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Will Coca-Cola's $9 Billion Transfer Pricing Tax Court Loss Be Overturned By The Eleventh Circuit?

William Byrnes (Texas A&M University Law) · Monday, August 5th, 2024

Coca-Cola announced that it would appeal to the Eleventh Circuit Court of Appeals, based in Atlanta, the Tax Court's final entered decision of August 2, 2024, in favor of the IRS' determination of $9 billion of transfer pricing adjustments and the validity of the IRS' blocked income regulations.[1]

The 240-page Coca-Cola 2020 Tax Court decision[2] held in favor of the IRS concerning $9 billion of transfer pricing adjustments for Coca-Cola's 2007, 2008, and 2009 tax years. The IRS alleged that U.S. Coca-Cola overcompensated its foreign syrup-manufacturing affiliates, known as "supply points," by under-compensating U.S. Coca-Cola to use its U.S.-owned proprietary intangibles. The supply points are in seven countries[3] but two countries, Ireland and Mexico, account for nearly $8 billion of the adjustment. Coca-Cola Ireland reported an income tax rate of only 1.4 percent during the period at issue.

Coca-Cola relied upon a transfer pricing method recorded in a 1996 IRS closing agreement to calculate its supply points' transfer pricing for the tax years 1987 through 1995 and has continued to rely upon the closing agreement method afterward. The 1996 closing agreement allowed the supply points to retain a profit equal to 10 percent of gross sales, with the remaining profit split equally between U.S. Coke and the foreign supply point. This closing agreement method became known as the 10-50-50 method. After eleven years of audits that did not challenge the 10-50-50 method, in 2007, the IRS changed tact and began employing a Comparable Profits Method (the "CPM") using data from Coca-Cola's unrelated bottlers as comparable entities. The CPM resulted in transfer pricing adjustments of $9 billion dollars from the foreign supply points to U.S. Coca-Cola.

In a follow-up decision in 2023, the Tax Court, based on its 2023 *3M* decision,[4] held that Coca-Cola could not rely on Brazil's law that blocked royalty payments to thwart the increased transfer pricing adjustment related to Brazil in favor of the U.S.[5]

What Do Coca-Cola's Financial Statements Disclose About This Transfer Pricing Controversy?

The IRS transfer pricing audit, the subject matter of the Coca-Cola Tax Court decision, began with Coca-Cola's 2007 fiscal year. For its 2007 fiscal year, Coca-Cola reported $7.873 billion in net income before taxes, $1.892 billion in income tax paid, and a 24.0 percent effective tax rate.[6] Income tax paid includes U.S. federal, state, local, and Subpart F, as well as foreign income taxes. In its 2007 report, Coca-Cola reported that in 2005, Coca-Cola repatriated $6.1 billion of its previously unremitted foreign earnings and recorded an associated tax expense of approximately $315 million. The relatively low tax expense resulted from a one-year temporary tax incentive for U.S. multinationals to repatriate foreign earnings at an approximate 5.25 percent effective tax rate pursuant to the American Jobs Creation Act of 2004.

Let's jump ahead to Coca-Cola's 2016 fiscal year report, the year it was notified that the IRS may assert transfer pricing penalties as part of an IRS transfer pricing adjustment for the years 2007 through 2009. For its 2016 fiscal year, Coca-Cola stated about the IRS' transfer pricing audit of 2007-2009:[7]

> The Company has followed the same transfer pricing methodology for these licenses since the methodology was agreed with the IRS in a 1996 closing agreement that applied back to 1987. The closing agreement provides prospective penalty protection as long as the Company follows the prescribed methodology and material facts and circumstances and relevant Federal tax law have not changed. On February 11, 2016, the IRS notified the Company, without further explanation, that the IRS has determined that material facts and circumstances and relevant Federal tax law have changed and that it may assert penalties. … The Company's compliance with the closing agreement was audited and confirmed by the IRS in five successive audit cycles covering the subsequent 11 years through 2006, with the last audit concluding as recently as 2009.
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> The disputed amounts largely relate to a transfer pricing matter involving the appropriate amount of taxable income the Company should report in the United States in connection with its licensing of intangible property to certain related foreign licensees regarding the manufacturing, distribution, sale, marketing, and promotion of products in overseas markets.[8]

Coca-Cola's statement regarding its reliance on the closing agreement seems reasonable because the Tax Court issued a summary judgment in favor of Coca-Cola on December 17, 2017, that included the facts of Coca-Cola's statement.[9] In this decision, the Tax Court granted Coca-Cola summary judgment on the limited issue of the validity of its foreign tax credits resulting from Mexico tax paid on the Mexican royalties calculated pursuant to the 1987 IRS closing agreement that the Mexico Tax Authority also accepted. The Tax Court acknowledged the 1987 closing agreement in its decision and that the agreement provided penalty protection for Coca-Cola both during the term of the agreement and for tax years after 1995. The Tax Court stated:

> For tax years after 1995, the agreement provided that Coca-Cola would meet the reasonable cause and good faith exceptions of sections 6664(c) and 6662(e)(3)(D) if its supply points continued to calculate royalties pursuant to the method of the agreement (the 10-50-50 method elaborated upon below). This protection applied to all of Coca-Cola's then-existing and future supply points.[10] The closing agreement expired on December 31, 1995. But the IRS examined petitioner's returns for each of the ensuing 11 years and concluded that "the continuing application of the closing agreement's terms and conditions to post-1995 years seems appropriate."

