CORPORATE TAX - USA

Coca-Cola Company challenges $9 billion transfer pricing adjustments

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Introduction

On September 17 2015 the Internal Revenue Service (IRS) issued a statutory notice of deficiency to the Coca-Cola Company, increasing its federal income taxes for 2007 to 2009 by $3.3 billion, based primarily on transfer pricing adjustments exceeding $9 billion. On December 14 2015 Coca-Cola petitioned the US Tax Court to overturn the adjustments.

This is a major case; the $9 billion income adjustment relates to only three years and there is no reason to think that the numbers will fall going forward. This update summarises key aspects of Coca-Cola's petition and the key takeaways.

Petition

The principal dispute involves transfer pricing between Coca-Cola and seven related foreign licensees (collectively, the 'licensees'). The licensees manufactured concentrate for sale to bottlers outside the United States. The IRS claims that royalties paid by the licensees to Coca-Cola for the use of trademarks and formula rights were less than arm's length. The IRS apparently made this determination based on a 'comparable profits method' (CPM) approach that tested the licensees' return on operating assets against that of selected unrelated companies.

In its petition, Coca-Cola makes the following claims:

- The IRS had accepted Coca-Cola's non-CPM transfer pricing model for 20 years, first in a closing agreement covering 1987 to 1995 and then in successive audits covering 1996 to 2006. The closing agreement went so far as to provide prospective penalty protection as long as the methodology was followed. The IRS gave no explanation for its departure from this approved methodology in the 2007 to 2009 audits.
- The IRS improperly applied the CPM to the licensees. The licensees bore substantially all entrepreneurial risk and responsibility for their businesses, and were part of local business units and regional operating groups with important decision-making authority for their operations. They had invested more than $45 billion in pre-royalty operating and marketing expenses and paid the parent more than $18 billion in royalties from 1987 to 2009. The petition implies that allocating only routine returns to the licensees, while assigning all non-routine profits to the parent (the legal owner of the intangibles), was inconsistent with an appropriate functional/risk analysis.
- The CPM analysis used inappropriate comparables. The IRS used beverage bottlers as comparables, rather than manufacturers such as the licensees.
- The petition implies that in applying the CPM, the IRS ignored the consequences of two rulings it had previously issued with respect to 26 US Code Section 367 transfers of intangibles to the Brazil and Ireland licensees.

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- The IRS took inconsistent positions. In a separate adjustment covered by the petition, the IRS had priced transactions between Coca-Cola US and its Canadian subsidiary (not one of the licensees) by allocating a routine return to the legal owner of the intangible property (the Canadian subsidiary) and all residual profit to the entity allegedly bearing the entrepreneurial risk (the US parent).
- The IRS improperly applied transfer pricing principles (the CPM) to reduce the income of a Mexican branch of a US group member and thereby reduce creditable foreign taxes. Coca-Cola claims to have exhausted all effective and practical remedies (including seeking competent authority relief) with respect to the Mexican taxes so as to entitle it to the credit.
- The IRS disregarded foreign legal restrictions (Brazilian currency and royalty limits) in making certain of the adjustments.
- After adjustment by the IRS, the royalties exceeded 100% of the licensees' aggregate operating profits – implicitly suggesting that the adjustments were unreasonable.
- The royalties paid pursuant to the closing agreement methodology (as well as intercompany charges for headquarters expenses) were actually excessive, not to the contrary.

Key takeaways

Although IRS resources are low and ebbing, the IRS Transfer Pricing Office is attempting to standardise the IRS approach to transfer pricing cases, both through the guidance and support of the transfer pricing practice and through publication of international practice units. The IRS is also carefully selecting cases for litigation.

The IRS's approach in *Coca-Cola* portends a number of behaviours in other cases.

Willingness to ignore past agreements
The IRS is not always happy with the closing agreements it reaches and *Coca-Cola* may be a case in point. The *Eaton* case pending in the Tax Court also involves an IRS departure from past closing agreements (and advance pricing agreements).

Willingness to ignore long-term risk allocations
In *Coca-Cola* the IRS relied on a CPM for some long-term licensees. Whatever the value of the intangibles licensed to the licensees, ignoring the entrepreneurial risks that they undertook – as a CPM test may do – seems arbitrary. Conversely, the IRS may assert that the selected comparables faced similar risks and owned similar intangibles.

Willingness to ignore informal shared intangible development arrangements
The outcome of accepting risk is in some contexts the ownership of soft intangibles resulting from the associated expenditures. Although Coca-Cola US owned the trademarks and formula rights, the licensees were responsible for developing local marketing strategies and relationships (expenses that the IRS often asserts give rise to intangibles). The IRS seemed to ignore any such intangibles as well as the intangibles transferred in 26 US Code Section 367 transactions to the Brazilian and Irish licensees. Again, the IRS may assert that its analysis is sound because the comparables faced similar risks and owned similar intangible assets.

Application of transfer pricing principles to determine foreign-source income
While there are circumstances in which transfer pricing principles may be applied to determine a US company's foreign-source income (eg, where US sourcing rules apply a facts and circumstances analysis or where the authorised Organisation for Economic Cooperation and Development approach applies to determine the profits of a permanent establishment), the petition suggests that the IRS did so here based on 26 US Code Section 482, and that this was improper. The IRS took an expansive (some might say aggressive) approach in this regard in a 2013 chief counsel advice memorandum.

Continued defence of IRS regulations with respect to foreign legal restrictions
The case involves a reprise of the issues raised in the ongoing *3M* Tax Court litigation (relating to Brazilian royalty limits) and adds Brazilian currency-remittance restrictions to the discussion.(1)

Comment

The IRS is yet to comment, but will undoubtedly offer robust defences for its positions. However, if

Coca-Cola is correct that the IRS abandoned a long-accepted transfer pricing methodology in the absence of a material change of facts, the IRS may be hard pressed to sustain the adjustments. Two of its substantive positions may be particularly problematic.

First, applying the CPM in these circumstances may have been aggressive. Unless the comparables used in the analysis also accept entrepreneurial risk, have responsibility for managing a complex business model and own some valuable intangibles, they likely are not truly comparable. The functional differences between manufacturers and bottlers also seem significant. It will be highly pertinent to learn what transfer pricing methodology was used in the IRS closing agreement for 1987 to 1995. Whether the IRS can defend the comparability of the companies it selected is thus the key issue in the case.

Second, the seemingly inconsistent position taken by the IRS with respect to the Canadian operation invites scrutiny. Given the significant adjustments relating to the seven licensees, one may wonder whether adding as a taxpayer target the much smaller adjustments relating to the Canadian subsidiary (some 2% of total adjustments) was a good strategy.

For further information on this topic please contact J Clark Armitage, Patricia G Lewis or Natalie Punchak at Caplin & Drysdale by telephone (+1 202 862 5000) or email (carmitage@capdale.com, plewis@capdale.com or npunchk@capdale.com). The Caplin & Drysdale website can be accessed at www.caplindrysdale.com.

Endnotes

(1) Treas Reg § 1.482-1(h)(2).
