CC-1997-012
Dec. 29, 1997

CC:TL-23558-94
EBEO:Br2:EEDwards

ACTION ON DECISION

Subject: William R. Jackson v. Commissioner,
108 T.C. 130 (1997),
T.C. Dkt. No. 23558-94

Issue:

Whether Termination Payments from an insurance company to a former insurance agent constitute net earnings from self-employment within the meaning of section 1402(a) of the Internal Revenue Code (the Code) so as to be subject to tax under the Self-Employment Contributions Act (SECA).

Discussion:

The Tax Court held that Termination Payments were not net earnings from self-employment because they did not "derive" from the agent's trade or business within the meaning of Code section 1402(a).

The taxpayer was a retired, independent-contractor agent for the State Farm Insurance Companies (State Farm). State Farm agents normally receive renewal commissions for a fixed period after the sale of policies, three years for life insurance policies, five years for all other policies. The State Farm Agent's Agreement (the Agreement) provided that, after termination of the Agreement for any reason, an agent with more than two years service would receive Termination Payments for five years. Termination Payments were based on a percentage of the taxpayer's book of business in the last year as an agent; the amount was calculated so as to yield 60 equal monthly payments. To qualify for Termination Payments, the agent had to return all property of State Farm and refrain from competition for one year.

Section 1402(a) of the Code provides, in relevant part, that net earnings from self-employment means gross income, less deductions, derived by an individual from any trade or business carried on by such individual. Section 1.1402(a)-1(c), Income Tax Regulations, states that SECA tax applies to income attributable in whole or in part to services rendered or acts performed in a prior taxable year. Renewal commissions of former insurance agents are subject to SECA tax, even though the agents are no longer selling insurance. Lencke v. Commissioner, T.C. Memo. 1997-284; Becker v. Tomlinson, 9 A.F.T.R. 2d (P-H) ¶ 1,408, 62-1 USTC (CCH) ¶ 9,446 (S.D. Fla. 1962).

The Tax Court concluded that Termination Payments do not "derive" from the sales activity of the insurance agent because they are not compensation for the sale of insurance. Here the court followed the reasoning of the Ninth Circuit in Milligan v. Commissioner, 38 F.3d 1094 (9th Cir. 1994), rev'g T.C. Memo 1992-655. See also Gump v. U.S., 96-1 USTC (CCH) ¶ 50,312 (Fed. Cir. 1996), rev'g 96-1 USTC (CCH) ¶ 50,211 (Fed. Cl. 1995).

The Tax Court rejected the argument that Termination Payments were deferred compensation, stating in dicta that the "typical deferred compensation arrangement," involves a salary reduction agreement and, a "vested right to payment of . . . particular funds or . . . [a] specific amount."

This definition excludes common types of deferred compensation arrangements. Although salary reduction agreement are characteristic of plans described in sections 401(k), 403(b), and 457 of the Code, they are not required under sections 403(b) and 457, and are not permitted under qualified deferred compensation plans other than section 401(k) plans. Deferred compensation arrangements need not involve agreements to reduce compensation. Further, the Employee Retirement Income Security Act of 1974 (ERISA), as amended, recognizes the existence of deferred compensation plans that are unfunded and unvested. See ERISA sections 201(2), 301(3) and 401(1), 29 USC sections 1051(2), 1081(3), 1101(a).

Sections 922 of the Taxpayer Relief Act of 1997, Pub. L. 105-34, codified as section 1402(k), provides that SECA tax does not apply to payments to former insurance agents after termination of an agreement to perform services if three conditions are satisfied. First, the individual must perform no services after termination of the agreement. Second, the individual must enter into a covenant not to compete of at least one year's duration. Third, the amount of the payment must depend primarily on policies sold by or credited to the account of the individual during the last year of the agreement, or the extent to which the policies remain in force for some period after termination, or both, and must not depend to any extent on length of service or overall earnings from services performed (without regard to whether eligibility for payment depends on length of service).

New section 1402(k) is effective for payments after December 31, 1997. However, this new section codifies the holdings in Milligan, Gump, and Jackson. Therefore, the Service will also apply these standards to distinguish between renewal commissions subject to SECA and termination payments not subject to SECA for payments before January 1, 1998.

Our acquiescence is in result only, and does not extend to the Tax Court's discussion of deferred compensation. AOD CC-1995-015 is hereby withdrawn.

Recommendation:

Acquiescence in result only.

Reviewers:
JEA 10/29/97
MEO 10/29/97

/s/
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