COCA-COLA V. COMMISSIONER: A MAJOR IRS WIN IN THE INTERNATIONAL TRANSFER PRICING WARS

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Abstract

In *Coca-Cola v. Commissioner*, the IRS won a major transfer pricing battle, successfully arguing that the Tax Court should apply the IRS's pricing methodology over one of the methods recommended by Coca-Cola. The IRS argued the proper valuation methodology was the comparable profits method ("CPM"). Under the CPM, a court analyzes the profits of the company in question with the profits from an uncontrolled party. The court rejected the methodology recommended by Coca-Cola, leaving Coca-Cola with a significant tax liability. This decision opens the door for the IRS to pursue transfer pricing issues more aggressively and may affect other companies with pending transfer price cases, depending on how broadly other courts apply the holding in this case.

This article will first provide a brief introduction of the case and the basic principles of transfer pricing. Next, Part II of the article will discuss *Coca-Cola v. Commissioner* in-depth. This section will include a background into Coca-Cola's unique business model, the arguments set forth by the IRS and Coca-Cola, and the findings and holdings of the Tax Court. Part III will examine several other transfer pricing cases that may be affected by the holding in *Coca-Cola v. Commissioner*. Finally, Part IV will conclude this article.

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I. Introduction

Coca-Cola Co v. Commissioner is a significant win for the IRS in a transfer pricing case, marking a possible turn in transfer pricing litigation.[3] In this case, the IRS successfully argued for the implementation of a CPM analysis despite Coca-Cola's argument for a different set of transfer pricing methodologies.[4] Coca-Cola's argument is based on its unique business model in which it licenses its intangible property to foreign supply points in order to create the concentrate which is the base for all Coca-Cola beverages.[5] The concentrate is then sold to independent bottlers who bottle and distribute the beverages to retailers.[6] The IRS's success in this case should serve as a warning to many other multinational corporations

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[3] *See generally* Coca-Cola Co. v. Comm'r, 155 T.C. 145 (2020) (finding that the Coca-Cola's pricing method was incorrect for three years resulting in increased tax liability for the company).
[4] *Id.* at 264–65.
[5] *Id.* at 149–50.
[6] *Id.* at 158.

to adjust their transfer pricing strategies by taking into account the narrow reading of prior settlements with the IRS and reasoning of the tax court.[7]

A. Transfer Pricing

In general, transfer pricing is the practice of a company charging another branch of their own company, usually an affiliate or subsidiary, for goods or services provided between the related parties.[8] Companies primarily use transfer pricing for goods and services, but it can also be used to value the use of the company's intangible property.[9] Theoretically, when a company uses transfer pricing that company employs an arm's length price. However, transfer pricing is susceptible to abuse when companies use it to shift income to jurisdictions with a lower corporate tax rate.[10] To combat the abuse of transfer pricing, the IRS can challenge transactions between related parties under IRC § 482.[11] In applying IRC § 482, the purpose is to "'place[] a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.'"[12] As a result, when courts are trying to discern the correct arm's length pricing for a transaction between related parties, the courts will apply the "best method rule."[13]

When the transfer pricing transaction involves intangible property, the parties must decide which one of four methods will be used for determining the correct arm's length pricing.[14] The four methods are: (1) the comparable uncontrolled transaction ("CUT") method; (2) the comparable profits method ("CPM"); (3) the profit split method; (4) "an 'unspecified method' subject to constraints set forth in the regulations."[15]

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7 *See generally id.*
8 Shobhit Seth, *Transfer Pricing: What It Is and How It Works, With Examples*, INVESTOPEDIA (May 28, 2023), [https://perma.cc/AAP9-QA8X].
9 *Id.*
10 *Id.*
11 Medtronic, Inc. v. Comm'r, No. 6944-11, 2016 Tax Ct. Memo LEXIS 111, at **79 (June 9, 2016) (holding "Section 482 was enacted to prevent tax evasion and to ensure that taxpayers clearly reflect income relating to transactions between controlled entities" (citing Veritas Software Corp. & Subs. v. Comm'r, 133 T.C. 297, 316 (2009))).
12 Amazon.com v. Comm'r, 934 F.3d 976, 980 (9th Cir. 2019) (quoting Treas. Reg. § 1.482-1(a)(1)). Under the regulations, a controlled taxpayer is "'any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers.'" Treas. Reg. § 1.482-1(i)(5).
13 Coca-Cola Co. v. Comm'r, 155 T.C. 145, 212 (2020) (Under the "best method rule," the regulations require "that '[t]he 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'" (citing Treas. Reg. § 1.482-1(c)(1))).
14 *Id.* at 212.
15 *Id.* The four methods are listed in Treas. Reg. § 1.482-4(a).

The CUT method may be selected as the best method when "an uncontrolled transaction involves the transfer of the same intangible under the same or substantially the same circumstances as the controlled transaction."[16] The CPM is "preferred where only one of two entities contributes meaningful intangible property."[17] The profit split method "evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is at arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss."[18] If none of the foregoing methods are chosen an unspecified method can be used, but that method should take into account the general principle that "uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it."[19]

When looking at which method to select in a given case, "there is no strict priority of methods, and no method will invariably be considered to be more reliable than others."[20] Thus, "[t]he reliability of any particular method depends on 'the facts and circumstances' of each case, especially on 'the quality of the data and assumptions used in the analysis' and 'the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables.'"[21]

II. *Coca-Cola v. Commissioner*

A. The Transaction

To fully understand the transfer pricing transactions at issue in *Coca-Cola Co. v. Commissioner*, a brief background of Coca-Cola's business structure is helpful to differentiate between the parties and to understand the relationship between the different entities involved in the transaction.[22]

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[16] *Medtronic, Inc.*, 2016 Tax Ct. Memo LEXIS 111, at **82 (Further, "[t]he CUT method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction").

