
IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

NO. 02-3262

WARREN L. BAKER, JR. AND DORRIS J. BAKER,
PETITIONERS-APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE.

APPEAL FROM THE JUDGMENT OF THE
UNITED STATES TAX COURT
Docket No. 599-00

BRIEF FOR THE APPELLANTS

Thomas J. O'Rourke
22 West Jefferson Street;
Suite 407
Rockville, MD 20850
301-309-3700

Counsel for Appellants

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ON

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DORRIS J. BAKER

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Attorney's Printed Name: THOMAS J. O'ROURKE

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Address: 22 West Jefferson Street; Suite 407
Rockville, MD 20850

Phone Number: 301-309-3700 Fax Number: 301-309-9550

E-Mail Address: tjorourke@erols.com

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BRIEF FOR THE APPELLANTS

I

JURISDICTIONAL STATEMENT

This Court has jurisdiction of this matter pursuant to Code §7482¹. The federal question presented is whether termination payments made to Warren L. Baker, Jr. by the State Farm Insurance Companies ("State Farm") qualify for treatment as long term capital gain under Code § 1222(3).

II

¹ All references to Code refer to the Internal Revenue Code of 1986, as amended, Title 26 U.S. Code.

ISSUE PRESENTED FOR REVIEW

Whether the Tax Court erred in determining that the termination payments paid to Warren L. Baker, Jr. by State Farm are taxable as ordinary income and are not entitled to be taxed as long term capital gains as defined in Code § 1222(3)?

III

STATEMENT OF THE CASE

Warren L. Baker, Jr. and Dorris J. Baker are husband and wife. They filed a timely, joint 1997 federal income tax return with the IRS Service Center in Kansas City, Missouri. All tax due on the return was paid at the time of filing. The Commissioner determined a deficiency in income tax and issued a statutory notice of deficiency dated December 22, 1999. The Bakers filed a timely petition with the U.S. Tax Court seeking a redetermination of this deficiency on January 18, 2000. The Tax Court had jurisdiction in this case pursuant to Code §§ 7442, 6213, and 6214.

The Tax Court filed its opinion on May 29, 2002 and issued a final decision dated June 10, 2002. The appellants filed a notice of appeal with the Tax Court on August 19, 2002. The present appeal is timely under 28 U.S.C. § 2107 and Fed. R. App. P. 4(a)(1).

IV

STATEMENT OF MATERIAL FACTS

A. Facts

The appellants, Warren L. Baker and Dorris J. Baker², are U.S. citizens who reside in Fairview Heights, Illinois. They filed a joint federal income tax return for their 1997 tax year. J.A. 13³. The only issue relates to the tax treatment of termination payments made to Mr. Baker by State Farm in 1997. J.A. 18.

Warren L. Baker, Jr. was affiliated with State Farm as an agent for the period from January, 1963 until February 28, 1997. J.A. 14. The terms of Mr. Baker's relationship with State Farm were at all times governed by an Agent's Agreement. J.A. 14. All of the Agents Agreements between Mr. Baker and State Farm were prepared by State Farm and offered to Mr. Baker (as well as other State Farm agents) on a take it or leave basis. J.A. 181. At all times relevant to the present case, Mr. Baker's relationship with State Farm was governed by a State Farm Agent's Agreement, Form AA-3. J.A. 15-16.

Mr. Baker's duties as an agent included soliciting applications for insurance, collecting payments, and generally assisting State Farm policyholders. He was compensated by receiving commissions on sales. J.A. 15. During the entire period

² Dorris Baker is a party to this matter because the petitioners filed a joint return. All issues in the case involve payments made to Warren L. Baker, Jr. by State Farm.

³ All references to J.A. followed by a number refer to the page of the joint appendix at which the cited reference appears.

of his affiliation with State Farm, Mr. Baker was an independent contractor. J.A. 50. He reported all income earned as an agent as self employment income on Schedule C to his federal tax return. J.A. 16.

When Mr. Baker opened his State Farm agency, he had no customers or policyholders. J. A. 127. During the thirty four years of his affiliation with State Farm, he developed a customer base of approximately 1800 households with approximately 4000 policies in force. J.A. 128.

