DEDUCTING MBA EDUCATION COSTS

1. WHO MAY DEDUCT MBA EDUCATION COSTS?

A typical MBA candidate can deduct education expenses if he or she currently operates a business, currently has a job with professional or managerial duties, or is currently in "job status".

Although the courts' interpretation of "job status" is unsettled, the following tend to support an MBA's claim of "job status" while in school:

- An expressed intention to return to the same employer, or at least to the same industry, after graduation. This intent is evidenced, for example, by a formal leave of absence, written statements in graduate school applications, or participation in career-related student organizations.
- Working for the same employer or in the same industry during school vacation periods
- Returning to the same employer or industry after graduation

Continuity in the "same" industry or function can often be achieved by contending that, both before and after receiving your MBA, you have worked, for example, broadly in "financial statement analysis," "marketing," "quantitative analysis," or "consulting."

2. WHAT EXPENSES ARE USUALLY DEDUCTIBLE?

Qualifying education expenses include the costs of application fees, GMAT fees and preparatory courses, tuition, registration fees, books, supplies, membership fees in most student organizations, and attending seminars.

Also, after excluding the percentage of time spent on non-educational personal-use, the remaining portion of the cost of a computer can be expensed in the year of purchase under a special provision called the "Section 179" immediate depreciation deduction.

Finally, if you moved more than 50 miles to attend school, you may be able to deduct your moving costs. Moving costs customarily include the costs of airfare for you and your family, as well as shipping costs for your belongings.

3. WHAT EXPENSES USUALLY ARE NOT DEDUCTIBLE?

The costs of campus parking and commuting generally may not be deducted

However, if you work at your job or business during a given day and then drive to campus the same day, the costs of getting to this second "work site" are deductible. A FEMBA student, therefore, probably can deduct commuting costs.

Room, board, and meals on or off campus generally cannot be deducted.

4. HOW MUCH IS THE TAX SAVING?

If you own your own business, your qualifying education expenses are allowed in full without limitation or reduction.

If you are an employee, the effective tax savings from deducting education expenses is computed as follows:

Step 1: Add your out-of-pocket expenses to certain miscellaneous expenses such as tax preparation fees paid and allowed job-search costs.

Step 2: Subtract from Step 1 an amount equal to 2% times your Adjusted Gross Income. If zero, stop.

Step 3: Add all other itemized deductions, such as state tax payments, charitable contributions, and home mortgage interest

Step 4: Subtract the Standard Deduction for your filing status, such as Single or Married Filing Jointly. If zero, stop.

Step 5: Multiply your top marginal tax rate times the amount remaining after Step 2 (or if lower, the amount remaining after Step 4). Most MBAs working full-time are subject to roughly a 25% top tax bracket, while students with only summer job income are usually subject to 10%.

5. WHEN ARE EDUCATION EXPENSES DEDUCTED?

Education expenses properly are claimed in the year in which you pay them.

From a planning standpoint, most MBA candidates will generate the largest tax savings by prepaying during their entering fall quarter their education expenses for the entire academic year and, if possible with modest penalties, post-paying their second academic year in their year of graduation.

The strategy is optimal for two reasons:

First, your tax bracket is highest in the calendar years in which you enter("year 1") and depart ("Year 3") school than in the calendar year ("Year 2") comprised of First Academic Year Winter and Spring quarters, Summer work, and Second Academic Year fall quarter.

Second, you are more likely to be itemizing your deductions in Years 1 and 3 because you already will have a substantial itemized deduction for state taxes paid or withheld in those working years.

6. DOES THE RISK OF AN IRS AUDIT INCREASE IF A PERSON CLAIMS EDUCATION EXPENSES?

Yes. Audit risk generally increases when a taxpayer claims an expense that is disproportionately large relative to statistical norms for his or her earnings and status. In addition, we are seeing a large increase in audits of the 1040NRs, commonly filed by international students, which contain this deduction.

7. WHAT PENALTIES APPLY IF A CLAIMED EDUCATION EXPENSE DEDUCTION IS DISALLOWED?

The IRS always imposes an interest-like penalty to the extent a taxpayer improperly retained use of funds that previously should have been paid to the government.
In addition, the IRS can impose modest penalties for negligence and severe penalties when a taxpayer recklessly has disregarded the truth, committed fraud, or failed to file a tax return.

In general, if you report honestly and in good faith, your risks are modest compared to the potential tax savings benefits.

8. WHAT SPECIAL TAX FORMS ARE NEEDED?

If you qualify, most MBA students should deduct their education expenses except moving costs on Form 2106 "Employee Expenses" on the line "Other", which are then in turn placed on Schedule A "Itemized Deductions."

If you operate your own business, you should deduct your education expenses except moving cost on Schedule C "Profit from Trade or Business."

Depreciation, including the Section 179 deduction for computers, also initially must be entered on Form 4562.

Moving costs should be deducted on Form 3903, which are in turn placed on the first page of your tax return.

9. DO SCHOLARSHIPS OR OUTRIGHT GRANTS REDUCE MY DEDUCTION?

Yes. You may only deduct education costs you paid yourself.

10. DO LOANS REDUCE MY DEDUCTION?

No. You are allowed to deduct the full amounts paid for your education, even if you spent money borrowed from your family, an employer, the government, or a financial institution. However, if a loan provided by an employer later is forgiven, you must report the debt relief benefit as compensation income.

11. WHAT IF MY EXPENSES EXCEED MY INCOME?

If your deductible expenses exceed your income for the year, you may have a net operating loss. Such loss may be carried back two years and/or forward up to 20 years.

