Coca-Cola Co. v. Commissioner, 106 T. C. 1 (1996)

A formulaic method, the production cost ratio (PCR), must be used to allocate and apportion U. S. affiliate expenses to component products under Section 936 of the Internal Revenue Code.

Summary

Coca-Cola Co. challenged the IRS's method for computing its Section 936 tax credit, which encourages U. S. business investment in Puerto Rico. The dispute centered on how to allocate expenses for soft-drink concentrate produced in Puerto Rico but sold as a component in the U. S. The Tax Court ruled that the applicable regulation, Q&A-12, mandates using a production cost ratio to allocate expenses, even if it results in a larger tax credit. This decision upheld Coca-Cola's right to use this formula, reinforcing the tax incentive's purpose to promote investment in U. S. possessions.

Facts

Coca-Cola's subsidiary, Caribbean Refrescos, Inc. (CRI), produced soft-drink concentrate in Puerto Rico, transferring it to Coca-Cola USA, which sold it to bottlers. The concentrate was either sold in unchanged form or converted into syrup or soft drinks before sale. Coca-Cola claimed a Section 936 tax credit based on the profit-split method, which required calculating combined taxable income (CTI) from these sales. The IRS disputed Coca-Cola's method of allocating expenses to the concentrate, arguing it should reflect the factual relationship between expenses and income.

Procedural History

Coca-Cola filed a motion for partial summary judgment in Tax Court. The IRS had previously conceded a similar case in 1992 but issued a deficiency notice in 1993 for tax years 1985 and 1986. The Tax Court granted Coca-Cola's motion, affirming the use of the production cost ratio (PCR) under the regulation for computing CTI.

Issue(s)

1. Whether Section 1. 936-6(b)(1), Q&A-12 of the Income Tax Regulations governs the computation of combined taxable income for sales of component concentrate to unrelated third parties.
2. Whether the production cost ratio must be applied to allocate U. S. affiliate expenses to the component concentrate.
3. Whether U. S. affiliate expenses allocable to the integrated product must be determined under Section 1. 861-8 of the Income Tax Regulations, as described in Q&A-1.
4. Whether Coca-Cola may net interest income against interest expense in computing combined taxable income.

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Holding

1. Yes, because Section 1. 936-6(b)(1), Q&A-12 specifically addresses the computation of CTI for component products, and it must be followed as written.
2. Yes, because Q&A-12 requires the application of the production cost ratio to allocate U. S. affiliate expenses to the component concentrate.
3. Yes, because Q&A-12 mandates that U. S. affiliate expenses allocable to the integrated product be determined under Section 1. 861-8, as described in Q&A-1.
4. Yes, because prior case law allows the netting of interest income against interest expense in computing CTI under Section 936.

Court's Reasoning

The Tax Court reasoned that Q&A-12 provides a clear and unambiguous method for computing CTI when a possession product is a component of a final product sold to third parties. The regulation requires using the production cost ratio (PCR) to allocate expenses, which is a formulaic approach chosen by the IRS to minimize factual disputes. The court rejected the IRS's argument to apply a factual relationship test, noting that Q&A-12 does not mention such a test. The court also found that the PCR method, while benefiting Coca-Cola, was consistent with the purpose of Section 936 to encourage U. S. investment in possessions. The court distinguished this case from Exxon Corp. v. Commissioner, where a literal interpretation of a regulation led to an absurd result, noting that the PCR method here did not shock general moral or common sense.

Practical Implications

This decision clarifies that taxpayers electing the profit-split method under Section 936 must use the production cost ratio to allocate expenses for component products, even if it results in a larger tax credit. It reinforces the tax incentive's goal to promote investment in U. S. possessions by upholding a method favorable to taxpayers. Legal practitioners should note that the IRS cannot retroactively challenge the application of a clear regulation like Q&A-12 without amending it. Businesses operating in U. S. possessions should consider the potential tax benefits of using the profit-split method for component products. This ruling may influence future cases involving the allocation of expenses under Section 936, emphasizing the importance of following the regulations as written until amended.

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