Mr. Baker operated his State Farm agency as his own independent business. He was responsible for securing office space, hiring and compensating employees, and paying all expenses associated with the operation of this business. J.A. 129. When he retired, his State Farm agency was assigned to an agent selected by State Farm. J.A. 131. Prior to Mr. Baker's retirement the new agent came by his office as often as possible to meet Mr. Baker's clients and to become familiar with the operation of the agency. J.A. 131.

Mr. Baker had two employees in his agency at the time of his retirement. Both were retained by the successor agent. J. A. 130. The successor agent opened his agency in the immediate vicinity of Mr. Baker's former office. J.A. 128. Approximately 90% of the policyholders developed by Mr. Baker were assigned to his successor agent. J.A. 128. The successor agent retained the same telephone

number Mr Baker had used for 34 years. J.A. 130.

When Mr. Baker initially affiliated with State Farm, he was advised that he would receive termination payments to compensate him for the business he developed as an independent business owner. These termination payments were in the nature of a buy back of his business and were based on the value of the business in place at the time he left his agency. J.A. 131-132.

State Farm relies on its agency work force for generating business, servicing policyholders, and marketing its products. J.A. 184. The individual agent is the primary method for State Farm to remain in touch with policyholders. The loyalty of the agent work force is a key to State Farm's success. J.A. 184-186. Termination payments are designed to insure agent loyalty to State Farm and to encourage the agent to continue his relationship with the Company. J.A. 184-185.

Termination payments are payable to a person who has worked as an agent for two or more continuous years and returns all property belonging to State Farm within ten days of termination. J.A. 52. The amount payable is based on the number of policies in force during the last 12 months of the agent's affiliation with the company. J. A. 52-55. An agent forfeits his right to termination payments if he solicits policyholders within one year after termination of affiliation. J.A. 52.

When an agent terminates his affiliation with State Farm, the

policies developed by the former agent are assigned to a successor agent. The successor agent is paid a reduced commission on these assigned policies. J.A. 59-60.

Mr. Baker became entitled to termination payments in February, 1997 when his agency was transferred to the successor agent designated by State Farm. In 1997, he received termination payments in the amount of \$38,622. J. A. 16. He reported all of these payments as long term capital gain. J.A. 38-40. The taxpayers described the termination payments as a sale of assets to State Farm and attached a Form 8594 (Asset Acquisition Statement Under Section 1060) to their return. They characterized these payments as consideration for a Class IV Asset⁴ (goodwill) and indicated that the total value of all termination payments to be made to Mr. Baker to be \$164,140.⁵ J.A. 39-41.

The Commissioner determined that the termination payments received by Mr. Baker are taxable as ordinary income and issued a statutory notice of deficiency to the Bakers dated December 22, 1999. J.A. 19-26.

⁴ Class IV assets acquired before February 14, 1997 include goodwill, going concern value and other intangible assets. Temp. Reg. 1.1060-1T(a)(2)(ii).

⁵ If an agent follows IRS instructions for Form 8594, he must report termination payments as a transfer of assets. The Tax Court's decision essentially ignores both Code § 197 and the instructions accompanying Form 8594.

B. Prior Cases Involving The Tax Treatment of Termination Payments.

The courts considered the tax consequences of termination payments in Milligan v. Commissioner, T.C. Memo 1992-655, rev'd at Milligan v. Commissioner, 38 F. 3d 1094 (9th Cir. 1994) and in Jackson v. Commissioner, 108 T.C. 130 (1997).⁶ The issue in each case was whether termination payments were subject to self employment tax.

In Milligan v. Commissioner, 38 F. 3d 1094 (9th Cir. 1994) the Court of Appeals reversed the Tax Court's determination that termination payments were deferred compensation derived from the former State Farm agent's trade or business. The appellate court held that termination payments were not deferred compensation, were not derived from the conduct of a trade or business, and were not subject to self employment tax. Id., at 1098-1099. It further stated that termination payments were not payments for services because the retired agent had been fully compensated for all

⁶ Subsequent to the issuance of the Tax Court's decision in the present case, a jury in State Farm v. John W. Weir and Richard L. Pyorre, Case No. 82814, Superior Court for Mendocino County, California, Ukiah Branch, determined that individual agents (and not State Farm) own everything associated with their independent businesses including all customer records, policy expirations, and all other matters associated with the operation of their agencies. The decision in this case is not final as of the time this brief was filed. If ultimately sustained, this decision changes the entire relationship between State Farm and its agents and the tax consequences that flow from this relationship.

services while he was an active agent. It did not characterize the nature of termination payments because of ambiguities in the Agent's Agreement. Id., at 1098.

