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International Lessons From *Coca-Cola*

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In this article, the authors examine the U.S. Tax Court's recent judgment in *Coca-Cola* and consider the potential consequences of the decision from an international transfer pricing perspective.

On November 18, 2020, the U.S. Tax Court ruled that the IRS had legitimately imposed a royalty adjustment on Coca-Cola U.S. up to $9 billion (upward) for the financial years 2007-2009 (the years under review).[1] This article reviews relevant facts of the case and provides some takeaways from an international transfer pricing perspective.

Factual Background

The Company's Structure

During the years under review, Coca-Cola U.S.[2] was the legal and economic owner of Coca-Cola's intellectual property, which includes trademarks, logos, and, of course, the secret recipe. Coca-Cola U.S. licensed the IP to foreign affiliates — both branches and subsidiaries — in seven jurisdictions (the supply points).[3] The supply points manufacture soft drink concentrate, which was then sold to mostly independent bottling companies (the bottlers). The bottlers used the concentrate to produce Coca-Cola and other soft drinks and sold these to local retailers, such as supermarkets and restaurants. Coca-Cola U.S. charged the supply points royalties for the right to use the IP. Coca-Cola U.S. also contracted with foreign affiliates (the ServCos) to perform local marketing and advertising services for the bottlers. The ServCos were, in principle, remunerated on a cost-plus basis by Coca-Cola U.S. However, in practice, part of the ServCos' expenses were allocated to the supply points based on decisions made by upper-level management in Atlanta.

Relevant facts are highlighted in the figure.

The Closing Agreement

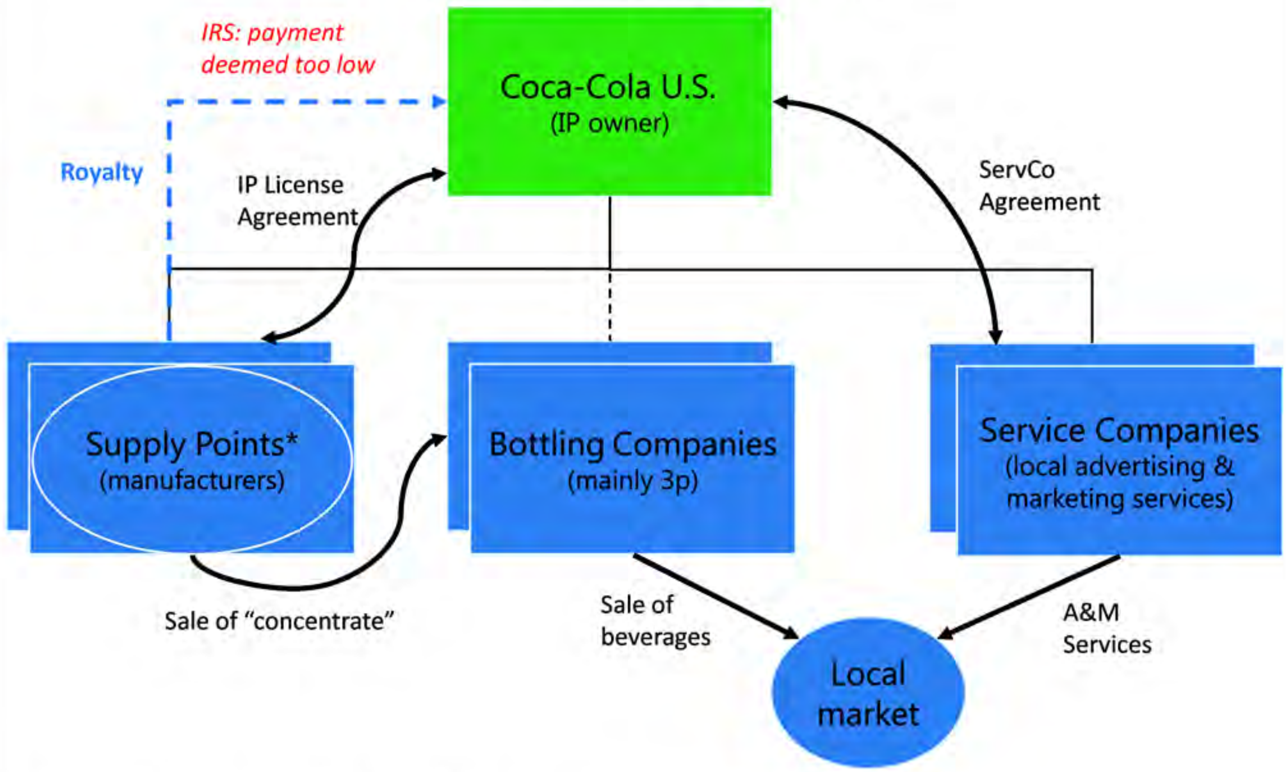
In 1996 Coca-Cola U.S. and the IRS reached an audit settlement (the closing agreement) regarding the financial years 1987-1995. This closing agreement included a 10/50/50 formulary apportionment method for allocating profits between the supply points and Coca-Cola U.S.

