GOODWILL AND MISTER DONUT – A GOING CONCERN?

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INTRODUCTION

A sale of a business to a buyer often involves an element of goodwill, a term that can have different meanings in different contexts, depending on whether the term relates to (i) purchase price allocations for financial statement purposes or income tax purposes or (ii) attempting to compute the source of income for foreign tax credit purposes. Compounding the definitional inconsistency, the meaning of the term has changed over time.

The Merriam-Webster Dictionary defines goodwill in a non-business context as "a kind, helpful, or friendly feeling or attitude." In a business context, the term is given various definitions, including

- the amount of value that a company's good reputation adds to its overall value,
- the favor or advantage that a business has acquired especially through its brands and its good reputation,
- the value of projected earnings increases of a business especially as part of its purchase price, or
- the excess of the purchase price of a company over its book value which represents the value of goodwill as an intangible asset for accounting purposes.

This article examines the evolution of the international tax consequences of controlled and uncontrolled sales of goodwill by a U.S. corporation, and begins with a 1989 sale of a regional donut shop franchise business operated outside the U.S. to an uncontrolled Japanese buyer.

THE INTERNATIONAL MULTIFOODS CORPORATION CASE

Taxpayer's Franchising Business

International Multifoods Corporation v. Commr.[1] is a case that involves a U.S. corporation ("U.S. Co") that operated a donut store franchising business. It perfected a system that utilized franchisees to prepare and merchandise distinctive donuts, pastries, and other food products. The franchise agreements refer to this system as the "Mister Donut System," which entailed a unique and readily recognizable design, color scheme and layout for the premises wherein such business is conducted and for its furnishings, signs, emblems, trade names, trademarks, certification marks, and service marks.

[1] 108 T.C. 25 (1997).

U.S. Co typically granted franchisees the right to open a fixed number of Mister Donut shops pursuant to established terms and conditions and at locations approved by U.S. Co. The franchise agreements provided that U.S. Co would not open or authorize others to open any Mister Donut shops in the franchisee's territory until the franchise agreement expired or was terminated, or unless the franchisee did not meet its development schedule by failing to open the requisite number of Mister Donut shops by the agreed-upon date. In the event the franchisee failed to open the agreed-upon number of shops, it lost its exclusive rights in the territory and could not open any additional Mister Donut shops.

Franchisees were entitled to use the building design, layout, signs, emblems, and color scheme relating to the Mister Donut System, along with petitioner's copyrights, trade names, trade secrets, know-how, and preparation and merchandising methods, as well as any other valuable and confidential information. However, U.S. Co retained exclusive ownership of its current and future trademarks, as well as any additional materials that constituted an element of the Mister Donut System. Use of these assets was prohibited after the termination of the franchise agreement.

Sale of Franchising Business

In early 1989, U.S. Co sold its Asian and Pacific Mister Donut franchising business to a Japanese purchaser for $2.05 million. Pursuant to the agreement, U.S. Co transferred its franchise agreements, trademarks, Mister Donut System, and goodwill for each of the Asian and Pacific countries in which U.S. Co had existing franchise agreements, as well as its trademarks and Mister Donut System for those Asian and Pacific countries in which it had registered trademarks but did not have franchise agreements. From the viewpoint of U.S. Co, the agreed price for the transaction took into account (i) the royalty income generated in the operating countries, (ii) the growth potential in the operating countries, (iii) the development potential in the nonoperating countries, and (iv) the value of the trademarks in the operating and nonoperating countries.

As a condition of the contract, U.S. Co agreed to a noncompete covenant for 20 years covering all countries in which franchising arrangements were in place or where trademarks were registered within the territory, but franchises did not exist. As a condition to full payment, U.S. Co needed to obtain consents of all franchisees.