The Tax Court again considered the tax consequences of termination payments in Jackson v. Commissioner, 108 T.C. 130 (1997). It acknowledged that its decision in Milligan was incorrect. It specifically held that termination payments were not deferred compensation, were not payment for services, were not derived from the conduct of a trade or business, and were not subject to self employment tax. Id., at 136-137. It did not decide whether termination payments were consideration for an agreement not to compete or the purchase of petitioner's agency, including its assets and goodwill. Id., at p. 140. In a separate concurring opinion, however, three Tax Court judges (including the author of the court's majority opinion) expressed the view that termination payments were compensation for the sale of the agent's business to State Farm. Jackson v. Commissioner, 103 T.C. at 141 et. seq.

As a result of the decisions in Milligan, Jackson, and Code § 1402(k)⁷ it has been conclusively established that termination payments are not compensation for services, are not deferred

⁷ Code § 1402(k) was added as part of the Taxpayer Relief Act of 1997, Pub. L. No. 103-34. This provision was added to codify the result reached in Milligan, Jackson, and Gump v. United States, 86 F. 3d 1126 (Fed. Cir. 1996) that post termination payments made to certain former insurance agents are not subject to self employment tax. See, General Explanation of Tax Legislation Enacted in 1997, prepared by the Staff of the Joint Committee on Taxation, at p. 125 (December 17, 1997).

compensation, and are not subject to self employment tax.

V

SCOPE OF REVIEW

Questions of law are subject to de novo review and questions of fact are reviewable under the clearly erroneous standard. Indianapolis Power and Light v. Commissioner of Internal Revenue, 857 F. 2d 1162, 1162 (7th Cir. 1988) aff'd 493 U.S. 203 (1990). The only issue in this case is a legal issue and is subject to review de novo.

VI

SUMMARY OF ARGUMENT

The facts in this case are not in dispute. Warren Baker started a State Farm agency with no customers. He operated this business for 34 years as an independent business owner and developed a customer base of approximately 4000 policies in force. When he ended his affiliation, State Farm agreed to pay him \$164,140⁸, provided he agreed not to solicit business from any of the policy holders developed during the operation of his business. The amount paid to Mr. Baker was based on the business in place during the last year of operation of his agency, the standard commonly used to value an insurance business at the time of sale.

⁸ This amount was to be paid in installments over a five year period. The amount paid in 1997 was \$38,662. J.A. 39.

To prevail in this appeal, the taxpayers must establish that the amount paid to Mr. Baker, his termination payments, are compensation for the sale or exchange of a capital asset. They satisfied this burden in the lower court, but the Tax Court reached an erroneous conclusion - one contrary to many of its own prior decisions.

Termination payments are not deferred compensation or payment for services (see cases and statute cited at p. 8-9, supra.)⁹ They are consideration for the intangible asset value (i.e. goodwill and going concern value) of Mr. Baker's business. These intangible assets are capital assets that were sold to State Farm in exchange for termination payments.

The Tax Court's conclusion that Mr. Baker had nothing to sell because State Farm owned virtually every aspect of his business is inconsistent with other decisions in both the Tax Court and in other courts that have recognized that an individual's relationship with clients and customers is personal in nature. It can not be considered an asset of any corporate entity with whom he may have been affiliated. This personal relationship is an intangible asset that qualifies as a capital asset. Sale of such an asset entitles a taxpayer to capital gain treatment. This position is supported by a number of decisions involving other insurance agents in

⁹ Despite the clarity of the opinions in Milligan and Jackson and the enactment of Code §1402(k), the only explanation offered by the Commissioner in the Tax Court was that termination payments were a form of deferred compensation. J.A. 216.

situations virtually indistinguishable from Mr. Baker's.

VII

ARGUMENT

A. TERMINATION PAYMENTS ARE CONSIDERATION FOR THE SALE OF A CAPITAL ASSET AND ANY GAIN ATTRIBUTABLE TO THIS SALE MUST BE TAXED AS A LONG TERM CAPITAL GAIN.

1. Requirements for Capital Gain Treatment

Gain from the sale or exchange of a capital asset is taxable as a long term capital gain, if the taxpayer held the asset for more than 1 year. Code § 1222(3). The maximum rate of tax on long term capital gains is 20%. Code § 1(h).