Coca-Cola reported $8.136 billion in income before taxes, $1.586 in taxes paid, and a 19.5 percent overall effective tax rate in 2016. Coca-Cola noted that its accumulated undistributed foreign earnings amounted to $35.5 billion.[11]

For its 2017 fiscal year report, Coca-Cola's income before taxes fell to $6.742 billion but its taxes jumped to $5.560 for an 82.5 percent effective tax rate. The reason for the jump in taxes paid and thus the effective tax rate was the Tax Cuts and Jobs Act one-time transition tax of 15.5 percent applicable to total accumulated cash and cash equivalents of post-1986 untaxed foreign earnings and profits. Coca-Cola estimated $42 billion of accumulated foreign earnings as of 2017, and a transition tax liability estimated at $4.6 billion.[12] For its 2018 fiscal year, Coca-Cola's effective tax rate returned to 19.4 percent, almost its 2016 rate, while its income before taxes grew to $8.350 billion, with taxes paid of $1.623 billion.[13]

In its most recent annual 2023 fiscal year filing, Coca-Cola noted that it has set aside a tax reserve of $439 million based on its more likely than not conclusion that the Tax Court decision will be overturned by the Eleventh Circuit Appeals Court.[14] The $439 million reserve was determined based on a calculation using the methodologies Coca-Cola thinks the federal courts will ultimately order to be used in calculating the transfer pricing deficiency and the accrued interest on such deficiency. Coca-Cola noted that the calculations incorporated the estimated impact of correlative adjustments to the previously accrued transition tax. If the Tax Court decision is upheld and the IRS' CPM methodology is applied to all tax years through 2023, the potential aggregate incremental tax and interest liability could be approximately $16 billion, increasing Coca-Cola's effective tax rate by 3.5 percent for these years.

Coca-Cola reported $12.952 billion in income before taxes, $2.249 billion of income tax paid, and a 17.4 percent effective tax rate for 2023. Not including the potential additional tax if the Tax Court decision is upheld, Coca-Cola estimates a 19.2 percent effective rate for 2024.[15]

Overview of the Tax Court Decision of 2020

In its 2020 decision, the Tax Court reached three primary conclusions.[16] The first and most important conclusion regards the transfer pricing adjustment. The Tax Court found that the IRS did not abuse its discretion under IRC section 482 when it reallocated income to The Coca-Cola Company by using the CPM whereby the IRS used the foreign supply points as the tested parties and used independent bottlers as the uncontrolled comparables. The first conclusion controls the impact of the second and third conclusions.

The second conclusion concerns the IRS' collateral adjustment for Coca-Cola's Mexican peso-based foreign currency gains and losses.[17] The Tax Court held that the IRS is allowed to adjust Coca-Cola's foreign currency losses to correlate with the reduced income of the Mexico supply point after the transfer pricing adjustment in favor of the U.S. Third, the Tax Court held that Coca-Cola is allowed to offset the transfer pricing adjustment regarding its Brazilian supply point with a collateral adjustment for the dividends paid by Brazil to the U.S. in satisfaction of the royalty determined using the 10-50-50 method.

On June 2, 2021, after nearly 200 days (well past the 30-day deadline), the Coca-Cola Company filed a motion with the Tax Court for reconsideration.[18] The Tax Court rejected the motion for reconsideration because it was well past the deadline.[19]

In a follow-up decision in 2023, the Tax Court, based on its 2023 *3M* decision,[20] held that Coca-

Cola could not rely on Brazil's law blocking royalty payments to thwart the increased transfer pricing adjustment of royalties due from the Brazil supply point.[21]

Background of the Coca-Cola – IRS Transfer Pricing Dispute

The Coca-Cola Company transfer pricing dispute arose from IRS Notices of Deficiencies resulting from IRC Section 482 transfer pricing adjustments under which the IRS reallocated significant amounts of foreign income to Coca-Cola U.S. mainly from related supply points plants in Brazil, Chile, Costa Rica, Egypt, Ireland, Mexico, and Swaziland. These supply points produced concentrate syrups, flavoring, powder, and other ingredients used in the production of The Coca-Cola Company brand name soft drinks, including Coca-Cola, Fanta and Sprite, and other nonalcoholic, ready-to-drink beverages.

The supply points sold and distributed concentrate to multiple unrelated bottlers, in Europe, Africa, Asia, Latin America, and the Pacific Rim. The bottlers ranged from small businesses to large MNEs. The bottlers used the supply points' concentrate to produce finished beverages that they would market directly or through distributors to millions of retail establishments outside the U.S. and Canada. To enable the supply points to manufacture and sell concentrate, they received licenses from Coca-Cola U.S. to use its proprietary IP, including trademarks, brand names, logos, patents, secret formulas, and proprietary manufacturing processes.

In 2007 through 2009, The Coca-Cola Company (Coca-Cola U.S.) reported income from foreign supply points using a revenue distribution method known as the "10-50-50 method", a formulary apportionment method. The Coca-Cola Company and the IRS agreed to this apportionment method, recorded in a 1996 closing agreement, to resolve previous tax disputes for taxable years 1987-1995. According to the 10-50-50 method, the supply points were authorized to retain profits equal to 10 percent of their gross sales, with the residual profits split equally (50 percent each) with The Coca-Cola Company. Although the 1996 closing agreement did not state which transfer pricing methodology to apply to taxable years beyond 1995, The Coca-Cola Company continued using the 10-50-50 method for its future tax years.

The payments subject to this 10-50-50 method were characterized as royalties, but the 1996 closing agreement permitted the supply points to satisfy their royalties by either making royalty payments or through equivalent dividend distributions. From 2007 through 2009, more than $1.8 billion of income received from the supply points was in the form of dividends. The Coca-Cola Company utilized deemed-paid foreign tax credits (FTCs) attached to the dividend distributions but would not have attached them to royalty payments.

For the tax years 2007 through 2009, the IRS changed tact regarding the 10-50-50 method. The IRS applied a CPM under which the independent bottlers of Coca-Cola beverages were used as benchmark comparable parties. The IRS found that the bottlers were the proper benchmark because they operated in a similar beverage industry, held the same economic risks and contractual relationships, employed the same intellectual property from Coca-Cola, and ultimately shared from the same income stream as the supply points sales. In implementing the CPM, the IRS calculated the average return on operating assets (ROA) for the bottlers. Then the IRS applied the average ROA to the supply points' operating assets to establish the supply points' operating profit. Applying the CPM and the ROA data led to the IRS' $9 billion adjustment from the foreign supply points to Coca-Cola U.S. Two foreign supply points, Ireland and Brazil, accounted for approximately 85 percent of the adjustment.

