The Coca-Cola Company & Subsidiaries v. Commissioner of Internal Revenue

Country of decision	United States
Case number	31183-15
Date of decision	18 November 2020
Court/Chamber	United States Tax Court
Parties	The Coca-Cola Company & Subsidiaries (the taxpayer) Commissioner of Internal Revenue (the tax Authority)
Treaty article(s) and paragraph(s)	United States
OECD equivalent article(s)	9 (Associated enterprises)
Keywords	transfer pricing; arm's length principle; transfer pricing methods; intangible property; royalties; comparability analysis; foreign exchange

Summary of facts

For the taxable years at issue (2007-2009), the Coca-Cola Company and its US domestic subsidiaries (collectively, the taxpayer) filed consolidated US federal income tax returns. The taxpayer's foreign manufacturing affiliates, referred to "supply points," functioned essentially as contract manufacturers for the taxpayer. The supply points had plants in Brazil, Chile, Costa Rica, Egypt, Ireland, Mexico and Swaziland, which produced concentrate (i.e. syrups, flavouring, powder and other ingredients) used in the production of the taxpayer's beverages. All the supply points except the Mexican supply point were controlled foreign corporations (CFCs). The Mexican supply point operated as a branch, and its income was reported on the taxpayer's US consolidated return.

The supply points sold concentrate to hundreds of bottlers in Europe, Africa, Asia, Latin America, and Australasia. Most of the bottlers were independent of the taxpayer. The bottlers used the concentrate to produce finished beverages that they marketed to millions of retail establishments throughout the world. The taxpayer's foreign activities, other than manufacturing, were performed by foreign affiliates that were referred to as local service companies ("ServCos"). ServCos were responsible for local advertising and in-country consumer marketing.

To enable the supply points to manufacture and sell concentrate, the taxpayer licensed them to use its intangible property (IP), including trademarks, brand names, logos, patents, secret formulas, and proprietary manufacturing processes. When the taxpayer reported income from the supply points (i.e. compensation to the taxpayer for the supply points' rights to use the taxpayer's IP) for 2007-2009, the taxpayer used the "10-50-50 method", as it had done for the previous 11 years (1996-2006). The 10-50-50 method was a transfer pricing method to which the taxpayer and the IRS had agreed in a closing agreement that was executed in 1996 to resolve the taxpayer's tax liabilities for 1987-1995. The 10-50-50 method permitted the supply points to retain profit equal to 10% of their gross sales, with the remaining profit being split 50%-50% with the taxpayer. The 1996 IRS closing agreement did not address what transfer pricing methodology would be used for years after 1995. The taxpayer, however, continue to use the 10-50-50 method.

The amounts due to the taxpayer under the 10-50-50 method were in the nature of royalties because the IRS closing agreement specified that the compensation was for use of the taxpayer's IP. Nevertheless, the IRS closing agreement permitted the supply points to satisfy their royalty obligations by paying actual royalties or by repatriating funds to the taxpayer in other ways, e.g. by paying dividends. During 2007-2009, more than USD 1.8 billion of the income that the taxpayer received from the supply points pursuant to the 10-50-50 method took the form of dividends rather than royalties.

The US Internal Revenue Service (IRS) examined the taxpayer's income tax returns for 2007-2009. The IRS concluded that the 10-50-50 method did not reflect arm's length pricing because it overcompensated the supply points and undercompensated the taxpayer for the use of its IP. The IRS reallocated income to the taxpayer using a comparable profits method (CPM), under which the IRS treated the independent bottlers as comparable parties to the supply points. To implement its CPM, the IRS determined the average return on operating assets (ROA) for a group of the independent bottlers that it deemed comparable. It applied that average ROA to the operating assets of each supply point, generating a deemed arm's-length operating profit. The IRS then reallocated to the taxpayer all income earned by each supply point in excess of that benchmark. Those adjustments increased the taxpayer's aggregate taxable income for 2007-2009 by more than USD 9 billion.

