Stewart v. Commissioner, 53 T. C. 344 (1969)

Distributions from a qualified retirement plan are only eligible for capital gains treatment if made on account of separation from service.

Summary

In Stewart v. Commissioner, the court ruled that a distribution from a retirement plan to an employee who remained employed did not qualify for capital gains treatment under section 402(a)(2) of the Internal Revenue Code. Whiteman Stewart, an employee of Ed Friedrich, Inc. , received a lump-sum distribution from the company's profit-sharing plan in 1965, despite continuing employment through multiple corporate changes. The court held that the distribution, prompted by union negotiations rather than separation from service, must be treated as ordinary income, emphasizing that both separation from service and a direct connection between the distribution and that separation are required for capital gains treatment.

Facts

Whiteman Stewart was employed by Ed Friedrich, Inc. , which adopted a profit-sharing plan in 1954. In 1961, Ling-Temco-Vought, Inc. (LTV) purchased all of Friedrich's shares, and in 1962, the profit-sharing plan was replaced with a retirement plan. In 1964, American Investors Corp. bought Friedrich's shares from LTV, liquidated Friedrich, and operated it as a division. In 1965, following union insistence, the retirement plan distributed the profit-sharing accounts to employees, including Stewart, who continued working for the company throughout these changes.

Procedural History

Stewart filed an amended return claiming the 1965 distribution as long-term capital gain. The Commissioner of Internal Revenue determined a deficiency, asserting the distribution should be treated as ordinary income. Stewart petitioned the United States Tax Court for relief.

Issue(s)

1. Whether the change in corporate ownership and plan structure in 1961 constituted a "separation from the service" under section 402(a)(2) of the Internal Revenue Code.
2. Whether the 1965 distribution from the retirement plan was made "on account of" any such separation from service.

Holding

1. No, because Stewart remained employed by the same entity throughout the

corporate changes, which did not constitute a separation from service.
2. No, because the distribution was the result of union negotiations, not directly related to any separation from service.

Court's Reasoning

The court applied section 402(a)(2), which requires both a separation from service and a distribution made on account of that separation for capital gains treatment. The court cited precedent that a mere change in corporate ownership without termination of employment does not constitute a separation from service. Stewart's continued employment through multiple corporate changes, including the transition from Friedrich to LTV and then to American Investors Corp. , did not meet this criterion. Furthermore, the court emphasized that the distribution was triggered by union negotiations, not any separation from service, thus failing the second requirement of section 402(a)(2). The court quoted from E. N. Funkhouser, 44 T. C. 178, 184 (1965), to clarify that the distribution must be directly related to a separation, using phrases like "by reason of," "because of," "as a result of," or "as a consequence of" the separation.

Practical Implications

This decision clarifies that for a distribution to qualify for capital gains treatment under section 402(a)(2), there must be a clear separation from service and the distribution must be directly connected to that separation. Attorneys should advise clients that distributions prompted by factors unrelated to separation, such as union negotiations, will not qualify for favorable tax treatment. This ruling impacts how distributions from retirement plans are structured and negotiated, particularly in corporate transactions where employment continuity is maintained. Subsequent cases have followed this precedent, reinforcing the necessity of a direct link between separation and distribution for capital gains treatment.