The Coca-Cola Company alleged that the IRS adjustments were arbitrary and capricious because the IRS disregarded the 10-50-50 method that had been acquiesced to in the immediate prior five audit cycles. The Coca-Cola Company also claimed that the IRS erred in applying the CPM method as the best method. The Coca-Cola Company argued that the unrelated bottlers are inadequate comparable parties to the supply points because the bottlers lack 'marketing intangibles' ownership. The Coca-Cola Company claimed that the supply points owned the local rights to use the Coca-Cola U.S.' marketing intangibles, and such intangibles resulted in the supra-normal level of returns. The Coca-Cola Company viewed its supply points as comparable to master franchisees or long-term licensees.

The Tax Court Holds the 1996 Closing Agreement Cannot Be Relied Upon Beyond 1995.

At the outset of its case, Coca-Cola argued that the IRS acted arbitrarily by departing from the 10-50-50 method to which the parties had agreed when executing the 1996 closing agreement, whereby the parties settled a transfer pricing dispute involving taxable years 1987 through 1995. The Coca-Cola Company pointed the Tax Court to the closing agreement language that for taxable years after 1995, to the extent The Coca-Cola Company applies the 10-50-50 method to determine the amount of its royalty income concerning existing or any future supply points, The Coca-Cola Company shall be considered to have met the reasonable cause and good faith exception to avoid accuracy-related penalties.[22]

Regarding the 1996 closing agreement, the Tax Court stated that it was silent on the transfer pricing methodology that the parties were expected to use for taxable years after 1995. The Tax Court stated that parties to a closing agreement may, and sometimes do, bind themselves to particular tax treatments for specified future years. Whereas, noted the Tax Court, Coca-Cola may have wished for the certainty that would arise from the indefinite future application of the 10-50-50 method, there is no evidence within the four corners of the 1996 closing agreement document that the IRS would have agreed to that indefinite future application. The Tax Court emphasized that there is nothing in the IRS closing agreement that suggests that the IRS regarded the 10-50-50 method as the platonic ideal of arm's-length pricing for The Coca-Cola Company concerning its supply points. The 10-50-50 method was simply a formula to which the parties conformed to settle the dispute before them at that moment in time.

Coca-Cola urged that the ordinary preclusion doctrine would prevent parties from revisiting a settlement agreement's factual underpinnings in later litigation when they intend their agreement to have a preclusive effect. However, the Tax Court noted that Coca-Cola must demonstrate that in 1996, the parties intended to address the same transfer pricing method for the years to follow 1995 by formalizing such intent within the closing agreement. The Tax Court considered that these sophisticated parties knew how to draft a conclusive closing agreement for future years had they agreed to such future certainty at the time of the agreement.

Explaining The Coca-Cola Company's Relationships With Its Foreign Supply Points and Independent Bottlers

The supply points manufacturing activity involves procuring raw materials and using The Coca-Cola Company's guidelines and production technologies to transform raw materials into concentrate. The procurement activities are limited. Many ingredients are obtained only through The Coca-Cola Company-owned flavor processing plants, and other ingredient purchases are acquired through procurement specialists from The Coca-Cola Company or its subsidiary entities known as “ServCos”. After completing the manufacturing process, the supply points package the concentrate into kits tailored to the needs and capacities of the bottlers to whom the concentrate is then distributed.

The bottlers oversee the finished product manufacturing. Having procured concentrate from the supply points, they prepared finished beverages by mixing the concentrate into purified water, carbon dioxide (for sparkling drinks), sugars, other sweeteners, and additional ingredients obtained from The Coca-Cola Company’s suppliers. The bottlers printed and added brand labels to cans and bottles before distributing or warehousing them as finished products.

From 2007 through 2009, The Coca-Cola Company performed most of the supply chain management. The bottlers were responsible for supply chain management from their concentrate receipt through distributing finished products with the wholesalers and retailers channels. The Coca-Cola Company identified approved suppliers for most raw materials. But the bottlers were responsible for securing the container materials which included aluminum, steel, and plastic. The bottler generally held a geographic territory where it claimed exclusivity. This exclusivity allowed the bottlers to cultivate an intimate understanding of the local retailers and wholesalers’ channels, anticipate local consumer preference, and build bottling and storage capacity.

Who Owned the Coca-Cola Intellectual Property?

Except for Canada, The Coca-Cola Company was the registered legal owner of the worldwide trademarks related to Coke, Fanta, Sprite, and other beverages. The trademark of the Coke products covers the Spencerian script, the dynamic ribbon, the red-and-white color palette, and the contour bottle shape. The Coca-Cola Company perpetuated its global brand by maintaining rigorous standards for the core visual design elements and messaging. The standards provide detailed guidance to keep marketing consistency.

The intercompany agreements granted the supply points no rights or ownership interest to The Coca-Cola Company’s trademarks. The intercompany agreements identified The Coca-Cola Company as the “owner” or “registered proprietor” of the trademarks, and it expressly reserved the right to control all things and acts related to or involving the use of the Coca-Cola trademarks. The supply points received a restricted right to use the trademarks concerning production and sales activities. Unlike most of the supply points, Brazil was initially allowed to contract with the bottlers, and it was therefore authorized to sublicense the use of Coca-Cola trademarks to local bottlers. The sub-licensing rights were later canceled.

The bottlers had access to trademark rights. While the bottlers could use Coca-Cola trademarks in connection with the production, sale, and distribution of finished beverages, they had to acknowledge that The Coca-Cola Company was the sole owner of those trademarks together with any goodwill generated by the bottler’s use of the trademarks. The Coca-Cola Company reserved the right to control most aspects of the trademark, and the bottlers agreed to seek approval from The Coca-Cola Company for advertising, promotions, or other marketing that involved the trademarks. In practice, the ServCos were in charge of administering such approval from The Coca-Cola Company side.

