



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

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Dear :

This letter responds to your inquiry to Senator Richard Shelby. He wrote to us on your behalf and asked us to respond to you directly about whether an insurance agent must treat termination payments from an insurance company upon retirement as ordinary income or gain on the sale of a capital asset. As explained below, termination payments received by an agent upon retirement are treated as ordinary income and not as capital gain.

In your letter, you state that you owned and operated a State Farm Insurance agency for 31 years before retirement. To operate as an agent, State Farm required you to execute an agreement under which it became obligated to make termination payments and extended termination payments to you upon your retirement. State Farm includes these payments in Box 3, Other Income, of the Form 1099 it sends to recipients. Your view is that State Farm made these payments for the purchase of your agency and for goodwill. Consequently, you think that the payments should be taxed as capital gain rather than ordinary income.

Gross income includes all income from whatever source derived unless excluded by law (§ 61 of the Internal Revenue Code and § 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 capital gain is taxed at a rate lower than ordinary income.

Several courts have concluded that payments made by an insurance company 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 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 agent's

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 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 must treat termination payments made by Farmers Insurance Companies as ordinary income.

Finally, in *Trantina v. United States*, 381 F. Supp.2d 1100 (D. Ariz. 2005), 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 arguments and held that the termination payments were ordinary taxable income.

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

Sincerely,

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