DEPARTMENT OF THE TREASURY
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OFFICE OF
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The Honorable Jerry Costello
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Costello:

This letter responds to your inquiry dated September 10, 2008, on behalf of your constituent, . He asked about the federal income tax treatment of termination payments he received from an insurance company from where he was an agent. Specifically, your constituent inquired about whether we classify the treatment of such income as ordinary income or capital gain. I am pleased to provide you with the following information on the tax treatment of the termination payments.

A taxpayer must have a net capital gain to consider income as capital gain, which is taxed at a lower rate than ordinary income (section 1(h) of the Internal Revenue Code (the Code)). To have a net capital gain, for federal income tax purposes, the taxpayer must own a capital asset and then sell or exchange that capital asset in a transaction resulting in net long-term capital gain (section 1222 of the Code). We define a "capital asset" as property the taxpayer holds (whether or not connected with his trade or business), but does not include any of the eight specifically enumerated exclusions listed in section 1221 of the Code. Thus, whether or not a taxpayer is subject to the capital gain tax rate depends on whether the taxpayer owned a capital asset for more than one year and then sold or exchanged that capital asset. Specifically for such termination payments, the issue is whether the termination payments are in consideration for the sale or exchange of a capital asset.

We do not know the specific details of your constituent's situation and cannot comment on it. However, the courts have addressed the general issue that he raises. In *Baker v. Commissioner*, 338 F.3d 789 (7th Cir. 2003), the taxpayer was an agent for State Farm Insurance Company (State Farm). As a State Farm agent, the taxpayer entered into an Agent's Agreement (the Agreement) with State Farm thereby agreeing to write insurance policies exclusively for State Farm as an independent contractor. The Agreement provided that all property including "any and all information about

policyholders" belonged to State Farm (Id. at 791). Specifically, the Agreement provided that (emphasis added by court):

> Information regarding names, addresses, and ages of policyholders of the Companies; the description and location of insured property; and expiration or renewal dates of State Farm policies … *are trade secrets wholly owned by the Companies*. All forms and other materials, whether furnished by State Farm or purchased by you, upon which this information is recorded *shall be the sole and exclusive property of the Companies*.

After 34 years, the taxpayer terminated his relationship with State Farm and, in accordance with the Agreement, returned policy and policyholder information and other insurance related books and documents to State Farm. State Farm assigned approximately 90% of the taxpayer's existing policies to his successor agent. Because the taxpayer fully complied with the terms of the Agreement, State Farm made termination payments to the taxpayer. The taxpayer reported this income as long-term capital gain "for the purchase and sale of business intangible assets" (Id. at 792).

In addressing whether the termination payments constituted ordinary income or capital gain, the court noted that in accordance with the terms of the Agreement the taxpayer "did not own any property related to the policies" and as such he could not sell anything (Id. at 793). In addition, the court addressed the issue of goodwill and determined that goodwill "cannot be transferred a part [sic] from the business with which it is connected" (Id). Thus, the court held that because the taxpayer did not own any property related to the policies that he sold to customers, or the goodwill developed over the course of his agency relationship with State Farm, the payments the taxpayer received were not consideration for the sale or exchange of a capital asset, and as such were taxable as ordinary income.

Similarly, in *Jones v. United States*, 355 F.Supp.2d 1292 (S.D. Ala. 2004), the taxpayer was an agent for State Farm. As a State Farm agent, the taxpayer entered into an Agreement with State Farm requiring him to sell insurance exclusively for State Farm as an independent contractor. After several years as a State Farm agent, the taxpayer eventually retired, at which time State Farm terminated the Agreement and assigned all of the taxpayer's policies to a successor agent who purchased the taxpayer's building and its furnishings. In accordance with the Agreement, the taxpayer returned all property to State Farm, including policies and policyholder descriptions, and other insurance books and documents. The taxpayer then received termination payments from State Farm pursuant to the Agreement. The taxpayer initially reported these payments as ordinary income but later amended his return to characterize the payments as long-term capital gain, claiming the payments were for intangible assets and that State Farm purchased a covenant not to compete.

