IRS Wins Big in *The Coca-Cola Company & Subs. v. Commissioner*

November 23, 2020

On November 18, 2020, the Tax Court ruled that respondent IRS had not abused its discretion under § 482 when it reallocated more than $9 billion in income for 2007-2009 to petitioner Coca-Cola from its foreign manufacturing affiliates.[1]

This significant transfer pricing case evaluated the relationships among the U.S. parent company (Coca-Cola), its foreign manufacturing affiliates (known as "supply points"), its local foreign service companies ("ServCos"), its independent foreign bottlers, and its "extremely valuable" intangible assets, including trademarks, logos, patents, secret formulas, and "the best known brand in the world."[2] This follows an earlier decision in this case[3] on whether taxes that Coca-Cola paid to Mexico were compulsory (and so creditable foreign taxes), notwithstanding the IRS position that Mexican taxes had been overpaid. The Tax Court concluded in the earlier decision that the taxes were creditable because the taxpayer met both prongs of the compulsory test. The taxpayer had relied on the advice of competent tax counsel in applying the transfer pricing method on which its return position was based, and would have sought competent authority relief (as a last step in exhausting its remedies to obtain a refund of the Mexican tax), but had been turned away by the IRS, which anticipated litigating the case.

The decision tackles so many distinct transfer pricing topics that no "alert" could do them all justice. We provide here a summary of key decision points.

Comparable Profits Method (CPM) Judged Most Appropriate

The Tax Court considered the IRS's use of a CPM analysis to be an appropriate, reliable, and conservative transfer pricing method for determining how much the supply points should have paid Coca-Cola for using its intellectual property. The Tax Court found that Coca-Cola's supply points were essentially "wholly-owned contract manufacturers" executing steps in the beverage-production process, and that Coca-Cola, rather than its supply points, owned "virtually all the intangible assets needed to produce and sell" the company's beverages.[4] In light of these findings, the Tax Court concluded that the CPM was "ideally suited" to determining Coca-Cola's compensation for the use of its intellectual property, because the CPM would be able to determine an arm's length profit for the supply points without needing to determine the value of Coca-Cola's uniquely valuable intangible assets.[5] The Tax Court agreed with the IRS that Coca-Cola's independent bottlers were appropriate comparable parties for the CPM analysis, because they operated in the same industry, with similar relationships to Coca-Cola, using Coca-Cola's intangible assets to perform similar functions. In addition, because the Tax Court found that these bottlers generally were entitled to a higher rate of return that the supply points, the Tax Court considered the IRS's CPM conservative.

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[1] *The Coca-Cola Company & Subs. v. Commissioner*, 155 T.C. No. 10 (Nov. 18, 2020) ("Opinion").
[2] Opinion at 7-8.
[3] *The Coca-Cola Company & Subs. v. Commissioner*, 149 T.C. 446 (2017).
[4] Opinion at 118, 169.
[5] Opinion at 118.

Applying this CPM during audit, the IRS determined that the ratio of operating profit to operating assets (ROA) for six of Coca-Cola's seven supply points during 2007-2009 was between 215% and 94%.[6] The interquartile range of ROAs of Coca-Cola's independent bottlers was 7.4% and 31.8%. After the IRS reallocation of income from the supply points to Coca-Cola, the ROAs of the six supply points were between 34.3% and 20.9%. The Tax Court noted that these ROAs remained higher than those of almost 80% of the manufacturers analyzed by the IRS.

Three Proposed Alternatives Rejected

Coca-Cola proposed three alternative transfer pricing methods to support its contention that, in arm's length transactions, Coca-Cola's foreign supply points would receive most of the income that Coca-Cola derives from foreign markets. The Tax Court rejected all three.

Proposed Alternative 1: Comparable Uncontrolled Transaction (CUT) Method

The Tax Court first analyzed Coca-Cola's proposed CUT method. This method compared Coca-Cola's foreign operations to those of fast food franchising companies, with Coca-Cola's supply points being compared to fast food master franchisees. The Tax Court identified several flaws in this comparison, including finding that beverages and fast food products are not similar products or in the same general industry or market. The Tax Court similarly noted that Coca-Cola's supply points did not have the long-term contracts, territorial exclusivity, or management responsibilities of fast food master franchisees. In addition, because Coca-Cola's analysis did not include data from unrelated party transactions involving the transfer of trademarks, secret formulas, and other intangible property used in producing branded beverage products, the Tax Court concluded that the CUT method's reliability in this case was questionable. The Tax Court described the application of the CUT method in the case as both "aggressive" and "mathematically and economically unsound."[7]

Proposed Alternative 2: Residual Profit Split Method (RPSM)

