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THE EDUCATIONAL PARADOX

Historically, various clauses of the United States Constitution are the basis for recurring controversy. In 1913, eight months after ratification of the Sixteenth Amendment,1 the first income tax act2 became effective. Legislators were not then as concerned with education in business as today.

Since World War II our society has placed greater emphasis on education. Growth of business, advanced technology, and the competitive nature of our economy necessitated a better-educated labor force. In order to meet the demands of the business community, the original income tax act3 had to undergo extensive modification.

This article examines the present and future status of the law concerning educational expense deductions under the 1954 Internal Revenue Code.4

The Internal Revenue Code5 never specifically provided for educational expense deductions. Section 162,6 however, provides, “There shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” Applying a literal construction of this section, the only way that educational expense deductions could be allowed was to find that they were ordinary and necessary in carrying on a trade or business. The terms ordinary and necessary, however, were nebulous terms which caused considerable litigation.

Until 1933, the phrases ordinary and necessary were given a literal interpretation. The courts construed them to mean only that which was needed to perpetuate the business. This point is best exemplified in Welch v. Helvering7 where the United States Supreme Court declared that ordinary is a variable. Any business expense will become ordinary when not unique in the business community of which the taxpayer is a part. Accordingly, ordinary business expense will vary with the economic conditions and the vicissitudes of life.

The Tax Court had consistently limited ordinary and necessary business expenses to the purchase of assets which had a direct relation to the nature of the business or profession. In accordance with the thinking during the 1920’s and 1930’s, and because the country was trying to stabilize business and the overall national economy, expenses were favored only if they bore some direct relation to the final product. It was generally considered that education had only

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1 U.S. Const. Amend. XVI (1913): “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”
2 38 Stat. 1067.
3 Id.
5 Id.
7 290 U.S. 111 (1933).
NOTES AND COMMENTS

incidental relation to the end result. Education is not a tangible that can be molded or attached to any other piece of property. On the contrary, educational expenses were regarded as personal expenditures for nondepreciable assets. Under Section 272, the deductions would not be allowed as personal expenses and Section 263 would prohibit the deduction as an acquisition of a capital asset.

As early as 1921, the Treasury Department in O.D. 984 declared that the costs of summer school classes attended by teachers to keep abreast of their subject areas were personal expenses and, therefore, not deductible. In Welch v. Helvering, the United States Supreme Court was faced with the question of whether payment to creditors of petitioner’s bankrupt company was an ordinary expense. The petitioner’s primary motivation was to improve his reputation. The Court, speaking through Mr. Justice Cardozo, declared in dictum that “reputation and learning are akin to capital assets, like the goodwill 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 in the operation of a business.” One can see that the reference to the cost of education as a personal expense was made only to illustrate the point that education is knowledge obtained for its own sake. This dictum established the basis for many later decisions.

In the middle 1930’s, when the country was beginning to recover from the impact of the depression, the Second Circuit Court of Appeals, in Blackmer v. Commissioner, opened the doors towards the allowance of educational expenses as necessary to the perpetuation of a business enterprise. In that case, the court explained that necessary meant “appropriate and helpful,” limited only to the taxpayer’s ingenuity while exercising prudent business discretion. In Hill v. Commissioner, the court was faced with the question of whether a school teacher was correct in deducting the cost of attending summer school as an ordinary and necessary expense. The teacher already had a college degree and a full-time teaching certificate. She was informed that once her certificate expired, it could not be renewed unless she complied with state regulations by 1) presenting additional college credit earned during the life of the certificate, or 2) passing an examination. The taxpayer chose the first alternative and sought to deduct the expenses incurred under Section 162. The Commissioner disallowed the deductions, stating that school teachers do not ordinarily attend summer school classes when there are other alternatives. Based on that assumption, the court

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8 Colony Coal and Coke v. Commissioner, 52 F.2d 923 (4th Cir. 1931).
12 290 U.S. 111 (1933).
13 Id. at 112.
14 70 F.2d 255, 256 (2d Cir. 1934).
15 181 F.2d 906 (4th Cir. 1950).
16 Int. Rev. Code of 1939, § 23. Hereinafter this section will be referred to as Section 162 of the 1954 Code.
followed the language in *O.D. 892*\(^{17}\) that "the expenses incurred by school teachers in attending summer school are in the nature of personal expenses incurred in advancing their education and are not deductible in computing net income."\(^{18}\) The Fourth Circuit Court of Appeals, however, held that the expenses were ordinary and necessary in carrying on a trade or business. One can surmise, that had she not chosen one of the alternatives afforded her by the state regulations, she would not have been able to maintain her employment status. The court recognized the burden inflicted upon her by her employer and would not penalize the taxpayer for her choice.

