

The effect of the Coca-Cola transfer pricing cases and selected shifts in the international tax regime on the determination of an arm's length price

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By Janet Gutsche
GTSJAN002

UNIVERSITY OF CAPE TOWN



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Supervisor: Associate Professor Johann Hattingh, Faculty of Law, Department of
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ABSTRACT

An era of legal loopholes and opportunities for double non-tax, along with economic, social and political developments in modern history have driven significant changes in the international tax environment facing taxpayers with cross border interests.

Transfer pricing and the arm's length calculation is central to this issue.

The proposition is that corporate tax evasion scandals and demanding government budget deficits have led to global shifts in the international tax environment. This has redefined the future of tax planning and may pose a threat to the rights of ethical and responsible international taxpayers intending to pay, *only*, their fair share of taxes.

The Coca-Cola Company is one of the most prominent and best known international organisations. Its vast and intricate international business structure and transfer pricing challenges are universal, relatively easy to understand, and relatable to other corporate taxpayers. The company has a significant presence in South Africa and 2 out of the 8 subsidiaries that were involved in the transfer pricing cases are African (Lesotho and Egypt).¹ These cases that have been proceeding since before 2017 are useful examples for anyone attempting to understand how the arm's length principle will be applied in the modern international tax era.

There is insufficient transfer pricing case law, specifically in South Africa, where the prevailing transfer pricing guidelines are contained in a practice note² that has remained unchanged since its introduction in 1999.³ The lack of precedent makes decisions regarding an appropriate arm's length price uncertain. It is necessary to analyse pertinent foreign case law that may provide guidance on how tax authorities and practitioners in South Africa may apply transfer pricing regulations.

The aim is to adopt the case study method to analyse the Coca-Cola transfer pricing cases in light of selected shifts in the international tax regime to explore what effect will be had on the determination of an arm's length price going forward.

¹ For further discussion, please refer to 5.2. Greater detail of the cases is provided in later chapter and throughout this research paper.

² SARS Practice Note No. 7 (6 August 1999); Section 31 of The Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing; <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>.

³ Deloitte (2022); When to expect a transfer pricing interpretation note? 2018/19 South African National Budget Expectations; <https://www2.deloitte.com/za/en/pages/tax/articles/when-to-expect-a-transfer-pricing-interpretation-note.html>.

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Chapter One

Introduction

An era of legal loopholes and opportunities for double non-tax, along with economic, social and political developments in modern history have driven significant changes in the international tax environment facing taxpayers with cross border interests.

Tax avoidance is a pervasive problem. Although it is generally accepted that companies should pay their fair share of taxes, what that means and how it is quantified continues to be fiercely debated amongst nation states and international taxpayers. It is possible for law abiding corporate citizens to intend to operate in a tax-efficient manner, without instituting structures that are aimed at achieving double non-tax or reducing their effective tax rate to below what would be considered fair, but these practises have come under greater scrutiny from tax authorities.

Transfer pricing is central to this issue. There is no hierarchy that prescribes⁴ which of the possible calculation methods will result in an objectively acceptable arm's length price, with the burden being on the taxpayer to prove compliance with the arm's length standard⁵. Interpreting the confines of the law, and determining what application will fit safely within it, is inherently subjective. This increases the challenges facing conscientious taxpayers and the notion that they have the right to structure their affairs efficiently⁶ when, by doing so successfully, the risk of costly legal disputes is increased. Balancing this potential financial and reputational risk with the need to implement tax-efficient structures presents a dilemma for tax professionals in the modern era who ultimately have a fiduciary duty to foster shareholder value.

The proposition is that corporate tax evasion scandals and demanding government budget deficits have led to global shifts in the international tax environment. This has redefined the future of tax planning and may pose a threat to the rights of ethical and responsible international taxpayers intending to pay, *only*, their fair share of taxes.

Transfer pricing matters disputed in Courts in the United States bring up pervasive issues that are common to taxpayers operating across OECD member and non-member states⁷ with the added nuances that are unique to the US and its own model tax convention.⁸ The US is home to some of the world's largest multinationals, with most international companies also having operations in America. These structures that cross through America are present in South Africa and throughout the African continent.

The Coca-Cola Company is one of the most prominent and best known international organisations. Its vast and intricate international business structure and transfer pricing challenges are universal, relatively easy to understand, and relatable to other corporate taxpayers. The company has a significant presence in South Africa and 2 out of the 8 subsidiaries that were involved in the transfer pricing cases are African (Lesotho and Egypt).⁹ These cases that have been proceeding since before 2017 are useful examples for anyone attempting to understand how the arm's length principle will be applied in the modern international tax era.

⁴ A.M. Leon et al., United States - Transfer Pricing, Country Tax Guides IBFD, 4.2. Hierarchy of methods.

⁵ J. Doonan, K.J. Peterson & J. (Joanne) Li, United States - Transfer Pricing & Dispute Resolution, Country Tax Guides IBFD, https://research-ibfd-org.ezproxy.uct.ac.za/#/doc?url=/document/tpdrtp_us_chaphead.

⁶ Duke of Westminster V Commissioners of Inland Revenue(1) (1933-1935) 19 TC 490.

⁷ Discussed in detail in later chapters. For reference, please see Chapter Eight.

⁸ Discussed in detail in later chapters. For reference, please see Chapter Nine.

⁹ For further discussion, please refer to 5.2. Greater detail of the cases is provided in later chapter and throughout this research paper.

There is insufficient transfer pricing case law, specifically in South Africa, where the prevailing transfer pricing guidelines are contained in a practice note¹⁰ that has remained unchanged since its introduction in 1999.¹¹ The lack of precedent makes decisions regarding an appropriate arm's length price uncertain. It is necessary to analyse pertinent foreign case law that may provide guidance on how tax authorities and practitioners in South Africa may apply transfer pricing regulations.

The aim is to adopt the case study method to analyse the Coca-Cola transfer pricing cases in light of selected shifts in the international tax regime to explore what effect will be had on the determination of an arm's length price going forward.

¹⁰ SARS Practice Note No. 7 (6 August 1999); Section 31 of The Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing; <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>.

¹¹ Deloitte (2022); When to expect a transfer pricing interpretation note? 2018/19 South African National Budget Expectations; <https://www2.deloitte.com/za/en/pages/tax/articles/when-to-expect-a-transfer-pricing-interpretation-note.html>.

Chapter Two

A brief modern history of selected shifts in the international tax environment

2.1 Introduction

Background to the international tax environment is necessary for orientating oneself in the pivotal place in international tax history that we are currently in so that we can seek to understand the effect that the Coca-Cola transfer pricing cases and selected shifts in the international tax regime will have on the determination of an arm's length price moving forward. This chapter introduces the international tax environment, the Coca-Cola cases and the principles and significance of the arm's length principle in transfer pricing.

2.2 Background

2.2.1 A Brief History of International Taxes

Since the 1996 Harmful Tax Competition initiative, driven by the G7 countries, the Organisation for Economic Co-operation and Development (the OECD), has been making futile attempts to curtail corporate tax avoidance. Its meagre attempts lacked sufficient support from key member states, preferential tax regimes, and the private sector. Much of the opposition to these proposals pointed to how they would encroach on tax sovereignty, and contradicted the importance of tax competition that was advocated by the OECD itself¹² (these issues remain relevant to the current global minimum tax proposals discussed in 0). The public had little influence over these policy decisions¹³ and the initiative faded after it lost US support in 2001. This left multinational corporations (MNCs) to continue to legally (and illegally) pursue aggressive tax strategies.¹⁴

Numerous findings highlighted the cost of lost corporate tax revenues on global economies but there was insufficient political resolve to confront the situation until the aftermath of the 2008 Financial Crisis, which demanded government austerity and prompted mainstream campaigns for tax justice. Tax overhauls gained momentum and were backed by public support, making them electorally appealing.¹⁵ With corporate tax dodging becoming a new priority on the voters' agenda, the barriers to multinational cooperation against tax avoidance began to break down. More members then made up the G20 nations that mandated the OECD Base Erosion and Profit Shifting (BEPS) report in 2012.¹⁶

In the previous century, the focus was on establishing bilateral agreements that were aimed at preventing double-tax, while overlooking loopholes that allowed for widespread non-tax. The final BEPS report published in 2015 represented a drastic shift in international norms with the new objective being

¹² Woodward, R. (2018). In *Business, Civil Society and the 'New' Politics of Corporate Tax Justice*, Ch1: "The evolution of the international corporate tax regime, 1920-2008." Cheltenham, UK: Edward Elgar Publishing. doi: <https://doi.org/10.4337/9781788114974.00009>.

¹³ Oxfam (2000), *Tax Havens: Releasing the Hidden Billions for Poverty Eradication*, available at <http://policy-practice.oxfam.org.uk/publications/tax-havens-releasing-the-hidden-billions-for-poverty-eradication-114611>

¹⁴ Woodward, R. (2018). In *Business, Civil Society and the 'New' Politics of Corporate Tax Justice*, Ch1: "The evolution of the international corporate tax regime, 1920-2008." Cheltenham, UK: Edward Elgar Publishing. doi: <https://doi.org/10.4337/9781788114974.00009>.

¹⁵ Ibid.

¹⁶ Mason, R. (2020). *The Transformation of International Tax*. *American Journal of International Law*, 114(3), 353-402. doi:10.1017/ajil.2020.33, <https://www.cambridge.org/core/journals/american-journal-of-international-law/article/transformation-of-international-tax/A335E9177D1C7A692362066205689D1B>.

to achieve 'full taxation'.¹⁷ New 'fiscal fail-safes' were increasingly being introduced to combat aggressive tax planning by requiring untaxed income in one state to automatically be taxable in another.¹⁸ However, the BEPS Monitoring Group noted that this resulted in increased complexity and contradictions¹⁹ that only created further opportunities for MNCs to reduce tax.²⁰

The United States' engagement in BEPS negotiations came to an end in the Trump administration. The country's refusal to sign the Multilateral Instrument (MLI) or join the common reporting standards gave it the reputation in the EU of being a tax haven.²¹ However, the US did not completely abandon BEPS and instead introduced unilateral measures in its 2017 Tax Cuts and Jobs Act (the TCJA) that relied on many of the same principles, such as that of the 'Single Tax Principle,' that all income should be taxed, once^{22,23}

Notwithstanding opportunities to escape paying its fair share, when the US corporate tax rate was 35% before the 2017 Tax Reform, Coca-Cola's effective tax rate was 24%. The lower rate simply reflected its significant global operations and the US's relatively high corporate tax rate that was later lowered to 21% by the TCJA.²⁴

The US had long been import-neutral with incentives to create offshore structures to achieve tax deferral benefits.²⁵ With Global Intangible Low-Taxed Income (GILTI), the TCJA legislated the move away from this by taxing foreign profits of US companies at approximately half the rate of their domestic profits (regardless of whether they were remitted).²⁶ This partially addressed the tax problem resulting from companies completely shifting profits offshore by using aggressive transfer pricing practices.²⁷ By 2019, opportunities for stateless income were being replaced with greater risks of double tax, raising concerns over whether the near future would be more focused on planning to avoid double tax, than on structuring into double non-tax.²⁸

¹⁷ The "Single Tax Principle" comprises of the two notions of "Full Taxation" of all income and the prevention of double taxation on any income. (Mason, 2020; Avi-Yonah, 2020)

¹⁸ Mason, R. (2020). The Transformation of International Tax. *American Journal of International Law*, 114(3), 353-402. doi:10.1017/ajil.2020.33, <https://www.cambridge.org/core/journals/american-journal-of-international-law/article/transformation-of-international-tax/A335E9177D1C7A692362066205689D1B>.

¹⁹ BEPS Monitoring Group (2015), 'Overall Evaluation of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project', available at <https://bepsmonitoringgroup.files.wordpress.com/2015/10/general-evaluation.pdf>.

²⁰ Woodward, R. (2018). In *Business, Civil Society and the 'New' Politics of Corporate Tax Justice*, Ch1: "The evolution of the international corporate tax regime, 1920-2008." Cheltenham, UK: Edward Elgar Publishing. doi: <https://doi.org/10.4337/9781788114974.00009>.

²¹ Avi-Yonah, R. (2020). A Positive Dialectic: Beps and The United States. *AJIL Unbound*, 114, 255-259. doi:10.1017/aju.2020.51, <https://www.cambridge.org/core/journals/american-journal-of-international-law/article/positive-dialectic-beps-and-the-united-states/479E3A344954F9E56161B4340539F361>.

²² Avi-Yonah, Reuven S. "Full Circle? The Single Tax Principle, BEPS." *Global Tax'n* 1, pt. 1 (2016): 12-22., <https://repository.law.umich.edu/articles/1820>.

²³ Avi-Yonah, R. (2020). A Positive Dialectic: Beps and The United States. *AJIL Unbound*, 114, 255-259. doi:10.1017/aju.2020.51, <https://www.cambridge.org/core/journals/american-journal-of-international-law/article/positive-dialectic-beps-and-the-united-states/479E3A344954F9E56161B4340539F361>.

²⁴ Waller, K (Coca-Cola CFO) interviewed in Leith, Scott (2018), *Talking Tax: How U.S. Changes Impact Coca-Cola's Global Business*, <https://www.coca-colacompany.com/news>.

²⁵ de Wilde, M (2021), "The Made in America Tax Plan: What's in store for other countries?," <http://kluwertaxblog.com/2021/04/26/the-made-in-america-tax-plan-whats-in-store-for-other-countries/>.

²⁶ The current US Corporate tax rate, applicable to domestic derived income, is 21%, with offshore earnings taxed at the GILTI rate of 10.5% and 13.125% (de Wilde, 2021)

²⁷ Silver, M (2021), *Legislation or Treasury Regulations: How Biden Will Fix the Tax System*, <https://www.taxnotes.com/tax-notes-today-international/tax-system-...how-biden-will-fix-tax-system/2021/02/08/2r43w?highlight=coca-cola>.

²⁸ Blough, S.R. (KPMG LLP) (2019), 19th Annual NYU / KPMG Tax Symposium "Global tax roller coaster: adapting to an environment riddled with complexity, uncertainty & instability", *Transfer pricing implications in a post-BEPS and post-US tax reform environment*, <https://www.youtube.com/watch?v=Bx8T8SRKNks&t=1607s>

In 2020, Pillar II of BEPS 2 globalised the TCJA policies to target undertaxed payments. It also introduced the notion of a global minimum tax.²⁹ Pillar I concentrates on the digital economy and proposes a partial abandonment of the long-established arm's length standard.³⁰ Although predominantly intended to encompass the lost tax revenues of major US-based firms,³¹ these proposals were not driven by the Trump administration. This left many to doubt whether it would achieve what it had set out to.³²

During the Covid-19 pandemic and under the new Biden administration, the US proposed the 'Made in America Tax Plan' in March and April of 2021. It contains major corporate tax reforms needed to fund ambitious investments on the political agenda.³³ If fully enacted, the US will engage a multinational approach, along with the OECD, to converge corporate international tax systems in the image of the US model and impose a global minimum tax rate.³⁴ Among other things, this will limit the opportunities for MNCs to structure their affairs in more efficient ways and it will increase the corporate tax burden.³⁵

In recent years, numerous international policies are being designed by the OECD, the EU, and individual states to target digital services companies and prevent them from avoiding taxes. Although unintended, these are expected to have significant ramifications on other types of companies. With little tax certainty, it is necessary for companies to review their current exposure and adjust their future tax plans. However, the US does oppose this specific industry targeting and instead proposed that countries isolate the world's 100 largest companies with revenues of at least USD 20 billion.³⁶ This was generally welcomed by the OECD³⁷ and the international community.³⁸

Tax professionals will need to consider their shareholders' tolerance for lower returns on their investments. They will need to decide on how much of this will be passed on to the public through price increases and cost cutting measures that could affect suppliers and employee wages,³⁹ as well as capital investments and corporate social initiatives.

Corporate taxpayers will also need to consider what the planned 67% increase in the annual IRS budget⁴⁰ will have on its ability to enforce its contentious transfer pricing adjustments and the sway that it will have on the climate of future tax courts. Currently revenue services and judiciaries in cases against multinationals contradict their own positions as to the best way to reach a fair transfer price (see Chapter Five and Chapter Six).

²⁹ Discussed in detail in later chapters. For reference, please see 0.

³⁰ Avi-Yonah, R. (2020). A Positive Dialectic: Beps and The United States. *AJIL Unbound*, 114, 255-259. doi:10.1017/aju.2020.51, <https://www.cambridge.org/core/journals/american-journal-of-international-law/article/positive-dialectic-beps-and-the-united-states/479E3A344954F9E56161B4340539F361>.

³¹ Ibid.

³² For further discussion, please refer to 0.

³³ Goulder, R (2021), The Biden Plan: Tax Reform Whistles an American Tune, <https://www.taxnotes.com/tax-notes-international/tax-reform/biden-...reform-whistles-american-tune/2021/04/19/4v98b?highlight=coca-cola>.

³⁴ de Wilde, M (2021), "The Made in America Tax Plan: What's in store for other countries?", <http://kluwertaxblog.com/2021/04/26/the-made-in-america-tax-plan-whats-in-store-for-other-countries/>.

³⁵ Discussed in detail in later chapters. For reference, please see 0.

³⁶ Discussed in detail in later chapters. For reference, please see 0.

³⁷ Discussed in detail in later chapters. For reference, please see 0.

³⁸ United States; OECD - Biden Administration Targets World's 100 Largest Companies in New OECD Proposals (09 Apr. 2021), News IBFD.

³⁹ de Wilde, M (2021), "The Made in America Tax Plan: What's in store for other countries?", <http://kluwertaxblog.com/2021/04/26/the-made-in-america-tax-plan-whats-in-store-for-other-countries/>.

⁴⁰ O. Marian, A New Direction for US International Tax Policy – Two Steps Forward, One Step Back?, 3 (2021), *Journal Articles & Opinion Pieces IBFD*.

2.2.2 The Arm's Length Principle

This is the prevailing standard that is applied by most countries and requires that the transfer price resemble the price that would be expected from a similar commercial transaction between companies that are independent, but operating under similar circumstances.⁴¹

2.2.3 Transfer Pricing in the United States

The federal statutory laws governing taxation in the United States are contained in the Internal Revenue Code⁴². This is administered by the Internal Revenue Service (the IRS) that is also responsible for collecting taxes on behalf of the federal government. The arm's length principle in US transfer pricing law stems from section 482⁴³ of the IRS Code. It bestows broad power on the US tax authorities to reallocate taxable income amongst parents and subsidiaries ("controlled companies"), if they deem this necessary to "clearly reflect the income"⁴⁴ of these companies, or to prevent tax evasion.⁴⁵

There are 4 authorised methods⁴⁶ available to calculate the arm's length price that most accurately reflects the commercial value of intangible asset transfers within a US controlled group.⁴⁷ Taxpayers are required to apply 'the best method rule' to test the results of each and, based on comparability, data quality, and the reliability of the assumptions, determine which will be the most appropriate for a given structure.⁴⁸ The decision is complex and, even after a reasonable interpretation and application of the law (as was found to be the case in *The Coca-Cola Company & Subsidiaries V. The IRS (2017)*), the taxpayer's choice can still be contested by the revenue authorities.

The IRS had a long and consistent transfer pricing losing streak,⁴⁹ but from 2018 that seemed to be coming to an end with another landmark victory in late 2020, this time against The Coca-Cola Company. One can only speculate the outcome of the eagerly awaited appeal. Expectations are that it will indicate the Courts' approach to these cases in future,⁵⁰ and influence the outcome of similar disputes that are currently pending, such as the one against Facebook.⁵¹

2.2.3.1 The Residual Profit-Split Method (RPSM)

⁴¹ OECD 2015. *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*.

⁴² This refers to title 26 of the U.S. Code ("the Code") and represents that tax laws that are enforced by the IRS and is interchangeably referred to as the "IRS Code", "the IRS Tax Code", the "Tax Code", and the "Internal Revenue Code".

⁴³ Hereafter referred to as "section 482" or I.R.C. §482.

⁴⁴ A.M. Leon et al., United States - Transfer Pricing, 2. Allocation of Income, Country Tax Guides IBFD, https://research-ibfd-org.ezproxy.uct.ac.za/#/doc?url=/document/tp_us_s_2.

⁴⁵ Ibid.

⁴⁶ The Comparable Uncontrolled Transaction (CUT) and Asset Management Method (AMM) were not relevant to the Coca-Cola cases and will not be discussed in any detail.

⁴⁷ A.M. Leon et al., United States - Transfer Pricing, Country Tax Guides IBFD, 4.8. Profit split method, https://research-ibfd-org.ezproxy.uct.ac.za/#/doc?url=/document/tp_us_s_4.

