

THE COCA-COLA COMPANY v/s THE IRS

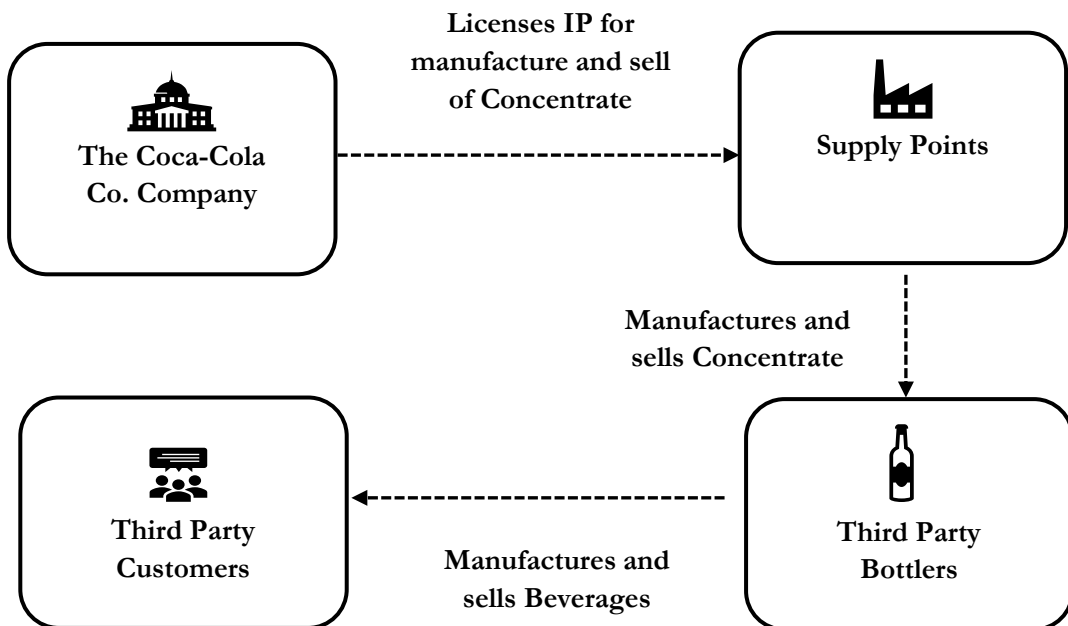
TRANSFER PRICING DISPUTE EXPLAINED

- ▶ The U.S. Tax Court issued its opinion in the case of **The Coca-Cola Co. v. Commissioner, 155 T.C. No. 10**, upholding that the IRS did not abuse its discretion under Section 482 of the Income Tax Regulation by reallocating income to Coca Cola using the Comparable Profits Method ('CPM'). This article provides summary of the U.S. Tax Court's ruling.

BACKGROUND OF THE CASE:

The Coca-Cola Co. ('The US Taxpayer') was the legal owner of intellectual property ('IP') necessary to manufacture, distribute, and sell some of the best-known beverage brands in the world. These IP included trade- marks, product names, logos, patents, secret formulas, proprietary manufacturing processes.

The US Taxpayer licensed its foreign manufacturing affiliates, called "Supply Points" to use this IP to produce concentrate that were then sold to unrelated bottlers, who produced finished beverages for distributors and retailers for selling it across the world. The graphical presentation of the entire supply chain is provided below:



During 2007-2009 the Supply Points compensated the US Taxpayer for use of its IP under a formulary apportionment method to which the US Taxpayer and the IRS had agreed in 1996 when settling the US Taxpayer's tax liabilities for 1987-1995 ('Closing agreement').

THE IRS POSITION:

Upon examination, the IRS determined that the US Taxpayer's methodology did not reflect arm's-length norms as it over-compensated the Supply Points and undercompensated the US Taxpayer for the use of its IP for the following reasons:

- The IRS found that the US Taxpayer was the legal owner of virtually all the trademarks and intangible property, owned the vast bulk of its brand value. However, the Supply Points, which functioned essentially as contract manufacturers, retained most of the profits generated by sales of concentrate to foreign bottlers.
- The IRS rejected “profit split” method by stating that it is unreliable where one party (the US Taxpayer) owned valuable intangible assets and the other parties (the Supply Points) owned virtually none.
- Further, the IRS selected the Supply Points as the tested parties for the transaction under consideration and selected third-party bottlers as the independent comparable to benchmark the return that the Supply Points should earn. The IRS then reallocated all of the supply points’ residual profit in excess of the routine return as royalties to the US Taxpayer for use of its IP.

THE U.S. TAX COURT’S FINDINGS:

- **Closing Agreement:** The U.S. Tax Court concluded that the closing agreement on which the US Taxpayer relied on does not have any persuasive value as there was nothing in the closing agreement to suggest that the Commissioner regarded the 10-50-50 method as the arm’s-length pricing for the US Taxpayer and its Supply Points. Rather, it was simply a formula to which the parties agreed in settling the dispute before them at that moment. Further, there was no evidence in the closing agreement to provide that the parties intended them to be binding for future years.
- **Best Method Rule and CPM Analysis:** The U.S. Tax Court also rejected the US Taxpayer’s argument that the CPM should be the method of last resort. In this regard, the U.S. Tax Court opined that the CPM should be treated as any other method and there is no strict priority of methods, and no method will invariably be more reliable than others.