The taxpayer challenged the IRS's transfer pricing adjustments as arbitrary and capricious. During trial, the IRS reallocated an additional USD 385 million of income to the taxpayer in connection with the taxpayer's practice of "split invoicing." Generally, bottlers paid the full concentrate price to the supply points from which they purchased concentrate. In some markets, however, the supply point invoiced the bottler for a portion of the concentrate price, and the local ServCo separately invoiced the bottler for the remainder of the concentrate price. When this practice, referred to as split invoicing, occurred, the ServCo received a portion of the revenues that the supply point would otherwise have received as payments for concentrate. The mark-ups that the ServCos received from the bottlers under split invoicing were significantly higher (almost 40% on average) than the mark-ups that the ServCos normally enjoyed under their contracts with the taxpayer (6% to 7%). Concluding that the ServCos' agreements with the taxpayer reflected arm's-length norms, the IRS took the position that any excess income that the ServCos received from the bottlers should be reallocated to the taxpayer.

Issues

(1) Whether the IRS abused its discretion by reallocating income to the taxpayer using the comparable profits method (CPM).

(2) Whether the IRS erred by reallocating income to the taxpayer in connection with split invoicing.

(3) Whether the IRS erred by recomputing the taxpayer's losses under section 987 of the US Internal Revenue Code (IRC) after the CPM changed the income allocable to the Mexican supply point, a branch of the taxpayer.

(4) Whether the IRS's reallocations to the taxpayer must be reduced by the amounts of the dividends paid by the supply points during 2007-2009 in satisfaction of their royalty obligations.

Court decision

Issue (1) – IRS Use of Comparable Profits Method (CPM)

The US Tax Court held that the IRS did not abuse its discretion in reallocating income from the supply points to the taxpayer by use of the CPM. This is discussed in Parts III and IV of the Opinion Section of the Court's decision.

As threshold considerations, the US Tax Court discussed the following three issues. First, the US Tax Court addressed the taxpayer's argument that the IRS acted arbitrarily by deviating from the 10-50-50 method, in which the IRS had acquiesced during the five prior audit cycles spanning a decade. The taxpayer maintained that the 1996 IRS closing agreement was predicated on certain factual underpinnings, including the IRS's recognition that the supply points were responsible for generating demand and were entitled to share in the resulting profits related to the IP. The taxpayer further argued that those factual underpinnings were binding on the IRS unless it could show some material change in the underlying fact.

The US Tax Court disagreed with the taxpayer, reasoning that the IRS closing agreement said nothing about the transfer pricing methodology that was to apply for years after 1995. The US Tax Court rejected the taxpayer's argument related to the factual underpinnings on the grounds that: (1) there was nothing in the IRS closing agreement to suggest that the IRS regarded the 10-50-50 method as the ideal of arm's length pricing for the taxpayer and its supply points, but instead the 10-50-50 method was simply a formula to which the parties agreed in settling the dispute before them at that moment; and (2) even if any factual underpinnings could be extracted from the IRS closing agreement, there was no evidence that the parties intended them to be binding for future years.

The US Tax Court found that the taxpayer was, in essence, arguing that it had relied to its detriment on a belief that the IRS would adhere to the 10-50-50 method indefinitely, but the Court determined that the IRS should not be estopped on the basis of a promise that it did not make.

Second, the US Tax Court considered the relevant parties and transactions in the present case. The US Tax Court referred to the Treasury Regulations issued under IRC section 482 (i.e. the US transfer pricing statutory provision) that require the Court to determine the "true taxable income of a controlled taxpayer" by examining the "controlled transactions" to which that the taxpayer was a party.

The US Tax Court determined that the IRS properly treated the supply points and the ServCos as distinct sets of "controlled taxpayers" that engaged in discrete sets of "controlled transactions" with the taxpayer. The US Tax Court explained that those entities performed distinct economic functions, i.e. the supply points manufactured concentrate, whereas the ServCos arranged local consumer marketing and liaison with bottlers. The US Tax Court further explained that those entities were separate legal entities that executed separate agreements with the taxpayer, and the taxpayer also treated them as separate legal entities. The US Tax Court stated that, while the IRS reallocated income to the taxpayer from the supply points, the IRS determined that the ServCos' transactions with the taxpayer, generally priced on a cost-plus basis, were conducted at arm's length, except where split invoicing occurred.