⁴⁸ 26 C.F.R. § 1.482-5 Comparable profits method, Electronic Code of Federal Regulations, <https://ecfr.federalregister.gov/current/title-26/chapter-I/subchapter-A/part-1/subject-group-ECFR2ae24c447fd0f0a/section-1.482-5>.

⁴⁹ Goulder, R (2021), Transfer Pricing Litigation: Has the Losing Streak Ended?, <https://www.taxnotes.com/tax-notes-international/transfer-pricing/transfer-pricing-litigation-has-losing-streak-ended/2021/03/08/3k57k>.

⁵⁰ Finley, R (2020), U.S. Tax Court's Coca-Cola Ruling: Early Sign of a New Approach?, <https://www.taxnotes.com/tax-notes-today-international/transfer-pricing/us-tax-courts-coca-cola-ruling-early-sign-new-approach/2020/11/30/2d7y1>.

⁵¹ Avi-Yonah, R.S & Mazzoni, G (2020), Coca-Cola : A Decisive IRS Transfer Pricing Victory, at Last, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3764501.

This method evaluates the relative value contributed by the controlled companies to the combined profit or loss from “*the most narrowly identifiable business activity*” that results from their engagement. The profit allocation must depict the functions performed, risks assumed, and the resources deployed by each of the parties and be comparable to what one would observe from an arm’s length transaction.⁵² It is generally appropriate when both parties transfer non-routine intangible assets.⁵³

2.2.3.2 The Comparable Profits Method (CPM)

Under this method, objective operating profit indicators from comparative companies transacting at arm’s length for similar transactions are applied to the earnings from “*the most narrowly identifiable business activity*” and used to test the appropriateness of the transfer price between the controlled companies.⁵⁴

According to the Tax Court that reallocated nearly USD 10 billion to Coca-Cola⁵⁵ using the CPM, “*where controlled transactions implicate high-value intangibles, therefore, the most reliable transfer pricing method is often one that avoids any direct valuation of those intangibles.*”⁵⁶

2.3 The Coca-Cola Transfer Pricing Cases

The Coca-Cola Company⁵⁷ openly supports the OECD’s mission to tackle base erosion and profit-shifting,⁵⁸ condemns the abusive use of tax havens,⁵⁹ and is committed to conservative tax structures that result in a fair global effective tax rate.⁶⁰

In terms of the 1996 Closing Agreement⁶¹ that applied for the period 1987-1995, TCCC and the IRS agreed to a formulaic approach to calculate the royalty owed by the foreign concentrate manufacturing plants (the ‘supply points’) for the use of the US company’s trademark and formula. This 10-50-50 method was used by Coca-Cola for the next 11 years, and specifically the disputed 2007-2009 period. It allocated the supply points 10% of their gross sales, as well as half of what remained. The other half was attributed back to the parent company and subject to tax in the US. Although this was previously sanctioned by the IRS, the continued use of the 10-50-50 method was the grounds for its assessment and subsequent legal action against the company where it advocated for the use of the CPM.

⁵² 26 C.F.R. § 1.482-6 Profit split method., Electronic Code of Federal Regulations, <https://ecfr.federalregister.gov/current/title-26/chapter-I/subchapter-A/part-1/subject-group-ECFR2ae24c447fd0f0a/section-1.482-6>.

⁵³ A.M. Leon et al., United States - Transfer Pricing, Country Tax Guides IBFD, 4.8. Profit split method, https://research-ibfd-org.ezproxy.uct.ac.za/#/doc?url=/document/tp_us_s_4.

⁵⁴ 26 C.F.R. § 1.482-5 Comparable profits method, Electronic Code of Federal Regulations, <https://ecfr.federalregister.gov/current/title-26/chapter-I/subchapter-A/part-1/subject-group-ECFR2ae24c447fd0f0a/section-1.482-5>.

⁵⁵ 155 T.C. No. 10, 2020 WL 6784134 (T.C. 18 November 2020).

⁵⁶ 26 C.F.R. § 1.482-5 Comparable profits method, Electronic Code of Federal Regulations, <https://ecfr.federalregister.gov/current/title-26/chapter-I/subchapter-A/part-1/subject-group-ECFR2ae24c447fd0f0a/section-1.482-5>.

⁵⁷ Hereafter referred to as TCCC

⁵⁸ The Coca-Cola Company (2020), The Coca-Cola Company – Tax Policy, 5. Tax Planning and Level of Risk, <https://www.coca-cola.co.uk/tax-policy>.

⁵⁹ Coca-Cola Hellenic Bottling Company (2021), Tax Policy, <https://www.coca-colahellenic.com/en/about-us/corporate-governance/policies/tax-policy>.

⁶⁰ Kathy Waller of The Coca-Cola Company (2018), Talking Tax: How U.S. Changes Impact Coca-Cola’s Global Business by Scott Leith, <https://www.coca-colacompany.com/news>, *ibid*.

⁶¹ Hereafter referred to as “the Closing Agreement” or TCA

In the first case regarding only its Mexican branch, the Judge ruled in favor of the company. In the recent decision over its foreign subsidiaries, the same Judge sided with the IRS, resulting in the largest transfer pricing amendment in history.⁶² The case is now being appealed on the grounds that using a methodology that is different to the one previously agreed-upon and audited for over a decade by the IRS, to retroactively impose a tax liability, is unconstitutional.⁶³

2.3.1 The Coca-Cola Company & Subsidiaries V. The IRS (2017)

The IRS argued that the company reported a royalty that was below the arm's length amount by not using the CPM.⁶⁴

The Judge held that the taxpayer calculated its taxes *"in a manner that is consistent with a reasonable interpretation and application of the...provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time...[its] reasonably expected liability under foreign law for tax,"* and further, that it had *"exhaust[ed] all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time...[its] liability for foreign tax,"* as required by the Treasury Regulations.⁶⁵

2.3.2 The Coca-Cola Company & Subsidiaries V. The IRS (2020)

The taxpayer argued that, not only did it err in doing so, the IRS abused its discretion to reallocate income by applying the CPM. Its decision to disregard the transfer pricing methodology contained in the closing agreement was arbitrary and capricious; and its use of the bottlers as comparatives was not appropriate because they do not have the same ownership of immensely valuable intangible assets that the supply points have.⁶⁶ The three alternative methods presented by the taxpayers experts were the CUT, RPSM, and Asset Management Model (the 'Unspecific Method'), which the company urged the Court to consider.⁶⁷

The Court held that the IRS in fact did not abuse its discretion when it adopted the CPM method and used the independent Coca-Cola bottlers as the uncontrolled comparable parties in the formula.

2.3.3 Motion for Reconsideration of Findings (2021)

In its most recent filing, that taxpayer argues, firstly, that the IRS acted unlawfully. It disregarded foundational principles when it failed to respect and account for the company's reasonable reliance interest that had been created; its decision to abandon its established position and retroactively apply a new one was arbitrary and capricious; and this *"bait-and-switch"* was unconstitutional. Secondly, it argues that the IRS violated Treasury Regulations because ultimately, as a matter of law, the CPM is not appropriate.⁶⁸

2.4 Conclusion

⁶² Avi-Yonah, R.S & Mazzoni,G (2020), Coca-Cola : A Decisive IRS Transfer Pricing Victory, at Last, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3764501.

⁶³ Avi-Yonah, R (2021), Coca-Cola : Unconstitutional? Nonsense!, <https://www.taxnotes.com/tax-notes-federal/transfer-pricing/coca-cola-unconstitutional-nonsense/2021/02/15/2zd58>.

⁶⁴ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15.

⁶⁵ Ibid.

⁶⁶ United States - IRS Wins USD 3 Billion Transfer Pricing Case Against Coca-Cola (20 Nov. 2020), News IBFD (accessed 17 Nov. 2021).

⁶⁷ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15.

⁶⁸ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

Before considering the research that was performed, it was necessary to put the case studies into perspective in terms of where they are placed in modern tax history. Events dating back from the 1996 Harmful Tax Competition initiative through to the 2008 Financial Crisis and Covid-19 pandemic have shifted public pressures, political agendas and attitudes towards international taxation. This has been the backdrop for shifts in international tax policies with the G20 and BEPS initiatives, the TCJA, the Single Tax Principle, GILTI, the 'Made in America Tax Plan', and the Two Pillar Solution discussed in Chapter Ten.

With opportunities for stateless income being replaced with the risk of double taxation, international taxpayers are understandably concerned that the near future may be less about structuring into double non-tax and more about planning to avoid double tax.⁶⁹ Determining the most appropriate transfer price is at the center of this discussion, as is being able to interpret and apply the various methods of calculating an arm's length price.

This brief modern history of selected shifts in the international tax environment should raise questions as to how the arm's length price will be determined after a decision is reached as to the largest transfer pricing adjustment in history. Addressing these questions is the aim of the research and analysis contained in the chapters that follow.

⁶⁹ Blough, S.R. (KPMG LLP) (2019), 19th Annual NYU / KPMG Tax Symposium "Global tax roller coaster: adapting to an environment riddled with complexity, uncertainty & instability", Transfer pricing implications in a post-BEPS and post-US tax reform environment, <https://www.youtube.com/watch?v=Bx8T8SRKNks&t=1607s>

Chapter Three

Research Overview

3.1 Introduction

To begin a discussion on the details of the Coca-Cola cases, it is necessary to determine why they are significant and worthy of examination, and how best to proceed with researching this unique topic. The importance of this work to tax professionals and taxpayers alike is what will be addressed in this Chapter.

The Case Study Method will be adopted with the aim of gaining a better understanding of how the arm's length price will be determined in the years following the outcome of the Coca-Cola case.

An overview of the succeeding chapters describes how the aim of this research will be attained.

3.2 Research Significance

Recent history and current evolutions in the international tax system necessarily raise significant questions surrounding the meaning of 'fair share.' Corporate taxpayers are increasingly being publicly questioned on what rights they believe they should have and whether the fruits that they have been enjoying from aggressive tax schemes are what they consider to be fair. Addressing the fair share principle, as it relates to international tax, would be an immense undertaking that is beyond the scope of this master's thesis yet the concept is unavoidable for everyday tax practitioners. Recognizing the importance of fairness to every tax decision is what inspired this topic. It is also this that makes the research performed on the arm's length price significant.

With the new US administration and complexities involved in getting new tax legislations enacted, by requiring both domestic approval and international cooperation, there is significant uncertainty as to how effective any proposed tax overhauls will be. What is undeniable is that big changes in how US MNCs pay tax are inevitable and that Coca-Cola case and the fair share principle are central parts of this discussion. This is encapsulated by Robert Goulder who wrote, "*...which bits of the U.S. corporate tax system need mending? Transfer pricing is traditionally near the top of my list. It has been broken for a long time, but the federal judiciary is getting around to solving matters on its own — or so it seems based on recent cases like Altera and Coca-Cola. Much of that progress boils down to assigning a fair meaning to the commensurate with income standard, which has been part of the tax code since the 1980s.*"⁷⁰

South Africa's dated, non-binding implementation⁷¹ of and adherence to the OECD guidelines,⁷² combined with its lack of legislated transfer pricing laws, has created uncertainty regarding the outcome of any future arm's length dispute. The question remains open as to what the South African authorities would do if transfer pricing cases were to become more frequent. One cannot say if the prevailing practice would continue, or be disregarded on the grounds that the OECD guidelines are not law (see 9.3

⁷⁰ Goulder, R (2021), The Biden Plan: Tax Reform Whistles an American Tune, <https://www.taxnotes.com/tax-notes-international/tax-reform/biden-...reform-whistles-american-tune/2021/04/19/4v98b?highlight=coca-cola>.

⁷¹ SARS Practice Note No. 7 (6 August 1999); Section 31 of The Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing; <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>.

⁷² Deloitte (2022); When to expect a transfer pricing interpretation note? 2018/19 South African National Budget Expectations; <https://www2.deloitte.com/za/en/pages/tax/articles/when-to-expect-a-transfer-pricing-interpretation-note.html>.

for the case in Malawi); or if the outcome of the Coca-Cola cases would influence the Courts' thinking, or be disregarded. Resorting to foreign case law for reference may be necessary.

The types of international business structures that require determination of an arm's length price are inevitably unique and complex, and tax is a significant and unavoidable expense for all businesses. Combined with the overall lack of case law or guiding precedent is the inherent nuance involved in interpreting and applying the law. This is only made more difficult given that these laws are changing at an accelerated rate on an international scale.⁷³

There is a need to research and analyse what useful and current foreign tax law does exist as it is taking place, and the Coca-Cola transfer pricing cases provide the opportunity to do so. The outcome of this significant transfer pricing dispute may influence the thinking of tax professionals and foreign Courts facing similar challenges in interpreting and applying the existing transfer pricing laws.

Put simply, the lack of tax certainty facing international taxpayers attempting to determine an appropriate arm's length price creates a significant need for research that may provide insight and guidance that could reduce the uncertainty to a more acceptable level.

3.3 Research Aim

The aim of this research is to perform a case study analysis on a landmark transfer pricing case against a prominent multinational company to consider how it will affect the determination of an arm's length price in light of selected shifts in the international tax regime. The analysis further aims to provide guidance to international taxpayers, either aiming to avoid a matter being taken to Court or preparing for legal proceedings, specifically in countries where there is a lack of transfer pricing case law, such as South Africa.

3.4 The Case Study Method for Research

The case study method has gained considerable acceptance as a research method and it is appropriate *"when investigators desire to (a) define topics broadly and not narrowly, (b) cover contextual conditions and not just the phenomenon of study, and (c) rely on multiple and not singular sources of evidence"*.⁷⁴

To produce a high quality dissertation that is rigorous and methodologically sound, Robert K. Yin's 'Case Study Research Design & Methods'⁷⁵, which is considered the seminal guide on the topic and is written to help students overcome the challenges in adopting this methodology,⁷⁶ will be consulted.

3.5 Chapter Outline

Each chapter is designed to address a particular piece of the puzzle that aims to discuss what effect the Coca-Cola transfer pricing cases and selected shifts in the international tax regime will have on the

⁷³ See Chapter Two and Epilogue

⁷⁴ Bulletin of Sociological Methodology / Bulletin de Méthodologie Sociologique , DECEMBER 1993, No. 41 (DECEMBER 1993), pp. 56-57 <https://www.jstor.org/stable/24311475>.

⁷⁵ Robert K. Yin. (2014). Case study research design and methods (5th ed.).

⁷⁶ Hollweck, T (2018), "Robert K. Yin. (2014). Case Study Research Design and Methods (5th ed.). Thousand Oaks, CA: Sage. 282 pages.", https://www.researchgate.net/publication/308385754_Robert_K_Yin_2014_Case_Study_Research_Design_and_Methods_5th_ed_Thousand_Oaks_CA_Sage_282_pages?enrichId=rgreq-879cdb1c162c4fd29f5de5d2799aaca1-XXX&enrichSource=Y292ZXJQYWdlOzMwODM4NTc1NDtBUzo2ODQ1MjY3NTM4MzI5NjRAMTU0MDIxNTMwNDg1OQ%3D%3D&el=1_x_2&_esc=publicationCoverPdf.

determination of an arm's length price. The chapters will introduce the topic to be addressed, present the research findings, and conclude on what was discussed.

Readers of Chapters One, Two and Three have been briefed on the modern history of international tax, and have been given an overview of the research performed.

The legal framework is presented in Chapter Four before the case studies are discussed in Chapter Five and Chapter Six, and an analysis of the appeal submission is done in Chapter Seven. Chapter Eight considers the impact that tax treaties have had, and could have, on determining an arm's length price. The potential outcomes of similar disputes in different countries are compared in Chapter Nine.

The final Chapter Ten presents the **Error! Reference source not found.** and **Error! Reference source not found.**

The analysis of the Coca-Cola transfer pricing cases and selected shifts in international taxation have inadvertently raised ancillary issues that require further research in allied fields. These are discussed in the Epilogue that follows the conclusion. References can be found at the end.

3.6 Conclusion

When determining an arm's length price, it is inevitable that one will be confronted with the need to address the issue of fairness. Although not an attainable undertaking at this time, a passion to pursue a deeper understanding of tax fairness was what inspired this research paper. Given the complexity of transfer pricing and the uncertainty surrounding how South African Courts would approach the subject, there is a need to study foreign case law that could provide guidance to taxpayers and influence the thinking of tax authorities. The Coca-Cola transfer pricing cases provide the opportunity for the case study method to be applied to a landmark foreign case that may be useful to international taxpayers in and outside the US because of the company's global presence and graspable operational structure. The chapters that following contain this research and analysis, and end with inadvertent ancillary issues that arose.

Chapter Four

The Legal Framework

4.1 Introduction

The Coca-Cola cases are argued in Courts in the United States, so it is imperative to have a basic understanding of the US legal framework to the extent that it is relevant to the transfer pricing dispute. A central aim of this research is to consider the effect that the outcome of this case will have on future transfer pricing decisions, which are inherently international and cannot be considered without understanding the OECD and UN transfer pricing guidelines, of which those pertaining to South Africa are particularly relevant. The methods for calculating the arm's length price that are discussed in the Coca-Cola cases are also common principles and regulations that are applied in most other countries.

4.2 Background

International tax disputes are, by definition, international. The Coca-Cola company cases provide an ideal example of the legal challenges that multinationals can face when understanding their tax burden. As many cases involving MNEs do, this dispute played out in the US but invariably addresses the legal issues that can, do, and will come up with transfer pricing methodology in all Courts.

The Coca-Cola cases were argued in the United States Tax Court and are pending appeal in the US Court of Appeals where the company proposes that the 2020 decision "*in this unprecedented tax case raises fundamental questions of tax, administrative, and constitutional law.*"⁷⁷

The 2017 case involved a dispute of legal issues arising from the interpretation and application of Section 901 of the US Tax Code that deals with Foreign Tax Credits. Specifically, disputed was whether a foreign tax paid by the taxpayer's branch in Mexico was considered 'compulsory' in accordance with US laws.

In 2020, the matter in dispute originated from Section 482 that prescribes how the taxpayer should determine an appropriate transfer price. The taxpayer's use of the RPSM was found to be less appropriate than the CPM used by the IRS in its transfer pricing adjustment.

Section 987 is referred to as it prescribes how American companies should translate the income of its foreign business into US dollars for the purpose of computing its US taxes.

In its most recent motion, Coca-Cola has proposed that "*the IRS's bait and switch*" is a violation of the US Constitution.⁷⁸

4.3 The United States Tax & Legal System

The US is a common law country, which means that both statutory law and judicial precedents apply to the interpretation of international tax cases and tax treaties.⁷⁹

⁷⁷ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

⁷⁸ Ibid.

⁷⁹ J.A. Becerra, Interpretation and Application of Tax Treaties in North America, Books IBFD (accessed 3 Nov. 2021).

The country has historically been on the worldwide tax system, which requires deferral options and foreign tax credits to prevent double taxation.⁸⁰ However, the TCJA moved the country towards being a hybrid of both the territorial and worldwide tax systems.⁸¹

4.4 The United States Tax Authorities and Hierarchy of Law⁸²

The Constitution is the highest form of legislative authority in the US and it is followed by the IRS Tax Code and the country's international tax treaties. As an administrative authority, the Treasury Regulations are almost as significant as the Tax Code. The relevance of judicial authorities depends on a number of factors, including the level of the court that made the decision.⁸³

4.4.1 Judicial Review

The Administrative Procedures Act (APA) is a federal statute that covers the practices and procedures of administrative law.⁸⁴ It provides for judicial review of decisions made by administrative agencies, such as the IRS, and it requires Courts to set aside a decision where the agency has acted in a way that is *"arbitrary, capricious, or an abuse of discretion."*⁸⁵ This⁸⁶ is known as the Arbitrary-or-Capricious Test.

4.4.2 Statutory Authority

4.4.2.1 Tax Treaties

Tax treaties and US tax legislation hold equivalent authority so where they conflict, the 'last-in-time' rule applies.⁸⁷ In 1888, the Supreme Court held that *"the courts will always endeavour to construe them so as to give effect to both, if that can be done without violating the language of either; but if the two are inconsistent, the one last in date will control the other [...]"*.⁸⁸ This rule was codified into law in 1988⁸⁹ when the tax code was amended to include that, *"[f]or purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law."*⁹⁰

4.4.2.2 The IRS Code

⁸⁰ Janovitz, D (2016); Holland & Knight Tax Compliance Blog; Avoiding Double Taxation: When is a Foreign Tax Credit Allowed?; <https://www.hklaw.com/en/insights/publications/2016/02/avoiding-double-taxation-when-is-a-foreign-tax-cre>.

⁸¹ Urban Institute, Brookings Institution (2021); Key Elements of the U.S. Tax System; <https://www.taxpolicycenter.org/briefing-book/what-territorial-tax-and-does-united-states-have-one-now>.

⁸² LSU Law Library (2019); Tax Policy and Procedure: Hierarchy of Tax Authorities; <https://libguides.law.lsu.edu/c.php?g=191374&p=1264047>.