[17] *Coca-Cola Co.*, 155 T.C. at 218. Additionally, "[t]he CPM evaluates whether the amount charged in a controlled transaction is arm's length according to objective measures of profitability (profit level indicators) derived from transactions of uncontrolled taxpayers that engage in similar business activities under similar circumstances." *Medtronic, Inc.*, 2016 Tax Ct. Memo LEXIS 111, at **81.

[18] *Medtronic, Inc.*, 2016 Tax Ct. Memo LEXIS 111 at *83.

[19] Treas. Reg. § 1.482-4(d)(1).

[20] *Coca-Cola Co.*, 155 T.C. at 212 (quoting Treas. Reg. § 1.482-1(c)).

[21] *Id.* at 213 (quoting Treas. Reg. § 1.482-1(c)(1)–(2)).

[22] *See generally id.* (examining the business structure of Coca-Cola in-depth).

Known as the "Coca-Cola System," The Coca-Cola Company ("TCCC") owns immensely valuable intangible property, such as the secret formulas and proprietary manufacturing processes to produce Coca-Cola products.[23] In 1930, when Coca-Cola began to expand internationally, Coca-Cola created the Coca-Cola Export Corporation ("Export"), a wholly-owned domestic subsidiary of The Coca-Cola Company.[24] Coca-Cola licenses the intangible property to supply points[25] in order to manufacture the concentrate used by independent bottlers to bottle and distribute the final product.[26] Many of the supply points that manufacture the concentrate are owned by Export.[27] Independent bottlers then purchase the concentrate from these supply points, bottle the product, and distribute the final product to retail establishments.[28] Export also owns many local service companies ("ServCos"), which handle local advertising and in-country consumer marketing in foreign markets for Coca-Cola.[29] However, the supply points "had little or no direct ownership interest in the ServCos that served these national markets."[30]

The main issues in this case center on the IRS reallocating income from the supply points back to Coca-Cola under IRC § 482.[31] In order for the "Coca-Cola System" to operate, the company needs to license their intangible property, including trademarks, brand names, logos, patents, secret formulas, and proprietary manufacturing processes, to supply points for those supply points to manufacture the concentrate, which is later sold to independent bottlers.[32] The Coca-Cola Company reported income from the supply points using the "10-50-50 method," in which the supply points retained "profit equal to 10% of their gross sales, with the remaining profit

23 The Coca-Cola Company, *The Coca-Cola System*, [https://perma.cc/F3MW-YM6Q].
24 *Coca-Cola Co.*, 155 T.C. at 153.
25 Foreign manufacturing affiliates are often referred to as "supply points" in the industry and are referred to as such in the case. *See id.* at 149.
26 *See id.* at 149–50.
27 *Id.* at 154.
28 *Id.* at 149.
29 *Id.* at 154–55.
30 *Id.* at 155. The supply points' "manufacturing activity consisted of procuring raw materials and using TCCC's guidelines and production technologies to mix and convert raw materials into concentrate." *Id.* at 160.
31 *Id.* at 149. IRC § 482, says in part, the IRS can "distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." 26 U.S.C. § 482 (2020).
32 *Id.* at 149–50. The supply points at issue in this case were located in Brazil, Chile, Costa Rica, Egypt, Ireland, Mexico, and Swaziland.

being split 50%-50%."[33] However, the IRS concluded that the 10-50-50 method was not an accurate reflection of arm's length pricing as it overcompensated the supply points and undercompensated petitioner for the use of petitioner's intangible property.[34] As a result of the IRS's transfer pricing adjustments, The Coca-Cola Company's taxable income increased by over $9 billion over the tax years 2007, 2008, and 2009.[35]

B. IRS Argument

The main contention of the IRS in this case is that the transactions between Coca-Cola and its supply points did not represent arm's length dealings, and in order to properly calculate arm's length pricing in this scenario, the comparable profits method ("CPM") should be used.[36] Under the CPM, the "determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable."[37] In examining transactions conducted by Coca-Cola and its different entities, the IRS concluded that the supply points underpaid Coca-Cola for the use of its valuable intangibles, while the ServCos conducted business with Coca-Cola at arm's length for the most part.[38] For example, the expert witness that prepared the CPM analysis for the IRS compared the average returns on operating assets (ROA) for independent bottlers deemed comparable and stated its findings that the "Irish, Brazilian, Chilean, and Costa Rican supply points, with ROAs of 215%, 182%, 149%, and 143%, respectively, had ROAs higher than any of the 996 companies in the comparison group—literally off the high end of the bell curve."[39] The IRS argued that supply points who only engaged in the manufacturing of concentrate should not be the

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[33] *Id.* at 150. Most, if not all, of the profit earned by the supply points were specified through contracts with Coca-Cola. These contracts "authorized the supply points to sell concentrate," but "they were permitted to sell concentrate only to bottlers that had an existing contract with TCCC." *Id.* at 172.

[34] *Id.* at 151. Black's Law Dictionary defines an arm's length transaction as, "[a] transaction between two parties, however closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises." *Arm's Length Transaction*, BLACK'S LAW DICTIONARY (11th ed. 2019).

[35] *Id.* at 148.

[36] *Id.* at 151. *See also* Treas. Reg. § 1.482-5 (2020).

