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IN THE UNITED STATES COURT OF APPEALS  
FOR THE SEVENTH CIRCUIT

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NO. 02-3262

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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

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REPLY BRIEF FOR THE APPELLANTS

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Respondent-Appellee

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PRELIMINARY STATEMENT

The parties agree that the termination payments made to Warren Baker by the State Farm Insurance Companies ("State Farm") are entitled to be taxed as long term capital gain if they are consideration for the sale of a capital asset by Mr. Baker to State Farm. They also agree that goodwill is a capital asset. They disagree about whether Mr. Baker owned a capital asset (goodwill) that he could sell, and whether the transaction between him and State Farm may be characterized as a sale.

The Appellee ("the Commissioner") argues that the taxpayers failed to prove that Mr. Baker either owned a capital asset or that the transaction between him and State Farm was a sale for tax purposes. These arguments are incorrect for the reasons set forth in this Reply.

## ARGUMENT

### **A. STANDARD OF REVIEW**

The taxpayers contend that the Tax Court's conclusion that Mr. Baker did not sell a capital asset (goodwill) to State Farm is reviewable de novo. (Appellant's Br. 9). The Commissioner argues this conclusion is a factual determination reviewable under the clearly erroneous standard (Appellee's Br. 14).

Whether Mr. Baker owned a capital asset and sold this asset is a legal determination based on the evidence presented at trial. None of the essential facts are in dispute. This court is being asked to review a legal conclusion derived from an interpretation of undisputed facts. If, however, the Court agrees that the determination of whether there was a sale of a capital asset is a factual determination, the Tax Court's determination is clearly erroneous because it is inconsistent with the undisputed evidence.

### **B. THE COMMISSIONER'S CONTENTION THAT MR. BAKER DID NOT OWN A CAPITAL ASSET IS ERRONEOUS.**

The Commissioner contends that Mr. Baker did not own any capital asset that he could sell. (Appellee's Br. 18-20). He argues that, under the Agent's Agreement, State Farm owned everything of value associated with Mr. Baker's insurance business and he had nothing of value to sell. (Appellee's Br. 16-18). The Commissioner further argues that the taxpayers failed to satisfy their burden of proving that any goodwill value attached to his business. (Appellee's Br. 18-20). Finally, the Commissioner asserts that Mr. Baker merely gave up his right to perform personal services and that consideration for this surrender is ordinary income. (Appellee's Br. 32-33). All of these contentions are either inconsistent with the evidence, ignore the substance of the transaction, or are contrary to applicable precedent.

**1. The Agent's Agreement**

The Commissioner argues that, under the Agent's Agreement, State Farm owned everything of value associated with Mr. Baker's business and that he had nothing of value to sell. (Appellee's Br. 16-18). State Farm controlled every aspect of its relationship with Mr. Baker. He was offered the Agent's Agreement on a "take it or leave it basis". He had no input into the structure of the Agreement. (J.A. 181).

State Farm acknowledges that agents are the exclusive means to market to potential customers and to service existing policies.

They are a key to its success. J.A. 184-185. While it controls the structure of the Agent's Agreement, it can not control agent-customer relations. It needs a mechanism to insure continued customer patronage after an agent ends his affiliation with State Farm. It does this by agreeing to pay termination payments.

The amount of termination payments is based solely on the value of business in place at the time of termination. A former agent forfeits his right to termination payments if he does anything to interfere with a former customer's continued patronage of State Farm. J.A. 52. Termination payments are designed to compensate the agent for the business he developed. (J.A. 132).<sup>1</sup> They are for the goodwill value of Mr. Baker's business. (See discussion at pp.5-8, infra).

