Gegax v. Commissioner, 73 T. C. 329 (1979)

A corporate reorganization that results in no substantial change in the makeup of employees does not constitute a separation from service for the purpose of receiving lump-sum distribution treatment under tax law.

Summary

In Gegax v. Commissioner, the U. S. Tax Court ruled that distributions from a profit-sharing plan following a corporate reorganization were not lump-sum distributions eligible for capital gains treatment. The reorganization involved transferring assets from OWJ Photo Corp. to Reuben H. Donnelley Corp. , with no change in employee composition. The court held that without a substantial change in employees, there was no separation from service under section 402(e)(4)(A), and thus, the distributions were taxable as ordinary income. The decision reinforced the requirement for a significant change in employment status to qualify for favorable tax treatment of retirement plan distributions.

Facts

Meisel Photochrome Corp. (Meisel) underwent a reorganization where it changed its name to OWJ Photo Corp. (OWJ) and transferred substantially all its assets to Reuben H. Donnelley Corp. (Donnelley) in exchange for Dun & Bradstreet (D&B) stock. The transaction was intended to comply with section 368(a)(1)(C) of the Internal Revenue Code. Donnelley then transferred these assets to a newly created Meisel Photochrome Corp. (Meisel/Donnelley). The employees of OWJ, including petitioners, continued their employment with Meisel/Donnelley without any change in their roles or the operation of the business. The Meisel Employees Profit Sharing Plan was not assumed by Meisel/Donnelley, and its assets were distributed to beneficiaries, including petitioners, six months after the reorganization, followed by OWJ’s liquidation.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in petitioners’ 1974 federal income taxes due to their reporting of the profit-sharing plan distributions as lump-sum distributions on Form 4972. Petitioners filed petitions with the U. S. Tax Court contesting these deficiencies. The cases were consolidated, and the court issued its decision on November 26, 1979, denying the lump-sum distribution treatment and affirming the tax deficiencies as ordinary income.

Issue(s)

1. Whether the distributions received by petitioners from the Meisel Employees Profit Sharing Plan in November 1974 were made “on account of” their separation from service, as required for lump-sum distribution treatment under section 402(e)(4)(A).

Holding

1. No, because the petitioners were not separated from service. The reorganization did not result in a substantial change in the makeup of employees, and petitioners continued their employment in the same capacity with Meisel/Donnelley, as established by the rule in Gittens v. Commissioner.

Court's Reasoning

The court applied the rule from Gittens v. Commissioner, which requires a substantial change in the makeup of employees to constitute a separation from service. The court found that all OWJ employees, including petitioners, became employees of Meisel/Donnelley, and the business continued to operate in the same manner under the same name. The court emphasized that a mere transfer of stock ownership and control, without a change in the employee composition, does not suffice as a separation from service. The court also noted the absence of congressional guidance suggesting a change in the interpretation of "separation from service" following the 1974 amendment to section 402(e). Judge Tannenwald dissented, arguing that a change in employer and ownership should be sufficient for capital gains treatment without requiring a change in employee composition.

Practical Implications

This decision impacts how corporate reorganizations are analyzed for tax purposes, particularly regarding the treatment of retirement plan distributions. It establishes that a reorganization that does not result in a significant change in employment does not qualify as a separation from service, affecting the tax treatment of distributions from profit-sharing plans. Legal practitioners must advise clients that maintaining the same employee base during a reorganization will likely result in distributions being taxed as ordinary income rather than capital gains. This ruling may influence business decisions on how to structure reorganizations and liquidations to avoid unfavorable tax consequences for employees. Subsequent cases, such as those following the Tax Reform Act of 1986, have further clarified the conditions for lump-sum distributions, but the principle established in Gegax remains relevant for understanding the tax implications of corporate reorganizations.