[1] *Coca-Cola Co. v. Commissioner*, 155 T.C. No. 10 (2020).

[2] The share interests in the foreign affiliates and the contracts with those companies were held by a non-U.S. company, "Export." For this article, no distinction is made between Export and Coca-Cola U.S.

[3] The supply points were located in Brazil, Chile, Costa Rica, Egypt, Ireland, Mexico, and Swaziland.

The Coca-Cola Group's Structure



*Located in Brazil, Chile, Costa Rica, Egypt, Ireland, Mexico, and Swaziland.

The formula allowed the supply points to retain profits equal to 10 percent of gross sales. The remaining profits were evenly split between the supply points and Coca-Cola U.S. The amount Coca-Cola U.S. received under the formulary apportionment method was considered to consist of royalties it charged the supply points for the right to use Coca-Cola U.S.'s valuable IP. In its tax return filings for subsequent years, including the years under review, Coca-Cola U.S. took the position that it could legally rely on the formulary apportionment method included in the closing agreement. In its audits for the financial years between 1996 and 2006, the IRS did not reject the application of the formulary apportionment method by Coca-Cola U.S. However, in its audit of the company for the years 2007-2009, the IRS asserted that the use of the formulary apportionment method resulted in an overcompensation of the supply points by Coca-Cola U.S. and that, using an arm's-length price, the latter should have charged higher royalties to the supply points during the years under review.

In its judgment, the U.S. Tax Court noted that the closing agreement constituted an agreement to settle a dispute between the IRS and Coca-Cola U.S. Although Coca-Cola U.S. may have wanted the closing agreement to provide certainty and act as an approval for the indefinite future application of the arrangement, the court notes that the agreement does not state that the parties intended for it to be binding for future years. The court also noted that the parties did not agree in the closing agreement that the application of the formulary apportionment method leads to arm's-length pricing: It is merely a formula used by the parties to settle their dispute at that time. Finally, the court notes that the existence of a penalty protection clause included in the closing agreement recognizes the possibility that the IRS may make transfer pricing adjustments for years after 1995.

Sometimes large multinational companies erroneously rely on informal statements from, or implicit agreements with, the tax authorities regarding their tax positions. Further, sometimes taxpayers misinterpret formal agreements with tax authorities, such as advance pricing agreements. For example, taxpayers may believe that they can legally rely on factual items in APAs that may be related to — but are not actually part of — the intercompany transactions for which the company requested advance confirmation.

The Ruling

Burden of Proof

In this case, the burden of proof rested with Coca-Cola U.S. to show that the comparable profits method (or the transactional net margin method in OECD parlance) was erroneous. Considering the difference between intercompany agreements and (alleged) conduct in this case, Coca-Cola U.S. had a virtually impossible task.