Mr. Baker is entitled to treat his termination payments as long term capital gain if he establishes that (i) he owned a capital asset;(ii) that he held this asset for more than one year; (iii) that he sold or exchanged this asset; and (iv) in consideration for this sale or exchange he received termination payments. He has satisfied this burden.

2. The Intangible Asset Value of Mr. Baker's Insurance Agency is a Capital Asset.

a. Requirements for capital asset treatment.

A capital asset is "all property" with certain enumerated exceptions not pertinent in the present case. Code § 1221. Intangible assets include goodwill, going concern value, a

customer-related information base, and other customer-based intangibles. Reg § 1.197-2(b)¹⁰. Intangible assets are capital assets. Aitken v Commissioner, 35 T.C. 227, 230 (1960) and Johnson v. Commissioner, 53 T.C. 414, 422 (1969).

Goodwill is the value of a business attributable to the expectancy of continued customer patronage Reg. §1. 197-2(b)(1). Going concern value is the additional value attributable to the ability of a business to continue to function and generate income notwithstanding a change of ownership. Reg. §1.197-2(b)(2)(d). Goodwill is acquired by the purchaser of a going concern where the transfer enables the purchaser to step into the shoes of the seller. Karan v. United States, 319 F. 2d 303, 306 (7th Cir. 1963); Decker v. Commissioner of Internal Revenue, 864 F.2d 51, 54 (7th Cir. 1988); Winn-Dixie-Montgomery, Inc. v. United States, 444 F.2d 677, 681 (5th Cir. 1971).

b. Mr. Baker owned a capital asset.

In Cordova v. State Farm Insurance, 124 F.3d 1145, 1147, at fn. 1(9th Cir. 1997), the court acknowledged that State Farm agents are self employed independent contractors who develop equity in an independent business. State Farm acknowledges that agents are critical to its success. Without agents, it would have no means to

¹⁰ All references to reg. refer to the Treasury Regulations that are set forth at Title 26, Code of Federal Regulations (C.F.R.).

market to potential customers or to service existing policy holders. J.A. 184. The relationship between agents and customers is essential to the success of State Farm's business and is the cornerstone of the "good neighbor" policy widely advertised by State Farm. J.A. 184-185.

During his more than 30 years as a State Farm Agent, Mr. Baker developed a customer base of approximately 4,000 policies in force. J.A. 128. The loyalty of the customer base was to Mr. Baker who sold and serviced their policies and not to State Farm. These customers and Mr. Baker's relationship with them is goodwill. MacDonald v Commissioner, 3 T.C. 720, 727 (1944) and Kenney v. Commissioner, 37 T.C. 1161, 1171 (1962). See discussion at pp.15-17, infra.

Termination payments are a means of encouraging agent loyalty to State Farm. Tr. 75. They are designed to insure continued customer patronage of State Farm without interruption notwithstanding a change of ownership of an agency. Such payments are for goodwill. They allowed Mr. Baker's successor agent to step into his shoes. Patterson v. Commissioner of Internal Revenue, 810 F. 2d 562, 569 (6th Cir. 1987); Decker v. Commissioner of Internal Revenue, 864 F.2d supra, at 54; Winn-Dixie-Montgomery, Inc. v. United States, 444 F.2d supra, at 681. See also, Jackson v. Commissioner, 108 T. C. supra, at 141.

c. The Tax Court's conclusion that Mr. Baker did not own any capital asset is contrary to the position it has taken in many prior cases.

The Tax Court rejected Mr. Baker's argument that he sold the goodwill and intangible asset value of his business in exchange for termination payments. It found that he did not have any vendible assets to sell. J.A. 224. It relied on the fact that, under the Agent's Agreement, State Farm owned all policy holder information including customer data and policy expiration dates.

This conclusion is not only contrary to the conclusion in Cordova v. State Farm Insurance, 124 F.3d supra, 1147, at fn. 1, that an agent has equity in his agency, but it also leads to a somewhat nonsensical result. If State Farm already owned everything associated with Mr. Baker's business, why did it obligate itself to pay him for what it already owned?

Termination payments are not deferred compensation, commissions, or payments for services. Milligan v. Commissioner, 38 F. 3d 1094 (9th Cir. 1994); Jackson v. Commissioner, 108 T.C. 130 (1997) and Code § 1401(k). The only logical explanation is that they were designed to compensate Mr. Baker for something he developed during the 34 years he operated his business - the

goodwill and intangible asset value of his business. This view is consistent with the position taken by the Tax Court in other comparable cases.

