, see also Amy J. Oliver, *Improving the Tax Code to Provide Meaningful and Effective Tax Incentives for Higher Education*, 12 U. FLA. J.L. & PUB. POL’Y 91, 129–37 (2000).

B. *Tracing the Evolution of the Monster*

Section 162 of the Code generally allows a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."⁵⁵ Even though this section's broad language would appear to encompass almost any educational expense connected with a trade or business, the regulation, first issued by the Department of the Treasury in 1958 and later amended in 1967, significantly narrows the scope of § 162 in the context of educational expenses. The regulation attempts to filter out deductible educational expenses under § 162 from nondeductible personal expenses under § 262⁵⁶ and capital expenditures⁵⁷ by articulating two affirmative tests and two disallowance tests.⁵⁸

55 I.R.C. § 162(a) (2000). For a more in-depth analysis of Code § 162 and the development of Treasury Regulation § 1.162-5, see Marcus Schoenfeld, *The Educational Expense Deduction: The Need for a Rational Approach*, 27 VILL. L. REV. 237 (1982).

56 I.R.C. § 262 (denying a tax deduction for "personal, living, or family expenses").

57 No general Code section specifies a rule to distinguish capital expenditures, but the capitalization principal arises from a number of scattered Code sections. *See, e.g., id.* § 195 (Lexis 2005) (disallowing a deduction for business "start-up expenditures"); *id.* § 263(a)(1)-(2) (denying a deduction for amounts "paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate" and "restoring property or in making the exhaustion thereof for which an allowance is or has been made"); *id.* § 263A (specifying that the taxpayer must capitalize the "proper share" of "indirect" costs of property produced or acquired for resale); *id.* § 446(b) (2000) (requiring that a taxpayer's accounting method "clearly reflect income"), *id.* § 1012 (defining the basis of property as "cost"); *id.* § 1016(a)(1) (requiring adjustment for expenditures "properly chargeable to capital account"); *see also* GUNN & WARD, *supra* note 3, at 270 (discussing the statutory roots of the "capitalization" requirements).

58 Treas. Reg. § 1.162-5(a)-(b) (as amended in 1967). Ultimately, the regulation's attempt to classify educational expenditures into these categories and the underlying assumption that taxpayers, the IRS, and courts can appropriately make this classification underlie the difficulties discussed in Part II. Classification of educational expenditures ultimately flows from Congress's legislative decision to tax net income, rather than gross income or consumption. *See* I.R.C. § 1(a)-(d) (imposing the tax rate on taxable income); *id.* § 63(a) (generally defining taxable income as gross income minus allowable deductions); *see also* 1 BORRIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 20.1.1, at 20-3 (3d ed. 1999) (noting that the Constitution does not require allowances for the cost of earning income). One legal scholar asserts that while Congress must allow a deduction for business expenses to effectively tax "net income," Congress must disallow deductions for personal expenses to prevent erosion to the tax base from personal living expenditures and to protect the notion of taxing economic gains. MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION* ¶ 7.01, at 177 (9th ed. 2002). In the context of educational expenditures, however, these distinctions impose a difficult, if not impossible,

The following analysis traces the early federal tax treatment of educational expenses under § 162, which evolved first into a “subjective” standard before becoming an “objective” standard under the current Education Regulation.

1. The Pre-Regulation Era: The Shaky Beginning

Almost from the beginning of the federal income tax system, the IRS and courts considered educational endeavors presumptively, if not per se, personal expenses and, therefore, disallowed any tax deduction under § 162.⁵⁹ In the mid-1920s, however, the Board of Tax Appeals signaled a change of course in *Shutter v. Commissioner*⁶⁰ by allowing a minister to deduct the cost of attending an essential church convention. Two years later, the Board reached a similar decision in *Silverman v. Commissioner*,⁶¹ holding that a college professor could deduct the cost of attending a professional convention. In response, in 1933 the IRS issued General Counsel’s Memorandum 11,654, which allowed a limited deduction for certain expenses incurred by college professors to attend professional conventions.⁶²

The theoretical debate over whether educational costs were capital expenditures or current expenses largely marked the next stage of development.⁶³ In *Welch v. Helvering*,⁶⁴ Justice Benjamin Cardozo suggested in dictum that the cost of an education could qualify as a business-related expense rather than a personal expense, but indicated

challenge for taxpayers, the IRS and courts. See 1 BITTKER & LOKKEN, *supra*, ¶ 22.1.1, at 22-5.

59 See, e.g., O.D. 892, 1921-4 C.B. 209, *obsoleted by* Rev. Rul. 69-31, 1969-1 C.B. 307 (stating that educational expenses incurred by school teachers attending summer courses were personal in nature and nondeductible); O.D. 894, 1921-5 C.B. 171, *obsoleted by* Rev. Rul. 69-31, 1969-1 C.B. 307 (concluding that educational expenses paid by doctors pursuing post-graduate courses were personal and, thus, nondeductible); I.T. 1520, I-2 C.B. 145-46 (1922), *revoked by* I.T. 2688, XII-1 C.B. 251 (1933) (characterizing a college professor’s research expenses that were encouraged by the college but not required as nondeductible personal expenses); Driscoll Appeal, 4 B.T.A. 1008, 1009 (1926) (denying a professional singer a deduction for the cost of voice lessons because the expenses were personal); *Darling v. Comm’r*, 4 B.T.A. 499, 504 (1926), *acq.* VI-1 C.B. 2 (disallowing a cartoonist from deducting the cost to study and practice sculpture because the expenses were “purely educational”).

60 2 B.T.A. 23 (1925), *acq.* IV-2 C.B. 4.

61 6 B.T.A. 1328 (1927), *acq.* VI-2 C.B. 6.

62 Gen. Couns. Mem. 11,654 (1933).

63 This debate substantially influenced the requirements later articulated in Treasury Regulation § 1.162-5.

64 290 U.S. 111 (1933).

that such costs more accurately represented a capital expenditure. In an oft-quoted passage, Justice Cardozo stated:

*Reputation and learning are akin to capital assets, like the good will of an old partnership. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.*⁶⁵

Following Justice Cardozo's proposition in *Welch* that linked education to capital expenditures, the Tax Court, in at least one case, denied a deduction for educational costs at least in part on the grounds that such payments represented nondeductible capital expenditures.⁶⁶

Decided in 1950, *Hill v. Commissioner*⁶⁷ was the first case in which a court permitted a deduction under § 162 for educational expenses for formal instruction rather than professional conventions or research expenses. At that time, Virginia law required school teachers to renew their license by either obtaining college credits or passing an examination on five selected books.⁶⁸ Petitioner Nora Payne Hill chose to attend summer school at Columbia University to meet the requirements to renew her teaching license.⁶⁹ In reversing the Tax Court's decision, the Fourth Circuit held Hill could deduct the educational costs because they "were incurred in carrying on a trade or business, were ordinary and necessary, and were not personal in nature."⁷⁰ The court found Hill incurred the educational 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."⁷¹ Notably, the court appeared to ignore the expense versus capital expenditure issue Justice Cardozo raised in *Welch*. Following its loss in *Hill*, the IRS soon released a pronouncement that afforded a limited deduction to teachers attending summer courses.⁷² Accordingly, *Hill* signaled a new era

65 *Id.* at 115-16 (emphasis added) (citation omitted).

66 *See, e.g., Osborn v. Comm'r*, 3 T.C. 603, 605 (1944) (denying a deduction for research expenses incurred by a college professor who received no compensation while conducting the research and noting that "[t]he expenses incurred in preparing himself are in essence the cost of the capital structure from which his future income is to be derived").

67 181 F.2d 906 (4th Cir. 1950).

68 *Id.* at 907-08.

69 *Id.* at 908.

70 *Id.* at 911.

71 *Id.* at 909. Ultimately, the court's language provided the framework for the soon-to-be-released Treasury Regulation.

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

by overturning the longstanding presumption that education was personal in nature and allowing a limited deduction for certain educational expenses.

2. The 1958 Treasury Regulation: The Subjective Phase

While the IRS and the Tax Court construed *Hill* and the subsequent IRS pronouncements narrowly,⁷³ the Second Circuit further questioned the proposition that educational expenses were nondeductible personal expenses in *Coughlin v. Commissioner*.⁷⁴ Coughlin, a general legal practitioner, agreed to handle cases involving federal tax issues. Although his firm did not require him to do so as a condition of his continued employment, Coughlin attended an annual tax institute to stay abreast on the latest tax developments and deducted the tuition and travel costs as a business expense. The Second Circuit, reversing the Tax Court, held that Coughlin could deduct tuition and travel costs under § 162 because he had a “professional duty to keep sharp the tools he actually used in his going trade or business.”⁷⁵ Influenced by the court’s decision in *Coughlin*, in 1958 the Department of the Treasury promulgated Treasury Regulation § 1.162-5,⁷⁶ which “constituted the first systematic analysis of many of the problems inherent in the area of educational expenditures and, in general, greatly liberalized deductibility.”⁷⁷

Under the 1958 regulation, a taxpayer could deduct educational expenses if the taxpayer satisfied either of two affirmative tests and did not violate the regulation’s disallowance tests. For an expense to qualify under the affirmative tests, the taxpayer must have undertaken the education “primarily for the purpose” of either (1) “[m]aintaining or improving skills required by the taxpayer in his employment or other trade or business” or (2) “[m]eeting 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.”⁷⁸ The regulation’s disallowance tests, however, prohibited a deduction for educational expenses if either (1) the taxpayer undertook the education “primarily for the purpose” of either “obtaining a new position or substantial advancement in po-

73 See Schoenfeld, *supra* note 55, at 249–55.

74 203 F.2d 307, 309 (2d Cir. 1953).

75 *Id.*

76 Treas. Reg. § 1.162-5 (1958).

77 Schoenfeld, *supra* note 55, at 255 (citations omitted).

78 Treas. Reg. § 1.162-5(a)(2). This Note will generally refer to both factors in Treasury Regulation § 1.162-5 that allow a deduction for educational expenses as the “affirmative tests.”

sition" or "fulfilling the general educational aspirations or other personal purpose of the taxpayer"⁷⁹ or (2) the education was "required of the taxpayer in order to meet the minimum requirements for qualification or establishment in his intended trade or business or specialty therein."⁸⁰

The 1958 regulation represented a fundamental change in the IRS's treatment of educational costs.⁸¹ The primary purpose standard, however, proved unworkable. First, the issue of the taxpayer's primary purpose was a question of fact and, therefore, courts often reached seemingly contradictory conclusions in nearly identical cases.⁸² Moreover, appellate courts could not easily articulate coherent standards, in part because the issues were factual decisions generally immune from appellate review.⁸³ To the extent that the 1958 regulation established that taxpayers could deduct certain educational expenses under § 162, however, the regulation successfully fulfilled its purpose.

