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Transfer Pricing: The New Frontier

Value Chains and Supply Chains in a Post-BEPS World

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Introduction

A few preliminary remarks: Value chain and/ or supply chain?

- OECD refers to value chain analysis in its various BEPS documents published in 2015-2017 but the definition of a value chain was provided only in 2018 in the Interim Report on the tax challenges arising from digitalization:
  - The value chain is a theory of the firm that models a long-linked technology.., where value is created by converting inputs into outputs through discrete but related, sequential activities (each of which can be thought of as a production function). It is a systematic way of examining all of the activities that a firm performs to design, produce, market, deliver and support its product(s) and how each of these functions interacts. (¶74)
- Post BEPS transfer pricing documentation requires a summary of the global **supply** chain and the identification of the **value** drivers.
- Post-BEPS, taxpayers are required to support TP policy with a more granular review of functions, risks, and assets
  - Such an analysis may help reduce the risk of having transactions re-characterized by tax administrations
  - It may also help MNEs to become more efficient
- Classical transfer pricing rules and arm's lenght principle are still the prevailing principles

Value Chains and Supply Chains Guidance post-BEPS

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2013 BEPS Action Plan

- September 6, 2013, the G20 Leaders' Declaration:
  - "Profits should be taxed where economic activities deriving the profits are performed and where value is created."
- OECD "Action Plan on Base Erosion and Profit Shifting" (2013) highlighted the changes in the global economy:
  - "Globalisation has resulted in a shift from country-specific operating models to global models based on matrix management organisations and integrated supply chains that centralise several functions at a regional or global level"
- ...and emphasized the importance of Value Chain Analyses:
  - Restore the full effects and benefits of international standards, specifically by adapting the rules "to prevent BEPS that results from the interactions among more than two countries and to fully account for **global value chains**."
  - "Assure that transfer pricing outcomes are in line with value creation" (ACTIONS 8, 9, 10), specifically, by ...adopting transfer pricing rules or special measures to: ... clarify the application of transfer pricing methods, in particular profit splits, in the context of **global value chains**" (Action 10)
  - "Re-examine transfer pricing documentation" (Action 13) including transparency relating to **value-chain analyses**

2015 OECD BEPS Reports (Actions 8-10)

- BEPS Actions 8-10 Final Reports "**Aligning Transfer Pricing Outcomes with Value Creation**" published October 2015.
- Incorporated in OECD Transfer Pricing Guidelines ("TPG") in July 2017
- Reports focus on "**value chain**" over specific transactions between specific related parties.
  - "it is important to understand **how value is generated by the group** as a whole, the **interdependencies of the functions** performed by the associated enterprises with the rest of the group, and the **contribution that the associated enterprises** make to that value creation" TPG ¶1.51
- Review the **substance of the supply chain**: TPG 2017 ¶1.66 "The **capability** to perform decision-making functions and the **actual performance** of such decision-making functions **relating to a specific risk** involve an understanding of the risk based on a relevant analysis of the information required for assessing the foreseeable downside and upside risk outcomes of such a decision and the consequences for the business of the enterprise." A mere **contractual form** of the decision-making process is **no longer sufficient** to demonstrate the performance of decision-making functions.
- Therefore, in the post-BEPS environment, **MNEs need to understand their value chain, including value drivers and related risks and functions**

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Value Chain and Profit Split: the 2016 Discussion Draft

- The 2016 Public Discussion Draft of Revised Guidance on Profit Splits contained a section on Value Chain Analyses (¶¶24-27) which was dropped from the final version. The 2016 discussion of value chain emphasized the following:
  - A value chain analyses can be used as "a tool to assist in delineating the controlled transactions, in particular in respect of the functional analysis, and thereby determining the most appropriate transfer pricing methodology."
  - A value chain analysis "does not, of itself, indicate that the transactional profit split is the most appropriate method, even where the value chain analysis shows that there are factors which contribute to the creation of value in multiple places, since all parties to a transaction can be expected to make some contributions to value creation."
- A value chain analysis might usefully provide information about the following aspects of the business activity:
  - The key value drivers in relation to the transaction, including how the associated enterprises differentiate themselves from others in the market;
  - The nature of the contributions of assets, functions, and risks by the associated enterprises to the key value drivers, including consideration of which contributions are unique and valuable;
  - Which parties can protect and retain value through performance of important functions relating to the development, enhancement, maintenance, protection and exploitation of intangibles;
  - Which parties assume economically significant risks or perform control functions relating to the economically significant risks associated with value creation;
  - How parties operate in combination in the value chain, and share functions and assets in parallel integration;
  - How the economic circumstances may create opportunities to capture profits in excess of what the market would otherwise allow, such as those associated with unique intangibles, first mover advantages, or other unique contributions.

