

# ***McEuen vs. Allemeier: M.B.A. Educational Deductions at the Crossroads***

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## **INTRODUCTION**

### *McEuen*

Over the course of time, trends in tax interpretation evolve. One recent example of evolution is the “bombshell” court decision in *McEuen vs. Commissioner* in which Tracy McEuen lost in her deduction bid. Writing on August 17, 2004 in *The Wall Street Journal* about the *McEuen* case, Jane J. Kim made the following gloomy forecast:

M.B.A. students could be at risk of losing one of their biggest breaks thanks to recent tax-court decisions.<sup>1</sup>

Further in the same article, Robert Willens stated:

It’s going to be virtually impossible to take a deduction for education expenses. ... I’m having a hard time coming up with a scenario where you can claim a deduction.<sup>2</sup>

Did those dire predictions portend the end of educational deductions for M.B.A. degrees or were there other decisions to come which would bring the concept of *stare decisis* back to a more logical and realistic “common sense” position?

### *Allemeier*

Slightly over one year later, the Tax Court decided in favor of the M.B.A. deductions for Daniel R. Allemeier, Jr. in *Daniel R. Allemeier, Jr., v. Commissioner*. While the facts and circumstances were slightly different in *McEuen* compared to *Allemeier*, there were many similarities which made it difficult to reconcile the opposite conclusions in each case.

Once again, Jane J. Kim was assigned to cover the *Allemeier* case in *The Wall Street Journal*. In the lead-in for her report, she exclaimed:

Business-school students may soon have better luck deducting their tuition expenses thanks to a new tax-court ruling.<sup>3</sup>

That statement was the exact opposite of what was written earlier about the *McEuen* case. What criteria will the courts use for future cases in this area? This article will address that issue, along with related items, and draw conclusions concerning those deductions.

### Internal Revenue Code (I.R.C.)

I.R.C. Section 162(a) states: “In General—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...”

While I.R.C. Section 162 does not explicitly mention educational expenses, Income Tax Regulations cover educational expenses and provide tests for deductions in Reg. Sec. 1.162-5.

### Income Tax Regulations

Reg. Sec. 162-5 (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**) [emphasis added.]

The prohibition for deductions in Reg. Sec. 162-5(b)(2) deals with minimum educational requirements. In general, those requirements state: “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” will not be deductible. In most cases, that restriction will eliminate almost all expenses of an undergraduate degree.

However, once a person has met the minimum requirements for a given field of endeavor with an undergraduate degree, any additional preparation in the same field will generally be deductible because it “maintains or improves skills required by the individual in his employment or other trade or business.” As an example, preparation to become a C.P.A. is not deductible because the individual is meeting the minimum requirements of the profession. But, once an individual has become a C.P.A., additional accounting studies are generally deductible because the individual has met the minimum requirements of the profession.

On the other hand, when a C.P.A. takes courses from a law school, Reg. Sec. 162-5(b)(2) ii clearly states that the C.P.A. could be entering the profession of law and disallows the deductions even if the C.P.A. has no intention of going into the legal profession. Law school tax courses are considered to be potential preparation for a new professional field for which the C.P.A. does not meet the minimum requirements and; hence, those expenses are not deductible even though the law school courses could benefit the C.P.A. in professional practice without going into a new profession.

### Inconsistencies Within the Regulations

There are some inconsistencies within the Regulations. Reg. Sec. 1.162-5(b) (3)(i)(a) through (d) states:

The following are examples of changes in duties which do not constitute new trades or businesses:

- (a) Elementary to secondary school classroom teacher.
- (b) Classroom teacher in one subject (such as mathematics) to classroom teacher in another subject (such as science).
- (c) Classroom teacher to guidance counselor.
- (d) Classroom teacher to principal.

In other words, a teacher is a teacher is a teacher. That stance is the official Regulation position in spite of the fact that some school districts will not consider teachers for the position of principal until they have received additional training and obtained a higher credential. In effect, many school districts do not believe that a classroom teacher has the minimum credential for the position of principal while the Regulations take exactly the opposite position, but only for educators. This extreme Regulation position,

only for educators, has put a shadow of controversy over what constitutes *minimum educational requirements*.<sup>4</sup> That shadow of controversy has spilled over into other areas including deductions for the M.B.A. degree. The question to ask in some cases is: *What are the minimum educational requirements for this field?*

If the Regulations stated that a businessperson is a businessperson in the same way that a teacher is a teacher, then there would be no doubt about the deductibility of the expenses of Tracy McEuen's graduate degree. As it stands currently, there is a shadow of controversy over what constitutes the minimum educational requirements for the field of business.