3. The Current Treasury Regulation: The Objective Phase

In 1967, the Department of the Treasury replaced the 1958 regulation with the current Education Regulation.⁸⁴ Similar to the 1958

79 *Id.* § 1.162-5(b).

80 *Id.* This Note will refer to the two factors in Treasury Regulation § 1.162-5 that deny a deduction for educational expenses as the "disallowance tests."

81 Although the 1958 regulations represented a change, the 1956 proposed regulation maintained the presumptively personal taint. "In general, a taxpayer's expenditures for his education are personal and are not deductible." Prop. Treas. Reg. § 1.162-5(a)(1), 26 Fed. Reg. 5091, 5093 (July 10, 1956).

82 Schoenfeld, *supra* note 55, at 260.

83 *Id.*

84 The relevant parts of the 1967 Treasury Regulation § 1.162-5 provide:

(a) *General Rule.* Expenditures made by an individual for education (including research undertaken as part of his educational program) which are not expenditures of a type described in paragraph (b)(2) or (3) of this section are deductible as ordinary and necessary business expenses (even though the education may lead to a degree) if the education—

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

(2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation.

(b) *Non deductible educational expenditures*—(1) *In general.* Educational expenditures described in subparagraphs (2) and (3) of this paragraph are personal expenditures or constitute an inseparable aggregate of personal and capital expenditures and, therefore, are not deductible as ordinary and

regulation, the 1967 regulation incorporates two disallowance tests,⁸⁵ sometimes referred to as the “entry level” and the “upward-bound” tests,⁸⁶ which automatically prohibit a deduction under § 162. Generally, the entry level test disallows a deduction under § 162 for any education required to meet the minimum educational requirements for qualification in the taxpayer’s trade or business.⁸⁷ The upward-bound test, on the other hand, prohibits a deduction for any education that is part of a program of study that will lead to qualifying the taxpayer for a new trade or business.⁸⁸

The 1967 regulation also substantially carried over the two affirmative tests⁸⁹ found in the 1958 regulation, referred to as the “skill-maintenance” and the “employer-mandate” standards.⁹⁰ Under the skill-maintenance standard, a taxpayer can deduct educational expenses that “maintain or improve skills required by the individual in his employment or trade or business.”⁹¹ In the alternative, a taxpayer can deduct educational expenses under the employer-mandate standard if the education “[m]eets the express requirements of the

necessary business expenses even though the education may maintain or improve skills required by the individual in his employment or other trade or business or may meet the express requirements of the individual’s employer or of applicable law or regulations.

(2) *Minimum Educational Requirements.* (i) The first category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business.

....

(3) *Qualification for a new trade or business.* (i) The second category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business. In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual’s present employment.

Treas. Reg. § 1.162-5(a)-(b) (as amended in 1967).

85 *Id.* § 1.162-5(b).

86 1 BITTKER & LOKKEN, *supra* note 58, ¶ 22.1.3, at 22-10 to 22-11.

87 Treas. Reg. § 1.162-5(b)(2).

88 *Id.* § 1.162-5(b)(3).

89 *Id.* § 1.162-5(a).

90 1 BITTKER & LOKKEN, *supra* note 58, ¶ 22.1.2, at 22-6.

91 Treas. Reg. § 1.162-5(a)(1).

individual's employer, or the requirements of applicable law or regulations" imposed as a condition to retaining an employment relationship, status, or rate of compensation.⁹²

In an attempt to clarify the confusing interplay between the affirmative and disallowance tests, the current regulation emphasizes the primacy of the disallowance tests.⁹³ In fact, taxpayers can only test educational expenses under the affirmative tests if those expenses can first pass the disallowance tests.

The 1967 regulation, without further explanation, also eliminated the "no specialty" test incorporated into the 1958 regulation's disallowance test.⁹⁴ For example, under the previous regulation, if a general medical practitioner took courses to specialize in pediatrics, the upward-bound test denied a deduction for the educational expenses.⁹⁵ Under the current regulation, as a comparable example, a psychiatrist who undertakes a program of study that qualifies the psychiatrist for the specialized practice of psychoanalysis does not fail the upward-bound test.⁹⁶

Most importantly, the current regulation boasts an objective standard intended to replace the 1958 regulation's unworkable subjective "primary purpose" test.⁹⁷ If the education leads to qualifying the taxpayer for a new trade or business, evidence that the taxpayer never intended to enter such trade or business is irrelevant under the 1967

92 *Id.* § 1.162-5(a)(2).

93 *See id.* § 1.162-5(a) (stating that "[e]xpenditures . . . which are not expenditures of a type described in paragraph (b) (2) or (3) of this section are deductible"); *see also id.* § 1.162-5(c)(1)-(2) (emphasizing that in no event may a taxpayer deduct educational expenses that fall within the disallowance tests, even if the education satisfies the affirmative tests).

94 *See* Treas. Reg. § 1.162-5(b) (1958) (disallowing a deduction if the education is required to meet the minimum requirements for qualification in the "intended trade or business or specialty therein").

95 *Id.* § 1.162-5(e) ex. 2 (stating that a general practitioner of medicine could not deduct courses in pediatrics because "the course of study qualified him for a specialty within his trade or business").

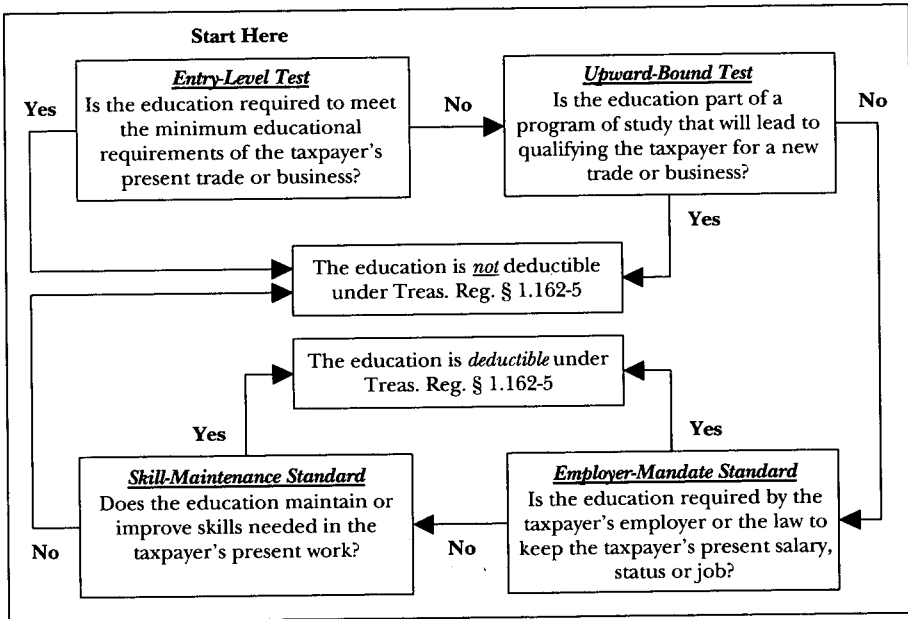
96 Treas. Reg. § 1.162-5(b)(3)(ii) ex. 4 (as amended in 1967) (concluding that a psychiatrist could deduct the cost of studying psychoanalysis because it "maintains or improves skills required by him in his trade or business and does not qualify him for a new trade or business"). Furthermore, the elimination of the specialty test potentially allows lawyers to deduct the educational costs related to obtaining specialized degrees such as an LL.M. *See, e.g.,* Ralph Conley Salyer, Jr., *Lawyers Going Back to School: It's All Tax Deductible*, ME. B.J., Jan. 1992, at 40.

97 *Compare* Treas. Reg. § 1.162-5 (as amended in 1967), *with* Treas. Reg. § 1.162-5 (1958).

regulation.⁹⁸ The 1958 regulation, on the other hand, relied on the primary purpose approach and, therefore, the taxpayer's subjective intent and purpose was often the determining factor. For example, under the 1958 regulation, a taxpayer could deduct educational expenses even if the education qualified the taxpayer for a new trade or business as long as the taxpayer could establish the primary purpose of undertaking the education was to maintain or improve the skills required by the employer and not to obtain a new position.⁹⁹ Undoubtedly, this transformation represents the most significant change to the current regulation.

The following chart summarizes the general requirements of the current Education Regulation and demonstrates the interplay of the affirmative and disallowance tests.

FIGURE 1.



II. ATTACKING THE EDUCATION REGULATION MONSTER

While commentators have long called for simplification of the tax maze, they often forget the monster within the maze. Most recently, the staff of the Joint Committee on Taxation advised Congress to sim-

98 See, e.g., Treas. Reg. § 1.162-5(b)(3) ex. 2 (as amended in 1967) (disallowing a deduction for the cost of attending law school even though the taxpayer intends to continue employment in a nonlegal profession).

99 See Treas. Reg. § 1.162-5(a)-(b) (1958).

plify the education tax maze by collapsing the § 25A Hope and Lifetime Learning Credits and the above-the-line deduction in § 222 for qualified tuition and related expenses into a single nonrefundable tax credit.¹⁰⁰ These proposals for simplification, while commendable, largely focus on dismantling the maze without considering the Education Regulation monster that has long haunted its inner corridors.

Those commentators who do recognize the monster have mounted attacks from several different fronts.¹⁰¹ First, commentators have called for the demise of the regulation because it fails to properly treat investments in "human capital" as capital expenditures and denies amortization for the cost over the useful life of the education.¹⁰² Second, at least one professor argues the regulation is an unreasonable interpretation of § 162(a) and plainly inconsistent with this provision.¹⁰³ Third, and more recently, one law professor critiques the regulation primarily because nothing in the Code restricts a deduction for educational costs and, therefore, the same standard should

100 See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 17, at 42.

101 Notwithstanding the united attack by scholars, lawyers, and taxpayers, courts have unanimously upheld the validity of the regulation. See, e.g., *Melnick v. United States*, 521 F.2d 1065 (9th Cir. 1975) (holding Treasury Regulation § 1.162-5 was not unconstitutional on Fifth Amendment due process grounds); *Taubman v. Comm'r*, 60 T.C. 814 (1973) (dismissing the taxpayer's argument that Treasury Regulation § 1.162-5 unconstitutionally discriminated in favor of teachers over other professionals); *Weiszmann v. Comm'r*, 52 T.C. 1106, 1111 (1969), *aff'd per curiam*, 443 F.2d 29 (9th Cir. 1971) (concluding the regulation was not inconsistent with § 162).