12. WHAT IF I AM CHANGING PROFESSIONS?

If you change professions or if you are not maintaining or improving existing skill, but instead are gaining new skills in your studies, you do not qualify to deduct continuing education costs under Internal Revenue Code Section 162. However, there is a limited deduction that students may be eligible for. For taxpayers with an Adjusted Gross Income (AGI) of $65,000 or less ($130,000 for joint filers), the maximum 2010 annual deduction is $4,000. For taxpayers with AGI over $65,000 but not greater than $80,000 ($160,000 for joint filers), a 2010 annual deduction of $2,000 is allowed.

THE LIFETIME LEARNING CREDIT

A. The General Rules

A taxpayer generally may claim a tax credit equal to 20% of the amount spent on education costs.

Qualifying education costs include amounts paid after June 30, 1998 for college, graduate school, or vocational training.

The maximum amount that qualified is $10,000 per year. Thus, the maximum credit allowable is $2,000 per person (20% x $10,000).

B. Limitations

You may not claim the lifetime learning credit if:

- You are claimed as a dependent, such as by your parents on their tax return

- Your adjusted gross income exceeds $61,000 as a single taxpayer or $122,000 as a married couple filing jointly. A partial credit is allowed for single taxpayer who earn between $51,000 and $61,000 and for married taxpayers who earn between $102,000 and $122,000.

- You claim a "<u>for</u> AGI deduction" for education expenses.

- You are filing a 1040NR as a non U.S. resident.

Further, this credit may only be used to eliminate your tax bill, but can not be used to create a tax refund.

You cannot claim the Hope or American Opportunity Credits because they apply only to undergraduate studies.

This is a federal credit. Therefore, it does not reduce your state taxes.

C. The Planning Strategies

If your income as a single student exceeds $51,000 in the graduation year, consider the following actions:

- Accelerate a portion of your signing bonus to an earlier year or delay a portion of your profit-sharing bonus to a later year.

  This may push your bonus into a higher tax bracket, but it generally is worthwhile to obtain the credit.

- Pre-pay your tuition in your mid-MBA year. The law anticipated this strategy and only allows up to three months pre-paid tuition to qualify for the credit.

- Also, a portion of the credit effectively is "wasted" if your tax liability does not equal at least $2,000.

  Accordingly, if your income will not create a pre-credit tax liability of at least $2,000, consider accelerating income or delaying deductions.

  A single taxpayer's pre-credit liability usually exceeds $2,000 if his gross income is at least $25,517.

  Your approximate liability is determined as follows:

  Taxable Income is your gross earnings, minus your Standard Deduction of $5,700 and Exemption of $3,650.
  To Illustrate:

Gross Income	$25,517
Less: Standard Deduction	(5,700)
Less: Exemptions	(3,650)
Taxable income	$16,167
Tax rate 10% first $8,500, remainder @ 15%	
Liability	$ 2,000
Credit	(2,000)
Tax Due	$ 0

MAY I DEDUCT MY EDUCATION AND ALSO CLAIM THE LIFETIME LEARNING CREDIT?

No. However, you may claim a credit for a portion of your education costs and may deduct the remainder as an itemized deduction should such education meet the continuing education requirements discussed.

DEDUCTING INTEREST ON STUDENT LOANS

A. The General Rules

A person generally may deduct interest paid on a student loan, as long as:

- An unmarried taxpayer's income is below $60,000, or a married couple's income filing jointly is below $120,000
- The debt is incurred by the taxpayer solely to pay qualified higher education expenses.
- The taxpayer is not claimed as a dependant by someone else, such as a parent, in the year interest payments are made
- For California tax purposes, the interest must be required payments incurred during the first 60 months of the loan.

However, taxpayers must reduce their allowed deduction if:

- Their interest payments exceed the maximum $2,500 annual limit.
- Their annual income exceeds a $60,000 base amount or, if married filing jointly, a $120,000 base amount.

The allowed deduction diminishes by about 6.67% for each $1,000 of income a person earns above the base amounts and by about 3.33% for each $1,000 of income a married (filing jointly) person earns above the base amount.

For example, assume that a single taxpayer paid the maximum interest amount of $2,500. If her income is $61,000, she must reduce her $2,500 deduction by 6.67% x $2,500, or $167. Accordingly, her allowed deduction is $2,500 -$167, or $2,333.

Because the allowed deduction phases out as a taxpayer's income increases, a single taxpayer may not claim any deduction if his income exceeds $75,000. A married couple may not claim any deduction if their income exceeds $150,000.

Student loan interest is a "For AGI" deduction. Thus, you may claim interest expense even if you do not itemize your deductions.

B. Calculating Your Deduction

A person computes his interest deduction on a student loan in three steps:

Step 1: Calculate your qualifying interest payments

As a general rule, the full amount of interest paid on a student loan during the year qualifies as long as:

- You incurred the loan while pursuing an undergraduate, graduate, or vocational education and maintained at least half-time student course load.
- The loan was taken out to pay for qualified education expenses, and cannot be from a related party or made under a qualified employer plan.

Step 2: Apply the annual $2,500 limit.

Step 3: Apply the income limits.

Reduce your "Step 2" annual limit amount if your income exceeds certain levels. These levels are $60,000 for an unmarried taxpayer and $120,000 for a married couple filing jointly.

This is achieved as follows:

(1) Enter your adjusted gross income.
(2) Subtract $60,000 if single or $120,000 if married filing jointly.
(3) If the result is zero or negative, stop. Step 3 does not apply. If the result is positive, divide this amount by $15,000 if single, $30,000 if married filing jointly.
(4) Then multiply the fraction in (3) by $2,500.
(5) Subtract the amount in (4) from your "Step 2" annual limit amount.

If the result is positive, this is your allowed deduction. Otherwise, no deduction is allowed.

C. Planning Strategies

Consider prepaying interest of $2,500 during years in which income is low enough to qualify for the deduction.