Goodwill Reported as a Separate Asset from Trademarks and Systems

At the suggestion of U.S. Co's tax department, the asset purchase agreement did not allocate the purchase price to the assets sold. The ostensible reason given in a memorandum was concern that certain countries within the territory might consider imposing withholding taxes on the amounts allocated to local trademarks. Although not in the memorandum, the advice reflected divergent tax treatment for the source of gains when computing the foreign tax credit limitation of a U.S. taxpayer under the rules of U.S. tax law.

- Section 865(a)(1) of the Internal Revenue Code then in effect ("Code") provided that income from the sale of personal property by a U.S. resident is generally sourced in the U.S.
- Code §865(d)(1)(A) provided that in the case of any sale of an intangible, the general rule would apply only to the extent that the payments in consideration of such sale were not contingent on the productivity, use, or disposition of the intangible.

- Code §865(d)(2) defined "intangible" to mean any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property.
- Code §865(d)(3) carved out a special sourcing rule for goodwill. Payments received in consideration of the sale of goodwill are treated as received from sources in the country in which the goodwill was generated.

Consistent with the foregoing tax rules controlling the source of income, the tax department of U.S. Co ultimately advised that amounts allocated to goodwill and the noncompete provision would produce foreign source income for U.S. Co that in theory could release unused foreign tax credits from earlier years. The effect would be that no U.S. cash tax would be paid with regard to those items and previously unused foreign tax credits would be used, thereby producing a benefit.

Based on a purchase price allocation report prepared by a major accounting firm for use by U.S. Co, $1.93 million of the sale price was allocated to goodwill and a covenant not to compete. On its 1989 Federal income tax return, U.S. Co reported the income allocated to those assets as foreign source income for purposes of computing the foreign tax credit limitation under Code §904(a).

"According to the court, U.S. Co was mistaken when it attempted to separate goodwill from the assets in which the goodwill was embodied. Goodwill represents an expectancy that old customers will resort to the old place of business."

Challenge to Separate Asset Called Goodwill

The I.R.S. examined the tax returns for the years involved and disallowed the company's application of Code §865(d)(3). It contended that U.S. Co sold a global franchise to the purchaser and that all the value was in the trademarks and the Mister. Donut System, and treated the gain as being derived from U.S. sources. The unused foreign tax credits from prior years no longer produced a cash tax benefit.

The company filed a petition to the Tax Court challenging the deficiency asserted by the I.R.S. based on the fact that the goodwill in issue was attributable to the foreign trademarks used in the foreign markets in which the company conducted its franchising business. The court agreed with the I.R.S. According to the court, U.S. Co was mistaken when it attempted to separate goodwill from the assets in which the goodwill was embodied. Goodwill represents an expectancy that old customers will resort to the old place of business.[2] The essence of goodwill exists in a preexisting business relationship founded upon a continuous course of dealing that can be expected to continue indefinitely.[3] The value of every intangible asset is related, to a greater or lesser degree, to the expectation that customers will continue their patronage.[4] An asset does not constitute goodwill, however, simply because it contributes to this expectancy of continued patronage.

The court agreed with the I.R.S. that the purchaser acquired a franchise from U.S. Co to operate, relying on the definition found in Code §1253(a). Under that provision, a franchise includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area. That was the essence of U.S. Co's agreement with the purchaser. It then

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2 *Houston Chronicle Publishing Co. v. U.S.,* 481 F.2d 1240, 1247 (5th Cir. 1973); Canterbury v. Commr, 99 T.C. 223, 247 (1992).

3 *Canterbury v. Commr., supra*; *Computing & Software. Inc. v. Commr*., 64 T.C. 223, 233 (1975).

4 *Newark Morning Ledger Co. v. U.S.,* 507 U.S. 546, 556. (1993).

concluded that the goodwill associated with the franchise business was part of, and inseverable from, the franchisor's rights and trademarks acquired by the purchaser.

