TaxNotes

News Analysis: Transfer Pricing Wars: IRS vs. Coke

POSTED ON OCT. 15, 2018

NANA AMA SARFO

Coca-Cola walked into the second quarter of 2018 unsure about how a new sugar tax in the United Kingdom would eat into its bottom line, bracing itself for potentially underwhelming results. Instead, the company received a delightful surprise: Sales and profits during that period surpassed expectations thanks mostly to Diet Coke, which is experiencing a renaissance after years of bad press about artificial sweeteners. It turns out that consumers don't mind drinking aspartame if it's cloaked behind trendy new Diet Coke flavors like mango and blood orange.

The company is riding the tax changes by slashing sugar in over half of its U.K. products, but it also made a calculated decision to keep the same formula for its Coca-Cola Classic, refusing to let the tax law alter its best-selling drink and instead opting to package it in smaller containers.

Across the Atlantic, the company is refusing to be intimidated by a different, thorny tax issue: a $3.3 billion transfer pricing row with the IRS that claims the company undercharged several of its foreign licensees to use Coke's intellectual property abroad, including beverage formulas and trademarks. Coca-Cola was essentially dragged into the litigation — the IRS designated the case for trial, eliminating Coca-Cola's ability to seek a settlement with IRS Appeals if it had wanted to. But Coca-Cola has maintained a strong stance from the outset, mentioning in several securities filings that it expects to win the case.

There's a lot at play here in the showdown between the world's largest beverage company and the IRS. The IRS says the foreign licensees should have paid Coca-Cola an additional $9.4 billion in royalties between 2007 and 2009, meaning that Coke should have paid an extra $3.3 billion in federal taxes. Coca-Cola contends that the $9 billion figure exceeds the total operating profits that the licensees at question earned during the three years. Beyond that, the company says the IRS is being arbitrary and capricious by suddenly challenging the transfer pricing method that Coke has relied on for the past two decades — a method that Coke and the IRS agreed on in a 1996 closing agreement.

The agreement has since expired, but the parties had an understanding that Coke would not incur penalties if it continued to rely on the method after the closing agreement formally ended. Both sides hashed out their arguments before the U.S. Tax Court during a spring trial and practitioners are hoping the impending decision will answer whether Coke's reliance on the closing agreement was reasonable. Beyond that, the case highlights the narrow path that taxpayers must walk between structuring business processes around prior IRS agreements and navigating transfer pricing in a post-base erosion and profit-shifting world in which tax authorities are reexamining those arrangements while obtaining more information via country-by-country reporting that could potentially upend existing arrangements.

Background

Atlanta-based Coca-Cola credits its international success to a decentralized business structure in which foreign licensees like Coca-Cola Egypt and Coca-Cola Ireland are responsible for driving all aspects of company business in their respective markets, according to court documents. At issue in the Tax Court case is Coca-Cola's relationship with six foreign licensees in Ireland, Swaziland, Egypt, Costa Rica, Brazil, and Chile.

Each licensee would develop and market beverages that suited local tastes, sell concentrate to local bottlers, take on entrepreneurial risks and responsibilities for their markets, and fund most of the expenses in those regions, according to documents filed by Coca-Cola. The licensees would also reimburse the parent company for the costs of activities that benefited their markets via a pro rata reimbursement process. Because of that system, Coke says it essentially has not borne any expenses in those regions.

It's a strategy that allowed the company to tailor thousands of different products to specific markets. It's also a strategy that is key to the company's profitability — according to documents filed by Coca-Cola, more than 75 percent of the company's beverage concentrate sales during the years at issue (2007 through 2009) occurred outside the United States.

In the 1990s, Coca-Cola and the IRS butted heads on the company's royalty rates, reaching a resolution in 1996 via a royalty closing agreement that applied to Coke's 1987-1995 tax years. At the time of the agreement, the Costa Rica licensee did not exist but was eventually treated in accordance with the agreement.

The closing agreement established that the foreign licensees would calculate their royalties according to a 10-50-50 residual profit split method. The licensees, also known as supply points, could retain 10 percent of their gross sales, and the residual amount was split fifty-fifty between the supply point and Coca-Cola. Coke says the formula attributed most of the foreign profit to the licensees in recognition of their contributions and investments in the company's international business.

According to Coke's pretrial memorandum, the agreement also gave the company ongoing penalty protection and established that Coke would not be hit with transfer pricing penalties so long as it used the 10-50-50 formula on current and new supply points and there were no material changes, including an advance pricing agreement or competent authority resolution.

Coca-Cola says it complied with the agreement's terms since 1996 and applied the 10-50-50 method to its foreign licensees, including the Costa Rica licensee after it was formed in 2001. The IRS continued to audit Coca-Cola and its compliance with the 10-50-50 method and accepted the company's tax returns through 2006.

