108 T.C. 25 (1997)

Goodwill inextricably linked to franchise rights and trademarks in a business sale is not treated as separate foreign-sourced goodwill for foreign tax credit purposes but is sourced based on the intangible asset it is embodied in, typically the seller's residence.

Summary

International Multifoods Corp. (Multifoods) sold its Asian and Pacific Mister Donut franchise operations, allocating a significant portion of the sale price to foreign-sourced goodwill. The Tax Court addressed whether the income from this sale, particularly the goodwill and a covenant not to compete, was foreign or U.S. source income for foreign tax credit limitations. The court held that the goodwill was inseparable from the franchise and trademarks, thus U.S. sourced income, while the covenant not to compete was severable and foreign sourced, albeit at a reduced allocated value. This case clarifies the sourcing of income from the sale of franchise businesses involving multiple intangible assets.

Facts

International Multifoods Corp. (Petitioner) franchised Mister Donut shops in the U.S. and internationally. In 1989, Petitioner sold its Asian and Pacific Mister Donut operations to Duskin Co. for $2,050,000. The sale included franchise agreements, trademarks, the Mister Donut System, and goodwill in operating countries (Indonesia, Philippines, Taiwan, Thailand) and trademarks and the Mister Donut System in non-operating countries. The purchase agreement allocated $1,930,000 to goodwill and a covenant not to compete. Petitioner reported this income as foreign source income to maximize foreign tax credits.

Procedural History

The Commissioner of Internal Revenue (Respondent) determined deficiencies in Petitioner's federal income taxes, arguing that the goodwill and covenant were inherent in the franchisor's interest, generating U.S. source income. Petitioner paid the deficiencies and petitioned the Tax Court, claiming an overpayment and seeking to maximize foreign tax credits based on foreign source income from the sale. The case proceeded in the United States Tax Court.

Issue(s)

1. Whether the income from the sale of goodwill associated with the Mister Donut franchise in Asia and the Pacific is foreign source income under Section 865(d)(3) when the goodwill is transferred as part of a sale of franchise rights and trademarks.
2. Whether the covenant not to compete provided in the sale agreement is severable from the franchise rights and trademarks and constitutes a separate

foreign source income asset.
3. Whether the allocation of the sale price to the covenant not to compete in the purchase agreement should be upheld for tax purposes.
4. Whether a pro rata portion of selling expenses should be allocated to the sale of the covenant not to compete.

Holding

1. No, because the goodwill was embodied in and inseparable from the franchisor's interest and trademarks, and thus, income from its sale is U.S. source income under Section 865(d)(1).
2. Yes, because the covenant not to compete possessed independent economic significance and was severable from the franchisor's interest and trademarks.
3. No, because the allocation in the purchase agreement was not the result of adverse tax interests between the parties and was not supported by sufficient evidence of its economic value beyond a reduced amount.
4. Yes, because a portion of selling expenses must be allocated to the sale of the covenant not to compete as it generated foreign source income.

Court's Reasoning

The court reasoned that while Section 865(d)(3) sources income from the sale of goodwill to the country where the goodwill was generated, this applies only to goodwill that is separate from other intangible assets listed in Section 865(d)(2), such as franchises and trademarks. The court stated, "If the sourcing provision contained in section 865(d)(3) also extended to the goodwill element embodied in the other intangible assets enumerated in section 865(d)(2), the exception would swallow the rule. Such an interpretation would nullify the general rule that income from the sale of an intangible asset by a U.S. resident is to be sourced in the United States."

The court found that the goodwill in this case was inextricably linked to the Mister Donut franchise system and trademarks. Quoting *Canterbury v. Commissioner*, the court noted, "The franchise acts as the repository for goodwill." Therefore, the sale of the franchise and trademarks, governed by Section 865(d)(1), resulted in U.S. source income because Multifoods was a U.S. resident.

Regarding the covenant not to compete, the court found it to have independent economic significance because it restricted Multifoods from re-entering the donut business in Asia and the Pacific, beyond merely protecting the franchise rights transferred to Duskin. However, the court reduced the allocated value of the covenant from $820,000 to $300,000, finding the initial allocation not to be the result of arm's-length bargaining and unsupported by sufficient valuation evidence. The court also mandated a pro-rata allocation of selling expenses to the covenant income, aligning with Section 862(b) and relevant regulations.

Practical Implications

International Multifoods provides critical guidance on sourcing income from the sale of franchise businesses with bundled intangible assets. It clarifies that for foreign tax credit purposes, goodwill is not always treated as foreign sourced simply because the business operates overseas. Attorneys should analyze whether goodwill is truly separate or embedded within other intangibles like franchises and trademarks. In franchise sales, especially, goodwill is likely to be considered part of the franchise itself, sourcing income to the seller's residence. Furthermore, the case underscores the importance of robust, arm's-length allocation of purchase price in agreements, particularly for covenants not to compete, and the necessity of allocating expenses proportionally to different income sources to accurately calculate foreign tax credits. Later cases will likely scrutinize allocations more carefully, demanding stronger evidence of independent economic value and adverse tax interests to uphold contractual allocations.