Prior to the present case, the Tax Court has consistently ruled that the relationship between an individual and his customers is an asset personal to the individual. It can not be considered a corporate asset. See, Martin Ice Cream Co. V. Commissioner, 110 T.C. 189, 207 (1998); Taracido v. Commissioner, 72 T.C. 1014, 1024 (1979); Cullen v. Commissioner, 14 T.C. 368, 372 (1950); MacDonald v. Commissioner, 3 T.C. 720, 727(1944). The relationships Mr. Baker developed over a period of 34 years was his personal asset and could not be considered as belonging to State Farm.

The Tax Court faced an analogous situation in Norwalk v. Commissioner, T.C. Memo 1998-279 (1998), 76 TCM 209(CCH 1998). In Norwalk, a professional corporation (an accounting firm) entered into employment agreements with its employees. The corporation structured these agreements to reflect that it, and not the individual employees, owned all of the tangible assets associated with the operation of the accounting practice. The Tax Court found, however, that, "Most, if not all of the clients of the corporation would have 'followed' the accountant who serviced that client if the accountant would have left the corporation". Norwalk v. Commissioner, T. C. Memo 1998-279, 76 TCM at 214 (CCH 1998).

MacDonald v Commissioner, 3 T.C. 720,726-727 involved the sale

of an insurance agency. The court stated the agency name, location, and existing customers had no value absent the personality and personal ability of the individual agent. The abilities of the agent represented the true goodwill value of the agency.

Likewise, in Kenney v. Commissioner, 37 T.C. 1161,1171 (1962), the Tax Court stated:

...[The ability, personality, integrity, and acquaintances of any individual selling insurance is important in whatever field of insurance it is. While these may be personal characteristics of the individual which help him build his clientele, they also generate confidence in his customers in the product which he sells which, at least initially, give his successor in business a considerable advantage over his competitors.

All of these tangible and intangible assets, whatever they may be called, go into what is considered goodwill,... and together they constitute a capital asset that is vendible because with it the purchaser is in a much better position to continue his business. (Emphasis supplied)

See also, Aitken v Commissioner, 35 T.C. 227 (1960) and Johnson v. Commissioner, 53 T.C. 414, 422 (1969).

In the present case, Mr. Baker's ability, personality, integrity, and acquaintances were the personal characteristics that helped him build his clientele. They generated confidence in his customers in the product he sold, and, at least initially, this gave his successor in business a considerable advantage over his competitors. As the court recognized in Norwalk, many of these customers would have left the business if Mr. Baker had chosen to affiliate with a company other than State Farm. The customer

lists, agency name, and business location had little value absent Mr. Baker's personal relationships. MacDonald v Commissioner, supra, at 726-727.

Mr. Baker's goodwill is a vendible asset, where, as here, it is coupled with a covenant not to compete associated with the transfer of this business to the agent designated by State Farm. Norwalk v. Commissioner, supra, at 76 TCM at 214(CCH 1998).

3. Mr. Baker Sold the Intangible Asset Value of His Business to State Farm in Exchange For Termination Payments.

a. A sale occurred in the present case.

The preceding discussion illustrates that Mr. Baker owned a capital asset (i.e. the relationship with his customers). He must show that he sold or exchanged this asset to qualify for capital gain treatment.

A sale occurs when there has been a transfer of property for a fixed price in money or its equivalent. Iowa v. McFarland, 110 U.S. 471, 478 (1885); Commissioner v. Brown, 380 U.S. 563, 570 (1965). In determining whether a sale occurred, the substance of the transaction and not its form is controlling. Commissioner v. Court Holding Co. 324 U.S. 331, 334 (1945).

Mr. Baker developed a customer base of approximately 4000 policies in force during the 34 year period he operated his business. He became entitled to termination payments when he

transferred the right to solicit business from these customers to State Farm. The view that this transfer is a sale is consistent with the view expressed by three Tax Court judges in the concurring opinion in Jackson v. Commissioner and by other courts that have reviewed similar arrangements.

Termination payments are payments for the goodwill value of the agent's business and should be treated as the sale of a capital asset for tax purposes. Jackson v. Commissioner, 108 T.C. at 141. They are designed to protect a customer base for the successor agent. In essence, the successor agent buys the retiring agent's business by receiving reduced commissions on any assigned policies. State Farm merely serves as the conduit through which these payments are made to the retired agent. Id., at 141.