Courts have found the termination payment provisions of the Agent's Agreement ambiguous. Milligan v. Commissioner, 38 F. 3d 1094, 1098 (9<sup>th</sup> Cir. 1994) and Jackson v. Commissioner, 108 T.C. 130, 140 (1997). Termination payments are provided without definition or explanation - they are simply there. State Farm was aware that the courts considered its termination payment provisions

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<sup>1</sup> Appellee states that Mr. Baker's testimony is self serving. It is also credible. The Tax Court based many of its factual determinations solely on his testimony. The Tax Court does not make any suggestion that his testimony lacks credibility. Mr. Baker's assertion that he was advised early in his tenure with the company that termination payments were designed as a buy back of his business was not contradicted by the Commissioner or by State Farm.

ambiguous, but made no effort to eliminate these ambiguities. J.A. 183-184. This suggests that the Agreement was intentionally ambiguous to allow State Farm to argue for a tax result that was in its own best interest.<sup>2</sup> Any ambiguity should be resolved in a manner adverse to the interpretation urged by the party who drafted the agreement. Bourke v. Dunn & Bradstreet, 159 F. 3d 1032, 1036 (7<sup>th</sup> Cir. 1998) and Williston on Contracts § 32:12 (4<sup>th</sup> ed. 1999).

If this principle of contract interpretation is applied and the agreement is construed in a manner consistent with the taxpayers' interpretation, it must be determined that State Farm paid Mr. Baker to insure the continued patronage of State Farm by the customers he developed. It paid him for the goodwill value of his business.

## **2. The Goodwill Value of Mr. Baker's Business**

Goodwill is the expectancy of continued customer patronage. Newark Morning Ledger Company v. United States, 507 U.S. 546, 555 (1993); Karan v. United States, 319 F. 2d 303, 306 (7<sup>th</sup> Cir. 1963); Decker v. Commissioner of Internal Revenue, 864 F.2d 51, 54 ( 7<sup>th</sup> Cir. 1988). Reg. §1. 197-2(b)(1). The Commissioner's assertion

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<sup>2</sup> If termination payments are for the goodwill value of Mr. Baker's business, they are not fully deductible in the year of payment, but must be amortized under Code § 197. By allowing itself the flexibility to argue that termination payments are not for goodwill, State Farm is able to deduct the full value of all payments in the year they are made.

that Mr. Baker failed to satisfy his burden of proving that any goodwill attached to his business is wrong.

The Tax Court found that Mr. Baker operated his insurance business for 34 years and that there were approximately 4,000 policies in force at the time of his retirement. J.A. 206-213. State Farm had a vested interest in making sure that any customers developed by Mr. Baker remained State Farm customers after he retired. They wanted to insure the continued patronage of these customers.

The mechanism used by State Farm to insure continued customer patronage was termination payments. Through these payments, it paid Mr. Baker an amount based on the value of business in place at the time of retirement. If he did anything to interfere with the continued patronage of State Farm by these customers, he forfeited his right to termination payments. J.A. 52.

While the Commissioner argues that the relationships developed by Mr. Baker over 34 years are not goodwill, this view is not supported by any precedent. The Court in Kenney v. Commissioner, 37 T.C. 1161,1171 (1962) acknowledged that an agent's relationships with customers is goodwill, when it 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).

The view that personal relationships of a person in a service business (such as an insurance agency) are goodwill owned by the individual who develops these relationships has been universally accepted by the courts. See Appellant's brief at pp. 16-18.

The sole motivation for State Farm to pay termination payments to Mr. Baker was to insure that the customers he developed over 34 years continued to buy State Farm insurance (i.e. to insure continued patronage) after he retired. It insured cooperation by requiring Mr. Baker to forfeit his termination payments if he did anything to interfere with a former customer's continued patronage. Such payments, coupled with a binding forfeiture covenant, are for the goodwill value of a business. Norwalk v. Commissioner, T.C. Memo 1998-279, 76 TCM at 214 (CCH 1998). The Commissioner's assertion to the contrary is incorrect.

3. **Termination Payments Are Not Designed to Compensate Mr. Baker for the Surrender of His Right to Render Personal Services to His Customers.**

The taxpayers have argued from the inception of this case that

termination payments are consideration for the goodwill value of Mr. Baker's business. The Commissioner has asserted that termination payments are not for goodwill, but, prior to filing his brief in the present appeal, neither he nor State Farm has offered a reasonable or plausible explanation of why State Farm agreed to pay Mr. Baker a substantial sum of money.<sup>3</sup>

In the brief filed with this Court, the Commissioner for the first time offers a rationale to explain the nature of termination payments. He argues they are designed to compensate Mr. Baker for the surrender of his right to provide personal services to the customers developed during the course of operating his business. Appellee's Br. 32-34. In the Commissioner's view, because payments for personal services (i.e. commissions on policies sold) are ordinary income, any payment for the surrender of this right must also be ordinary income.