Value Chains and Supply Chains Guidance post-BEPS

- In the final version of the Guidance on Profit Splits , none of the above language was retained
  - Public comments to the 2016 Discussion Draft argued that "value chain analysis" was synonymous with the "functional analysis" and, therefore, would be appropriately included in Chapter I of the OECD Transfer Pricing Guidelines, if guidance on value chain analysis was distinct from the guidance on functional analysis
  - Another concern was that because BEPS Actions 8-10 Final Reports "Aligning Transfer Pricing Outcomes with Value Creation" focus on "**value chain**" over specific transactions between specific related parties, emphasis on the value chain analysis might unduly elevate the significance of Profit Splits even in cases where PSM is not the best method.
- Value chain analysis – or at least its components – still permeates the various OECD pronouncements:
  - Value driver framework underlies the functional analysis of the transfer pricing documentation
  - Reference to profit drivers, the supply chain, and value creation in Master file
  - Reference to value creation in Chapter VI on intangibles
  - Emphasis on value in Attribution of profits to PE
  - Value creation in digital economy

The Concept of *Value* in Functional Analysis

- "Value" in Functional Analysis
  - "it is important to understand **how value is generated by the group** as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group, and the **contribution that the associated enterprises make to that value creation**. It will also be relevant to determine the legal rights and obligations of each of the parties in performing their functions." ¶1.51
  - "The economically relevant characteristics or comparability factors that need to be identified in the commercial or financial relations between the associated enterprises in order to accurately delineate the actual transaction" include "the functions performed.., assets used and risks assumed, including how those functions relate to the wider **generation of value** by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices." ¶1.36
  - "[W]hen conducting a functional analysis to identify the commercial or financial relations in fragmented activities, it will be important to determine whether those activities are highly **interdependent**, and, if so, the nature of the interdependencies and how the commercial activity to which the associated enterprises contribute is co-ordinated." ¶1.55
  - Determining the economic significance of risk and how risk may affect the pricing of a transaction between associated enterprises is part of the broader functional analysis of **how value is created by the MNE group**, [and] the activities that allow the MNE group to **sustain profits** ¶1.73

The Concept of *Value* in the Analysis of Intangibles

- "Value" in Analysis of Intangibles
  - "The functional analysis should identify all **factors that contribute to value creation**, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others." ¶6.133
  - "In cases involving the use or transfer of intangibles, it is especially important to ground the functional analysis on an understanding of the MNE's global business and the manner in which **intangibles are used by the MNE to add or create value across the entire supply chain**." ¶6.3
  - "In a transfer pricing analysis of a matter involving intangibles, it is important to identify the relevant intangibles **with specificity**. The functional analysis should identify the relevant intangibles at issue, the manner in which they **contribute to the creation of value** in the transactions under review, the important **functions performed and specific risks assumed in connection with the development, enhancement, maintenance, protection and exploitation of the intangibles** and the **manner in which they interact** with other intangibles, with tangible assets and with business operations to **create value**. ...[I]t is **not sufficient to suggest** that vaguely specified or undifferentiated intangibles have an effect on arm's length prices or other conditions." ¶6.12
  - However, "**items not treated as intangibles**" can also "contribute to the **creation of value** in the context of the MNE's global business." ¶6.18

Value and Attribution of Profits to PE

- March 2018 additional guidance on the attribution of Profits to PE's applies the revised guidance contained in the Report on *aligning transfer pricing Outcomes with Value Creation (BEPS ACTIONS 8-10).*
- Attribution should be determined as if the entity were a separate and independent enterprise
  - Step 1: Recognition of an internal dealing between the PE and the head office
  - Step 2: guidance in the TPG is applied by analogy