*W. M., III, and T. L. McEuen vs. Commissioner of Internal Revenue*

While this is a very interesting ruling from the Small Cases Division of the Tax Court, it may not be treated as precedent under I.R.C. Section 7463(b). However, it does provide some valuable insight into current IRS philosophy. Because of the relatively small amount of money involved, Mr. & Mrs. McEuen represented themselves. On the other hand, the IRS was represented by a trained professional, Timothy A. Lohrstorfer. As a result of that representation combination, the McEuen's may have participated in a court case where the playing field was not completely "level."

*Summary of the McEuen Case*

Tracy L. McEuen (petitioner) [hereafter T. McEuen] earned a B.A. degree, with distinction, in mathematics and economics, from Indiana University in 1992 and began working as a "financial analyst" at Merrill Lynch (M-L) the same year. In order to progress from "financial analyst" to "associate," an employee had to have an M.B.A. degree and was given three years by M-L to obtain the degree.

At the end of the three year period, T. McEuen had not received an M.B.A. degree and went to work as a financial analyst with the corporate finance department of Raymond James Financial, Inc. (James) in June, 1995. After only year at James, T. McEuen was accepted into the Kellogg School of Management (Kellogg) at Northwestern University in June, 1996 and resigned from James to attend Kellogg.

In June, 1998, T. McEuen received her Master of Management (M.M.) degree from Kellogg. According to the court record, that degree was considered the equivalent of the M.B.A. degree from other institutions. After her graduation, T. McEuen "did not return to an investment banking firm as an analyst or associate." According to the court documents, she was hired by Spring Industries (sic) in September, 1998. [The actual name of the company is Springs Industries, Inc.]

Spring Industries is a diversified company which traces its origins back to 1887 when Samuel E. White formed Fort Mill Manufacturing Co. The name Springs Industries, Inc. (SII) comes from the fact that Leroy Springs assumed control of the Fort Mill operations in 1914. Currently, SII has recognized brand names such as Wamsutta, Springmaid, and others.

At the time T. McEuen was hired into the "General Management Program" of SII, candidates for the position "were required to have an M.B.A. or equivalent." In that context, what would an equivalent be? There is no discussion of this factor in the court proceedings.

Is it possible that SII could have considered a degree in economics which contains the underlying framework for all business plus four years of experience with two major brokerage firms to be the equivalent of an M.B.A.? If so, T. McEuen could have argued that she already met the minimum requirements for her position and that her studies for the Masters degree at Kellogg were actually in a program that maintained and improved her skills. Furthermore, the M.M. degree would not have enabled her to go into a new field because she had already met the minimum requirements for the field of business.

## Other Issues with the *McEuen* Case

### IRS Audit Selection

In the court proceedings, the McEuen's claimed a deduction of \$20,317 for "required education" on Schedule A of their 1998 U. S. Form 1040. After reducing the total educational expenses of \$21,125 by 2% of AGI (\$808), the McEuen's computed their deduction of \$20,317. If 2% of AGI is \$808, then it can be calculated algebraically that the McEuen's had AGI of \$40,400. In effect, one of their "miscellaneous itemized deductions" of \$20,317 was more than 50% of AGI.

With around 1% of individual returns selected for IRS audit annually, why was the McEuen's return selected in the first place? While there are many possibilities for a return being selected for audit, one high probability for audit selection for the McEuen's would be the Discriminate Function (DIF). In this system, returns are scored using statistical information to select returns with the greatest probability of error and; hence, the greatest probability for additional tax assessments.

Because the relationship between "miscellaneous itemized deductions" and AGI was materially out of line, a "red flag" in the system could have triggered the McEuen's return for audit. While the IRS has been successful in maintaining the secrecy of the exact scoring formula for the DIF, it is very reasonable to believe that the DIF score may have triggered the McEuen's audit.

### Burden of Proof—Internal Revenue Section 7491

I.R.C. Section 7491 deal with the burden of proof and states:

- (1) General Rule—If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.
- (2) Limitations—Paragraph (1) shall apply with respect to an issue only if-
  - (A) the taxpayer has complied with the requirements under this title to substantiate any item;
  - (B) the taxpayer has maintained all records required under this title and has cooperated with all reasonable requests by the Secretary for witnesses, information, documents, meetings, interviews...

In the discussion portion of the case, the court propounded the following statement:

The Court decides this case on the preponderance of the evidence, regardless of the allocation of the burden of proof. Section 7491 is therefore inoperative.

