***Armantrout v. Commissioner*, 67 T.C. 990 (1977)**

Employer-provided educational benefits for the children of key employees are considered taxable compensation to the employees when the benefits are tied to employment and serve as a form of remuneration, even if paid directly to a trust for the children's education.

Summary

Hamlin, Inc., established an "Educo" trust to fund college expenses for the children of key employees. Petitioners, key employees of Hamlin, challenged the Commissioner's determination that payments from the Educo trust to their children were taxable income. The Tax Court held that these payments constituted taxable compensation to the employees. The court reasoned that the Educo plan was designed to attract and retain key employees, serving as a substitute for direct salary increases. The benefits were directly linked to the employees' performance of services and were considered a form of deferred compensation, thus includable in their gross income under section 83 of the Internal Revenue Code.

Facts

Hamlin, Inc., a manufacturer of electronic components, established the Educo plan to provide college education funds for the children of key employees. Hamlin contributed to a trust administered by Educo, Inc. The plan provided up to $10,000 per employee's children, with a maximum of $4,000 per child. Benefits covered tuition, room, board, books, and other college-related expenses. Key employees were selected based on their value to the company, and the plan was intended to relieve their financial concerns about college costs, thereby improving their job performance and aiding in recruitment and retention. Employees had no direct access to the funds, and benefits ceased upon termination of employment, except for expenses already incurred.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' federal income tax for the years 1971-1973, arguing that the Educo trust payments were taxable income. The taxpayers petitioned the Tax Court to contest these deficiencies. The cases were consolidated for trial, briefing, and opinion in the Tax Court.

Issue(s)

1. Whether amounts paid by the Educo trust for the educational expenses of petitioners' children are includable in the gross income of the petitioners.

Holding

1. Yes. The amounts paid by the Educo trust are includable in the petitioners' gross income because they constitute additional compensation for services performed by the petitioners for Hamlin, Inc.

Court's Reasoning

The Tax Court applied the principle that "income must be taxed to him who earns it," citing *Lucas v. Earl*, 281 U.S. 111 (1930). The court emphasized that the substance of the transaction, not its form, governs tax consequences. It found the Educo plan was compensatory in nature because it was directly linked to the employees' performance of services and their value to Hamlin. The court noted, "The Educo plan was adopted by Hamlin to relieve its most important employees from concern about the high costs of providing a college education for their children. It was hoped that the plan would thereby enable the key employees to render better service to Hamlin." The court distinguished *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972), and *Paul A. Teschner*, 38 T.C. 1003 (1962), arguing that in those cases, the taxpayer was legally or contractually prohibited from receiving the income directly, unlike in this case where the employees could have bargained for direct salary instead of the Educo benefits. The court concluded that the Educo plan was an "anticipatory arrangement" to deflect income, and section 83 of the Internal Revenue Code supported the inclusion of these benefits in the employees' gross income, as property was transferred in connection with the performance of services to a person other than the person for whom the services were performed.

Practical Implications

Armantrout establishes that employer-provided benefits, even when structured as educational trusts for employees' children, can be considered taxable compensation if they are fundamentally linked to the employment relationship and serve as a form of remuneration. This case highlights the importance of analyzing the substance of employee benefit plans to determine their taxability. It cautions employers and employees that benefits designed to attract, retain, and reward employees, even if paid indirectly, are likely to be treated as taxable income to the employee. Legal professionals should advise clients that such educational benefits, especially for key employees and tied to employment performance, are unlikely to be considered tax-free scholarships or gifts and will likely be viewed by the IRS as deferred compensation. Later cases have applied *Armantrout* to scrutinize various employee benefit arrangements, reinforcing the principle that benefits provided in connection with employment are generally taxable unless specifically excluded by the tax code.