The argument that termination payments are compensation for services has been advanced and rejected. Milligan v. Commissioner, 38 F. 3d 1094 (9<sup>th</sup> Cir. 1994); Jackson v. Commissioner, 108 T.C. 130 (1997); Code § 1402(k).

In a series of cases in the 1960's, the Commissioner advanced a similar argument in cases involving the admission of a partner to

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<sup>3</sup> At trial, Commissioner's counsel stated it was his view that termination payments were deferred compensation. This view had consistently been rejected by the courts. See, Milligan v. Commissioner, 38 F. 3d 1094 (9<sup>th</sup> Cir. 1994) and in Jackson v. Commissioner, 108 T.C. 130 (1997).

a business. He asserted that by admitting a new partner, existing partners were merely giving up the right to earn payments for future services. Thus, in his view, admission of a new partner was not a sale, but merely an anticipatory assignment of the right to earn ordinary income from existing clients. In the present case, the Commissioner makes the identical argument - by accepting termination payments, Mr. Baker is merely giving up the right to receive future commission income from sales of insurance to his customers.

The Commissioner's argument has consistently been rejected. For example, in Butler v. Commissioner, 46 T.C. 280 (1966), the court held that, by admitting a new partner, the existing business owner transferred an intangible asset, the goodwill value of his relationships with existing clients. This transfer was not a substitute for the right to receive fee income in the future, but constituted the sale of a capital asset (goodwill) entitling the seller to capital gain treatment. See also, Watson v. Commissioner, 35 T.C. 203 (1960) and Rees v. United States, 187 F. Supp. 924, 925 (D. Ore. 1960) aff'd per curiam 295 F. 2d 817 (9<sup>th</sup> Cir. 1961).

In Revenue Ruling 70-45, 1970-1 C.B 17, the Commissioner essentially abandoned the position now being advocated. He acknowledged that it is possible to transfer goodwill upon the admission of a partner in a service business. The determination of whether such a transfer has occurred will be based on all relevant

facts and circumstances.

The Commissioner's argument that termination payments are designed to compensate Mr. Baker for the right to earn ordinary income in the future has been rejected in the past and should be rejected in the present case.

**C. THE COMMISSIONER'S ARGUMENT THAT NO SALE OCCURRED IS ERRONEOUS.**

The Commissioner argues that the taxpayers are not entitled to capital gain treatment because no sale occurred. His position is that the transaction was not structured as a sale and the taxpayer is bound by the form he has selected. (Appellee's Br. 24-27). The Commissioner also contends that to argue that State Farm bound itself to pay a specific purchase price at the time it entered into the Agent's Agreement is far fetched. (Appellee's Br. 25).

**1. The Form of the Transaction vs Its Substance.**

The Commissioner argues that the Agent's Agreement is not structured as a sales agreement and termination payments are not characterized as consideration for the sale of goodwill. (Appellee's Br. 24-27). The Commissioner asserts that the taxpayer is bound by the form of the transaction he selected and may not argue substance over form. (Appellee's Br. 28).

The Commissioner's argument is contrary to the Tax Court's

conclusion that the substance of the transaction and not its form governs the tax consequences. J.A. 221. The taxpayers agree with the Tax Court's conclusion that substance governs, but contend that it erred in applying the form vs substance test. See Appellant's Br.20-25.

While a taxpayer is usually bound by the form of the transaction he chose, Mr. Baker did not select the form of the Agent's Agreement. It was dictated to him on a take it or leave it basis. J.A. 181. State Farm selected the form of the transaction and structured an agreement it knew was ambiguous. This agreement should be interpreted in an manner adverse to the interest of State Farm. See discussion at pp. 4-5, supra.

While courts generally refuse to permit a taxpayer to argue substance over form, this rule is not always applicable. In Comdisco, Inc. v. United States, 756 F. 2d 569, 578 (7<sup>th</sup> Cir. 1973), this Court stated:

Resort to substance is not a right reserved for the Commissioner's exclusive benefit, to use or not to use - depending on the amount of tax to be realized. The taxpayer too has a right to assert the priority of substance - at least in a case where his tax reporting and actions show an honest and consistent respect for the substance of a transaction.