The US Tax Court rejected the taxpayer's suggestion that the Court treat the taxpayer's foreign business units (BUs) as the relevant controlled taxpayers. BUs were managerial lines of reporting that crossed the lines of the underlying legal entities. Each BU had responsibility for the economic performance within a geographic market, which could consist of one or more countries. The US Tax Court explained that the BUs were not legal entities and were not taxpayers, and that the BU engaged in no economic transactions that could be tested for compliance with the arm's length standard. The US Tax Court further explained that the taxpayer's suggestion would entail both duplication and inconsistency because the taxpayer would treat the ServCos as controlled taxpayers transacting with the taxpayer at arm's length, while using the BUs, which consisted almost entirely of personnel employed by the ServCos, as proxies or substitutes for the supplying points.

Third, the US Tax Court rejected the taxpayer's argument that the CPM is inferior to other methods for pricing transfers of IP. The taxpayer made the argument mainly in reliance on a statement in the preamble to the 1994 final regulations (TD 8552), where the CPM was referred to as a "method of last resort." The US Tax Court clarified that the preamble's reference to the CPM as a "method of last resort" is predicated on the assumption that "adequate data" are available to apply other methods for determining an arm's length price, but that the taxpayer identified no pricing data for transactions with unrelated parties that involve the transfer of the same IP. The US Tax Court further clarified that, by replacing the previous hierarchical approach with the "best method rule," which requires the arm's length result of a controlled transaction to be determined under the method that provides the most reliable measure of an arm's length result in light of the facts and circumstances, the final regulations make it clear that there is no strict priority of methods, and that the CPM is subject to the same considerations as any other method.

The US Tax Court then proceeded to evaluate the IRS's application of the CPM. The CPM is a specified method for determining the arm's length consideration for the transfer of IP (Treasury Regulations section 1.482-4(a)). Under the CPM, the determination of an arm's length result is based on the amount of operating profit (i.e. gross profit reduced by operation expenses) that a controlled taxpayer would earn if its "profit level indicator" (PLI) were equal to that of an uncontrolled comparable (Treasury Regulations section 1.482-5(b)(1)). Reported operating profits in excess of the benchmark PLI are allocated to the other controlled party (in the present case, the taxpayer). The IRS employed a CPM that benchmarked the supply points' profits to the profits earned by the independent bottlers. The IRS concluded that the best PLI was an ROA, i.e. the ratio of operating profits to operating assets (i.e. the value of all assets used in the relevant business activity, including fixed assets and current assets). The Treasury Regulations list an ROA as a specified PLI for comparing operating profits of a controlled party and those of uncontrolled comparables.

The US Tax Court determined that the IRS did not abuse its discretion by using the bottler ROA to reallocate income between the taxpayer and the supply points. First, the US Tax Court found that a CPM analysis was appropriate given the nature of the assets owned, and the activities performed, by the controlled taxpayers (in the present case, the taxpayer, the supply points and the ServCos). The US Tax Court explained that, although the profit split method is often appropriate where both controlled taxpayers contribute significant IP, the CPM is often preferred where only one of the two entities contributes meaningful IP, like in the present case where the taxpayer owned virtually all the IP needed to produce and sell the beverages. The US Tax Court stated that the CPM determined an arm's length profit level for the supply points without attempting a direct valuation of the taxpayer's hard-to-value IP, and that the supply points' residual income was necessarily reallocated to the taxpayer, the owner of the IP, because the ServCos—the other group of controlled taxpayers—received arm's length compensation, with the exception for the split invoicing allocations.

Next, the US Tax Court determined that the IRS selected appropriate comparable parties. The US Tax Court reasoned that the independent bottlers were comparable to the supply points because they operated in the same industry, faced similar economic risks, had similar (but more favourable) contractual and economic relationships with the taxpayer, employed in the same manner many of the same IP (including the taxpayer's brand names, trademarks and logos) and ultimately shared the same income stream from sales of the taxpayer's beverages.