From 2007 through 2009, The Coca-Cola Company showed average book assets of around $15 billion. These assets ($11.7 billion on average) comprised investments in subsidiaries and other affiliates. The Coca-Cola Company’s balance sheets report trademarks and other intangible assets of around $500 million. This figure does not reflect the market value of The Coca-Cola Company's self-developed intangibles and beverage brands. The Coca-Cola Company is the registered owner of virtually all trademarks covering the Coca-Cola, Fanta, and Sprite brands and of the most valuable trademarks covering the other soft-drink products. The Coca-Cola Company is the registered owner of nearly all of the patents, including patents covering aesthetic designs, such as bottle shapes and caps, packaging materials, beverage ingredients, and production processes. The Coca-Cola Company owns all intangible property from the research and development of new products, ingredients, and packaging. The ServCo agreements executed after 2003 explicitly stipulated that any marketing concepts developed by third-party vendors are property of a subsidiary of The Coca-Cola Company called "Export," securing the ownership of all developed marketing intangibles.

Four supply points, Ireland, Costa Rica, Egypt, and Swaziland, showed no trademarks or other intangible property on their balance sheets. Only Brazil's supply point reflects intangible property, representing about 11 percent of its book assets.

What Were the Terms Recorded in Coca-Cola's Inter-Company and Bottler Agreements?

The supply points sold and distributed concentrate to multiple unrelated bottlers, in Europe, Africa, Asia, Latin America, and the Pacific Rim. The bottlers ranged from small businesses to large MNEs. The bottlers used the supply points' concentrate to produce finished beverages that they would market directly or through distributors to millions of retail establishments outside the U.S. and Canada. To enable the supply points to manufacture and sell concentrate, they received licenses from The Coca-Cola Company to use its proprietary IP, including trademarks, brand names, logos, patents, secret formulas, and proprietary manufacturing processes.

> Although The Coca-Cola Company had relied on the 10-50-50 method to compute royalties payable by the supply points, ***the intercompany agreements were silent on this method***.

For instance, the Mexico supply point agreement specified a royalty computed as an operating profit percentage. The Ireland and Swaziland supply point agreements specified a royalty computed as a percentage of concentrate sales. The Brazil supply point agreement stipulated a $100 royalty. As a business practice, The Coca-Cola Company credited all the supply point payments against the royalty obligation of the 10-50-50 method.

The bottlers remunerated The Coca-Cola Company through the price they paid for the concentrate. The price bundled all of the Coca-Cola Company's valuable inputs into a single bill, ostensibly for concentrate. With a bundled payment, the bottlers secured not only the physical beverage base but also the entire package of rights and privileges required to operate as official bottlers. The bundled payment includes the right to use the Coca-Cola trademarks, access to approved suppliers, company databases, marketing materials, and support.

The Coca-Cola Company reserves a unilateral right to set the concentrate price, which in theory enabled it to set up the bottler's profitability, although concentrate prices were established through local negotiation to equitably share operating profit. Although the parties' goal was to achieve something near a "50 percent-50 percent" split of the profit, in practice, the profit split usually ranged between 45 percent and 55 percent in favor of one party or the other. The bottlers might negotiate a share near the high end of the 50 percent range in cases involving economic headwinds or large capital expenditures.

The Coca-Cola Company derives its share of income through the bottlers' payments for concentrate. The supply points receive most of this income, remitting to The Coca-Cola Company only what is needed to satisfy the royalty obligation determined under the 10-50-50 method. The administrative and marketing expenses are incurred through The Coca-Cola Company or the ServCos. These expenses are shifted to the supply points books through intercompany charges. The Coca-Cola Company's income stream reflects its role as the brand owner and administrator. Its gross receipts for 2007 through 2009 consisted primarily of pro-rata royalties for using its intangible property.

The IRS Basis of its Adjustments Of Royalties Due Coca-Cola U.S.

The IRS selected The Coca-Cola Company's 2007, 2008, and 2009 returns for examination. During the audit work, the IRS Field Exam determined that the 10-50-50 method did not reflect arm's-length conditions because this method under-compensated The Coca-Cola Company for the use of its intangibles. IRS economists identified The Coca-Cola Company as the legal owner of virtually all the company trademarks and intangible property, thus owning the vast majority of brand value. The supply points functioned essentially as contract manufacturers yet kept most of the income generated by concentrate sales to the foreign third-party bottlers. The IRS concluded that an adjustment to income was warranted to reflect an arm's length income distribution between The Coca-Cola Company and its supply points.

Concluding that no uncontrolled transaction could accurately capture the value of licensing the Coca-Cola unique brand, the IRS Economists rejected the Comparable Uncontrolled Transaction (CUT) method as an appropriate method. Likewise, the Profit Split method was rejected, finding it unreliable where one party, The Coca-Cola Company, owns all valuable intangible assets while the counterparties, the supply points, own virtually none. Instead, the IRS identified the Comparable Profits Method (CPM) as the best method whereby the third-party bottlers were comparable entities to benchmark the results of the supply points.

In a report that the IRS expert witness, economist T. Scott Newlon, presented to the U.S. Tax Court, Newlon selected 18 independent Coca-Cola bottler entities headquartered in 10 countries having qualified auditors statements for 2007 through 2009. The Newlon report concludes that a return on operating assets (dividing operating income by operating assets) derived from the bottlers' operations would yield adequate adjustments to the supply points' income. Newlon concluded that some of the supply points received compensation above arm's-length. His report features three main recommendations:

> [1] The income for Brazil, Chile, Costa Rica, and Mexico supply points will be adjusted downward to reflect an ROA consistent with the ROAs of the Latin American bottler segment.
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> [2] The income of the Ireland and Swaziland supply points should be adjusted downward to reflect an ROA consistent with the ROAs of bottlers, except for those in East Asia.
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> [3] Adjusting upward the 2007 and 2008 income for Egypt's supply point.