In addressing whether the payments constituted ordinary income or capital gain, the

court stated that the taxpayer did not own the intangible assets that he claimed to have sold since the Agreement provided that "State Farm owns all policy records and policy information" (Id. at 1296). In addition, the court addressed the issue of goodwill and going concern value. The court stated that goodwill was connected to the insurance business, "and the goodwill of that business – insurance policies and policyholder information – were owned by State Farm," and not by the taxpayer (Id). Further, the court stated that the going concern value was also attached to the insurance business, comprised of insurance policies and policyholder information belonging to State Farm, and was not the taxpayer's to sell. The fact that the taxpayer, unlike the taxpayer in the *Baker* case, had sold his office building and personal property to a successor agent did not change the tax treatment of the termination payments under the Agreement with State Farm. Thus, the court held that the taxpayer did not sell any intangible assets because State Farm owned those assets (and the tangible assets to which they attached). Therefore, the payments received by the taxpayer were not entitled to capital gains treatment.

The Ninth Circuit addressed essentially the same issue in *Trantina v. United States*, 512 F.3d 567 (9th Cir. 2003). In *Trantina*, the taxpayer was an agent for State Farm. The taxpayer initially operated his insurance agency as a sole proprietorship and then later incorporated the agency (the Corporation) with the taxpayer as the sole shareholder. Upon incorporation, State Farm and the Corporation entered into a Corporation Agent Agreement (the Agreement) which governed all aspects of the Corporation's relationship with State Farm. The Agreement required that the Corporation's principal business be the fulfillment of the Agreement and that the Corporation and its sales representatives sell insurance exclusively for State Farm. The terms of the Agreement were nearly identical to the Agreement in *Baker*, and provided a blanket reservation that all property rights in the policies and policyholder information belonged to State Farm (See id. at 573). Specifically, the Agreement provided:

> Information regarding names, addresses, and ages of policyholders of the Companies; the description and location of insured property; and expiration or renewal dates of State Farm policies … *are trade secrets wholly owned by the Companies*. All forms and other materials, whether furnished by State Farm or purchased by the Agent, upon which this information is recorded *shall be the sole and exclusive property of the Companies*.

The taxpayer retired after serving as State Farm's agent for 38 years. In accordance with the Agreement, the Corporation returned all of State Farm's property, such as the forms, manuals, and other documents containing information concerning insurance policies and policyholders to State Farm, and the taxpayer complied with a non-compete provision contained in the Agreement. Because the Corporation complied with the terms of the Agreement, it was entitled to receive termination payments from State Farm. The Corporation received the termination payments until its dissolution and following the dissolution, the taxpayer, as the Corporation's sole shareholder, received

the termination payments. The taxpayer initially reported the termination payments as ordinary income but later amended his return seeking to classify the termination payments as "long-term capital gain resulting from the sale or exchange of a capital asset – the Agreement itself – held longer than one year" (Id. at 570).

In addressing whether the termination payments constituted ordinary income or capital gain, the court looked to whether the Agreement itself was a capital asset that could be sold or exchanged with State Farm for the termination payments. In determining that the Agreement itself was not a capital asset, the court noted that neither the taxpayer nor the Corporation had any property rights under the Agreement beyond the contractual obligation to perform services and to be compensated for those services, and contracts for the performance of personal services are not capital assets and the proceeds from their transfer or termination are not accorded capital gains treatment but are ordinary income (See id. at 571-76). In reaching this decision, the court noted that under the terms of the Agreement, the taxpayer had "no property that could be sold or exchanged" as the Agreement forbade the taxpayer from transferring or assigning the taxpayer's interest in the Agreement itself (Id. at 573). Further, the court noted that the taxpayer did not have "any property rights in the policies" as the policies and all identifying information belonged to State Farm (Id). Thus, the court held that as the taxpayer did not have any property rights that he could sell under the express terms of the Agreement, the termination payments were properly characterized as ordinary income.

I hope this information on certain general principles of the law is helpful. It is intended for informational purposes only and does not constitute a ruling (Revenue Procedure 2008-1, section 2.04, 2008-1 Internal Revenue Bulletin 7 (Jan. 7, 2008)). If you have any questions, please contact me or at .

Sincerely,

JOHN P. MORIARTY
Chief, Branch 1
(Income Tax & Accounting)