[37] Treas. Reg. § 1.482-5(b) (2020).

[38] *Coca-Cola Co.*, 155 T.C. at 208.

[39] *Id.* at 216. Return on assets (ROA) is defined as a "profitability ratio that provides how much profit a company is able to generate from its assets." Claire Boyte-White, *How to Calculate Return on Assets (ROA) With Examples*, INVESTOPEDIA (May 5, 2022) [https://perma.cc/ZCE7-JDVE].

most profitable beverage companies in the world, especially considering the profitability of these supply points "dwarf[ed]" that of Coca-Cola which owns the valuable intangibles and licensed such intangibles to the supply points.[40] The IRS further argued using CPM was the appropriate method to determine arm's length pricing in part because, in controlled transactions implicating high-value intangibles, the most reliable transfer pricing method is often one that avoids any direct valuation of those intangibles.[41] Further, the "CPM will often be preferred where only one of two entities contributes meaningful intangible property."[42] In this case, the supply points did not own any valuable intangibles, thus the only meaningful intangible property was contributed by Coca-Cola.[43] In arguing the CPM was the best method for determining arm's length pricing, the IRS concluded the independent bottlers were "appropriate comparable parties for purposes of a CPM/ROA analysis."[44]

C. Taxpayer Argument

Coca-Cola employed several arguments to combat the IRS's reallocation of income away from the supply points and back to Coca-Cola.[45] Coca-Cola argued the IRS acted arbitrarily by challenging the 10-50-50 method which the company had been using for years.[46] Further, Coca-Cola argued the supply points and the bottlers were not comparable in the CPM analysis because the supply points "own immensely valuable intangible assets that do not appear on their balance sheets or in any written contract."[47] These intangible assets, or "marketing intangibles," Coca-Cola argued were "created when the supply points financed consumer advertising in foreign markets."[48] Further, Coca-Cola argued that "a comparable uncontrolled transaction (CUT) model and a residual

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40 *Coca-Cola Co.*, 155 T.C. at 197, 217.
41 *Id.* at 218. The two methods for indirect valuation are the profit split method and the CPM. *Id.*
42 *Id.* (citing Treas. Reg. § 1.482-8(b), Example (9)).
43 *Id.* at 219
44 *Id.* at 221–22. In determining comparability, the court may look to "all the relevant facts and circumstances, including the relevant lines of business, the product or service markets involved, the asset composition employed (including the nature and quantity of tangible assets, intangible assets and working capital), the size and scope of operations, and the stage in a business or product cycle." Treas. Reg. § 1.482-5(c)(2)(i)(2020).
45 *Coca-Cola Co.*, 155 T.C. at 151–52.
46 *Id.* at 150–51. In regards to the 10-50-50 method, "[t]his was a formulary apportionment method to which petitioner and the IRS had agreed in a closing agreement executed in 1996, which resolved petitioner's tax liabilities for 1987-1995."
47 *Id.* at 152.
48 *Id.*

profit split method (RPSM) as the best methods for determining the supply points' true economic income."[49]

Coca-Cola reasoned the IRS should allow the 10-50-50 method because the two parties agreed to allow this method to be used for tax years 1987–1995 in a 1996 closing agreement.[50] A closing agreement is a contract between the IRS and a taxpayer, which can restrict the discretion of the IRS.[51] Further, Coca-Cola asserted the "closing agreement was predicated on certain 'factual underpinnings,' including a 'recogni[tion]' by the IRS that the supply points 'were responsible for generating demand and were entitled to share in the resulting profits related to the . . . [Company's] intangibles."[52] Further, Coca-Cola said these factual underpinnings "are binding on the Commissioner unless he can show some material change in underlying fact."[53] Thus, Coca-Cola argued the IRS should be required to adhere to the 1996 closing agreement which allowed the 10-50-50 method.[54]

Coca-Cola further argued the supply points owned valuable marketing intangibles not taken into account when the IRS's expert performed the CPM analysis.[55] Thus, the supply points should be able to retain more income than calculated by the IRS in determining the arm's length pricing for the use of the intangibles.[56] Coca-Cola said that its intangibles were essentially "wasting assets" because "what kept TCCC's products fresh in consumers' minds, petitioner says, were the billions of dollars spent annually on television advertisements, social media, and other forms of consumer marketing."[57] Coca-Cola said these intangibles would lose value over time had these supply points not invested into marketing, keeping these intangibles relevant and valuable.[58] Coca-Cola further argued under temporary regulations that "states that legal or contractual ownership is dispositive 'unless such ownership is inconsistent with the economic substance of the underlying transactions."[59] Additionally, Coca-Cola reasoned that the supply points and the

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[49] *Id.*
[50] *Id.* at 204–05.
[51] *Id.* at 204. Under IRC § 7121, "[t]he Secretary is authorized to enter into an agreement in writing with any person relating to the liability of such person (or of the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period." 26 U.S.C. § 7121(a).
[52] *Coca-Cola Co.*, 155 T.C. at 205.
[53] *Id.*
[54] *Id.* at 204–07.
[55] *Id.* at 239.
[56] *Id.* at 239–41.
[57] *Id.* at 240.
[58] *Id.*
[59] *Id.* at 245.

independent bottlers were not comparable because they "occupied different points in the Company's supply chain and did business at different 'levels of the market. . .'"[60]