Further, the US Tax Court determined that the IRS computed and applied its ROA using reliable data, assumptions and adjustments. The US Tax Court found that the bottlers in many respects enjoyed an economic position superior to that of the supply points, which would justify a high relative return for the bottlers, and thus the IRS's methodology was conservative. The US Tax Court, however, also ruled that the IRS's reallocations of income should be adjusted to exclude income attributable to trademarks owned by the supply points, as identified by the taxpayer and accepted by the IRS.

The US Tax Court upheld the IRS's reallocations of income under the CPM, subject to certain adjustments.

Issue (2) – Split Invoicing

The US Tax Court held that the IRS did not err by reallocating income from the ServCos to the taxpayer in connection with split invoicing. This is discussed in Part V of the Opinion Section of the Court's decision.

As a result of split invoicing, the participating supply points lost revenue, which was diverted to the ServCos that invoiced the bottlers for a portion of the price of the concentrate sold by the supply points. The parties agreed that six ServCos received excess income from the bottlers, i.e. income in excess of the cost-plus compensation to which they were entitled under their normal contracts with the taxpayer. The taxpayer also did not dispute the amounts of excess income calculated by the IRS. The taxpayer, however, argued that the supply points should be deemed to have received, and should be allowed to retain, the excessive income derived by the ServCos from the bottlers.

The US Tax Court determined that, because the extra income received by the six ServCos was in excess of their arm's-length income, and because it cannot be allocated to the supply points without exceeding their arm's length income, it must necessarily be reallocated to the taxpayer as the owner of the valuable IP. The US Tax Court thus concluded that the IRS did not err with its income reallocations related to split invoicing. The US Tax Court left it to the parties to calculate the exact amount of the additional tax deficiencies in a manner consistent with the evidence submitted for trial.

Issue (3) Foreign Branch Losses

The US Tax Court held that the IRS did not err by recomputing the taxpayer's foreign branch losses after the CPM changed the income allocable to the taxpayer's Mexican supply point, a branch of the taxpayer. This is discussed in Part VII(A) of the Opinion Section of the Court's decision.

The discussion relates to IRC section 987, which requires a US taxpayer that operates through a foreign branch to compute the income or loss of the branch using the functional currency in which the branch conducts its operations and keeps its books and records. The income or loss as expressed in the functional currency is then translated into US dollars using the appropriate exchange rate and reported on the taxpayer's US federal income tax return. Foreign exchange gain or loss can result at the time when the branch makes a distribution or payment to the US taxpayer. Treasury Regulations section 1.482-1(g)(2)(i) provides that, when the IRS "makes an allocation under section 482 (referred to … as the primary allocation), appropriate correlative allocations will be made with respect to any other member of the group affected by the allocation." Consistent with the regulation, when the IRS reallocated income to the taxpayer from the Mexican branch, the IRS made correlative allocations that reduced the income of the Mexican branch.

The reductions to the Mexican branch's income, originally recorded in pesos, caused the losses recognized under IRC section 987 to be incorrect. The IRS therefore recomputed the taxpayer's section 987 losses reported on the taxpayer's 2007-2009 returns to reflect the collateral allocations to the Mexican branch. The IRS's recomputations increased the section 987 losses for 2007 and 2008, and decreased the losses for 2009, which in the aggregate decreased the taxpayer's section 987 losses by more than USD 2 million.

The foreign exchange gain or loss recognized under IRC section 987 generally results from, and varies with, the exchange rate difference between the year the foreign income is earned and the year it is remitted to the US home office.

The US Tax Court rejected the taxpayer's argument that, because the IRS's primary allocation from the Mexican branch's income, which the taxpayer had reported on its US consolidated return, did not increase the taxpayer's taxable income, the IRS's section 987 recomputations were impermissible. The US Tax Court explained that the recomputations resembled those that commonly occur when the IRS adjusts a taxpayer's income in other respects, e.g. by recomputation of a medical expense deduction or deductible rental real estate loss to reflect changes to adjusted gross income. Alternatively, the US Tax Court explained that the recomputations could be viewed as "further correlative allocations … required by the initial correlative allocation" as provided in Treasury Regulations section 1.482-1(g)(2)(i).