> While there are no cases on point under section 865, case law interpreting other provisions of the Code supports respondent's position. In *Canterbury v. Commissioner*, 99 T.C. 223 (1992), we considered whether the excess of a franchisee's purchase price of an existing McDonald's franchise over the value of the franchise's tangible assets was allocable to the franchise or to goodwill for purposes of amortization pursuant to section 1253(d)(2)(A). We recognized that McDonald's franchises encompass attributes that have traditionally been viewed as goodwill. The issue, therefore, was whether these attributes were embodied in the McDonald's franchise, trademarks, and trade name, which would make their cost amortizable pursuant to section 1253(d)(2)(A), or whether the franchisee acquired intangible assets, such as goodwill, which were not encompassed by, or otherwise attributable to, the franchise and which were nonamortizable.
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> We found that the expectancy of continued patronage which McDonald's enjoys "is created by and flows from the implementation of the McDonald's system and association with the McDonald's name and trademark." Id. at 248 (fn. ref. omitted).

Because no portion of U.S. Co's gain from the sale of its Mister Donut franchise business was attributable to a separate asset called "goodwill," the entire gain produced domestic source income for a U.S. corporate tax resident. Previously unused foreign tax credits were not available to offset U.S. tax on any portion of the U.S. Co's gain.

Legacy of Court's Decision

International Multifoods reinforced a long line of thought that goodwill is generally inseparable from trademarks and other marketing intangibles. It did not provide a promising path forward for other taxpayers that might want to allocate amounts toward goodwill, and thereby change the source of the income. The court defined goodwill as the "expectancy of continued patronage."[5] Less established companies naturally have less of a track record that might draw customers back in. Trademarks and other forms of branding may have a bigger role in attracting repeat customers. In other words, business goodwill might be more tied to other intangibles and less able to stand on its own.

Such reasoning seemed particularly relevant to Mister Donut. All its Asia-Pacific franchises were fairly new. In several countries for which Mister Donut sold franchise rights, Mister Donut owned registered trademarks in jurisdictions where operations were not yet carried on. Whatever goodwill it had in such countries could only be attributed to its franchise system. But dominance of franchise rights value is equally true for more established companies. The court relied on older cases involving franchises by more familiar names, such as McDonald's and Coca-Cola, that similarly held goodwill to be inseparable from the companies' franchises. The message of *International Multifoods* was that for most businesses, new and old, separating goodwill from other intangibles is a difficult task.

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[5] Citing *Houston Chronicle Publishing Co.,* 481 F.2d 1240. (1973).

The I.R.S. applied this logic in the context of like-kind exchanges. In Technical Advice Memorandum ("T.A.M.") 200602034, the I.R.S. held that trademarks are part of goodwill, going concern value, or both. As goodwill and going concern are unique to each business, trademarks were unique to each business, as well. Consequently, an exchange of trademarks could not qualify for nonrecognition as a like-kind exchange within the meaning of Code §1031.

Three years later, the I.R.S. explicitly rescinded T.A.M. 200602034 with Chief Counsel Advice ("C.C.A.") 200911006, which concluded that trademarks and similar assets can qualify for favorable like-kind exchange tax treatment. The conclusion reached in C.C.A. 200911006 provided support for the possibility of separating goodwill from marketing-based intangibles. The I.R.S. stated:

> Upon further consideration, the Office of Associate Chief Counsel (Income Tax & Accounting) has concluded that the analysis of Newark Morning Ledger Co. applies in determining whether intangibles constitute goodwill or going concern value within the meaning of §1.1031(a)-2(c)(2). Accordingly, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill qualify as like-kind property under §1031. In our opinion, except in rare and unusual situations, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles can be separately described and valued apart from goodwill.

The I.R.S.'s *volte-face* was driven by *Newark Morning Ledger*, a Supreme Court case that preceded *International Multifoods*.[6] In *Newark Morning Ledger*, a newspaper wanted to take deductions related to its amortization of its "paid subscribers." The I.R.S. argued that the asset was too connected to goodwill, which was not amortizable.[7] The Supreme Court focused on whether paid subscribers should be an amortizable asset, but in deciding in favor of the newspaper, it rejected the I.R.S.'s argument that goodwill could not be distinguished from paid subscribers.