The Tax Court next analyzed Coca-Cola's proposed RPSM, finding it "wholly unreliable."[8] The proposed RPSM involved estimating a value for nonroutine intangibles that Coca-Cola asserted were the property of the supply points. This estimate was based on capitalized advertising costs less amortization, rather than on external market benchmarks. The Tax Court found that this estimation method made the proposed RPSM unreliable for at least two reasons: (1) the lack of consensus about whether the costs of advertising can be capitalized into an intangible asset, and about what that asset's useful life might be, and (2) such an asset would have no value to an unrelated party because an unrelated party could not use the asset without infringing Coca-Cola's trademarks. The Tax Court also identified several other flaws in the proposed RPSM. As it had when analyzing Coca-Cola's proposed CUT method, the Tax Court found that the supply points were the relevant controlled taxpayers under the § 482 regulations, and that it was not appropriate to consider a combination of Coca-Cola's supply points and local foreign service companies to be the relevant controlled taxpayer instead. The Tax Court also found that Coca-Cola, not its supply points, was the owner of the intangible assets involved in the transactions at issue. Even if the supply points

[6] Opinion at 171. The seventh supply point, in Egypt, had a negative average ROA due to "historical reasons." *See* Opinion at 10, 82.
[7] Opinion at 196-197.
[8] Opinion at 205.

themselves owned any intangible assets, the Tax Court found that it would not be appropriate to exclude the value of Coca-Cola's own intangible assets from determinations of the relative value of nonroutine intangible property in the RPSM.

Proposed Alternative 3: Unspecified Method

The Tax Court then analyzed Coca-Cola's proposed unspecified method, which was based on the fee structure typically used to compensate hedge fund managers. The Tax Court noted that this method "does not remotely resemble any of the 'specified methods' for valuing intangibles under the section 482 regulations."[9] Because this method proposed to compensate Coca-Cola only for asset management services, and not for the use of Coca-Cola's trademarks or secret formulas or other intangible assets, the Tax Court found that this method "ignores the intangibles that are central to this case."[10]

Blocked Income Ruling Reserved

The Tax Court reserved ruling on Coca-Cola's argument that Brazilian law would have prevented Coca-Cola's Brazilian supply point from paying more than a small fraction of the hundreds of millions of dollars of additional income that the IRS determined should be reallocated from the Brazilian supply point to Coca-Cola. The IRS asserted that under Treasury Regulation § 1.482-1(h)(2), known as the "blocked income" regulation, such provisions in Brazilian law should not be taken into account when determining an arm's length transfer price. Coca-Cola argued, alternatively, that the regulation is inapplicable, that the regulation's conditions for taking Brazilian law into account were met, or that the regulation is invalid. Because the validity of the blocked income regulation is currently before the Tax Court in *3M Co. & Subs. v. Commissioner*,[11] the court in the *Coca-Cola* case decided not to rule on these arguments until an opinion is issued in the *3M* case.

Collateral Adjustments Allowed

The Tax Court also allowed two types of collateral adjustments for 2007-2009: (1) the IRS's adjustment of Coca-Cola's losses under § 987 for its Mexico supply point after the IRS reallocated income from the Mexico supply point to Coca-Cola, and (2) reductions or offsets of the royalty amounts owed by supply points to Coca-Cola as a result of the adjustments, equal to the amount of dividends these supply points had previously remitted to Coca-Cola to satisfy their royalty obligations.

For the § 987 adjustment, the Tax Court rejected Coca-Cola's arguments and found that the court had jurisdiction to review the adjustment, that the computation of the adjustment was neither premature nor dependent on Mexican law, and that the recomputation was a necessary part of "produc[ing] the same result that would have occurred if [Coca-Cola] and its Mexican branch had reported income consistently with the arm's-length standard from the outset."[12]

For the dividend offsets – the only taxpayer win in the case – the Tax Court rejected the IRS's argument that

[9] Opinion at 207-208.
[10] Opinion at 208.
[11] *3M Co. & Subs. v. Commissioner*, T.C. Dkt. No. 5816-13 (filed Mar. 11, 2013),
[12] Opinion at 208-218.

any offset was barred by Coca-Cola's failure to file the explanatory statements required for taxpayers electing dividend offset treatment for taxpayer-initiated § 482 adjustments. The Tax Court instead found that Coca-Cola substantially complied with this requirement in the "peculiar circumstances of this case," where such explanatory statements "would have added nothing to the IRS' sum of knowledge" about Coca-Cola's adjustments and offsets.[13]

An Appeal Is Possible

On the day after the Tax Court's opinion was published, Coca-Cola stated that it was "disappointed with the outcome," is considering "potential grounds for its appeal," and "intend[s] to continue to vigorously defend our position."[14]

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[13] Opinion at 227-228.
[14] https://www.coca-colacompany.com/media-center/comments-on-united-states-tax-court-opinion

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