Although educational expenses had been recognized as allowable deductions for teachers, there was little litigation in which the *Hill* case was applied to other professions or businesses. Only three years later, however, in *Coughlin v. Commissioner*,\(^{19}\) the Second Circuit Court of Appeals was faced with the question of whether an attorney who attended an institute on federal taxation to maintain his skill by keeping informed of changes in the tax law could deduct the expenses as an ordinary and necessary business expense. In that case, the taxpayer was a member of a law firm which engaged in general practice but did considerable tax work. The taxpayer's partners relied on him to keep them advised on that subject. While attending the institute the attorney incurred certain expenses for tuition, travel, board and lodging which he sought to deduct.\(^{20}\) The Tax Court was reluctant to extend the *Hill* case and disallowed the deduction on the ground that the expenses were non-business ones "because of the educational and personal nature of the object pursued by the petitioner."\(^{21}\) The Second Circuit Court of Appeals reversed, drawing a parallel to *Hill*, stating that attendance at the institute was a means adopted to fulfill a professional duty to keep sharp the tools actually used in a going trade or business.

As a direct and natural consequence of *Hill* and *Coughlin*, the Treasury Department decided that certain guidelines had to be established for allowing educational expense deductions.

In 1958, a regulation was promulgated which provided that

Expenditures made by an individual for education (including research undertaken as part of his educational program) . . . are deductible as ordinary and necessary business expenses (even though the education might lead to a degree) if the education—

1. Maintains or improves the 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 regulation, imposed as a condi-


\(^{18}\) Id. at 17.

\(^{19}\) 203 F.2d 307 (2d Cir. 1953).

\(^{20}\) Treas. Reg. § 1.162-5.

\(^{21}\) 18 T.C. 528.
tion to the retention by the individual of an established employment relationship, status or rate of compensation.22

The regulation differentiates between the expenditures which constitute ordinary and necessary trade or business expenditures and those which are personal. It attempts to remove some of the speculation as to which educational expenses will be deductible. The language of the adopted regulation is taken practically verbatim from Hill and Coughlin.

The Treasury Department's efforts initially were futile. In fact, the regulation was a Pandora's box. Considerable litigation resulted. In Devereaux v. Commissioner,23 the Third Circuit Court of Appeals was confronted with the question of whether a college professor could deduct the educational expenses he incurred while working toward a doctoral degree. The taxpayer had been appointed to the faculty of a university. At the time of his appointment and at all times thereafter, the university required assistant professors to have a terminal degree before tenure would be granted. A letter was written by the head of the taxpayer's department to the dean of the school requesting that permanent tenure be granted. The letter contained a statement that the taxpayer made assurances that he would begin studying for a doctorate. Tenure was granted, and the taxpayer periodically continued his pursuit of a Ph.D. The expenses he incurred in doing so he sought to deduct as ordinary and necessary business expenses. The Tax Court disallowed the deductions on the grounds that after tenure was granted, the continued education was not primarily to maintain his position. The basis for this decision was the acquisition of a capital asset concept expressed in Welch v. Helvering24 by Mr. Justice Cardozo. The Third Circuit Court of Appeals reversed and held that the taxpayer began his studies to induce the university to renew his contract and thereby to maintain the same status and salary he then had. Unless he could secure his present status, any aspiration of promotion or increase in salary would be greatly diminished.

Applying the regulation to Devereaux, there should not have been any doubt as to the deductibility of the educational expense. The taxpayer had no immediate aspiration of obtaining a new position or an increase in salary. He was compelled to enhance his education as a condition to retain his established employment, status and rate of compensation.