Value and Digitalisation of the Economy

- OECD "Tax Challenges Arising from Digitalisation –(non –consensus) Interim Report 2018"
  - Provides the most extensive review of value chains of all OECD documents but the issues facing the digitalized economy are more complex that those of traditional economy
- OECD Public Consultation Document «*Addressing the tax challenges of the digitalisation of the economy*» (February 13)
  - Revised profit allocation and nexus rule: 3 proposals having as objective to recognize the **value – not currently recognized -** created by a business activity or participation in user/ market juridictions:
    - *The user participation proposal*
    - *The marketing intangibles proposal (link between marketing intangibles and market juridiction)*
    - *The significant economic presence proposal*

Analysis of Value and Supply Chains

Value Chain Analysis

- The concept of a "value chain":
  - "A value chain is the full range of activities that firms engage in to bring a product to the market, from conception to final use. Such activities range from design, production, marketing, logistics and distribution to support to the final customer. They may be performed by the same firm or shared among several firms. As they have spread, value chains have become increasingly global." (OECD, *Interconnected economies benefiting from global value chains, synthesis report*, Paris, 2013, at 8.)

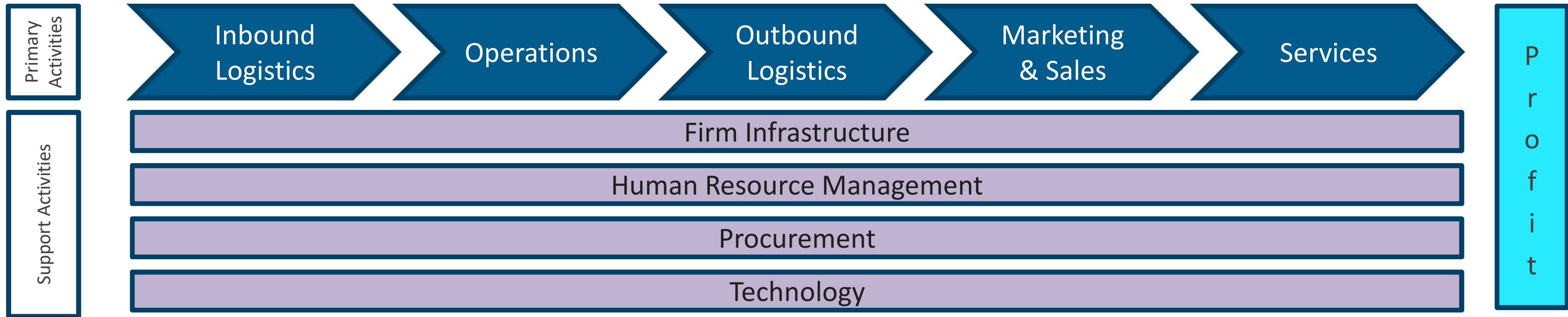
- Characteristics of Global Value Chains ("GVC"):
  - Vertical integration of economic activities
  - ...which, at the same time, are fragmented and dispersed across countries
  - ...are increasingly specialized in tasks and business functions
  - ...and rely on coordinated networks of buyers and suppliers

Value Chain Analysis

- The concept of a "value driver" is not defined consistently:
  - "Value Driver is something that contributes to the creation of an MNE's income but is not an asset in the accounting sense." *Value Drivers & Intangibles*, OECD Business Consultation, November 2011
  - In the academic literature "key value drivers" are defined as "the performance variables that will actually create the value of the business"
    - …but often such performance variables describe the supply chain, rather than the value chain, such as, for example, "stores per warehouse," "cost per warehouse," "trips per transaction," or "cost per trip" for a distribution company
- Different emphasis on value drivers depending on whether transfer pricing considerations are present:
  - Outside of transfer pricing, value drivers can be assessed for purposes of value generation for business as a whole
  - Value drivers in transfer pricing have to be assessed through the prism of DEMPE functions and risk and control analyses

