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$10 BILLION MAY BE AT STAKE

Coca-Cola set to battle IRS for billions

BY DAVID ALLISON
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The **Coca-Cola Co.** may be on the hook for as much as $10 billion in a giant fight with the IRS.

Last September, after a five-year audit of Coca-Cola, the **Internal Revenue Service** surprised the company with a "notice of deficiency" saying the company owes an additional $3.3 billion in taxes for 2007, 2008 and 2009.

In December, Coca-Cola moved to challenge the IRS by filing a case with the U.S. Tax Court in Washington. The case was assigned to a judge last month.

Coca-Cola's dispute with the IRS involves what's known as "transfer pricing," where Coca-Cola licenses intangible property – such as the use of Coca-Cola's brand and trade name and formulas –to its foreign licensees so they can make, distribute, sell, market and promote Coca-Cola products.

The stakes for the Atlanta-based soft drink giant are huge.

In its Feb. 25 annual report, Coca-Cola reported that "If the IRS were to prevail on its assertions, it would likely also seek transfer pricing adjustments of a similar nature for subsequent tax years. Consequently, if this dispute were to be ultimately determined adversely to us, the additional tax, interest and any potential penalties could have a material adverse impact on the company's financial position, results of operations or cash flows."

ILLUSTRATION BY JAMES C. WATTS

If the IRS makes comparable claims for the six tax years 2010 to 2015, "you're dealing with not $3.3 billion but maybe $10 billion of potential tax liabilities," says **Julian A. Fortuna**, a tax partner with the law firm of **Taylor English Duma LLP** in Atlanta who, at Atlanta Business Chronicle's request, reviewed publicly available information about the dispute.

Coca-Cola's battle comes as international taxes are a growing U.S. political issue. U.S. companies including **Amazon.com**, **3M Co.**, **Eaton Corp.**, **Caterpillar Inc.** and **Microsoft Corp.** have all been involved in recent years in big IRS disputes over international transfer pricing.

Coca-Cola's case "arises out of the same IRS initiative, which is to examine U.S.-based multinational companies with respect to their transfer pricing for intangible assets," says Taylor English's Fortuna, who worked as a tax attorney for the IRS in the 1980s and has argued cases before the Tax Court.

Some critics say large U.S.-based multinational corporations are shifting profits overseas in order to pay less taxes in the United States, whose 35 percent rate is the highest in the industrialized world.

On March 4, the advocacy organization **Citizens for Tax Justice** said American Fortune 500 corporations are holding $2.4 trillion of profits offshore and avoiding up to $695 billion in U.S. federal income taxes. The group called on Congress to repeal the rule that indefinitely exempts offshore profits from U.S. income tax until these profits are returned to the United States.

In 2015, 54 percent of Coca-Cola's operating revenues were generated outside the United States. As of the end of 2015, Coca-Cola was holding $31.9 billion in "undistributed earnings" in its overseas subsidiaries, where the money is not taxed by the United States. Of that amount, $17.9 billion was in cash. Some other large Georgia-based companies also are holding billions in earnings overseas (see chart on next page).

Coca-Cola's dispute with the IRS involves how the company allocated income between itself and seven of its foreign licensees in Ireland, Swaziland, Brazil, Mexico, Chile, Costa Rica and Egypt. During the three years in dispute – 2007, 2008 and 2009 – the seven foreign licensees paid the company more than $6 billion in royalties. The IRS contends the licensees should have paid the company an additional $9.4 billion. But according to Coca-Cola, that combined amount is more than the aggregate operating profits

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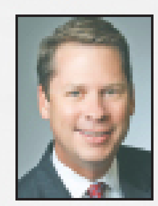

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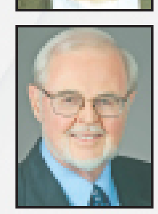

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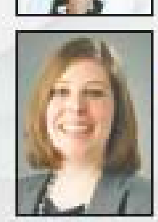

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of the licensees during the three years.

The IRS claims the company's U.S. taxable income should be increased by an amount that creates an additional federal income tax liability of $1.1 billion each year for 2007, 2008 and 2009.

Coca-Cola says it reached an agreement with the IRS in 1996 about how to allocate foreign-earned income between the licensees and the home company, and says it consistently followed the agreement for the next 20 years. It says the agreement gave the company "prospective penalty protection" as long as it followed the agreed-to methodology and the relevant federal tax law didn't change.

