



A Capital Idea-But Not In the Eyes of the Court  
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## **Capital Asset...Or Not**

This week we look at the Ninth Circuit's affirmation of a United States District Court decision in the case of *Trantina v. United States*, 2008 TNT 7-8, affirming DC AZ 381 F. Supp. 2d 1100. In this case the taxpayer was attempting to claim that payments he received from State Farm in exchange for the termination of agreements related to his insurance agency were for the sale of a capital asset and taxable as long term capital gain.

The Ninth Circuit sided with the IRS, seeing the case as being similar to the case of *Baker v. Commissioner*, 338 F.3d 789 that the Seventh Circuit decided in 2003 with the same result for the taxpayer.

## **Capital Asset**

A capital asset is defined broadly under the Internal Revenue Code in §1221(a), which reads:

(a) In general

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by--

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by--

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in

subparagraph (A);

(6) any commodities derivative financial instrument held by a commodities derivatives dealer, unless--

(A) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and

(B) such instrument is clearly identified in such dealer's records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe);

(7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or

(8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

The general rule appears to be that everything is a capital asset, unless it's contained on the limited list of items that are excluded. However, the courts have indicated it's not quite that simple to find a capital asset. In the opinion for this case, the Ninth Circuit refers us to the United State Supreme Court's decision in *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130. In that case, the Supreme Court noted:

While a capital asset is defined in Section 117 (a)(1) as "property held by the taxpayer," it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term "capital asset" is to be construed narrowly in accordance with the purpose of Congress to afford capital - gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year. *Burnet v. Harmel*, 287 U.S. 103, 106. Thus the Court has held that an unexpired lease, *Hort v. Commissioner*, 313 U.S. 28, corn futures, *Corn Products Co. v. Commissioner*, 350 U.S. 46, and oil payment rights, *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260, are not capital assets even though they are concededly "property" interests in the ordinary sense. And see Surrey, *Definitional Problems in Capital Gains Taxation*, 69 Harv. L. Rev.

985, 987-989 and Note 7.

As well, if a taxpayer receives what is essentially a prepayment of amounts that would have been reported as ordinary income, that is not treated as capital asset. The Ninth Circuit held that a lump sum payment of a right to receive future payments that would be ordinary income is generally not a sale of a capital asset for a capital gain, in holding that the sale of rights to receive lottery winning payments was taxable as ordinary income in the case of *United States v. Maginnis*, 356 F.3d 1179, a holding that was repeated by the Third Circuit in *Lattera v. Commissioner*, 97 AFTR 2d ¶2006-506.

## State Farm Payments and Agent Trantina

This particular case is another try by a former State Farm insurance agent to obtain capital gain treatment on the amounts paid by State Farm when the agent retired and shut down his practice. The issue had previously been considered by the Tax Court in 2002 in the case of *Baker v. Commissioner*, 118 TC No. 28, and its ruling that the payments constituted ordinary income was upheld by the Seventh Circuit (338 F.3d 789) in 2003.

Mr. Trantina is trying the case in a different initial venue (United States District Court as opposed to the U.S. Tax Court) located in a different circuit (the Ninth) and with a slightly different set of facts—but the result ends up being the same both at the District Court and on appeal. The case was originally heard in the United States District Court for Arizona.

In *Baker* the Seventh Circuit outlined a basic problem for State Farm agents under this program—their agreements with State Farm didn't appear to leave them owning anything to sell—and you need to sell something to have a capital gain from a sale or exchange. As the Seventh Circuit noted:

Fundamentally, in order to have the ability to sell something, one must own it. Because Warren Baker did not own any property related to the policies, he could not sell anything. Section D of the Agreement provides:

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*.

(emphasis added). Thus, according to the terms of the Agreement,

Warren Baker did not own anything related to the policies.

Mr. Baker attempted to argue that what he did own was goodwill...and that's what State Farm's payments were related to. However, the Seventh Circuit found that problematical as well because it could not sold apart from the assets that State Farm owned. As the Seventh Circuit noted:

While Baker built the insurance agency; the tools he used were on loan from State Farm. State Farm's termination payments were not for the sale of a business where a buyer was able to step into the seller's shoes. Baker owned nothing. Thus, he could sell no assets, including goodwill. We agree that goodwill was developed during Baker's tenure; however, it was not his to sell.

