Reinhardt v. Commissioner, 85 T. C. 511 (1985)

A change from employee to independent contractor status, without a cessation of services to the same employer, does not constitute a 'separation from the service' under Section 402(e)(4)(A)(iii) of the Internal Revenue Code.

Summary

Dr. Jules Reinhardt, a shareholder-employee at Knollwood Clinic, terminated his employment agreement and sold his clinic-related interests, subsequently entering into an independent contractor relationship with the same clinic. He received a distribution from the clinic's pension and profit-sharing plans, which he reported using the 10-year averaging method. The U. S. Tax Court held that Reinhardt's change in employment status did not qualify as a 'separation from the service' under IRC Section 402(e)(4)(A)(iii), thus disallowing the 10-year averaging method for the distribution. The court emphasized that 'separation from the service' requires a complete severance of connection with the employer, not merely a change in employment status.

Facts

Dr. Jules Reinhardt was a shareholder-employee and practicing physician at Knollwood Clinic. On June 30, 1979, he terminated his employment agreement and sold his stock in the clinic and related entities. Two days later, he entered into an association agreement with the clinic as an independent contractor, continuing to provide the same medical services. In July 1979, Reinhardt received a distribution of $150,744 from the clinic's pension and profit-sharing plans, which he reported using the 10-year averaging method on his 1979 tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Reinhardt's 1979 federal income tax and denied the use of the 10-year averaging method for the distribution. Reinhardt petitioned the U. S. Tax Court for review. The case was submitted fully stipulated, and the Tax Court ruled in favor of the Commissioner, finding that Reinhardt did not qualify for the 10-year averaging method.

Issue(s)

1. Whether Dr. Jules Reinhardt's change in employment status from an employee to an independent contractor constituted a 'separation from the service' within the meaning of IRC Section 402(e)(4)(A)(iii).

Holding

1. No, because Reinhardt continued to provide the same services to Knollwood Clinic after changing his employment status, and thus did not sever his connection

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with the employer as required by the statute.

Court's Reasoning

The Tax Court relied on the legislative history and judicial interpretations of 'separation from the service,' which indicate that a true separation requires a complete severance of the employee's connection with the employer. The court cited cases such as *Bolden v. Commissioner* and *Estate of Fry v. Commissioner* to support this view. The court distinguished Reinhardt's situation from cases where a complete cessation of services occurred, such as *Rev. Rul. 69-647*. The court also referenced *Ridenour v. United States*, where a similar change from employee to partner status was not considered a separation from the service. The court concluded that allowing preferential tax treatment for Reinhardt's distribution would contravene the congressional policy of discouraging early distributions not related to retirement purposes.

Practical Implications

This decision clarifies that a mere change in employment status, without a complete cessation of services to the same employer, does not qualify as a 'separation from the service' for tax purposes. Attorneys and tax professionals must advise clients that such changes do not trigger eligibility for the 10-year averaging method under IRC Section 402(e)(4)(A)(iii). This ruling impacts how professionals structure employment transitions and manage pension and profit-sharing plan distributions, emphasizing the need for a true severance from the employer. Subsequent cases, such as *Olson v. United States*, have followed this precedent, reinforcing its application in similar situations.

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