The IRS implemented these adjustments consistent with the recommendation. It adjusted downward the income of Brazil, Chile, Costa Rica, and Mexico supply points to reflect the median ROA of the Latin America Bottler segment. It adjusted downward the income for Ireland and Swaziland supply points to reflect the median ROA of the 13 non-East Asia bottlers. To the extent a supply point reported income exceeding its benchmark, the IRS determined to allocate additional royalty income to The Coca-Cola Company from that supply point.

Reflecting these adjustments, the IRS issued a Notice of Deficiency which The Coca-Cola Company challenged before the U.S. Tax Court. Following discovery, the government amended its answer to assess additional deficiencies related to The Coca-Cola Company's practice referred to as "split invoicing," under which certain ServCos received compensation from the bottlers at rates that were, on average, higher than the rates specified in the agreements the ServCos would have executed with Export. Concluding that the ServCo agreements with Export were not reflecting arm's-length conditions, the IRS alleged that excess income ServCo received from the bottlers, such as compensation over a markup on non-direct marketing expenses, should be reallocated to The Coca-Cola Company. These adjustments produced additional deficiencies totaling $134,905,174 for the three audit years.

The IRS' Best Method Rule Application and Choice of Comparables

The best method rule requires that the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. No method is invariably considered more reliable than others. For controlled transfers of intangible property, the regulations provide four methods to determine an arm's-length result:[23] [1] Comparable Uncontrolled Transaction (CUT) method, [2] Comparable Profits method (CPM), [3] Profit Split method, and [4] an unspecified method. CUT provides an especially high degree of reliability only "[i]f an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction." The Tax Court found that the Coca-Cola Company did not identify pricing data for transactions with unrelated parties that involved the transfer of the same intangibles, and thus, Coca-Cola's attempt at CUT was inapplicable.

Newlon, in his report prepared for the IRS, determined that the supply points (other than the Egypt supply point) enjoyed levels of profitability unjustified by the level of economic functions. The supply points were engaged almost exclusively in manufacturing functions, and The Coca-Cola Company expert witnesses in the trial also confirmed that the supply points exercised a routine activity that is equivalent to the activities of contract manufacturers. The supply points in Brazil, Chile, and Egypt employ personnel who engage in additional activities, such as marketing, sales, and finance. To the extent the supply points performed non-manufacturing activities, they discharged functions similar to those performed by ServCo employees. The ServCos were compensated for their employees' services on a cost-plus basis, with an average markup of six percent to seven percent. The Coca-Cola Company did not question the arm's-length character of the ServCos' compensation. Based on ServCos then, the arm's-length compensation for the supply points services should range between six percent and 8.5 percent over cost. But the profits of the supply points exceeded this range.

The supply points' average annual revenue surpassed the yearly average cost by $3.85 billion ($10.57 billion – $6.72 billion). They enjoyed, on average, a markup on costs of about 57 percent ($3.85 billion ÷ $6.72 billion). That return level is close to seven times the 8.5 percent return that represents the arm's-length value of their manufacturing activities, using the IRS method.

The Coca-Cola Company, with a 55 percent ROA, was highly profitable; it outperformed 968 (or 97 percent) of the 996 tested companies. But its supply points produced an even higher ROA reflecting intercompany profit shifting. The supply points in Ireland, Brazil, Chile, and Costa Rica generated a ROA of 215 percent, 182 percent, 149 percent, and 143 percent on average ROA, respectively. These four had a ROA higher than the 996 companies from the benchmark group. The supply points in Swaziland and Mexico, each with 129 percent and 94 percent ROA had ROAs higher than 99 percent of the companies in the benchmark group. This situation resulted in the Tax Court pondering a question: Why are the supply points, engaged as they are in routine contract manufacturing, the most profitable food and beverage companies in the world?

In the report that Newlon prepared for the IRS, he included a list of comparable entities consisting in 18 unrelated bottlers, headquartered in ten countries all with qualified auditor statements. In the expert witness report that Newlon later submitted to the Tax Court, this comparable list was enlarged to 24 bottlers. The same report concluded that the best profit level indicator (PLI) is ROA.

Tax Court Decision Regarding Supply Points

The Tax Court concluded that the IRS did not abuse its discretion by using the bottler’s ROA to adjust income between The Coca-Cola Company and the supply points. First, the CPM was a reasonable method to apply given the nature of the assets owned and the activities performed by the controlled taxpayers. Second, the IRS’ selection of comparable parties was appropriate. Third, the IRS computed and applied ROA using reliable data, assumptions, and adjustments. The Tax Court found that the bottlers, in many respects, enjoyed an economic position superior to that of the supply points, which justifies a higher return for the bottlers.

The Tax Court opined that the case is particularly susceptible to applying CPM because The Coca-Cola Company owned virtually all the intangible assets needed to produce and sell the soft-drink beverages. The Coca-Cola Company was the registered owner of almost all trademarks covering the Coca-Cola, Fanta, and Sprite brands and of the most valuable trademarks for other products. The Coca-Cola Company was the registered owner of nearly all the patents, including patents covering aesthetic designs, packaging materials, beverage ingredients, and production processes. The Coca-Cola Company owned all rights to secret formulas and proprietary manufacturing protocols. The Coca-Cola Company owned all intangible property resulting from R&D concerning new products, ingredients, and packaging. The Coca-Cola Company was the counterparty to all Bottler agreements, giving it ultimate control over the distribution system for the soft-drink beverages.

