Burton v. Commissioner, 99 T. C. 622 (1992)

A change from a corporate to a sole proprietorship form of business without a substantial change in employment or ownership does not constitute a 'separation from service' for tax purposes.

Summary

Dr. Burton, a plastic surgeon, liquidated his professional corporation and continued his practice as a sole proprietor. He received distributions from the corporation's pension and profit-sharing plans, claiming they qualified for lump-sum treatment under IRC section 402(e). The Tax Court held that the change in business form was merely technical and did not result in a 'separation from service' as required for such tax treatment. The court emphasized that no meaningful change in employment or beneficial ownership occurred, and the distributions were not made 'on account of' any separation from service but due to plan terminations.

Facts

Dr. Francis C. Burton, Jr. , a plastic surgeon, operated his practice through a professional association (P. A.) until its liquidation in October 1984. Immediately after, he continued his practice as a sole proprietor at the same location. The P. A. had established qualified pension and profit-sharing plans, which were terminated in July 1984. Dr. Burton received distributions from these plans in December 1985 and January 1986, reporting them as lump-sum distributions on his tax returns.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Dr. Burton's 1985 and 1986 federal income taxes due to his use of the 10-year forward averaging method for the distributions. Dr. Burton and his wife petitioned the Tax Court, arguing that the liquidation of the P. A. constituted a 'separation from service' under IRC section 402(e)(4)(A)(iii), thus qualifying the distributions for lump-sum treatment. The Tax Court ruled in favor of the Commissioner, holding that no such separation occurred.

Issue(s)

1. Whether Dr. Burton's change from a sole shareholder-employee of a professional association to a sole proprietor constitutes a 'separation from service' within the meaning of IRC section 402(e)(4)(A)(iii).
2. Whether the distributions from the pension and profit-sharing plans were made 'on account of' Dr. Burton's 'separation from service. '

Holding

1. No, because the change from a professional association to a sole proprietorship

was merely a technical change in form without a meaningful change in employment or beneficial ownership.
2. No, because the distributions were made due to the termination of the pension and profit-sharing plans, not on account of any separation from service.

Court's Reasoning

The court reasoned that 'separation from service' requires more than a formal or technical change in the employment relationship. It cited prior cases and IRS rulings indicating that a change in business form without a substantial change in the makeup of employees or beneficial ownership does not qualify as a separation from service. The court found that Dr. Burton continued to perform the same services in the same location with no change in ownership or control over the business. Furthermore, the court noted that IRC section 402(e)(4)(G) requires that community property laws be disregarded in determining separation from service, dismissing Dr. Burton's argument about beneficial ownership changes due to Texas community property laws. The court also emphasized that the distributions were not made 'on account of' any separation from service but rather due to the termination of the plans, for which Dr. Burton failed to establish a causal link to any separation.

Practical Implications

This decision clarifies that a mere change in business form, such as from a corporation to a sole proprietorship, does not automatically qualify as a 'separation from service' for tax purposes. Taxpayers must demonstrate a substantial change in employment or ownership to claim lump-sum distribution treatment. Legal practitioners should advise clients considering similar business restructurings to carefully evaluate the impact on their retirement plans and tax liabilities. The ruling also reinforces the IRS's position against using plan terminations to secure favorable tax treatment without a genuine separation from service. Subsequent cases have followed this reasoning, emphasizing the need for a real change in the employment relationship to qualify for lump-sum distributions.