WTR
World Trademark Review

22 Apr
2021

Best practice in brand ownership and tax reporting post-*Coca-Cola*

By **Jonathan G Polak**, **Todd C Lady** and **Joseph Balthazor Jr**

- **Coca-Cola's defeat over how it allocates branding profits among its international subsidiaries – and the resulting tax bill – has sent shockwaves around the world.**
- **The case highlights that brand owners cannot rely on past rulings from the IRS but should constantly review their calculation methods.**
- **Taxpayers should ensure that their intercompany agreements are up to date and that these reflect a sustainable approach to allocating income from the exploitation of IP rights.**

Coca-Cola is the most famous trademark in the world. In fact, it is "recognized by more of the planet's 7.7 billion inhabitants than any other English word but 'OK'", according to a recent groundbreaking judgment from the US Tax Court (*The Coca-Cola Co v Comm'r of Internal Revenue*, 31183-15, 2020 WL 6784134, at *2 (TC, 18 November 2020)). However, as that case has made all too clear, such valuable brands must be taxed at the correct level – or pay a steep price.

Coca-Cola's trademarks, combined with its famous trade-secret-protected recipe, constitute highly valuable intellectual property. Like all multinationals, Coca-Cola must account for its use of these in all the jurisdictions in which it operates. The manner in which a company does this is a high-stakes game on many fronts, including that of income tax.

For large multinationals, allocating income from intangibles owned by one corporate entity and exploited by another is referred to as 'transfer pricing'. In its simplest form, a transfer price is the value at which a controlled owner of property (or performer of services) charges a related party for such property or service. US tax law contains a complex set of regulations, court decisions and administrative guidance for determining the appropriate transfer price – all of which seek to achieve an arm's-length return for the rights holder. If the government decides that a transfer price is not arm's length, it may be adjusted, leading to a steep tax bill – as was the case for Coca-Cola.

Coca-Cola v the IRS

In the case at hand, the Internal Revenue Service (IRS) asserted that Coca-Cola had improperly relied on an inappropriate method to determine the transfer price for its intellectual property.

The company had used a methodology for charging royalty rates to its foreign subsidiaries and affiliates that had previously been approved by the IRS. The IRS' contention was that while this may have been appropriate in the past, continuing to apply this methodology in the years in question significantly undervalued the intellectual property – meaning that Coca-Cola was under-charging its foreign affiliates and thereby failing to pay tax in the United States on the resulting income. According to the IRS, Coca-Cola should have been using a different formula, one that relies on a relationship almost as old as the drink itself: the company and its independent bottlers.

The IRS prevailed in determining that Coca-Cola should have been valuing the subject property rights at a royalty rate consistent with the rate charged to independent bottlers. On that basis, the Tax Court reallocated $9 billion in taxable income from Coca-Cola's foreign subsidiaries and affiliates to its US parent.

The crucial takeaway for multinationals with foreign subsidiaries is that improperly charging affiliates for the use of intellectual property may result in the under-reporting of profits and a multi-billion-dollar tax penalty. To avoid this, such companies must ensure that agreements governing relationships with foreign subsidiaries and affiliates properly apply the correct transfer pricing rules.

In particular, Coca-Cola's reliance on a previously approved methodology cut no ice with the IRS or the Tax Court; multinationals must periodically revisit their transfer pricing positions to ensure that they are still valuing their intangibles correctly.

Licensing the Coca-Cola brand

At its heart, the battle between Coca-Cola and the IRS concerns the relationships among the soft drink giant's subsidiaries and affiliates, independent bottlers and other third-party stakeholders in its global supply-chain network.

Coca-Cola supply points

It is this complex network that has allowed Coca-Cola to realise enormous profits worldwide. According to the Tax Court, about three-quarters of the company's revenue originates outside the US market. Thus, the case involved the appropriate transfer price to be paid to the US parent group for valuable intellectual property associated with the manufacture, distribution and sale of one of the world's best-known brands.