The supply points, by contrast, owned few, if any, valuable intangibles. Their agreements with The Coca-Cola Company explicitly acknowledged that Coca-Cola U.S. owned the company trademarks, giving the supply points only a limited right to use the intellectual property. Four supply points booked zero trademarks or other intangible assets. Only Brazil booked $190 million of intellectual property assets but attributed to local brands. The supply points’ agreements with The Coca-Cola Company granted rights to produce and sell concentrate, and The Coca-Cola Company refers to these rights as “franchise rights.” But the agreements were terminable at will. No supply point enjoyed any form of territorial exclusivity, and no supply point was granted any right, express or implied, to concentrate production. Thus, the Tax Court concluded that the supply points did not own valuable intangible assets in the form of “franchise rights.”

The Tax Court analyzed whether the unrelated bottlers that the IRS selected were reasonably treated as comparable to the supply points. The CPM requires consideration of the general comparability of five factors which include [1] functions performed, [2] contractual terms, [3] risks, [4] economic conditions, and [5] property employed or transferred. The Tax Court found that the five factors were present when comparing the bottlers with the supply points. The Tax Court agreed with the IRS' analysis that the bottlers operate in the same industry, face similar economic risks, share similar contractual and economic relationships with The Coca-Cola Company, use most of the same intangibles (brand names, trademarks, and logos), and share the same income stream from the sale of soft drinks. In many aspects, the bottlers and supply points share comparable economic conditions. Both sets of companies are participants of the Non-Alcoholic-Ready-to-Drink (NARTD) industry where revenues are dependent on the retail of soft drink beverages, and both face risks from economic cycles.

After its analysis, the Tax Court concludes that the IRS did not abuse its discretion in reallocating income from the supply points to The Coca-Cola Company by using the bottlers' ROA data. The Coca-Cola Company did not carry its burden of showing that such determination was arbitrary, while the IRS presented substantial evidence supporting its adjustment.

What About the Supply Points' Marketing Intangibles?

In its petition, the Coca-Cola Company argued that the supply points owned valuable marketing intangibles generated by the spending of advertising dollars that the IRS neglected to consider when applying CPM. These marketing intangibles should be included among the supply points' operating assets for their ROA computation.

Yet, the Tax Court found no support for this argument, stating that The Coca-Cola Company and the supply points **did not enter** into a Qualified Cost-Sharing Arrangement. The Coca-Cola Company was the registered legal owner of all trademarks and intangibles used to manufacture and produce branded beverages. The ServCos' consumer marketing activities presumably enhanced the value of The Coca-Cola Company's intangibles in local markets. However, the supply points received only a restricted right to use intangibles in their production and sales activities. The Tax Court concluded that the supply points were neither the legal owners of long-term licenses nor holders of rights constituting an intangible property pursuant to contractual terms. The supply points enjoyed none of the privileges or protections a genuine long-term licensee would otherwise enjoy.

Likelihood of the Eleventh Circuit Overturning the Tax Court?

Coca-Cola's argument that it should be able to rely upon the 1996 closing agreement's 10-50-50 method may resonate with Eleventh Circuit judges. Yet, a closing agreement is not an Advanced Pricing Agreement like at issue in the IRS loss at the Sixth Circuit in *Eaton*.[24] I think Coca-Cola has a steep uphill climb in its Eleventh Circuit Appeal because it lacks contractual documentation regarding using the 10-50-50 method between Coca-Cola U.S. and its foreign supply points. The variants within the contractual documentation with supply points and with the local accounting of payments to Coca-Cola U.S. do not work in Coca-Cola's favor. Moreover, the lack of a cost-sharing arrangement among the parties regarding a transfer from Coca-Cola U.S. of marketing intangibles or the generation of marketing intangibles by the supply points concerning their expenditure of advertising dollars, or an agreement of substantive rights for the supply points reflected in a long-term license, favors the IRS' argument that the supply points do not own or control marketing intangibles.

Yet, if Coca-Cola establishes that the supply points have or control some intangibles, taxpayers have had success arguing that a CUT applies and that the IRS' CPM approach does not. Or, as seen with the most recent Medtronic Tax Court decision (see my Kluwer International Tax Blog *Medtronic* article here), the Tax Court has applied a hybrid combined approach of CUT and CPM. Coca-Cola's litigation team must be keenly aware of the importance that Coca-Cola proves that the supply points hold some intangibles.

Will the Blocked Income Regulations Be Upheld by the Eleventh Circuit?

The Coca-Cola Company contends that if it had owned the trademarks for Brazil, Brazil law would have prevented the Brazil supply point from paying royalties for the use of those trademarks anywhere close to the amounts determined in the IRS Notice of Deficiency. The Brazilian domestic law restricted the amount of trademark royalty and technology transfer payments that Brazilian entities could pay to their foreign parents. The IRS responded that the Brazil law restriction did not control the determination for arm's-length conditions. The Blocked Income Regulations provide those foreign legal restrictions are taken into account only if certain conditions are met.[25] The Coca-Cola Company retorted that the Blocked Income Regulations conditions are met. In the alternative, The Coca-Cola Company contends that the Blocked Income Regulations were invalid under the Administrative Procedure Act.[26]

The Tax Court took notice that the validity of the Treasury Regulations Section 1.482-1(h)(2) was undergoing a legal challenge by another taxpayer, 3M Co., whereby the Tax Court granted 3M Co. a motion to submit the case for decision without trial under Rule 122.[27] Given the pending status of the 3M case at the time of the initial Coca-Cola decision, the Tax Court reserved its ruling on the validity of the Blocked Income Regulations until a decision in the 3M case. Yet, the 3M case was decided in favor of the IRS, and thus, this aspect of Coca-Cola was also decided in favor of the IRS. However, the Tax Court's 346-page 3M decision was split nine in favor of the IRS and eight in dissent. The nine judges in favor of the IRS split across three decisions, of which no decision received a majority of the Tax Court. The dissenting judges also filed three decisions.[28]

Boiling down the 3M decision to its bare essence, the outcome in the Eleventh Circuit, I think, will be determined by two issues: whether the blocked income regulation validity is controlled by the Supreme Court Court's 1972 decision *Comm'r v. First Security Bank of Utah* ("*First Security*")[29] and whether the blocked income regulation meets the promulgation requirements of the Administrative Procedure Act.[30] Regarding the second issue, the U.S. Supreme Court in 2024 overturned the applicability of *Chevron* deference that favored the government's (i.e. the IRS') regulatory interpretation of a statute.[31] I previously wrote about the potential impact of Chevron's overturning on this Kluwer International Tax Blog: "How May the Supreme Court Overturning of Chevron Deference Impact International Tax Regulations and Pending Cases?"[32] Coca-Cola has a stronger argument for its appeal regarding the IRS' adjustment applied to its Brazilian subsidiary, with *Chevron's* deference overruled.