The U.S. Tax Court found that Supply Points were essentially wholly owned contract manufacturers engaged in routine manufacturing, mixing ingredients specified by the US Taxpayer according to manufacturing protocols supplied by the US Taxpayer. Further, the US Taxpayer owned virtually all the intangible assets needed to produce and sell the beverages. The supply points, by contrast, owned few (if any) valuable intangibles.

Considering the above findings, the U.S. Tax Court concluded that the CPM was “ideally suited” to determining the US Taxpayer’s compensation for the use of its IP, as the CPM would be able to determine an arm’s length profit for the Supply Points without needing to determine the value of the US Taxpayer’s uniquely valuable intangible assets.

- **Selection of Bottlers as comparable:** The U.S. Tax Court upheld the IRS position to select unrelated bottlers as the independent comparable as they operated in the same industry, faced similar economic risks, had similar contractual and economic relationships with petitioner, employed in the same manner many of the same intangible assets (petitioner’s brand names, trademarks, and logos), and ultimately shared the same income stream from sales of petitioner’s beverages.
- **Rejection of Proposed Alternative Transfer Pricing Methodologies:**

The US Taxpayer rejected the three alternative transfer pricing methodologies proposed by the US Taxpayer in order to substantiate that the Supply Points would be entitled to receive the vast bulk of the income from the US Taxpayer who ultimately derives income from foreign markets.

1. Comparable Uncontrolled Transaction (CUT) Method

Under this approach, the US Taxpayer compared the “master franchisee” transaction of some of the fast-food companies to US Taxpayer’s foreign operations. The U.S. Tax Court rejected application of CUT method based on the following reasons:

- ✓ The U.S. Tax Court stated that the concentrate and hamburgers are not “similar products,” and beverage manufacturers and fast-food restaurants are not “in the same general industry.” Accordingly, the same cannot be compared.
- ✓ The U.S. Tax Court also noted that the contractual terms of the master franchisees were significantly different than the contractual terms of the US Taxpayers with its Supply Points.
- ✓ Additionally, the U.S. Tax Court also found that the US Taxpayer could not identify any pricing data for transactions with unrelated parties that “involve the transfer of the same intangible”- viz., the trademarks, brand names, logos, secret formulas, and proprietary manufacturing processes used to produce beverages.

2. Residual Profit Split Method (RPSM)

Under this approach, the US Taxpayer suggested that the arm’s length compensation by the Supply Points to the US Taxpayer would be the royalty paid by independent third parties for use of such IP. To calculate the residual profit to be split between the US Taxpayer and its Supply Points, the US Taxpayer first determined the “routine profit” to be assigned to the supply points for their manufacturing activity. The residual profit after deducting routine profit to be allocated between the US Taxpayer and its Supply Points on the basis of historical spending for consumer advertising. The U.S. Tax Court rejected the application of RPSM for the following reasons:

- ✓ The U.S. Tax Court observed that the premise for the US Taxpayer’s RPSM was that the Supply Points owned intangible assets. However, the Supply Points were neither the legal owners of so-called IP nor holders of rights constituting IP pursuant to contractual terms or other legal provision.
- ✓ The U.S. Tax Court also stated that even if the Supply Points deemed to own IP, the US Taxpayer did not determine the relative value of nonroutine intangible property contributed by the US Taxpayer and its Supply Points.
- ✓ Further, the U.S. Tax Court also stated that by focusing solely on historic advertising expenditures, the US Taxpayer puts nothing in the US Taxpayer’s side of the ledger to reflect the immensely valuable intangible assets (Brands, trademarks, tradenames, patents, logos, secret formulas, and proprietary manufacturing processes, etc.) used by it.
- ✓ The U.S. Tax Court found that the US Taxpayer employed an estimate based on capitalized advertising costs less amortization to determine the value of nonroutine intangibles involved in the transaction. The U.S. Court stated that this approach is unreliable as there is no consensus among economists that ordinary advertising costs can properly be capitalized as an intangible asset and about what the useful life of such an asset would be. Further, such an asset would have no value to an unrelated party as this asset could not be deployed by an unrelated party without violating the US Taxpayer’s trademarks.

3. Unspecified Method

Under this approach, the US Taxpayer suggested the “asset management model” often employed to compensate asset managers in the financial services sector. The U.S. Tax Court found that this method does not remotely resemble any of the ‘specified methods’ for valuing intangibles under the section 482 regulations. Further, the U.S. Tax Court also stated that Hedge fund managers typically do not supply intangibles to the portfolio companies they manage. By compensating the US Taxpayer only for services, it ignored the intangibles that are central to this case.

Based on the above, The U.S. Tax Court held that the IRS did not abuse its discretion under section 482 by reallocating income to the taxpayer by employing a CPM as the best method by using the supply points as the tested parties and the bottlers as the uncontrolled comparables.

KEY TAKEAWAY:

- The taxpayers should review their inter-company pricing policies and transfer pricing model annually to assess whether it satisfies the arm’s length test based on the facts and circumstances of each case. There is no certainty on the tax position adopted by the taxpayers, only because the same was accepted by the tax authority in previous years.
- The inter-company agreement plays vital role and acts as a starting point for analysing the inter-company transactions. The taxpayers should make sure that the inter-company agreement is aligned with the actual conducts of the parties involved in the transaction.
- While preparing the transfer pricing documentation, it is important to not only document why a particular method was selected as the best method, but also give to provide a detailed reasoning for rejection of other transfer pricing methods.

KNAV’s transfer pricing team continues to monitor the transfer pricing updates and its potential impact on our client’s business. We are happy to address any queries you may have with respect to this article and provide our recommendations for your specific fact situation.

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