### **But I Have An Asset...**

In the Trantina case, the taxpayer attempted to argue that State Farm paid for the rights under the Corporation Agent Agreement it entered into with his corporation. The District Court outlined the following facts related to the situation:

Plaintiff Charles Trantina was employed as an independent insurance agent of State Farm Life Insurance Companies ("State Farm"), first in his individual capacity and later on behalf of the Trantina Insurance Agency, Inc. (the "Corporation"), an Arizona corporation formed in 1978. Following incorporation, State Farm executed a Corporation Agent Agreement ("Corporate Agreement") with the Corporation, which replaced Trantina's previous Individual Agent Agreement ("Individual Agreement"). Trantina was at all times the sole shareholder in the Corporation; he held 1100 shares of capital stock obtained in exchange for cash and other property paid to the Corporation.

In 1996, Trantina wished to retire and the Corporation advised State Farm of the termination of the Corporate Agreement as of June 30, 1996. Pursuant to the Corporate Agreement, the Corporation became entitled to termination payments after fulfilling certain requirements such as the return of State Farm's property within ten days. State Farm commenced making such payments to the Corporation in July 1996.

The corporation was liquidated and the rights under this agreement transferred to Mr. Trantina as sole shareholder. Mr. Trantina originally reported the amounts received from State Farm under this agreement as ordinary income, but then

filed amended returns for 1997, 1998 and 1999 claiming that the amounts should have been treated as capital gains and asking for a refund of taxes. The IRS denied the claim, and the taxpayer brought suit in United States District Court.

The District Court also denied the claim, finding that:

The suggestion that the Corporate Agreement is itself an asset, when it declares that all assets pertaining to Plaintiffs' insurance agency belong to State Farm, is paradoxical. As a matter of logic, it is difficult to see how a contract declaring that Plaintiffs own no assets may be an asset itself. Although Plaintiffs possessed certain rights under the Corporate Agreement, such as the right to solicit customers, submit applications for insurance, and collect premiums, Plaintiffs could not sell, assign, or pledge any of these interests without the prior written consent of State Farm. Unlike the taxpayer in the case of *Commissioner of Internal Revenue v. Ferrer*, 304 F.2d 125 (1962), cited by Plaintiffs in support of the proposition that contractual rights may be assets, Plaintiffs lacked even a "negative power" to prevent State Farm from certain behavior. Plaintiffs had no ability to obtain value from the Corporate Agreement other than through compliance with its terms. Even the simple termination of Plaintiffs' rights under the Corporate Agreement would not result in the accretion of value through termination payments unless Plaintiffs also complied with additional terms pertaining to the return of State Farm property and solicitation of policyholders.

In the Court's view, there was nothing to sell and, once concluding that, there could not be a capital gain from the sale of a capital asset.

But the Court went on to argue that even if some sort of asset did exist in the contract, what happened wasn't a sale. The Court notes:

Even assuming arguendo that the Corporate Agreement may be deemed an asset belonging to Plaintiffs, Plaintiffs must nevertheless prove that this asset was sold or exchanged for the termination payments. This interpretation of events simply does not fit the facts at hand. The termination payments were not received in exchange for the sale of the Corporate Agreement; they were received *under* the Corporate Agreement in exchange for compliance with other terms thereof, such as the return of all property belonging to State Farm within a given period of time and the signature of a covenant not to compete. The discharge of a contract by payment in accordance with its terms does not constitute the sale or exchange of property. See *Spray Water Power & Land co. v. Comm'r of Internal Revenue*, 20 T.C.M. (CCH) 353 (1961); *Gann v. Comm'r of Internal Revenue*, 41,

B.T.A. 388, 395-96 (1940).

## Ninth Circuit Weighs In...And Agrees With the Other Courts

The Ninth Circuit was the next stop for this and, unfortunately, he found it no more willing to consider the capital gain treatment than the District Court.