⁸³ de Klerk, S (2021); Hierarchy of Authority for Federal Tax Purposes; <https://study.com/academy/lesson/hierarchy-of-authority-for-federal-tax-purposes.html>, *ibid*.

⁸⁴ Cornell School of Law, Legal Information Institute (2021); Administrative Procedure Act; https://www.law.cornell.edu/wex/administrative_procedure_act.

⁸⁵ U.S. Code § 706(2)(a).

⁸⁶ § 10 of the APA, 5 USC §§ 701-706.

⁸⁷ J.A. Becerra, Interpretation and Application of Tax Treaties in North America, Books IBFD (accessed 3 Nov. 2021).

⁸⁸ *Whitney v. Robertson*, 124 U.S. 190 (1888).

⁸⁹ A.C. Infanti, Chapter 13 United States in Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), Books IBFD (accessed 3 Nov. 2021).

⁹⁰ I.R.C. § 7852(d)(1).

The US Code of Laws (the USC)⁹¹ contains 53 titles, which represent the federal statutes.⁹²

The Internal Revenue Code (the IRC) refers to Title 26 of the U.S. Code. It contains all of the federal tax laws, which are enforced by the Internal Revenue Service (the IRS). It is commonly referred to as the IRS code, or the IRS tax code.⁹³

All statutory references in the cases are to the Internal Revenue Code ('the Code') in effect for the years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.⁹⁴

4.4.3 Administrative Authority

4.4.3.1 Treasury Regulations

The Code of Federal Regulations (the CFR) is the official publication of the Federal Register (FR) that contains rules prescribed by government agencies, public notices, and proposed during public meetings. It contains more information and it essentially analyses the laws in the USC and provides guidance on complying with the law. Rather than being a product of congressional code, the CFR is produced by the agencies, such as the IRS, that are affected by the code.⁹⁵

Treasury Regulations are the tax rules issued by the IRS as a bureau of the Treasury Department. They are the Treasury's official interpretations of the Tax Code and are a source of federal income tax law that provides guidance on new legislation and addresses issues in interpreting the Code.⁹⁶

4.4.3.2 The Eleventh Circuit

The Coca-Cola case will be heard by the US Court of Appeals for the Eleventh⁹⁷ Judicial Circuit that predominantly hears questions of law and not disputes over the findings of facts.⁹⁸ This Court has jurisdiction over federal cases that originate in Georgia, as well as Alabama and Florida, and has precedence over the tax courts in these jurisdictions. However, tax courts outside of these States are free to rule differently on the same facts.⁹⁹

4.5 The US Foreign Tax Credits Regimes

The US has a Foreign Tax Credit (an FTC) regime aimed at preventing double tax. Section 901 provides for a credit equivalent to the amount of foreign tax, which can be applied against the amount of US tax calculated for that foreign income.¹⁰⁰

⁹¹ Also known as 'Code of Laws of the United States', 'United States Code', 'The U.S. Code', 'U.S.C.', or 'USC'

⁹² U.S. Government Publishing Office (2021); United States Code, 1994 to Present;
<https://www.govinfo.gov/help/uscode>.

⁹³ U.S. Census Bureau (2020); History: Title 26, U.S. Code;
https://www.census.gov/history/www/reference/privacy_confidentiality/title_26_us_code_1.html.

⁹⁴ The US tax cases referenced throughout this thesis

⁹⁵ The U.S. National Archives and Records Administration (2021); About the Code of Federal Regulations;
<https://www.archives.gov/federal-register/cfr/about.html>.

⁹⁶ LSU Law Library (2019); Tax Policy and Procedure: Hierarchy of Tax Authorities;
<https://libguides.law.lsu.edu/c.php?g=191374&p=1264047>.

⁹⁷ (<https://www.ca11.uscourts.gov/about-court>)

⁹⁸ National Timber Tax Website; U.S. Court of Appeals;
https://www.timbertax.org/research/process/judicial/court_of_appeals/.

⁹⁹ Ibid.

¹⁰⁰ I.R.C. § 1.901-2.

For the credit to be allowed, all four of the following criteria must be met:¹⁰¹

1. The tax must be accrued to or paid by the taxpayer
2. It must be imposed by a foreign country, not the US
3. The tax must be a legal tax liability and therefore be 'compulsory'
4. The tax must either be an income tax, or levied in lieu of an income tax

Foreign taxes must be considered an 'income tax' and foreign levies are considered a 'tax' if they are made compulsory by a foreign tax authority. These distinctions must be considered in terms of US laws and principles, and not those of the foreign state.¹⁰²

An amount of tax that has been paid is only considered a 'compulsory payment' to the extent that it does not exceed the tax liability imposed by the foreign law. The criteria for the amount to be considered compulsory is that the amount paid is:¹⁰³

1. Determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and
2. If the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment).

In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (e.g., a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous.¹⁰⁴

4.6 Transfer Pricing Adjustments

According to the Best Method Rule, a method may only be applied by the taxpayer if i) the comparability, ii) quality of data, and iii) the reliability of assumptions, make that method more reliable than any other reasonable determination of the arm's length amount.¹⁰⁵ Although taxpayers are required to determine and apply one of the four authorised methods that they deem to be most suited to their transfer pricing arrangement by using the best method rule, in the case of businesses owned or controlled, directly or indirectly by the same party, income, deductions, credits and allowances may be distributed, apportioned or allocated between those business by the Secretary as it deems necessary for the prevention of tax evasion, or for the accurate reflection of the income of the individual businesses.¹⁰⁶

4.7 Translating Foreign Business Income

Where the taxpayer has a 'qualified business unit' that uses a functional currency other than the US dollar, taxable income shall be computed by determining first, the taxable income/loss of each separate

¹⁰¹ Internal Revenue Service Dept. of Treasury (2017); Foreign Tax Credit (Individual Outbound); Creditability of Foreign Tax Credit Claimed; https://www.irs.gov/pub/int_practice_units/ftc_c_10_01_03.pdf.

¹⁰² sec. 1.901-2(a)(2)(i).

¹⁰³ s901-2(e)(5)(i).

¹⁰⁴ Ibid.

¹⁰⁵ §1.482-1(c), Electronic Code of Federal Regulations (eCFR) (2021); §1.482-8 Examples of the best method rule; <https://www.ecfr.gov/current/title-26/chapter-I/subchapter-A/part-1/subject-group-ECFR2ae24c447fd0f0a/section-1.482-8>.

¹⁰⁶ U.S. Code § 482. Allocation of income and deductions among taxpayers.

business unit¹⁰⁷ in its functional currency, and then translating that into dollars at the relevant exchange rate. This should account for the transfer pricing adjustments required by the Secretary.¹⁰⁸ A Qualified Business Unit is a clearly identifiable, separate trading or business unit of the taxpayer that maintains independent accounting records.¹⁰⁹

4.7.1 The OECD and UN Transfer Pricing Guidelines

Although without specific mention, the US domestic regulations are consistent with OECD and UN transfer pricing guidelines, including the arm's length principle contained in Article 9 of both the OECD and UN Model tax treaties.¹¹⁰

This is also the case in South Africa, with one difference.¹¹¹ Although absent from the Income Tax Act,¹¹² the OECD guidelines are provided for in Practice Note 7 that was issued by the South African Revenue Service (SARS) and has remained unchanged for over 20 years¹¹³. The note is not legally binding but can constitute a 'practice generally prevailing'¹¹⁴ for the purposes of interpretation and application of tax laws.¹¹⁵ Although the country has upheld the OECD's guidance thus far, it is not law so there is no saying whether it will continue to do so in future. Whether or not more transfer pricing disputes have arisen but have been settled outside of the Courts and off the record, is uncertain as well.

4.7.2 Related Parties

The OECD refers to 'associated enterprises' as those that are either owned, controlled, or managed by the same entity,¹¹⁶ or where one entity has this relationship with the other.¹¹⁷ This concept is contained in the definition of 'connected persons'¹¹⁸ in South Africa, and in the US where a 'controlled' taxpayer refers to an interest's direct or indirect ownership or control.¹¹⁹

4.7.3 Transfer Pricing Methods

¹⁰⁷ Hereafter referred to as a "BU"

¹⁰⁸ I.R.C. sec. 987 Computing Foreign Branch Transactions.

¹⁰⁹ 26 U.S. Code § 989 - Other definitions and special rules; <https://www.law.cornell.edu/uscode/text/26/989>.

¹¹⁰ The OECD (2021); Transfer Pricing Country Profiles; <https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profiles.htm>. South Africa

¹¹¹ The United Nations Department of Economic & Social Affairs (2017); Practical Manual on Transfer Pricing for Developing Countries (2017), D.5. SOUTH AFRICA—COUNTRY PERSPECTIVE; <https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-03/Manual-TP-2017.pdf>.

¹¹² South African Income Tax Act 58 of 1962.

¹¹³ SARS Practice Note No. 7 (6 August 1999); Section 31 of The Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing; <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>.

¹¹⁴ Tax Administration Act, No 28 of 2011 (TAA); s1 of the TAA as read with s5(1)

¹¹⁵ Cliffe Dekker Hofmeyr (2021); Status of SARS interpretation notes (2018); <https://www.cliffedekkerhofmeyr.com/en/news/publications/2018/Tax/tax-alert-4-may-status-of-sars-interpretation-notes-.html>.

¹¹⁶ Income and Capital Model Convention and Commentary (2017). Art. 9(1)(b)

¹¹⁷ Ibid. Art. 9(1)(a)

¹¹⁸ South African Income Tax Act 58 of 1962.; Section 1

¹¹⁹ Treas. Reg. §1.482-1(i)(5).

Taxpayers in both the US and South Africa have the same methods available to them. The exception is in the US where certain adaptations of prescribed methods are allowed, along with the income, market cap and acquisition price methods.¹²⁰

Neither country provides for a hierarchy of methods.¹²¹ However, the US proposes its 'best method rule' for determining which method should be used,¹²² and South Africa relies on the OECD guidelines for finding the most appropriate method.¹²³ Emphasis on the availability and reliability of information is made across-board, but the OECD also requires consideration of the strengths and weaknesses of the methods, their appropriateness considering the outcomes of a functional analysis, the comparability of controlled transactions with similar uncontrolled ones, and the reliability of any adjustments that are necessary to allow for such comparability.¹²⁴

4.7.4 Nuances in the Application of Transfer Pricing in South Africa

Unlike the US, South African legislation does not specify how taxpayers should perform the comparability analysis, but rather refers to the OECD guidelines. The same applies for specific rules relating to Intangible Property, Intra-Group Services, and Cost Contribution Agreements, where the US provides specific domestic legislation.¹²⁵

4.8 Conclusion

The understanding of the US legal system, and transfer pricing principles and practises in South Africa, provides a platform from which to consider the legal transfer pricing nuances disputed in the Coca-Cola cases. A more detailed study of a particular legal framework that is required for the discussion of a specific topic will be addressed in the section in which it arises.

¹²⁰ The OECD (2021); Transfer Pricing Country Profiles; <https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profiles.htm>.

¹²¹ A.M. Leon et al., United States - Transfer Pricing, Country Tax Guides IBFD, 4.2. Hierarchy of methods.

¹²² The OECD (2021); Transfer Pricing Country Profiles; <https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profiles.htm>. South Africa

¹²³ Ibid.

¹²⁴ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations; Chapter II Transfer Pricing Methods. Part 1. A. (2.2)

¹²⁵ The OECD (2021); Transfer Pricing Country Profiles; <https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profiles.htm>.

Chapter Five

The Coca-Cola Company & Subsidiaries V. The IRS (2017)

5.1 Introduction

The following discussion of the first case against Coca-Cola provides useful background to the succeeding case and appeal submission. It also provides an adjudicated decision on a transfer pricing matter that could arise in a similar situation for a different company or in another country, for a similar set of facts, as was the situation in the subsequent case against Coca-Cola in 2020 that is discussed in the following chapter.

5.2 Background

The Coca-Cola parent company in the US licenses its secret soft drink formula, and other intellectual property (IP), to its foreign manufacturing affiliates that produce and sell the concentrated syrup to independent Coca-Cola bottlers who manufacture the beverage around the world. These foreign licensees, or concentrate plants, are referred to as 'supply points' and located in Mexico, Brazil, Chile, Costa Rica, Ireland, Egypt and Swaziland.

The 2017 case, which is referred to as the 'Mexico Foreign Tax Credit' issue,¹²⁶ focused on the Mexican supply point, which is the only one that operates as a branch and not as a Controlled Foreign Corporation (CFC). Where transfer pricing adjustments of the other subsidiary supply points would increase the taxpayer's gross income in the US, here the IRS attempted to increase the US company's tax liability by reducing the foreign tax credit it was allowed to claim for the taxes it paid in Mexico for the years 2007-2009.

5.3 Dispute¹²⁷

The IRS based its assessment on the grounds that the calculation of the royalty expense owed by the supply point to the parent company was below the arm's length amount, leading to the Mexican branch's income being overinflated, along with the corresponding foreign tax payment. This prevented the Mexican taxes paid from qualifying for the US foreign tax credit (FTC) to the extent that they were considered 'non-compulsory' and therefore not considered 'taxes' in the US sense.¹²⁸

5.4 The 1996 Closing Agreement with the IRS

The IRS performed an investigation to determine whether the taxpayer's royalty payments were at arm's length for the years 1987-1989. This led to their agreement that is known as the 1996 'closing agreement' that covered the period 1987-1995.

The agreement established the '10-50-50 method' that calculated the royalty payment for each supply point by leaving it with 10% of its gross sales, and then splitting the residual profit equally between it and the US parent company (with certain adjustments).

¹²⁶ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15.

¹²⁷ For ease of reference, please consult the summary of the case in Appendix 1: Summary of The Coca-Cola Company & Subsidiaries V. The IRS (2017)

¹²⁸ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15.

Although it did not prescribe the transfer pricing method to be used after 1995,¹²⁹ the agreement did provide the company with penalty protection from 1987 for all its supply points, whether branches or CFC's. After 1995, it provided that, when the taxpayer continued to apply this method, it also met the legal requirements of the "*reasonable cause and good faith exceptions.*"¹³⁰

When the agreement expired at the end of 1995, the IRS determined that "*the continuing application of the closing agreement's terms and conditions to post-1995 years seems appropriate.*"¹³¹ It concluded its tax audits for the following 11 years without the need for any adjustments and merely by ensuring that the reported royalty amount was consistent with the terms of the agreement, without scrutinizing the appropriateness of the method that it itself prescribed.¹³²

5.5 The Specific Legal Framework

The US laws require that the payments be 'compulsory' and considered 'taxes' to qualify for the FTC. It is however the Mexican income tax laws that make such amounts 'compulsory' and the regulatory test for this has two components: the taxpayer is required to make a reasonable interpretation of foreign law and exhaust all remedies.

5.5.1 Reasonable Interpretation of Foreign Law and Reliance on Tax Professionals

The first component of the regulatory test that is required by US regulations is that the Mexican tax liability be calculated "*in a manner that is consistent with a reasonable interpretation and application*" of foreign law, "*so as to minimize its reasonably expected liabilities*" for foreign income tax.¹³³ What would be required reasonable is not explicit, but taxpayers are provided refuge by being allowed to "*rely on good faith advice from a competent tax professional to whom they have disclosed the relevant facts.*"¹³⁴ If, however the taxpayer is given notice that its consultant's interpretation of the law is not likely to be correct, it would not satisfy the reasonability criteria.¹³⁵

The taxpayer relied on the competent and experienced tax lawyer, Mr. Ortiz. In 1997,¹³⁶ he obtained two resolutions from the Mexican tax authorities (the SAT) that stipulated that the 10-50-50 method resulted in the arm's length royalty amount and would be allowed as a deduction. Once these resolutions had expired, he, on many occasions, advised the taxpayer to continue to apply this method. There had not been any material changes that would warrant a higher royalty and the IRS's audits showed its continued approval. Once it had confirmed that the 10-50-50 method was used, the SAT made no adjustments to the royalty amount for the 2007-2009 period. Neither did the IRS, which stated that "*the continuing application of the closing agreement's terms and conditions to post- 1995 years seems appropriate.*"¹³⁷ Throughout this time Mr. Ortiz continued to provide his services to the company.¹³⁸

The IRS argued that not all of the relevant facts had been disclosed to Mr. Ortiz because it was unclear whether he was aware that a portion of the Mexican branch's operations were shifted to Ireland. This did not persuade the Judge. Rather, the 10-50-50 formula was not impacted by this change and as the Mexican supply point produced less, there was a corresponding decrease in the royalty amount calculated. Thus, the shifts in annual revenue amongst supply points was not a material fact that required

¹²⁹ Ibid.

¹³⁰ Ibid.

¹³¹ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15.

¹³² Ibid.

¹³³ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15.

¹³⁴ Ibid.

¹³⁵ Ibid.

¹³⁶ After Mexico first introduced the arm's length standard

¹³⁷ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15.

¹³⁸ Ibid.

disclosure.¹³⁹ As Judge Lauber described in his judgement, *“If a particular supply point departed from the 10-50-50 method without other supply points’ making adjustments in the opposite direction, the whole system would quickly go entropic. It seems obvious that the 10-50-50 method that the IRS embraced before 2011 did not countenance such ad hoc adjustments.”*¹⁴⁰

5.5.2 Exhaustion of All Remedies

The second component of the regulatory test is that the taxpayer must *“exhaust all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer’s liability for foreign tax.”*¹⁴¹ This means that the cost of the process must be reasonable considering the amount of tax it relates to, and the likelihood of success.¹⁴²

The Judge agreed with the taxpayer’s assessment that it had exhausted all remedies given that the IRS invoked its power to make transfer pricing adjustments that had not yet been adjudicated, and that it refused to engage in competent authority procedures.¹⁴³

The IRS could not put forward any alternative remedies that would have been practical and effective for the company to reduce its Mexican tax liability.

US taxpayers may claim a refund for an overpayment of foreign taxes,¹⁴⁴ but any such claim would have been premature until the IRS’s transfer pricing adjustments had been settled. If not yet finalised in the US, one could not assume that the Mexican authorities would agree with the IRS’s abandonment of the 10-50-50 method or have any other reason to allow a higher royalty deduction.

Further, the taxpayer was *“not required to take futile additional administrative steps”*¹⁴⁵ to satisfy this criterion, and that would anyway have had no likelihood of success.¹⁴⁶

To establish that all remedies have been exhausted, the last remaining option would be to seek competent authority proceedings, which the taxpayer did, and to which the IRS refused. The Judge remarked that the IRS *“is in a poor position to contend that [the taxpayer] has failed to exhaust its remedies when [the IRS], by his unilateral action, has made it impossible for petitioner to pursue the only remedy that exists.”*¹⁴⁷

Failing to provide any other current remedies, the IRS proposed that the taxpayer could seek competent authority proceedings, if and when the Court allows its transfer pricing adjustment. If that then showed that the assessment was in fact incorrect, then the FTC would be allowed. This argument is based on the laws for ‘foreign tax redeterminations.’¹⁴⁸ It provides a credit in the US when the exact amount of foreign tax is ascertainable, recognising that it is not always immediately possible to determine at the time that the US tax return is filed. This would also apply when a taxpayer receives a refund on its foreign taxes.¹⁴⁹ The Judge cited legal precedent and quoted the IRS when, in a separate case, it contradicted its current position by arguing that *“It is not the intention of the law to deprive the taxpayer of the right to obtain credit for foreign taxes because of the fact that the taxpayer...protests the assessment and has made*

¹³⁹ Ibid.

¹⁴⁰ Ibid. Page 20

¹⁴¹ Ibid.

¹⁴² Ibid.

¹⁴³ Ibid.

¹⁴⁴ Cf. Rev. Rul. 92-75, 1992-2 C.B. 197; Rev. Rul. 80-231, 1980-2 C.B. 219.

¹⁴⁵ Schering Corp. v. Commissioner, 69 T.C. 579, 602 (1978).

¹⁴⁶ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15.

¹⁴⁷ Ibid. Page 25

¹⁴⁸ IRC Section 905(c).

¹⁴⁹ Ibid. (C).