102 See, e.g., Bernard Wolfman, *Professors and the "Ordinary and Necessary" Business Expense*, 112 U. PA. L. REV. 1089, 1112 (1964) (stating that courts and the IRS have "too rarely differentiated between the capital educational expenditure and the personal. They have been unmindful of Justice Cardozo's analysis in *Welch v. Helvering* which suggested . . . that when the purpose of such education is to get started in business, the cost must be capitalized"); Brian E. Lebowitz, *On the Mistaxation of Investment in Human Capital*, 52 TAX NOTES 825 (1991) (criticizing the Code's discrimination of investments in human capital); Hamish P.M. Hume, Note, *The Business of Learning: When and How the Cost of Education Should Be Recognized*, 81 VA. L. REV. 887, 887 (1995) (arguing that the tax rules should capitalize educational expenses and provide a deduction for amortization); Richard C. Spencer, Comment, *The Deductibility of Educational Expenses: Administrative Construction of Statute*, 17 BUFF. L. REV. 182, 209 (1968) (arguing that the "education which [the professional] must acquire, perhaps three or four years of professional schooling, is a capital asset, albeit intangible, under all common definitions of that term"); David C. Tarshes, Comment, 1980 DUKE L.J. 997, 1021 (stating that "[t]he major flaw in section 1.162-5 is not its inconsistency, its broad definition of 'new trade,' or its susceptibility to subjective considerations, but rather its failure to comport with a theoretically sound treatment of educational expenses as capital expenditures").

103 Schoenfeld, *supra* note 55, at 314.

apply to educational expenses as other business expenses.¹⁰⁴ Congress has even recognized, in passing, the weaknesses of the regulation,¹⁰⁵ but rather than confront the monster, it added further complex incentives for higher education and, thus, constructed new levels on the tax maze.

This Note renews the attack on the Education Regulation monster by critiquing elements of the regulation primarily through the lens of cornerstone principles of good tax policy: certainty and simplicity.¹⁰⁶ In particular, the following section analyzes the Code's

104 Jay Katz, *The Deductibility of Educational Costs: Why Does Congress Allow the IRS to Take Your Education So Personally?*, 17 VA. TAX REV. 1, 3 (1997).

105 See S. REP. NO. 95-1263, at 100 (1978) (stating that “[b]ecause ambiguities exist in the ‘improve or maintain skills’ test imposed under [Treasury Regulation §1.162-5], the taxability of educational assistance programs of particular employers necessarily depends on IRS agents’ case-by-case analyses of the skills needed for the jobs held by each employee participating in such programs”); see also STAFF OF THE JOINT COMM. ON TAXATION, 107TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 107TH CONGRESS 46 (Joint Comm. Print 2003) (observing that “[b]ecause the determination of whether particular educational assistance is job related is based on the facts and circumstances, it may be difficult to determine with certainty whether the educational assistance is excludable from income. This uncertainty may lead to disputes between taxpayers and the Internal Revenue Service.”); STAFF OF THE JOINT COMM. ON TAXATION, 106TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 106TH CONGRESS 24 (Joint Comm. Print 2001) (same).

106 In general, the principles of certainty and simplicity are related. If a tax provision is complex or confusing, that provision will often be uncertain as well. Although scholars and policymakers do not universally agree on the criteria by which to evaluate a tax system, Adam Smith suggested four general maxims of good tax policy that broadly encompass the principles of certainty and simplicity: (1) *Equality*, which dictates that “[t]he subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities”; (2) *Certainty*, which requires that “[t]he tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person”; (3) *Convenience of payment*, which provides that “[e]very tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it”; and (4) *Economy of collection*, which states that “[e]very tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.” ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 888–90 (Edwin Cannan ed., Random House, Inc. 1994) (1776). Professors Richard K. Vedder and Lowell E. Gallaway, in a report prepared for the Joint Economic Committee, identified similar underlying principles of tax policy, concluding that a good tax is (1) “Not costly for either government or taxpayers to calculate or administer; on the other hand, tax avoidance is difficult and risky”; (2) “Neutral in its impact on resource allocation decisions, minimizing negative effects on economic growth; it does not lead to unproductive economic activity that is tax-induced”; (3) “Fair; people believe that the tax burden is equitably distributed amongst the tax-paying popula-

threshold “carrying on any trade or business”¹⁰⁷ test and the regulation’s upward-bound disallowance test¹⁰⁸—the primary pitfalls when applying the regulation—in light of these principles. As the following discussion reveals, the “carrying on” requirement and the upward-bound test are often confusing and difficult standards to apply for both taxpayers and courts, causing special uncertainty surrounding the application of these standards in addition to the inherent uncertainty flowing from the required fact-based inquiry. As expected, these combined failings encourage taxpayers to play the “audit lottery” and aggressively claim a deduction for educational expenses even when the education probably does not pass the regulation’s rigid tests.

A. *The “Carrying on” Requirement*

Individuals must not only satisfy the Education Regulation’s requirements to deduct educational expenses, but must also meet § 162(a)’s threshold “carrying on any trade or business” test.¹⁰⁹ Although the Code does not define a “trade or business,” the United States Supreme Court recently held that “[t]o be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer’s primary purpose for engaging in the activity must be for income or profit.”¹¹⁰ Because the performance of services as an employee constitutes a “trade or business,”¹¹¹ the “carrying on” element of § 162 often represents a confusing and complex element in the context of educational expenses and a focal point of controversy between taxpayers and the IRS. Accordingly, two issues relating to the “carrying on” requirement ultimately contribute to the uncertainty of the Education Regulation: (1) when has a taxpayer engaged in “carrying on” a trade or business, and (2)

tion”; and (4) “[T]ransparent; people are aware of its existence and know the burden that it imposes; one objection to deficit financing is that it imposes disguised or stealth taxation; this should be avoided in using tax financing.” JOINT ECONOMIC COMM., 105TH CONG., SOME UNDERLYING PRINCIPLES OF TAX POLICY 4 (Comm. Print 1998) (prepared by Richard K. Vedder & Lowell E. Gallaway).

107 I.R.C. § 162(a) (2000).

108 Treas. Reg. § 1.162-5(b)(3) (as amended in 1967).

109 I.R.C. § 162(a); *see also* Treas. Reg. § 1.262-1(b)(9) (as amended in 1972) (“Expenditures made by a taxpayer in obtaining an education or in furthering his education are not deductible unless they qualify under section 162 and § 1.162-5.”).

110 *Comm’r v. Groetzinger*, 480 U.S. 23, 35 (1987).

111 *See* Treas. Reg. § 1.162-17(a) (as amended in 1990). A taxpayer can also carry on a “trade or business” as a self-employed person, either in a sole proprietorship, partnership, or similar unincorporated business organization.

does a taxpayer, previously engaged in carrying on a trade or business, continue to carry on a trade or business during the period that the taxpayer attends school rather than actively participating in the business?¹¹²

The first issue—whether a taxpayer has engaged in carrying on a trade or business—often arises for students who have recently obtained a bachelor's degree or a law degree and secure summer employment before pursuing an advanced degree. This becomes important because taxpayers cannot technically deduct educational expenses unless they engage in “carrying on” a trade or business. In other words, taxpayers cannot deduct expenses incurred prior to starting a business or employment.¹¹³ Regretfully, the Code and regulation are silent on the level of activity required to engage in “carrying on” a trade or business. The Tax Court, moreover, has explicitly declined “to set a minimum period of time that one must be employed”¹¹⁴ to begin carrying on a trade or business; the other scattered cases addressing the issue also provide little help in formulating consistent guidelines.

Although far from clear, a body of case law seems to mark the ends of the spectrum. At one end, a taxpayer who secures summer employment before graduating probably has not commenced carrying on a trade or business. In *Wassenaar v. Commissioner*,¹¹⁵ the taxpayer worked as a law clerk prior to graduating from law school. After graduation, Wassenaar spent the summer studying for the bar exam and attended New York University in the fall to obtain an LL.M. in taxation.¹¹⁶ The court denied the taxpayer's deduction for the expenses incurred while attending NYU, concluding that the work he performed before graduating from law school “in no way constituted his being engaged in the practice of law.”¹¹⁷ At the other end of the spectrum, courts seem to find a two-year period of employment sufficient

112 See CARLA NEELEY FREITAG & LISA MARIE STARCZEWSKI, SCHOLARSHIPS AND EDUCATIONAL EXPENSES, at A-30 (BNA Tax Management Portfolio 517, 1998); see also Schoenfeld, *supra* note 55, at 241.

113 See *Frank v. Comm'r*, 20 T.C. 511, 513 (1953) (denying a deduction under § 162 for travel and legal expenses spent searching for potential business ventures because the taxpayer was not engaged in a trade or business at the time the taxpayer incurred the expenses); see also I.R.C. § 195 (Lexis 2005) (disallowing a current deduction for “start-up expenditures,” but allowing an amortization deduction over a sixty-month period at the taxpayer's election).

114 *Link v. Comm'r*, 90 T.C. 460, 464 (1988), *aff'd without published opinion*, 869 F.2d 1491 (6th Cir. 1989).

115 72 T.C. 1195 (1979).

116 *Id.* at 1197.

117 *Id.* at 1199.

to establish that a taxpayer has engaged in carrying on a trade or business. In *Sherman v. Commissioner*,¹¹⁸ the Tax Court held that a taxpayer who worked as a manager for two years with the Army and Air Force Exchange Service before pursuing an M.B.A. degree at Harvard had sufficiently established himself as an employee who was a business manager.¹¹⁹

In between the extremes marked by *Wassenaar* and *Sherman*, the tax cases provide limited help in developing general guidelines for the "carrying on" requirement in the context of educational expenses. In *Ruehmann v. Commissioner*,¹²⁰ the taxpayer received an LL.B. from the University of Georgia Law School in June 1967 and worked as a law clerk for a firm the summer before graduation.¹²¹ Ruehmann passed the state bar exam and was admitted to practice law in Georgia after his second year of law school as permitted under state law.¹²² During the summer following graduation, Ruehmann worked as an attorney for the same firm.¹²³ In September 1967, Ruehmann attended Harvard Law School and received a graduate law degree in June 1968.¹²⁴ The law firm offered Ruehmann a permanent position, as the firm customarily did even when students planned to spend one year pursuing a judicial clerkship or an advanced legal degree.¹²⁵ The Tax Court disallowed a deduction for the cost of completing the last two quarters of his LL.B. degree at least in part because as a clerk he was not carrying on a trade or business as a lawyer. The court, however, expressly held that Ruehmann could deduct the cost of pursuing the graduate law degree from Harvard because he engaged in carrying on a trade or business as a lawyer during the three summer months following graduation.¹²⁶

In *Link v. Commissioner*,¹²⁷ however, the Tax Court reached the opposite conclusion. Link graduated in May 1981 with a bachelor's degree in operations research and worked as a market research analyst for Xerox Corporation from June 1981 to September 1981 before pursuing, full-time, an M.B.A. degree at the University of Chicago.¹²⁸

118 1977 T.C.M. (P-H) ¶ 77,301.

