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U.S. Tax Court: Transfer pricing adjustments, deficiencies upheld

The U.S. Tax Court today issued its opinion in a case upholding the IRS's findings of deficiencies stemming from transfer pricing adjustments made under section 482 and by which the IRS reallocated substantial amounts of income (approximately $9 billion) to the taxpayer from its foreign manufacturing affiliates.

The case is: *The Coca-Cola Co. v. Commissioner,* 155 T.C. No. 10 (November 18, 2020).

Summary

The purpose of this report is to provide text of this lengthy opinion. The following is based on the Tax Court's summary of the case.

The taxpayer (a U.S. corporation) was the legal owner of the intellectual property (IP) necessary to manufacture, distribute, and sell some of the best-known beverage brands in the world. This IP included trademarks, product names, logos, patents, secret formulas, and proprietary manufacturing processes. The taxpayer licensed foreign manufacturing affiliates—called "supply points"—to use this IP to produce concentrate that they sold to unrelated bottlers, who produced finished beverages for sale to distributors and retailers throughout the world. The taxpayer's contracts with its supply points gave them limited rights to use the IP in performing their manufacturing and distribution functions but gave the supply points no ownership interest in that IP.

During 2007-2009:

- The supply points compensated the taxpayer for use of its IP under a formulary apportionment method to which the taxpayer and the IRS had agreed in 1996 when settling the taxpayer's tax liabilities for 1987-1995. Under that method, the supply points were permitted to satisfy their royalty obligations by paying actual royalties or by remitting dividends.

- The supply points remitted to the taxpayer dividends of about $1.8 billion in satisfaction of their royalty obligations. The 1996 agreement did not address the transfer pricing methodology to be used for years after 1995.

On examining the 2007-2009 returns, the IRS determined that the taxpayer's methodology did not reflect arm's length norms because it overcompensated the supply points and undercompensated the taxpayer for the use of its IP. The IRS reallocated income between the taxpayer and the supply points employing a comparable profits method (CPM) that used the taxpayer's unrelated bottlers as comparable parties. These adjustments increased the aggregate taxable income for 2007-2009 by more than $9 billion.

The Tax Court held:

- The IRS did not abuse its discretion under section 482 by reallocating income to the taxpayer by employing a CPM that used the supply points as the tested parties and the bottlers as the uncontrolled comparables.

- The IRS did not err by recomputing the section 987 losses after the CPM changed the income allocable to the taxpayer's Mexican supply point (a branch of the taxpayer).

- The taxpayer 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. Thus, the IRS reallocations to the taxpayer were accordingly to be reduced by the amounts of those dividends.