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Taxation--Termination of Employment Required for Preferential Treatment of Lump-Sum Distributive Share of Employees' Trust (United States v. Johnson, 331 F.2d 943 (5th Cir. 1964))

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cause for the Regional Director to believe a charge that a labor union was engaged in an unfair labor practice in violation of section 8(b)(7)(C), a temporary injunction should issue pending the final disposition of the charge.[31] Thus, it would appear that in cases where an unfair labor practice is actually present, an injunction should a fortiori issue.[32] However, the Court in *Penello* held that the finding of an unfair labor practice did not ipso facto make it "just and proper" for a court to grant injunctive relief to the victim of that practice, and that in a proper case, as in the instant case, it would not be "just and proper" to issue an injunction.

The holding of the Court is open to the criticism that it has assumed a legislative function and by this means has diluted the purpose and force of a statute. The legislative history of section 8(b)(7) shows that the statute was enacted to proscribe the evil of recognitional picketing. Section 10(l) was enacted to provide an essential remedy for the victim of such an unfair labor practice. By limiting the remedy provided by section 10(l), the Court in the instant case may have mitigated the effect that Congress sought to achieve when it enacted section 8(b)(7).

TAXATION — TERMINATION OF EMPLOYMENT REQUIRED FOR PREFERENTIAL TREATMENT OF LUMP-SUM DISTRIBUTIVE SHARE OF EMPLOYEES' TRUST—In 1945 plaintiff's employer, the Waterman Steamship Corporation, established a non-contributory retirement plan for its employees. Ten years later, on May 5, 1955, C. Lee Company purchased over ninety-nine per cent of the outstanding stock of Waterman. A newly elected Board of Directors voted to terminate the plan as of the date of the stock acquisition and pursuant to the Board's resolution, distribution was made on August 1, 1955. Subsequently, Lee merged into Waterman. The Internal Revenue Code provides for long-term capital gains treatment of lump-sum distributions of employees' trusts, if such distribution is on account of the employee's death or other "separation from the service."[1] Plaintiff brought this suit for recovery of income taxes on the contention that the change in stock ownership, resulting in the new management's termination of the plan, was a change of employers tantamount to a "separation from the service." In reversing

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[31] *Ibid.*

[32] Phillips v. United Mine Workers of America, *supra* note 27; Compton v. Local 346, Int'l Leather Goods Union AFL-CIO, *supra* note 27; Alpert v. Local 271, Int'l Hod Carriers' Bldg., and Common Laborers' Union of America, 198 F. Supp. 395 (D.R.I. 1961).

[1] INT. REV. CODE OF 1954, § 402(a)(2).

the district court's decision, the Court of Appeals for the Fifth Circuit *held* that mere change of stock ownership and control is not tantamount to a "separation from the service." *United States v. Johnson,* 331 F.2d 943 (5th Cir. 1964).

Until 1942 the Internal Revenue Code made no provision for preferential tax treatment of lump-sum distributions of employee retirement trusts. To remedy the "bunched income" situation[2] arising from such distributions, the Code was amended at that time to provide for long-term capital gains treatment of these lump-sum payments. Under this amendment, that part of the amount received in excess of the employee's contributions would be given long-term capital gains treatment if the distribution was "paid to the distributee within one year of the distribution *on account of the employee's separation from the service.*"[3]

The Tax Court strictly construed the meaning of "separation from the service," and consequently long-term capital gains treatment was allowed "only if the employee had been separated from the service of the employer through retirement, discharge or resignation, or because of death."[4]

However, a liberalization of the Tax Court's application of preferential tax treatment occurred in *Mary Miller.*[5] Therein the plaintiff was an employee of the Strouss-Hirshberg Company which was dissolved pursuant to an agreement and plan of reorganization involving the transfer of its assets, in exchange for stock, to the May Company. The acquiring company terminated the contributory retirement fund. Miller, now an employee of May Company, continued in her previous position. In applying section 165(b) the court stated that it had no "difficulty in finding that petitioners, on that day [the closing date], had severed connections with their former employees. . . ." [6] Thus, the court held that payments incident to a change of employers were to be viewed as being made on account of "separation from the service."