119 *Id.* at 1190.

120 1971 T.C.M. (P-H) ¶ 71,157.

121 *Id.* at 710.

122 *Id.*

123 *Id.*

124 *Id.* at 708.

125 *Id.*

126 *Id.* at 710-11.

127 90 T.C. 460 (1988), *aff'd without published opinion*, 869 F.2d 1491 (6th Cir. 1989).

128 *Id.* at 461-62.

The court held Link never engaged in carrying on a trade or business and his three month employment after graduation was “merely a temporary hiatus in a continuing series of academic endeavors . . . [and] a sporadic and isolated deviation from his ‘career’ as a student.”¹²⁹ The *Link* court expressly refused, however, to establish a minimum period of time that a taxpayer must be employed to carry on a trade or business.¹³⁰

Cases such as *Link* and *Ruehmann* provide little guidance for determining whether a taxpayer engaged in carrying on a trade or business. *Link* and *Ruehmann* cannot be distinguished on the grounds that *Ruehmann* was admitted to practice law during the three-month period before pursuing his graduate law degree because the tax cases clearly establish that bar admission or membership in good standing in the profession are not tantamount to carrying on the profession for purposes of § 162(a).¹³¹ Moreover, the fact that *Ruehmann* worked for the same firm during the summers before and after his graduation from law school and prior to pursuing his graduate law degree cannot distinguish the cases because the *Ruehmann* court expressly rejected the argument that he engaged in carrying on a trade or business during the three summer months prior to graduation.¹³² Rather than distinguish the instant case from *Ruehmann*, the *Link* court disregarded the case, concluding that it was based upon specific factual findings and not dispositive of the issues before the court as either legal or factual precedent.¹³³ Subsequent courts have also declined to distinguish *Link* and *Ruehmann*.¹³⁴

The second issue under § 162(a)’s “carrying on” requirement—whether a taxpayer carries on an existing trade or business during the time period when the taxpayer undertakes the education or training—is key because taxpayers cannot deduct educational expenses if

129 *Id.* at 464–65.

130 *Id.* at 464.

131 *Johnson v. United States*, 332 F. Supp. 906, 908 (1971) (“Professional status in and of itself is not sufficient basis to conclude that taxpayer is ‘carrying on a business.’”); *Weyts v. Comm’r*, 2003 T.C.M. (RIA) ¶ 2003-068, at 334 (reaffirming that “[a]dmission to the bar is not tantamount to being engaged in a trade or business of practicing law”); *Wassenaar v. Comm’r*, 72 T.C. 1195, 1199–200 (1979) (recognizing the “well-established principle that being a member in good standing of a profession is not tantamount to *carrying on* that profession for the purpose of section 162(a)”).

132 *Ruehmann v. Comm’r*, 1971 T.C.M. (P-H) ¶ 71,157, at 710 (concluding that *Ruehmann*’s “work while he was a law student at the University of Georgia was secondary to his attendance at law school and did not place him in the trade or business of being a lawyer”).

133 *Link*, 90 T.C. at 464.

134 *E.g.*, *Weyts*, 2003 T.C.M. (RIA) at 334.

they ceased "carrying on" a trade or business.¹³⁵ This issue generally arises when a taxpayer who had actively engaged in carrying on a trade or business leaves for a period of time, either by taking a leave of absence or severing employment, to pursue education and returns to the same or different trade or business. In Revenue Ruling 68-591,¹³⁶ the IRS announced the bright-line rule that it would consider a taxpayer engaged in carrying on an existing trade or business although the taxpayer "temporarily ceases" active involvement in the trade or business to undertake education or training, provided that the suspension was for a period of a one year or less and the taxpayer resumed the same employment or trade or business.¹³⁷

The courts recognize a similar "hiatus principle" that provides a taxpayer may carry on a trade or business within the meaning of § 162(a) during a "transition period" after leaving a trade or business to seek different employment or undertake education. In *Sherman v. Commissioner*¹³⁸ and subsequent cases,¹³⁹ however, the Tax Court expressly refused to accept the IRS's one year rule as an absolute limitation. Sherman left employment as a manager with the Army and Air Force Exchange Services to attend Harvard University for two years to obtain an M.B.A. degree.¹⁴⁰ Dismissing the IRS's bright-line rule as merely an "opinion of one of the litigants in the case," the Tax Court held Sherman's two-year suspension of active participation in "carrying on" a trade or business was "temporary and definite."¹⁴¹ Furthermore, the court stated "[t]here is no magic in a one year limit on 'temporary' (other than possible ease of administration), and we believe a facts and circumstances test is the appropriate test for determining whether a hiatus is temporary rather than indefinite."¹⁴² The court also asserted "carrying on" a trade or business does not require a

135 This logically follows from § 162(a), which requires that a taxpayer engage in "carrying on [a] trade or business." I.R.C. § 162(a) (2000).

136 1968-2 C.B. 73.

137 *Id.*

138 1977 T.C.M. (P-H) ¶ 77,301.

139 See *Damm v. Comm'r*, 1981 T.C.M. (P-H) ¶ 81,203, at 672 (determining a two-year period of study was temporary); *Picknally v. Comm'r*, 1977 T.C.M. (P-H) ¶ 77,321, at 1292 (considering a three-year period of study "temporary"); see also *Johnson v. Comm'r*, 1988 T.C.M. (P-H) ¶ 88,177, at 932-33 (allowing a university professor to deduct educational expenses to attend a two-year doctoral program full-time without questioning the "carrying on" requirement).

140 *Sherman*, 1977 T.C.M. (P-H) at 1190.

141 *Id.* at 1191-92.

142 *Id.*

person to obtain a leave of absence to undertake education nor to return to the same employer.¹⁴³

The *Sherman* court cautioned, however, that the “hiatus principle” is not without limits. According to the court, a taxpayer is not “carrying on” a trade or business while attending school if the taxpayer severs employment for a “prolonged period of study with no apparent continuing connection with either his former job or any clear indication of an intention to actively carry on the same trade or business upon completion of study.”¹⁴⁴ To the extent that courts look for a clear indication of intent to return to the same trade or business, however, courts have further complicated the calculus by reintroducing the inquiry into the taxpayer’s subjective intent that the current regulation tried to eliminate.

Notwithstanding the court’s decision in *Sherman*, the IRS adamantly maintains that a temporary suspension must be for one year or less.¹⁴⁵ In the end, the tension between the IRS and courts regarding the hiatus principle only causes further confusion and uncertainty for taxpayers already lost within the depths of the maze.

The Code, regulation, administrative interpretations, and judicial decisions addressing the “carrying on” requirement leave many unanswered questions for taxpayers contemplating further education or training. Unfortunately, only the most general guidelines can be drawn from the cases and IRS pronouncements: taxpayers must work *long enough* to engage in “carrying on” a trade or business, but taxpayers must not study *too long* lest they cease “carrying on” the trade or business. Beyond this, the definition of “long enough” and “too long” are subject to uncertainty, confusion, and even disagreement between the IRS and courts.

B. *The Upward-Bound Disallowance Test*

The upward-bound and minimum entry disallowance tests unquestionably form the heart of the regulation and, not surprisingly, have represented the most frequently litigated areas of the current regulation.¹⁴⁶ The regulation asserts that the disallowance tests serve the purpose of filtering out nondeductible expenses that are either

143 *Id.* at 1191.

144 *Id.*

145 Priv. Ltr. Rul. 87-14-064 (Jan. 8, 1987) (“[T]he *Sherman* case, which the government lost, does not reflect the position of the Service . . .”); Priv. Ltr. Rul. 85-38-068 (June 26, 1985) (“Even though the government lost the *Sherman* case, [Revenue Ruling 68-591] remain[s] the position of the Internal Revenue Service.”).

146 Schoenfeld, *supra* note 55, at 277.

“personal expenditures or constitute an inseparable aggregate of personal and capital expenditures.”¹⁴⁷ As discussed above, a number of legal commentators have criticized the regulation’s treatment of investments in “human capital.”¹⁴⁸ Instead of critiquing the theoretical treatment of educational expenses, this section critiques the application of the upward-bound disallowance test. More specifically, this section wrestles with the difficult and confusing application of the upward-bound test—arguably the regulation’s most demanding yet elusive standard—and the resulting uncertainty that leads to aggressive tax positions and increased administrative costs.

1. The Underlying Standards for Applying the Upward-Bound Test

The current regulation’s upward-bound disallowance test automatically denies a deduction for any educational expenditure “which is part of a program of study being pursued by him which *will lead to qualifying him in a new trade or business.*”¹⁴⁹ As discussed previously, the 1967 amendments significantly altered the upward-bound test.¹⁵⁰ As a result of the shift from the subjective “primary purpose” to the objective “new trade or business” test, courts have focused on three key factors when determining if an education leads to qualifying a taxpayer for a new trade or business: (1) the “change of duties” rule, (2) the “commonsense” test, and (3) the “objective” standard.¹⁵¹

Even though the upward-bound test relies significantly on the concept of a “new trade or business,” the regulation fails to define this phrase except in the negative for one limited exception: “In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual’s present employment.”¹⁵² The regulation, however, does not clarify the application of the change of duties rule except in the case of teachers, in which case the regulation considers all teaching and related duties to involve the same general type of work.¹⁵³ As a result, the regulation left many unanswered questions

147 Treas. Reg. § 1.162-5(b)(1) (as amended in 1967).

148 See sources cited *supra* note 102.

149 Treas. Reg. § 1.162-5(b)(3)(i) (emphasis added).

150 See *supra* notes 97–99 and accompanying text.

151 See FREITAG & STARCZEWSKI, *supra* note 112, at A-52 to A-53.

152 Treas. Reg. § 1.162-5(b)(3). Although the change of duties rule only refers to employees, Professors Bittker and Lokken suggest that same rule presumptively applies to self-employed persons as well. 1 BITTKER & LOKKEN, *supra* note 58, ¶ 22.1.3, at 22-12 n.42.

153 Treas. Reg. § 1.162-5(b)(3)(a)–(d).

for applying the upward-bound test and necessarily passed the responsibility of crafting a meaningful standard to the courts.