Coca-Cola proposed several other transfer pricing methodologies which they contend would more accurately reflects arm's length pricing between the parties.[61] One method proposed by a Coca-Cola expert witness was the CUT method, in which the expert compared the controlled transaction with the supply points to "'master franchising transactions' that companies like McDonald's and Domino's Pizza execute with regional franchisees abroad."[62] In calculating the royalty rate in the uncontrolled transactions, the expert concluded "that the supply points at arm's length would be entitled to keep 87.7% of the Company's total revenues from the markets the supply points served."[63] Another expert proposed the residual profit split method under Treas. Reg. 1.482-6(c)(3), in which "the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following the two-step process" described later in the regulations.[64] This expert concluded "that the supply points, at arm's length, would pay TCCC a weighted average royalty rate of 5.4% for 2007, 4.9% for 2008, and 4.6% for 2009."[65] Another Coca-Cola expert suggested using an asset management model, an unspecified method, as the best method for determining an arm's length price.[66] Under this method, the expert made "numerous assumptions and an extremely complex series of calculations," from which he derived "estimates for TCCC's 'assets under management' and annual 'net asset appreciation' for 2007, 2008, and 2009."[67] Based on his calculations, the expert came "up with a weighted average annual royalty rate of 9.3%."[68]

D. Holding

The tax court found in favor of the IRS, upholding the IRS's reallocation of income to Coca-Cola as well as the IRS's use of the bottler

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[60] *Id.* at 227.
[61] *Id.* at 264–75.
[62] *Id.* at 265. The CUT method "valuates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction." Treas. Reg. § 1.482-4(c)(1) (2022).
[63] *Coca-Cola Co.*, 155 T.C. at 265.
[64] *Id.* at 268–74; Treas. Reg. § 1.482-6I(3)(i) (2022).
[65] *Coca-Cola Co.*, 155 T.C. at 268.
[66] *Id.* at 210–12.
[67] *Id.* at 275.
[68] *Id.*

CPM.[69] In addressing Coca-Cola's argument regarding the closing agreement from 1996, the court noted, "[t]he short and (we think) the complete answer to petitioner's argument is that the closing agreement says nothing whatever about the transfer pricing methodology that was to apply for years after 1995."[70] Additionally, the court said, "[t]here is nothing within the four corners of the closing agreement to suggest that the Commissioner regarded the 10-50-50 method as the Platonic ideal of arm's-length pricing for petitioner and its supply points."[71] Additionally, "there is no evidence that the parties intended them to be binding for future years."[72] The court further explained the parties could have intended for the document to agree to the 10-50-50 method for future tax years because the agreement provides for future penalty protection for Coca-Cola for using the 10-50-50 method, but the agreement does not explicitly establish the 10-50-50 method to be arm's length pricing between the parties.[73] In other words, the "petitioner urges that it relied to its detriment on a belief that the IRS would adhere to the 10-50-50 method indefinitely," but Coca-Cola "cannot estop the Government on the basis of a promise that the Government did not make."[74]

In regards to Coca-Cola's proposed transfer pricing methodologies, the court found that Coca-Cola's experts tried to group Coca-Cola's foreign affiliates into one group which the experts called "the Field."[75] The Coca-Cola experts sought "to frame the task before us as dividing income between HQ and 'the Field' on the basis of the 'historical marketing spend' by 'the Field.'"[76] However, the tax court refused to group all the foreign entities together because this would lead to "duplication and inconsistency."[77]

In responding to Coca-Cola's argument that the CPM is inferior to other transfer pricing methods, the court noted, "[t]reasury's reference

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69 *See generally id.* at 203–75 (looking at arguments presented by the IRS and the court's subsequent analysis of each).

70 *Id.* at 205.

71 *Id.*

72 *Id.* at 206.

73 *Id.*

74 *Id.* at 207. The court also cited ATL & Sons Holdings, Inc. v. Comm'r, which says, "[e]ach tax year stands on its own and must be separately considered," and "[t]he Commissioner may challenge in a succeeding year what was condoned or agreed to for a prior year." 152 T.C. 138, 147 (2019).

75 *Coca-Cola Co.*, 155 T.C. at 208.

76 *Id.*

77 *Id.* at 209. *See generally id.* ("The MAUs, BUs, and OGs were not legal entities; rather they identified lines of managerial reporting from smaller to larger geographical territories and ultimately to HQ in Atlanta."); *id.* at 210 ("we will not conflate the ServCos with the supply points, attribute the activities of the ServCos employees to the supply points, or otherwise combine them for purposes of our transfer pricing analysis.")

to the CPM as a 'method of last resort' is predicated on the assumption that 'adequate data' are available to apply the CUT method."[78] Further, the court recognized the CUT method only has a high degree of reliability when "'an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction.'"[79] Thus, the court found "the circumstances that caused Treasury to refer to the CPM as a 'method of last resort' do not exist here."[80]

As a result, the court examined the bottler CPM set forth by the IRS, keeping in mind "[t]he reliability of any particular method depends on 'the facts and circumstances' of each case, especially on 'the quality of the data and assumptions used in the analysis' and 'the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables.'"[81]

In regards to using CPM and the independent bottlers as the comparable party to the supply points, the court held, "the Commissioner did not abuse his discretion by using the bottler ROA to reallocate income between petitioner and the supply points."[82] Further, the court found the "CPM analysis was appropriate given the nature of the assets owned and the activities performed by the controlled taxpayers," the independent bottlers were "appropriate comparable parties," and "the Commissioner computed and applied his ROA using reliable data, assumptions, and adjustments."[83] In fact, the court found "the bottlers in many respects enjoyed an economic position superior to that of the supply points, which would justify for the bottlers a higher relative return."[84]