But on Feb. 11 of this year, the IRS notified the company "without further explanation" that the IRS has determined that the relevant federal tax law has changed.

Coca-Cola says it doesn't agree with the IRS since the company's compliance with the agreement was audited and confirmed by the IRS. The company says the IRS's action against it "represents a repudiation of the methodology previously adopted in the 1996 closing agreement." (To read Coca-Cola's petition to the Tax Court, visit http://bizj.us/1m33lm).

Fortuna agrees that the IRS may be overreaching because while the IRS has issued some new regulations, the applicable law itself has not changed.

In a statement to the Chronicle, Coca-Cola said "We firmly believe the IRS' proposed income tax assessments of our company are without merit, and we plan to pursue all administrative and judicial remedies necessary to resolve this matter. The company has followed the same methodology for determining our U.S. taxable income from certain foreign company operations for nearly 30 years. The IRS formally agreed to this methodology for the company's 1987-1995 tax returns and subsequently approved the methodology during five successive audits through tax year 2006. The IRS now seeks to depart from this long-standing practice in order to increase substantially the amount of tax. We are among hundreds of other companies currently facing these types of adjustments involving payments between related companies, and we will vigorously defend our position. We are confident we will prevail on the merits of this case."

Julian A. Fortuna

The dispute is unlikely to be settled quickly. The IRS has designated the dispute for litigation, meaning Coca-Cola will be prevented from pursuing any administrative settlement.

The government has become much more litigious in transfer pricing disputes of late, said Fortuna.

Transfer pricing rules require transactions between "commonly controlled entities," such as between Coca-Cola and its seven licensees, to be priced at fair value, what's called the "arm's-length standard" or what an unrelated third party would charge in the situation for similar services or asset transfers, according to Fortuna. A transfer of intangible assets must be compensated by a price commensurate with the income earned by the intangible assets.

"These rules are really important to multinational companies like The Coca-Cola Co.," Fortuna said. Tax rates vary from country to country. The rate in the United States is 35 percent, while some other countries have rates as low as 10 or 12 percent. So to the extent that a multinational company has income that's allocable to a country with a low rate, its global tax cost is lower, Fortuna said.

Congress started encouraging the IRS in 1996 to look at its policies, regulations and rules to try to strengthen its examination and enforcement of transfer pricing rules, according to Fortuna. "Since that time the IRS has focused more and more on transfer pricing, viewing it as an area in which they can raise a significant amount of revenue," he said. "And again, with encouragement from Congress that there are potential abuses in the shifting of income to low tax countries."

Fortuna noted that there have been recent cases in Tax Court involving Amazon.com, 3M Co., and Eaton. Caterpillar and Microsoft are also under examination. "This is very hot area right now of tax investigation and tax issues," he said. "And so even though you might look at this Coca-Cola Co. case and say 'wow it's huge,' and it is a very big case, there are others out there that are of comparable size and importance."

Fortuna believes the biggest issue in Coca-Cola's dispute with the IRS is probably with the company's Irish licensee, "which is not unusual for a U.S.-based multinational because the [tax] rate in Ireland is 12 1/2 percent," he said. "Ireland encourages multinational companies to set up an operation there and to license intangibles into Ireland." One favorable aspect of the case for Coca-Cola, according to Fortuna, is that it obtained a ruling from the IRS way back in 1984 regarding its transfer of intangible assets to Ireland.

From a tax policy perspective, while there's a lot of saber rattling in Congress about multinational companies shifting income offshore, there are two sides of the coin, Fortuna said. In the Coca-Cola dispute with the IRS, for example, the IRS may contend Coca-Cola's income should be shifted from a foreign country to the United States, but the foreign country may have already taxed it. A taxpayer isn't supposed to be paying double tax on the same income, so it should be either taxed in the United States or in the foreign country, but not in both places.

"You can't just look at these things from the U.S. perspective, because there's another country involved," Fortuna said.

The issue also applies to foreign-based multinational companies that do business in the United States through U.S.-based subsidiaries, according to Fortuna. "How should we feel if a foreign-based multinational says that they're not going to allocate income to a U.S. subsidiary because our [35 percent tax] rate's too high? So what they're going to do is typically try to minimize the amount of income in the U.S. subsidiary through their transfer pricing and financing and other types of things. And so do we want to take the position that it's not a good idea for the local country subsidiary to have income? Well, it might be a good idea when we have a U.S-based multinational, but what about when we're on the other side of the issue?"