Value and Supply Chains

- **Porter's Value Chain Model**



- **Definitions**:
  - "Supply Chain Management is the management of relationships in the network of organizations, from end customers through original suppliers, using key cross-functional business processes to create value for customers and other stakeholders." *Supply Chain Management Institute*
  - Value Chain represents "a collection of activities that are performed to design, produce, market, deliver, and support its product." "[v]alue is the amount buyers are willing to pay for what a firm provides them." *Michael Porter (1985)*

Value Chain Analysis

- Porter: "Industry structure …determines the industry's long-run profit potential because it determines how the economic value created by the industry is divided – how much is retained by companies in the industry versus bargained away by consumers and suppliers, limited by substitutes, or constrained by potential new entrants."
- "Strategy" is company's approach to navigate within the industry
  - cost competitor would have value drivers like "procurement excellence", "manufacturing efficiency" and "above market supply chain synchronization"
  - Product differentiation/brand: "superior brand management", "product development" and "top retail locations".
- Operational efficiencies are present in both, but have a far greater significance for the cost competitor than for the brand owner. Similarly, intangible ownership, risk bearing and management will have different weight in the value chain depending on the company's strategy.
- The direction of the analysis differs
  - Cost advantage analysis:
    - From supplier to the end customer, focusing on factors that drive the cost of each activity
  - Differentiation Advantage:
    - The analysis is done in reverse, from end customer through production to design and R&D
    - At customer level, the analysis focuses on product features, marketing, and customer service

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Tools for the Supply Chain and Value Chain Analyses

- Supply Chain:
  - Supply Chain Operations Reference Model (SCOR)
  - Activity-Based Costing (ABC) or Activity-Based Management (ABM)
  - Collaborative Planning, Forecasting, and Replenishment (CPFR) tool
  - Global Supply Chain Forum (GSCF) framework
- Process Analysis:
  - Business Process Modelling and Notation (BPMN)
  - Process Classification Framework (PCF) by American Productivity & Quality Center
- Value Chain:
  - Balanced Scorecard (BSC)
  - Process Contribution Analysis (PCA)
  - Resource-Based View (RBV)
  - Combination of PCA and emerging method for causal inference called "process tracing" (PT), based on generative causality and taking a probabilistic approach to the interpretation of evidence

Approaches to the Value Chain Analyses

- Balanced Scorecard:
  - Introduced by Robert S. Kaplan and David P. Norton in “The Balanced Scorecard—Measures that Drive Performance,” *Harvard Business Review*, January–February 1992.
  - Provides answers to four basic questions: (i) How do customers see us? (customer perspective); (ii) What must we excel at? (internal perspective); (iii) Can we continue to improve and create value? (innovation and learning perspective); (iv) How do we look to shareholders? (financial perspective)
- Process Contribution Analysis:
  - An approach to assess causal questions and infer causality in program evaluations
- While there is significant overlap with a typical supply chain analysis – e.g., time and cost of delivery from the customer’s perspective, or cycle time and productivity from the internal perspective – BSC and PCA provide a more comprehensive approach to identifying value drivers relative to a supply chain analysis
- Still, identifying and quantifying the various value drivers is extremely difficult to do:
  - Often no direct impact on revenue and profit, but, instead, through chains of cause-and-effect relationships
  - The value created by individual intangible assets is neither linear nor additive.

Approaches to the Value Chain Analyses

- Process Contribution Analysis coupled with the RACI Matrix
  - Mentioned in
    - OECD 2014 Profit Split Discussion Draft, Scenario 6
    - EU JTPF "Profit Split Method (PSM) Summary of Replies to the Survey" June 2018
  - How applied:
    - Interviews or questionnaires (often, Likert-type analysis)
    - Cost contribution
    - Scenario analysis (with/without, before/after)
  - Example:

PROCESS	PROCESS	SHARES IN PROCESS		VALUE CONTRIBUTIONS	
	WEIGHT	DISTRIBUTOR	MANUFACTURER	DISTRIBUTOR	MANUFACTURER
Logistics	5.2	16.80%	83.20%	0.87	4.33
Manufacturing	12.3	3.22%	96.78%	0.40	11.90
Procurement	5.3	6.72%	93.28%	0.36	4.94
Planning	14.2	47.72%	52.28%	6.78	7.42
Distribution	6.5	100.00%	-	6.50	-
Marketing	30.3	100.00%	-	30.30	-
R&D	26.2	-	100.00%	-	26.20
Total Value	100				
Splitting Ratio				45.21	54.79

