

CPA Client Bulletin

Smart Tax, Business & Planning Ideas from your Trusted Business AdvisorSM

Tax Court Spells Out MBA Tax Deduction

April 2010

If you go back to school to get an MBA, your costs might be tax deductible. A recent decision from the U.S. Tax Court (*Singleton-Clarke*, T.C. Summary Opinion 2009-182, 12/2/09) shows when you can sustain such a deduction.

The case involved a nurse who had over 20 years of experience. She signed up for an online course and eventually received an MBA with a specialization in health care management (MBA/HCM). The nurse paid \$14,787 in tuition for the course and claimed a corresponding deduction on her federal income tax return. When the IRS denied the deduction, the nurse took the dispute to the Tax Court.

Regarding the regulation

The case turned on IRS regulations regarding education deductions. As the Tax Court explained, "if the education qualifies the individual for a new trade or business, then the education expenses are not deductible." On the other hand, "if the education maintains or improves skills required by the individual in his employment or other trade or business," the taxpayer may deduct the expenses. The

court concluded that the key question was whether the nurse's MBA qualified her for a new career.

In its opinion, the court provided some examples. A student who takes an MBA

before starting a career does not qualify for the deduction because any job would be a new one. The same is true for a military officer who leaves the service and goes right to graduate school for an MBA. Conversely, the court's opinion stated that it previously had ruled in favor of taxpayers who were already established in their trade or business. If the

MBA study "merely improved preexisting skills for the same general duties" they were already performing, the court had upheld deductions.

In this case, the nurse was not working at a position where she helped doctors deal with patients. For several years, she had been a quality control coordinator at various hospitals, at one point managing 110 nurses and technicians. "The MBA/HCM may have improved petitioner's preexisting skill set," the court's opinion noted, "but objectively, she was already performing the tasks and activities of her trade or business before commencing the MBA." Therefore, the nurse was able to deduct her MBA tuition payments.

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America Counts on CPAs

Retirement Alert

Required Minimum Distribution rules have resumed in 2010.

Deciphering the decision

The Tax Court's decision means that many people will be able to deduct the costs of acquiring an MBA. If you have worked in a given field and want to improve the skills necessary to perform well there, you have a good rationale for deducting unreimbursed expenses. Our office can evaluate your specific circumstances.

Moreover, if your education qualifies, you can deduct the costs of books and lab fees as well as tuition. You also can deduct the costs of transportation if you attend courses at a school and travel there from your workplace rather than from home.

Unfortunately, if you work as an employee, MBA costs are unreimbursed employee business expenses, which are included among miscellaneous itemized deductions. Miscellaneous deductions are deductible only to the extent that they exceed 2% of your adjusted gross income. They are not deductible at all if you are subject to the alternative minimum tax (AMT).

Therefore, if you are not subject to the AMT and your education costs are substantial in relation to your income, you may be able to use tax savings to trim the cost of a career-boosting MBA. ■

Trusted Advice

- ❖ The tax code contains many deductions and credits for educational expenses.
- ❖ Educational assistance programs permit employers to deduct expenses paid for employees' tuition, fees, books, supplies, and equipment.
- ❖ Employees can exclude from income up to \$5,250 worth of such benefits each year.
- ❖ The courses covered by educational assistance programs do not have to be work related. They can be undergraduate or graduate level courses.
- ❖ Courses involving sports, games, or hobbies are not covered by educational assistance programs unless they have a reasonable relationship to the company's business.

Two Sides to Mortgage Prepayments

Prepaying your home mortgage can be tempting these days, compared to the alternatives. You'll earn next to nothing by putting money into bank accounts and money market funds. Tax-deferred accounts such as 401(k) plans may be unappealing if you fear you'll withdraw money at higher tax rates in the future. Inside or outside a 401(k), you might not want to hold too much of your net worth in the volatile stock market.

By contrast, paying down your home mortgage may be a safe way to put extra cash to good use. You'll reduce the amount of interest you pay to your lender. In case of a financial emergency, you might be happy to have a lighter debt load.

Mortgage prepayments may make sense—but they may not. Typically, the decision to pay down your mortgage is half financial and half emotional.

Focus on finance

To determine the financial pros and cons of a mortgage prepayment, run the numbers. Chances are, your home mortgage interest rate is 6% or less because rates have been in this neighborhood for a few years. As of this

writing, the national average rate for a 30 year fixed mortgage is 5.3%. If you have a mortgage with a much higher rate and you have sufficient home equity, refinancing can be a good choice.