*application for a refund. The tax assessed constitutes a liability against the taxpayer. In the instant case such liability was met by actual cash disbursements. If the protest by the taxpayers against the original assessment prevails, any difference can readily be adjusted pursuant to the provisions of section 905(c) of the Code.”*¹⁵⁰

The IRS argued that there would be no incentive for the taxpayer to seek a refund in Mexico that would merely result in a balancing reduction of its US FTC and result in no change to its overall tax expense. It claims that this means that the US would be forced to cede its taxing rights to another country.¹⁵¹ The Court noted that *“the IRS is perfectly capable of initiating competent authority proceedings with the SAT directly if it believes that such proceedings are necessary to correct a fiscal imbalance under the treaty.”* This argument was disregarded on the grounds that it is a policy argument that does not relate to any laws in existence. The Judge said that *“if the IRS considers that protection of the public fiscus requires prohibiting foreign tax credits until the taxpayer exhausts its litigation remedies, the IRS should seek an amendment to the final regulations. That is a task for the Secretary of the Treasury, not this court.”*¹⁵²

Ultimately, this case represents the exact set of circumstances envisioned by US Congress when it provided for an estimated FTC until such time as the foreign tax amount could be determined, at which time the *“accounts would be squared”* if a refund was made.¹⁵³

5.6 Outcome

Judge Lauber concluded that, because the transfer pricing adjustments had not yet been adjudicated, the taxpayer had no available remedy in Mexico. The only remaining *“effective and practical”* option would be to request competent authority proceedings, which the IRS refused. The taxes paid were ‘compulsory’ because the company *“exhausted all effective and practical remedies”* and calculated its taxes by performing a *“reasonable interpretation of Mexican tax law.”* Thus the FTC was allowed.

5.7 Conclusion

Explanation of the taxpayer’s business operations and transfer pricing structure is necessary to analyse both cases and the grounds of the pending appeal. The revenue authority’s assessment was based on its determination that the taxpayer’s calculation of the royalty was below the arm’s length amount, resulting in an overpayment of foreign taxes and an excesses Foreign Tax Credit claim. In its assessment, the portion of the FTC disallowed was argued to not be ‘taxes’ in the US sense given that it was a ‘non-compulsory’ payment.

The Judge did not agree and held that the foreign taxes were ‘compulsory’ given that the company *“exhausted all effective and practical remedies”* and calculated its taxes by performing a *“reasonable interpretation of Mexican tax law”*.

At first, the taxpayer’s victory seems to provide clarity and guidance to a taxpayer calculating an arm’s length transfer price. If that were true, exhausting all effective and practical remedies and making a reasonable interpretation of foreign tax law should be sufficient to prevent a dispute with the revenue authority. Although this case was settled in favour of the taxpayer, the issue regarding the appropriateness of the 10-50-50 method reappeared in the 2020 case. Therefore, this case serves as more of a cautionary example to taxpayers the outcome of the 2020 case that was ruled in favor of the IRS that is discussed in the next chapter.

¹⁵⁰ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15. Pg 28-29

¹⁵¹ Ibid.

¹⁵² Ibid. Pg 30

¹⁵³ Ibid. Pg 30

Chapter Six

The Coca-Cola Company & Subsidiaries V. The IRS (2020)

6.1 Introduction

The next case that will be discussed involves the IRS victory for the largest transfer pricing adjustment in history made against the Coca-Cola Company in 2020. It is the subject of the appeal that was lodged in 2021 and that is discussed in the next chapter. In its defence, the taxpayer accused the IRS of an abuse of its power to make transfer pricing adjustments. It is necessary to consider what authority and limitations were afforded to the IRS at the time that the assessment was made. The chapter ends with an analysis of the Court's ruling in favour of the IRS.

6.2 Overview of the Case¹⁵⁴

This case was based on many of the same facts of the 2017 case. The supply points involved were the Controlled Foreign Companies (CFCs) in Brazil, Chile, Costa Rica, Ireland, Egypt, and Swaziland, rather than the branch in Mexico. The same 1996 closing agreement and transfer pricing methodology for the royalty calculation were central to the dispute, with the IRS disregarding the 10-50-50 method in favor of the CPM. Instead of disallowing an FTC, the income reallocation increased the US parent company's gross income.¹⁵⁵

There were two distinct legal arguments presented by the taxpayer in this case that were also featured in its appeal. First, the taxpayer argued that the IRS abused its discretion when it reallocated income using a new method, and that its abandonment of the terms of the closing agreement was arbitrary and capricious.¹⁵⁶ This was found against by Judge Lauber. Second, the taxpayer presented a technical argument that the IRS's application of transfer pricing methodology was misguided because its adoption of the CPM, and then its use of the bottlers as the uncontrolled comparable component, was erroneous. Although it presented comprehensive arguments for three alternative methods, Judge Lauber held that, in this case, the IRS was correct.

6.2.1 Authority of the IRS

The IRS issued a statutory notice of deficiency, or a '90-day letter', that explains the deficiency and new tax computation, and provides the taxpayer with the opportunity to accept the change before the IRS makes an assessment. The presumption is that this determination is correct unless the taxpayer satisfies the burden of proving otherwise.¹⁵⁷ This presumption does not however apply to any "any new matter, increases in deficiency, and affirmative defences" presented by the IRS during the case.¹⁵⁸

The Commissioner has the authority to allocate income and deductions if he determines that this is necessary,¹⁵⁹ and the Court recognised that the status of this power is that "*In matters intrusted to the discretion of administrative officers,*" we said, "*there is a heavy burden on him who claims error in its*

¹⁵⁴ For ease of reference, please consult the summary of the case in Appendix 2: Summary of The Coca-Cola Company & Subsidiaries V. The IRS (2020)

¹⁵⁵ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15.

¹⁵⁶ United States - IRS Wins USD 3 Billion Transfer Pricing Case Against Coca-Cola (20 Nov. 2020), News IBFD (accessed 17 Nov. 2021).

¹⁵⁷ The IRS (2020); Internal Revenue Manuals Part 4. Examining Process Section 9. 4.8.9 Statutory Notices of Deficiency; https://www.irs.gov/irm/part4/irm_04-008-009.

¹⁵⁸ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15.

¹⁵⁹ Asiatic Petroleum Co. v. Commissioner, 31 B.T.A. 1152 (1935), aff'd, 79 F.2d 234 (2d Cir. 1935).

*exercise.*¹⁶⁰ The test to determine whether the IRS is acting within its authority was set out by the Court as follows, “Where a statute commits to an executive department of the government a duty requiring the exercise of administrative discretion, the decision of the executive department, as to such questions, is final and conclusive, unless it is clearly proven arbitrary or capricious, or fraudulent, or involving a mistake of law.”¹⁶¹ This remains the current standard of review embodied in Section 482 that affords the IRS this discretion when it deems that an adjustment would be necessary to accurately report income or to prevent tax evasion.¹⁶² The Judge in the 2017 case against Amazon said that “The Commissioner has broad discretion in applying section 482, and we will uphold his determination unless the taxpayer shows it to be arbitrary, capricious, or unreasonable.”¹⁶³ The IRS can be found to have abused its discretion when it is found¹⁶⁴ that there is insufficient support for its allocation.¹⁶⁵ The taxpayer would require “substantial evidence”¹⁶⁶ to allow the Court to rule in its favour.

The Court focuses on the reasonableness of the result of the IRS’s assessment, rather than on the specifics of its methodology.¹⁶⁷ The taxpayer needed to show that the evidence that it presented proved that the adjusted transfer price was not reflective¹⁶⁸ of any similar transaction between uncontrolled parties.¹⁶⁹ The structure of the company’s global operations is unique and the company holds many highly valuable intangible assets, making a comparative tax situation difficult to find.¹⁷⁰

If successful in either of its arguments, the taxpayer must present an alternative method that would meet the arm’s length standard so that the Court would not be required to employ its best judgement to determine the correct transfer price. If the Court cannot determine that either party in this dispute is correct, it could make partial allocations.¹⁷¹

Finally, the IRS is only limited by the arm’s length standard to the extent that it has the discretion to make transfer pricing adjustments.¹⁷² It may also voluntarily restrict its authority by entering into a closing agreement¹⁷³ such as the one agreed with taxpayer in 1996.

6.2.2 Legal Status of Closing Agreements

Closing agreements are governed by US contract laws and the intent of the parties and the legal implications of their agreement must be inferred from the “*the four corners of the document*,” to the extent that they are not ambiguous.¹⁷⁴

6.2.2.1 The explicit terms of the 1996 Closing Agreement

1. The parent company owned intangible property that was used by its supply points
2. The parties disputed the amount of the royalty between the company and the supply points
3. The parties agreed to apply the 10-50-50 method for the period 1987-1995

¹⁶⁰ Ibid.

¹⁶¹ Ibid.

¹⁶² The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15.

¹⁶³ Amazon.com, Inc. & Subs. v. Commissioner, 148 T.C. 108, 150 (2017).

¹⁶⁴ Ibid.

¹⁶⁵ Marc’s Big Boy-Prospect, Inc. v. Commissioner, 52 T.C. 1073, 1092 (1969).

¹⁶⁶ Ibid.

¹⁶⁷ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Page 90

¹⁶⁸ Lufkin Foundry & Mach. Co. v. Commissioner, 468 F.2d 805, 807-808 (5th Cir. 1972).

¹⁶⁹ Sec. 1.482-1(b)(1), Income Tax Regs.

¹⁷⁰ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15.

¹⁷¹ Ibid.

¹⁷² Ibid.

¹⁷³ Ibid.

¹⁷⁴ Ibid.

The Court held that the short and complete answer was that the agreement made no mention of the method to be used after 1996.¹⁷⁵

The taxpayer presented the argument that the agreement was based on the recognition of certain facts that are binding unless the IRS could prove that there had been a material change. One such fact was that the supply points made significant contributions to the overall operations of the company and were entitled to share in the profits generated from the intangible assets.¹⁷⁶ This argument did not persuade the Court, which at one point noted that the “*petitioner cannot estop the Government on the basis of a promise that the Government did not make.*”¹⁷⁷

Firstly, the Court noted that the IRS can enter into agreements for many reasons such as “*to avoid the hazards of litigation, to minimize litigation costs, or to seek other fish to fry,*” and that here, the purpose of the agreement was to settle the dispute and not to make assumptions as to any factual underpinnings.¹⁷⁸ It noted that the agreement makes only one mention of the arm’s length standard and does not contain any indication that the intent of the IRS was to declare the “*10-50-50 method as the Platonic ideal of arm’s-length pricing for petitioner and its supply points.*”¹⁷⁹ Rather, the method merely represented a solution to resolving the dispute between them.¹⁸⁰

The second fault that the Court pointed to was that there was no evidence within the document that the IRS intended for the agreed solution to extend beyond 1996, even if it did recognise certain factual underpinnings. The company argued on the grounds that the principles of the ‘ordinary preclusion doctrine’ apply and that unless the IRS could show a change in the previously agreed factual underpinnings, it cannot relitigate a dispute that had already been settled.¹⁸¹ However, unless it can be shown that the parties to the earlier agreement intended for the transfer pricing methodology to have issue preclusion, the closing agreement would not have this effect.¹⁸²

The taxpayer presented evidence that the document was intended to have some prospective standing because of the penalty protection it was afforded against any underpayment of a royalty from any of its existing or future supply points, provided that it was made in good faith and satisfied the reasonable cause exception.¹⁸³ The Court found that this hindered the taxpayer’s argument, rather than furthered it, as it specifically provided for a situation where the IRS would make a future transfer pricing adjustment.¹⁸⁴

The Court then stated that the actions taken by the taxpayer to minimize its international tax exposure (partly by interpreting the terms of the closing agreement in such a way that would allow it to shift its operations amongst its various foreign supply points) harmed the foundational submission of its case that its supply points owned off-book intangible assets that were of sufficient value to justify the high profits they reported.¹⁸⁵

6.3 Conclusion

¹⁷⁵ Ibid.

¹⁷⁶ Ibid.

¹⁷⁷ Ibid. Page 98

¹⁷⁸ Ibid. Page 95

¹⁷⁹ Ibid. Page 95

¹⁸⁰ Ibid.

¹⁸¹ Ibid.

¹⁸² *Arizona v. California*, 530 U.S. 392, 414 (2000), supplemented by 531 U.S. 1 (2000).

¹⁸³ *The Coca-Cola Company & Subsidiaries V. The IRS* (2017); 149 T.C. No. 21; Docket No. 31183-15.

¹⁸⁴ Ibid.

¹⁸⁵ Ibid.

In this case, the taxpayer argued that the revenue authority abused its discretion to reallocate income by adopting different transfer pricing methodology that is erroneous, arbitrary, and capricious. It provided three alternative methods, each of which was disregarded by the Court that upheld the assessment and ruled in favor of the revenue authority.

Considerable commentary has originated from this decision. Notable observers have scrutinised technical matters arising in the case as well as its outcome. There has also been speculation as to how this will affect future transfer pricing decisions in the US and elsewhere.

This case forms the basis for that taxpayer's appeal contained its Motion for Reconsideration of Findings filed in 2021 that is discussed in the next chapter.

Chapter Seven

The Taxpayer's Appeal

7.1 Introduction

After the unfavourable outcome of the 2020 case, the taxpayer pursued an appeal on fundamental tax, administrative and constitutional grounds. The arguments can be separated into two distinct parts. The first is that the IRS's conduct was unlawful. The second is that the transfer pricing methodology that formed the basis of the assessment was legally erroneous. The taxpayer's argument is examined below.

7.2 Summary of the Taxpayer's Argument¹⁸⁶

As the petitioner in its Motion for Reconsideration of the Court's 2020 decision,¹⁸⁷ the taxpayer argues that the unique and unprecedented tax ruling *"raises fundamental questions of tax, administrative, and constitutional law"*¹⁸⁸ that are of *"national importance"*¹⁸⁹ and that the actions of the IRS were *"arbitrary, capricious and unconstitutional."*¹⁹⁰ The company wishes to recognise a well-established principle that, when an agency takes an alternative position to the expectations that its prior conduct created, and that was legitimately relied upon by the taxpayer, it has acted in an arbitrary, capricious and therefore unlawful manner. It goes on to say that not only was the IRS's retroactive imposition of a changed method (without any change in the law or circumstances) unlawful, the IRS went so far as to have *"led the Court astray from the outset"*¹⁹¹ when it attempted to deny the *"relevance and admissibility"*¹⁹² of the 1996 Closing Agreement that influenced company's taxes for almost 25 years.¹⁹³

7.3 Unlawful Conduct

The first fundamental question raised regards the actions and behaviour of the IRS: *"whether the IRS acted unlawfully in failing even to consider Coca-Cola's substantial and indisputable reliance interests in the continued application of the 10-50-50 method during the tax years at issue, interests that were created by the Closing Agreement and then repeatedly reinforced by the IRS's continuous course of conduct auditing and approving Coca-Cola's use of this tax calculation methodology for more than a decade."*¹⁹⁴

The company proposes that this threatens the foundations of American society that rely on the rule of law and that provides the expectation that the government will treat its citizens in a matter that is rational, reasonable, non-arbitrary and consistent with Constitutional values.¹⁹⁵ It quotes Judge

¹⁸⁶ For ease of reference, please consult the summary of the petitioner's submission in Appendix 3: Summary of Motion for Reconsideration of Findings (2021)

¹⁸⁷ The Motion is based on Judge Lauber's opinion in the 2020 Coke case. Any references to "the Court" or "the Judge" refer to, and can be found in, this case. Citations to the Motion are comments in the documented opinion of the company's legal representatives, and not necessarily the author of this thesis.

¹⁸⁸ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

¹⁸⁹ Ibid.

¹⁹⁰ Ibid.

¹⁹¹ Ibid.

¹⁹² Ibid.

¹⁹³ Ibid.

¹⁹⁴ Ibid.

¹⁹⁵ Ibid.

Kavanaugh, in a prior case involving a similar imposition of a retroactive change,¹⁹⁶ who stated that when a “government agency officially and expressly tells you that you are legally allowed to do something, but later tells you ‘just kidding’ and enforces the law retroactively against you and sanctions you for actions you took in reliance on the government’s assurances, that amounts to a serious due process violation,” and that the IRS has now committed such a “serious due process violation.” If the Court were to uphold such a violation, one of the serious consequences would be that it declares “open season for the IRS to set a trap for any taxpayer that relies in good faith on the IRS’s representations and course of conduct.”¹⁹⁷

Judge Kavanaugh’s¹⁹⁸ use of a hypothetical scenario to explain the underlying principle of a separate case is quoted. He said, “Put aside all the legalese for a moment. Imagine that a police officer tells a pedestrian that the pedestrian can lawfully cross the street at a certain place. The pedestrian carefully and precisely follows the officer’s direction. After the pedestrian arrives at the other side of the street, however, the officer hands the pedestrian a \$1,000 jaywalking ticket. No one would seriously contend that the officer had acted fairly or in a manner consistent with basic due process in that situation.” The company applies this analogy to its own case by saying that “[H]ere, the IRS is attempting to impose a multi-billion-dollar jaywalking ticket on Coca-Cola, after acknowledging that Coca-Cola was crossing the street lawfully, and then watching Coca-Cola cross the street at that place for more than a decade without as much as suggesting that it was not crossing the street at the appropriate place. The Constitution prohibits this.”¹⁹⁹

The reason for the Closing Agreement was that it recognised that the 10-50-50 method resulted in the appropriate arm’s length price. This, the taxpayer argued, was without limitations. The taxpayer continues to note that the agreement contained a prospective penalty protection provided that the method was continued to be used to calculate the transfer price (absent any material changes) and that this in fact meant that the taxpayer could be penalised if it were disregard the 10-50-50 without any material changes in its circumstances. This agreement was relied upon to the taxpayer’s detriment when it structured its international affairs for the almost two decades that followed.²⁰⁰

It goes on to note that at no time in its numerous years of tax audits did the IRS make any suggestion that it would require a new method that it would retroactively consider, nor that the method used and the continued reliance on the terms of the Closing Agreement were either unlawful or inappropriate, as recognised by the Court²⁰¹ in its summary judgement. In its audits up to 2006, the IRS even went as far as to limit its examinations to the application of the Agreement’s provisions on royalties that were received from the supply points. The Court recognised that by doing so, the IRS “explicitly or implicitly” approved the use of that method for the almost 20 years to 2006.²⁰² By “pulling the rug out from under it,” the IRS acted against the taxpayer in a way that was both arbitrary and capricious.²⁰³

Finally, the company argues that the arbitrary-or-capricious test develops from the constitutional principles that the IRS’s unfair “bait and switch” defies. It believes that constitutional principles, such as the right to due process, should provide sufficient protection from the significant financial liability

¹⁹⁶ PHH Corp. v. CFPB, 839 F.3d 1, 48 (D.C. Cir. 2016) (Kavanaugh, J.), reinstated in pertinent part on reh’g en banc, 881 F.3d 75, 83 (D.C. Cir. 2018) (en banc).

¹⁹⁷ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

¹⁹⁸ PHH Corp., 839 F.3d at 49.

¹⁹⁹ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

²⁰⁰ Ibid.

²⁰¹ Coca-Cola Co. v. Commissioner, 149 T.C. 446, 449 (2017) (quoting Ex. 246-J at EXHJ00004503 (IRS Notice of Pro-posed Adjustment)).

²⁰² Ibid.

²⁰³ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

because, without fair notice or reason, the IRS applied “a new rule to past conduct and actions that were taken in justifiable reliance on the government’s previously existing rule.”²⁰⁴

The company presents its evidence against the transfer pricing methodology adopted by the IRS to show how it acted unlawfully by way of incorrectly applying the law.²⁰⁵

7.4 Incorrect Transfer Pricing Methodology

The second fundamental question is related to the interpretation and application of the Treasury Regulations on transfer pricing and is posed as “whether the IRS and the Court erred in determining that the IRS’s “own transfer-pricing regulations and other governing principles that require consideration of the Company’s Supply Points’ valuable licenses of and billions of dollars spent marketing the Coca-Cola brands were entirely inapplicable for the sole reason that Coca-Cola “was the registered legal owner of virtually all trademarks and other intangible assets”.”

7.4.1 Dr. Newlon’s CPM

As part of the 2020 case, the IRS engaged the services of the economist, Dr. Scott Newlon, to consult on the most appropriate transfer pricing method for the taxpayer. He rejected the CUT method because, in his opinion, there are no uncontrolled transactions that would accurately reflect the value attained from licensing the company’s brands. He also noted that the “*profit split*” method would be inaccurate in all cases where one party, the US parent company, owned valuable intangible property, but the other, the supply points, owned close to none.²⁰⁶

He established that the supply points operated as contract manufacturers that retained a significant portion of the profits generated from the sale of concentrate syrup, even though much of the value of the brands were held by the parent company as the owner of the trademarks and intellectual property. He recommended the CPM that used the independent bottlers as comparable parties to the supply points.²⁰⁷

7.4.2 Failure to account for the intangible assets owned by the supply points

The transfer pricing adjustment that was based on Dr. Newlon’s CPM can only apply on the condition that the supply points do not own any significant intangible assets that contribute to the profits of the group.²⁰⁸ The taxpayer argues that its immense global success relies on the contributions made by its supply points through manufacturing its concentrate syrup, marketing, and developing local markets. The IRS’s experts acknowledged the reliance that the company has on these affiliates to maintain the value of its brands.²⁰⁹ The supply points bore the cost, risk, and responsibility of local marketing. Depending on the local factors and preferences of the country in which they operated, the supply points decided on what products to sell, for what price and occasion, under what brand, and in which packaging and supply channel. They then designed and implemented suitable advertising campaigns.²¹⁰ In the report presented by the taxpayer’s expert, Dr. Willig, it was estimated that a conservative value of the marketing intangible development costs for the supply points was approximately \$9.4 billion for the two years between 2007 and 2009 alone.²¹¹

²⁰⁴ Ibid.

