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

OFFICE OF
CHIEF COUNSEL

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Dear :

This letter responds to your request for information dated March 27, 2005. You wrote to Commissioner Everson on behalf of yourself, and other retirees, regarding the federal income tax treatment of retirement income received from an insurance company for which you were an agent. Specifically you inquired about treating such income as ordinary income rather than capital gain. In response to your inquiry, I am pleased to provide you with the following information regarding ordinary income and capital gain tax with regard to the treatment of your retirement Income.

In order to be subject to the capital gain tax rate, which is taxed at a lower rate than ordinary income, the taxpayer must have a net capital gain. *See* section 1(h) of the Internal Revenue Code (the Code). In order to have a net capital gain, for federal income tax purposes, the taxpayer must own a capital asset and then sell or exchange that capital asset in a transaction resulting in net long-term capital gain. *See* section 1222 of the Code. A "capital asset" is defined as property held by the taxpayer (whether or not connected with his trade or business), but does not include any of the eight specifically enumerated exclusions listed in section 1221 of the Code. Section 1221(a) of the Code. Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year. Section 1222(3) of the Code. Thus, whether or not a taxpayer is subject to the capital gain tax rate turns on whether the taxpayer owned a capital asset for more than one year and then sold or exchanged that capital asset. Specifically with regard to retirement Income, the issue is whether the retirement income is payment in consideration for the sale or exchange of a capital asset.

We do not know the specific details of your situation and cannot comment on it. However, the courts have addressed the general issue you raise. In *Baker v. Commissioner*, 118 T.C. 452 (2002), *aff'd by* 338 F.3d 789 (7th Cir. 2003), the taxpayer was an agent for State Farm Insurance Cos. (State Farm). As a State Farm agent, the taxpayer entered into an agreement with State Farm thereby agreeing to write insurance policies exclusively for State Farm as an independent contractor. The agreement provided that all property including any and all information about policy

holders belonged to State Farm. *Baker v. Commissioner*, 338 F.3d 789, 791 (7th Cir. 2003). Specifically, the agreement provided (emphasis added by court):

> Information regarding names, addresses, and ages of policyholders of the Companies; the description and location of insured property; and expiration or renewal dates of State Farm policies … *are trade secrets wholly owned by the Companies*. All forms and other materials, whether furnished by State Farm or purchased by you, upon which this information is recorded *shall be the sole and exclusive property of the Companies*.

After 34 years, the taxpayer terminated his relationship with State Farm and in accordance with the agreement returned policy and policyholder information and other insurance related books and documents to State Farm. Approximately 90% of the taxpayer's existing policies were then assigned to his successor agent. Since the taxpayer fully complied with the terms of the agreement, State Farm made termination payments to the taxpayer. The taxpayer reported this income as long-term capital gain "for the purchase and sale of business intangible assets."

In addressing whether the termination payments constituted ordinary income or capital gain, the court noted that in accordance with the terms of the agreement the taxpayer "did not own any property related to the policies" and as such he could not sell anything. In addition, the court addressed the issue of goodwill and determined that goodwill "cannot be transferred apart from the business with which it is connected." Thus, the court held that since the taxpayer did not own any property related to the policies that he sold to customers, or the goodwill developed over the course of his agency relationship with State Farm, the payments the taxpayer received were not consideration for the sale or exchange of a capital asset, and as such were taxable as ordinary income.

Similarly, in *Jones v. United States*, 355 F. Supp. 2d 1292, 1293 (S.D. Ala. 2004), the taxpayer was an agent for State Farm. As a State Farm agent, the taxpayer entered into an agreement with State Farm requiring him to sell insurance exclusively for State Farm as an independent contractor. After several years as a State Farm agent the taxpayer eventually retired, at which time the agreement was terminated and all of the taxpayer's policies were assigned to a successor agent who purchased the taxpayer's building and its furnishings. In accordance with the agreement, the taxpayer returned all property to State Farm, including policies and policyholder descriptions, and other insurance related books and documents. The taxpayer then received termination payments from State Farm pursuant to the Agreement. The taxpayer initially reported these payments as ordinary income but later amended his return to characterize the payments as long-term capital gain, claiming the payments were for intangible assets and that State Farm purchased a covenant not to complete.

In addressing whether the payments constituted ordinary income or capital gain, the court stated that the taxpayer did not own the intangible assets that he claimed to have sold since the agreement provided that "State Farm owns all policy records and policy information." In addition, the court addressed the issue of goodwill and going concern value. The court stated that goodwill was connected to the insurance business, "and the goodwill of that business--insurance policies and policyholder information--were owned by State Farm," and not by the taxpayer. Furthermore, the court stated that the going concern value was also attached to the insurance business, comprised of insurance policies and policyholder information belonging to State Farm, and was not the taxpayer's to sell. The fact that the taxpayer, unlike the taxpayer in the *Baker* case, had also sold his office building and personal property to a successor agent did not change the tax treatment of the termination payments under the agreement with State Farm. Thus, the court held that the taxpayer did not sell any intangible assets because those assets (and the tangible assets to which they attached) were owned by State Farm. Therefore, the payments received by the taxpayer were not entitled to capital gains treatment.

This letter has called your attention to certain general principles of the law. It is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2005-1, §2.04, 2005-1 IRB 7. If you have any additional questions, or need further assistance, please contact me or at .

Sincerely,

Thomas A. Luxner
Branch Chief, Branch 1
(Income Tax & Accounting)