In response, courts developed the “commonsense” comparison test to determine whether education or training leads to qualifying a taxpayer for a new trade or business. Under this test, courts compare the types of tasks and activities the taxpayer is qualified to perform *before* undertaking education or training with the tasks and activities the taxpayer is qualified to perform *after* achieving the particular title or degree; if the tasks or activities are significantly different, the education qualifies a taxpayer for a new trade or business.¹⁵⁴ Courts generally look to the degree of supervision and responsibility involved in the tasks and activities before and after pursuing the education.¹⁵⁵ Moreover, courts often rely on educational prerequisites under state law regulating certain occupations and professions.¹⁵⁶ Under the commonsense approach, the taxpayer does not have to complete the education program or actually commence the different employment or new trade or business for courts to conclude the education fails the upward-bound test.¹⁵⁷ Indeed, under the language of the regulation and the courts’ application of the commonsense standard, the education itself does not have to qualify a taxpayer for a new trade or business, but only “lead to qualifying” a taxpayer for this new position.¹⁵⁸

154 See *Weiszmann v. Comm’r*, 52 T.C. 1106, 1110 (1969), *aff’d per curiam*, 443 F.2d 29 (9th Cir. 1971) (first articulating the comparison standard for the upward-bound test under the 1967 Treasury Regulation); see also *Glenn v. Comm’r*, 62 T.C. 270, 275 (1974) (upholding the comparison standard as the “only commonsense approach to a classification”).

155 See, e.g., *Weiszmann*, 52 T.C. at 1110 (applying the commonsense approach by comparing the difference between a lawyer and a patent trainee, specifically the varying tasks, relative responsibilities and supervision, comparative compensation, and state requirements for admission to the bar).

156 See *id.*

157 See, e.g., *Burt v. Comm’r*, 1980 T.C.M. (P-H) ¶ 80,363 (denying a “Minister of Music” a deduction for the cost of obtaining a bachelor of music degree even though he continued with his work in church music and never intended to pursue the new trade or business); *O’Donnell v. Comm’r*, 62 T.C. 781, 783 (1974), *aff’d*, 519 F.2d 1406 (7th Cir. 1975) (denying a deduction for a law degree because it qualified the taxpayer for a new trade or business, and the fact that he “neither practiced nor intended to practice law during the year at issue is irrelevant”); *Weiszmann*, 52 T.C. at 1111 (stating that the “regulations do not predicate disallowance of the deduction on the actual practice of the new trade or business”).

158 Treas. Reg. § 1.162-5(b)(3); see also *Browne v. Comm’r*, 73 T.C. 723, 727 (1980); *Diaz v. Comm’r*, 70 T.C. 1067, 1075 (1978), *aff’d*, 607 F.2d 995 (2d Cir. 1979); *Glenn*, 62 T.C. at 275–76. But see *Blair v. Comm’r*, 1980 T.C.M. (P-H) ¶ 80,488, at 2101 (rejecting the “one step along the way” argument because the court could not “perceive an unfolding pattern of action by [the taxpayer] which would have qualified her as a public accountant”).

Therefore, if the education combined with further work experience, an examination, obtaining a license or permit, or completing further educational requirements qualify a taxpayer for a new trade or business, as determined by the commonsense test, the expenses are non-deductible under the upward-bound test.¹⁵⁹

Although the 1967 amendments clearly eliminated reliance on the taxpayer's subjective primary purpose,¹⁶⁰ taxpayers continued to justify a deduction for educational expenses on the basis that they never intended to engage in a new trade or business, but undertook the education solely to maintain or improve their current job skills. Courts responded by emphasizing that an "objective standard" applies under the current regulation's upward-bound test and the fact that the taxpayer never actually undertook the new trade or business and never intended to undertake the new trade or business was irrelevant.¹⁶¹ As the objective standard took form, courts used the standard to exclude evidence that a taxpayer's employer required, encouraged, or recommended the education¹⁶² or evidence that pursuing such new trade or business was economically infeasible for the taxpayer.¹⁶³

159 See, e.g., *Cristea v. Comm'r*, 1985 T.C.M. (P-H) ¶ 85,533 (denying an engineering aide a deduction for the expenses for engineering courses because it led to qualifying a taxpayer to practice as a professional engineer even though state law required him to complete the education, obtain four years of work experience, and pass an examination); *Cooper v. Comm'r*, 1979 T.C.M. (P-H) ¶ 79,241, at 915 (denying an unlicensed accountant a deduction for the cost of accounting courses because the education led to qualifying the taxpayer for a new trade or business as a certified public accountant even though he failed the C.P.A. exam three times); *O'Donnell*, 62 T.C. at 784 (denying a taxpayer a deduction for pursuing a law degree because the education represents "one step along the path" to qualifying him for the legal profession).

160 See *supra* notes 97–99 and accompanying text.

161 E.g., *O'Donnell*, 62 T.C. 781; *Burt*, 1980 T.C.M. (P-H) ¶ 80,363.

162 See Treas. Reg. § 1.162-5(b) (ii) ex. 2; see also *Malek v. Comm'r*, 1985 T.C.M. (P-H) ¶ 85,428, at 1902 (concluding the taxpayer could not deduct expenses to obtain a bachelor of arts degree that qualified her for a new trade or business even though her employer required the degree as a condition of continued employment); *Roussel v. Comm'r*, 1979 T.C.M. (P-H) ¶ 79,125 (denying a ground school safety instructor a deduction for the cost of taking flying lessons even though the taxpayer's employer threatened the taxpayer with dismissal for not teaching the class from a pilot's perspective).

163 See *Roussel*, 1979 T.C.M. (P-H) at 536 (denying an education deduction for flying lessons because the lessons qualified the taxpayer for a career as a commercial pilot even though the court recognized that embarking on this new career was economically infeasible); see also *Hinton v. Comm'r*, 1982 T.C.M. (P-H) ¶ 82,539, at 2432 (denying a deduction for commercial pilot courses even though "in today's job market it is highly unlikely that petitioner . . . could embark on a career as a commercial

2. The Confusing Interplay of Standards

Not surprisingly, the interplay between the commonsense standard and the objective standard has not only plagued potential students, but courts as well. For example, the taxpayer in *Wiertzema v. United States*¹⁶⁴ worked on the family farm, but enrolled in a sixteen week welding course that would qualify him to work as a welder anywhere in the United States.¹⁶⁵ Upon completing the program, however, the taxpayer used the skills to repair machinery and equipment and to construct farm implements used in the farming operations.¹⁶⁶ The court, struggling to apply the regulation, concluded “[t]here appears to be a split in the circuits” after observing that the Seventh Circuit applied an “objective test,” the Second Circuit used the “commonsense” approach, while the Tax Court has applied both approaches.¹⁶⁷ Following the commonsense approach, the court allowed an educational deduction on summary judgment after concluding the welding courses maintained or improved his skills.¹⁶⁸

Although the *Wiertzema* court correctly identified two different standards under the upward-bound test, the court mistakenly concluded that the objective standard and the commonsense test conflicted.¹⁶⁹ Because the regulation fails to provide clear guidance and courts sometimes further confuse the interplay by applying both standards but failing to expressly or accurately label them, observers can understand the confusion.¹⁷⁰ The case law indicates, however, that both the objective and commonsense standards apply under the upward-bound test, but each standard addresses separate and distinct issues.¹⁷¹

The commonsense test specifically addresses the issue of whether the education leads to qualifying the taxpayer for a new trade or busi-

pilot. The situations in which petitioner could earn a livelihood are limited, and becoming a commercial pilot may be a detrimental career move for him to make.”).

164 747 F. Supp. 1363 (D.N.D. 1989).

165 *Id.* at 1364.

166 *Id.*

167 *Id.*

168 *Id.* at 1365.

169 See also FREITAG & STARCZEWSKI, *supra* note 112, at A-52 n.516.

170 *Id.* (noting that some cases do not expressly refer to the objective standard and other cases do not mention the comparison test because the taxpayers probably did not raise any subjective factors or the education clearly qualified the taxpayers for new trades or businesses).

171 *E.g.*, *Vertick v. Comm’r*, 628 F.2d 885, 886 (5th Cir. 1980); *Brown v. Comm’r*, 73 T.C. 723, 726–27 (1980); *Weiszmann v. Comm’r*, 52 T.C. 1106, 1110–11 (1969), *aff’d per curiam*, 443 F.2d 29 (9th Cir. 1971).

ness. *Weizmann v. Commissioner*¹⁷² established the commonsense test. In that case, a part-time patent trainee enrolled in law school and deducted the educational expenses under § 162. The court denied the deduction under the upward-bound test, concluding “[t]he trade or business of attorney is *sufficiently different* from that of a patent trainee to constitute a new trade or business.”¹⁷³ In reaching this decision, the court compared a lawyer and a patent trainee, noting the difference between the varying tasks, relative responsibilities and supervision, comparative compensation, and state requirements for admission to the bar.¹⁷⁴ In *Glenn v. Commissioner*,¹⁷⁵ the Tax Court later expressly adopted the *Weizmann* commonsense approach when applying the upward-bound test. In that case, the court, recognizing the limited case law suggesting a standard for applying the upward-bound test, concluded:

What has been suggested, and we uphold such suggestion as the only commonsense approach to a classification, is that a comparison be made between the types of activities which the taxpayer was qualified to perform before the acquisition of a particular title or degree, and those which he is qualified to perform afterwards. Where we have found such activities and abilities to be significantly different, we have disallowed an educational expenses deduction based on our finding that there had been qualification for a new trade or business.¹⁷⁶

The objective standard, on the other hand, addresses the issue of what evidence is relevant when applying the upward-bound test. In particular, the objective standard primarily excludes evidence of the following when applying the upward-bound test: the taxpayer’s subjective intent or motive for undertaking the education; whether the taxpayer’s employer required, encouraged, or recommended the education; or whether economic infeasibility precluded the taxpayer from actually pursuing the new trade or business.¹⁷⁷ In *O’Donnell v. Commissioner*,¹⁷⁸ a tax accountant argued he pursued a law degree to improve his accounting and tax skills and never practiced or intended to practice law. Denying the education deduction under the upward-bound test, the court emphasized that the fact that O’Donnell neither practiced nor intended to practice law was irrelevant, stating that this

172 52 T.C. 1106.

173 *Id.* at 1110 (emphasis added).

174 *Id.*

175 62 T.C. 270 (1974).

176 *Id.* at 275 (citation omitted).