The IRS focused on certain affiliates with manufacturing plants in Brazil, Chile, Costa Rica, Egypt, Ireland and Mexico. These businesses produce the concentrate syrups, flavourings, powders and other ingredients for Coca-Cola's soft-drink and other non-alcoholic beverages, which they sell on to Coca-Cola bottlers across Africa, Asia, Australia, Europe and Latin America. These affiliate plants are often referred to as 'supply points'.

IP licensing

Coca-Cola licenses its IP portfolio to the supply points in connection with their ability to manufacture and sell concentrate, including the company's trademarks, brand names, logos, patents, secret formulas and manufacturing processes. In return, the affiliates pay royalty fees for the use of the company's portfolio.

Coca-Cola also has agreements with independent bottlers and service companies, allowing them to use its IP portfolio in exchange for a royalty rate. For years, Coca-Cola has charged its subsidiaries and affiliates a far lower royalty rate than that which it charges to independent bottlers and affiliates.

Tax Court opinion

In its simplest form, the case considered the appropriate split of profits between Coca-Cola's US group and various foreign affiliates in connection with the manufacture and sale of products outside the United States. After examining the company's tax returns between 2007 and 2009, the IRS determined that the old formula Coca-Cola had been using – which the IRS had approved under a 1996 settlement – failed to appropriately reflect an arm's-length pricing structure because it overpaid the supply points and underpaid the company for its IP portfolio.

Such overpayment took the form of a too-low royalty rate charged to the affiliate, which had the net effect of increasing the affiliate's income and decreasing the US group's income. To determine the tax liability, the IRS instead used the independent bottlers as a comparison.

Old formula: 10-50-50 method

This is not Coca-Cola's first time battling the IRS over allocating foreign profits. In 1996 it settled a dispute for tax liabilities between 1987 and 1995. As part of the settlement, Coca-Cola agreed to use a formula to calculate the appropriate IP charges to impose on its foreign affiliates for the taxable years spanning 1987 through to 1995, known as the '10-50-50 method'.

Under this method, supply points were permitted to retain 10% of their gross sales in profits, with the remaining profit split 50-50 with the parent company. Based on the contractual relationship between the parent company and the affiliates, payments were then calculated and implemented as royalties for the right to use the relevant intellectual property. Quite logically, following the settlement of the dispute in 1996, Coca-Cola applied the 10-50-50 method to determine the allocation of profits between the US group and its foreign affiliates.

Coca-Cola argued that the IRS commissioner's decision to ignore the 1996 closing agreement was arbitrary and capricious. It reasoned that the agreement was intended to have a prospective effect because it protected the company from certain tax penalties in future years. The Tax Court rejected this, relying on the plain language of the agreement itself. It determined that the commissioner had not abused their discretion in concluding that Coca-Cola's 10-50-50 formula did not represent an arm's-length pricing structure under Section 482 of the US Internal Revenue Code because the royalty prices undercompensated the company for the use of its extremely valuable IP portfolio.

The statutory underpinning of the US transfer pricing laws is set out in Section 482, which provides as follows:

> *In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may 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. In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.*

In other words, this section gives the IRS broad discretion to prevent corporate tax evasion within the context of intellectual property, among other things. Relying on its authority under Section 482, the IRS proposed adjusting the transfer price between the US group and its foreign affiliates.

New formula: comparable profits method

The IRS's argument was first and foremost that the 1996 agreement was not controlling. Once the Tax Court agreed with that contention, the IRS was free to provide expert testimony on the best method for determining the appropriate transfer price.

One of the approved methods provided for in the Transfer Pricing Regulations is the comparable profits method (CPM). This seeks to align the profits of a related-party transaction with those of unrelated parties by determining the appropriate profit that an independent party would earn in a similar business arrangement.