Source: EU JTPF, pp.14-16; "Contribution analysis (with a preliminary carve out of the contribution of the IPs)"

  - This is not necessarily (i) a bottom-up approach using existing indicators; or (ii) an approach based on peer results

Legal Aspects/Case law

Medtronic, Inc. v. Commissioner

Medtronic: Background

- Since the early 1960s, Medtronic has been a leading medical device technology company
- Medtronic designs, manufactures and sells medical devices through related entities around the world
- Medtronic US is the headquarters of the worldwide cardiac and neurologic businesses
- Medtronic US is responsible for research related to refinements to existing products and to new therapies
- Medtronic's largest manufacturing facility is Medtronic Puerto Rico Operations Co. (MPROC)
- MPROC's management is responsible for all of its operations, including quality compliance, operational excellence, business profitability, innovation and establishing strategic goals
- MPROC licensed the intangible property required to manufacture medical devices from Medtronic US
- MPROC paid royalties of 29% to Medtronic US on intercompany sales of devices and 15% on sales of leads
- The Commissioner issued a notice of deficiency to Medtronic determining deficiencies in tax of $548 million for 2005 and $810 million for 2006

Medtronic: IRS's Position

- Medtronic US performed all but one of the economically significant functions for Medtronic's cardiac and neuro businesses
- The only economically significant function that MPROC performed was assembling finished products
- The IRS calculated the deficiencies by applying the comparable profits method (CPM)
- As part of the CPM, the Commissioner used a "value chain analysis"
- The value chain analysis segments a company's operations into functional activities, allowing qualitative assessment of each participant's economic contributions
- Individual transactions cannot be viewed in isolation but must be viewed in the context of the overall US value chain
- Medtronic US performed most of the functions of the cardio and neuro value chains

Medtronic: IRS’s Position

- The IRS’s value chain analysis considered each party’s functions, assets and risks
- The purpose of the IRS’s analysis is to determine the arm’s length returns and associated profits for MPROC’s operations versus Medtronic US
- The IRS asserts that MPROC performed only the final manufacturing steps
- The CPM provides MPROC with an appropriate return for its finished-product manufacturing
- All intangibles needed to perform manufacturing, other than assembled workforce and process improvements, were licensed from Medtronic US

Medtronic: The Commissioner's value chain analysis

- The IRS's value chain analysis consisted of four steps
  - First, the IRS calculated the value chain operating profit
  - Second, the IRS applied the CPM to Medtronic US's sale of certain components to MPROC for the production of devices and leads
  - Third, the IRS applied the CPM to MPROC's sale of finished devices and leads to Medtronic US
  - In the final step, the IRS applied the CPM to the devices and leads licenses to reach the technology royalty rate
- The IRS selected MPROC as the tested party because it purportedly performed less complex functions than Medtronic US
- As comparables, the IRS selected 14 companies in the medical device industry

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Medtronic: The Commissioner's value chain analysis

- The IRS determined that MPROC incurred about 10% of the value-added costs in the US cardio and neuro value chains but earned about 60% of the operating profits
- The IRS converted its arm's length results into royalty payments to Medtronic US for intangibles used by MPROC
- The IRS concluded that there should be royalties of 49.4% and 58.9% on Medtronic US end sales for 2005 and 2006, respectively
- Under these calculations, the operating profits attributable to Medtronic US were 91.9% and 94.4% for 2005 and 2006 respectively
- In reaching its conclusions, the IRS determined that MPROC's contributions did not include non-routine intangibles or activities

Medtronic: The Role of Quality

- In order to place a value on the finished product manufacturing of MPROC, the IRS had to examine the role of quality
- Medtronic stressed that quality is critical in the medical device industry and to MPROC in particular
- The IRS downplayed the role of quality
- The IRS spread the quality risk throughout the entire value chain
- Medtronic believed that the finished product had to be of the highest quality, and that quality assurance was MPROC's responsibility

