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TaxNewsFlash

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U.S. Tax Court: Brazilian legal restriction not taken into account in determining arm's length transfer price under section 482

The U.S. Tax Court today released a memorandum opinion holding that Treas. Reg. § 1.482-1(h)(2) prevented a Brazilian legal restriction from being taken into account in determining the arm's-length transfer price for intangible property (IP) licensed by the taxpayer to its Brazilian manufacturing affiliates.

The case is: *The Coca-Cola Company and Subsidiaries v. Commissioner*, T.C. Memo 2023-135 (November 8, 2023). Read the Tax Court's opinion [PDF 244 KB]

Background

The taxpayer and its domestic subsidiaries joined in filing consolidated federal income tax returns for 2007–2009. Upon examination of those returns, the IRS made adjustments that increased the taxpayer's aggregate taxable income by more than $9 billion, producing tax deficiencies that the IRS determined to be in excess of $3.3 billion.

These deficiencies chiefly resulted from transfer pricing adjustments under section 482, by which the IRS reallocated income to the taxpayer from its foreign manufacturing affiliates. These affiliates ("supply points") manufactured concentrate—syrups, flavorings, powder, and other ingredients—used to produce the taxpayer's branded soft drinks. The supply points sold concentrate to independent bottlers throughout the world (excluding the United States and Canada), and the bottlers used the concentrate to produce finished beverages that they marketed to millions of retail establishments worldwide.

To enable the supply points to manufacture and sell concentrate, the taxpayer licensed them use of its IP. On its tax returns for 2007–2009, the taxpayer took the position that the arm's length compensation the supply points were obligated to pay for use of such IP must be calculated using the "10-50-50" method. That was a formulary apportionment method to which the taxpayer and IRS had agreed as a mechanism for settling a dispute regarding the taxpayer's tax liabilities for 1987–1995. That settlement, embodied in a closing agreement executed in 1996, permitted a supply point to satisfy its royalty obligation to the taxpayer by paying actual royalties or by paying dividends.

The closing agreement was valid and binding only for the tax years it covered (i.e., for 1987–1995). But for all subsequent years the taxpayer continued to use the 10-50-50 method to calculate the supply points' royalty obligations. The gist of the IRS position is that the amounts thus calculated for 2007–2009 did not sufficiently compensate the taxpayer for use of its IP.

The Tax Court in November 2020 issued an initial opinion in this case in *Coca-Cola Co. & Subs. v. Commissioner*, 155 T.C. 145 (2020) in which it held that the IRS did not abuse its discretion in reallocating income to the taxpayer using a "comparable profits method" that treated the independent bottlers as comparable parties. The IRS regarded these bottlers as comparable to the supply points because they operated in the same industry, faced similar economic risks, had similar contractual relationships with the taxpayer, employed many of the same intangible assets, and ultimately shared the same income stream from sales of the taxpayer's beverages. In essence, the court held that the independent bottlers furnished a benchmark for arm's length profitability and that, to the extent the supply points enjoyed profits in excess of that benchmark, the excess must be reallocated to the taxpayer as compensation for use of the taxpayer's IP.

The court left one issue for resolution, however, involving the taxpayer's Brazilian manufacturing supply point, which paid no actual royalties to the taxpayer during 2007–2009. Rather, it compensated the taxpayer for use of the IP by paying dividends of $886,823,232, the aggregate amount of the royalty obligation that the taxpayer calculated using the 10-50-50 method. The court previously held that the Brazilian supply point's arm's length royalty obligation for 2007–2009 was actually about $1.768 billion, as determined by the IRS. But the court held that the dividends remitted in place of royalties must be deducted from that sum, resulting in a net transfer pricing adjustment to the taxpayer from the Brazilian supply point of about $882 million. The issue left for resolution by the court was whether this $882 million net transfer pricing adjustment is barred by Brazilian law.

During 2007–2009 Brazil capped the amounts of trademark royalties and technology transfer payments that Brazilian companies could pay to foreign parent companies. The parties have stipulated that the Brazilian legal restriction capped the royalties payable by the Brazilian supply point to the taxpayer at roughly $16 million for 2007, $19 million for 2008, and $21 million for 2009. The taxpayer contends that Brazilian law thus blocks the $882 million net transfer pricing adjustment sustained as arm's length compensation to the taxpayer for use of its IP.

The IRS argued that the Brazilian legal restriction must be given no effect in determining the arm's length transfer price, relying on Treas. Reg. § 1.482-1(h)(2), commonly called the "blocked income" regulation. That regulation generally provides that foreign legal restrictions will be taken into account for transfer pricing purposes only if four conditions are met, including the requirement that the restrictions must be "applicable to all similarly situated persons (both controlled and uncontrolled)." The taxpayer urged that the blocked income regulation did not apply or that, if it did apply, it was invalid under the Administrative Procedure Act (APA) and/or *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

When the Tax Court issued its November 2020 opinion in this case, challenges to the validity of the blocked income regulation had been taken under advisement by another division of the Tax Court, so the court reserved ruling on the effect of the Brazilian legal restriction until a decision was rendered in that case. The court in February 2023 issued an opinion in that case—*3M Co. & Subs. v. Commissioner*, No. 5816-13, 160 T.C. (Feb. 9, 2023)—in which it rejected the taxpayer's *Chevron* and APA arguments and sustained the validity of the blocked income regulation. Read *TaxNewsFlash*

Today's Tax Court opinion

The Tax Court first noted that it was not convinced that the Brazilian legal restrictions which prevented the Brazilian supply point from paying royalties in excess of $56 million during 2007– 2009 actually blocked the payment of arm's length compensation because the Brazilian supply point could have paid such compensation in the form of dividends, rather than royalties. Nonetheless, because the validity of the blocked income regulation had already been sustained by the court in *3M*, the court decided to consider how it applied in this case, assuming that the Brazilian legal restriction actually accomplished the blocking function the taxpayer ascribed to it.

As described above, the blocked income regulation specifies four conditions, all of which must be satisfied before a foreign legal restriction will be given effect in determining the arm's length transfer price. The first condition requires that the foreign legal restriction be "publicly promulgated [and] generally applicable to all similarly situated persons (both controlled and uncontrolled)." As decided by the court in *3M*, the court today held that because the Brazilian legal restriction has no application to royalties paid to unrelated parties, but only to royalties paid to a controlling foreign company, the legal restriction is not "generally applicable to all similarly situated persons (both controlled and uncontrolled)." Consequently, the court held that the legal restriction must be disregarded in determining the arm's length transfer price in this case.

The court further rejected various arguments made by the taxpayer that the blocked income regulation's effective date provision exempted or "grandfathered" some portion of the IP exploited by the Brazilian supply point from application of the regulation.