In concluding that termination payments were in the nature of a buyout, the concurring opinion in Jackson relied on the reasoning in Darden v. Nationwide Mutual Insurance Company, 922 F.2d 203,208 (4th Cir. 1991), rev'd on other grounds, 503 U.S. 318 (1992) in which the court found:

The nature of the payments is not indicative of a pension or retirement plan. The amount of the payment is tied to only one factor, the amount of business in the last year prior to termination. The payments are recouped from the individual's successor. In sum, the benefits are in the nature of a buy out in which the departing agent receives payments based on what he leaves behind in the way of business for his successor. If the departing agent goes into competition with his successor, he is destroying the resources that would be used to pay him. (emphasis supplied).

Jackson v. Commissioner, 108 T.C. at 142.

This "buy out" characterization has also been adopted in Petr v. Nationwide Mutual Insurance Company, 712 F.Supp. 504, 506 (D.Md. 1989) and in Wolcott v. Nationwide Mutual Insurance, 664 F.Supp. 1533, 1538 (S.D. Ohio 1987) aff'd 884 F.2d 245 (6th Cir. 1989). These Nationwide case are significant because there is no meaningful difference between termination payments paid to former State Farm agents and extended earnings paid to a former Nationwide agent. Gump v. United States, 86 F. 3d 1126, 1129 (Fed. Cir. 1996).

The foregoing discussion indicates termination payments were paid as consideration for the goodwill and intangible assets value of Mr. Baker's insurance business.

b. The Tax Court incorrectly applied the benefits and burdens of ownership test in concluding that no sale occurred.

The Tax Court stated that in deciding whether a sale occurred it is necessary to determine whether the benefits and burdens of ownership pass from seller to buyer. It acknowledged that it is necessary to analyze the substance of the transaction and not merely to its form. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996) and Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981).

While the Tax Court mentioned the benefits and burdens test, it did not apply it. After stating that substance, not form controls, it focused solely on one factor - the form of the transaction. The only factor it mentioned was whether title to any tangible assets passed from Mr. Baker to State Farm. It concluded that State Farm owned virtually everything associated with Mr. Baker's business and that he had nothing to sell. The decision is contrary to appellate court's conclusion in Cordova v. State Farm supra, 124 F. 3d at 1147 and elevates form over substance.

The benefits and burdens test was developed and is most frequently used in the real estate context. Not all of the factors mentioned by the Tax Court are applicable in a case such as the present one that does not involve real estate. Indeed, this analysis is not routinely used in cases involving the sale of intangible assets. See cases discussed at pp. 15-17, supra.

If the Tax Court had analyzed the factors it mentioned, it would have concluded that Mr. Baker did transfer the benefits and burdens of his agency in exchange for termination payments. The factors mentioned, but not analyzed by the Tax Court, are follows:

i. Whether Title Passed

Mr. Baker transferred the goodwill and intangible asset value of the customer base he developed to State Farm. Such factors are not evidenced by title and this factor is not relevant in the

present circumstances. The courts have repeatedly held that goodwill and intangible assets value may be sold without ever mentioning the concept of title. See pp. 15-17, supra. Mr. Baker did surrender his right to solicit business from his customers in exchange for termination payments. J.A. 52.

ii. How the Parties Treat the Transaction.

The parties treated Mr. Baker's termination as a sale. Before termination, he had the absolute and indefinite right to continue to market to the customers he had developed. This contract right is a property right. North Dakota State University v. United States, 84 F. Supp. 2d 1043, 1050 (D.N.D. 1999). At termination, he surrendered this right. Thereafter, it belonged to State Farm.

iii. Whether equity was acquired in the property.

Prior to termination, Mr. Baker had the absolute right to continue to sell to his customers and derive commissions from these sales. After the sale, this right belonged solely to State Farm (or the agent to whom it assigned these policies).

iv. Whether the contract requires a present obligation on the seller to deliver a deed and a present obligation of the

buyer to make payments.

The concept of a deed is unique to real estate transactions and is not relevant in the present context. Mr. Baker was, however, obligated to transfer virtually everything associated with his business to State Farm and to refrain from soliciting business from customers he had developed. The successor agent operated close by, hired Mr. Baker's employees, and used the same phone number he had used for 34 years. In exchange for this surrender of assets, Mr. Baker was entitled to receive termination payments.

v. Whether the right of possession is vested in the purchaser.