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[2] The "bunched income" concept relates to a situation where an individual receives an extraordinary amount of gross income in one year. Capital gains treatment is granted in order to provide relief from the impact of progressive rates.

[3] Int. Rev. Code of 1939, § 165(b), added by ch. 619, 56 Stat. 798 (1942). In order for capital gains treatment to be available for a plan, it was necessary that it qualify under § 165(a) as an exempt trusteed plan. See Hess v. Commissioner, 271 F.2d 104 (3d Cir. 1959); Harry K. Oliphint, 24 T. C. 744 (1955), *aff'd on other grounds,* 234 F.2d 699 (5th Cir. 1956).

[4] *E.g.,* Estate of Frank B. Fry, 19 T.C. 461 (1952), *aff'd,* 205 F.2d 517 (3d Cir. 1953); Edward J. Glinske, 17 T.C. 562 (1951); 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 25B.52 (rev. ed. 1960); *cf.* Janet H. Gorden, 26 T.C. 763 (1956).

[5] 22 T.C. 293 (1954), *aff'd,* 226 F.2d 618 (6th Cir. 1955).

[6] *Id.* at 301.

Two subsequent cases, decided on the basis of the 1939 Code, attempted to delineate *Miller's* scope. In *Lester B. Martin*[7] the court found for the taxpayer on the ground that the liquidation of petitioner's employer corporation terminated petitioner's employment with it. To wit, "separation from the service" required a termination of employment and that requirement had been met. In *Harry K. Oliphint*[8] the court stated that a change in stock ownership and control did not terminate petitioner's employment with the corporate employer. Since no "separation from the service" was effected by the change in ownership, the distribution would not qualify for preferential tax treatment.

The 1954 Code distinguished between distributions made on account of the employee's death or other "separation from the service" and distributions made as a result of "the complete termination of a plan." Where the distributions resulted from a "separation from the service," section 402(a) (2), providing for long-term capital gains treatment, was applicable. Where the distributions resulted from the "termination of the plan," similar preferential tax treatment was restricted to those distributions made during the 1954 calendar year.[9] The latter was essentially an attempt to provide preferential tax treatment for those who had acted in reliance on *Miller* which had granted such treatment to distributions made upon termination of a plan incident to a corporate reorganization.[10]

The Internal Revenue Service, in a series of 1958 rulings, found that there was a "separation from the service" where the plan was discontinued incident to a sale of assets, or a liquidation or reorganization of the employer corporation involving a real change in the ownership of the business, even though the employees continue in the employ of the successor.[11] This is essentially an expansion of the availability of long-term capital gains treatment to distributions made *after 1954* upon termination of a plan incident to a reorganization. In other words, a "separation from the serv-

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[7] 26 T.C. 100 (1956).

[8] 24 T.C. 744 (1955).

[9] INT. REV. CODE OF 1954, § 402(e).

[10] See MERTENS, *op. cit. supra* note 4, § 25B.58; see also S. REP. No. 1622, 83d Cong., 2d Sess. 54, 289 (1954).

[11] Rev. Rul. 58-94, 1958-1 CUM. BULL. 194; Rev. Rul. 58-95, 1958-1 CUM. BULL. 197; Rev. Rul. 58-96, 1958-1 CUM. BULL. 200; Rev. Rul. 58-97, 1958-1 CUM. BULL. 201; Rev. Rul. 58-98, 1958-1 CUM. BULL. 202; Rev. Rul. 58-383, 1958-2 CUM. BULL. 149.

For an interesting discussion of the issuance of revenue rulings, see Goodman, *Pension and Profit-Sharing Rulings and Procedures*, N.Y.U. 17TH INST. ON FED. TAX 993, 1022 (1959). See also Sporn, *Some Proposed Revisions of the Provisions of the Internal Revenue Code Governing the Taxation of Deferred Compensation Arrangements*, 14 TAX L. REV. 289, 306 (1959).

ice" is said to occur when there is a mass severance of employees from the service of the employer, as when the corporate entity disappears through dissolution or merger.