Medtronic: The Role of Quality

- The IRS contends that MPROC's role is not appreciably more significant than that of a components manufacturer
- The IRS contends that it is Medtronic's new product pipeline, successful clinical trials and well-trained sales force that differentiate Medtronic from its competitors
- Medtronic's chief executive testified that product quality is the single greatest factor in market share
- Medtronic asserted that MPROC's role in quality was unique
- The Court found that the IRS did not place enough emphasis on quality
- The Court determined that product quality is the foundation on which medical devices can be successful

Medtronic: Medtronic's Pricing Method

- Contrary to the IRS's value chain analysis, which aggregated multiple transactions, Medtronic applied a Comparable Uncontrolled Transaction (CUT) analysis to determine an arm's length royalty for intangible property licensed by MPROC
- Medtronic's CUT analysis was based on a third-party licensing transaction, the Pacesetter agreement
- Medtronic's expert agreed that the Pacesetter agreement was not a perfect comparable, but asserted that it was the best available comparable

Medtronic: The Court’s Decision

- Aggregating transactions under the IRS’s value chain analysis did not result in a determination of true taxable income because it allocated an unreasonably small percentage of profits to MPROC by dismissing the importance of quality
- The royalty rates proposed by Medtronic were not arm’s length because appropriate adjustments were not made to the CUT to account for variations in profit potential
- The IRS took an all-or-nothing approach, refusing to suggest adjustments to Medtronic’s CUT method
- The Court made several adjustments to the Pacesetter royalty
- The court arrived at a revised royalty rate on intercompany sales of 44% for devices and 22% for leads

Medtronic: The Commissioner's Appeal

- In the face of a significant loss with respect to its favored value chain theory, the IRS appealed the Tax Court's decision to the 8th circuit
- The 8th circuit has remanded the case to the Tax Court for further consideration of whether the Pacesetter agreement is an appropriate CUT

THE COCA-COLA COMPANY v. COMMISSIONER

Coca-Cola: Background

- The primary issue involves the royalty to be paid to The Coca-Cola Company (TCCC) by six related Foreign Licensees
- The IRS determined an approximately 45% royalty using a CPM method based upon income earned by unrelated Coca-Cola bottlers
- IRS issued a Notice of Deficiency asserting deficiencies in tax of over $3 billion for the tax years 2007 through 2009

Coca-Cola: The Taxpayer’s Position

- Coca-Cola conducted the core aspects of its business through related Foreign Licensees and Service Companies (the “Business Units”)
- The Foreign Licensees: (1) conducted strategic planning; (2) developed consumer marketing; (3) guided the local bottlers to align their marketing with local customers; and (4) manufactured and sold concentrate to local bottlers
- The Foreign Licensees carried out all of their activities using the proceeds of concentrate sales to finance their activities
- Consumer marketing and advertising is the most important activity and the one that requires the largest financial commitment
- By necessity, these critical activities occur in local markets
- The ideas and opportunities identified by the Business Units drove the Company’s R&D priorities

Coca-Cola: The Taxpayer's Position

- The magnitude of local adaptation is reflected by the fact that the Company's hundreds of product lines are offered in over three thousand formulations
- Vast amounts are spent locally on consumer advertising and marketing
- The Foreign Licensees have borne substantially all of the expenses associated with their territories
- Any headquarters expenses that provided even an indirect benefit to the foreign business were allocated from the headquarters on a pro rata basis
- The independent bottlers are essentially distributors responsible for manufacturing finished products and distributing them

Coca-Cola: The IRS's Position

- TCCC was the legal owner of the Company's most valuable intangible property
- The Foreign Licensees produced and sold beverage concentrates to bottlers under manufacturing and quality guidelines set by TCCC
- The Service Companies performed routine marketing on a cost-plus basis
- The Foreign Licensees faced relatively low market and business risks
- Bottlers and Foreign Licensees licensed the same intangible property owned by TCCC
- Bottlers employed substantial sales forces that ensured widespread availability of the Company's products
- Bottlers worked closely with the Company in developing and integrating business and marketing plans
- According to the IRS, the Foreign Licensees earned over $11 billion in operating profits, while TCCC reported approximately $800 million in operating profits