²⁰⁵ Ibid. Page 49

²⁰⁶ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Page 79

²⁰⁷ Ibid. Page 79

²⁰⁸ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 49

²⁰⁹ Ibid. Page 49-50

²¹⁰ Ibid. Page 50

²¹¹ Ibid. Page 50

7.4.2.1 Licenses to use Coca-Cola Trademarks

When it made its analysis of the transfer pricing adjustment, the Court did not account for the licenses that the supply points had that allowed them to use the parent company's intellectual property to produce and sell concentrate on the grounds that the parent was the legal owner of those assets. The taxpayer holds that this is legally erroneous because it misinterprets and violates the Treasury Regulations,²¹² which include with the legal owner, the holder of contractual rights (such as licenses) that constitute distinct intangible assets, where this ownership is consistent with the economic substance of the transaction.²¹³ This dual-intangible principle was established to prevent this type of "all-or-nothing" result that fails to account for, and attribute income to, separate parties' contributions to the value of these types of intangible assets.²¹⁴ "Put simply, the Treasury Regulations say that a licensee is entitled to keep the premium profits when its marketing efforts result in increased sales."²¹⁵

The taxpayer describes this relationship by saying that it is irrelevant "that the Supply Points did not have or share ownership of Coca-Cola's "crown jewels"—the trademarks themselves...The Supply Points are Coca-Cola's licensed alchemists, who turn those jewels into liquid and revenue." It concludes its argument by stating that it is legal error to deny the compensation owed to the supply points because of "the Court's mistaken singular focus on legal ownership of Coca-Cola's intellectual property and observation that the Supply Points' agreements with Coca-Cola gave the Supply Points "no rights or ownership interest in [Coca-Cola's] intangible property,"..."²¹⁶

7.4.2.2 Compensation for Investment

Even if the supply points did not own the intangible property and only added to the value of these assets, the Treasury Regulations require that they be compensated for the marketing cost, risk and responsibility that they bore to contribute to the value of not only their own licences, but the underlying assets of the parent.²¹⁷ This is in line with the common-sense understanding that no unrelated company would invest marketing efforts to increase the value of assets that it does not itself benefit from, without being compensated.²¹⁸ Instances of where the Courts in Amazon²¹⁹ inter alia have endorsed these principles were highlighted in the company's argument. It also cited the DHL case where the Judge said "that where "the value of the DHL trademark was created only by virtue of the sustained and combined efforts of both DHL and DHLI,...the analysis had to reflect the value of DHLI's contributions, whether as developer or assister."²²⁰ It was proposed further that the IRS itself has applied these principles to the treatment of The Coca-Cola Company when it allocated profits to the US company from Canadian sales, despite the legal owner of the Canadian trademarks being the Canadian affiliate and not the American parent.²²¹ It explicitly explained in that Notice of Proposed adjustment that "legal ownership of intangible property alone is not enough to assure supra-normal return. The more important considerations are allocations of

²¹² Ibid. Page 52

²¹³ Treas. Reg. § 1.482-4T(f)(3)(i)(A), 71 Fed. Reg. at 44,484.

²¹⁴ Treatment of Services Under Section 482; Allocation of Income and Deductions from Intangibles, 68 Fed. Reg. 53,448, 53,449 (Sept. 10, 2003).

²¹⁵ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 53

²¹⁶ Ibid. Page 53

²¹⁷ Ibid. Page 55

²¹⁸ Id. § 1.482-1T(d)(3)(ii)(C), Example 4, 71 Fed. Reg. at 44,482.

²¹⁹ Amazon.com, Inc. v. Commissioner, 148 T.C. 108, 199-202 (2017),.

²²⁰ DHL Corp. v. Commissioner, 285 F.3d 1210, 1222 (9th Cir. 2002).

²²¹ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 56

*income consistent with expected commercial behaviours and principles, and the relative responsibilities for intangible development costs and risks necessary to develop the intangible.*²²²

The taxpayer showed that there need not be a challenge in finding an appropriate method to account for the intangible assets of the supply points as the Treasury Regulations²²³ provide that the capitalised development and improvement cost, less amortization, is a sufficient estimation of the relative value of each parties' contribution to the value of nonroutine intangibles.²²⁴ To this point, the company's experts suggested the residual profit split method where the residual profits would be divided by the capitalised costs of each parties' contributions.²²⁵ The method adopted by the IRS disregards this contribution and merely accounts for investments in tangible assets.²²⁶

7.4.2.3 Goodwill

It was the intention of the US Congress that goodwill should not be subject to tax on transfer. This was upheld by the Court in the Amazon.com case where goodwill that was transferred from the US company to the foreign affiliate was not considered an intangible asset and therefore did not require a royalty payment back to the US.²²⁷ However, the supply points of Coca-Cola had their own goodwill which they invested in that did not belong to the US parent.²²⁸ The IRS previously recognised that the goodwill of the Irish supply point "*includ[ed] excess earning capacity, competitive advantage, anticipated continued patronage of transferred business, and successful working relationship[s] with local government, banks and other authorities.*"²²⁹ The supply points deserved to be compensated for their valuable goodwill.²³⁰ The taxpayer concludes its argument by reversing the perspective and explaining that, by treating this goodwill as an asset of the parent company, the supply points would owe a royalty to the US, which exactly contradicts the intention of Congress that was actioned in the Amazon.com case.²³¹ It holds that this is a legal error on the part of the IRS and the Court.²³²

7.4.2.4 The Danielson Rule

The Court relied on the Danielson Rule to support its conclusion that the supply points did not deserve the compensation they received because there was no written contract that recognised the related valuable marketing intangibles.²³³ This rule is intended to protect parties from a unilateral reformation of an agreement for unjust enrichment, increase predictability of contract interpretation, and protect the IRS from having to contest multiple parties to collect a single tax.²³⁴ The taxpayer argued that because none of these factors are present in this dispute, the rule should not apply.²³⁵

²²² Sept. 11, 2012, Notice of Proposed Adjustment).

²²³ Treas. Reg. § 1.482-6T(c)(3)(i)(B)(2), 71 Fed. Reg. at 44,487; see also Treas. Reg. § 1.482-6(c)(3)(iii), Example 1 (applying this principle).

²²⁴ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 57

²²⁵ Ibid. Page 57

²²⁶ Ibid. Page 57

²²⁷ Ibid. Page 59-60

²²⁸ Ibid. Page 59-60

²²⁹ 1984 IRS Letter Ruling Regarding Transfer of Irish Branch Assets.

²³⁰ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 59-60

²³¹ Ibid. Page 60-61

²³² Ibid. Page 60-61

²³³ Ibid. Page 61

²³⁴ Ibid. Page 62-63

²³⁵ Hospital Corp. of Am. v. Commissioner, 72 T.C.M. (CCH) 1581, 1592 (1996) (citing cases).

The Treasury Regulations require the terms of an agreement to accurately reflect the economic substance of a relationship. These terms may need to be imputed into a contract between controlled parties²³⁶ or be respected²³⁷ when they already exist. The taxpayer argues that the Courts reliance on the Danielson Rule violates these regulations because the substance of its relationship with the supply points is accurately reflected in both the application of the 10-50-50 method and in the terms their agreement, which should be respected.²³⁸

The Rule is intended to only impute terms where there is no written agreement.²³⁹ It is not intended to alter standard contract interpretation,²⁴⁰ or to apply when there is ambiguity, silence,²⁴¹ or no contract²⁴² at all. The company argues that this rule only applies when a contracting party, and not the IRS, argues against the form of the contract.²⁴³ The parties are adhering to the form of the licensing agreement that provides for a reciprocal income-based royalty. Failing to consider that the intangible asset in these agreements is the license itself, is an error.²⁴⁴

The taxpayer concludes that the closing agreements, and the IRS's conduct in the decade after, gave it no reason to formalise its agreements with its supply points when it is not uncommon for related parties to have and honour informal arrangements.²⁴⁵

7.4.2.5 Marketing Obligation

The Treasury Regulations embody the natural understanding that, if not legally obligated to, a business would only invest money for its own benefit. Even if there is no legally binding agreement in place, if the investment would be to enhance the value of another party's assets, one would expect that a company would only proceed under the promise of receiving adequate compensation in return.²⁴⁶ The fact that details of this relationship may not be formalised in a written agreement is why the economic substance analysis exists to impute terms to reflect the conduct of the parties.²⁴⁷ The taxpayer argues that the IRS and the Court were responsible for imputing the terms that obligated the supply points to bear the significant marketing expenses for which they were ultimately responsible, and should be allowed compensation.²⁴⁸ Here the Court is also disregarding what it and the IRS had previously recognised, that investments in advertising constitute part of the value on an intangible asset.²⁴⁹

7.4.2.6 Operational Reality of Marketing

The Coca-Cola Company and its bottlers have an informal agreement to split the costs of marketing 50/50²⁵⁰ with the parent company taking primary responsibility for consumer marketing so that the

²³⁶ Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2); see also T.D. 9278, 71 Fed. Reg. at 44,478.

²³⁷ Treas. Reg. § 1.482-1(d)(3)(ii)(B)(1).

²³⁸ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 62

²³⁹ Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2); see also T.D. 9278, 71 Fed. Reg. at 44,478.

²⁴⁰ Tseytin v. Commissioner, 698 F. App'x 720, 723 (3d Cir. 2017) (discuss-ing Amerada Hess Corp. v. Commissioner, 517 F.2d 75, 85-86 (3d Cir. 1975)).

²⁴¹ Patterson v. Commis-sioner, 810 F.2d 562, 572 (6th Cir. 1987).

²⁴² North Am. Rayon Corp. v. Commissioner, 12 F.3d 583, 588-89 (6th Cir. 1993).

²⁴³ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 61

²⁴⁴ Ibid. Page 61

²⁴⁵ Ibid. Page 63

²⁴⁶ Ibid. Page 63-64

²⁴⁷ Ibid. Page 63

²⁴⁸ Ibid. Page 63

²⁴⁹ See, e.g., RJR Nabisco Inc. v. Commissioner, 76 T.C.M. (CCH) 71, 83-84 (1998); Jackson v. Commissioner, 86 T.C. 492, 517-18 (1986), aff'd, 864 F.2d 1521 (10th Cir. 1989).

²⁵⁰ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Page 20

bottlers can focus on trade marketing.²⁵¹ The company operates internationally through its local business units (BUs) that are responsible for local territories but are not separate legal entities.²⁵² An expert witness representing the IRS described that the local BU's performed market research and local advertising and coordinated their efforts with the local bottler operating in their region.²⁵³ Their finance teams worked with the supply points to ensure that they "*understood and could bear those local marketing expenses*" before they took on the actual expense and payment, and were not merely allocated amounts.²⁵⁴ The Court also recognised that marketing, sales, and finance were all executed by the employees of the supply points in Brazil, Chile and Egypt.²⁵⁵ To describe how drastic the adjustments were using the CPM, the Court used the example that application of the method resulted in a reverse allocation from the parent to the Egyptian supply point owing to its poor economic performance.²⁵⁶ The taxpayer uses this to show how the supply points, along with the parent company, have a lot to lose from poor marketing decisions, either through lost revenues or uncaptured growth.²⁵⁷ Yet in 2020 the Court still determined that "*the supply points had nothing to do with consumer marketing,*" and that this investment was not grounded in "*operational reality*".²⁵⁸ The taxpayers response was that "*nothing could be further from the truth. And, with respect, this was clear error.*"²⁵⁹

7.4.2.7 Terminability of the Licence Agreements

Instead of considering a range of factors, when determining the rights of a controlled party and deciding on whether a controlled transaction was at arm's length,²⁶⁰ the Court focused only on the fact that the agreements with the supply points lacked territorial exclusivity and were terminable at the will of the company, and according to the taxpayer, it failed to explain²⁶¹ this analysis.²⁶²

An expert of the IRS admitted that it is "*fairly well-understood*"²⁶³ that lower royalties result from shorter and non-exclusive license agreements.²⁶⁴ The supply points in fact deserved higher compensation because the terminability and non-exclusivity of their licenses meant that they took on additional risk of not benefiting from their investment²⁶⁵ into the development of the company's brand in their territory.

Dr. Newlon recognised that the parent company would not have the capacity to serve its markets without these concentrate plants,²⁶⁶ and at the very least, it would have to take on the full marketing risk²⁶⁷ and responsibility. Just because it legally could, does not mean that the parent company would

²⁵¹ Ibid. Pages 20 & 37.

²⁵² Ibid. Pages 19

²⁵³ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 65

²⁵⁴ Ibid. Page 65

²⁵⁵ Ibid. Page 65

²⁵⁶ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Page 10

²⁵⁷ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 66

²⁵⁸ Ibid. Page 64-65

²⁵⁹ Ibid. Page 65

²⁶⁰ Treas. Reg. § 1.482-1(d)(1) (stating that "each method requires analysis of all of the factors that affect comparability under that method," and listing factors).

²⁶¹ *Contra Pine Mountain Pres. LLLP v. Commissioner*, 978 F.3d 1200, 1210 (11th Cir. 2020); *Med-tronic, Inc. v. Commissioner*, 900 F.3d 610, 614 (8th Cir. 2018).

²⁶² Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 66-67

²⁶³ Ibid. Page 67

²⁶⁴ Ibid. Page 67

²⁶⁵ Ibid. Page 67

²⁶⁶ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Page 174

²⁶⁷ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 68

terminate these agreements.²⁶⁸ Yet, without considering the manufacturing alternatives available to the company (or lack thereof), this is exactly what the Court assumed.²⁶⁹

In terms of their revenue contribution, the two key territories disputed are Ireland and Brazil. The Irish supply point that accounted for more than 60% of the total concentrate revenue²⁷⁰ had operated under the same licensing agreement for almost 30 years before 2007. In 2018, the President of Coca-Cola for Latin Centre, Roberto Mercadé, said that they were proud to be celebrating 50 years of the supply point manufacturing concentrate in Costa Rica by announcing a further \$50 million investment in a new state of the art production facility.²⁷¹ On the announcement, the Minister of Trade said that they “congratulate Coca-Cola for reaffirming its partnership and its long-term commitment with Costa Rica”.²⁷² Barring any evidence to the contrary,²⁷³ how could these primary supply points not have reasonably expected to continue this relationship indefinitely?²⁷⁴ The Court was merely required²⁷⁵ to consider whether, based on their course of conduct, the parties to the Coca-Cola system anticipated that they would continue to do business beyond the 12-month contract term.²⁷⁶

Dr. Ednaldo Silva contributed to the drafting of the U.S. transfer-pricing regulations and is currently the Senior Economic Advisor in the IRS Office of Chief Counsel.²⁷⁷ Among a host of other public comments, he said that “*The court’s accepted notion that the supply points can be destitute of the licensed intangibles at will is unconvincing. No frequency of such occurrence is given as probative evidence, just hearsay.*”²⁷⁸

7.4.2.8 Payment vs. Performance

The Treasury Regulations show that the party that is entitled to the increase in the value of the intangible asset is the one that pays for and bears the cost of marketing, even when it outsources these activities to another party to perform this function²⁷⁹ (as is not uncommon in practice). There is agreement that the supply points took on this marketing burden yet their marketing expenditure was disregarded by the Court on the basis that the activities were carried out by the company’s local service companies (ServCos) that performed a host of the parent company’s local business functions,²⁸⁰ including advertising and marketing.²⁸¹

7.4.3 The Transfer Pricing Method as a Matter of Law

²⁶⁸ Ibid. Page 68

²⁶⁹ Ibid. Page 68

²⁷⁰ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Page 72

²⁷¹ Alvarado, L (March 8, 2018); The Costa Rica Star; The Coca Cola Company Announced Establishment of One of its Largest Plants in Guanacaste, Costa Rica; <https://news.co.cr/coca-cola-company-announced-establishment-one-largest-plants-guanacaste-costa-rica/71357/>.

²⁷² CINDE (2018); Coca-Cola begins to construct its most innovative concentrates plant in Liberia, Guanacaste; <https://www.cinde.org/en/essential-news/cocacola-begins-to-construct-its-most-innovative-concentrates-plant-in-liberia-guanacaste>.

²⁷³ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 68

²⁷⁴ Ibid. Page 67

²⁷⁵ Treas. Reg. § 1.482-1(d)(3)(ii)(B), *ibid*.

²⁷⁶ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 67

²⁷⁷ See Footnote 289 for a comprehensive biography of Dr. Silva

²⁷⁸ Ednaldo Silva, U.S. Tax Court Decision in Coca-Cola Is at Odds with Economic Principles, MNE Tax (Mar. 3, 2021), <https://mnetax.com/us-tax-court-decision-in-coca-cola-is-at-odds-with-eco-nomic-principles-42856>.

²⁷⁹ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 69

²⁸⁰ Ibid. Page 69

²⁸¹ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Page 15

7.4.3.1 Marketing Intangibles

For any transfer pricing method to be reliable as a matter of law it must account for all of the most important variables.²⁸² Coca-Cola is widely known for its ability to develop, market and deliver some of the world's leading brands to every corner of the globe. Country-specific, tailored, local marketing is undeniably central to the brands that drive revenue and profitability within the Coke system. This highly valuable marketing intangible asset cannot go without consideration yet it plays no role in Dr. Newlon's CPM that was endorsed by the IRS and supported by the Court.²⁸³

7.4.3.2 Bottlers as Comparatives

Setting aside the importance of the marketing intangibles, and even if applying the CPM was not a mistake, this method relies on using the bottlers as comparatives, which the taxpayer argues is legally erroneous in itself.²⁸⁴

The Court noted that such unique intangible assets are hard to value because²⁸⁵ 1) it is their uniqueness that makes them so valuable;²⁸⁶ 2) the value of the intangibles is closely connected to the synergistic assets of the business as a whole; and 3) the earning capacity of the intangibles is not tethered to a specific cost or resource.²⁸⁷

7.4.3.2.1 The Opinions of Commentators on the Court's decision in relation to Economic Principles

In his recent publication,²⁸⁸ Dr. Silva²⁸⁹ provides detailed and extensive calculations and economic evidence to support his harsh criticism of using the bottlers as comparisons for the supply points to result in what he calls the IRS's "super-royalties."²⁹⁰ He first questions the independence of the bottlers when 14 of the 24 comparables operate under the Coca-Cola trade name and notes that the Treasury Regulations²⁹¹ provide a broad definition of 'controlled' that includes "any kind of control, ... however exercisable or exercised." He then examines the IRS's determination that the supply points are contract manufacturers, which would merely make "routine" returns on their operating assets. In his opinion, the supply points have monopolies in their areas and so would be expected to earn higher returns than oligopolies like the bottlers that operate under competition. He notes that all but one of the supply

²⁸² § 1.482-1(d)(1)

²⁸³ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://abouttax.com/XSP>. Page 70

²⁸⁴ Ibid. Page 71

²⁸⁵ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Pg 115-116

²⁸⁶ United States v. E.I. du Pont de Nemours & Co., 351 U.S. 377, 392 (1956); Comparable external transactions involving high-value intangibles may occasionally exist. See Amazon.com, Inc., 148 T.C. at 167 (finding a reliable CUT where the taxpayer built for an unrelated party a website that included all the features of the taxpayer's own website and enabled the other party to sell its retail products online). But external transactions involving a company's "crown jewels" are quite rare.

²⁸⁷ Yariv Brauner, "Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes," 28 Va. Tax Rev. 79, 89 (2008).

²⁸⁸ Ednaldo Silva, U.S. Tax Court Decision in Coca-Cola Is at Odds with Economic Principles, MNE Tax (Mar. 3, 2021), <https://mnetax.com/us-tax-court-decision-in-coca-cola-is-at-odds-with-economic-principles-42856>.

²⁸⁹ Ibid. "Dr. Ednaldo Silva is Founder & Director of RoyaltyStat, a leading online database of royalty rates extracted from unredacted license agreements filed with the SEC. He is an economist with over 25 years of experience in transfer pricing innovation and the valuation of intangibles. Dr. Silva helped draft the US transfer pricing regulations as Senior Economic Adviser in the IRS Office of Chief Counsel. He was the originator and developer of the "comparable profits method" and introduced the best method rule and the concept that arm's length is represented by a range of results. Dr. Silva was also the first economist in the IRS's Advance Pricing Agreement (APA) Program."

²⁹⁰ Ibid.