This can be compared to the comparable uncontrolled transaction (CUT) method, which seeks to find publicly available licensing arrangements with similar factual bases and use the royalty rates in such arrangements as a guide to the royalty to be charged in the transactions being assessed.

Applying the CPM, the IRS determined that Coca-Cola's foreign affiliates should essentially earn a profit comparable to independent bottling companies. The IRS chose independent bottlers as comparable because they:

- operate in the same industry;

- face similar economic risks;
- have similar contractual relationships;
- use many of the same Coca-Cola brand names, trademarks and logos; and
- share the same income stream from sales of Coca-Cola products.

Coca-Cola argued that the CPM ignored a valuable off-book asset for the supply points, which it referred to as 'marketing intangibles'. The company acknowledged that the parent owned virtually all of the trademarks and similar intangible assets that allowed the supply points to manufacture the soft drinks and other non-alcoholic beverages. However, it reasoned that without the billions of dollars spent on global marketing, the Coca-Cola IP portfolio would not be as valuable as it is.

The Tax Court was not persuaded. The test for identifying an intangible asset is legal ownership; therefore, the ownership of the company's intellectual property played a key role in its decision. On petition, Coca-Cola challenged the reasonableness of the CPM. However, the Tax Court explained that comparing supply points to independent bottlers was appropriate because the proper testing party was the affiliates, rather than the parent. Since the Coca-Cola parent entity owns all of its intangible assets, the Tax Court determined that the residual income was properly reallocated to it, just as it is when the company sells to the independent bottlers.

Lessons learned

The case highlights several tax and IP lessons for companies big and small, including:

- whether it is a good idea to rely on past IRS settlements;
- how to assess IP ownership in a complex multinational context;
- how to choose the best method to calculate IP valuation; and
- how to build a multinational corporate structure.

Relying on past IRS settlements

For Coca-Cola, a particularly frustrating component of the case is the fact that, not unreasonably, it relied on a previous settlement formula with the IRS. Such reliance and, in particular, the reasonableness thereof might serve as grounds for a future appeal.

However, it is axiomatic in US tax law that each tax year stands on its own. In the Tax Court's view, nothing in the 1996 agreement provided a basis for Coca-Cola to apply the terms of the agreement going forward with impunity. Certainly there were no contractual terms in the agreement that purported to have future affect.

In any event, the lesson is apparent. Multinationals must re-evaluate their transfer pricing routinely to determine whether an arm's-length standard is being maintained. Indeed, many intercompany agreements contain price adjustment clauses that allow intercompany charges (eg, royalty rates) to be adjusted on a periodic basis to conform with updated transfer pricing analyses. However, those clauses serve their purpose only if the company engages in the underlying analyses to support the current pricing or make the requisite adjustments.

IP ownership

The case is also a timely reminder that companies should consider the IP ownership structure among parents, subsidiaries and affiliates. The Tax Court relied heavily on Coca-Cola's agreements that allowed the parent company to own all of its intellectual property, leaving the subsidiaries and affiliates with only a licensed right to it.

With an IP portfolio as valuable and famous as Coca-Cola's, that approach might make sense, but it comes with a price – the affiliates' exploitation of the intellectual property must result in compensation to the actual owner.

In evaluating ownership, an integral step is to identify allthe intellectual property in question. Coca-Cola attempted to argue that the supply points developed their own intellectual property in their local markets. However, based on the legal agreements, the Tax Court found that the US group maintained ownership of the intellectual property and thereby remained the taxpayer to be compensated for its use.

Choosing where new intellectual property is owned can be a crucial decision, with long-term consequences. Companies developing brands with an international reach and marketing intangibles (or acquiring such rights from third parties) should address these issues early on.