Certain examples should be scrutinized in order to determine with some degree of probability whether a deduction will be allowed. In Sandt v. Commissioner,25 for example, the Third Circuit Court of Appeals decided that a research chemist who attended law school was not allowed to deduct his educational costs. The taxpayer had done satisfactory work and his job was not in jeopardy. After several years, he learned that his employer had a vacancy in the position of pa-

22 Treas. Reg. § 1.162-5.
23 292 F.2d 637 (3d Cir. 1961).
24 290 U.S. 111 (1933).
25 303 F.2d 111 (3d Cir. 1962).
tent chemist in the patent and contracts division. He was informed by the department manager that upon assuming the new position he would be required to obtain a legal education. The Tax Court, in applying subparagraph (2), disallowed the deduction on the ground that the expenditures were incurred primarily to obtain a new position and not to retain existing employment. Although the taxpayer would have been able to retain the new position, the court found that the further education was a means of attaining the minimum qualifications of a new trade. While the court recognized that there could exist more than one purpose for advanced education, it followed earlier language that "where several purposes exist as the motivation for undertaking the expenditure, it is the primary one that is decisive in determining deductibility."26

In Commissioner v. Johnson,27 the Ninth Circuit Court of Appeals decided that educational expense deductions would be allowed when there are dual objectives. The taxpayer had a temporary teaching certificate although she had not yet qualified for a permanent position. At the end of the academic year, she had been rehired on the condition that she qualify for issuance of a second certificate by attending summer school. The Tax Court and the Ninth Circuit Court of Appeals found that there were two motivating factors for the education, namely that of securing the right to continue under a temporary certificate and that of completing a college education. The courts found that the issuance of the temporary teaching certificate was indicative that the taxpayer had met the minimum requirements of her trade. The fact that the courses she selected would also assist her in eventually securing a permanent certificate was considered incidental to her primary reason for taking additional education, that of acquiring a full-time teaching certificate.28

The Sandt and Johnson cases spell out that intent necessary to comply with the regulation.

In Sandt, the taxpayer intended to meet his employer’s requirements to acquire a new position, a patent chemist. He did not create an educational expenditure to meet the express requirements of his employer as a condition to retention of his employment status. Rather, his intent was to fulfill a personal aspiration, to attain a higher employment status and increased salary. The Johnson case, on the other hand, is illustrative of the liberal construction of subparagraph (2). The logic of the Ninth Circuit Court of Appeals is clear. The taxpayer already had a temporary teaching certificate which was the minimum requirement

26 Marlor v. Commissioner, 251 F.2d 615 (2d Cir. 1958) 1 AFTR 2d 813, 814.
27 313 F.2d 668 (9th Cir. 1963) ; accord, United States v. Michaelson, 313 F.2d 668 (9th Cir. 1963). The court was faced with the problem of determining where the demarcation line shall be drawn between current business expenses of a teacher and those of a preparatory and qualifying character. The State Board of Education required a fifth year of education after meeting two other compulsory requirements in order to receive a general teaching certificate. The taxpayer had been issued a provisional certificate and it was necessary for her continued employment that she comply with the provision. The court found that the provisional certificate met the minimum requirements of the trade.
28 Id.
in her profession. This factual situation is similar to that in *Devereaux*. If the taxpayer there refused to undertake the additional education she would not be rehired. It is important to note that the taxpayer in *Johnson* was not permitted to deduct the expenses incurred to secure the temporary certificate. Distinguishing *Sandt*, the taxpayer in *Johnson* did not manifest an intent to meet the minimum requirements of a new trade.

When educational expense deductions are taken pursuant to subparagraph (2), the express request of the employer must be shown or the existence of some law or regulation is determinative of the deductibility. If the taxpayer can produce a written request from his employer, that will generally be sufficient for allowing the deduction under subparagraph (2). If, however, the written request requires the taxpayer to undertake the additional education to meet the minimum requirements of a new trade, employment relationship, or status, the deduction will not be allowed.

