Is It the Real Thing?
The IRS Makes $9+ Billion of Transfer Pricing Adjustments Against The Coca-Cola Company

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

This is a huge case. The $9 billion income adjustment relates only to three years and there's no reason to think the numbers will fall going forward. In this alert, we summarize some key aspects of Coca Cola's petition and suggest what to watch for as the case progresses.

The Petition

The principal dispute involves transfer pricing between Coca-Cola and seven related foreign licensees (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 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 Tax Court petition, Coca-Cola contends that:

- The IRS accepted Coca-Cola's non-CPM transfer pricing model for 20 years, first in a closing agreement covering 1987-1995, then through successive audits covering 1996-2006. 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 2007-2009 audit.

- The IRS improperly applied the CPM to the Licensees. The Licensees bore substantially all entrepreneurial risk and responsibility for their businesses. The Licensees were part of local business units and regional operating groups with important decision-making authority for their operations. They invested more than $45 billion in pre-royalty operating and marketing expenses and paid the parent more than $18 billion in royalties for 1987-2009. The petition seems to imply that allocating only "routine" returns to the Licensees, while assigning all non-routine profits to the parent (the legal owner of the intangibles), is inconsistent with an appropriate functional/risk analysis.

- Moreover, the CPM analysis uses inappropriate comparables. The IRS used beverage bottlers as comparables rather than manufacturers like the Licensees.

- In applying the CPM, the petition seems to imply that the IRS ignored the consequences of two rulings it had earlier issued with respect to Code section 367 transfers of intangibles to the Brazil and Ireland Licensees.

- The IRS took inconsistent positions. In a separate adjustment covered by the petition, the IRS 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 aggregate operating profits of the Licensees – implicitly suggesting 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 the contrary

Key Take-Aways

Although IRS resources are low and ebbing, the IRS Transfer Pricing Office is attempting to standardize 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. What then does the IRS's approach in the Coca-Cola case portend for IRS behavior in other cases?

- *A willingness to ignore past agreements*. The IRS is not always happy with the closing agreements it reaches ("buyer's remorse" . . .) and Coca-Cola may be a case in point. The pending *Eaton* case in the Tax Court also involves an IRS departure from past closing agreements (and APAs).

- *A willingness to ignore long-term risk allocations*. In Coca-Cola, the IRS relied on a CPM for some (very) 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. The IRS may, on the other hand, assert that the selected comparables faced similar risks and owned similar intangibles.

- *A 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 Code section 367 transactions to the Brazilian and Irish Licensees. Again, the IRS may assert that its analysis is not flawed 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 where transfer pricing principles may be applied to determine a US company's foreign source income (e.g., where US sourcing rules apply a facts and circumstances analysis or where the Authorized OECD Approach applies to determine the profits of a permanent establishment), the petition suggests that the IRS did so here based on 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 (and unsurprising) defense of IRS regulations with respect to foreign legal restrictions (Treas. Reg. § 1.482-1(h)(2))*. The case involves a reprise of the issues raised in the on-going *3M* Tax Court litigation (Brazilian royalty limits), and adds Brazilian currency-remittance restrictions to the discussion.

Conclusion

We have heard so far from only one party. The IRS undoubtedly will offer robust defenses for its positions. However, if Coca Cola is correct that the IRS abandoned a long-accepted TPM 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 be 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. And the functional differences between manufacturers and bottlers seem significant. Of course, it will be highly pertinent to learn what TPM was used in the IRS closing agreement for 1987-1995. 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 huge adjustments relating to the seven Licensees, one has to 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.

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