The tax court then turned to whether the CPM was the best method in which to begin the transfer pricing analysis or if another method set forth by Coca-Cola was more reasonable.[85] The court began by saying the case at hand was "particularly susceptible to a CPM analysis because petitioner owned virtually all the intangible assets needed to produce and sell the Company's beverages."[86] As clarified in the regulations, the CPM is preferred where one party contributed most or all of the intangibles in a given transaction.[87] Further, in the agreements

[78] *Id.* at 213. Coca-Cola referred to the preamble to the 1994 final regulations which stated the CPM was "a method of last resort." *Id.* at 212.
[79] *Id.* at 213 (quoting Treas. Reg. § 1.482-4(c)(2)(ii) (2022)).
[80] *Id.* at 213.
[81] *Id.* at 215 (citing Treas. Reg. § 1.482-1(c)(1) (2022)).
[82] *Id.* at 217.
[83] *Id.* at 217–18.
[84] *Id.*
[85] *Id.* at 218–21.
[86] *Id.* at 218.
[87] *Id.* at 219–20; *see* Treas. Reg. § 1.482-8(b), Example (9) (2022).

between the supply points and Coca-Cola, Coca-Cola licensed the intangibles to the supply points in order for the supply points to manufacture concentrate, but these agreements "were terminable by petitioner at will," the supply points did not gain "any form of territorial exclusivity, and no supply point was granted any right, express or implied, to guaranteed production of concentrate."[88] Additionally, the court found that Coca-Cola did not set forth any unrelated transactions that involved the same type of intangibles as in this case, and thus, "[t]he reliability of any CUT method is considerably reduced here."[89] Further, once the CUT method was essentially set aside for this case, the court noted the CPM was preferable to the profit split method in cases where one party owns a majority of the intangibles in the transaction.[90]

Next, the tax court analyzed whether the supply points and the independent bottlers were comparable under the factors set forth under the regulations, ultimately determining that the parties were comparable.[91] Under the regulations, "[t]he determination of the degree of comparability between the tested party and the uncontrolled taxpayer depends upon all the relevant facts and circumstances."[92] In taking into account all relevant facts and circumstances, the factors which determines the degree of comparability are "(i) functions performed, (ii) contractual terms, (iii) risks, (iv) economic conditions, and (v) property employed or transferred."[93] The court ultimately held the independent bottlers and the supply points were comparable because both entities "operated in the same industry, faced similar economic risks, had similar (but more favorable) 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."[94] Taking the factors in turn, the tax court analyzed each party's functions performed and determined the supply points and the independent bottlers both manufactured and distributed beverage

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[88] *Id.* at 219–20 ("The CPM is ideally suited to this scenario: The CPM evaluates the profitability only of the tested party--here, the supply points--and it can thus determine an arm's-length profit range for the supply points without attempting a direct valuation of the Company's hard-to-value intangible assets.").
[89] *Id.* at 220.
[90] *Id.* at 220–21.
[91] *Id.* at 221–29.
[92] *Id.* at 221 (quoting Treas. Reg. § 1.482-5(c)(2)(i) (2022)). The regulation further explains, "[a]s with all
methods that rely on external market benchmarks, the greater the degree of comparability between the tested party and the uncontrolled taxpayer, the more reliable will be the results derived from the application of this method." Treas. Reg. § 1.482-5(c)(2)(i) (2022).
[93] *Coca-Cola. Co.*, 155 T.C. at 221.
[94] *Id.* at 222.

products "according to detailed protocols supplied by petitioner."[95] Under contractual terms, the court looked to the agreements the supply points and independent bottlers had with Coca-Cola, finding the bottlers had more favorable terms than the supply points.[96] Because the independent bottlers had more favorable contract terms than the supply points, the court noted "the bottlers would be deserving of a higher ROA than the supply points."[97] In regards to economic conditions, the supply points and the independent bottlers both earned revenue through the sale of beverage products stemming from Coca-Cola's intangibles, but the bottlers were positioned better economically because the bottlers are not easily replaceable and have higher bargaining power.[98] In terms of resources employed, the court found the independent bottlers and the supply points "used a similar mix of resources to discharge" their functions as beverage manufacturers.[99] The tax court also noted that both the supply points and the independent bottlers shared very similar risks because both parties were reliant on the success of Coca-Cola products and both operate within the same market.[100] In response to Coca-Cola's argument that the supply points had marketing risk, the tax court found the supply points "did not have 'marketing-intensive operations,'" because, for all but the Brazilian supply point, the supply points "engaged in no marketing operations."[101]

Next, the tax court analyzed the "selection and quality" of the data used by the IRS's expert as well as the "assumptions employed to bridge any gaps" in the data.[102] The court found that the IRS expert did not err in selecting bottlers to be used in the CPM analysis and agreed with most of the assumptions made by the IRS's expert.[103] The court did note, however, that the parties needed "to adjust the allocations of income set forth in the notice of deficiency to exclude income attributable to

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95 *Id.*
96 *Id.* at 223–24. The agreements between the supply points and Coca-Cola were short-term contracts, "gave the supply points no territorial exclusivity," did not provide for "guaranteed production," and Coca-Cola could terminate the agreements at will. *Id.* The court further noted that Coca-Cola "closed (or shifted production away from) at least 18 supply points between 1986 and 2009." *Id.* at 223. However, the independent bottlers had long-term contracts with Coca-Cola and had exclusive rights to sell in a set geographical area. *Id.*
97 *Id.* at 224.
98 *Id.* at 225.
99 *Id.*
100 *Id.* at 225–26.
101 *Id.* at 227. The Tax Court further explained in regard to comparing the independent bottlers and the supply points, "we focus on the economic functions they actually performed and the risks they actually assumed, not on inter-company charges made by their parent." *Id.* at 227.
102 *Id.* at 229–37.
103 *Id.* at 237.