177 See *supra* notes 160–63 and accompanying text.

178 62 T.C. 781 (1974), *aff’d*, 519 F.2d 1406 (7th Cir. 1975).

fact may have been relevant under the 1958 regulation, but “[t]he *objective test* incorporated in the existing regulations applies.”¹⁷⁹ Indicating that the commonsense and objective standards are separate and distinct, the *O’Donnell* court then applied the commonsense standard, concluding that as an attorney, O’Donnell “would be qualified to perform tasks far greater and more than he could as an accountant. . . . These possibilities make it abundantly clear that . . . by attending law school, [he] has qualified himself for a new trade or business.”¹⁸⁰ Ironically, the *Wiertzema* court cited *O’Donnell* for the proposition that the circuits were split on the standard, yet *O’Donnell* clearly applies, although not expressly by name, both the objective and the commonsense standards.¹⁸¹

3. The Difficult Application of the Upward-Bound Test

Applying the upward-bound test is arguably the most mind-numbing undertaking required by the current regulation. As discussed above, this test automatically disallows a deduction for educational expenses if the education is part of a program of study that “leads to qualifying” the taxpayer for a “new trade or business.”¹⁸² Accordingly, courts generally must wrestle with two main issues when applying the upward-bound test: (1) does the education “lead to qualifying” a taxpayer for existing¹⁸³ “trades or businesses” and (2) are these trades or businesses “new” to the taxpayer? The following subsections focus on the difficult and confusing application of the upward-bound test, in particular, the seemingly speculative search for new trades or businesses and the narrow lines courts sometimes draw when applying the

179 *Id.* at 783 (emphasis added).

180 *Id.* (citing *Weismann v. Commissioner*, 52 T.C. 1106, 1110 (1969)).

181 *Wiertzema v. United States*, 747 F. Supp. 1363, 1364 (D.N.D. 1989).

182 Treas. Reg. § 1.162-5(b)(3) (as amended in 1967).

183 It is not sufficient to apply the commonsense standard in a vacuum. Instead, the court should consider the taxpayer’s newly acquired skills, abilities, degrees, or titles in light of existing employment positions and trade or business opportunities. In *Gruman v. Commissioner*, 1982 T.C.M. (P-H) ¶ 82,388, a co-pilot of a Boeing 707 aircraft for American Airlines took courses that certified him as an airline transport pilot for the Cessna Citation aircraft. *Id.* at 1699. Prior to taking the courses, the co-pilot could operate a Cessna Citation under the applicable FAA regulations, but not for a common carrier. At that time no common carrier flew the Cessna Citation. *Id.* The court held that although the airline transport pilot certificate appeared to have considerably increased the co-pilot’s abilities, as a practical matter the certificate did not expand the scope of piloting activities available to him because the new trade or business of piloting a Cessna Citation for a common carrier “*simply did not exist.*” *Id.* at 1700 (emphasis added).

commonsense approach to determine if the trades or businesses are “new” to the taxpayer.

a. Searching for Existing “Trades or Businesses”

The upward-bound test serves the theoretical purpose of filtering out education expenditures that represent nondeductible personal expenses or capital expenditures. The 1967 amendments to the upward-bound test adopted an objective standard to avoid the former dilemma of determining whether taxpayers intended to stay in their current trade or business or use the education to move on to a new trade or business. The current regulation, however, has replaced the old problem of determining intent with the new problem of an almost unrestrained search for existing trades or businesses in an effort to separate capital expenditures and personal expenses from business expenses. To demonstrate by comparison the speculative nature of this search, imagine that a police officer issued a ticket to Jane for speeding or attempting to speed after she picked up a driver’s manual to study for the exam at the local branch office of the state department of motor vehicles because this represented “one step” along the path that leads to qualifying her to violate the traffic laws. The officer had to assume, however, that Jane would undertake driver’s training, pass the examination and obtain her driver’s license, and actually drive a car in excess of the speed limit, but had to ignore any evidence that she could not afford to pay for automobile insurance or to buy a car or that she never intended to drive a car. One would likely conclude that this is ridiculous. As the following discussion reveals, the search for new trades or businesses under the upward-bound test as shaped by the courts essentially involves similar speculation often hinging upon difficult assumptions and ignoring important factual realities.

Courts have struggled with the “lead to qualifying” element of the upward-bound test when determining the degree to which the education itself must play a role in qualifying a taxpayer for a new trade or business. Courts have taken several different approaches. *O’Donnell v. Commissioner*, for example, adopted the “one step” approach that requires the education to serve a minor role: the education needs only to represent “one step along the path of entering the new trade or business.”¹⁸⁴ Therefore, the one-step approach only requires the education to be “helpful” in qualifying the taxpayer for the new trade or

184 *O’Donnell*, 62 T.C. at 784.

business.¹⁸⁵ The court, however, required more in *Blair v. Commissioner*.¹⁸⁶ The *Blair* court expressly held that the education must not just be “one step along the path,” but the taxpayer must undertake an “unfolding pattern of action” that would have qualified the taxpayer for a new trade or business for the court to disallow the deduction.¹⁸⁷ By comparison, the court in *Cristea v. Commissioner*¹⁸⁸ seemed to take a more intermediate approach, denying a deduction for the cost of obtaining a bachelor of science degree in engineering because it represented the “*crucial first step* in his travel along a path culminating in his qualifying for the new trade or business.”¹⁸⁹

Of these three approaches, most courts follow the more rigid *O'Donnell* one-step approach. While qualification in the new trade or business may require significant additional steps, such as completing the education, pursuing further education, passing an examination, securing licenses or permits, or obtaining more experience, under the upward-bound test the taxpayer does not actually have to complete any of these prerequisites.¹⁹⁰ Instead, courts assume the taxpayer can and will complete all additional prerequisites to enter the new trade or business. Moreover, building on the one-step test, courts do not require the education to be a “necessary” step to enter the new trade or business. Instead, education that is an “alternative step” is sufficient to deny the deduction.¹⁹¹ For example, if the taxpayer could satisfy a prerequisite for a new trade or business by either further education or additional work experience and the taxpayer chose to pur-

185 See, e.g., *Sharon v. Comm'r*, 66 T.C. 515, 530 (1976) (concluding that bar review courses “helped” qualify a lawyer engaged in the practice of law in New York to engage in the new trade or business of practicing law in California); *Archie v. Comm'r*, 1978 T.C.M. (P-H) ¶ 78,425, at 1753 (“Thus, the obtaining of a certificate as a CPA clearly is ‘one step along the path’ of entering the trade or business of public accounting.”).

186 1980 T.C.M. (P-H) ¶ 80,488, at 2099.

187 *Id.* at 2101.

188 1985 T.C.M. (P-H) ¶ 85,533, at 2397.

189 *Id.* at 2400.

190 See cases cited *supra* note 159.

191 See, e.g., *Reisinger v. Comm'r*, 71 T.C. 568, 570 (1979) (stating a physician’s assistant under state law can qualify on the basis of “training, skill, experience or background,” but taxpayers who choose to qualify through education and examination cannot deduct the educational expenses); *Cristea*, 1985 T.C.M. (P-H) at 2400 (holding an engineering degree qualified the taxpayer for a new trade or business and “[n]either does the fact that petitioner could have chosen an alternative route to qualify for his new profession, one that does not require education but requires 12 or 20 years of work experience . . . justify the deductibility of the educational expense that he chose to incur”).

sue the education, courts may treat the education as "one step" leading to qualifying the taxpayer for this new position.

Factual realities and sensibility do not seem to restrain the search for trades or businesses by the courts or the IRS, either. Indeed, in the name of objectivity, courts disallow a deduction for educational expenses that represent "one step" along the path to a new trade or business even though the taxpayer never intends to enter the trade or business,¹⁹² the taxpayer's employer requires or encourages the education,¹⁹³ the taxpayer's duties are not significantly different after the education from what they had been before the education,¹⁹⁴ or even if pursuing the new trade or business would be economically prohibitive for the taxpayer.¹⁹⁵

While the regulation attempted to eliminate reliance on the taxpayer's subjective intent and most courts exclude all evidence of the taxpayer's intent, some courts, either intentionally or not, have allowed the taxpayer's subjective intent to slip back into the equation when searching for trades or businesses. For example, in *Cooper v. Commissioner*,¹⁹⁶ the taxpayer, an unlicensed accountant working for his father's accounting firm, enrolled in a program leading to a master's degree in accounting for the purpose of completing the accounting courses necessary to take the C.P.A. exam. The taxpayer took two mathematics courses, one economics course, one finance course, and one accounting course.¹⁹⁷ The Tax Court denied a deduction for the cost of taking the accounting course, but allowed a deduction for all the other courses.¹⁹⁸ The court reasoned only the accounting courses led to qualifying the taxpayer for a new trade or business because the taxpayer "needed only additional courses in accounting to meet the prerequisites to sit for the C.P.A. examination."¹⁹⁹ At the time of trial, the taxpayer worked as an unlicensed

192 See cases cited *supra* note 161.

193 See sources cited *supra* note 162.

194 See, e.g., *Vertrick v. Comm'r*, 628 F.2d 885, 887 (5th Cir. 1980) (denying a deduction for the cost of attending law school by a taxpayer who was admitted to and regularly practiced in federal courts prior to attending law school); *Grover v. Comm'r*, 68 T.C. 598, 602 (1977) (denying a deduction for the cost of law school, but acknowledging that prior to graduation from law school he "performed many of the same tasks and activities often performed by lawyers, or their military equivalent, judge advocates"); *Sharon v. Comm'r*, 66 T.C. 515 (1976) (denying a New York lawyer a deduction for a bar review course to prepare for the California bar exam).

195 See cases cited *supra* note 163.

196 1979 T.C.M. (P-H) ¶ 79,241, at 913.

197 *Id.* at 914.

198 *Id.* at 915.

199 *Id.*

accountant and had taken, and failed, the C.P.A. exam three times.²⁰⁰ The taxpayer's obvious and admitted purpose for undertaking the education was to complete the necessary accounting courses to take the C.P.A. exam and become a certified public accountant.²⁰¹ It is equally fair to say, however, that the taxpayer did not intend to become a mathematician, school teacher, stockbroker, or financial analyst. Nonetheless, the mathematics, economics, and finance courses unquestionably represent "one step" along a path that might lead to qualifying the taxpayer for these careers. Consequently, by disallowing a deduction for the accounting course and allowing a deduction for the other courses, the court let the taxpayer's apparent subjective intent influence the application of the upward-bound test by focusing only on the trade or business the taxpayer *intended* to pursue.

In an effort to identify capital expenditures and nondeductible personal expenses, the upward-bound test requires a search for new trades or businesses. When performing this seemingly speculative search to identify some new trade or business, courts generally require the education to serve only a minor role as one "helpful" step, make unlikely assumptions, and ignore important factual evidence, such as economic practicability, employer requirements, and the taxpayer's intent. As a result, this speculative search is a confusing and problematic approach for determining tax incentives for higher education.

b. Identifying "New" Trades or Businesses

After identifying any trades or businesses that the education leads to qualifying the taxpayer to perform, courts must then determine if the trades or businesses are "new" to the taxpayer. To do so, courts apply the commonsense approach and compare the tasks and activities the taxpayer was qualified to perform before and after the education. In some cases, the education obviously qualifies a taxpayer to perform substantially different tasks and activities.²⁰² In other cases, however, courts have concluded the education qualifies a taxpayer for a new trade or business when the tasks and activities have remained

200 *Id.* at 914.