Coca-Cola's approach to the closing agreement is not abnormal, according to Susan Fickling-Munge, managing director at Duff & Phelps LLC.

"Historically, taxpayers have thought that, 'Well, we had an agreement, we should continue to use that approach,'" Fickling-Munge told *Tax Notes*. "When we're talking to our clients in the context of a transfer pricing analysis, or when we're thinking about IP valuation, certainly some of the questions we ask are about the audit history and what prior agreements with the IRS have been."

The reality is that there are a lot of practical implementation issues that make multinationals wary of changing a strategy that the IRS previously agreed to, Barbara Mantegani of Mantegani Tax PLLC told *Tax Notes*.

"Unless and until something happens with the business model or market conditions or with the related parties themselves, like a big corporate restructuring, it's much less likely that any tax authority would mess with it," Mantegani said. "If you have agreed on a particular structure and it's built into the taxpayer's system, you don't just change that on a whim."

But things changed after Coke filed its 2007-2009 tax returns. In a 2011 audit, the IRS said the six licensees should have allocated all residual profits to Coca-Cola, after an outside economist assessed the royalties based on the comparable profits method. Broadly speaking, the CPM compares a controlled transaction against a similar transaction between uncontrolled taxpayers to determine whether the controlled transaction was arm's length. The CPM lies at the heart of many of the IRS's transfer pricing battles — usually on the basis that taxpayers should have applied that method instead of others like the comparable uncontrolled transaction method.

"The IRS in their audits and all the way into litigation typically look more into profit-based methods, profit splits, because there's an inherent asymmetry of information when you're looking at CUTs. The taxpayer knows everything about that CUT, and the IRS really has to know what questions to ask," according to Mantegani.

In this case, the IRS argued that the royalty rate should have been 45 percent, using the returns the company's local bottlers as a profit level indicator.

Coca-Cola argued that the bottler-based CPM was inappropriate because it used the balance sheet operating assets of bottlers to establish comparable profit levels, although their functions, risks, and assets are not similar to those of the foreign licensees. According to Coca-Cola, the bottlers' business relied heavily on tangible assets because they primarily purchased beverage concentrate from the licensees and distributed finished beverages. The licensees' business, on the other hand, did not rely on tangible assets as deeply. Beyond that, the bottlers and licensees did not use Coca-Cola's trademarks in similar ways, according to the company. The bottlers were limited to using the trademarks as distributors of Coke products, while the licensees developed IP in their regions and conducted marketing.

On that basis, the company said the bottler-based CPM was not a reliable method or the best method for pricing the licenses. The company further alleged that the IRS ignored the fact that the Brazilian licensee was subject to foreign legal restrictions that blocked it from allocating income to Coca-Cola.

The transfer pricing dispute also implicated Coca-Cola's foreign tax credits. The IRS reduced Coke's FTCs for 2007-2009 after determining that the company's Mexico licensee failed to pay Coca-Cola arm's-length royalties under the 10-50-50 formula and subsequently overpaid its Mexican income tax. According to the IRS, the overpayments weren't obligatory and consequently weren't taxes. The Mexico issue was addressed in a December 2017 Tax Court ruling that restored roughly $139 million worth of FTCs to Coca-Cola. The court found that Coca-Cola had sought appropriate counsel about its Mexico licensee and whether the entity's payments were arm's length under Mexican law.

Reasonableness and Reliance

Why did Coca-Cola continue to rely on the arrangement for so many years? The company says the closing agreement's ongoing penalty protection freed Coca-Cola from conducting annual transfer pricing documentation under section 6662(e) of the IRC. It's a perk Coke says was immensely valuable since it did not have to spend time and expenses on applying the best method rule. The best method rule under Treas. reg. section 1.482-1(c)(1) requires taxpayers to determine the method that gives the most reliable arm's-length result under their facts and circumstances.

Beyond that, Coca-Cola says the nature of the provision discouraged the company from changing its intercompany licensing structures and arrangements or applying new ones to future supply points. Essentially, the company is saying that it was boxed in by its understanding with the IRS.

The IRS apparently thinks differently. Shortly before trial it sought to exclude the closing agreement from evidence — a clear indicator of its stance on the matter. But the agency ultimately lost that issue when the Tax Court ruled in September 2017 that the agreement was a historical piece of evidence that could not be ignored.

“To me, what that means is that the judge may be considering the closing agreement as something that could be relied upon by the taxpayer affirming their transfer pricing position,” Marcum LLP tax partner Elizabeth Mullen told *Tax Notes*.

