The Coca-Cola Co. & Subsidiaries v. Commissioner of Internal Revenue, 155 T. C. No. 10 (2020)

The U. S. Tax Court upheld the IRS's transfer pricing adjustments to The Coca-Cola Company, reallocating over $9 billion in income from foreign manufacturing affiliates to the U. S. parent for underpayment of royalties for intellectual property. The court affirmed the use of the Comparable Profits Method (CPM) and rejected Coca-Cola's arguments on marketing intangibles and long-term licenses, confirming that the IRS's methodology was reasonable and consistent with the arm's-length standard.

Parties

The Coca-Cola Company & Subsidiaries (Petitioner) filed consolidated Federal income tax returns for 2007, 2008, and 2009. The Commissioner of Internal Revenue (Respondent) issued a notice of deficiency, adjusting the taxable income of the Petitioner by reallocating income from its foreign manufacturing affiliates, known as supply points, which were located in Brazil, Chile, Costa Rica, Egypt, Ireland, Mexico, and Swaziland. The supply points were either controlled foreign corporations (CFCs) or branches of a U. S. subsidiary, Export.

Facts

The Coca-Cola Company (TCCC) is a U. S. corporation that owns intellectual property (IP) necessary for manufacturing, distributing, and selling its beverage brands worldwide. TCCC licensed this IP to its foreign manufacturing affiliates, referred to as supply points, which produced and sold concentrate to bottlers. These bottlers produced finished beverages for sale to distributors and retailers. TCCC used a formulary apportionment method, the 10-50-50 method, to calculate royalties payable by the supply points, which was agreed upon in a 1996 closing agreement with the IRS. During the tax years in question (2007-2009), the supply points remitted about $1. 8 billion in dividends to TCCC in satisfaction of their royalty obligations. The IRS, upon examination, determined that the 10-50-50 method did not reflect arm's-length pricing and reallocated income using a Comparable Profits Method (CPM) that used independent Coca-Cola bottlers as comparables.

Procedural History

The IRS examined TCCC's 2007-2009 returns and determined that the reported income from the supply points did not reflect arm's-length pricing. The IRS issued a notice of deficiency, reallocating over $9 billion in income to TCCC from its supply points. TCCC petitioned the U. S. Tax Court for a redetermination of the deficiencies. The IRS later amended its answer to assert additional deficiencies related to TCCC's practice of "split invoicing," where certain foreign affiliates received payments from bottlers for services. The Tax Court reviewed the IRS's adjustments under the abuse of discretion standard applicable to section 482

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determinations.

Issue(s)

Whether the IRS abused its discretion in reallocating income to TCCC by using a CPM that utilized the supply points as tested parties and independent Coca-Cola bottlers as uncontrolled comparables?

Whether the IRS erred in recomputing TCCC's section 987 losses after the CPM changed the income allocable to TCCC's Mexican supply point?

Whether TCCC made a timely election to employ dividend offset treatment with respect to dividends paid by the supply points during 2007-2009 in satisfaction of their royalty obligations?

Rule(s) of Law

The IRS may reallocate income under section 482 to prevent evasion of taxes or to clearly reflect the income of related entities. The IRS's determination is reviewed for abuse of discretion and must be sustained unless the taxpayer shows it to be arbitrary, capricious, or unreasonable. The arm's-length standard is used to determine the true taxable income of controlled taxpayers. The CPM is an acceptable method for valuing transfers of intangible property when no comparable uncontrolled transactions exist.

Holding

The Tax Court held that the IRS did not abuse its discretion in reallocating income to TCCC using the CPM with independent Coca-Cola bottlers as comparables. The court also held that the IRS did not err in recomputing TCCC's section 987 losses. Lastly, the court held that TCCC made a timely election for dividend offset treatment, and the IRS's reallocations to TCCC must be reduced by the amounts of those dividends.

Reasoning

The court found that the CPM was an appropriate method given the nature of the assets owned by TCCC and the activities performed by the supply points. The court determined that the independent Coca-Cola bottlers were suitable comparables because they operated in the same industry, faced similar economic risks, and had similar contractual relationships with TCCC. The court rejected TCCC's arguments that the supply points owned "marketing intangibles" or had long-term licenses, finding no legal or factual support for these claims. The court upheld the IRS's methodology as reasonable, noting that the bottlers were in a stronger economic position than the supply points, which justified using them as a conservative benchmark. The court also found that TCCC's election for dividend offset treatment was timely and substantially compliant with the applicable revenue procedure,

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despite not including explanatory statements with its tax returns.

Disposition

The Tax Court upheld the IRS's reallocations of income from the supply points to TCCC, subject to adjustments for dividends paid by the supply points in satisfaction of their royalty obligations. The court also upheld the IRS's recomputation of TCCC's section 987 losses.

Significance/Impact

This case is significant for its application of the CPM in valuing transfers of intangible property in a multinational corporate structure. It reaffirms the IRS's broad discretion under section 482 and the importance of the arm's-length standard in transfer pricing. The decision also highlights the complexities of valuing marketing intangibles and the challenges of establishing comparability in transfer pricing analyses. The case may influence future transfer pricing disputes, particularly those involving intellectual property and the use of the CPM.

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