



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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The Honorable Richard Shelby
United States Senator
1800 Fifth Avenue North
321 Federal Building
Birmingham, AL 35203

Dear Senator Shelby:

I am responding to your inquiry dated November 13, 2008, on behalf of your constituent, _____, a retired State Farm insurance agent, contends that termination payments he received from State Farm after his retirement should be taxed as proceeds from the sale of capital assets. In earlier letters to _____, we explained why the IRS and the courts have concluded that such termination payments are taxable as ordinary income.

State Farm Termination Payments

_____ owned and operated a State Farm insurance agency for 31 years. To operate as an agent, State Farm required him to execute a standard State Farm Agent Agreement (Agent Agreement) obligating State Farm to make termination payments to _____ when he retired. _____ believes that State Farm made these payments to purchase his agency's intangible capital assets, and therefore the payments should be taxed as proceeds from the sale of capital assets rather than ordinary income.

The issue has been litigated repeatedly, and the courts have uniformly rejected _____ view. The courts carefully reviewed the standard State Farm Agent Agreement (and other companies' agent agreements). The courts concluded that, under the Agent Agreement, State Farm owned all the books, records, customer information, policy information, and related proprietary goodwill created or developed during the term of the Agent Agreement. Because those assets belonged to State Farm not the agent, the agent could not have sold the capital assets to the insurance company. Consequently, the courts concluded that an insurance company's termination payments to retired agents constitute ordinary income rather than proceeds from the sale of capital assets. See *Baker v. Commissioner*, 118 T.C. 452 (2002), *aff'd*, 338 F.3d 789 (7th Cir. 2003); *Jones v. U.S.*, 355 F. Supp.2d 1292 (S.D. Ala. 2004); and

Trantina v. U.S., 512 F.3d 567 (9th Cir. 2008). No court has held that termination payments were made to purchase intangible capital assets from the agent.

In his September 2008 letter, _____ asked seven questions raising points in support of his position. _____ has restated the questions and asks how our explanation of the law (above and in our earlier correspondence) specifically responds to his points. The law applies as follows.

Operating a Business (Questions 1-3)

_____ operated the agency as a business and properly filed income and employment tax returns for the business. He submits that his efforts created the intangible capital assets of the agency and that he “acquired” or owned the assets due to his efforts to create them. He asks why the IRS considers those intangible capital assets not his property to sell. As explained above, the Agent Agreement governing the business relationship between State Farm and _____ reserved ownership of those assets, however created, in State Farm. That is not uncommon in agency and franchise agreements. As the litigation cited above shows, the practice is standard in the insurance industry.

Section 197 Property (Questions 4-5)

_____ reads the Agent Agreement as limiting State Farm’s ownership to only certain policy holder and policy information constituting “trade secrets.” _____ contends that the Agent Agreement did not reserve in State Farm the ownership of a broader class of other intangible assets described in section 197 of the Code, for example, workplace in force, agency books and records, customer based intangibles, etc. Unfortunately, the courts have not accepted _____ interpretation. The courts have held that the Agent Agreement reserves in State Farm the ownership of all the agency intangibles, whether described in section 197 or not.

Reporting Position (Questions 6-7)

For federal tax purposes, State Farm reported the termination payments under the Agent Agreement as ordinary income to _____ (and other agents) on the theory that the termination payments were in consideration for the termination of the agency relationship and for _____ agreement not to compete with State Farm for a period of time following retirement. That treatment is consistent with the view that State Farm owned the intangible assets and was not paying to purchase them from _____.

_____ questions whether State Farm’s reporting position should bind him. _____ submits that whether a transaction constitutes a sale or exchange of a capital asset should be determined by the facts and circumstances, regardless of the way another party labels the transaction for reporting purposes. _____ correctly states the legal standard. Unfortunately, under that standard, the courts have determined that State Farm’s payments to _____ were not for the purchase of any capital assets he owned. _____ characterization of the intangible capital assets as his property and

the termination payments as the proceeds from the sale of those capital assets is contrary to the determination of the courts, discussed above.

Consequently, the IRS does not consider the termination payments that received to be the proceeds from his sale of capital assets to State Farm. Those payments are ordinary income.

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

Sincerely,

Michael J. Montemurro
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)