Yet, *Newark Morning Ledger* covered fairly narrow grounds and focused on a specific type of intangible asset. Nothing in the case necessarily contradicted the long-standing idea that marketing-based intangibles like trademarks are inseparable from goodwill. *International Multifoods* mentioned the case but was not bound by it. And the Supreme Court even warned other taxpayers that the burden of splitting goodwill from other intangibles would still be "too great to bear" in most cases.

A conservative reading of C.C.A. 20091106 is that it applies only to like-kind exchanges. The case also lacked a franchise, which was an important factor in *International Multifoods*. There are ways to distinguish C.C.A. 20091106 from *International Multifoods*. For a franchisee, goodwill is embedded in the trademark, the brand advertising, the layout of the premises, and the sale of a standardized product.

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6 507 U.S. 546 (1993).

7 This is no longer an issue due to Code §197 allowing for amortization of goodwill.

Is one franchisee's Mister Donut donut different from another franchisee's Mister Donut donut? Yet, the comment that goodwill can usually be split from trademarks and other intangibles is generally stated. Whether by accident or by design, the I.R.S. has cast doubt on the relevance of *International Multifoods*, at least within the newspaper industry.

Status of the Statutes

Other changes have followed this trend. Valuation of goodwill was important in the context of Code §367, which requires gain recognition for transfers of certain property to foreign corporations, with Code §367(d) covering intangible property. Goodwill was originally not included in Code §367(d), because it was already located outside the U.S. This created an incentive to allocate sums to goodwill, since it could escape recognition treatment. The Tax Cuts and Job Acts of 2017 ("T.C.J.A.") added goodwill to Code §367(d), removing one need to value goodwill separately from other intangibles.[8] The preamble to the Code §367 regulations suggest that the I.R.S. wanted to reduce the number of difficult goodwill valuation fights.

But it would be hasty to conclude that *International Multifoods* is of no relevance. The impetus behind the case – the favorable sourcing rule for goodwill in Code §865(d)(3) that can be used to access unused foreign tax credits – still exists. C.C.A. 20091106 might have given fresh vigor to taxpayers hoping to take advantage of this rule.

International Multifoods may have drawn some helpful lines for taxpayers looking to fiddle with goodwill allocation. The court found that the existence of a franchise system subsumed all the goodwill in Mister Donut's franchising business. Mister Donut not only allowed the purchaser the use of its franchise system but dumped all its rights in Asia-Pacific into the agreement:

> Petitioner not only sold [the purchaser] petitioner's rights as franchisor in the existing franchise agreements in the operating countries, but also all its rights to exclusive use in the designated Asian and Pacific territories of its secret formulas, processes, trademarks, and supplier agreements; *i.e.*, its entire Mister Donut System.

This was backed up by the existence of noncompete covenants that prevented the parties from operating in each other's region. Taxpayers looking to benefit from a favorable goodwill allocation might be advised to move away from using franchises. Given opportunities for intangible allocation arbitrage still exist, these are still useful lessons.

CONTROLLED SALES OF GOODWILL

International Multifoods was a case about an uncontrolled sale of goodwill. Is the decision relevant for controlled sales of goodwill? At the time of *International Multifoods*, goodwill was not defined as an intangible asset under Code §367(d), but was defined under Code §936(h)(3)(B)(vi) as any similar item, which has substantial value independent of the services of any individual.

Following the *International Multifoods* decision in1997, goodwill became a definitional component of all other intangible property under Code §936(h)(3)(B)(i)-(v), namely:

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8 See "Controlled Sales of Goodwill," below, for further discussion of this change.

(i) patent, invention, formula, process, design, pattern, or know-how,

(ii) copyright, literary, musical, or artistic composition,

(iii) trademark, trade name, or brand name,

(iv) franchise, license, or contract,

(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data.

