

2017 MBA HANDOUT

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% of your Adjusted Gross Income. If zero, stop.
- Step 3: Add all other itemized deductions, such as property taxes, state income taxes, home mortgage interest, and charitable contributions.
- 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 a 10% tax rate.

Note: Additional tax saving will result with CA tax filings. MBAs should note that there are other factors that can reduce tax savings such as Alternative Minimum Tax and the new Phase out of Itemized Deductions that effects high income individuals. Due to the complicated nature of the deductions, we strongly recommend MBA seeks professional tax assistance in preparing their returns.

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 brackets 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 Business Expenses” on the line “Other”, which are then in turn reported 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 reported 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?

In order to deduct expenses as business continuing education, taxpayer must be maintaining or improving existing skills in their existing profession. Such education cannot meet minimum standards for job or qualify taxpayer for a new trade or business. This is open to great debate and there are many court cases that discuss “What qualifies a taxpayer for a new business”, “whether changes of industry, job title, or employer is a profession change” and “whether the education is required or just preferred for a job”. The results are sometimes broadly defined in favor of the taxpayer and may surprise you.

However, should you be deemed to have 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, see the lifetime learning credit below for an annual credit related to education for taxpayers regardless of their professions.

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. Educational costs do not include books or other course materials for this credit.

Qualifying education costs include amounts paid 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 \$66,000 as a single taxpayer or \$132,000 as a married couple filing jointly. A partial credit is allowed for single taxpayer who earn between \$56,000 and \$66,000 and for married taxpayers who earn between \$112,000 and \$132,000.
- You claim a “for 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 cannot be used to create a tax refund.

You cannot claim the American Opportunity Tax (Hope) Credit because it applies only to undergraduate studies.

Lifetime Learning Credit only applies to federal income tax liability.

C. The Planning Strategies

If your income as a single student exceeds \$50,000 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 \$26,841.

Your approximate liability is determined as follows:

Taxable Income is your gross earnings, minus your Standard Deduction of \$6,350 and Exemption of \$4,050.

To Illustrate:

Gross Income	\$ 26,841
Less: Standard Deduction	(6,350)
Less: Exemptions	<u>(4,050)</u>
Taxable income	\$ 16,441
Tax Liability (10% rate on the first \$9,325, remainder at 15%)	\$ 2,000
Credit	<u>(2,000)</u>
Tax Due	\$ 0

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

Yes , 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 \$65,000, or a married couple's income filing jointly is below \$130,000
- The debt is incurred by the taxpayer solely to pay qualified higher education expenses.
- The taxpayer is not claimed as a dependent 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 \$65,000 base amount or, if married filing jointly, a \$130,000 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 \$70,000, she must reduce her \$2,500 deduction by $5 \times 0.0667 \times \$2,500$, or \$834. Accordingly, her allowed deduction is \$2,500 - \$834, or \$1,666.

Because the allowed deduction phases out as a taxpayer's income increases, a single taxpayer may not claim any deduction if his income exceeds \$80,000. A married couple may not claim any deduction if their income exceeds \$160,000.

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

B. Planning Strategies

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

RETIREMENT ACCOUNT PLANNING

In addition to the deductions discussed above, students should consider the benefits of converting their 401(k) and IRA accounts to ROTH IRAs while in school. As the typical student has many years until retirement funds will be used and is in a low tax bracket relative to future years this may be very beneficial. Converting to a ROTH IRA will create taxable income in the year of the conversion.

However, it will allow all future growth to be tax free income instead of tax deferred income as was the case in the other retirement plans. Further, if the student is deducting their entire MBA education, often there are significant deductions which reduce the amount taxed from the conversion. ROTH IRAs also offer greater flexibility in retirement as to their distribution rules.