

# **GUMP v. U.S., Cite as 76 AFTR 2d 95-8112, 3/06/1995 , Code Sec(s) 1402**

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## **Opinion**

**Judge:** WIESE, Judge:

This tax refund suit comes before the court on the parties' cross-motions for summary judgment. Herbert and Marilyn Gump, a married couple filing joint income tax returns for the calendar years in question (1990 and 1991), seek a refund of taxes imposed by the Self Employment Compensation Act of 1954, I.R.C. sections 1401-1403 (1988 & Supp. V. 1993).<sup>1</sup>

Following his retirement as an independent insurance sales representative, Herbert Gump began receiving monthly income payments from the insurance company with which he previously had been affiliated. The question presented here is whether these payments are derived from Mr. Gump's activities as an insurance sales agent and thus represent self-employment income (defendant's contention) or, instead, are payments provided either in return for Mr. Gump's agreement not to compete or for the purchase of his business assets and goodwill, and hence, do no constitute compensation subject to the self-employment tax (plaintiff's position). The court, having considered the parties' briefs and their oral arguments, now rules in defendant's favor.

## **Facts**

Herbert J. Gump began working as an exclusive insurance sales agent for Nationwide Mutual Insurance Company (Nation- [pg. 95-8113] wide) in 1953.<sup>2</sup> He sold Nationwide policies as an independent contractor and operated under the name "Gump Insurance Agency." In 1990, shortly after his retirement, Mr. Gump began to receive monthly payments from Nationwide as contemplated by the terms of his contract with that organization. This contract, called an "Agent's Agreement," was one of several such contracts executed during Mr. Gump's thirty-six year tenure as a representative for Nationwide. The agreement in force at the time Mr. Gump retired (and pursuant to which he received the income at issue in this case) became effective on January 1, 1987. Its several provisions are of significance in resolving the issue in dispute here.

## **Compensation Under The Agent's Agreement**

Paragraph 7 of the Agent's Agreement lays out the terms of Mr. Gump's standard compensation. That compensation was determined pursuant to Nationwide's General Schedule; it consisted of original and renewal commissions earned by him on policies he wrote while working as an agent. Paragraph 11 of the agreement, titled "Agency Security Compensation," lays out the terms under which Mr. Gump became eligible for additional, post-affiliation, compensation. Two forms of such additional compensation are contemplated: Deferred Compensation Incentive Credits (DCIC) and Extended Earnings.

It is the latter, Extended Earnings, which plaintiffs claim is not subject to self-employment tax.

DCIC are essentially income credits accumulated during the agent's active service years that are paid out after termination of the agency agreement. These payments are supplemental to the schedule compensation earned pursuant to paragraph 7 and are calculated as a percentage of annual original and renewal commissions earned by the agent. Extended Earnings, by contrast, are determined against a narrower base, namely the renewal commissions paid the agent during the twelve month period immediately preceding termination of the Agent's Agreement. To be eligible to receive Extended Earnings, an agent must first meet the earnings threshold specified for participation in DCIC benefits.

There are several conditions attached to the receipt of additional compensation under paragraph 11. To begin with, no payments of either DCIC or Extended Earnings are distributable until there has been a "qualified cancellation" of the Agent's Agreement. Cancellation can occur either upon an agent's retirement, or upon an agent's death or disablement or through the parties' mutual agreement to dissolve the relationship. However, to effect a qualified cancellation of the agreement an agent must not have encouraged policyholders to allow their premium payments to lapse or to transfer purchase of their insurance requirements to another company. The agreement further stipulates that an agent must have been associated with the company for at least five years in order to become eligible for any compensation under paragraph 11.

Entitlement to both DCIC and Extended Earnings is further conditioned upon the return to the company of all records and materials that it provided to the agent for the conduct of business; additionally the agent may not engage in the sale of any competing insurance products in the same geographic area during the one-year period immediately following cancellation of the Agent's Agreement.

Finally, the agreement stipulates in paragraph 11g that benefits received under the Agency Security Compensation plan are intended to be in lieu of any state statutory or regulatory benefits and, to the extent an agent receives compensation from such alternate sources, benefits under the company plan are correspondingly reduced.

## **Mr. Gump's Retirement**

On December 31, 1989, Mr. Gump retired. Having satisfied all the conditions stipulated in paragraph 11 of the Agent's Agreement, he became entitled to the payment of additional compensation, specifically \$116,805.86 of DCIC and [pg. 95-8114] \$101,267.06 of Extended Earnings. These monies were disbursed in monthly installments of \$3,750.85 over a five-year period. Mr. Gump and his wife reported these payments on their 1990 and 1991 joint tax returns as self-employment income and paid the appropriate tax under I.R.C. section 1401(a).

On June 29, 1992, plaintiffs filed timely claims for refund with the Internal Revenue Service asserting that the Extended Earnings portion of their monthly payments was not self-employment income. On November 27, 1992, the Service summarily disallowed both claims for refund. The Service's position was that because Mr. Gump's affiliation with Nationwide had been that of an independent contractor rather than statutory employee, imposition of the self-employment income tax on the payments received from Nationwide was correct. Plaintiffs filed suit in this court on March 24, 1993, seeking a refund of \$5,464.00 for the 1990 tax year and \$5,095.00 for tax year 1991, along with interest, costs and attorney's fees.

## Discussion

[1] Section 1401(a) of the Internal Revenue Code imposes an old-age, survivor's and disability insurance tax "on the self-employment income of every individual...." Section 1402(b) identifies self- employment income as "net earning from self-employment." Section 1402(a), in turn, defines "net earnings from self-employment" as "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed...." Thus income subject to the self-employment tax is income that is; (i) derived (ii) from a trade or business (iii) carried on by the taxpayer.

