Multifoods Distribution Group, Inc. v. Commissioner, 109 T. C. 303 (1997)

Income from the sale of intangible assets like franchises and trademarks is sourced in the seller's residence, while income from a covenant not to compete can be allocated to foreign source income if it has independent economic significance.

Summary

Multifoods Distribution Group, Inc. sold its Asian and Pacific Mister Donut operations to Duskin Co. for $2,050,000, allocating the sale price among goodwill, trademarks, and a covenant not to compete. The Tax Court held that income from the sale of franchises and trademarks was U. S. source income, as these assets were not separable from the goodwill they embodied. However, the court allocated $300,000 of the sale price to the covenant not to compete, treating it as foreign source income due to its independent economic significance. This decision underscores the importance of distinguishing between the sale of intangible assets and separate covenants, affecting how businesses allocate income for tax purposes.

Facts

Multifoods Distribution Group, Inc. (Multifoods), through its subsidiary Mister Donut, sold its Asian and Pacific operations to Duskin Co. (Duskin) on January 31, 1989, for $2,050,000. The sale included existing franchise agreements, trademarks, the Mister Donut System, and goodwill in operating countries, and trademarks and the Mister Donut System in nonoperating countries. Multifoods allocated the sale price as follows: $1,110,000 to goodwill, $820,000 to a covenant not to compete, and $120,000 to trademarks. Multifoods reported the goodwill and covenant income as foreign source income, and the trademark income as U. S. source income.

Procedural History

Multifoods paid the assessed deficiencies and filed a petition with the Tax Court claiming an overpayment of income tax for the taxable years ended February 28, 1987, and February 29, 1988. Multifoods sought to amend its petition to claim an increased overpayment due to a foreign tax credit carryback from the 1989 taxable year. The court granted the motion in part. The central issue was the sourcing of income from the sale to Duskin.

Issue(s)

1. Whether the income from the sale of goodwill, franchises, and trademarks should be sourced as foreign income under Section 865(d)(3) of the Internal Revenue Code.
2. Whether the covenant not to compete had independent economic significance, and if so, what portion of the sale price should be allocated to it.

Holding

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1. No, because the income from the sale of franchises and trademarks is sourced in the United States under Section 865(d)(1), as these assets embody the goodwill and are not separately sourced under Section 865(d)(3).
2. Yes, because the covenant not to compete had independent economic significance, and $300,000 of the sale price was allocated to it as foreign source income.

Court's Reasoning

The court reasoned that goodwill is an expectancy of continued patronage and is embodied in intangible assets like franchises and trademarks. Therefore, income from these assets is sourced in the seller's residence under Section 865(d)(1). The court rejected Multifoods' argument that the entire sale constituted goodwill, finding that the franchises and trademarks were the repositories of goodwill. Regarding the covenant not to compete, the court found it had independent economic significance, as it prohibited Multifoods from reentering the doughnut business in the sold territories. The court valued the covenant at $300,000, lower than Multifoods' expert's valuation, due to concerns about the expert's assumptions and calculations. The court also held that a pro rata portion of selling expenses must be allocated to the covenant.

Practical Implications

This decision clarifies that income from the sale of intangible assets like franchises and trademarks is sourced in the seller's residence, affecting how multinational corporations allocate income for tax purposes. It emphasizes the need to distinguish between the sale of intangible assets and separate covenants not to compete, as the latter can be treated as foreign source income if it has independent economic significance. Businesses must carefully allocate sale proceeds and consider the tax implications of such allocations. The ruling may impact how companies structure transactions involving intangible assets and covenants, potentially affecting their tax planning strategies and the negotiation of sale agreements.

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