Assuming that you have a mortgage with an interest rate around 6%, the numbers are not hard to crunch. Say your effective income tax rate (federal and state) is around 30%. Your total tax savings from deducting your interest payments would be about 1.8%: 30% times 6%. If you pay 6% in interest and save 1.8% in tax, your after-tax cost of the mortgage is 4.2% in this hypothetical example.

In this case, prepaying your mortgage would produce an after-tax return of 4.2%: that's the annual rate of interest you'd avoid paying with each prepayment. Moreover, that's a 4.2% return, after tax, without the investment risk you'd assume by putting money into stocks or bonds.

Does it make sense to pay down a 6% mortgage for a risk-free after-tax return of around 4%? Perhaps, if you have a large amount of money in low yielding bank accounts or money market funds. However,

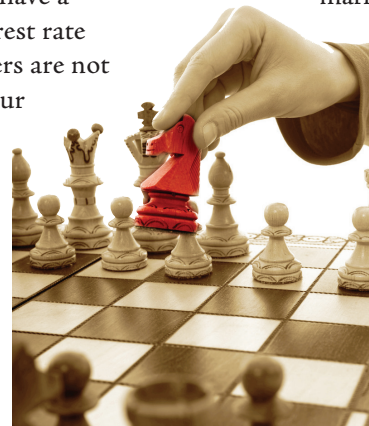
you should realize that using cash to prepay your mortgage reduces your access to money you might need in the future.

Emotional reactions

On paper, you have a good chance of earning a return higher than 4.2%,

after tax, from other investments. Even after the bear markets of 2000-2002 and 2007-2009, the broad stock market has posted returns of about 9% over the last 20 years.

Despite the historical record, you may prefer a sure 4% return from a mortgage prepayment to a potential 6%, 8%, or 10% return from stocks or other investments. Retirees especially might choose to prepay a mortgage



rather than investing; they may like the idea of not having a mortgage now that they're no longer earning income. Similarly, pre-retirees often have a goal of being debt free, with no monthly mortgage to pay, by the time they retire.

The bottom line is that there is no answer that's right for everyone.

If you have ample income and a sizable net worth, you may prize the tax deductions you get with every mortgage payment. If you're far from retirement and comfortable about your financial future, you may like the idea of putting extra cash into stocks and other assets with the potential for superior long-term returns.

Carrying a mortgage has drawbacks, though. If you'd rather reduce your financial risk and the stress that accompanies it, paying down your mortgage might give you better sleep at night. Our office can go over the numbers to show you precisely the return you can expect from mortgage prepayments. ■

Milking the Right Cash Cow

You probably will run into a situation some day that requires a large amount of cash. It could be a wonderful time in your life, such as making a down payment on a home or paying for a daughter's wedding. Alternatively, you might have to find funds for an emergency, such as an uninsured medical or dental bill. In any of these or other circumstances, you may have to choose among several possible sources for the money you need.

Reach into reserves

You can consider money market funds or bank accounts as sources of ready cash. Many financial advisors recommend keeping a substantial reserve in these vehicles to meet such cash needs. Assuming no penalties are involved and these accounts are not held in a retirement plan, you can tap them with no costs or tax consequences. Today, with interest rates at low levels, you won't be losing much by drawing them down.

However, if you have money tied up in bank certificates of deposit (CDs), you'll have to pay a penalty for premature withdrawals. That penalty might be six months' worth of interest on a CD maturing in more than 18 months, or three months' interest on shorter-term CDs. Therefore, you should hold money that you'll need for emergency funds in an account that provides immediate access to your cash.

Money from home

If you have a home equity line of credit (HELOC), borrowing against that line also may be a good source of funds. You typically can access a HELOC by simply writing a check. Interest rates are relatively low, with the national average currently around 5%. Moreover, interest you pay on a HELOC is tax deductible on loan balances up to \$100,000.

Example 1: Margaret Anderson borrows \$125,000 by tapping her HELOC. She pays 5% interest for the entire year of 2010, for a total of \$6,250. Margaret can deduct \$5,000 of the interest she pays: 5% of \$100,000.

You may not have access to a HELOC, though. As home prices have fallen, many lenders have limited these lines of credit or cut them off altogether. Moreover, you might not want to increase the amount of debt that's secured by your home; if you can't make all the required interest payments, you could lose it.

Portfolio payout

When your cash needs go beyond your reserves and your home equity, you may have to draw upon your investment portfolio. For many people, the first decision is to choose between your taxable accounts (with a broker or with a mutual fund family, perhaps) and your tax-favored retirement plans, such as an IRA or 401(k).