The key question becomes, as under *Baker*, whether there was the sale of an asset in this transaction. The Ninth Circuit focuses on what has to exist for a contractual right to be treated as a capital asset, noting:

The parties spend considerable time in the briefs discussing cases involving the question of whether a contractual right qualifies as a capital asset. These cases demonstrate that, when the property right asserted concerns the contractual right to perform a service and receive compensation for the service, a payment made to terminate the contract cannot be considered a capital asset unless the contract confers something more than the right to perform services or receive compensation for services performed...The question in the present case is thus whether the Corporate Agreement conferred on Trantina some right or interest beyond the right to perform the services required by the agreement or to receive compensation for the services performed under the agreement.

The Court discusses the *Baker* case from the Seventh Circuit and notes immediately that they wish to adopt the reasoning of the Seventh Circuit in that case. And, they go on to hold, that case goes further than merely deciding that goodwill wasn't sold—rather, it should be read to conclude nothing was sold because there simply was nothing the taxpayer owned that could be sold.

The Ninth Circuit specifically rejects the view that the Corporate Agreement was a capital asset that was sold. The opinion continues:

Trantina attempts to avoid the plain language of the Corporate Agreement by characterizing the Corporate Agreement itself as a capital asset that was exchanged with State Farm for the termination payments when Trantina retired. On this theory, Trantina had "rights and interests in valuable assets, the managed insurance policies," which he asserts gave him "some interest or estate in or encumbrance upon some property with which the contract is concerned." *Md. Coal & Coke Co.*, 350 F.2d at 293. Yet this characterization of the Corporate Agreement does not fit with the express terms of the agreement. As noted above, Trantina did not have any property rights in the policies under the

express terms of the agreement. The policies, including all identifying information which might have been taken or conveyed to another insurance agency, belonged to State Farm, not Trantina. Furthermore, the Corporate Agreement expressly forbade Trantina from transferring or assigning his interest in the Agreement itself. Section VI.B of the Corporate Agreement states that

neither the Agreement nor any interest thereunder can be sold, assigned, or pledged; and no right in any sum due or to become due to the Agent hereunder can be sold, assigned, or pledged without the prior written consent of the Companies.

To quote the district court, "[t]he suggestion that the Corporate Agreement is itself an asset, when it declares that all assets pertaining to Plaintiffs' insurance agency belong to State Farm, is paradoxical." *Trantina*, 381 F. Supp. 2d at 1106. It is likewise paradoxical to suggest that the Corporate Agreement was an asset when the agreement itself stated that it could not be sold or otherwise exchanged.

The Ninth Circuit also disagreed with the taxpayer's position that the contract gave him certain rights. The fact that he could release ¼ of his contracts to State Farm and receive compensation showed, in the Court's view, only that he could get an early partial retirement payment, not that he had some ownership interest. As well, the Court refused to view a provision that restricted the taxpayer (and presumably other State Farm agents) from "poaching" policies serviced by other agents of State Farm as indicating that he had valuable rights that could be sold. The Court notes that State Farm retained the right to terminate the agreement by written notice and thereby reassign his policies.

The Court also didn't buy three other theories:

- A right was created by state law covenant of good faith and fair dealing in the contract—the Court found that argument would convert every contract for services into a capital asset
- The fact that he could use employees in meeting his obligation to State Farm also showed no asset—the ability to "enlist the assistance of others" is perfectly permissible in a contract for personal services.
- The fact he had a "substantial economic investment in the Agreement" by the opportunity cost incurred by not pursuing some other line of work also was deemed far too broad, since all individuals would have such an opportunity cost

One argument the court refused to address is noted at the end of the opinion—that of whether the agreement was, essentially, a franchise recognized as an

intangible asset under §197. The opinion notes:

Finally, Trantina incorporates by reference the argument of the amici that the substance of the Corporate Agreement was essentially a franchise, which is recognized as a capital asset. See 26 U.S.C. § 197 (including franchise within the definition of intangible property). However, Trantina's oblique reference in his reply brief to the brief of the amicus curiae is the first time this argument is mentioned. It was not raised in the district court. It has therefore been forfeited.

## Conclusions

The question of what is a capital asset isn't always simple, as these cases (and the lottery cases) point out. While the statutory language appears to encompass almost everything in its definition, in reality the treatment isn't available nearly that easily.

A fundamental issue to remember is that in order to have a capital gain, we need the sale of a capital asset. As the State Farm cases have pointed out, the first step in getting that treatment is to show you owned an asset which could be sold—something the taxpayers in both *Baker* and *Trantina* failed to do.