Regarding the first issue, the IRS has consistently rejected foreign legal restrictions. However, the IRS's refusal to recognize the impact of foreign legal restrictions was rejected by the Sixth Circuit Court of Appeals in *Procter & Gamble Co. v. Commissioner*.[33] The Sixth Circuit treated foreign legal restrictions as being similar to domestic legal restrictions, although the Sixth Circuit stated that foreign legal restrictions may require heightened scrutiny to make sure that the taxpayer was not responsible for the restriction. In that case, the IRS attempted to apply IRC Section 482 to attribute a two-percent royalty to Procter & Gamble's Swiss subsidiary from its Spanish subsidiary. The Spanish subsidiary was directly owned by the Swiss subsidiary. The effect of applying IRC Section 482 in that case would have been to increase the Swiss subsidiary's Subpart F income taxable to Procter & Gamble, the U.S. parent. Following the U.S. Supreme Court decision of *First Security*,[34] the Sixth Circuit held that the restrictions of Spanish law, not Procter & Gamble's control, caused the Spanish subsidiary to fail to pay royalties. The Sixth Circuit held that because control is a predicate to applying IRC Section 482, that section could not be applied.

The principle of *Procter & Gamble* was extended in *Exxon Corp. v. Commissioner*.***[35]*** In *Exxon*, the foreign legal restriction was less formal than the restrictions in prior court decisions. *Exxon* was involved in a crude oil pricing restriction imposed by the government of Saudi Arabia on a U.S. corporation that required the pricing of oil below the market price. The restriction prohibited the sale of Saudi crude oil at a price above the official selling price set by Saudi Arabia. The IRS tried to reallocate income to Exxon and other U.S. taxpayers who complied with this restriction. The Tax Court nevertheless found that there was a valid and binding restriction of the government of Saudi Arabia and disallowed the reallocation. The U.S. Court of Appeals for the Fifth Circuit, finding that the restriction had the effect of law, affirmed the Tax Court's ruling in *Exxon*.[36]

Moreover, if the Eighth Circuit overturns the 3M Tax Court decision (whether by its own analysis and judgment or remanding the case to the Tax Court in light of Chevron's demise), then the last part of the Coca-Cola Tax Court decision addressing the same blocked income regulations may also be remanded by the Eleventh Circuit (because the Coca-Cola decision relied specifically on the outcome of the 3M decision).[37]

My crystal ball informs me that the Eleventh Circuit will side with Coca-Cola on the blocked income issue.

Professor William Byrnes is the primary author of the 2,000-page treatise Practical Guide to U.S. Transfer Pricing.

[1]The primary 2020 Tax Court decision was finalized on August 2, 2024. The four-year lapse between its initial Coca-Cola decision and the entry of the final decision was due to the Tax Court waiting on its 2023 decision in the 3M case before adjudicating Coca-Cola's blocked income regulations claim. After a split Tax Court sided with the IRS on the blocked income regulations in the 3M case decided February 9, 2023, the Tax Court issued its second Coca-Cola decision on Nov. 8, 2023. *See* "U.S. Tax Court Enters Decision in Ongoing Dispute Between The Coca-Cola Company and the U.S. Internal Revenue Service," Coca-Cola Press Release, August 2, 2024, https://investors.coca-colacompany.com/news-events/press-releases/detail/1115/u-s-tax-court-enters-decision-in-ongoing-dispute-between.

[2] Coca-Cola Co. v Comm'r, 155 T.C. 145, 155 T.C. No. 10, 2020 U.S. Tax Ct. LEXIS 27 (Nov. 18, 2020).

[3] Brazil, Chile, Costa Rica, Egypt, Ireland, Mexico and Swaziland.

[4] Read about the 3M decision at William Byrnes "The 3M Decision: Did Treasury or Congress Overturn Past Jurisprudence?" Kluwer International Tax Blog (Feb. 11, 2023), https://kluwertaxblog.com/2023/02/11/the-3m-decision-did-treasury-or-congress-overturn-past-jurisprudence.

[5] Coca-Cola Co. v. Comm'r, No. 31183-15, 2023 Tax Ct. Memo LEXIS 138 (T.C. Nov. 8, 2023).

[6] Coca-Cola 10-K 2007 at 113.

[7] Coca-Cola 10-K 2017 at 23.

[8] Coca-Cola 10-K 2017 at 41.

[9] Coca-Cola Co. v. Comm'r, 149 T.C. No. 21, 5 (U.S.T.C. Dec. 14, 2017).

[10] Coca-Cola Co. v. Comm'r, 149 T.C. No. 21, 6 (U.S.T.C. Dec. 14, 2017).

[11] Coca-Cola 10-K 2017 at 42.

[12] Coca-Cola 10-K 2017 at 41.

[13] Coca-Cola 10-K 2018 at 48.

[14] Coca-Cola 10-K 2024 at 30.

[15] Coca-Cola 10-K 2024 at 61.

[16] Coca-Cola Co. v Comm'r, 155 T.C. 145, 2020 U.S. Tax Ct. LEXIS 27, 155 T.C. No. 10 (Nov. 18, 2020).

[17] IRC § 987.