The 'best' method

Choosing the method by which to establish a particular transfer price can be a complex process. As noted above, the applicable regulations require the taxpayer to use the best method. The Tax Court determined that the original 10-50-50 pricing formula failed to produce an arm's-length result and need not be applied by the IRS based on the terms of the prior settlement. Further, the court determined that the CUT method advanced as an alternative by Coca-Cola's experts at trial was not the best method because of the lack of comparable royalty arrangements relating to such valuable intellectual property, which undermined the probative value of the data. Instead, the court, agreeing with the IRS, selected the CPM method.

All taxpayers undertaking a transfer pricing analysis should establish the method selected in their back-up documentation and why it satisfies the best method requirement (ie, why it is superior to other available methods). As in all things, the advice sought and the documentation put in place should be practically scaled to the taxpayer in question.

Today, even relatively small US companies engage in international operations through foreign affiliates. Not all such taxpayers have the resources to undertake large-scale transfer pricing analyses performed by experts. In such cases, what can be viewed as relatively expensive prophylactic measures against future potential risks can have trouble gaining institutional support. However, transfer pricing diligence has become a cornerstone of the modern M&A diligence process, with financial buyers recognising the risks inherent in an undocumented or badly thought-out pricing strategy. Thus, although it may be challenging to garner support within a small company, implementing a transfer pricing plan remains an important aspect of a business' tax-risk profile.

The importance of documentation

The cornerstone of justifying a company's transfer pricing position in light of an IRS (or foreign taxing authority) challenge is documentation. Without proper documentation, the IRS has a much freer hand to make adjustments and, in many instances, impose penalties.

Having documentation alone is not enough; it must comport with economic realities. For example, self-serving documentation that purports to charge an unsubstantiated transfer price may be ignored by both the IRS and the courts. Thus, taxpayers must strive to marry legal documentation with an accurate pricing methodology that can be sustained as the best method upon challenge.

Multinational structures

Not all multinationals are as complex as Coca-Cola. The company only found itself in this battle because it does business with hundreds of its own affiliates and subsidiaries while also dealing with independent bottlers. However, intercompany commercial arrangements with related foreign (and domestic) affiliates can be highly influenced by corporate structure.

In some instances, the presence of a large minority owner may influence the pricing. Similarly, certain legal structures may result in one jurisdiction having a greater stake in a transfer pricing outcome while another is ambivalent. Intercompany agreements cannot be structured in a tax, legal or commercial vacuum. All stakeholders in the company's organisational structure must be consulted and should provide input on how related affiliates are legally held and conduct business.

Whoever you are, check your documents

Large multinationals are paying attention to Coca-Cola's case, not only because of the large tax bill, but because it represents a major victory for the IRS on several technical fronts.

The case serves as a reminder for all taxpayers operating through affiliate entities of how crucial it is to document intercompany agreements, particularly the pricing used therein. The IRS undertakes transfer pricing examinations for taxpayers of all sizes, not just large multinationals. At a minimum, all taxpayers should ensure that their intercompany agreements are up to date and that they reflect a sustainable approach to allocating income from the exploitation of their IP rights.

Top takeaways

- Multinationals must routinely re-evaluate their transfer pricing in order to determine whether the arm's-length standard is being maintained.
- When it comes to evaluating IP ownership, an integral step is to identify all the intellectual property in question.
- All taxpayers undertaking a transfer pricing analysis should establish in their back-up documentation the method selected and the reason why it satisfies the 'best method' requirement (ie, why it is superior to the other potentially available methods).
- Documentation is the cornerstone for justifying a company's transfer pricing position in light of an IRS (or foreign taxing authority) challenge.
- Intercompany agreements cannot be structured in a tax, legal or commercial vacuum – all stakeholders in the company's organisational structure should be consulted and provide input on how related affiliates are legally held and conduct business.

Jonathan G Polak

Partner and IP practice group leader
Taft Stettinius & Hollister LLP

Todd C Lady

Partner
Taft Stettinius & Hollister LLP

Joseph Balthazor Jr

Associate
Taft Stettinius & Hollister LLP

TAGS

Brand management, Food and Beverage, International, North America, United States of America