Coca-Cola: The IRS's Value Chain Analysis

- The IRS's adjustments to the Foreign Licensees' royalties apply a Comparable Profits Method using the ROA of unrelated bottlers as the Profit Level Indicator
- The IRS determined that the bottlers were uncontrolled comparables for which reliable data could be found
- Applying a supply chain analysis, the IRS concludes that bottlers are compelling comparables for the Foreign Licensees because they
  - used the same intangible property;
  - they operated in the same industry and sold the same products;
  - operated in the same supply chain;
  - performed similar manufacturing functions;
  - acquired similar local knowledge and performed similar customization;
  - faced similar risks;

Coca-Cola: The IRS's Value Chain Analysis

- followed similar standards and guidelines;
- developed and pursued similar business strategies;
- performed similar marketing activities and incurred similar marketing costs

- The IRS concludes that ROA is an appropriate profitability benchmark for manufacturing and distribution activities
- The IRS calculated the ROA of 24 independent bottlers and compared the ROAs to the Foreign Licensees ROAs
- The IRS concluded that the compensation reported by the Foreign Licensees exceeded the amount they would have received in arm's length transactions
- According to the IRS, the legal owner of intangible property is able to extract 100% of all projected income from the licensed intangibles

Coca-Cola: The IRS's Value Chain Analysis

- The IRS concludes that the profits that the Foreign Licensees retained from their sales of concentrate were attributable to TCCC's intangible property
- The IRS asserts that the Foreign Licensees were mainly manufacturing plants
- The Foreign Licensees performed routine manufacturing of concentrate and paid for marketing costs
- TCCC ensures that the brand identity and vision of Coca-Cola are consistent worldwide
- Bottlers incurred significant amounts of direct marketing expenses which they split with the Company on roughly a 50-50 basis
- Neither the bottlers nor the Foreign Licensees owned any interest in the valuable intangibles owned by TCCC
- Because the bottlers funded and performed marketing, the IRS's adjustments adequately compensated the Foreign Licensees for their role in marketing

Coca-Cola: The IRS's Value Chain Analysis

- One relevant factor in determining economic substance of risk allocation is the extent to which each controlled taxpayer exercises managerial or operational control over business activities
- The IRS asserts that TCCC had a great deal of control over the business activities that directly influence the amount of income or loss realized
- The IRS asserts that the Foreign Licensees had limited control over their own risks
- The IRS asserts that TCCC maintained control over the Foreign Licensees' cash flows by
  - approving prices that bottlers paid for concentrate;
  - designating which Foreign Licensees supplied which bottlers;
  - setting and monitoring business targets;
  - evaluating business and capital plans;
  - reviewing and negotiating mergers and acquisitions;
  - limiting and overseeing the capital expenditures; and
  - limiting the ability of the Foreign Licensees to spend money without TCCC approval

Coca-Cola's Response

- The 1994 regulations state that with adequate data, methods that determine an arm's length price (e.g. the CUP method) generally achieve a higher degree of comparability than the CPM
- In practice, however, the IRS has frequently applied the CPM, particularly in outbound intangibles licensing cases
- The IRS applied a CPM to allocate only routine returns to the Foreign Licensees even though they bore the greatest direct and indirect costs in developing the intangible property in their regions
- The implication of the IRS's CPM is that Foreign Licensees are not entitled to any credit for the investment in the consumer marketing and advertising that drive the local business
- The CPM regulations require functional comparability and similarity of assets composition. The Foreign Licensees and independent bottlers have neither
- The bottlers and Foreign Licensees flunk the comparability requirements of the CPM regulations because they have fundamentally different responsibilities, functions, assets and economic profiles

Coca-Cola's Response

- The IRS's theory is irreconcilable with arm's length behavior, which reflects that licensees share in intangible-related profits
- The Foreign Licensees, as the entrepreneurs in the Coca-Cola system, were primarily responsible for the Company's business in the foreign geographies
- The bottlers, which operated further down the value chain, functioned as the distributors of the Company's products
- The differences between the Foreign Licensees and bottlers are reflected in their different financial profiles. The Foreign Licensees invested far more in consumer advertising than in fixed tangible assets such as property, plant and equipment
- ROA is not a reliable PLI, since tangible operating assets play a small role in generating operating profits for the Foreign Licensees
- The ROA is flawed because it fails to compensate the Foreign Licensees for their substantial investments in intangible assets