trademarks owned by the supply points, as identified by petitioner's experts and accepted by Dr. Newlon" in their Rule 155 computations.[104]

In addressing Coca-Cola's argument the IRS's expert did not take into account marketing intangibles held by the supply points, the tax court said, "[w]e find no support for petitioner's argument in law, fact, economic theory, or common sense."[105] The tax court explained under the regulations "legal ownership is the test for identifying the intangible."[106] The legal owner of the intangibles is Coca-Cola, and the marketing costs sustained by the foreign entities "enhanced the value of the trademarks and other intangible assets that were legally owned by TCCC."[107] Further, in addressing Coca-Cola's argument "that legal or contractual ownership is dispositive 'unless such ownership is inconsistent with the economic substance of the underlying transactions,'" the court found that: (1) "only the Commissioner, and not the taxpayer, may set aside contractual terms as inconsistent with economic substance," and (2) "even if the petitioner could set aside the terms of its own contracts, it has failed to establish that the economic substance differs from the contractual form."[108]

In addressing the other proposed transfer pricing methodologies set forth by Coca-Cola, the tax court found that the expert which proposed the CUT method grouped all the foreign entities into "the Field," which the court rejected.[109] Further, the court said of the expert's CUT analysis, "[t]here are so many flaws in Dr. Unni's construct that it is difficult to know where to begin."[110] A few of the main issues the tax court found in the CUT analysis were: the expert selected data from a completely different industry than the beverage industry; the expert did not compare contractual terms in comparing the different parties; and "many of his adjustments were shown by respondent's experts to be mathematically and economically unsound."[111] The court also found the proposed profit split

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[104] *Id.* Dr. Newlon is the IRS expert in this case that performed the CPM analysis. *Id.* at 195. Rule 155 "computations are designed to ascertain the bottom-line tax effect of the determinations made in the Court's opinion," and "[i]f the parties' computations are not in agreement, the Court has discretion to afford them 'an opportunity to be heard in argument thereon.'" Vento v. Comm'r, 152 T.C. 1, 7–8 (2019), *aff'd*, 836 F. App'x 607 (9th Cir. 2021) (citing TAX CT. R. PRAC. & P. 155.

[105] *Id.* at 241.

[106] *Id.* (citing DHL Corp. v. Comm'r, 285 F.3d 1210, 1221–22 (9th Cir. 2002)).

[107] *Id.*

[108] *Id.* at 245. Coca-Cola was relying on a provision in the regulations which says, "[l]egal or contractual ownership is not dispositive, however, if 'such ownership is inconsistent with the economic substance of the underlying transactions.'" *Id.* (citing Treas. Reg. § 1.482-4T(f)(3)(i)(A) (2022)).

[109] *Id.* at 264–66.

[110] *Id.* at 266.

[111] *Id.* at 267–68.

method and unspecified method to be inadequate for similar reasons as the CUT method.[112]

III. Analysis

A. Precedent for Other Companies

The *Coca-Cola* decision may have a widespread effect on large multinational corporations if the decision is upheld on appeal.[113] As of right now, Coca-Cola appears to be preparing an appeal of the Tax Court's decision and recently hired a new attorney to advise the company on matters relating to the ongoing litigation.[114] As a result of the *Coca-Cola* decision, the IRS will likely be more aggressive in challenging transfer pricing transactions where foreign entities are earning high percentages of profit based on intangibles owned by the US corporation.[115] Now that the IRS has won its first major transfer pricing case more multinational corporations may enter into advance pricing arrangements where the IRS and the company agree on an arm's length price, thus reducing transfer pricing litigation.[116]

On the other hand, some corporations may still challenge the IRS stance on transfer pricing methodology because of the unique fact pattern present in the *Coca-Cola* case.[117] The *Coca-Cola* case may be more susceptible to CPM analysis than other cases because the independent bottlers served as a very comparable party to the supply points, which is a result of Coca-Cola's unique business model.[118] Other companies with different business models may not have such a comparable party and thus other transfer pricing methodologies may be more appropriate under a different fact pattern.[119] Additionally, the *Coca-Cola* decision "casts serious doubt on taxpayers' ability to seek more favorable results than their own intercompany contracts allow."[120]

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112 *Id.* at 268–74.
113 Reven S. Avi-Yonah & Gianluca Mazzoni, *Coca-Cola: A Decisive IRS Transfer Pricing Victory, at Last*, TAX NOTES (Dec. 30, 2020), [https://perma.cc/45HW-A2D9].
114 Aysha Bagchi, *Coca-Cola Hires Star Lawyer, Signals Aggressive Tax Fight*, BLOOMBERG LAW: TAX (Jan. 7, 2021), [https://perma.cc/EE2U-YWZC].
115 Avi-Yonah & Mazzoni, *supra* note 113.
116 *Id.*
117 Aysha Bagchi, Isabel Gottlieb & Jeffrey Leon, *Coca-Cola Sends Warning on Facebook, Medtronic Tax Fights*, BLOOMBERG TAX (Nov. 23, 2020), [https://perma.cc/NK3J-EANZ].
118 *Id.*
119 *See id.*
120 Ryan Finley, *U.S. Tax Court's Coca-Cola Ruling: Early Sign of a New Approach?*, TAX NOTES (Nov. 30, 2020), [https://perma.cc/2DQY-6NKE].