²⁹¹ Regs. § 1.482-1(i)(4) and (5).

points are located in developing countries with weak currencies. It would not be advisable hold these in large cash reserves due to the risk of currency devaluation; yet the balance held in Ireland, a recognised tax haven, is the lowest by a significant margin when compared to the average of the other supply points.²⁹²

He uses Brazil, the second largest supply point by revenue and central to this tax liability, as an example of how inaccurate it is to use bottlers in different countries to the supply points when varying domestic economic conditions make it impossible to equalise the profit margin and asset turnover variables for the purpose of comparison. In his opinion of economic analysis, *“there is no economic mechanism ensuring the cross-country equalization of asset turnovers.”*²⁹³ Only businesses in Mexico, Costa Rica and Chile were used, unadjusted, as prima facie comparables, without a single one conducting its business within the challenging Brazilian economy. With a greater knowledge of economics than this dissertation aims to address, he *“suspects that against competent challenges, the IRS implied theory about the return on assets gravitation to a global (reduced to a super-regional rate of return) cannot convince. Academic idealists and promoters of global trade teach that product price equalization can produce “factor price equalization,” but no realist economist believes in such fantasy. The IRS selection of comparables defies the factors of comparability of Reg. § 1.482-1(d).”*²⁹⁴

Among the factors already listed, he notes that the supply points have a low rate of depreciable assets when compared to their revenue. He puts down the IRS win to it using unreliable profit indicators that account for the high value of the supply points and result in high asset turnover rates, when he says that this measure is unrelated to transfer pricing. The biggest failure that he believes *“contributed to the perdition of Coca-Cola in court”*²⁹⁵ is that there was no attempt to make any comparison to unrelated licence agreements that could at least be used to test the reasonableness of the IRS comparatives by providing a range of expected royalty amounts. He states that, *“missing relevant information produces bias and does not provide confidence in an opinion.”*²⁹⁶ He is even *“suspicious”* of *“the IRS data quality and univariate analysis.”* It uses a sample of 996 companies in various countries that showed the supply points as *“the only high outliers,”* when one would reasonably expect a histogram of return on assets from such a large sample size to produce *“a long tale”*²⁹⁷ that would imply a higher frequency of outliers.

Note that of the 18 bottlers used by Dr. Newlon in his Return on Assets (ROA) analysis that is quoted by the Court, 5 were in Asia, only 1 was African and none were in Central America. This was in spite of the reality that none of the supply points were located in Asia and 2 out of the 7 were in Africa. 7 were from developed economies like the USA, Japan and Australia, and the only countries with bottlers included in the analysis were those in Chile and Mexico.²⁹⁸

The real and greater impact that this case and others like it can have on developing countries, especially in light of the threat that the OECD and US-driven global minimum tax imposes on the tax sovereignty of resource-poor nations, is also addressed. He concludes by saying that *“The Coca-Cola loss sends a distress signal that besides multinational corporate tax base erosion and profit shifting, the court can be another vehicle appealing at confiscating a material fraction of the tax revenue from affected developing*

²⁹² Ednaldo Silva, U.S. Tax Court Decision in Coca-Cola Is at Odds with Economic Principles, MNE Tax (Mar. 3, 2021), <https://mnetax.com/us-tax-court-decision-in-coca-cola-is-at-odds-with-economic-principles-42856>.

²⁹³ Ibid. Page 4

²⁹⁴ Ibid. Page 4

²⁹⁵ Ibid. Page 5

²⁹⁶ Ibid. Page 5

²⁹⁷ Ibid. Page 5

²⁹⁸ See page 80 in the 2020 Coke case

countries. The supply points are in politically weak countries, and thus, I am not surprised that...the US Treasury did not interfere in this large (precedent-setting) case.”²⁹⁹

7.5 Consideration of the Potential Outcome

If the appeal is to end in failure for the taxpayer, it would need to apply for a Foreign Tax Credit. The response of the revenue authority could be telling.

In 2017, the taxpayer won its case that the lower royalty calculation was correct and therefore its Mexican taxes were compulsory. The IRS was prevented from disallowing the credit.

In the 2020 case, the revenue authority’s assessment leads to the inference that the taxpayer paid more tax in the foreign countries than they were required to because the royalty amount was too small. It owes more tax in the US and has essentially overpaid tax in the foreign countries.

This raises the question of whether the reasoning that the IRS argued for unsuccessfully in the 2017 case, would now prevent it from allowing the FTC that arises from its most recent adjustment to the extent that the “*overpayments*” were not ‘compulsory’ and not ‘taxes.’ According to the reasoning put forward by the revenue authority in 2017, a portion of foreign taxes would not be considered ‘compulsory’ and creditable ‘taxes.’

7.6 Conclusion

In its first argument, the petitioner claims that the revenue authority acted unlawfully by disregarding foundational legal principles. It failed to respect and account for the company’s reasonable reliance interest that was created; its decision to abandon its established position and retroactively apply a new one was arbitrary and capricious; and this ‘bait-and-switch’ was unconstitutional. Secondly, it argues that the revenue authority is in violation of legislated regulations because the transfer pricing method that it adopted was incorrect as a matter of law.³⁰⁰

The outcome of this appeal is pending and open to speculation. What will be discussed in the following chapters is the potential outcome of the Coca-Cola transfer pricing case and how this could differ under the terms of a treaty. The differing approaches taken by authorities in various countries are also compared and considered.

²⁹⁹ Ednaldo Silva, U.S. Tax Court Decision in Coca-Cola Is at Odds with Economic Principles, MNE Tax (Mar. 3, 2021), <https://mnetax.com/us-tax-court-decision-in-coca-cola-is-at-odds-with-economic-principles-42856>. Page 5

³⁰⁰ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

Chapter Eight

Treaty Considerations

8.1 Introduction

Neither of the controlled companies involved in the 2020 case were residents covered by the provisions of a treaty with the US. For the sake of completeness, it is necessary to consider how the nuances of treaty interpretation and application could influence thinking on future arm's length discussions.

A hypothetical case based on the same facts of the 2020 case will be considered with the exception being that the supply point will be a resident of a country that is a treaty partner of the US. The potential outcomes of the hypothetical and the appeal will be compared. The hypothetical supply point will be covered by the South Africa - United States Income Tax Treaty (1997) ("the Treaty").

The United States – Mexico Income Tax Convention (1992) that applied in the 2017 case is also covered by this analysis given the assumption that the outcome would be the same because both treaties are based on the United States Model Income Tax Convention.³⁰¹

8.2 A Case about Non-Treaty Territories

The taxpayer has supply points in 19 different countries.³⁰² Of these, the only ones that were subject to the IRS assessment were the 7 that are residents of non-US treaty states. In 2017, the IRS explained "*that any adjustments to the Mexico Licensee's royalty payments might result in double taxation for which petitioner would have the right to seek competent authority relief under the U.S.-Mexico treaty.*"³⁰³ This right does not exist for the taxpayer in the subsequent assessment issued by the IRS. The revenue service has the discretion to make an adjustment that would result in double tax, without requiring consensus from 7 foreign revenue authorities.

8.3 US Model Treaties

Treaties based on the US Model are agreements between the US and another 'Contracting State' for the "*avoidance of double tax*" and the "*prevention of fiscal evasion.*" The treaty with South Africa is aimed at promoting and strengthening the economic relations between the countries.³⁰⁴ The US resident Coca-Cola Company (the parent company) and its hypothetical South African resident supply point (the subsidiary) would be covered by the agreement³⁰⁵ and considered 'associated enterprises' that because they are ultimately owned by the same persons.³⁰⁶

8.3.1 Art. 9: Primary and Secondary Transfer Pricing Adjustments

³⁰¹ Any differences between the 1981 and 1997 Models that affect the relevant provisions of the treaties that arise will be noted.

³⁰² CINDE (2018); Coca-Cola begins to construct its most innovative concentrates plant in Liberia, Guanacaste; <https://www.cinde.org/en/essential-news/cocacola-begins-to-construct-its-most-innovative-concentrates-plant-in-liberia-guanacaste>.

³⁰³ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15. Page 11

³⁰⁴ The South Africa - United States Income Tax Treaty (1997). Subtitle and Preamble

³⁰⁵ Ibid. Art. 1 & 4

³⁰⁶ Ibid. Art. 9(1)(b)

Art. 9 of the US Model Treaty essentially introduces the transfer pricing provisions and the arm's length principle contained in Section 482 of the US Code.³⁰⁷ These apply to any taxable profits attributed between the companies, including the royalties covered by Art. 12. It is worth noting that the second paragraph providing for the transfer pricing adjustments requires the other contracting state to make a corresponding 'secondary adjustment' to the tax liability of its resident to "*balance the scales.*"³⁰⁸ The other Contracting State must agree to this adjustment, having "*due regard*" to the other provisions of the Treaty (such as Art. 12).³⁰⁹ Consultation between the competent authorities of both countries may be necessary.³¹⁰

In this case, the South African Revenue Service (SARS) would be required to adjust the subsidiary's taxes to account for the IRS's assessment that increased the royalty payment and essentially decreased the amount of South African tax that the supply point should pay, if the scales were to be balanced.³¹¹ If SARS did not agree with the adjustment, both countries' competent authorities would need to be engaged until consensus is reached.

The royalty calculations for the 2007-2009 years that were made using the 10-50-50 method and formed the basis of the IRS assessment were each audited, without adjustments, by the revenue authorities of the 7 states where the supply points were residents. It is uncertain whether these revenue authorities would agree to making the secondary adjustments and whether there would be consensus if competent authority procedures were required (without overlooking the fact that their domestic tax bases do benefit from the lower royalty). The IRS could also refuse to partake in competent authority procedures as it did with Mexico in the 2017 case.

According to the US Technical Explanations for the treaty, a broad interpretation of Art. 9 provides the revenue authorities of the contracting states extensive power to make primary transfer pricing adjustments. As is the case with the OECD Model, "*it is understood, though not explicitly stated, that the adjustments to income provided for in paragraph 1 do not replace, but complement, the adjustments provided for under the internal laws of the Contracting States. The Contracting States preserve their rights to apply internal law provisions relating to adjustments between related parties. They also reserve the right to make adjustments in cases involving tax evasion or fraud. Such adjustments ... are permitted even if they are different from, or go beyond, those authorized by paragraph 1 of the Article, as long as they accord with the general principles of paragraph 1, i.e., that the adjustment reflects what would have transpired had the related parties been acting at arm's length.*" The following is provided as an example, "*while paragraph 1 explicitly allows adjustments of deductions in computing taxable income, it does not deal with adjustments to tax credits. It does not, however, preclude such adjustments if they can.*"³¹² This gives the IRS broad, but not unlimited, authority to apply US laws to the calculation of the royalties between the parent company and its international subsidiaries.

Secondary adjustments are deferred to the domestic law of the State considering making the adjustment (see 0 and **Error! Reference source not found.** below).³¹³ According to the US Treasury, "*when an adjustment under Article 9 has been made, one of the parties will have in its possession funds that it would not have had at arm's length. The question arises as to how to treat these funds. In the United States the general practice is to treat such funds as a dividend or contribution to capital, depending on the relationship between the parties. Under certain circumstances, the parties may be permitted to restore*

³⁰⁷ Department of The Treasury Technical Explanation of The Convention Between The United States of America and The Republic Of South Africa (1998). Art. 9

³⁰⁸ The South Africa - United States Income Tax Treaty (1997). Art. 9(2)

³⁰⁹ Ibid. Art. 9(2)

³¹⁰ Ibid. Art. 9(2)

³¹¹ Ibid. Art. 9(2)

³¹² Department of The Treasury Technical Explanation of The Convention Between The United States of America and The Republic Of South Africa (1998). Art. 9 Paragraph 1.

³¹³ Ibid. Art. 9 Paragraph 1.

the funds to the party that would have the funds at arm's length, and to establish an account payable pending restoration of the funds." The other articles of the treaty would then apply if the adjustment would for example, change the nature of the payment from being a royalty to a dividend subject to withholding tax (Art. 10) or be eligible for a tax credit (Art. 23).³¹⁴

In the hypothetical example, the US would consider South Africa as having in its possession, tax revenue that it would not have had, had the US parent company correctly calculated an arm's length royalty. These funds could be treated as contributions of capital from the parent company. If the situation were reversed, the excessive royalty amount received by the parent could be considered a dividend payment from the subsidiary. The overpayments could be returned so that the income and expense payments would match the tax adjustments.

When competent authorities have agreed to make transfer pricing adjustments, these must be implemented regardless of procedural limitations in domestic law.³¹⁵ The Technical Explanations³¹⁶ provide the example³¹⁷ that *"If a taxpayer has entered a closing agreement ... with the United States prior to bringing a case to the competent authorities, the U.S. competent authority will endeavour only to obtain a correlative adjustment from the South African competent authority and will not take any actions that will otherwise change such agreements."* If the example is reversed for application to the hypothetical case, SARS would have made an adjustment to the taxpayers royalty calculation after the parent company had entered into the closing agreement with the IRS before bringing the case to the US competent authorities. In that case, the US would be required to seek compensation from SARS and not from the taxpayers because the IRS would be required to honour its agreement.³¹⁸

8.3.2 Art. 12: Royalties

The payments made by the subsidiary to the parent company for the use of, or right to use, its patents, trademarks and secret formula would be considered royalties in terms of Art. 12.³¹⁹ It provides that royalties *"derived and beneficially owned"* by a company should only be taxable in that company's resident state. Therefore, the amount of royalties derived and beneficially owned by the South African subsidiary could not be taxed in the US.³²⁰ The IRS could argue that the lower royalty is the result of the special relationship that exists between the associated enterprises and, in that case, South Africa only has the sole taxing right to the extent that the payment represents the appropriate arm's length amount.³²¹ The upwards adjustment would then be taxable in the US according to its tax laws but having *"due regard"* to the other articles of the treaty³²² (such as the one for Associated Enterprises).

³¹⁴ Ibid. Art. 9 Paragraph 2.

³¹⁵ Ibid. Art. 9 Paragraph 2.

³¹⁶ Ibid. Art. 9 Paragraph 2.

³¹⁷ "For example, if the effect of a secondary adjustment is to treat a U.S. corporation as having made a distribution of profits to its parent corporation in South Africa, the provisions of Article 10 (Dividends) will apply, and the United States may impose a 5 percent withholding tax on the dividend. Also, if under Article 23 South Africa would generally give a credit for taxes paid with respect to such dividends, it would also be required to do so in this case."

³¹⁸ "If a correlative adjustment is made under paragraph 2, it is to be implemented, pursuant to paragraph 2 of Article 25 (Mutual Agreement Procedure), notwithstanding any time limits or other procedural limitations in the law of the Contracting State making the adjustment. If a taxpayer has entered a closing agreement (or other written settlement) with the United States prior to bringing a case to the competent authorities, the U.S. competent authority will endeavor only to obtain a correlative adjustment from the South African competent authority and will not take any actions that will otherwise change such agreements. See Rev. Proc. 96-13, 1996-13 I.R.B. 31, Section 7.05." Department of The Treasury Technical Explanation of The Convention Between The United States of America and The Republic Of South Africa (1998).

³¹⁹ The South Africa - United States Income Tax Treaty (1997). Art. 12(2)(a)

³²⁰ Ibid. Art. 12(1)

³²¹ Ibid. Art. 12(4)

³²² Ibid. Art. 12(4)

8.3.3 Art. 1(4): The Savings Clause

The treaty between the US and South Africa contains the traditional “*savings clause*” that is unique to the US and included in all of its treaties³²³ but it is not found in the OECD model convention.³²⁴ It limits the scope of the treaty by allowing the US to retain the right to tax its citizens and residents as if the treaty were not in effect.³²⁵ The savings clause is overridden by the provisions of for Associated Enterprises, the Elimination of Double Tax, and Mutual Agreement Procedures, but not by Art. 12 for Royalties.

When determining the appropriate transfer price for associated enterprises, the treaty requires consideration of the other relevant articles. Art. 12 would need to be consulted in this case of a disputed royalty. Because a special relationship exists between the parties to the royalty in this case, due regard should be had to the relevant provisions of Art. 9 and the savings clause in Art. 1. When Art. 1 is read with Art. 9, one could infer that the intention of the contracting states was that the savings clause would apply when the IRS makes an adjustment to a royalty between two associated enterprises.

However, the primary purpose of the savings clause is for the US to continue to tax its citizens on their worldwide income, regardless of residency, when a treaty provision would otherwise allocate this taxing right to the other Contracting State.³²⁶ Although possible, it is unlikely that the savings clause would influence the outcome of the hypothetical case involving the South African subsidiary.

8.3.4 Art. 23: Elimination of Double Tax

The subsidiary would have deducted the royalty expense from its taxable income when calculating its South African tax liability, resulting in less tax. The same royalty would have been added to the parent company’s income and subject to US tax at the higher rate (see Figure 1.). The subsidiary distributes dividends to the US parent from its after-tax profits³²⁷ and that South African tax is applied as a credit³²⁸ against the parent company’s US tax liability.

The application of the credit method in the US is such that the company would not benefit from the lower tax rate on corporate profits in South Africa (see Figure 1.) because income tax is calculated before the credit is taken into consideration and the payment liability is merely reduced by amounts of tax already paid (albeit in the foreign country).

Figure 1. Corporate Tax Rates in South Africa and the US for 2007-2009³²⁹

³²³ Department of The Treasury Technical Explanation of The Convention Between The United States of America and The Republic Of South Africa (1998).

³²⁴ J.A. Becerra, Chapter 1: Early Tax Treaty Developments and Interpretation Principles in Interpretation and Application of Tax Treaties in North America (Second Revised Edition) (IBFD 2013), Books IBFD (accessed 1 Dec. 2021).

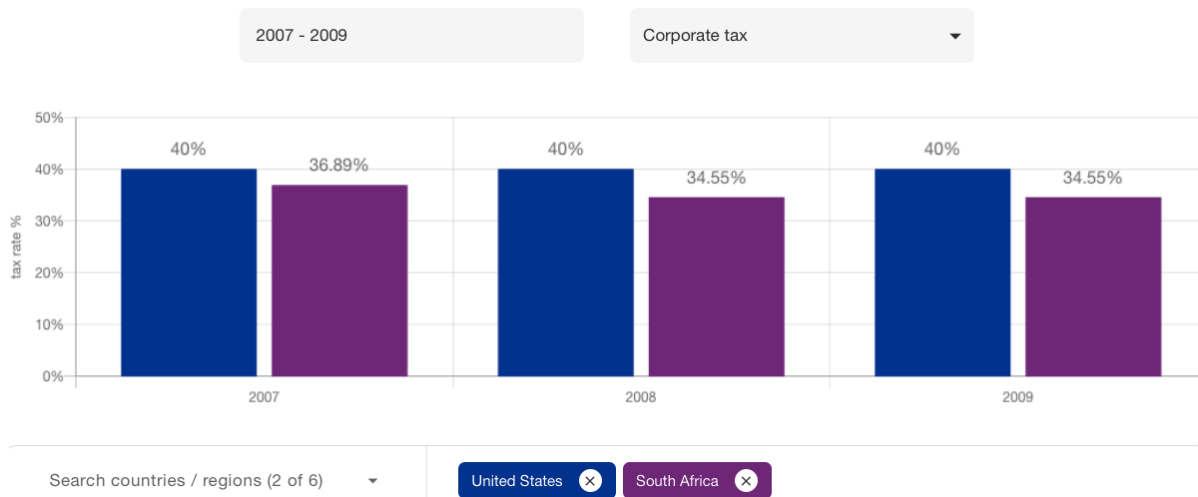
³²⁵ The South Africa - United States Income Tax Treaty (1997). Art. 1(4)

³²⁶ J.A. Becerra, Chapter 1: Early Tax Treaty Developments and Interpretation Principles in Interpretation and Application of Tax Treaties in North America (Second Revised Edition) (IBFD 2013), Books IBFD (accessed 1 Dec. 2021).

³²⁷ The South Africa - United States Income Tax Treaty (1997). Art. 23(1)(b)

³²⁸ Ibid. Art. 23(3)

³²⁹ KPMG Tax Rates Online (2021); <https://home.kpmg/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online.html>.



Like Art. 24 of the Mexican treaty,³³⁰ the credit that is provided for in Art. 23 is subject to the limitations imposed by US law so the taxpayer would be in the same position as if the US domestic Foreign Tax Credit had applied. The IRS still has discretion to consider whether the foreign taxes meet the criteria provided for in section 901, including that the payment be considered a ‘tax’ in the US sense. For that there must be a ‘compulsory’ South African tax liability that the company has calculated based on a reasonable interpretation and application of the South African Income Tax Act, exhausting all effective and practical remedies to reduce this foreign tax burden over time.³³¹

Provided that the taxpayer followed the same procedures that it did when it calculated its Mexican tax liability, if the supply points in the 2020 case were residents of South Africa or another country with a similar treaty with the US, the same justification for the ruling in favor of the taxpayer in the 2017 case would apply and the Court would not be able to uphold the same decision that it made in favor of the IRS in the 2020 case.