Coca-Cola's Response

- The IRS's CPM analysis assumes that TCCC is entitled to all non-routine returns. However, the Company's decentralized business model reflects a limited contribution by TCCC
- The transfer pricing regulations have always recognized that registered ownership of intellectual property, including trademarks, is not determinative of ownership for transfer pricing purposes
- The Foreign Licensees bore the risk and responsibility for their business operations in the markets they served, including substantially all funding of the activities in those markets and substantially all of the headquarters expenses allocable to those markets
- The Foreign Licensees had operational and financial responsibilities for Coke's business in their geographies. In contrast, the independent bottlers primary role was to distribute the finished products they produced from concentrate
- The differences between the Foreign Licensees and the bottlers' roles are reflected in the differences between their asset compositions and financial profiles

Coca-Cola’s Response

- The Foreign Licensees’ ratio of intangible investments (in the form of large ongoing consumer advertising) to balance sheet fixed assets (property, plant and equipment) was dramatically higher
- The Company corrects the IRS’s CPM by capitalizing the Foreign Licensees’ and independent bottlers’ marketing costs. The IRS in turn asserts that by portraying distribution as routine the Company minimizes the magnitude of the bottler marketing spend and its importance

Coca-Cola’s Transfer Pricing Method

- Coke asserts that its international business is a franchise business, in which the Company and its bottlers serve distinct functions in the same supply chain
- As its primary transfer pricing method, Coke looks to master franchising transactions involving trademarks and other intangible property owned by McDonald’s and other franchises. Coke asserts that master franchising transactions are CUTs
- Master franchising is a business model in which a franchisor licenses its trademark, product formulations, and other intangible property to a third party – the master franchisee. The Foreign Licensees operate at a similar intermediate level between TCCC (the franchisor) and the bottlers (sub-franchisees)
- Coke asserts that application of its CUT analysis yields a royalty rate of 12.3% on concentrate sales. The result of this analysis is a profit split of 28.8% to the franchisor and 71.2% to the master franchisee
- Coke asserts that the CUT method using master-franchising transactions is the best method for determining the arm’s length royalty

Coca-Cola's Transfer Pricing Method

- Coke's expert concludes that the Foreign Licensees' pre-royalty intangibles-related operating profit margins are similar to the intangibles-related profit margins for the uncontrolled master-franchising transactions that serve as CUTs
- Coke concludes that at arm's length franchisors that make available intangible property to master franchisees share significant intangibles-related profits with the master franchisees
- In addition to its master franchisee analysis, the Company uses a residual profit split method to price the controlled transactions. The company splits the residual profit using capitalized costs of TCCC and the Foreign Licensees
- The IRS asserts that capitalized costs of TCCC and the Foreign Licensees cannot reliably measure the value of TCCC's contributions of trademarks and formulas

Coca-Cola: The IRS's Response

- The IRS asserts that the functions, assets and risks of the Foreign Licensees are nothing like those of master franchisees
- According to the IRS, the Company's residual profit split method postulates that the marketing spend by the Foreign Licensees creates a separate intangible owned by the Foreign Licensees rather than maintaining or enhancing the intellectual property for which TCCC owns all residual rights

Closing remarks

Closing Remarks

- Post-BEPS environment focuses extensively on value creation
  - But there is no consensus on the definitions of “value chains” and “value drivers”
- Several analytical tools exist to help with measurement of the process contributions
  - But very few go to the heart of the value creation process
- Various sections of the Guidelines now require attention to value drivers, including the analysis of functions, risks, and assets, and the transfer pricing documentation
  - But there is no explicit guidance as to what type of analysis and information will be considered “necessary” and “sufficient”
- At this point it would appear that the descriptive presentation – rather than quantitative – should be sufficient
  - However, a more detailed internal analysis of the value chain and the value drivers can be very beneficial to the company because it would provide a risk assessment tool that would help MNEs to:
    - better understand its own business;
    - properly align profits and value creation;
    - insure consistency between DEMPE functions and legal structure; and
    - help understand the risk of PE exposure

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