Mr. Baker did not choose the form of the Agent's Agreement. Rather, this agreement was structured to insure continued patronage of State Farm by his customers. If he did anything to interfere with this continued patronage, he lost his right to termination payments.

State Farm structured the transaction in a form designed to allow it to achieve tax benefits that were in its best interest.<sup>4</sup> It did this by structuring an intentionally ambiguous agreement and offering it to agents on a take it or leave it basis. The agreement should be interpreted in accordance with Mr. Baker's interpretation and in a manner consistent with its substance - the purchase of a customer base to insure continued patronage by this customer base of State Farm. See pp. 5-8, supra.

**2. The Consideration Paid for the Taxpayer's Business is in Accord with the Applicable Industry Standard.**

The amount of termination payments is computed in accord with the industry standard for valuing an insurance business. The Commissioner asserts that it is far fetched to suggest that State Farm would commit itself to a purchase price many years in advance of the actual purchase. (Appellee's Br. 25).

The position that the value of business in place at the time of sale is the standard used to value an insurance business is the conclusion of the U.S. Court of Appeals in Gump v. United States, 86 F. 3d 1126, 1129-1130 (Fed Cir. 1996).

In the Agent's Agreement, State Farm did not commit years in

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<sup>4</sup> By calling agents independent business owners, it avoided such obligations as employment taxes, pensions, and insurance benefits. By making the rationale for termination payments ambiguous, it gave itself the flexibility to deduct all such payments in the year made.

advance to a specific price for an agent's business. The sale, the value of accumulated assets, the purchase price, and how much Mr. Baker would be compensated was all agreed to at the inception of the Agent's Agreement. The parties agreed to use the mechanism standard in their industry. The use of this commonly accepted standard is a factor indicative that termination payments are consideration for the purchase of Mr. Baker's business.

**C. THE COMMISSIONER'S RELIANCE ON CASES INVOLVING COMPANIES OTHER THAN STATE FARM IS MISPLACED.**

The Commissioner cites a number of cases in which the Tax Court ruled that payments made to retired insurance agents after termination of affiliation are not in the nature of a purchase of the agent's business. (Appellee's Br. 27, 33). None of the cases cited by the Commissioner involve State Farm or the Agreement in the present case. The Tax Court has acknowledged that the State Farm agreement is significantly different than agreements used by other insurance companies. Schelble v. Commissioner, T.C. Memo 1996-269, 71 TCM 3166, 3167-3. See pp. 27-29 of Appellant's brief.

**D. TERMINATION PAYMENTS ARE FOR THE GOODWILL VALUE OF MR. BAKER'S BUSINESS AND ARE TAXABLE AS CAPITAL GAINS.**

Warren Baker developed a base of approximately 4,000 policies

in force over 34 years of operating an independent business. State Farm wanted to insure the continued patronage of these policyholders after Mr. Baker terminated his affiliation. It paid him for the value of business in place at the time of his termination to insure continued patronage of State Farm - the standard typically used in the insurance industry.

Virtually all of Mr. Baker's customers were assigned to one agent. This agent paid Mr. Baker for these assigned policies by receiving reduced commissions for ten years.<sup>5</sup> State Farm merely served as a conduit in the transaction.

#### **CONCLUSION**

For all of the foregoing reasons, the arguments advanced in the Commissioner's brief are erroneous and should be rejected.

Respectfully submitted,

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<sup>5</sup> While the Commissioner asserts that Mr. Baker did not pay for any policies assigned to him, he is incorrect. Under the Agent's Agreement an agent always "pays" for assigned policies by receiving reduced commissions. J.A. 209. In essence the receiving agent "buys" these policies from the assigning agent. State Farm facilitates this transaction by serving as a conduit. It pays the selling agent termination payments. It collects the purchase price from the buying agent by paying him reduced commissions on the assigned policies.

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. On this January 17, 2003 two copies of Appellants' Reply Brief and accompanying diskette were mailed by regular first class mail, postage prepaid, to:

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