B. Related Cases

1. Altera v. Commissioner

In *Altera v. Commissioner*, the Ninth Circuit reversed the decision of the tax court, which had reached five holdings: (1) the 2003 amendments to C.F.R. § 1.482-7A(d)(2) fall under the requirements of the Advance Pricing Agreement (APA); (2) found the standards set forth in *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.* was the correct standard of review because the "standard set forth in [*Chevron*] incorporates *State Farm's* 'reasoned decision making' standard;" (3) the IRS "did not support adequately its decision to allocate the costs of employee stock compensation between related parties;" (4) the IRS's "procedural regulatory deficiencies were not harmless;" and (5) under the APA, § 1.482-7A(d)(2) is invalid.[121]

In this case, Altera Corporation and its foreign affiliate Altera International entered into a cost-sharing agreement where Altera licensed intangible property to the foreign affiliate and both parties agreed to share research and development costs for new projects.[122] For the tax years 1997–2003, Altera and the IRS entered into an APA, and under this agreement "Altera shared with Altera International stock-based compensation costs as part of shared R&D costs."[123] However, after the underlying regulations were amended in 2003, the IRS ultimately challenged Altera because the company "did not account for R&D related stock-based compensation costs on their consolidated 2004–2007 federal income tax returns."[124]

In finding in favor of Altera, the tax court made several determinations regarding transfer pricing methodologies and the underlying regulations.[125] The court found "that the Commissioner's allocation of income and expenses between related entities must be consistent with the arm's length standard."[126] The tax court further determined "that the arm's length standard is not met unless the Commissioner's allocation can be compared to an actual transaction

121 Altera Corp. & Subsidiaries v. Comm'r, 926 F3d. 1061, 1074 (9th Cir. 2019) (citing Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983); Chevron U.S.A. Inc. v. NRDC, 467 U.S. 837 (1984)).
122 *Id.* at 1073.
123 *Id.*
124 *Id.* at 1074.
125 *Id.*
126 *Id.*

between unrelated entities."[127] In holding Treasury's decision making process was flawed, the tax court noted Treasury "rested on speculation rather than on hard data and expert opinions" and "failed to respond to significant public comments."[128]

In determining the validity of the 2003 amendments, the Ninth Circuit analyzed the regulations under both *Chevron* and *State Farm*.[129] In apply *Chevron*, the Ninth Circuit found that IRC § 482 did not directly speak to the issue at hand, which was "whether the Commissioner may require parties to a QCSA to share employee stock compensation costs in order to receive the tax benefits associated with entering a QCSA."[130] In moving to the second step in the *Chevron* analysis, the Ninth Circuit found Treasury's interpretation of the regulations to be reasonable.[131] The court noted, "Treasury reasonably concluded that doing away with analysis of comparable transactions was an efficient means of ensuring that §482 would 'operat[e] to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in [QCSAs]."[132] In addressing the *State Farm* analysis, the Ninth Circuit found, "[t]hough it could have been more specific, Treasury 'articulated a rational connection' between its decision and these industry standards."[133] The Ninth Circuit concluded, "we disagree with the Tax Court that the 2003 regulations are arbitrary and capricious under the standard of review imposed by the APA."[134] Thus, the Ninth Circuit reversed the decision of the tax court.[135]

The decision by the Ninth Circuit upheld the Treasury regulations which requires that related companies share R&D related stock-based compensation costs under cost sharing arrangements.[136] However, despite the ruling by the Ninth Circuit, taxpayers in other circuits may still be successful in arguing the Treasury Regulations should not be upheld.[137] Although the IRS will try to extend the reasoning from the Ninth Circuit to other circuit courts, taxpayers may be able to succeed in other circuits due to the widespread disagreement on the enforceability of the Treasury Regulations from *Altera*.[138] The issues presented in *Altera* were somewhat

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[127] *Id.*
[128] *Id.*
[129] *Id.* at 1075.
[130] *Id.* at 1076. QCSA stands for qualified cost-sharing arrangements. *Id.* at 1067.
[131] *Id.* at 1076–1078.
[132] *Id.* at 1078.
[133] *Id.* at 1085.
[134] *Id.* at 1087.
[135] *Id.*
[136] Sean Foley et al., *Practical Implications of Denial of Review in* 'Altera v. Commissioner', BLOOMBERG LAW (June 22, 2020), [https://perma.cc/AS73-5BSF].
[137] *Id.*
[138] *Id.*

narrow in scope and application, whereas the holding in *Coca-Cola* has the potential to affect more transfer pricing cases moving forward.[139]

2. *Medtronic, Inc. v. Commissioner*

In *Medtronic v. Commissioner*, the Eight Circuit reversed and remanded the tax court's ruling which held Medtronic's CUT method was the best method to determine arm's length pricing because the tax court's "factual findings are insufficient to enable us to conduct an evaluation of that determination."[140] Medtronic, a medical device company, used the CUT method to "determine the royalty rates paid on its intercompany licenses," and allocated income between Medtronic US, Med USA, and Medtronic Puerto Rico.[141] The IRS challenged Medtronic's allocation of income. The two parties ultimately entered into a Memorandum of Understanding in which Medtronic Puerto Rico "agreed to pay royalty rates of 44% for devices and 26% for leads on its intercompany sales."[142] A few years later, however, the parties disagreed again on the correct method to determine the intercompany royalty rates.[143] The IRS argued the CPM was the best method, while Medtronic argued for using the CUT method.[144]

