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

A temporary strike does not constitute a 'separation from service' under Section 402(a) of the Internal Revenue Code for tax treatment purposes.

Summary

In Stewart v. Commissioner, the Tax Court held that a temporary strike did not qualify as a 'separation from service' under Section 402(a) of the Internal Revenue Code. The case involved Whiteman Stewart, who argued that a distribution from his employer's trust should be taxed as long-term capital gain because it was made after a strike-induced absence from work. The court, however, ruled that Stewart remained an employee during the strike and the distribution was due to a collective bargaining agreement, not his absence. This decision clarifies that only permanent severance from employment qualifies for favorable tax treatment under this section.

Facts

Whiteman Stewart, an employee, received a distribution from his employer's qualified trust on September 22, 1960. This distribution followed a strike from June 1, 1966, to August 4, 1966, which Stewart argued constituted a 'separation from service. ' The strike was part of union negotiations that resulted in an amendment to the trust on August 23, 1966, effective August 31, 1966, leading to the distribution. Stewart returned to work after the strike, and the court noted he remained an employee during the entire period.

Procedural History

Stewart petitioned the Tax Court after the Commissioner of Internal Revenue determined that the distribution should be taxed as ordinary income rather than long-term capital gain. The Tax Court's decision was the final ruling in this case, determining that the distribution did not qualify for capital gains treatment under Section 402(a).

Issue(s)

1. Whether a temporary strike constitutes a 'separation from service' under Section 402(a) of the Internal Revenue Code?
2. Whether the distribution from the trust was 'on account of' Stewart's alleged separation from service or due to the collective bargaining agreement?

Holding

1. No, because a temporary strike does not sever the employee's connection with the employer.
2. No, because the distribution was 'on account of' the collective bargaining agreement, not Stewart's absence from work.

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Court’s Reasoning

The court relied on prior interpretations of ‘separation from service’ requiring a permanent severance of the employee’s connection with the employer. They cited cases like Estate of Frank B. Fry and United States v. Johnson, which defined ‘separation’ as death, retirement, or severance of connection. The court emphasized that during the strike, Stewart remained an employee, and his union continued negotiations on his behalf. Even if the strike could be considered a temporary separation, the distribution was clearly linked to the subsequent amendment of the trust due to the collective bargaining agreement, not Stewart’s absence. The court quoted, ‘The phrase ‘separation from the service’ . . . has been interpreted to mean that the employee dies, retires, or ‘severs his connection’ with his employer. ‘ This decision was unanimous with no dissenting or concurring opinions noted.

Practical Implications

This ruling clarifies that for tax purposes under Section 402(a), only a permanent separation from employment qualifies for capital gains treatment of trust distributions. Legal practitioners advising clients on tax planning must ensure that any claimed ‘separation from service’ is indeed a permanent severance, not a temporary absence like a strike. Employers and unions must be aware that distributions made due to collective bargaining agreements will not receive favorable tax treatment under this section. Subsequent cases, such as Estate of George E. Russell and E. N. Funkhouser, have similarly distinguished between temporary and permanent separations for tax purposes. This decision impacts how similar cases involving trust distributions are analyzed and underscores the importance of the underlying reason for the distribution in determining its tax treatment.

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