201 *Id.*

202 Bachelor's degrees and law degrees are the two primary examples of degrees that, according to the courts, obviously qualify a taxpayer for new trades or businesses. *See, e.g., Warren v. Comm'r*, 2003 T.C.M. (RIA) ¶ 2003-175, at 932 ("It may be all but impossible for a taxpayer to establish that a bachelor's degree program does not qualify the taxpayer in a new trade or business."); *Galligan v. Comm'r*, 2002 T.C.M. (RIA) ¶ 2002-150, at 967 (disallowing a deduction for the cost of obtaining a law degree because a law degree qualified the taxpayer for a new trade or business).

substantially the same. *Sharon v. Commissioner*²⁰³ provides the quintessential example of this result.

In *Sharon*, an attorney licensed to practice law in New York took a California bar review course to prepare for the California bar exam. A sharply divided Tax Court held, notwithstanding the fact that Sharon was licensed to practice law in New York, that the courses led to qualifying him for a new trade or business and, therefore, denied the deduction under § 162 for the cost of the review course.²⁰⁴ According to the court, Sharon could perform substantially different tasks and activities in California after undertaking the bar review course and subsequently receiving a license to practice law in California; thus, under the commonsense approach the education qualified him for a new trade or business.

The court's conclusion that the tasks and activities of a New York lawyer differ significantly from those performed by a California lawyer contradicts common sense. Surely, as an attorney practicing in California, Sharon would perform the same general type of tasks and activities that he previously performed practicing law in New York. Indeed, Judge Irwin, one of the four dissenting judges in *Sharon*, took this view. Judge Irwin sharply criticized the court for departing from the commonsense approach and argued that the bar review course did not qualify Sharon for a new trade or business because he "could perform the same types of tasks and activities in that state as he was already qualified to perform in New York."²⁰⁵

Consider for a moment the far-reaching consequences of this holding for professions requiring a state license. As one example, all states impose minimum educational requirements for individuals seeking to become certified public accountants. Some states, such as New Hampshire, only require a bachelor's degree with a certain number of accounting and business credits;²⁰⁶ other states, such as New York, require a bachelor's degree plus a total of 150 credit hours, which generally requires thirty credit hours more than most bachelor's degree requirements.²⁰⁷ Under *Sharon*, a certified public accountant who has met New Hampshire's requirements is forever barred from deducting the cost of additional education for college credit because it would "lead to qualifying" the taxpayer for a "new trade or business" as a certified public accountant in New York. Recall

203 66 T.C. 515 (1976).

204 *Id.* at 529–30.

205 *Id.* at 537 (Irwin, J., dissenting).

206 N.H. CODE ADMIN. R. ANN. AC 302.02 (1996).

207 N.Y. COMP. CODES R. & REGS. tit. 8, § 70.1 (2001).

that the accountant's intent for actually undertaking the education is irrelevant.

This Part began by describing the confusion in determining what standards—the commonsense approach, the objective standard, the change of duties rule—are used in applying the regulation's upward-bound test. Next, this Part analyzed the primary difficulties in actually applying these standards, specifically the speculative nature of the test and the seemingly narrow definition some courts give to new trades or businesses when the tasks and activities seem to be substantially the same. The aura of confusion and uncertainty surrounding this aspect of the Education Regulation monster indicates that the upward-bound test is ill-equipped to appropriately determine the deductibility of educational expenses. Instead, one unified tax credit would provide simplicity and certainty for taxpayers pursuing higher education.

C. *Playing the "Audit Lottery"*

The uncertainty and complexity flowing from the application of the regulation's vague tests and the intensive fact-based inquiry increase the likelihood taxpayers may incorrectly claim a deduction for educational expenses. Four general possibilities exist under the regulation: (1) the regulation in fact allows a deduction for the education and the taxpayer claims the deduction; (2) the regulation in fact disallows a deduction for the education and the taxpayer does not claim the deduction; (3) the regulation in fact disallows a deduction for the education, but the taxpayer claims the deduction; and (4) the regulation in fact allows a deduction for the education, but the taxpayer does not claim the deduction. With the first two possibilities, the taxpayer properly treats the educational expenses under the regulation. With the last two possibilities, the taxpayer incorrectly treats the educational expenses under the regulation.²⁰⁸

The uncertainty caused both by the required fact-based inquiry and the regulation's confusing and difficult tests increases the likelihood that taxpayers incorrectly treat the educational expenses—either failing to claim a deduction the regulation permits or, more importantly, claiming a deduction the regulation disallows. Although taxpayers may in good faith deduct the educational expenses accord-

208 When a taxpayer qualifies for a deduction under the Education Regulation and the tax benefit from this deduction exceeds the potential benefit from § 25A or § 222, the taxpayer pays more taxes than required by the Code by not claiming the deduction. If a taxpayer does not qualify for the deduction, but nevertheless claims the deduction, the taxpayer pays less tax than required unless § 25A or § 222 would provide a greater potential benefit.

ing to the regulation and the tangled body of case law, the IRS and courts might disallow the deduction because the determination of deductibility depends on the facts of the particular case. The uncertain and confusing application of the tests not only increases administrative costs, but may deter some taxpayers from claiming a deduction they are entitled to under the regulation.

Even more troubling, the often confusing and uncertain application of these tests increases the chance that taxpayers will play the “audit lottery” and claim the education deduction even in questionable cases if it provides a greater tax benefit. The “audit lottery” generally refers to the likelihood that the IRS will examine the taxpayer’s tax return; on average this risk is less than one percent for individual taxpayers.²⁰⁹ Essentially, taxpayers who consider playing the “audit lottery” generally perform a rough cost benefit analysis. The risk of audit and the potential additional tax, penalties, and interest for improperly claiming the education deduction all impact the expected cost. In particular, the accuracy-related penalty in § 6662 serves as the IRS’s main weapon against taxpayers who play the lottery and underpay their tax liability by taking aggressive tax positions that fall short of fraud.²¹⁰ This penalty can be reduced or eliminated, however, if the taxpayer (1) relied on “substantial authority” for the deduction or (2) disclosed the relevant facts and had a “reasonable basis” for such treatment.²¹¹ Taxpayers considering deducting educational expenses may survey the sometimes confusing and inconsistent case law and conclude that they can avoid at least the accuracy related penalty. Moreover, taxpayers evaluating the expected cost might think that the IRS would prefer to settle rather than litigate a deduction for educational expenses based on the seemingly confusing clutter of case law.

209 INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, INTERNAL REVENUE SERVICE DATA BOOK 2004, at 18 tbl.10, available at <http://www.irs.gov/pub/irs-soi/04databk.pdf> (reporting that the IRS examined only 1,007,874 of the 130,134,277 individual income tax returns filed in 2003 amounting to 0.77% audit rate).

210 GUNN & WARD, *supra* note 3, at 21; see also I.R.C. § 6662 (Lexis 2005) (imposing a penalty for an understatement of tax attributable to, among other things, negligence or disregard for the tax rules or substantial understatement of income tax). The Code imposes various other penalties as well, including a penalty for an underpayment of tax due to fraud under § 6663 and a penalty on tax-return preparers under § 6694 for understatements due to tax positions that lack a “realistic possibility of being sustained on [the] merits.” I.R.C. §§ 6663, 6694 (2000). Courts have not shied away from upholding these penalties when the taxpayer aggressively claimed a tax deduction under the regulation. *E.g.*, *Kersey v. Comm’r*, 1993 T.C.M. (RIA) ¶ 93,641, at 3397, *aff’d*, 50 F.3d 15 (9th Cir. 1995) (upholding a penalty under § 6662 for improperly claiming a deduction for a bachelor of arts degree).

211 I.R.C. § 6662(d)(2)(B).

For certain taxpayers, however, the rewards for claiming the deduction are quite high. In particular, taxpayers who cannot claim the Hope or Lifetime Learning Credits or the deduction for qualified tuition and related expenses under § 222 because their income exceeds the phase-out amounts established in the respective provisions have a significant incentive to claim a deduction under § 162.²¹² Ironically, taxpayers who cannot take full advantage of the nonrefundable credit because they have little income or tax liability may also have an incentive to claim the deduction to generate a net operating loss for business expenses that may offset income in past or future years.²¹³ Moreover, taxpayers who incur educational expenses greater than the \$10,000 amount eligible for the Lifetime Learning Credit²¹⁴ or who undertake education that fails to meet the requirements for the Hope and Lifetime Learning Credits or the deduction under § 222 also have an incentive to claim a deduction under § 162.²¹⁵ Accordingly, such taxpayers have a particular incentive to play the “audit lottery” because the potential tax benefits exceed the perceived costs should the IRS audit their tax return.

One commentator described how an accountant speaking at a prestigious business school told M.B.A. students that they should deduct their tuition expenses under the regulation even in cases at the margins because the “law was uncertain and manipulable, the chances of getting audited slim, and the penalty for doing so low.”²¹⁶ In fact, the accountant expressed that students had a ninety-seven to ninety-eight percent chance of not getting audited, allowing them to “save \$15,000 on [their] taxes!”²¹⁷ As another example, a tax accountant, targeting prospective M.B.A. and graduate students who potentially qualify for a deduction under the regulation, boldly states on his website that the benefit of deducting educational expenses under the regulation is “saving a lot of money,” while the “worst case scenario is that your deduction is disallowed and you simply repay your taxes plus interest This means that your only ‘loss’ is the repayment of the interest expense.”²¹⁸ Moreover, the accountant notes he “provides all

212 See *supra* notes 27, 44 and accompanying text.

213 See I.R.C. § 172 (Lexis 2005); Treas. Reg. § 1.172-3(a)(3)(i) (as amended in 1986).

214 See *supra* note 26 and accompanying text.

215 See *supra* Part I.A.

216 K. Sandra Favelukes, *Tax Economics 101—The Need for Enforcement*, 103 TAX NOTES 353, 353 (2004), available at LEXIS, 2004 TNT 76-28.

217 *Id.* at 355.