Difficulty arose due to the Service's emphasis on change of corporate ownership at the expense of the concept of termination of employment. The Tax Court, in *Thomas E. Judkins*,[12] considering the same trust distribution as that in the instant case, allowed the taxpayer to treat his distributive share as a long-term capital gain. The court found that since Judkins actually terminated his employment with the corporate employer the distribution was made on account of petitioner's "separation from the service." The Tax Court seemed to indicate that a "separation from the service" could be established on the basis of a change in ownership of the corporation.[13]

The indefinite *Judkins* reasoning led to conflicting decisions by two district courts. In *Martin v. United States*,[14] a case involving the identical pension plan as was under consideration in the instant case, the court cited *Judkins* and the revenue rulings as authority for the proposition that a transfer of corporate ownership effects a "separation from the service," and on the basis of this authority, found for the taxpayer.

This position was rejected in *Nelson v. United States*.[15] There the statute's requirement that the distribution be made "on acount of the employee's death or other separation from the service" was interpreted by the court as requiring that "the employee must be separated from the service of his employer either because of the employee's death or for reasons equally definite and certain."[16] They found no "separation from the service" of the employer since the *corporate entity*—as distinguished from the *corporate ownership*—continued to exist and the plaintiff continued to be employed by it. The lump-sum distributions were, therefore, held not entitled to long-term capital gains treatment.

The *Judkins* reasoning, with its emphasis on change of ownership, was the basis of the district court's finding for the taxpayer in *Peebles v. United States*[17] and *Johnson v. United States*.[18] In each of these cases the distribution of the Waterman plan was again at issue.

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[12] 31 T.C. 1022 (1959).

[13] *Id.* at 1030.

[14] — F. Supp. — (D.C. Minn.), CCH 1963 Stand. Fed. Tax Rep. (63-2 U.S. Tax Cas.) ¶ 9718 (1963).

[15] 222 F. Supp. 712 (D. Idaho 1963).

[16] *Id.* at 715.

[17] 208 F. Supp. 385 (S.D. Ala. 1962), *rev'd*, 331 F.2d 955 (5th Cir. 1964).

[18] — F. Supp. —, 11 Am. Fed. Tax R.2d 1018 (S.D. Ala. 1963), *rev'd* 331 F.2d 943 (5th Cir. 1964).

On appeal of these cases, the Government contended that the distribution was based upon termination of the plan rather than on "separation from the service," and, therefore, did not qualify for preferential tax treatment. Conversely, the taxpayer urged that the change in ownership of stock, which resulted in the new management's termination of the plan, was a change in employers tantamount to a "separation from the service."

In reversing the *Johnson* and *Peebles* decisions, the Court in the instant case carefully analyzed the legislative history of sections 402(a)(2) and 402(e), and concluded that it showed "a manifest congressional intent to distinguish between termination of the corporate entity of the employer, as opposed to mere termination of the plan, which is not a separation from the service."[19] There was no indication from congressional intent that change of stock ownership was to be equated with termination of the corporate entity so as to effect a termination of employment.[20] Since there was neither a change of employers nor a change in the employee-employer relationship, a "separation from the service" could not be found. In the absence of the employee's "separation from the service" of the employer, the Court found the lump-sum distribution to be merely a consequence of the termination of the plan and thus held that preferential tax treatment was not available.[21] Petitioner's rights, therefore, were fixed upon termination of the plan. The subsequent merger of Lee into Waterman was an inoperative fact.

In so far as the revenue rulings emphasized change of ownership at the expense of the concept of termination of employment as the basis for preferential tax treatment, the Court found them in error. The Court did not disagree with the results of these rulings, but rather, with the basis upon which the results were reached. The premise that a change of ownership was tantamount to a "separation from the service" was founded on an erroneous assumption, viz., if a change in corporate ownership was not tantamount to "separation from the service" this would have the effect of discriminating against the corporate employee.[22] In other words, since a change of ownership of a non-corporate business would effect a "separation from the service" of the employer, a change of ownership of a corporation, brought about by the sale of stock, should have the same result. This rationale fails when one considers, as the Court did, that "the very purpose of using the

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[19] United States v. Johnson, 331 F.2d 943, 948 (5th Cir. 1964).