The tax court rejected both parties' calculations as to the correct royalty rate, determined that the CUT method was the best method for determining the royalty rates, and made adjustments to Medtronic's calculations.[145] The tax court held the IRS's "allocations were arbitrary, capricious, or unreasonable." The tax court further found that: the CPM "'downplayed' Medtronic Puerto Rico's role in ensuring the quality of the devices and leads"; "did not reasonably attribute a royalty rate to Medtronic's profits"; "used an incorrect return on assets approach"; and "ignored the value of licensed intangibles."[146]

Under the § 482 regulations, "'there is no strict priority of methods' when determining an arm's length result of a controlled transaction."[147] Further, an "arm's length result may be determined under any method without establishing the inapplicability of another method,

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139 *See* Finley, *supra* note 120; *Altera*, 926 F.3d at 1067. *See generally* Coca-Cola Co. v. Comm'r, 155 T.C. 145 (2020).
140 Medtronic, Inc. v. Comm'r, 900 F.3d 610, 614 (8th Cir. 2018).
141 *Id.* at 612.
142 *Id.*
143 *Id.*
144 *Id.*
145 *Id.* at 613.
146 *Id.*
147 *Id.* (citing Treas. Reg. § 1.482-1(c)(1)).

but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used."[148] Additionally, when choosing between methods to determine an arm's length price, the court may consider "the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis."[149]

The Eighth Circuit, however, found that the tax court's factual findings were insufficient in comparing the uncontrolled action with the controlled action.[150] For example, the Eighth Circuit said "the tax court did not analyze the degree of comparability of the Pacesetter agreement's contractual terms and those of the Medtronic Puerto Rico licensing agreement."[151] The Eighth Circuit held that "[i]n the absence of findings regarding the degree of comparability between the controlled and uncontrolled transactions, we cannot determine whether the Pacesetter agreement constituted an appropriate CUT."[152] This decision by the Eighth Circuit leaves the door open to allow the tax court to make more detailed factual findings and still uphold the use of the CUT method.[153] However, especially in light of the *Coca-Cola* decision, the tax court may be more likely to find in favor of CPM, deferring to the IRS so long as the method is applied correctly.[154]

3. Facebook Case

Facebook has been in ongoing litigation challenging the IRS's position that Facebook undervalued its intangible assets and transferred the value of the intangible assets to low corporate tax rate jurisdictions.[155] Even though the amount at controversy in the current litigation is only $1.73 million, a finding in favor of the IRS's position could expose Facebook to tax liability for subsequent years.[156] Facebook estimates, if the

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148 *Id.*
149 *Id.* (citing Treas. Reg. § 1.482-1(c)(2)).
150 *Id.* at 614.
151 *Id.*
152 *Id.*
153 *See id.* at 615.
154 *See id.*; Finley, *supra* note 120, at 4.
155 Jeffery Leon, *Facebook Heads to Trial in Tax Dispute That Could Cost $9 Billion*, BLOOMBERG LAW: TAX (Feb. 14, 2020), [https://perma.cc/N9X3-RRHH].
156 *Id.*

IRS's position prevails, the company could be liable up to $9 billion plus interest and penalties for other years currently not at issue.[157]

The *Coca-Cola* case may impact how the tax court views the issues in the Facebook case as Facebook is also arguing to use the CUT method, despite the fact that Coca-Cola was unsuccessful in setting forth that argument.[158] In arguing against the IRS's position, Facebook argued "that the Dublin headquarters received investment, developed its own technology, and took risks in 2010, making the case it was fair to book some profits there."[159] Further, Facebook is arguing "that the updated cost-sharing regulations are subject to the same fundamental restrictions as the 1995 regulations and that any regulatory provision that states otherwise is invalid."[160] However, other experts note that the *Coca-Cola* case may not be a factor in the Facebook litigation because, "'Facebook has zero in common with Coca-Cola in terms of its business, its business model, etc.'"[161] Interestingly, Facebook has sold three of its subsidiaries in Ireland which were holding some of these intangibles at issue in the current litigation.[162]

IV. Conclusion

In conclusion, the IRS received a very favorable ruling in the *Coca-Cola* case, which means that it will continue to challenge transfer pricing transactions it deems to fail arm's length pricing. As we have seen with domestic IRS litigation matters—like its prosecution of syndicated conservation easements and § 831(b) micro-captive insurance companies—courtroom wins often become administrative bully pulpits for forcing settlements favorable to Treasury.[163] However, the case will still most likely be appealed, but considering the IRS has also received a few favorable results in the circuit courts the last few years, the IRS may prevail on appeal as well. If the IRS prevails on appeal, this may cause large multinationals to change their transfer pricing practices in order to avoid

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157 *Id.*

158 Bagchi, Gottlieb, & Leon, *supra* note 117, at 1.

159 Hanna Murphy, *Facebook accused of downplaying IP value in $9bn US tax case*, FINANCIAL TIMES (Feb. 19, 2020), [https://perma.cc/8XCF-QCH8].

160 Kiarra M. Strocko, *Facebook Liquidates Irish Subsidiaries Holding IP Assets*, TAX NOTES (Jan. 4, 2021), [https://perma.cc/U7LY-GRWU].

161 Bagchi, Gottlieb, & Leon, *supra* note 117 (quoting Barbra Mantegani of Mantegani Tax PLLC).

162 Strocko, *supra* note 160.

163 Beckett G. Cantley & Geoffrey C. Dietrich, *Calculating Captive Insurance Settlement Initiative Benefits*, 168 TAX NOTES FED. 183 (2020), [https://perma.cc/3YNT-HURY].

large tax bills, such as the tax liabilities seen in the *Coca-Cola* case and the Facebook case.

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