[18] Coca-Cola Co. v. Comm'r, doc. No. 31183-15, T.C. (filed June 2, 2021).

[19] Coca-Cola Co. v. Comm'r, doc. No. 31183-15, T.C. (October 26, 2021). Coca-Cola filed its motion late, 166 days past the 30-day deadline.

[20] Read about the 3M decision at William Byrnes "The 3M Decision: Did Treasury or Congress Overturn Past Jurisprudence?" Kluwer International Tax Blog (Feb. 11, 2023), https://kluwertaxblog.com/2023/02/11/the-3m-decision-did-treasury-or-congress-overturn-past-jurisprudence.

[21] Coca-Cola Co. v. Comm'r, No. 31183-15, 2023 Tax Ct. Memo LEXIS 138 (T.C. Nov. 8, 2023).

[22] IRC §§ 6664(c) and 6662(e)(3)(D).

[23] Treas. Reg. 1.482-4(a).

[24] Eaton Corp. v. Comm'r, 2022 U.S. App. LEXIS 23853 (6th Cir. 2022). For my analysis of the Eaton case, see William Byrnes, "Heads I Win, Tails You Lose. Or is an APA a contract subject to contract law?", Kluwer International Tax Blog (August 29, 2022) https://kluwertaxblog.com/2022/08/29/heads-i-win-tails-you-lose-or-is-an-apa-a-contract-subject-to-contract-law.

[25] Treas. Reg. 1.482-1(h)(2)

[26] Referring to Chevron, U.S.A., Inc. v NRDC, Inc., 467 U.S. 837, 104 S.Ct. 2778, 1984 U.S. LEXIS 118 (1984).

[27] 3M Co. & Subs. v. Commissioner, T.C. Docket No. 5816-13 (filed Mar. 11, 2013).

[28] William Byrnes "The 3M Decision: Did Treasury or Congress Overturn Past Jurisprudence?" Kluwer International Tax Blog (Feb. 11, 2023), https://kluwertaxblog.com/2023/02/11/the-3m-decision-did-treasury-or-congress-overturn-past-jurisprudence.

[29] Commissioner v. First Security Bank of Utah, N.A., 405 U.S. 394 (1972).

[30] 5 U.S.C. §§ 551–559.

[31] Loper Bright Enters. v. Raimondo, Nos. 22-451, 22-1219, 2024 U.S. LEXIS 2882 (June 28, 2024), overturning Chevron, U.S.A., Inc. v. NRDC, Inc., 467 U.S. 837, 104 S. Ct. 2778 (1984).

[32] William Byrnes, "How May the Supreme Court Overturning of Chevron Deference Impact International Tax Regulations and Pending Cases?", Kluwer International Tax Blog (July 1, 2024), https://kluwertaxblog.com/2024/07/01/how-may-the-supreme-court-overturning-of-chevron-deference-impact-international-tax-regulations-and-pending-cases.

[33] 961 F2d 1255 (6th Cir. 1992), aff'd 95 T.C. 323 (1990).

[34] Comm'r v. First Security Bank of Utah, 405 U.S. 394, 92 S. Ct. 1085 (1972).

[35] 66 T.C.M. 1707 (1993), aff'd sub nom, Texaco, Inc v Commr, 98 F.3d 825 (5th Cir. 1996), cert. denied, 520 U.S. 1185 (1997).

[36] Texaco v. Comm'r, 98 F.3d 825 (5th Cir. 1996).

[37] Coca-Cola Co. v. Comm'r, No. 31183-15, 2023 Tax Ct. Memo LEXIS 138 (T.C. Nov. 8, 2023).

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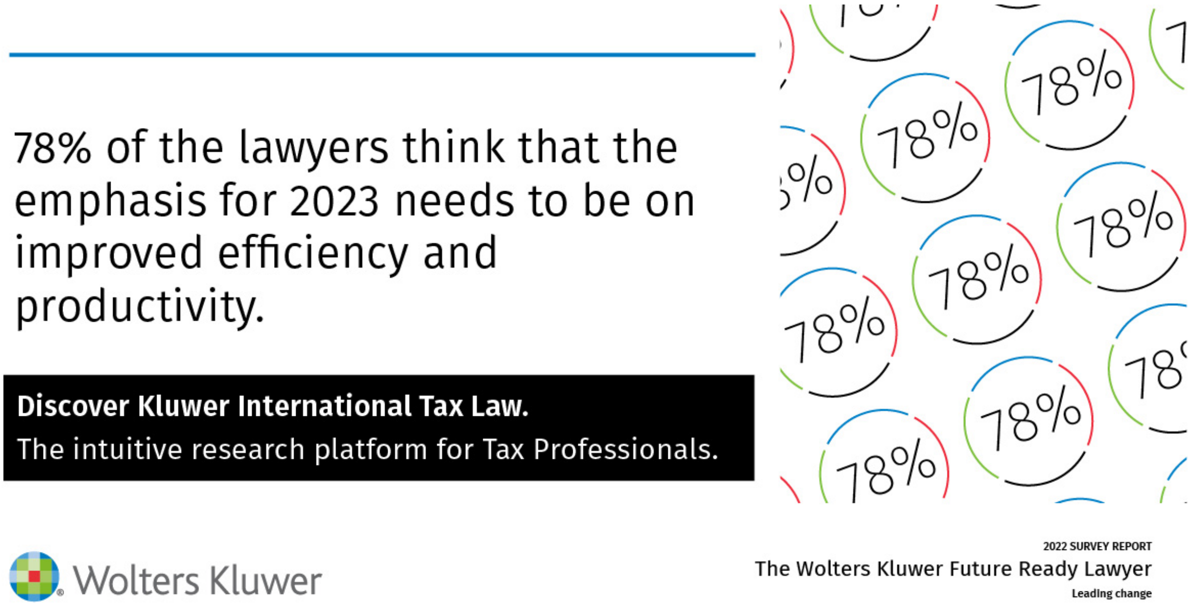

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