The US Tax Court also rejected the taxpayer's argument that the IRS's correlative allocations (and the section 987 loss recomputations) were premature under Treasury Regulations section 1.482-1(g)(2)(iii), which provides that "a primary allocation will not be considered to have been made (and therefore, correlative allocations are not required to be made) until the date of a final determination with respect to the allocation under section 482."

The US Tax Court reasoned that, in providing that correlative allocations "are not required to be made" until a judicial decision has become final for the primary allocation, the regulations afford the IRS more time to make correlative allocations, but that nothing in that provision prevents the IRS from making such adjustments earlier or affects the Court's jurisdiction.

The US Tax Court accordingly upheld the IRS's section 987 adjustments.

<u>Issue (4) – Adjustment for Dividends Paid</u>

The US Tax Court held that the IRS's reallocations should be reduced by the amounts of the dividends paid by the supply points during 2007-2009 to satisfy the supply points' royalty obligations. This is discussed in Part VII(B) of the Opinion Section of the Court's decision.

As had been permitted by the 1996 IRS closing agreement, the supply points discharged more than USD 1.8 billion of their royalty obligations to the taxpayer during 2007-2009 by remitting dividends rather than royalties.

The taxpayer contended that those dividends should be offset against, i.e. should reduce, the royalty obligations of the supply points as determined in the present case.

The US Tax Court referred to Treasury Regulations section 1.482-1(g)(3)(i), which provides that "appropriate adjustments must be made to conform a taxpayer's accounts to reflect allocations made under section 482." Where income is reallocated from a subsidiary to a parent, the subsidiary ends up with excess income (cash) on its books. To account for how that cash got there, the parent is normally deemed to have made a capital contribution to the subsidiary in the amount of the primary section 482 reallocation. Alternatively, the regulations permit "repayment of the allocated amount [by the subsidiary to the parent] without further income tax consequences.

The US Tax Court also referred to Revenue Procedure 99-32, 1999-2 C.B. 296, which implements the latter type of conforming adjustment by permitting the offset, against a primary section 482 allocation, of otherwise-taxable dividends received from the other controlled taxpayer during the taxable year for which the section 482 allocation is made. The US Tax Court stated that, unlike the previous revenue procedure that had similar implementing provisions, Revenue Procedure 99-32 has a new provision directing a taxpayer seeking dividend offset treatment to claim such treatment on a timely-filed income tax return and to file with the return a statement the taxpayer desires dividend offset treatment and acknowledges that it is bound by its election of such treatment.

The taxpayer elected dividend offset treatment on its timely filed returns for 2007-2009, but it did not attach to those returns the explanatory statements. The IRS took the position that this omission should be fatal to the taxpayer's claim for dividend offsets. The taxpayer, on the other hand, urged that it substantially complied with the requirements of Revenue Procedure 99-32 and thus it should be entitled to the dividend offset treatment.

The US Tax Court agreed with the taxpayer. The US Tax Court stated that the IRS added the explanatory statement requirement because the IRS feared that the potential availability of dividend offset treatment incentivized taxpayers to play what has been called the "audit lottery." The US Tax Court further stated that, in omitting to include an explanatory statement, the taxpayer was not playing the "audit lottery" because the IRS had examined the taxpayer's returns for every year between 1996 and 2006 and thus the IRS was aware that the taxpayer was reporting its royalty income and claiming dividend offsets on its timely filed 2007-2008 returns exactly as had been agreed in the 1996 IRS closing agreement. The US Tax Court found that the taxpayer's inclusion of explanatory statements would have added nothing to the IRS's sum of knowledge.

The US Tax Court concluded, on the specific facts of the present case, that the taxpayer satisfied the essential requirements of Revenue Procedure 99-32.

The US Tax Court further stated that insisting on strict compliance would deny the taxpayer dividend offsets of USD 1.8 billion, effectively requiring the supply points to repatriate taxable royalties twice, which would constitute a sanction that is not warranted or justified.

Editor's notes

For more information see: J. Clark Armitage, H.D. Schafroth, Elizabeth. J. Stevens, H.D. Rosenblum: *United States – Coke Concentrate: A Recipe for Understanding the IRS's Biggest Win in 40 Years*, International Transfer Pricing Journal, 2021 (Volume 28), No.2.

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