To address that "other side" of the issue, on April 4, the U.S. Treasury issued new regulations effectively blocking the so-called "inversion" deals in which U.S. companies move their bases to foreign countries to reduce their U.S. taxes. The new regulations killed a $160 billion merger of Pfizer Inc. and Allergan Plc.

And on April 5, President Barack Obama linked inversion deals to the recently released "Panama Papers" that exposed widespread international tax avoidance schemes. In an April 5 speech, he said that when corporations "exploit loopholes" to reduce their taxes, "it makes it harder to invest in the things that are going to make the American economy strong for generations to come. It sticks the rest of us with the tab, and it makes hard-working Americans feel like the deck is stacked against them."

Most disputes like the one between Coca-Cola and the IRS will be settled outside of trial, Fortuna said. "You're dealing with an issue over which qualified experts can have differences of opinion," he said. "It's like any kind of valuation issue. There's no one right answer. There's usually a range of answers within which a taxpayer's position can be reasonable. And the IRS may have a different position. But usually the courts, the judge, will encourage the parties to discuss why their expert opinions differ or see if the parties can come closer together and settle on somewhere in between where they currently stand."

Yet Coca-Cola and the IRS are pretty far apart right now, with maybe $10 billion at stake, Fortuna said. "To settle a case like that may be difficult. Even though Coca-Cola is a very big company, $10 billion is a lot of money."

GEORGIA COMPANIES ARE HOLDING BILLIONS OVERSEAS

"Undistributed earnings" of large Georgia-based companies that were held overseas and not taxed by the U.S. government, as of Dec. 31, 2015:

The Coca-Cola Co.	$31,900,000,000
United Parcel Service Inc.	$4,954,000,000
The Home Depot Inc.	$3,500,000,000
Intercontinental Exchange Inc.	$2,900,000,000
NCR Corp.	$2,400,000,000
AGCO Corp.	$2,300,000,000
Coca-Cola Enterprises Inc.	$1,800,000,000
Mohawk Industries Inc.	$1,680,000,000
Fleetcor Technologies Inc.	$1,097,100,000

SOURCE: FORM 10-KS FILED BY THE COMPANIES WITH THE SECURITIES AND EXCHANGE COMMISSION

Atlanta Business Chronicle asked Atlanta international tax attorneys Marc Schwartz and Paul Tadros of Schwartz International to review The Coca-Cola Co.'s dispute with the IRS that's now before the U.S. Tax Court in Washington. Here are some of their comments:

Broad transfer pricing overview: The IRS audit of Coca-Cola has been described as focusing on transfer pricing. The United States and most other industrialized countries have transfer pricing rules designed to ensure that payments for goods and/or services between related parties are made at fair value — often referred to as the arm's-length standard. As an example, suppose a U.S. company has a subsidiary in a low tax jurisdiction such as Ireland (12.5 percent rate versus 35 percent in United States). All else equal, the global group maximizes revenue when more of its profits face Ireland tax rather than U.S. tax, so to the extent that there needs to be a payment from Ireland to the U.S. parent, the group attempts to keep that payment as low as reasonably possible, and vice versa. That is classic transfer pricing strategy. Since many of the foreign subsidiaries at issue with Coca-Cola/IRS are not in low-tax jurisdictions, we believe the audit has a different focus.

Our approach to this particular audit: This audit does not have the feel of a classic IRS transfer pricing approach in terms of merely adjusting intragroup prices. First and foremost, there appears to be a material disconnect between what Coca-Cola states is the function of its subsidiaries — semi-autonomous if not autonomous companies responsible for their own income and expense control — versus how the IRS describes the subsidiaries — "supply points" that should be treated more like bottlers. This issue is of critical importance because the specific functions and entrepreneurial risk that each entity has plays a material role in the anticipated and expected profit margins.

Second, even if the IRS wins its argument that the profit margin should be similar to that of bottlers, the IRS position, without more detail, appears interesting at best. For instance, one would anticipate some positive net margin at the subsidiaries. However, the IRS admits that its proposed transfer pricing will leave various subsidiaries with expenses above and beyond their income. Even giving the IRS the benefit of the doubt in all other areas, this particular aspect seems off-base. Certainly the foreign tax authorities would not support such a position.