8.3.5 Mutual Agreement Procedures

Regardless of the remedies in US domestic legislation, when the taxpayer determines that the revenue authority’s transfer pricing adjustment violates the arm’s length principle, it has the right to present its case to the competent authorities of the US, South Africa, or Mexico as the case may be. In the 2017 case, both the parent company made this appeal to the IRS and the Mexican licensee to the SAT. If the complaint “*appears*” to the competent authority to be “*justified*”, it “*shall endeavour*” to come to a solution by mutual agreement with the competent authority of the other state.³³² Although theoretically conclusive, in practice the IRS rejected these requests without providing reason other than that it had “*designated for litigation the issue pertaining to the transfer pricing adjustments for tax years 2007, 2008, and 2009.*”³³³ This measure to prevent double tax and promote fair administration of international tax laws proved ineffective so it leaves room to doubt whether the mechanism would be more resolute in the hypothetical case involving South Africa.

8.4 Conclusion

The facts of the cases against the taxpayer and the justification for Judge Lauber’s ruling in each was compared to what could be expected to be the outcome of the 2020 case, had the supply point/s been

³³⁰ Art. 24 of the United States – Mexico Income Tax Convention (1992).

³³¹ s901-2(e)(5)(i).

³³² Art. 26(2) of the United States – Mexico Income Tax Convention (1992).

³³³ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15. Page 12

covered by a treaty based on the US Model Convention. The finding was that if the 2020 involved supply points that were covered by the treaty, the outcome would likely have been in favor of the taxpayer as it was in 2017, rather than in favor of the IRS as was decided in 2020. The next chapter considers other what factors, over and above a treaty, would influence the outcome of future transfer pricing disputes.

Chapter Nine

Country Comparisons

9.1 Introduction

The unique provisions contained in the US Model are relevant given that most of the largest multinationals either operate or are based in the US. Of the countries involved in these cross-border operations, many have adopted the OECD and UN transfer pricing guidelines, whether or not they are members of the OECD. The principles may not necessarily be codified as law and can merely be partially or fully adhered to. The following is an analysis of the nuances that arise in transfer pricing decisions in South Africa, Malawi and Zambia that could be useful for approaching similar issues in other African countries as well.

9.2 Transfer Pricing in South Africa

As with most countries (other than the US, see 4.7.1 above), South Africa has incorporated the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations into its domestic transfer pricing law.³³⁴ The provisions are contained in section 31(2) of the Income Tax Act and should be read with SARS Interpretation Note 7.³³⁵ The principles have wide application and the SARS Commissioner would have discretion to make a transfer pricing adjustment to increase or decrease the royalty between the 'connected persons' to reflect an arm's length price.³³⁶

The same basic principle applies that *"the transaction should have the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost possible benefit from the transaction."*³³⁷ SARS recognizes that *"The problem to be resolved is how a multinational should determine what price would have arisen if transactions between its members were subject to market forces."*³³⁸ It provides that *"The solution advanced by the arm's length principle is that a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the multinational's prices (the controlled transaction). ... An arm's length price that will reflect the economic contributions made by the parties to the transaction can be determined for the controlled transaction."*³³⁹

These issues are central to the 2020 case. The taxpayer and its experts provided ample evidence that the bottlers were not 'independent' for the purpose of the analysis and difficulty quantifying the economic contributions of the supply points compared to those of the parent company is exactly what this case is about. The OECD and SARS both acknowledge that other non-tax considerations *"such as governmental*

³³⁴ Silke on International Tax (2021); § 10.1 Introduction South African transfer pricing provisions; <https://www-mylexisnexis-co-za.ezproxy.uct.ac.za/Index.aspx?permalink=SVNpbGtliENoIDewLjEkNDA1ODQ1MSQ3JExpYnJhcnkkSkQkTGlicmFyeQ>.

³³⁵ Silke on International Tax (2021); § 10.2 The law and practice; <https://www-mylexisnexis-co-za.ezproxy.uct.ac.za/Index.aspx?permalink=SVNpbGtliENoIDewLjEkNDA1ODQ1MSQ3JExpYnJhcnkkSkQkTGlicmFyeQ>.

³³⁶ South African Income Tax Act 58 of 1962. S31(2).

³³⁷ SARS Practice Note No. 7 (6 August 1999); Section 31 of The Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing; <https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf>. Para 7.1

³³⁸ Ibid. Para 7.3

³³⁹ Ibid. Para 7.3

regulations (for example price or exchange controls) may distort prices charged between connected persons."³⁴⁰ Dr. Silva (see page 43) specifically highlighted how the unique market forces in Brazil made the comparatives used inappropriate and the existence of a suitable comparison almost impossible. This "solution"³⁴¹ may create more problems than it solves.

What it seems the case is lacking is what, although not legally binding, the Practice Note aims to provide. That is "*broad guidelines about the business and economic concepts which serve to indicate what information, data and other evidence would support a contention that a transaction has occurred at arm's length.*"³⁴²

As if speaking directly on the 2020 case, the note provides that "*The objective of comparability is to always seek the highest practical degree of comparability, recognizing though that there will be unique situations and cases involving unique intangibles where it is not practicable to apply methods based on a high degree of comparability.*"³⁴³ There would be a strong argument in a South African court that the effectiveness of the CPM directly relies on the degree of comparability and that the bottlers would fail to meet these criteria for the reasons mentioned above (see page 43).

As to the terminability of the agreements, the OECD guidelines provide that in a functional analysis of the transaction, to consider whether the risk undertaken by each party is consistent with the substance of the transaction, "*the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk.*"³⁴⁴ With nothing more than a common understanding of the Coca-Cola system and the numerous examples of how it has maintained decade-long relationships with its supply points (with specific mention to Ireland and Costa Rica above), it would be challenging to present a strong case that that 1) The parent company was unlikely to continue these relationships beyond the 12-month contract terms and that 2) the fact that the contracts were technically terminable at the will of the company did not increase the stakes for the supply points, rather it reduced their downside risk (see Terminability of the Licence Agreements above).

The SARS Practice Note includes the relevant factors that should be identified for a market analysis of a potentially suitable comparative.³⁴⁵ These include the geographic location, size, competitiveness, availability of substitutes, and costs of transportation, of the market, as well as what level³⁴⁶ (such as manufacture, retail, wholesale, or logistics etc.) the comparative is at in the market. It is not unique to South Africa but common to the supply point countries that "*these factors may have a particular importance...Because South Africa is a small country, it may be difficult to obtain comparables from the South African market.*"³⁴⁷ Yet the IRS almost completely disregarded the geographic locations and competitiveness of the oligopolist bottlers as discussed by Dr. Silva (see page 43), as well as the smaller sizes of these developing countries when compared to many of the comparatives from developed countries used in Dr. Newlon's analysis (see Dr. Newlon's CPM above).

The Practice Note also mentions that the business strategies of the parties could provide useful information as to their comparability.³⁴⁸ The supply points merely serve the Coca-Cola bottlers in their territory, yet the bottlers aim to penetrate and grow the consumer and retail markets at every level.

³⁴⁰ Ibid. Para 7.5

³⁴¹ Ibid. Para 7.5

³⁴² Ibid. Para 7.5

³⁴³ Ibid. Para 8.1.4

³⁴⁴ Ibid. Para 8.3.8

³⁴⁵ Ibid. Para 8.3

³⁴⁶ Ibid. Para 8.4.2

³⁴⁷ Ibid. Para 8.4.3

³⁴⁸ Ibid. Para 8.5.1

It is not for the author of this dissertation to determine what the outcome of the 2020 case would be had it involved a South African supply point. The point being made here is that if this were taken to mutual agreement procedures between the competent authorities of SARS and the IRS, SARS would have a lot of room to present a strong case against lowering the royalty and limiting its source taxing rights. As South Africa, and many of the supply point countries that were not adjusted by the IRS, have all similarly adopted the OECD guidelines, one could see how it could be futile for the IRS to attempt to make those transfer pricing adjustments that rely on mutual agreement with its treaty partners that have the incentive to increase their own tax bases.

9.3 Transfer Pricing in Other African Countries

In the 2020 case, the Judge stated that, to consider whether the revenue authority had abused its discretion, the Court must focus on the reasonableness of the result of the IRS's assessment, rather than on the specifics of the methodology it used.³⁴⁹ This was the central point of the taxpayer's first argument in its Motion for Reconsiderations of Findings submitted in 2021.³⁵⁰

In South Africa, administrative law remedies would be pursued to address concerns over 'reasonableness', not substantive tax laws.³⁵¹ This differs from the approach in the US where the actual amount of tax due from the taxpayer was determinant on the procedures followed by IRS.³⁵²

Similar to those in the US and South Africa, taxpayers of Malawi are required to determine the transfer price by applying "*the method most appropriate*" from a list of allowable methods provided by its domestic regulations.³⁵³ Although all of its (only 6) tax treaties follow the OECD Model, the outcome of a 2018 case showed that these guidelines are not given the same status of law³⁵⁴ that they hold in South Africa (reference to Practice Note 7 that is not legally binding but has been consistently adhered to) and elsewhere.

The Judge in the case emphasised the fact that it was not the Court's responsibility to determine the correct transfer price, but rather to evaluate how the revenue authority selected and applied the method that it used to impose an additional assessment on the Taxpayer.³⁵⁵

The conflict in this case was interesting in that the taxpayer followed the Tax Act and Regulations by applying the 'method most appropriate', which it selected from the prescribed list. The revenue authority made its assessment based on a different method that it determined to be appropriate by clearly favouring the OECD Transfer Pricing Guidelines over the domestic regulations.

In an IBFD publication on the use of OECD guidelines by revenue authorities³⁵⁶, commentators Roeleveld and Johnson noted that although, by ruling in favor of the taxpayer, the outcome was in accordance with the 'method most appropriate' requirement, the Court in Malawi had based its decision on the incorrect assertion that applying the OECD guidelines went against the laws of the country.³⁵⁷ It was not the use of the OECD methodology that was disallowed, but rather the total disregard of the Taxpayer's method in

³⁴⁹ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Page 90

³⁵⁰ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

³⁵¹ Prof. Hattingh, J (UCT) (1 February, 2022)

³⁵² Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

³⁵³ Malawi: The Taxation Act and Taxation (Transfer Pricing) Regulations of 2009. Section 6(1).

³⁵⁴ J. Roeleveld & T. (Tracy) Johnson, OECD Transfer Pricing Guidelines are not law in Malawi in Tax Treaty Case Law around the Globe 2019 (M. Lang et al. eds., IBFD 2020), Books IBFD (accessed 7 Feb. 2022). Part 1

³⁵⁵ Ibid. Part 3

³⁵⁶ Ibid.

³⁵⁷ Ibid.

favor of a different one.³⁵⁸ The domestic laws are what afford the revenue authority its powers to make an additional assessment. Because the OECD guidelines are not codified into the tax laws of Malawi, the Commissioner erred by misusing them in place of the law and by relying on them as something more than the interpretative tool that they are.³⁵⁹

The case illustrates that regardless of whether a revenue authority applies domestic legislation or the OECD Transfer Pricing guidelines, it should still not have full discretionary power to determine a particular transfer price.³⁶⁰

The OECD guidelines are also not legislated in the US where the cases were brought against Coca-Cola. The principles that have come out of the Malawi case are relevant to the US taxpayer's argument that, over and above the IRS's methodology being unjustified, its 'arbitrary and capricious' disregard of the taxpayer's method was unlawful.³⁶¹ If this case was to come under a judicial review of the "*decision-making process and not the merits of the decision itself*,"³⁶² the outcome could be that the IRS also lacks the full discretionary power to determine the transfer price and disregard the taxpayer's method (that was found by a previous Court to be the result of a reasonable interpretation of the law) in favor of the CPM, despite that being a method sanctioned by the OECD.

A later case in Zambia³⁶³ further showed that if the taxpayer's method of calculating a transfer price was to be considered reasonable, then a tax authority would be prevented from disregarding that method for another one that would allow it to collect more tax revenue.³⁶⁴

9.4 Conclusion

The purpose of this chapter was to consider how the OECD and UN transfer pricing guidelines would influence a future transfer pricing decision on similar facts to the one's addressed in the case studies that could manifest in other countries, particularly in African countries. The analysis of transfer pricing in South Africa, Malawi and Zambia were useful examples of how these issues may be addressed or resolved in countries that may not be members of the OECD, or have the OECD model transfer pricing regulations fully adopted as law.

³⁵⁸ Ibid.

³⁵⁹ Ibid.

³⁶⁰ Ibid.

³⁶¹ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

³⁶² J. Roeleveld & T. (Tracy) Johnson, OECD Transfer Pricing Guidelines are not law in Malawi in Tax Treaty Case Law around the Globe 2019 (M. Lang et al. eds., IBFD 2020), Books IBFD (accessed 7 Feb. 2022).

³⁶³ Nestlé Zambia Trading Limited v. Zambia Revenue Authority (2019).

³⁶⁴ J. Roeleveld & T. (Tracy) Johnson, OECD Transfer Pricing Guidelines are not law in Malawi in Tax Treaty Case Law around the Globe 2019 (M. Lang et al. eds., IBFD 2020), Books IBFD (accessed 7 Feb. 2022). Part 5

Chapter Ten

Conclusion

10.1 Introduction

Developments in the international tax environment raised the question of whether opportunities for double non-tax were being replaced with greater risks of double tax.³⁶⁵ Understanding the meaning of fairness³⁶⁶ inspired this research, which aimed to perform a case study analysis on the landmark tax case against The Coca-Cola Company that resulted in the largest transfer pricing adjustment in history,³⁶⁷ and, in light of selected shifts in the international tax regime, consider the determination of an arm's length price will be affected. The analysis further intended to provide guidance to international taxpayers wanting to avoid a legal dispute or preparing a case for Court, specifically in countries where there is a lack of transfer pricing case law, such as South Africa.³⁶⁸

10.2 Overall Research Findings

The Judge in the first case that was studied ruled in favor of the taxpayer. Three years later, the same Judge ruled in favor of the revenue authority. Both cases were based on the same multinational controlled group structure and a similar set of facts. They differed in that the first case involved a branch that was covered by a tax treaty, whereas the second case involved foreign subsidiaries without access to a treaty. The taxpayer has submitted its appeal against the unique and unprecedented tax ruling, stating that it “*raises fundamental questions of tax, administrative, and constitutional law.*”³⁶⁹

The Coca-Cola Company & Subsidiaries V. The IRS (2017)

The revenue authority argued that the taxpayer calculated a royalty that was below the arm's length amount. The foreign tax credit was disallowed because an overpayment of foreign taxes is ‘non-compulsory’ and not considered ‘taxes’ in terms of domestic law. It was held that the taxpayer made a reasonable interpretation of the law and had exhausted all the effective and practical remedies that were available.³⁷⁰

The Coca-Cola Company & Subsidiaries V. The IRS (2020)

The taxpayer made two distinct legal arguments. The first was that the revenue authority abused its discretion to reallocate income because its disregard of the taxpayer's transfer pricing method was ‘arbitrary’ and ‘capricious’. The second was that the new transfer pricing methodology adopted by revenue authority was erroneous and not appropriate to calculate the arm's length price. The taxpayer offered three alternative methods. The Court focused on the reasonableness of the result of the transfer price adjustment, rather than on the specifics of its methodology, and held that the revenue authority had not abused its discretion.³⁷¹

The Taxpayer's Appeal

³⁶⁵ 2.2.1 A Brief History of International Taxes

³⁶⁶ 3.1 Introduction

³⁶⁷ 2.3 The Coca-Cola Transfer Pricing Cases

³⁶⁸ 3.3 Research Aim

³⁶⁹ For reference, please see The Coca-Cola Transfer Pricing Cases

³⁷⁰ For reference, please see Chapter Five

³⁷¹ For reference, please see Chapter Six

The taxpayer again put forward two distinct legal arguments. It firstly claims that the revenue authority acted unlawfully by disregarding foundational legal principles and that its actions against the company were unconstitutional. Secondly, the taxpayer argues that the revenue authority adopted a transfer pricing method that was incorrect as a matter of law. The outcome of the appeal is pending.³⁷²

10.3 Research Conclusions

The Coca-Cola Company & Subsidiaries V. The IRS (2017)

The Judge's reasoning for ruling in favour of the taxpayer in 2017 inferred that taxpayers that make every reasonable attempt to accurately interpret and apply the law to calculate an appropriate arm's length price would prevent a transfer pricing dispute and are "*not required to take futile additional administrative steps.*" If the revenue authority still issued an unfavourable assessment, the taxpayer has the right to invoke Competent Authority Procedures and expect the matter to be resolved through Mutual Agreement. If the revenue authority were to refuse, it would be "*in a poor position to contend that [the taxpayer] has failed to exhaust all remedies when, by his unilateral action, [the revenue authority] has made it impossible for [the taxpayer] to pursue the only remedy that exists,*"³⁷³ and the assessment would not be upheld.

The Judge also stated that if the revenue authority wishes to meet the fiscal demands,³⁷⁴ it "*should seek an amendment to the final regulations. That is a task for the Secretary of the Treasury, not this court.*" The finding is that expanding the tax base requires a commitment to improving the legal framework.

The findings of this case could have been relied on by other taxpayers seeking guidance on how to properly approach the arm's length calculation and implement a robust transfer pricing structure that would not come under undue scrutiny. Instead, further research shows that this case is rather a cautionary example for international taxpayers.

The Coca-Cola Company & Subsidiaries V. The IRS (2020)

After studying the decision made in 2017, the unfavourable outcome for the taxpayer in the 2020 case, which was based on a similar set of circumstances, was unexpected. The taxpayer calculated its arm's length price for the same period that was the subject of the 2017 case, using the same method that the Judge had considered reasonable. However, the subject of this case was seven subsidiaries that (unlike the branch in the first case) were not covered by a double tax treaty and the remedies that would otherwise be afforded by a treaty were not available to the taxpayer.

Merely proving that a reasonable attempt was made by the taxpayer showed to be insufficient to allow the Court to rule in its favour. Domestic law provided the revenue authority with broad powers to exercise its judgement. The adjustments that it made were final, unless the taxpayer could provide clear proof that the decision was arbitrary, capricious, or a mistake of law. There was a "*heavy burden*" on the taxpayer that was required to provide "*substantial evidence.*"

The foundational principles that support the notion of a 'practice generally prevailing' in South African tax law cannot be expected in the United States where the taxpayer was unable to rely on any inference drawn regarding the intention of the revenue authority from its continued acceptance of an agreed upon methodology that was "*outside of the four corners*" of their agreement.

The Taxpayer's Appeal

³⁷² For reference, please see Chapter Seven

³⁷³ *The Coca-Cola Company & Subsidiaries V. The IRS (2017)*; 149 T.C. No. 21; Docket No. 31183-15. Page 25

³⁷⁴ For reference, please see Introduction

Studying the outcomes of the 2017 and 2020 cases raised fundamental questions about transfer pricing tax laws and the constitutional values that govern the conduct of revenue authorities. The appeal highlights a potentially serious risk to international taxpayers that is best described by Judge Kavanaugh,³⁷⁵ who explains that when a “government agency officially and expressly tells you that you are legally allowed to do something, but later tells you ‘just kidding’ and enforces the law retroactively against you and sanctions you for actions you took in reliance on the government’s assurances, that amounts to a serious due process violation.” If this appeal is unsuccessful, taxpayers intending to rely in good faith on the representations and conduct of a revenue authority have been warned of an “open season” for entrapment.³⁷⁶

When questioning the principle of fairness, one would expect that all parties would deserve consideration, including corporate taxpayers. In its Constitutional argument in the 2021 Motion for Reconsideration of the Courts, Coca-Cola is essentially asking for the foundational principles of American and civil society to be extended to it as a rightful taxpayer. As it put in its introductory remarks,³⁷⁷ America is “a government of laws and not of men.”³⁷⁸

There does not seem to be evidence that the taxpayer violated international laws or common legal principles. Instead, it is the taxpayer that has provided evidence to the Courts of legal errors and violations on the part of the revenue service. If this is true, as may be settled by the 11th District Court, then is it not a substantial upgrade of the international tax framework that is need. Rather the abusive invocation of the powers inferred to the revenue services for the limited purpose of only enforcing the existing legal framework should be addressed.³⁷⁹

One of the well-established mechanisms to promote fairness in the international tax system is the option to invoke competent authority procedures, yet here the IRS denied the taxpayer’s request without providing any reason at all. Another is the specific transfer pricing methodologies that apply to royalties and are intended to fairly distribute revenues to where intangible asset investments have been made. Instead of appealing to the Judiciary to amend these laws to improve clarity and reduce subjectivity, the IRS has attempted to manipulate these laws to retroactively target a taxpayer for merely continuing to do what the IRS itself had approved for almost a decade.³⁸⁰

Without the need for IRS intervention, the OECD and G20 have long been working on such an overhaul with the mission to make fairness part of the international tax system.³⁸¹

Treaty Considerations

An analysis of these cases cannot ignore the fact that, after the revenue authority lost its case in 2017, partly because it refused to engage in mutual agreement proceedings, the 2020 case involved only the seven subsidiaries that were not covered by a treaty. The research on the transfer pricing guidelines provided by the OECD and adhered to by countries, such as South Africa, that are treaty partners with the United States, leads to the conclusion that the US tax authority would have been less likely to succeed in the 2020 case if the subsidiaries were covered by the treaty provisions that have been studied. Each of the revenue authorities from the seven countries audited the taxpayer’s calculation of an arm’s length

³⁷⁵ PHH Corp. v. CFPB, 839 F.3d 1, 48 (D.C. Cir. 2016) (Kavanaugh, J.), reinstated in pertinent part on reh’g en banc, 881 F.3d 75, 83 (D.C. Cir. 2018) (en banc).

