



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

OFFICE OF  
CHIEF COUNSEL

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Dear [REDACTED]:

I apologize for the delay in responding to your inquiry to the President of the United States, dated March 30, 2002. You wrote that termination payments received by insurance agents should be taxable as capital gain rather than ordinary income.

A long-term capital gain is a gain from the sale or exchange of a capital asset held for more than one year [Section 1222(3) of the Internal Revenue Code (IRC)]. A capital asset means property held by a taxpayer (whether or not connected with the taxpayer's trade or business), except for certain assets listed in I.R.C. § 1221.

A recent Tax Court decision addressed the issues you raised [*Baker v. Commissioner*, 118 T. C. No. 28 (May 29, 2002)]. In that case, the court rejected the petitioner's argument that the termination payment he received upon his retirement as an insurance agent should be taxable as capital gain because the payment represented proceeds from the sale of a business, business assets, or goodwill. Instead, the court held that the petitioner did not have any assets to sell, and the termination payments were therefore taxable as ordinary income.

Mr. Baker, the petitioner, was an independent contractor of an insurance company. The petitioner conducted his business as the Warren Baker Insurance Agency selling policies, developing a customer base, hiring and paying employees, paying expenses of the office, and establishing a trust fund into which he deposited premiums on behalf of the insurance company. The petitioner entered into an agent's agreement with the insurance company to write insurance policies exclusively for the insurance company. The agreement provided that all property used in the course of the petitioner's business, including information about policy holders, belonged to the insurance company and would revert to the insurance company upon termination. After years of providing services for the insurance company, the petitioner retired and assigned ninety percent of his policies to a successor agent. The petitioner complied with the provision in the agreement requiring him to return all property and assets used in his business to the insurance company. Upon termination of his services, the petitioner received a payment according to the agreement based on the percentage of policies that remained in force after termination or that were in force for the twelve months preceding termination. The petitioner and his wife took the position that the

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termination payment represented proceeds from the sale of a business and therefore reported the payment on their federal income tax return as long-term capital gain on a Schedule D, Capital Gain and Losses. Concluding that the petitioner neither owned nor sold a capital asset to the insurance company, the court upheld the Internal Revenue Service's disallowance of capital gain treatment and determined that the termination payment was taxable as ordinary income.

Generally, ordinary income of an insurance agent, who is an independent contractor, would be subject to self-employment tax. Self-employment income is the gross income, less certain allowable deductions, derived by an individual from any trade or business carried on by such individual [Section 1402(a) of the Code]. However, the law allows an exclusion from self-employment tax for certain termination payments received by former insurance agents. [Section 1402(k) of the Code].

I hope this information is helpful. If you have any questions, please call  
at (202) 622-6040.

Sincerely,  
Lynne Camillo  
Chief, Employment Tax Branch 2  
Office of Assistant Chief Counsel  
(Exempt Organizations/  
Employment Tax/Government Entities)