The concept of possession applies in real estate cases and has little applicability in the present circumstances. Prior to the sale, Mr. Baker operated his business. After the sale, this right belonged solely to State Farm.

vi. Which Party Pays the Taxes.

Prior to the sale all obligations associated with running the business, including taxes, were the responsibility of Mr. Baker. After the sale, the obligations rested with State Farm or its designated agent.

vii. Which Party Bears the Risk of Loss.

Prior to the sale, Mr. Baker bore all risks associated with the operation of his business. After the sale, these risks belonged to State Farm or its designated agent.

viii. Which party receives the profits from the operation and sale of the property.

Prior to the sale, all commissions from the sale of insurance belonged to Mr. Baker. After the sale these profits belonged to State Farm or its designated agent. No portion of Mr. Baker's termination payments was payment for services, deferred compensation, or commissions. Milligan v. Commissioner, 38 F. 3d 1094 (9th Cir. 1994) and in Jackson v. Commissioner, 108 T.C. 130 (1997); Code § 1402 (k).

If the Tax Court had applied the benefits and burdens test instead of focusing exclusively of the passage of title to tangible assets, it would have concluded that a sale did occur.

4. The Consideration Paid to Mr. Baker was Computed in Accord with the Standard Industry Practice for Valuing an Insurance Agent's Business.

The amount of termination payments was based solely on the premium volume of business in place during the last twelve months of Mr. Baker's active service. J.A. 52-54. Business in place at the time of sale is the benchmark typically used to value insurance

agencies. Gump v. Commissioner, 86 F. 3d at 1129-1130. Payments made in this context are for intangible assets, General Insurance Agency, Inc. v. United States, 401 F. 2d 324, 329-330 (4th Cir. 1968) and are taxable as capital gains. Kenney v. Commissioner, 37 T.C. 1161 (1962) and Aitken v. Commissioner, 35 T.C. 227 (1960).¹¹

State Farm's Agent's Agreement is consistent with the standard practice in the insurance industry. Through termination payments, it pays a departing agent an amount equivalent to the intangible asset value of his agency, provided he refrains from soliciting his former customers. J.A. 52.

5. No Portion of Mr. Baker's Termination Payments are Allocable to a Covenant Not to Compete.

The Agent's Agreement prohibited Mr. Baker from soliciting business from his former customers for a period of one year following the sale of his business to State Farm. This restriction is a covenant not to compete. To the extent any portion of the termination payments are allocable to a covenant not to compete, they are ordinary income. Where a covenant is inseparable from goodwill, all consideration must be allocated to goodwill and is taxable as capital gain. Karan v. United States, supra, 319 F. 2d

¹¹ These cases do not involve State Farm agents, but indicate that State Farm followed the insurance industry standard for valuing an insurance business. It pays a departing agent this value through termination payments.

at 306; Mesquiallette v. United States, 239 F. 2d 322, 326 (5th Cir. 1957); Isley v. Commissioner, T.C. Memo 1964-90 (1964).

In the present case, the covenant not to compete is inseparable from the goodwill value of Mr. Baker's business. No portion of the consideration paid to Mr. Baker is allocable to this covenant.

**6. Conclusion - Termination Payments Are Taxable as Long
Term Capital Gain.**

Mr. Baker built a successful, independent, insurance business over more than 30 years of service as an independent State Farm agent. When he started the business, he had no customers. When he retired, his business had approximately 4,000 policies in force. This customer base was built primarily through his personal efforts and to a large extent was based on the loyalty of his customers to him.

Termination payments were designed to compel his cooperation in an effort to insure continued customer patronage without interruption notwithstanding a change of ownership of the agency. They were designed to allow Mr. Baker's successor agent to step into his shoes. The successor agent compensated Mr. Baker for this by receiving lower commissions on this assigned book of business.

Termination payments are for the intangible asset value of his business. These intangible assets are capital assets and gain from

their sale is capital gain. Kenney v. Commissioner, 37 T.C. 1161 (1962) and Aitken v. Commissioner, 35 T.C. 227 (1960). Since Mr. Baker owned these assets for more than one year, he is entitled to treat his gain as long term capital gain. Code §1222(3).