³⁷⁶ For reference, please see Chapter Seven

³⁷⁷ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Page 4

³⁷⁸ Mass. Decl. of Rights, pt. 1, art. 30 (John Adams).

³⁷⁹ For reference, please see Chapter Seven

³⁸⁰ For reference, please see Chapter Seven

³⁸¹ For reference, please see Chapter Seven

transfer price based on the method, without adjustment. It would have been highly unlikely that the competent authorities of these states would have approved the US tax authority's adjustments if they had engaged in mutual agreement procedures. The research finding is that the revenue authority's victory in the 2020 case (and its loss in 2017) shows a strong correlation to the existence, or non-existence, of a double tax treaty.³⁸²

Transfer Pricing in South Africa

Part of the aim of this research was to provide insight on how foreign tax decisions could influence thinking on transfer pricing disputes in South Africa. The Malawi case study warns that regardless of a consistent adherence to the OECD guidelines, South Africa's outdated guidance and lack of recorded case law leaves taxpayers with no certainty as to how the determination of an arm's length price will be approached by the country's revenue authority going forward.³⁸³

10.4 Conclusion

The overall conclusion on the research findings has been a warning to taxpayers to expect uncertainty in future transfer pricing decisions.

As the Coca-Cola transfer pricing cases unfolded, and during the time that the research for this dissertation was performed, the shifts in the international tax regime that it aimed to study continued to progress at an unprecedented rate; the announcements made in 2021 alone could make it the most pivotal year in international tax history. This process has inadvertently raised ancillary issues that require further investigation in allied fields.

The most recent developments in the international tax regime are not only designed to directly solve the transfer pricing problems addressed in this dissertation but go as far as aiming to be the solution to tax fairness that this dissertation could not even begin to address. As any scholar of international tax is expected to do, further research on these developments has been done and is contained in the epilogue that follows.³⁸⁴

³⁸² For reference, please see Chapter Eight

³⁸³ For reference, please see Chapter Nine

³⁸⁴ For reference, please see Epilogue

Epilogue

Introduction

The recognition of fiscal demands influencing revenue authorities that were noted in the introductory chapters is directly addressed by the OECD that stated that this most recent international tax reform initiative “will provide much-needed support to governments needing to raise necessary revenues to repair their budgets and their balance sheets while investing in essential public services, infrastructure and the measures necessary to help optimise the strength and the quality of the post-COVID recovery.”³⁸⁵ This dissertation has considered the past to attempt to understand the future of transfer pricing. From the outset, it shared the inspiration that is embodied in this statement made by the OECD a month after it first announced the adoption of the global minimum tax that forms part of its “new two-pillar plan to reform international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate.”³⁸⁶

The Two Pillar Solution – An International Tax “Solution” for Fairness?

On 8 October 2021, jurisdictions comprising more than 90% of global GDP and represented by 136 countries (out of the 140 OECD members)³⁸⁷ agreed to finalise the OECD’s ‘Statement on the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy’ that aims to “fundamentally reform international tax rules” and “make our international tax arrangements fairer and work better.”³⁸⁸

The global minimum tax of 15% contained in Pillar Two will be imposed on all MNEs with revenue above €750 million to ensure that companies pay their fair share of taxes. For those taxing rights to be more fairly distributed among countries,³⁸⁹ 25% of profit above the 10% threshold will be redistributed by Pillar One from resident to source states, for MNEs with global sales of more than €20 billion that are specifically targeted as the “winners of globalisation”. The OECD will create “model rules” to provide guidance to countries on how to integrate Pillar Two into domestic legislation during 2022 so that it can be effective as early as 2023.

Relevant proposals in the plan includes the simplification of the arm’s length principle, the ‘subject to tax rule’, and the specific carve out.

The new “simplified and streamlined” “formulaic approach” to applying the arm’s length principle to “in-country baseline marketing and distribution activities” is specifically intended to benefit low capacity and developing countries that otherwise have difficulty implementing the existing transfer pricing rules.

The ‘subject to tax rule’ will be required to be implemented in existing treaties between developing countries and all countries that tax royalties (and other types of payments that are commonly base-eroding) at a rate below 9%. It will introduce a limited source tax to protect the taxing rights of developing countries. The rule also aims to prevent treaty abuse by companies that have long avoided tax

³⁸⁵ The OECD (01/07/2021); 130 countries and jurisdictions join bold new framework for international tax reform; <https://www.oecd.org.ezproxy.uct.ac.za/tax/beps/130-countries-and-jurisdictions-join-bold-new-framework-for-international-tax-reform.htm>.

³⁸⁶ Ibid.

³⁸⁷ Kenya, Nigeria, Pakistan and Sri Lanka have not agreed to participate

³⁸⁸ OECD (08/10/2021); International community strikes a ground-breaking tax deal for the digital age; <https://www.oecd.org/tax/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm>.

³⁸⁹ Ibid.

on profits from developing countries by deducting royalties and taking advantage of minimal treaty withholding rates, as well as the little to no tax that is imposed in the resident States.

There will be a specific carve-out of the 15% minimum tax that will allow tax incentives that support “*substantial business activities*” with “*real [economic] substance*,” such as “*investing in a factory*.”

Countries around the world can expect an additional \$150 billion of annual revenue from the new global minimum tax on MNEs from 2023, \$125 billion of which will be coming from the world’s 100 largest companies. Reallocations of these profits from resident states to market jurisdictions is intended to result in more significant benefits for developing countries, especially in relation to the digital economy where most companies now participate in some way or another.³⁹⁰

The objective is to promote fairness in the international tax system.

Alignment (or Misalignment) with the Coca-Cola Cases

The US is the home of The Coca-Cola Company. Ireland, Brazil, Mexico, Swaziland, Chile, Costa Rica, and Egypt are the market jurisdictions where the supply points conduct their business operations and marketing activities. Except for Ireland, which has a developed economy and a tax rate of 12,5%, the other market jurisdictions are developing countries that have maintained corporate tax rates well-above 15% since 2007.³⁹¹ The United States is the largest economy in the world, Brazil is 12th and Mexico is 16th,³⁹² neither Ireland nor any of the other supply point territories come within the top 20 in terms of GDP.³⁹³

It is worth considering whether the case against Coca-Cola is aligned (or misaligned) with the worthy objectives of the “*solution*,” or whether the move would be considered outdated in terms of revolutionised tax philosophies. Firstly, the direct result of an IRS victory would be to increase the US tax base by reallocating revenue from the mostly developing source countries. None of these countries have treaties with the US that the company could use to take advantage of any reduced royalty withholding taxes.

Since 1996 the company has used the simple 10-50-50 formula to determine its royalty. This has been accepted by the revenue authorities in the supply point countries with no suggestion that this formulaic approach has been difficult for them to implement (there have been cases against the Coca-Cola taxpayers in these countries). The 7 pages³⁹⁴ used by the Judge to describe the analysis performed by Dr. Newlon certainly does not seem simple or practical for the source countries to replicate, especially when considering the number of complicated and unique MNCs that operate in the developing world.

Finally, long before these outcomes became formal objectives of the OECD that were documented in this proposal, The Coca-Cola Company, through globalisation and as one of its “*winners*”, has been providing developing countries with significant “*genuine, substantive foreign direct investment*”³⁹⁵ through, *inter alia*, the supply points that “*invest in factories*” and conduct business and marketing “*activities that have*

³⁹⁰ Ibid.

³⁹¹ See Figures 1 and 2

³⁹² Research FDI (8 February 2021); The top 20 largest economies in the world by GDP; <https://researchfdi.com/world-gdp-largest-economy/>.

³⁹³ Ibid.

³⁹⁴ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Pages 79-85

³⁹⁵ OECD/G20 Base Erosion and Profit Shifting Project (October 2021); Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy; <https://www.oecd.org/tax/beps/brochure-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf>

real substance."³⁹⁶ Execution of marketing, sales, and finance by the employees of the supply points in Brazil, Chile and Egypt were afforded specific recognition by the Court, as previously mentioned.³⁹⁷

When its initial investment of \$50 million in a new concentrate plant in Costa Rica was announced in 2018, the President *"thanked the company's decision to expand its presence in the country by constructing this plant, which will significantly impact local economic development."*³⁹⁸ This is just one of so many examples [that it is not be necessary to make specific mention of any others] of the impact that this winner of globalisation makes around the world.

Closing Remarks

This dissertation concluded with warnings to international taxpayers that are required to calculate arm's length transfer prices. However, now that the OECD has the support of The United States, the discussions that have been taking place on an international scale, with announcements made in 2021, create the hope that the mission to promote fairness in the international tax system could be accomplished.

³⁹⁶ Ibid.

³⁹⁷ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>. Page 65

³⁹⁸ CINDE (2018); Coca-Cola begins to construct its most innovative concentrates plant in Liberia, Guanacaste; <https://www.cinde.org/en/essential-news/cocacola-begins-to-construct-its-most-innovative-concentrates-plant-in-liberia-guanacaste>.

References

12.1 Appendices

12.1.1 Appendix 1: Summary of The Coca-Cola Company & Subsidiaries V. The IRS (2017)

The IRS argued that the company reported a royalty that was *below the arm's length amount* by not using the CPM.³⁹⁹

The judge held that The Coca-Cola Company

- calculated its taxes “in a manner that is consistent with a reasonable interpretation and application of the...provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time...[its] reasonably expected liability under foreign law for tax,” and further, that
- it had “exhaust[ed] all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time...[its] liability for foreign tax,” as required by the Treasury regulations.⁴⁰⁰

12.1.2 Appendix 2: Summary of The Coca-Cola Company & Subsidiaries V. The IRS (2020)

Coca-Cola argued that, not only did it err in doing so, the IRS abused its discretion to reallocate income by applying the CPM and that its decision to disregard the transfer pricing methodology contained in the closing agreement was arbitrary and capricious, and that the bottlers were not appropriate comparatives because they do not have the same ownership of immensely valuable intangible assets that the supply points have.⁴⁰¹ The three alternative methods presented by its experts were the CUT, RPSM, and Asset Management Model (the “Unspecific Method”), which the company urged the court to consider.⁴⁰²

The court held that the IRS in fact did not abuse its discretion when it adopted the CPM method and used the independent Coca-Cola bottlers as the uncontrolled comparable parties in the formula.

Petitioner's Arguments

A. Supposed “Marketing Intangibles”

1. Legal Ownership
2. Economic Substance
 - a. Setting Aside Contract Terms
 - b. Consistency With Economic Substance
- B. Supposed “Long-Term Licenses”

C. Royalties Payable by Brazilian Supply Point

1. Ownership of Brazilian Trademarks
2. Brazilian “Blocked Income”

D. Bottlers' Ownership of Intangibles

³⁹⁹ The Coca-Cola Company & Subsidiaries V. The IRS (2017); 149 T.C. No. 21; Docket No. 31183-15.

⁴⁰⁰ Ibid.

⁴⁰¹ United States - IRS Wins USD 3 Billion Transfer Pricing Case Against Coca-Cola (20 Nov. 2020), News IBFD (accessed 17 Nov. 2021).

⁴⁰² The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15.

E. Proposed Alternative Transfer Pricing Methodologies

1. Proposed CUT Method
2. Proposed “Residual Profit Split Method”
3. Proposed “Unspecified Method”

12.1.3 Appendix 3: Summary of Motion for Reconsideration of Findings (2021)

In its most recent filing, Coca-Cola argues firstly that the IRS acted unlawfully. It disregarded the foundational principle when it failed to respect and account for the company’s reasonable reliance interest that had been created; its decision to abandon its established position and retroactively apply a new one was arbitrary and capricious; and this ‘bait-and-switch’ was unconstitutional. Secondly, it argues that the IRS violates Treasury Regulations because ultimately, as a matter of law, the CPM is not appropriate.⁴⁰³

ARGUMENT

I. The IRS acted unlawfully in retroactively imposing Dr. Newlon’s CPM after leading Coca-Cola to reasonably rely on the 10-50-50 method to calculate the Company’s taxes.

- A. Well-established principles require agencies to respect and account for a regulated party’s reasonable reliance interests created by the government.
- B. The IRS’s change in position and retroactive imposition of Dr. Newlon’s CPM was arbitrary and capricious.
 1. The IRS’s course of conduct over more than a decade created reasonable reliance interests on Coca-Cola’s part in the propriety and use of the 10-50-50 method
 2. The IRS’s sudden and unwarned change in position was arbitrary and capricious
 3. The IRS’s abrupt change in position was arbitrary and capricious for the additional reason that it resulted in the agency’s simultaneous advancement of inconsistent positions.
- C. The IRS’s bait and switch violates the Constitution of the United States

II. The IRS’s application of Dr. Newlon’s new method violates the Treasury Regulations by failing to credit the Supply Points’ valuable intangibles and marketing contributions.

- A. Contrary to the Treasury Regulations, the Court erroneously concluded that the Supply Points owned no intangibles and were not otherwise entitled to any compensation for contributing to the value of Coca-Cola’s brands.
 1. The Court contravened the Treasury Regulations by failing to account for the Supply Points’ licenses to use Coca-Cola’s trademarks
 2. The Treasury Regulations likewise required compensation for the Supply Points even if all they did was add value to Coca-Cola’s trademarks.
 3. The Court’s failure to account for the Supply Points’ ownership of goodwill also contravened the Treasury Regulations
- B. The Court’s contrary reasoning is incompatible with the Treasury Regulations, the caselaw, and economic substance.
- C. Dr. Newlon’s CPM is the wrong method as a matter of law.

⁴⁰³ Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161 (06/02/21); Electronically Filed Docket No. 31183-15; <https://aboutbtax.com/XSP>.

12.2 Table of Figures

Figure 1. Corporate Tax Rates in South Africa and the US for 2007-2009⁴⁰⁴

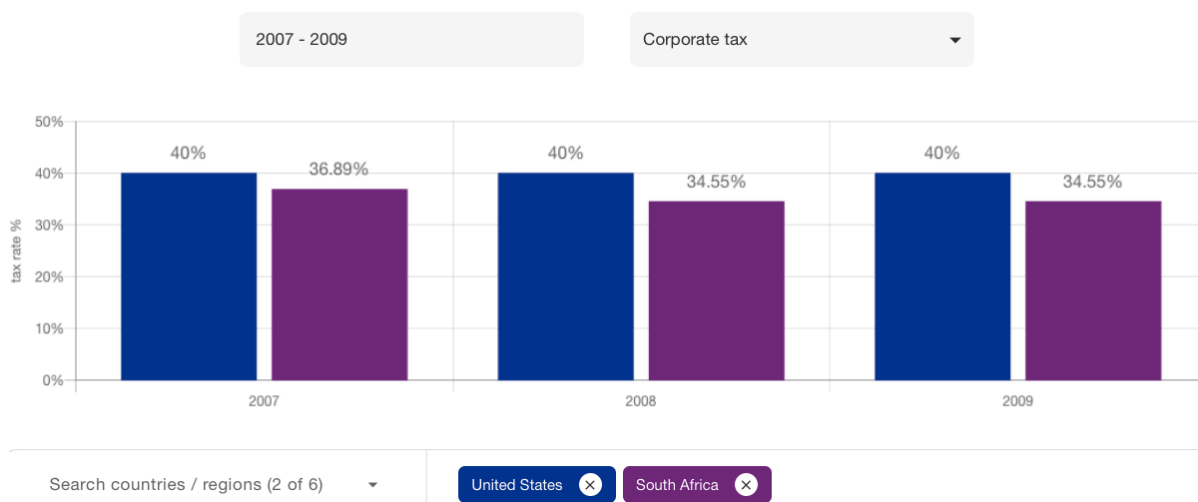


Figure 2. Current Corporate Tax Rates

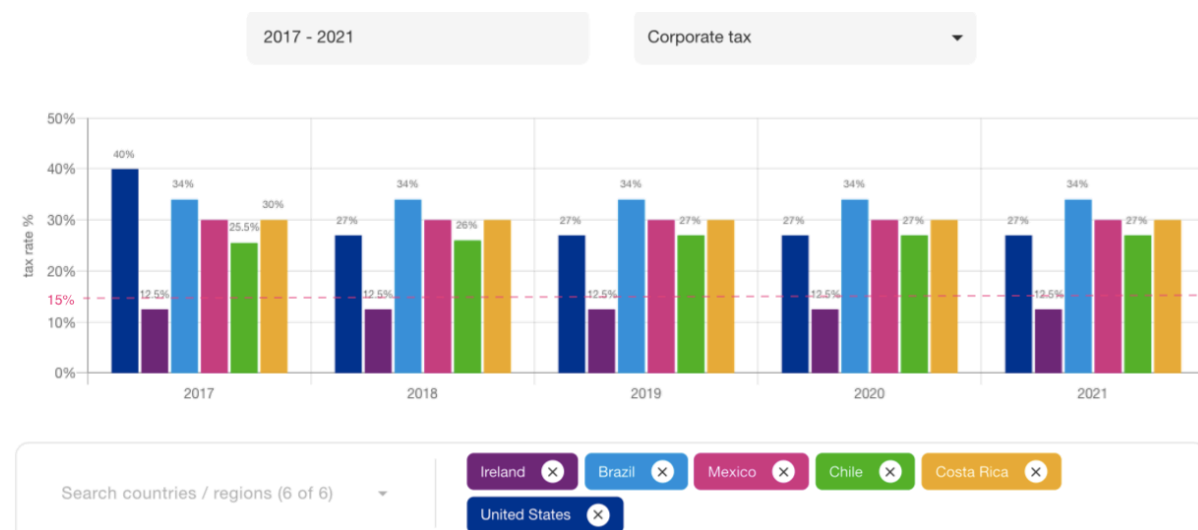


Figure 3. Historical Tax Rates for the 6 largest supply point revenue contributors⁴⁰⁵

⁴⁰⁴ KPMG Tax Rates Online (2021); <https://home.kpmg/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online.html>.

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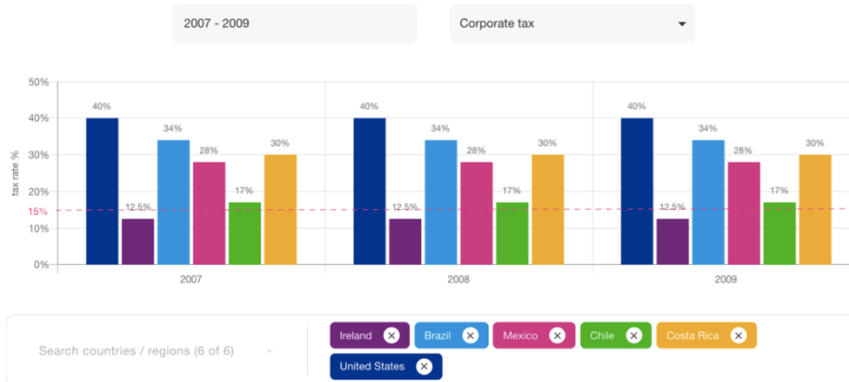


Figure 4. The revenues reported by the supply points for 2001 through 2009⁴⁰⁶

Supply point revenue (US\$ millions)

Year	Brazil	Chile	Costa Rica	Egypt	Ireland	Mexico	Swazi-land	Total
2001	\$626	\$177	\$8	\$111	\$3,184	\$935	\$284	\$5,324
2002	447	167	93	104	3,586	930	359	5,685
2003	409	159	119	96	4,510	752	478	6,523
2004	481	170	130	100	5,075	647	638	7,242
2005	646	186	135	115	5,334	689	690	7,795
2006	849	223	157	129	5,760	772	696	8,586
2007	1,138	261	186	147	6,596	883	800	10,011
2008	1,286	313	220	216	7,276	941	773	11,025
2009	1,306	345	231	265	6,799	872	863	10,680

⁴⁰⁶ The Coca-Cola Company & Subsidiaries V. The IRS (2020); 155 T.C. No. 10; Docket No. 31183-15. Page 72

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