218 Tax Man, Inc., *MBA & MPA Students*, at <http://www.taxman.com/students.html> (last visited Apr. 18, 2005) (emphasis omitted).

clients with FREE expert audit assistance, in the unlikely event of an audit” and proudly boasts that the IRS only audited forty-four of his many M.B.A. and graduate clients, resulting in forty-two wins and two compromises during appeal.²¹⁹ As a final incentive, the website allows students to calculate the potential tax savings by deducting their educational expenses.²²⁰

In response to this concern, one commentator encourages the IRS to initiate “[m]ore audits and more law suits to clarify the gray areas within the law and overturn any bad precedent” and to “impose penalties more aggressively on individuals who engage in questionable tax strategies.”²²¹ While this response may deter some taxpayers from aggressively deducting the educational expenses, it fails to adequately and timely remedy the weaknesses of the regulation: its vague tests, the confusing and seemingly speculative standards adopted by courts for applying these tests, and the inherent uncertainty flowing from the regulation’s required fact-based inquiry. Moreover, this response would impose additional administrative costs. Instead, this Note encourages Congress and the IRS to focus directly on the Education Regulation monster that has long plagued taxpayers and courts. Specifically, Congress can provide simplicity and certainty and surely reduce administrative costs by slaying the monster and dismantling the education tax maze.

MODIFIED PROPOSAL AND CONCLUSION

With the existing tax incentives for current higher education expenses, taxpayers must enter a complex tax maze and may confront the Education Regulation monster. In the process, a taxpayer will likely analyze no less than four separate provisions: the Hope Credit, the Lifetime Learning Credit, the above-the-line deduction for qualified tuition and related expenses, and Treasury Regulation § 1.162-5. To “promote simplicity in delivering education tax benefits,”²²² the staff of the Joint Committee on Taxation proposed combining the Hope and Lifetime Learning Credits and the above-the-line deduction for qualified tuition and related expenses into a single nonrefundable credit.²²³ The staff also proposed that the unified education credit

219 *Id.* (emphasis omitted).

220 Tax Man, Inc., *Tax Savings Calculator*, at http://www.taxman.com/tax_calculator.html (last visited Apr. 18, 2005).

221 Favelukes, *supra* note 216, at 353.

222 STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 17, at 42.

223 *Id.* Because a nonrefundable tax credit only offsets tax liability and because lower income taxpayers generally do not have sufficient tax liability to fully utilize the Hope or Lifetime Learning Credits, many commentators have suggested making the

provide benefits on a per student basis, similar to the current Hope Credit, and equal to twenty-five percent of the first \$10,000 dollars of qualified educational expenses for both graduate and undergraduate studies regardless of enrollment status (i.e., half time or otherwise).²²⁴ In addition, the phase-outs for the proposed credit would begin when adjusted gross income exceeds \$70,000 (\$140,000 if married filing a joint return).²²⁵

This Note supports this proposal, but to provide true simplification of the tax incentives for current higher education expenses, this Note recommends Congress bravely confront and slay the Education Regulation, a monster that has long plagued taxpayers and courts. Congress can effectively slay the monster by enacting a statutory provision that simply denies a deduction under § 162 for education and related expenditures paid or incurred for enrollment at an eligible educational institution²²⁶ in a program leading toward a postsecondary degree, certificate, or other recognized postsecondary educational credential.²²⁷ If the educational expenditure passes this threshold bright-line test, the taxpayer may deduct the expenditure under § 162 if the taxpayer meets § 162's other general require-

education credit refundable. For example, Dr. Susan Dynarski, Assistant Professor of Public Policy at Harvard University, encourages Congress to make the education credit refundable because the current incentives "offer the most help to a very atypical student, the one who attends an elite private university." *The Role of Higher Education Financing in Strengthening U.S. Competitiveness in a Global Economy: Hearing Before the Senate Comm. on Fin.*, 108th Cong. 5 (2004) (statement of Dr. Susan Dynarski, Assistant Professor of Pub. Policy, John F. Kennedy Sch. of Gov't, Harvard Univ.). Dr. Dynarski recommends a refundable credit to make education more affordable to lower income taxpayers and, in turn, better encourage lower income taxpayers to pursue higher education. *Id.* The staff of the Joint Committee on Taxation, however, counters that federal programs provide direct grants for lower income students and that "refundable credits are administratively complex and potentially more subject to fraudulent claims that are difficult to recoup." STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 17, at 43.

²²⁴ STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 17, at 43.

²²⁵ *Id.* Compare the proposed phase-out limits to the § 25A phase-outs, *supra* note 27 and accompanying text, and the § 222 deduction phase-outs, *supra* note 44 and accompanying text.

²²⁶ For purposes of this provision, the definition of "eligible educational institution" would generally mean an accredited college, university, vocational school, or other postsecondary educational institution that participates in or is eligible to participate in the federal financial aid program. This definition mirrors the definition used by the Hope and Lifetime Learning Credits. See Treas. Reg. § 1.25A-2(b) (2002).

²²⁷ This statutory provision adopts the Hope Credit's "degree requirement" and essentially provides a bright-line rule by channeling all degree-seeking taxpayers into the new unified education tax credit. See Treas. Reg. § 1.25A-3(d)(1)(i) (as amended in 2003).

ments.²²⁸ Accordingly, this limit on a deduction under § 162 and the proposed unified education credit would provide broader simplification of educational tax incentives.

This limitation on § 162 and the proposed unified education credit compliment each other. Most importantly, the above statutory limit to § 162 would eliminate the most troubling aspect of the current regulation by shifting all educational expenses paid or incurred by a taxpayer who enrolls at an eligible education institution in a degree program out of § 162 and into the unified education credit. For example, the typical student who enrolls in a degree program at an eligible educational institution would only qualify for the proposed unified education credit, and not a deduction under § 162. A student who enrolls in a degree program at an ineligible educational institution (e.g., certain unaccredited colleges) could not claim the credit but may claim a potential deduction under § 162. On the other hand, the typical professional or employee who undertakes work-related continuing professional education at somewhere other than an eligible educational institution would only potentially qualify for a deduction under § 162. If a taxpayer pursues courses or seminars at an eligible educational institution but does not enroll in a degree program, the taxpayer could potentially claim the deduction or the proposed unified education credit.²²⁹

228 Such educational expenditures must meet the general requirements of § 162 for business expenses. Specifically, the taxpayer must engage in carrying on a trade or business, the expenses must be ordinary and necessary, and the expenses must have some direct relationship to the taxpayer's trade or business. *See* Treas. Reg. § 1.162-1(a) (as amended in 1958). The author recognizes that taxpayers who potentially qualify for a deduction under § 162 must continue to wrestle with the vague "carrying on" requirement discussed in Part II.A, but the proposed limitation would generally eliminate the most troubling cases where degree-seeking taxpayers undertake education full-time at an eligible educational institution.

229 The proposed unified education credit presumably adopts the Lifetime Learning Credit's more liberal definition of "qualified tuition and related expenses" to include "amounts paid for a course at an eligible educational institution . . . if the course is either part of a postsecondary degree program or is not part of a postsecondary degree program but taken by the student to acquire or improve job skills." Treas. Reg. § 1.25A-4(c) (2002); *see also supra* note 224 and accompanying text. If Congress wants to simplify educational tax incentives further, it should limit the unified education credit to degree-seeking candidates at eligible educational institutions, as required by the current Hope Credit. *See* Treas. Reg. § 1.25A-3(d)(1) (as amended in 2003). First, this would simplify educational tax incentives even further by completely integrating § 162 and the credit—if the educational expenses potentially qualify for the credit, the expenses could not qualify for a deduction under § 162; if the educational expenses potentially qualify for a deduction under § 162, the expenses could not qualify for the credit. Moreover, the Lifetime Learning Credit requires a

This proposed limitation on § 162 would continue to provide employees a current tax benefit for employer-provided educational assistance found in § 127.²³⁰ In particular, if an employer provides educational assistance pursuant to a program described in § 127, the employer may deduct the cost of providing such assistance and the employee may exclude from gross income an amount up to \$5250. If an employer provides educational assistance in excess of \$5250, the next issue is whether the employee could deduct the educational expenses under § 162's limiting provision as described above. If the employee could deduct the educational expenses, the excess amount is generally considered a working condition fringe benefit and excluded from the employee's gross income.²³¹ If the employee could not deduct the educational expenses, the excess amount is included in the employee's gross income, but the employee may qualify to claim the unified education credit on his or her individual tax return.

Slaying the Education Regulation monster by limiting an education deduction under § 162 and dismantling the maze by combining

business nexus for non-degree-seeking students, more properly the realm of § 162 work-related expenses.

230 If an employer provides educational assistance, the employee-student must also consider § 127. This section allows an employee to exclude from gross income up to \$5250 for employer-provided educational assistance furnished pursuant to a qualified program. I.R.C. § 127(a) (2000). For an educational assistance program to satisfy the Code's requirements, an employer must (1) prepare a separate written plan exclusively for the benefit of employees, (2) not discriminate in favor of highly compensated employees, (3) not pay or incur for the year more than five percent of the amounts paid for educational assistance to benefit the class of individuals consisting of shareholders or owners (or their spouses or dependents) who own more than five percent interest in the employer, (4) not provide employees with a choice between educational assistance and other payments includible in gross income, and (5) provide reasonable notice to eligible employees. *Id.* § 127(b)(1)–(6). Section 127, of course, provides detailed definitions, attribution rules, and related provisions that are beyond the scope of this Note. *See id.* § 127(c)(2)–(5).

For purposes of the § 127 exclusion, the Code defines educational assistance to mean (1) payment by an employer for educational expense, including undergraduate and graduate tuition, fees, books, supplies, and equipment and (2) courses provided by an employer and related books, supplies, and equipment. Educational assistance specifically excludes payments for tools or supplies the employee may retain, meals, lodging, or transportation, or payment for education involving sports, games, or hobbies. *Id.* § 127(c)(1) (Supp. I 2001).

Section 127 specifies how its provisions relate to other Code sections. In particular, § 127(c)(7) denies a deduction or credit for any amount excluded from income. Of some significance, § 127 specifically provides that it shall not be construed to affect the tax treatment of educational expenses under §§ 117, 162, or 212. *Id.* § 127(c)(6) (2000).

231 *Id.* § 132(a), (d) (Lexis 2005).

§ 25A and § 222 achieves several principal policy objectives. First, and most importantly, this proposal provides simplicity and certainty for taxpayers pursuing higher education by providing one unified education credit and avoiding the troubling application of the regulation to the common degree-seeking taxpayer.²³² Second, and as a result of the first objective, this proposal would help minimize the “audit lottery” incentive and likely reduce administrative costs and the tax gap. Finally, it would achieve a more equitable benefit by making the credit apply on a per student basis rather than per taxpayer,²³³ as well as by eliminating the seemingly arbitrary method of determining who may claim a tax deduction under the current regulation. Accordingly, Congress should bravely enter the education tax maze, dismantle § 25A and § 222, and slay the Education Regulation monster to provide more effective and simplified tax incentives for higher education in the new millennium.

232 See STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 17, at 43 (discussing the policy objectives accomplished by combining § 25A and § 222).

233 *Id.* (discussing the policy objective of achieving more equitable benefits by combining § 25A and § 222).