The parties do not dispute that the activity of selling insurance constitutes the conduct of a trade or business within the meaning of the referenced Code sections. Nor is it disputed that payments received after retirement can be considered self-employment income. See Treas. Reg. section 1.1402(a)-1(c) (as amended in 1974) (self- employment income includes income received "even though such income may be attributable in whole or in part to services rendered or other acts performed in a prior taxable year...."). Thus the question we are left with is simply whether the Extended Earnings paid to Mr. Gump represent payments derived from his past activities as a sales agent for Nationwide.

It is hard to see how that question can be answered other than in the affirmative. Extended Earnings are part and parcel of the consideration promised by the company in return for the exclusive sales representation undertaken by the agent. Indeed, the value of those earnings—the amount that can be received—is tied directly to the level of renewal commissions generated by the agent in this final year of service. Since Extended Earnings represent a right to compensation established by the terms of the business relationship formalized in the Agent's Agreement they are necessarily "derived" from that relationship.<sup>3</sup> (In common parlance, "derived" is understood to mean "drawn, obtained, descended, or deduced from a source." 4 The Oxford English Dictionary 501 (2d ed. 1989)).

In an effort to avoid this conclusion, plaintiffs point out that had Mr. Gump entered into competition with Nationwide during his retirement years, the right to receive Extended Earnings benefits would have been forfeited. Therefore, plaintiffs contend, the real purposes motivating the payment of Extended Earnings was the protection of Nationwide's customer base. Accordingly, the argument continues, Extended Earnings cannot be regarded as payments derived from Mr. Gump's insurance agency. Rather, it is claimed, they represent the quid pro quo for his independent undertaking to refrain from entering into competing sales activity, either individually or in association with another company. We do not find this argument analytically sound.

Undoubtedly, preservation of a customer base was a material consideration underlying Nationwide's promise to pay Extended Earnings. That is evident from the conditional nature of the Company's obligation: "All liability of the Companies for Agency Security Compensation...shall cease...in the event" of the agent's marketing of competing products in the same geographic area within one year of the agreement's cancellation. However, the question here does not turn on the conditions plaintiff had to observe in order to *preserve* his eligibility to receive Extended Earnings. Rather, the focus has to be on those transactions or events that gave rise to the right to receive such earnings in the first instance. Therein lies their source. As we have noted, it is the business arrangement that was formalized in the agent's Agreement that is the source of the right in issue, specifically that part of the agreement setting forth Nationwide's promise to pay Extended Earnings to Mr. Gump in return for his success in obtaining renewal commissions in the final year of his service. Clearly, Extended Earnings are derived from Mr. Gump's insurance agency.

There is second argument to be consideration here. Plaintiffs contend that, even if the court should find Extended Earnings to be derived from Mr. Gump's insurance business, nevertheless, those earnings are to be excluded from the definition of self- employment income pursuant to the provisions of section 1402(a)(3)(A).

Section 1402(a)(3)(A) provides for exclusion from self-employment income of any gain or loss "which is considered as gain or loss from the sale or exchange of a capital asset." Plaintiffs insist that they meet the requirements for exclusion under section 1402(a)(3)(A) because, in their assessment, Extended Earnings can legitimately be construed as payments given for the sale of a business.

This argument too we reject; the Agent's Agreement offers no language to support it. Indeed, paragraph 11g of that agreement points quite the other way. That paragraph expressly declares that "Agency Security Compensation [meaning both Deferred Compensation Incentive Credits and Extended Earnings] is intended to be in lieu of the compensation and/or benefits awarded by any state statute or regulation" and election of such statutory benefits shall operate as a pro tanto reduction of benefits otherwise due under paragraph 11.

The agreement of the parties must be ascertained from the words through which it is expressed. Where those words give no hint of the purpose plaintiffs now seek to attribute to the payment of Extended Earnings, that purpose can gain no enforceable recognition. See *Lane Bryant Inc. v. United States*, 35 F.3d 1570, 1574 [74 AFTR 2d 94-6329] (Fed. Cir. 1994) ("[T]ax consequences flow from the agreement as written, not from later allegations of what was intended by the contracting parties.").

In addition to the arguments considered above, plaintiffs have raised other points in support of their position. Although we have considered these arguments, we feel it unnecessary to specifically address them here. Suffice it to say, these arguments do not alter the fact that the right to the income in issue was established by the terms of Mr. Gump's agency agreement. And since that agreement defined the terms of Mr. Gump's business, the income generated under it is necessarily income derived from the conduct of a trade or business. The court so holds.

## Conclusion

For the reasons stated, plaintiffs' motion for summary judgment is Denied and defendant's cross-motion is Granted. The Clerk shall enter judgment dismissing the complaint.

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<sup>1</sup>

Although the issues in this case center on Herbert Gump's business activities, Marilyn Gump appears as a co-plaintiff in the suit because she filed joint returns with her husband.

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<sup>2</sup>

Mr. Gump sold policies for a group of Nationwide insurance companies. This group shall be referred to as "Nationwide."

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<sup>3</sup>

The Tax Court has reached the \*\*\* result in similar cases. See *Lothar v. Koszewa*, 68 T.C.M. (CCH) 714, 716 [1994 RIA TC Memo ¶94,458] (1994) (denying the agent's claim because extended earnings payment were "integrally related to [the agent's] previous

business...."); Dunn v. Commissioner, 68 T.C.M. (CCH) 503, 606-607 [1994 RIA TC Memo ¶94,414] (1994) (finding payments "were derived exclusively from [the agent's] last year's sales performance or from the renewal rate in the first year after his retirement."). With respect to payments such as Extended Earnings, the Service has