[20] *Id.* at 949. The Court also criticized Martin v. United States, — F. Supp. — (D.C. Minn. 1963), wherein the decision was based upon the faulty assumption that a change of corporate ownership is a "separation from the service." *Id.* at 952.

[21] *Id.* at 954.

[22] *Id.* at 952.

corporate form in business is to attain immortality; a bare change in stock ownership cannot affect the corporate existence."[23]

The sole dissenter failed to discuss the concept of "change in ownership" or that of "termination of employment," but, instead, based his position on the taxpayer's reliance on the revenue rulings and their binding effect upon the Internal Revenue Service.[24] The dissent did not consider whether or not the bases of these rulings were valid in light of the statute.

As has been seen, the revenue rulings and the Tax Court decisions failed to fully evaluate the legislative history in the light of the statute. Although, as the Court in the instant case showed, Congress intended "separation from the service" to mean "termination of employment," this was discarded for a "change of ownership" concept. The Court found no basis, either on the face of the statute or in its background, to justify such a shift in emphasis.

The Court has halted the unwarranted trend towards recognition of a change in corporate ownership as affecting a "separation from the service." Ergo, the distribution did not fall within the ambit of preferential long-term capital gains treatment. The Court found that there was neither a change in the corporate entity nor a substantial change in the make-up of employees which could constitute a termination of employment so as to fall within the concept of "separation from the service."

The analysis of the 1958 revenue rulings undertaken by the Court will certainly have an effect on subsequent rulings. The shift of emphasis from corporate ownership to termination of employment should lead to clarification by the Service of its interpretation of the availability of preferential tax treatment under section 402(a)(2). Although the Service may reach the same result as in the 1958 rulings, those rulings may very well be repealed due to their faulty "change of ownership" foundation.

Because of the inherently independent nature of the Tax Court (it is technically an independent agency in the executive branch),[25] the effect of the *Johnson* decision is uncertain. The Tax Court's position is still defined by the revenue rulings and the *Judkins* reasoning, both of which gave rise to the fallacious belief that a

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[23] "The statement that for the purpose of Section 402(a)(2) employees of corporate employers must not be treated differently from employees of non-corporate employers cannot be taken literally. The existence of the corporate cloak bears directly on whether there is the 'disappearance of the corporate entity' contemplated in the Senate Report." *Id.* at 951.

[24] *Id.* at 955 (dissenting opinion). Judge Gewin takes the position that "legitimate rights may even accrue in reliance upon an unconstitutional statute" as justification for his maintaining that the prior incorrect interpretations given to § 402(a)(2) be applied in the instant case. *Ibid.*

[25] For a general discussion of the Tax Court and other agencies involved in the field of taxation, see SURREY & WARREN, FEDERAL INCOME TAXATION ch. 1 (1960 ed.).

change of ownership would effect a "separation from the service." But in the light of the finding by the Court in the instant case that a change of control and stock ownership is not tantamount to a "separation from the service," and that the taxpayer's rights were fixed on the date of the termination of the plan, it is probable that the Tax Court will distinguish, if not overrule, the *Judkins* case. Nevertheless, if the Tax Court fails to agree with *Johnson's* re-evaluation of the intended meaning and scope of "separation from the service," the Government may appeal as a matter of right to the United States Courts of Appeals. The persuasive authority of the instant case in those jurisdictions outside its own circuit will greatly diminish the effect of any Tax Court determination adverse to the instant case.

The Court has reassessed the availability of long-term capital gains treatment under section 402(a)(2) by clarifying the basis upon which the "separation from the service" concept was grounded. This basic determination obviously requires much judicial reflection before its full effect will be realized. Furthermore, its very fundamental nature emphasizes the importance of the Court's judicial attitude that a "separation from the service" requires a "termination of employment."