"Where the acquirer of goodwill planned to earn passive income, cost-sharing arrangements were adopted as replacements for actual transfers, especially as large tech companies began expansion outside the U.S. after the 1990's."

At that time, the definition of an intangible asset under Treas. Reg §1.482-4 referenced Code §367(d), which in turn referenced Code §936(h)(3)(B).[9] Controlled transactions that were nonrecognition transactions under Code §351 or §361 often relied on the active-trade-or-business exemption under Code §367(a)(3) to conclude a transfer of goodwill by the U.S. transferor without the recognition of any gain for the transferred goodwill asset. Other sale transactions involving a buyer that planned to use the transferred goodwill to earn income other than active business income relied on an accurate estimation or valuation of the arm's length consideration payable to the seller.

Valuation issues or issues with the application of a selected transfer pricing method dominated definitional issues in the context of a controlled transaction where the foreign acquirer's intent was the generation of passive income. Here, the cost approach to valuation likely would not have captured the dynamic effect of continued business patronage at the heart of goodwill value. The income approach that used a limited useful life or a steeply declining royalty rate over time may not have captured the momentum effect of goodwill in future sales or margins. Among the key assumptions that required robust support were (i) customer retention and (ii) an understanding of the way in which a retained customer base grows and contributes to sales and margins. Required forecasting assumptions may have influenced intangible asset value in transactions at that time.

Where the acquirer of goodwill planned to earn passive income, cost-sharing arrangements were adopted as replacements for actual transfers, especially as large tech companies began expansion outside the U.S. after the 1990's. One-time or lump-sum sales of goodwill therefore gave way to buy-in payments, known currently as platform contribution transaction payments, followed by cost-sharing payments between the participants over the term of a cost-sharing agreement.

Following the decision in International Multifoods, the citation trail is almost nonexistent in the context of controlled goodwill sales and its influence diminishes much the same way as uncontrolled goodwill sales.

2017 T.C.J.A.

Treasury clarified the valuation or quantification issue by codifying the requirement for aggregate valuation of intangible property transferred in foreign controlled transactions as part of the 2017 T.C.J.A.[10] At the same time, the definition of an intangible

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[9] As mentioned below in connection with the 2017 T.C.J.A., the list in Code §936(h)(3)(B) has been moved to Code §367(d)(4). In addition, two new categories of intangible property have been added.

[10] Dec. 22, 2017, 131 Stat. 2219, Pub. L. 115-141.

asset under Code §936 was replaced by an expanded definition under new Code §367(d)(4) that explicitly includes (i) goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment) and (ii) any other item, the value or potential value of which is not attributable to tangible property or the services of any individual.

Goodwill and Chapter VI of the 2017 OECD Guidelines

In the 2017 edition of the O.E.C.D. Guidelines,[11] goodwill is handled not as a separate intangible asset but rather as a component of value of other intangible assets in the context of a controlled sale or other transfer. As such, it is consistent with the Tax Court's decision in *International Multifoods*. Going concern value is accorded the same treatment.[12] The I.R.S. view of goodwill as part of an aggregate intangible asset transfer is therefore currently consistent with the controlled transaction treatment of goodwill by other O.E.C.D. member state treaty partners.

CONCLUSION

Has the precedential value of *Mister Donut* gone stale?

The general approach of *International Multifoods* to foreign goodwill sales in the controlled transaction context remains very much in line with current law and is broadly consistent with multilateral guidance when Competent Authority is asked to address intangible property transactions with treaty partners.

In a unilateral context, the well-established theory behind *International Multifoods* is of uncertain status. The I.R.S.'s comments in C.C.A. 200911006 make it unclear whether the I.R.S. has fundamentally shifted its thinking or whether those remarks were intended to apply only in specific contexts. Either way, *International Multifoods* still matters. The taxpayer was unsuccessful, but it might only have provided an example of how not to play games with goodwill.

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[11] O.E.C.D. (2017), O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, O.E.C.D. Publishing, Paris.

[12] *Id.* paragraph 6.28.