B. THE TAX COURT'S ANALYSIS SUGGESTS AN ARBITRARY APPROACH AND ITS DECISION SHOULD BE REVERSED.

The Tax Court's opinion in the present case is puzzling because of its reliance on Schelble v. Commissioner, T.C. Memo 1996-269, aff'd at 130 F. 3d 1388 (10th Cir. 1997), its disavowal of the concurring opinion in Jackson v. Commissioner virtually without discussion, and its conclusion that the personal relationships of a business owner developed over a long period of time is not goodwill that he may sell.

The Tax Court reliance on Schelble is ironic. In Schelble v. Commissioner, T.C. Memo 1996-269 , 71 TCM 3166, 3167-3, it stated:

" We conclude that this case is distinguishable on its facts from Milligan due to substantial differences that exist between petitioner's payments herein and the payments at issue in Milligan."

The agreement in Milligan is the identical agreement at issue in the present case. The payments in question under the two different agreements are different. The Tax Court's conclusion quoted above can not be reconciled with its reliance on Schelble in

the present context.

Moreover, in Schelble, the court found that the payments made to Mr. Schelble were in the nature of deferred compensation derived from the conduct of his insurance business. The decisions in Milligan and Jackson, establish that termination payments are not compensation for services, deferred compensation, or derived from the active conduct of Mr. Baker's insurance business. Schelble has no significance in the present circumstances.

The Tax Court's almost cavalier disavowal of the concurring opinion in Jackson v. Commissioner is puzzling. In Jackson, the Tax Court expressly stated that it did not decide the character of termination payments. The only suggestion offered as to the nature of these payments was the concurring opinion. The concurring judges characterized termination payments as consideration for the goodwill value of an agent's business. One of the concurring judges, Judge Dawson, both authored the Court's opinion in Jackson and adopted the Special Trial Judges' opinion in the present case. The only explanation is that he simply changed his mind. Such a change of opinion without explanation hints at arbitrariness.

Finally, the Tax Court reached contradictory conclusions. It found that Mr. Baker established and operated an independent business for more than 30 years and built a customer base from nothing to approximately 4000 policies in force. It concluded, however, that there was no goodwill value associated with this

business. This conclusion defies common sense and is inconsistent with the position adopted by the Tax Court in many other cases. (See discussion at pp. 15-17, supra and at pp. 19-20 supra). It is also inconsistent with the conclusion in Cordova v. State Farm Insurance, supra 124 F. 3d at 1147 that a State Farm agent is an independent business owner who develops equity in his business.

The Tax Court reached an illogical conclusion, inconsistent with many of its own prior decisions. Accordingly, its decision is erroneous and should be reversed.

VIII

CONCLUSION

When the substance of the transaction between Mr. Baker and State Farm is analyzed, it is clear that Baker sold the goodwill and intangible assets value of his business to State Farm in exchange for termination payments. These assets are capital assets held by Mr. Baker for more than 30 years. Accordingly, the taxpayers are entitled to treat the gain from this sale as a long term capital gain. The Tax Court's decision to the contrary is incorrect and should be reversed.

Respectfully submitted,

Date: _____

Thomas J. O'Rourke
22 West Jefferson Street
Suite 407
Rockville, MD 20850
(301) 309-3700

Attorney for Appellants

CERTIFICATE OF COMPLIANCE/CERTIFICATE OF SERVICE

The undersigned certifies as follows:

1. The foregoing brief and the accompanying diskette have been included in the pdf format required by Circuit Rule 31.
2. The material required to be included in the Short Appendix has been included as required by Circuit Rule 30.
3. The material in the Short Appendix is not available to the appellants and has not been provided by the Tax Court in a pdf format.
4. On this ____ day of November, 2002, two copies of Appellants' Brief were mailed by regular first class mail, postage prepaid, to:

Gary R. Allen
Chief, Appellate Section
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

Francesca M. Ugolini
Tax Division
Department of Justice
Post Office Box 502
Washington, D.C. 20044

Thomas J. O'Rourke

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

NO. 02-3262

WARREN L. BAKER, JR. AND DORRIS J. BAKER,
PETITIONERS-APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE.

APPEAL FROM THE JUDGMENT OF THE
UNITED STATES TAX COURT
Docket No. 599-00

BRIEF FOR THE APPELLANTS

Thomas J. O'Rourke
22 West Jefferson Street;
Suite 407
Rockville, MD 20850
301-309-3700

Counsel for Appellants