A terse one sentence "discussion" by the Court negates I.R.C. Section 7491. Did the taxpayers violate Sec. 7491(1) by not providing credible evidence or was there a violation of Sec. 7491(2)(A) or (B) requirements? The court record discusses none of those potential violations and simply states that Sec. 7491 "is therefore inoperative." Is it possible that the court simply finessed that issue because the petitioners were pro se and did not realize what had happened to them? It is probably a distinct benefit to the Internal Revenue Service that a decision of the Small Cases Judge is final and cannot be appealed.

### Summary of the *McEuen* Case

The McEuen's, while very intelligent by virtue of their jobs and educational attainments, were not formally trained in tax matters and missed some golden opportunities to win their case. Does the I.R.S. victory in the *McEuen* case pronounce the end of "M.B.A. deductions"? Hardly!

### Summary of the *Allemeier* Case

On August 31, 2005, the Tax Court issued a Memorandum Decision allowing Daniel R. Allemeier, Jr. (pro se) to deduct the M.B.A. expenses of attending Pepperdine University. Concurrently, Mr. Allemeier lost on some other issues which were not related directly to the deduction of the M.B.A. expenses. The facts of the *Allemeier* case follow.

Before he had completed his undergraduate degree, D. R. Allemeier (Allemeier) began selling a single product, a protective mouthguard, for Selane Products, Inc. (Selane) in 1996 on a part-time basis. Selane is an orthodontic and pediatric laboratory that specializes in making removable orthodontic appliances.

Upon graduation from Wingate University with a bachelor's degree in sports medicine, Allemeier began working full-time for Selane. His work duties were expanded significantly and his "responsibilities ranged from making sales calls by phone and managing small budgets to working directly with dentists and athletic trainers..."

His C.E.O., Dr. Rob Veis, testified that by all accounts, petitioner excelled in his duties at Selane Products, and in a few years he became a leading salesman for the company. Because of his skills and abilities, Allemeier was given more responsibilities and duties before obtaining a graduate degree.

After being in a full-time position for about three years, Allemeier decided to obtain an M.B.A. degree. Dr. Veis told Allemeier that an M.B.A. degree would "speed his advancement within the company" but Selane did not require petitioner to obtain the M.B.A. degree for advancement. Also, Selane had a strict policy of not reimbursing employee educational costs.

The following paragraph directly from the court record should prove conclusively that:

1. Allemeier met the "minimum requirements" for his position;
2. He was not going into a "new profession"; and
3. He was simply maintaining and improving the "minimum requirements" which he had already attained.

Shortly after petitioner enrolled in, but before he completed, the MBA program, he was promoted to several new positions at Selane Products. Petitioner was promoted to Marketing Manager, Managing Director of the Appliance Therapy Practitioners Association, Head of the SMILE Foundation, Practice Development Consultant, and Project Development Consultant. In these new capacities, petitioner's duties expanded and included analyzing financial reports, designing action plans for sales, and evaluating the effectiveness of marketing campaigns. Petitioner performed many of these same functions before he earned his MBA. Petitioner remained a full-time employee of Selane Products while in the MBA program.

### **Why Do Some Firms Require an M.B.A. Degree?**

An excellent question to pose is this: "Why do some firms require an M.B.A. degree?" Is it because they desire additional depth and breadth of knowledge and other sophistication that is inherent in the degree? Or, are there other factors which come into play?

In both Merrill Lynch and Raymond James (the two firms in the *McEuen* case), there have been numerous high level producing associates who did not obtain M.B.A. degrees. By requiring M.B.A. degrees, are they artificially raising standards to appeal to the ego of “select” individuals?

Another factor which has caused some firms to seek an M.B.A. is that global academic standards have deteriorated. Many college and university administrators worship at the shrine of the “SCH” or Student Credit Hour. That factor trumps all other considerations in a “quality education” in far too many cases in the educational process. In order to recruit an employee candidate with the skills that a bachelor’s degree holder used to have, some firms are seeking M.B.A.’s. The M.B.A. degree may be the equivalent of what a bachelor’s degree was a few years ago.<sup>5</sup>

However, the lowering of standards should not be used as an excuse to set the minimum standards for the field of business as the M.B.A. There are still many bachelor’s degree holders who are well trained for the field of business. Therefore, the bachelor’s degree should remain the minimum requirements for the field of business just as the Regulations declare that teacher certification is the minimum requirement for any teacher or principal at kindergarten through twelfth grade level.

