



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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The Honorable Ron Wyden  
United States Senate  
230 Dirksen Senate Office Building  
Washington, DC 20510

Dear Senator Wyden:

I am responding to your inquiry on behalf of your constituent, \_\_\_\_\_, asked if he may treat termination payments he received from State Farm Insurance Company as gain on the sale of a capital asset, rather than ordinary income.

\_\_\_\_\_ said that he operated an insurance agency for 28 years under the terms of an agent's agreement with State Farm Insurance Company. The agent's agreement provided that State Farm owned all of the agency's policies, records, and customer data and that \_\_\_\_\_ must return that property to State Farm upon termination of the agency relationship. The agreement also obligated State Farm to make termination payments and extended termination payments to \_\_\_\_\_ upon his retirement. State Farm reported its retirement payments to \_\_\_\_\_ as ordinary income in Box 3, Other Income, of the Form 1099. Despite the agreement's provisions designating State Farm as the owner of the agency's assets, \_\_\_\_\_ believes that State Farm made the retirement payments to purchase his capital assets, the agency and its goodwill. Consequently, \_\_\_\_\_ contends that the payments are capital gain rather than ordinary income.

Gross income includes all income from whatever source derived unless excluded by law (section 61 of the Internal Revenue Code and section 1031-1(a) of the Income Tax Regulations). In general, if the sale of a capital asset held for more than one year results in a gain, the gain is income but the law taxes the gain at a lower tax rate than ordinary income. Other income is generally taxed at the rates for ordinary income.

Several courts have reviewed the State Farm agent's agreement and have concluded that State Farm's retirement payments are ordinary income to the agent. In *Baker v. Commissioner*, 118 T.C. 452 (2002), *aff'd*, 338 F.3d 789 (7<sup>th</sup> Cir. 2003), both the Tax

Court and the Seventh Circuit held that the taxpayer could not treat termination payments received from State Farm as proceeds from the sale or exchange of a capital asset. The courts found that the capital asset (the insurance agent's books and records and customer lists, as well as any goodwill) belonged to State Farm rather than to the agent. In other words, the capital asset was not the agent's to sell, and the termination payments could not have been payment for the capital asset. Rather, the payments were ordinary income.

Employing the rationale of *Baker*, a district court in Alabama reached the same conclusion in *Jones v. United States*, 355 F. Supp.2d 1292 (S.D. Ala. 2004). The Tax Court in *Parker v. Commissioner*, T.C. Memo. 2002-305, held that termination payments made by Farmers Insurance Companies were ordinary income to its agents.

Finally, in *Trantina v. United States*, 381 F. Supp.2d 1100 (D. Ariz. 2005), *aff'd*, 512 F.3d 567 (9<sup>th</sup> Cir. 2008), a taxpayer attempted to distinguish the above-cited cases by arguing that (1) the corporate agreement between State Farm and the company through which the taxpayer conducted his insurance business was a capital asset, (2) the termination payments were received in exchange for the corporate agreement, and (3) the payments should be treated as capital gain rather than ordinary income. The court rejected the taxpayer's argument and held that the termination payments were ordinary income.

I hope this information is helpful. If you have any questions, please contact me or  
, at ( ) .

Sincerely,

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George J. Blaine  
Associate Chief Counsel  
(Income Tax and Accounting)