When an educational expense deduction is taken under subparagraph (1),²⁹ liberal construction of the regulation has not been prevalent. In fact, there has been little consistency between the decisions rendered by the Tax Court and those by the Federal District Courts. The federal courts have generally construed subparagraph (1) liberally³⁰ while the Tax Court has been quite restrictive.³¹ The dichotomy is readily apparent when comparing two recent cases determined on substantially the same facts. In *Condit v. Commissioner*,³² the Tax Court was confronted with the question of whether an accountant who served as office business manager and attended law school at night could deduct the cost of his education. His duties included investigating personal injury claims and property damage claims. He was also instrumental in the negotiation of contracts for two corporations. The taxpayer enrolled in law school expressing a desire to take

²⁹ Treas. Reg. § 1.162-5.
³⁰ Campbell v. United States, 250 F. Supp. 941 (E.D. Pa. 1966). (Forensic pathologist allowed deduction of expenses of acquiring a law degree despite the fact that he knew only four out of two hundred forensic pathologists having a law degree); Greenberg v. Commissioner, 367 F.2d 663 (1st Cir. 1966) (psychiatrist who completed one year of residency thereby qualifying for the practice of psychiatry, attended a program for psychoanalysis); Markham v. United States, 245 F. Supp. 505 (S.D.N.Y. 1965) (psychologist undertook psychoanalytical training to become a psychoanalyst and/or psychotherapist); Frank Kilgannon 24 CCH Tax Ct. mem. 619 (1965) (accountant studied law); Fortney v. Campbell, CCH 1964 Stand. Fed. Tax Rep., U.S. Tax cas. (64-1) 9489 (N.D. Texas 1964) (Internal Revenue examiner acquired a law degree); Milton L. Schultz, 23 CCH Stand. Fed. Tax Rep., U.S. Tax cas. 1372 (1964) (Internal Revenue agent attended law school and was allowed a deduction despite his intent to qualify as an estate and gift examiner).
³¹ Carroll v. Commissioner, 51 T.C. No. 22 (November 1968). Carroll was employed as an investigator with the Chicago Police Department. A general order was issued encouraging college education. Subsequently, Carroll enrolled in college stating in his admission application that he wished to prepare for law. His courses were in accordance with the prerequisites for law school admission. The court found that a general college curriculum increased overall competence and was inconsistent with maintaining or improving skills; accord, Baker v. Commissioner, 51 T.C. No. 26 (December, 1968); Condit v. Commissioner, 329 F.2d 153 (6th Cir. 1962).
³² 329 F.2d 153 (6th Cir. 1962) aff'g 210 F. Supp. 597, 62, 245-P-H Memo. T.C.
only those courses which would help him improve the skills his employment required. The law school, however, did not permit students to enroll for less than a full schedule. On his admission application he answered affirmatively the question "Do you wish to adopt the legal profession as a life's work?" Also, when asked to state his future plans, the taxpayer answered that he would return to his employer and combine his accounting background with law and develop corporation law. The taxpayer, at trial, explained these statements in light of all circumstances, i.e. that because of the nature of the corporation he would perform the same duties. After taking the bar examination, the taxpayer did in fact return to his employer. The employer never promised the taxpayer any advancement or increases in remuneration upon the completion of his education. Despite the taxpayer's overt manifestations of his intent to improve his skills and apply these skills to his present employment, the Tax Court placed significant emphasis upon the answer given in the admission application. Consequently, the court held that when the taxpayer completed his legal education he would not necessarily have returned to his employer in the position he held before his legal education. His duties might now include those which are peculiar to the legal profession. The court stated that "the fact that the employer will not change is not the criteria [sic] in determining whether educational expenses are primarily for the purpose of improving skills in that person's present position. . . ." The fact that the taxpayer had enrolled in a complete program of legal education to qualify to meet the minimum standards of the legal profession was conclusive. Clearly, meeting the minimum requirements of a new trade is not within the purview of subparagraph (1). It is evident that had the taxpayer taken only those courses which were directly related to the skills he already used in his employment, the education deduction certainly would have been allowed.