### **Insights from Other Cases for M.B.A. Deductions**

#### *Steven G. Sherman v. Commissioner of Internal Revenue*

In June, 1965, Mr. Sherman (petitioner) received a Bachelor of Arts degree in *English* from Tufts University. Subsequently, he served as an officer in the U.S. Army until June, 1968 when he was discharged. While in the Army, he held three top-level positions. After his Army tour-of-duty, he was employed by the Army and Air Force Exchange Service, (AAFES) as Chief, Plans and Programs Office in Viet Nam. While in that position:

His duties in this position involved formulating and monitoring management, contingency, and emergency plans for the Viet Nam region. He coordinated the phase-down of the Viet Nam exchanges (PX’s) concurrent with troop redeployment. He also represented his region in discussions about exchange operations with high-level Department of Defense, Department of State and legislative officials.

“At some point prior to May, 1971,” Sherman was accepted into the Harvard M.B.A. program and completed his degree in June, 1973, when “petitioner was not under an employment agreement and did not receive a salary from any source.”

At the conclusion of the case, the ruling was: “Decision will be entered for the petitioner.” The decision was declared even though the I.R.S. was represented by Lawrence Becker and Joyce Britt while Sherman was represented pro se.

What is the significance of the *Sherman* case? First, the case demonstrated that Sherman could deduct M.B.A. Expense even though he did not have an undergraduate in business. The case is silent on the issue of minimum requirements for a career in business. The fact that Sherman held very high level jobs in the Army and also with AAFES would indicate that Sherman had met the minimum requirements for the field of business *even without an undergraduate degree in business administration*.

Second, *Sherman* was able to overcome the “one-year-rule” in *Furner*. After the *Furner* case, the I.R.S. issued a Revenue Ruling stating that: “Ordinarily a suspension for a period of a year or less, after which the taxpayer resumes the same employment or trade or business, will be considered temporary.” Sherman spent two years in his M.B.A. studies and the court decreed that the time was still “temporary” and that

the expenses were deductible. In effect, *Sherman* negated Revenue Ruling 68-591 with regard to time requirements.

Last, what is the relationship of the *Sherman* case to the *McEuen* case? While it would appear that the *Sherman* case was directly on target for *McEuen*, that case was not included in the cases considered by the court. Is it possible that the *McEuen*'s did not know of its existence and the I.R.S. did not want to introduce it because of the potential damage that it would have done to their position? The answer to that question may never be known because of the non-appeal position of the Small Cases Division of the Tax Court. Was the Small Cases Division of the Tax Court negligent in its administration of the *McEuen* case? Its decision left much to be desired.

#### Ross L. Link vs. Commissioner of Internal Revenue

Ross Link graduated from Cornell University in May, 1981 with a bachelor's degree in operations research. In September, 1981, Link began graduate school and was awarded an M.B.A. degree in May, 1983. When he attempted to deduct his M.B.A. expenses, the court stated: "he had not established himself in his trade or business." The facts of the case indicate the Link had not met the minimum requirements for his field and; hence, the expenses were not deductible.

Unlike *McEuen*, Link worked for Xerox Corp. for only three months from "June, 1981 to September, 1981." In effect, he had a "summer job" and then started his M.B.A. An operations research degree is, at best, only tangentially related to the field of business. On the other hand, *McEuen* earned a bachelor's degree in economics at a major university and gained four years experience at two major brokerage firms. That should be the equivalent of a bachelor's degree in business administration and should have satisfied the minimum requirement for the field of business.

### **Who Is Responsible for the Shadow of Controversy Concerning M.B.A. Deductions?**

#### The Department of Treasury

There are many parties who share responsibility for the controversy concerning M.B.A. deductions. First, the Department of Treasury has committed a disservice by providing negligible guidance in the Income Tax Regulations concerning the minimum requirements for the field of business. According to the Regulations for education, a teacher has met the minimum requirements when the educator is initially certified. If the educator is promoted from:

classroom teacher to  
assistant principal to  
principal, and subsequently,  
to superintendent of schools,

that educator can deduct all educational expenses incurred after being initially certified even though there may be different credentials required for every promotion. In effect, many school boards maintain that each promotion requires a different level and type of training, whereas the Regulations propound that each one is essentially the same with no substantive difference between each level.

