26 T.C. 100 (1956)

A lump-sum payment from a pension plan, received by an employee due to the liquidation of their employer and subsequent separation from service, is taxable as long-term capital gain, not ordinary income.

Summary

The United States Tax Court considered whether a lump-sum distribution from a pension plan should be taxed as ordinary income or as long-term capital gains. The petitioner's employer, Dellinger Manufacturing Company, was liquidated and its assets were transferred to Sperry Corporation, its sole stockholder. The petitioner, an employee of Dellinger, then became an employee of Sperry. Subsequently, the pension plan was terminated, and the petitioner received a lump-sum payment from the trust. The court held that the distribution was a capital gain, following the precedent established in *Mary Miller*, affirming that separation from the service occurred when the employee ceased working for the original employer, Dellinger.

Facts

Lester B. Martin was employed by Dellinger Manufacturing Company from 1937 to 1949. Dellinger established a tax-exempt pension trust in 1943. In 1948, Sperry Corporation purchased all of Dellinger's stock. In 1949, Dellinger was liquidated, and its assets were transferred to Sperry. Martin, along with other Dellinger employees, became employees of Sperry on the same day. Dellinger ceased to exist. The pension plan was subsequently terminated, and the pension board authorized the trustee to liquidate the trust assets. Martin received a lump-sum distribution of $3,168.55 from the pension trust, which he reported as a long-term capital gain. The Commissioner of Internal Revenue determined that the distribution was ordinary income.

Procedural History

The case was heard in the United States Tax Court. The Commissioner of Internal Revenue determined a tax deficiency, which was contested by the taxpayer. The Tax Court ruled in favor of the taxpayer, holding that the lump-sum distribution was taxable as long-term capital gain.

Issue(s)

1. Whether the lump-sum distribution to the petitioner was made "on account of the employee's separation from the service" within the meaning of Section 165(b) of the Internal Revenue Code of 1939.

Holding

1. Yes, because the court found that the separation from service occurred when the

employee ceased working for the original employer, Dellinger, due to the liquidation and transfer of assets to Sperry.

Court's Reasoning

The court relied on the language of Section 165(b) of the Internal Revenue Code of 1939, which addressed the taxability of distributions from employees' trusts. The key issue was whether the distribution was made "on account of the employee's separation from the service." The court referenced its prior decision in *Edward Joseph Glinske, Jr.,* which held that "on account of the employee's separation from the service" means separation from the service of the employer. The court further relied on and followed *Mary Miller*, where the same principle was applied, even though the employee continued to work for the successor company. The court emphasized that the petitioner's rights arose because of the liquidation of Dellinger, resulting in separation from Dellinger's service, even though the petitioner continued to work for Sperry. The court reasoned that the termination of employment with Dellinger was a separation from service, making the lump-sum distribution eligible for capital gains treatment. The court rejected the Commissioner's argument that the distribution was made due to the dissolution of Dellinger and termination of the plan, not the separation from service.

Practical Implications

This case provides critical guidance on the tax treatment of lump-sum distributions from pension plans following corporate liquidations and reorganizations. It clarifies that the separation from service occurs when an employee's employment with the original employer is terminated, even if the employee continues working for a successor entity. This has significant implications for tax planning, particularly during corporate restructuring. Employers and employees should understand that the tax treatment of such distributions depends on whether there was a separation from service of the employer maintaining the pension plan. This ruling has been applied in subsequent cases involving similar fact patterns.