An inconsistent decision was reached in *Welsh v. United States.* There, the taxpayer, an employee of the Internal Revenue Service in the Fraud Group, had been promised a transfer to the Intelligence Division and subsequently enrolled in law school. In fact, law school attendance was a customary practice for the other men in that division. On the admission application, the taxpayer made an affirmative statement about his intent to adopt the legal profession as a life's work. Shortly after passing the bar examination he terminated his employment and entered general legal practice. Finding that the proximity in time between passing the bar and leaving his employment only raised a permissive inference of his intent at the commencement of his education, the Federal District Court for the Northern District of Ohio held that the shortness in time was only proof of his intention at the time of the specific act. The inference was refuted, according to the court, when viewing intent in light of all other facts. In addition to the taxpayer's testimony that he did not formulate his intention to leave his employment until after he met the qualifying standards of the legal profession, recognition was given to his demeanor and prior war record. The fact that the taxpayer

83 62, 245 P.H Memo. T.C. at 43-75.
84 329 F.2d (6th Cir. 1962).
had been a war veteran and needed security influenced the court to find that the taxpayer had no intention to leave the security afforded by Government service. The finding that other established members of the taxpayer's trade had already obtained a law degree was fundamental to the court in allowing the deduction. Applying the language in *Welsh v. Helvering*,\(^5\) one might conclude that obtaining a law degree would be ordinary and is within the trade or business limitation. The court, therefore, allowed the deduction of the expenses for education as a means of improving the taxpayer's skills.

There are differences between the *Condit* and *Welsh* cases. Although the Treasury regulation provides that whether or not education is to maintain or improve skills shall be determined from all the facts in each case, in *Condit* the court placed great emphasis on the law school application. No other factors were taken into account. In *Welsh*, on the other hand, the court viewed the statements on the law school application in light of several other facts and circumstances. It is this writer's opinion that the court in *Welsh* reached out to find reasons to justify its decision. First, demeanor and prior war experiences are not facts which are indicative of subjective intent, certainly not stronger than the manifested intent expressed in *Condit*. Second, the short period of time between passing the bar examination and departing from employment should create a presumption of fact, not a permissive inference. It appears to be conclusive that the taxpayer lacked the primary intent of improving his skills at the time he had undertaken the education. The Sixth Circuit failed to observe a possible motive in *Welsh*: to obtain a legal education at no personal cost under the guise of subparagraph (2) of the Regulations.

The congeries of cases show a reluctance on the part of the courts to allow education as a business expense. This reluctance was fostered because the American courts were enthralled initially by the rhetoric of Mr. Justice Cardozo. Although the *dictum* in *Welsh* was used merely as illustrative of a point wholly unrelated to education, it became the basis for later decisions. It stymied progress and stifled the education of the working populace. Education was a luxury, an indulgence for the affluent. Soon after World War II, education was recognized as necessary for the business man to successfully compete in the business community. The courts, in order to keep abreast of our dynamic society, recognized the importance of education in business. In an effort to promote a better educated population, the courts rewarded business for taking the initiative in promoting education by allowing a business deduction for the cost incurred.

The 1958 Treasury regulation attempted to codify from case law adequate guidelines for allowing educational expense deductions. It attempted to distinguish the personal expense from the trade or business expense.\(^6\) It attempted to

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\(^5\) 290 U.S. 111 (1933).

\(^6\) Whether or not education is the type referred to in subparagraph (1) of this paragraph shall be determined upon the basis of all the facts of each case. If it is customary for other established members of the taxpayer's trade or business to undertake such education, the taxpayer will ordinarily be considered to have under-
restrict the taxpayer from making arbitrary and capricious deductions. But the regulations are virtually ineffective, and by their broad general terms have created a chaotic state. Examination of the above cited cases demonstrates the existing confusion. Their is no uniformity of rationale and the taxpayer is necessarily bewildered about the status of his deduction. Courts are overburdened with litigation in which they must determine the deductibility of an educational expense. The costs of litigation are a burden to all taxpayers and in many cases, prohibitive. The result is that the individual taxpayer who cannot afford litigation is compelled to pay additional taxes.

