1 T.C. 1180 (1943)

Payments to nonresident aliens for agreeing not to compete with a U.S. company are considered income from sources within the United States and are subject to withholding tax.

Summary

Korfund Co., a U.S. corporation, made payments to two nonresident aliens, Stoessel and Zorn, in exchange for their agreements not to compete with Korfund in the United States. The IRS determined that these payments constituted income from sources within the United States and were subject to withholding tax. Korfund argued that the income stemmed from the negative acts of refraining from competition, which originated in Germany where the aliens resided. The Tax Court held that the payments were indeed income from U.S. sources because they represented the value of the right to do business in the U.S., which Stoessel and Zorn relinquished.

Facts

Korfund Co., a New York corporation, manufactured and sold vibration absorbers. Hugo Stoessel, a nonresident alien residing in Germany, owned a majority of Korfund's stock. Korfund entered into agreements with Stoessel and Emil Zorn Aktiengesellschaft (Zorn), a German corporation also controlled by Stoessel, where they agreed not to compete with Korfund in the U.S. In return, Korfund made payments to Stoessel and Zorn. Korfund later ceased payments, leading to litigation and a final settlement in 1938. The IRS assessed withholding taxes on these settlement payments.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Korfund's income tax, asserting liability for withholding taxes on payments to nonresident aliens. Korfund petitioned the Tax Court for a redetermination of the deficiency.

Issue(s)

Whether payments made to nonresident aliens in exchange for agreements not to compete with a U.S. company constitute income from sources within the United States under Section 119 of the Revenue Act of 1938, and are therefore subject to withholding tax under Sections 143(b) and 144 of the same Act.

Holding

Yes, because the right to compete in the U.S. is a valuable property right located in the U.S., and payments made in exchange for relinquishing that right are considered income derived from U.S. sources.

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Court’s Reasoning

The Tax Court distinguished this case from cases where income was generated by activities or services performed outside the U.S. The court relied on cases like *Sabatini*, which held that payments for exclusive publishing rights in the U.S. were U.S.-sourced income. The court reasoned that Stoessel and Zorn possessed the right to compete with Korfund in the U.S., a right that had economic value. By relinquishing this right in exchange for payments, they were effectively receiving income derived from the use of that right within the U.S. The court stated that “the rights of Stoessel and Zorn to do business in this country, in competition with the petitioner, were interests in property in this country.” The income was “in lieu of what they might have received” had they competed. The court also dismissed Korfund’s argument that the negative nature of the act (refraining from competition) meant the income’s source was Germany, where the aliens resided.

Practical Implications

This case clarifies that payments for non-compete agreements are sourced based on where the competition would have occurred, not the residence of the party agreeing not to compete. It establishes that the right to conduct business within the U.S. is a valuable property right. This ruling impacts how companies structure agreements with foreign nationals, particularly in industries where competition is a key concern. Legal practitioners must consider this precedent when advising clients on the tax implications of non-compete agreements involving foreign entities. Later cases have cited *Korfund* to support the principle that the source of income is determined by the location of the income-producing activity or property right, regardless of the obligor’s location.

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