Grant-Jacoby, Inc. v. Commissioner, 73 T. C. 700 (1980)

Payments under an employer-sponsored educational benefit plan to children of key employees are taxable as deferred compensation to the employees.

Summary

Grant-Jacoby, Inc. adopted an educational benefit plan to fund college expenses for children of key employees, with payments ceasing if employment terminated. The IRS argued these payments were taxable to the employees either as dividends or compensation. The Tax Court held that these distributions constituted deferred compensation to the employees, taxable when received by their children. Additionally, the court ruled that the plan was akin to a profit-sharing plan, thus the employer's deductions were governed by section 404(a)(5), allowing deductions when the distributions became taxable income to the employees.

Facts

Grant-Jacoby, Inc. established an educational benefit plan in 1973, administered by Educo, Inc. , to cover college expenses for children of certain key employees. The plan was designed to attract and retain valuable employees. Only key employees, selected by the board of directors, were eligible, and their children's participation ended if the employee left the company. Grant-Jacoby made contributions to a trust, and the children received payments for their educational expenses during the years in question. The company deducted these contributions as business expenses, but the IRS disallowed the deductions and assessed deficiencies against both the company and the employees.

Procedural History

The IRS issued deficiency notices to Grant-Jacoby, Inc. and the employees for the taxable years ending in 1973 and 1974, asserting that the educational payments were taxable as dividends or compensation. The case proceeded to the United States Tax Court, which held that the payments were deferred compensation to the employees and that the employer's deductions were governed by section 404(a)(5).

Issue(s)

1. Whether distributions under an employer-sponsored educational benefit plan to children of key employees represent income to the employees as dividends or compensation.
2. If such distributions represent compensation, whether the employer's contributions are deductible under section 162(a) when made or under section 404(a)(5) when the distributions are includable in the employees' gross income.

Holding

© 2025 SCOTUSreports.com. All rights reserved.

1. No, because the distributions are not dividends but represent additional compensation to the employees. The plan was designed to reward key employees and motivate them to remain with the company.
2. No, because the plan is a form of nonqualified profit-sharing plan, making the employer's contributions deductible under section 404(a)(5) when the distributions are includable in the employees' gross income.

Court's Reasoning

The court relied on the precedent set in *Armantrout v. Commissioner*, which found similar educational plans to be deferred compensation. The court reasoned that the right to educational benefits was tied to the employees' continued service, and the plan was a reward for their employment. The court rejected the argument that the payments were dividends, emphasizing the plan's business purpose of retaining key employees. Regarding the deductibility of contributions, the court applied the *Latrobe Steel Co.* test, determining that the plan was similar to a profit-sharing plan because it benefited the company's owners, who were also the key employees. The court concluded that contributions were deductible under section 404(a)(5) when the payments were includable in the employees' income, aligning with the policy of deferring deductions for plans that benefit owners.

Practical Implications

This decision clarifies that employer-sponsored educational benefit plans, where the benefits are contingent on continued employment, are treated as deferred compensation to the employees. Employers must be aware that such plans are subject to section 404(a)(5), affecting the timing of deductions. For employees, this means that benefits received by their children under such plans are taxable as income to them. The ruling impacts how companies structure compensation packages, particularly for owner-employees, and reinforces the principle that anticipatory arrangements to shift tax liability will not be recognized. Subsequent cases like *Citrus Orthopedic Medical Group v. Commissioner* have applied this ruling, emphasizing the need for careful planning of deferred compensation arrangements.

© 2025 SCOTUSreports.com. All rights reserved.