1968 Amendment

In 1967, an amendment, which became effective January 1, 1968, was promulgated which provides that:

... 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. For this purpose, all teaching and related duties shall be considered to involve the same general type of work. 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.87

The latest amendment will have a great influence upon the amount of litigation. A taxpayer will not be refused an educational deduction so long as his duties are generally the same as before his education. However, the new provision specifically benefits teachers. While the Treasury Department states that the examples cited are only illustrative of the "same general type of work," the application of the subparagraph to later examples seems inconsistent.88

88 (1) A, a self-employed individual practicing a profession other than law, for
only examples, they appear to be regarded as a statement of the law by many courts. Accordingly, it appears that attending law school and obtaining a law degree has been eliminated as a possible educational expense unless the facts are clearly within the language of the new regulation. While it may be true that there has been considerable litigation concerning legal education, that is no reason to expressly refuse a deduction. The only result achieved by the exclusion of obtaining a law degree is to reduce the litigation in a very narrow area. However, in light of the express provisions of the amendment, the Condit case is clearly inconsistent. In that case, the taxpayer's duties did not change. After he passed the bar examination he returned to his employer and resumed his former duties. This is clearly within the same general type of work. It appears that the Commissioner recognized the dichotomy between Welsh and Condit when passing the new regulation. Rather than permit a paradoxical situation to continue, the regulation is an attempt to correct the problem.

In fact, the examples concerning teachers are inconsistent with the general provision. Subparagraph (d),[39] for example, indicates that a change from a classroom teacher to principal does not constitute a new trade. This is not a change from one type of work to other work of the same general type. The duty of a classroom teacher is to impart knowledge and instruct students. The duty of a principal, on the other hand, is to act as an administrator. These duties appear to be mutually independent. It does not appear, at least to this writer, that the respective functions constitute the same general type of work. It appears that the new amendment is inequitable. It allows a taxpayer who frequently changes employers and takes courses to aid him in his position to deduct these expenses. Concurrently, these courses might be accumulated toward a degree which meets the standards of a new profession. It seems a paradox to allow an individual a deduction for all but one course he takes to improve his skills and then penalize him for taking the one extra course which qualifies him for a new trade or profession. Since the courts are willing to scrutinize the intent of the taxpayer to allow the deduction initially, they should also examine the motivation for taking the final qualifying course. Many taxpayers take the extra course for purely personal satisfaction, knowing that they can meet higher standards. Many others may feel that they should have something to show for their extra years of study,

example, engineering, accounting, etc., attends law school at night and after completing his law school studies receives a bachelor of laws degree. The expenditures made by A in attending law school are nondeductible because this course of study qualifies him for a new trade or business.

(2) Assume the same facts as in example (1) except that A has the status of an employee rather than a self-employed individual, and that his employer requires him to obtain a bachelor of laws degree. A intends to continue practicing his nonlegal profession as an employee of such employer. Nevertheless, the expenditures made by A in attending law school are not deductible since this course of study qualifies him for a new trade or business. Although the taxpayer in example (2) may be doing the same general type of work, perhaps the same work, he will not be given the tax benefit which the new amendment expressly allows. Example (2) is consistent with the Condit case, but it does not appear to follow the express provisions of the amendment.

namely some kind of degree. The list of possible motives is lengthy and beyond the scope of this article. The possible motives are left to the ingenuity of the taxpayer, the recognition of these motives for the courts.

Although there has not been any case law with respect to the new amendment, the trend in the past is indicative that the dichotomy will continue.

In retrospect, a cursory examination of the congeries of cases would undoubtedly leave any taxpayer bewildered about the status of the law regarding educational expense deductions. Almost two decades have elapsed since the initial inroad in *Hill* of the original Internal Revenue Act, but the law in this area appears to be in the embryonic stage. Although the adoption of Treasury Regulation Section 1.162-5 attempted to reduce the area of deductible expenses, the criterion for determining whether educational expenses comply with the positive language of the regulations is flexible. It varies according to the complexity of our society. In today’s dynamic and competitive environment, specialization is a pre-requisite of success. The fact that further education will equip the taxpayer with a specialty is irrelevant if the taxpayer can manifest that his primary intent is to enhance his competence in a pre-existing vocation. The only pragmatic limitation on education expense allowance should be that there be a reasonable nexus between the courses taken and the skills to be improved as well as the purpose. Then, the social and economic goals of society will be best served.

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40 38 Stat. 1067.