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Tax dispute over Coca-Cola's non-US trademarks explained

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The US Internal Revenue Service (IRS) and Coca-Cola are locked in a battle regarding the proper allocation of income between Coca-Cola and its foreign affiliates pursuant to trademark and trade secret licences. However, the IRS seems to have overlooked a significant economic component of the licence agreement by not recognising the benefit that Coca-Cola receives in the form of more valuable foreign trademark rights.

In September 2015, the IRS issued a notice of deficiency to Coca-Cola, increasing its federal income tax due for the years 2007 to 2009 by over $3 billion. The alleged deficiency arose when the IRS disagreed with the accounting for Coca-Cola's royalty income for its trademark and trade secret (formula rights) licences with seven foreign affiliate companies. In December 2015, Coca-Cola petitioned the US Tax Court to reject the deficiency (*Coca-Cola Co v Commissioner*, TC 031183-15); the IRS filed its response in February and the case was assigned to Judge Albert Lauber in March.

It appears that Coca-Cola's foreign affiliates paid royalties totalling $6 billion for the tax years at issue. The IRS claims that the foreign affiliates paid less than fair market value for those rights and, consequently, a disproportionate amount of Coca-Cola's global profits were assigned to (ie, earned by) the foreign affiliates. Coca-Cola argues that its affiliates have paid fair market royalties because they also paid for all of the operating expenses of making concentrate for sale to bottlers and all of the marketing expenses in their respective markets.

To show that the royalties paid were less than fair market value, the IRS argues that Coca-Cola's foreign affiliates earned more than they should have as demonstrated by their profits being higher than those of allegedly comparable beverage bottlers. However, by taking the position that the comparable transactions (*ie*, benchmark transactions for determining the 'correct' tax result) are bottling agreements between a beverage company and a beverage bottling company, instead of licensing and marketing agreements between a beverage company and company that manufactures and sells concentrate to bottling companies, the IRS is overlooking, *among other things*, some important trademark and marketing aspects of those licences. In its licensing arrangements with foreign affiliates, Coca-Cola profits both from royalty payments and from the increase in the value of its foreign trademarks. By focusing solely on the amount of royalties Coca-Cola receives, the IRS is ignoring important economic aspects of the licences at issue. Because trademark rights are territorial in nature, Coca-Cola's brand value resides not in a single worldwide trademark, but in a portfolio of country-specific trademarks. Coca-Cola reportedly owns its trademark, but the foreign affiliates are responsible for the operational and marketing expenses in their respective territories. Therefore, Coca-Cola receives the benefit of owning a more valuable COCA-COLA trademark in that foreign country, while its affiliate pays for the marketing expenses. The increase in value of the local COCA-COLA trademark due to those marketing expenditures would belong to the US company. A rational foreign affiliate presumably would not agree to such an arrangement unless it received compensation (eg, a lower royalty rate). In this scenario, Coca-Cola pays US taxes on less royalty income, but has no corresponding foreign marketing expense deductions because those expenses are paid by the affiliate. Coca-Cola would not immediately realise any income from the appreciation of its trademark.

Setting aside the different payment structures for marketing expenses, the IRS seems to ignore the fact that value is being stored in the foreign trademark rights. That appreciation in value is not immediately taxable under US federal tax law. Regardless of which entity pays for the marketing expenses, appreciation in the value of Coca-Cola's foreign trademarks will not be taxed in the United States as long as there is no change in ownership.

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