



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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The Honorable Richard Burr
United States Senate
Washington, DC 20510

Dear Senator Burr:

This letter responds to your inquiry dated November 12, 2008, on behalf of your constituent, . He asked about the federal income tax treatment of termination payments received from an insurance company where he was an agent. Specifically, he asked if we classify termination payments as ordinary income or capital gain, and what type of ordinary income these payments represent. As explained below, we treat termination payments an agent receives on retirement as ordinary income and not as capital gain.

said he owned and operated a State Farm Insurance agency for 26 years before retirement. To operate as an agent, State Farm required him to execute an agreement that obligated State Farm to make termination payments and extended termination payments to him on his retirement. State Farm includes these payments in Box 3, Other Income, of the Form 1099 it sends to recipients. believes that State Farm made these payments for the buy-out and transfer of agent owned business assets to the control of State Farm in exchange for the termination payments.

Gross income includes all income from whatever source derived unless excluded by law (section 61 of the Internal Revenue Code and section 1.61-1(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 law taxes the capital gain at a rate lower than ordinary income.

Several courts have concluded that payments an insurance company makes to a retired agent constitute ordinary income rather than capital gain. In *Baker v. Commissioner*, 118 T.C. 452 (2002), *aff'd*, 338 F.3d 789 (7th 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 insurance agent's books and records and customer lists, as well as any

goodwill developed during the term of the agent's agreement with State Farm, belonged to State Farm rather than to the agent. Employing the rationale of *Baker*, a district court in Alabama also 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, also held that agents were to treat termination payments from Farmers Insurance Companies as capital gain.

Finally, in *Trantina v. United States*, 381 F. Supp.2d 1100 (D. Ariz. 2005), *aff'd*, 512 F.3d 567 (9th Cir. 2008), a taxpayer attempted to distinguish the above-cited cases by arguing that the corporate agreement between State Farm and the company through which the taxpayer conducted his insurance business was a capital asset, the termination payments were received in exchange for the corporate agreement, and, consequently, 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 to be taxed as ordinary income.

In addressing whether the termination payments constituted ordinary income or capital gain, the Ninth Circuit, in determining that the agreement itself was not a capital asset, noted that neither the taxpayer nor the corporation had any property rights under the agreement beyond the contractual obligation to perform services and receive compensation for those services. 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 Trantina*, 512 F.3d. at 571-76). Thus, the court held that the termination payments were properly characterized as ordinary income.

I hope this information on certain general principles of the law is helpful. This letter 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)