If the same Regulations were in effect for business that are in place for education, then a person with a bachelor's degree in any area of business would meet the minimum requirements for the field. It is possible that a bachelor's degree in any field would be sufficient because many people with degrees outside of business, such as physical education, go into business and have very successful careers. The *Sherman* case demonstrated that a bachelor's degree in English can provide the minimum requirements for the field of business when it is supplemented with additional high-level training. The Department of Treasury bears some responsibility for the controversy concerning deductions for the M.B.A. degree.

### U. S. Congress

Of course, if it is the intent of Congress for the minimum requirements for business to be an M.B.A. (or equivalent), then they should pass legislation which clarifies that point for the Department of Treasury. However, if Congress did that, then it would be inconsistent with position for education and that issue should be addressed as well. The U. S. Congress has, to some degree, contributed to the lack of certainty dealing with deductions for the M.B.A. degree.

### The Judiciary

Perhaps the greatest share of responsibility for the current confusion concerning M.B.A. deductions is the U.S. Judiciary. Judges have taken the extreme position that the M.B.A. is the minimum requirement for business in some cases. To champion that argument in light of current business operations is a huge stretch of the imagination and totally inconsistent with the field of education cases.

Actually, the *McEuen* controversy came from the Small Cases Division of the Tax Court. There was a great deal of room for improvement in the administration of the *McEuen* case. That decision may have created a controversy where none would have been present otherwise. Perhaps *Allemeier* will cause the pendulum of justice to swing back to a more realistic position in the future.

### **What Should Be Done About the M.B.A. Deduction Conflict?**

If the Executive (Department of Treasury), Legislative (Congress), or Judicial Branches were to make some slight modifications, then the entire issue should evaporate. If the Department of Treasury were to review their Regulations and modify them to state that a bachelor's degree in business met the minimum requirement for subsequent business education deductions, then the M.B.A. controversy should be resolved. However, if Treasury Officials took the position that the M.B.A. degree is the minimum requirement for the field of business, then that position would completely contradict their position for the field of education. While Treasury is working on that task, they should also state that the acquisition of an M.B.A. degree for a person in business does not constitute a new profession. That was clearly the stance taken in the *Allemeier* and *Sherman* cases and the correct position regarding the issue.

On the other hand, if Congress were to amend I.R.C. Section 162 to state that a bachelor's degree in business meets the minimum requirements for future business educational deductions, then the M.B.A. deduction controversy should cease. But, if Congress stipulated that an M.B.A. was the minimum requirement, then it would defy all logic and be completely inconsistent with the Regulations for the field of education.

Last, but the easiest to implement, would be for the judiciary to admit that the minimum requirement for business education deductions is the bachelor's degree in business from an AACSB accredited school [or equivalent accrediting body]. Perhaps, any bachelor's degree from an accredited school (as was the case in *Sherman* when there is significant prior business experience) would be sufficient to meet the minimum requirements for entry into the field of business and; thereby, allow deductions for advanced studies in business.

### **Summary and Conclusions**

The *McEuen* case stirred up a hornet's nest. Was it really necessary? The evidence presented in this article suggests strongly that the McEuen's could have prevailed in their endeavor to deduct M.B.A. expenses with just a little bit of coaching or personal advocacy. Tracy McEuen certainly satisfied the requirements for the deduction according to the Regulations. She met the minimum requirements for the field of business with a bachelor's degree in economics and four years of experience at two major brokerage firms. Also, she was not going into a new field but was maintaining and improving her



business skills. It could be persuasively argued that T. McEuen had more formal training in business than Steven Sherman did but *Sherman* triumphed and deducted his M.B.A. expenses while *McEuen* lost and could not deduct her M.B.A. expenses. Ideally, the principle of *stare decisis* in *Sherman* and *Allemeier* will set the precedent for future decisions in that area. There are many scenarios where M.B.A. expenses will be deductible in the future.

#### Endnotes

1. Kim, Jane J., "M.B.A. Students May Lose Tax Break," *The Wall Street Journal*, August 17, 2004, p. D2.
2. *Ibid.*
3. Kim, Jane J., "Tax Court Ruling Allows Deduction on M.B.A. Degree," *The Wall Street Journal*, September 8, 2005, p. D2.
4. Please see: Posey, Clyde L., "Educational Expense Deductions: Issues at the Crossroads," *The Journal of Higher Education*, Vol. 52, No. 6, pp. 624-639.
5. For a complete discussion of this phenomenon, please see M. I. Rapert, S. Smith, A. Velliquette and J. A. Garretson, "The Meaning of Quality: Expectations of Students in Pursuit of an MBA," *Journal of Education for Business*, September/October, 2004, pp. 17-24.