Between those two choices, you're usually better off tapping your taxable accounts first. If you draw down your taxable accounts, you'll have more time for tax-deferred accumulation within your retirement accounts. (And if you have a Roth IRA, your accumulation can be tax free.) Within your taxable account, if you own individual bonds such as municipal or Treasury issues, you can pocket cash for spending money when those bonds mature.

Otherwise, your first step in taking cash from taxable investment accounts might be to sell stocks, bonds, or funds trading at prices that will result in a capital loss. Any capital loss you take can save tax by offsetting capital gains you take. If you wind up the year with more capital losses than capital gains, you can deduct up to \$3,000 of net capital losses on your income tax return. You can carry over any net losses you don't use right away to future tax returns, with no limit; those excess capital losses can offset future capital gains and provide tax deductions of up to \$3,000 per year until they're all used.

After you have taken capital losses, you can meet further cash needs by taking capital gains in taxable accounts. As mentioned, you can use capital losses to avoid paying tax on such gains.

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Cracking your nest egg

Some people do virtually all of their investing inside their retirement accounts. If you are among them, you may have to tap those funds when you need cash. Generally, those transactions will be taxable, so you might need to withdraw more than you actually need.

Example 2: Jim Barnes, age 60, needs \$30,000 in cash, and his only possible source is his IRA. Jim expects to be in a 25% income tax bracket this year. Thus, Jim withdraws \$40,000 from his IRA. He reserves \$10,000 to pay the tax bill (25% of \$40,000) and uses the other \$30,000 to pay for expensive dental work. Note that if Jim had withdrawn only \$30,000 from his IRA, he would have paid all the money to his dentist and still owed \$7,500 (25% of \$30,000) in tax.

In this example, 60-year-old Jim does not owe an early withdrawal penalty. Up until age 59½, however,

you would owe an extra 10% in tax unless you qualified for an exception.

If you are tapping a 401(k) to meet a cash need, keep these points in mind:



- **Plan loans.** Many 401(k) plans permit employees to borrow up to 50% of their vested account balance, with a \$50,000 cap. These loans have some advantages: you'll avoid tax and you repay the loan with contributions to your own retirement fund. They also have drawbacks: they're repayable in full, usually within 60 days, if you leave the company. Still, if you have no other choices for getting cash, you might find that a 401(k) loan is

better than paying tax and possibly a penalty on a 401(k) withdrawal.

- **Departure date.** Suppose your only source of cash is your 401(k) and you leave your company, perhaps involuntarily. You could roll over the money in your account to an IRA, maintaining the tax deferral, and then withdraw needed funds. You would owe income tax and a possible 10% penalty before age 59½. However, if you leave the company during or after the year you reach age 55, you should keep the money in the 401(k) and take cash from that account. You will still owe income tax, but you won't owe the penalty tax on such withdrawals if the money comes from a 401(k). Therefore, leaving money in a 401(k) may allow you to withdraw money at or after age 55, penalty free, while rolling your money into an IRA leaves you exposed to the 10% penalty until age 59½. ■

TAX CALENDAR

APRIL 2010

April 15

Individuals. File a 2009 income tax return. If you want an automatic six-month extension of time to file the return, file Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return, or you can get an extension by phone or online. Then, file Form 1040, 1040A, or 1040EZ by October 15.

If you are not paying your 2010 income tax through withholding (or will not pay in enough tax during the year that way), pay the first installment of your 2010 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in March if the monthly rule applies.

Household employers. If you paid cash wages of \$1,700 or more in 2009 to a household employee, file Schedule H (Form 1040) with your income tax return and report any employment taxes. Report any federal unemployment (FUTA) tax on Schedule H if you paid total cash wages of \$1,000 or more in any calendar quarter of 2008 or 2009 to household employees. Also report any income tax you withheld for your household employees.

Partnerships. File a 2009 calendar year return (Form 1065). Provide

each partner with a copy of Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., or a substitute Schedule K-1. If you want an automatic five-month extension of time to file the return and provide Schedule K-1 or a substitute Schedule K-1, file Form 7004. Then file Form 1065 by September 15.

Electing large partnerships. File a 2009 calendar year return (Form 1065-B). If you want an automatic six-month extension of time to file the return, file Form 7004. Then file Form 1065-B by October 15.

Corporations. Deposit the first installment of estimated income tax for 2010.

MAY 2010

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2009. This due date applies only if you deposited the tax for the quarter in full and on time.

May 17

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.