Interestingly, the Tax Court implied just that in the FTC dispute — the court mentioned that the IRS had consistently approved the 10-50-50 method in the years prior to its 2011 audit. In a footnote, the court also dismissed the IRS’s assertion that it had put Coca-Cola retroactively on notice for the 2007-2009 tax years when it sent the company a notice of possible adjustments in 2011.

“This argument is hard to take seriously,” the court said. “Petitioner cannot have had actual or constructive notice of a fact during 2007-2009 when the communication that put it on notice of that fact did not occur until 2011.”

What Must You Show

The closing agreement issue adds a twist to a case that otherwise raises the perennial battle between the CUT method and the CPM. Coke said the CUT method was preferable in its situation because the method relies on master franchising comparables — real-world transactions — and the prices that licensors and third-party licensees settle on. In some fairly recent transfer pricing cases, the Tax Court has prioritized CUTs in favor of the taxpayer — *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009), *Amazon.com Inc. v. Commissioner*, 148 T.C. No. 8 (2017), and *Medtronic v. Commissioner*, T.C. Memo. 2016-112 — even in instances in which the method wasn’t completely perfect. *Medtronic*, which was recently remanded by the Eighth Circuit, does throw up an asterisk in that trend.

In Medtronic’s case, the IRS and the company inked a memorandum of understanding on the company’s Puerto Rican CUT royalty rates during an audit of the company’s 2002 tax year, agreeing to apply it prospectively, barring any material changes in facts. The agency later reassessed Medtronic’s 2005 and 2006 taxes and hit the company with an additional $1.2 billion in taxes, arguing that Medtronic should have based its calculations on the CPM instead of the CUT. The Tax Court ruled in Medtronic’s favor, but the Eighth Circuit in August ordered the Tax Court to provide additional factual analysis for its finding that the CUT was the best method.

To cover all bases, taxpayers have to be ready to show results under different methods, according to Fickling-Munge.

“What I’ve heard people doing, and what I recommend people do, is think about doing analyses for multiple methods. If you go in with a comparable uncontrolled transaction as your primary method — that’s the one that seems to be the most popular in court cases and you would certainly want to consider it — also know what the results would be under a CPM. If you did a profit split, what would the results of that be, where would that put you, and what would that look like. It’s about using multiple methods but considering the realistic alternatives,” Fickling-Munge said. “I’ve always told my clients before meetings with the IRS that you have one chance to tell your story, and if your story is, ‘This is our method and we’re sticking to it,’ but you know in the back of your mind that you have another method to help support you, you go in with a much better negotiating position.”

Transparency and reassessment are also key, Mantegani told *Tax Notes*.

"Even if you do have this agreement, you actually do have to keep looking at it; taxpayers know that. The IRS has always tended to attack CUTs because of their argument about asymmetry of information. If you want to present a CUT, for example, as part of your APA, you have to be completely transparent. If it's a big enough transaction and you're relying on a CUT, trying to get a bilateral APA is never a bad idea," Mantegani said.

"There's only so much certainty you're going to get with regarding transfer pricing even with a closing agreement," Mantegani added. "Even if you have a closing agreement for five years, on the five year plus one day, everybody can rethink everything. And that applies to the taxpayer as well as the government. Also, with the increased attention being paid to transfer pricing around the globe it is possible that regardless of how satisfied the IRS and the U.S. taxpayer are with their agreement, other countries involved in the transactions might raise adjustments and it will be no defense to a foreign-based adjustment that you were complying with your IRS closing agreement."

Tightening Scrutiny

Coca-Cola's 2011 audit coincided with some important changes within the IRS's Large Business and International Division meant to ramp up the agency's transfer pricing capabilities. Around that time, the agency created a new director of transfer pricing operations, and the APA and mutual agreement procedure programs were consolidated and rebranded as the advance pricing and mutual agreement program. The program moved out of the IRS chief counsel's office and into the transfer pricing division.

"I think with the Transfer Pricing Operations unit and with the efforts that they've made to be more consistent in their analysis of transfer pricing, there may be closing agreements or even APAs that are coming to the end of a term that are no longer consistent with the government's current thinking or maybe were outliers to begin with, which speaks to the critical need to conduct a full internal review on a regular basis," Mantegani said.

The IRS is also just beginning to parse the contents of CbC reports filed by multinationals as part of the OECD's BEPS project. The first reports under Form 8975 were filed for tax years starting on or after June 30, 2016, and apply to multinationals with $850 million or more in annual revenue, who must list financial information for each jurisdiction where they do business. It's unclear how the IRS will use that information and how it may influence transfer pricing audits and litigation in the future, especially given the already strong scrutiny on transfer pricing.

"You have a lot of things converging all at once. You have the change in reporting, you're going to have the results of this case, and it will be interesting to see how this plays out and whether the taxpayer could in fact rely on the closing agreement," Mullen told *Tax Notes*.