Marketing Intangibles

In its defense, Coca-Cola U.S. argued that the supply points should be considered the economic owners of valuable marketing intangibles, and that therefore, at arm's length, the supply points were entitled to profits in excess of those alleged by the IRS. Coca-Cola U.S. seemed to rely on a "lifting the corporate veil" argument when it stated that valuable marketing intangibles needed to be attributed to the supply points because the latter were allocated part of the expenses that the ServCos incurred when rendering local marketing and advertisement activities. The Tax Court rejected this argument, highlighting that the supply points and ServCos are separate taxable and legal entities and that these entities cannot be amalgamated vis-à-vis Coca-Cola U.S. for transfer pricing purposes. Also, the fact that supply points were passive recipients of charges — that is, they were only allocated part of the costs without having a role in the services for which they were made financially responsible — does not mean that they acquired valuable marketing intangibles for transfer pricing purposes.

Although one should be careful about drawing general conclusions from the court's ruling, EU entrepreneurs engaged in business activities in the United States using routine affiliates may use the ruling's line of argumentation in situations in which the IRS alleges that the local group company should be deemed to have developed (marketing) intangibles in the United States.

Comparability

When applying the CPM, the IRS identified the bottlers as the comparable parties for the purpose of determining the arm's-length profit of the supply points. This was based on the argument that the bottlers and supply points were active in the same industry, had similar relationships with Coca-Cola U.S., had the same income stream from sales of Coca-Cola's beverages, and used the same IP to perform their services. Coca-Cola U.S. claimed that the application of the CPM was erroneous because the bottlers were not comparable to the supply points; more specifically, it claimed that the bottlers bore more risks and functions than the supply points because the bottlers contributed to the development of IP. However, the Tax Court deemed the bottlers to be sufficiently comparable — even if there were a difference in the risks assumed by the bottlers vis-à-vis the supply points, the Tax Court argued that any such difference was appropriate from the viewpoint of Coca-Cola U.S. A "riskier" comparable would result in a higher profit allocation to the supply points and, therefore, would ultimately be favorable to Coca-Cola U.S.

Preferred Method

The court found that the comparable uncontrolled transaction (or the comparable uncontrolled price in OECD parlance) method, as proposed by Coca-Cola U.S., was unreliable because the case involved "unique and extremely valuable intangible property," for which a CUT was unlikely to exist.

In an EU context, we've found that tax authorities are increasing the frequency with which they challenge the application of the CUP method when it is used to substantiate arm's-length pricing for intercompany royalty payments, specifically in cases involving "brand fees" charged within groups that operate business to business. For example, in a 2018 Dutch transfer pricing decree, the Dutch State Secretary for Finance found that information derived from public databases containing third-party royalty rates generally lacks sufficiently detailed data, and thus it was not appropriate to use the information to perform a comparability analysis.[4]

Case Closed?

We understand from various news reports that Coca-Cola U.S. is working on its defense, which suggests that the company is likely to file an appeal.[5] If it is not appealed or it is sustained on appeal, the case results in a massive amount of double taxation. This is because the supply points will already have filed tax returns and paid the corresponding tax in their jurisdictions of residence for the years under review. The IRS's adjustment will require that a large portion of their taxable profits be taxed again in the United States.

Coca-Cola U.S. may be able to request that the U.S. competent authority seek correlative relief[6] from the competent authorities in the supply points' jurisdictions with which it concluded bilateral tax treaties that provide for the mutual agreement procedure and arbitration. Notably, the United States has concluded tax treaties with Egypt, Mexico, and Ireland, and the latter two also contain arbitration clauses. These arbitration clauses are not binding and, therefore, only provide the possibility to submit a case for arbitration. This means that there is no guarantee that double taxation will be resolved. ■

[4]Decree of Apr. 22, 2018, No. 2018-6865 (in Dutch).

[5]*See, e.g.*, the Coca-Cola Company's release on retaining Laurence H. Tribe as counsel (Feb. 24, 2021).

[6]The U.S. competent authority's objective will be limited to negotiating with the other jurisdictions to obtain an adjustment that corresponds to the amount of the initial U.S. correction (that is, the initial U.S. correction cannot be reduced as a result of the mutual agreement procedure).