Lessons learned: court cases on intangibles

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OECD - Definition of intangibles

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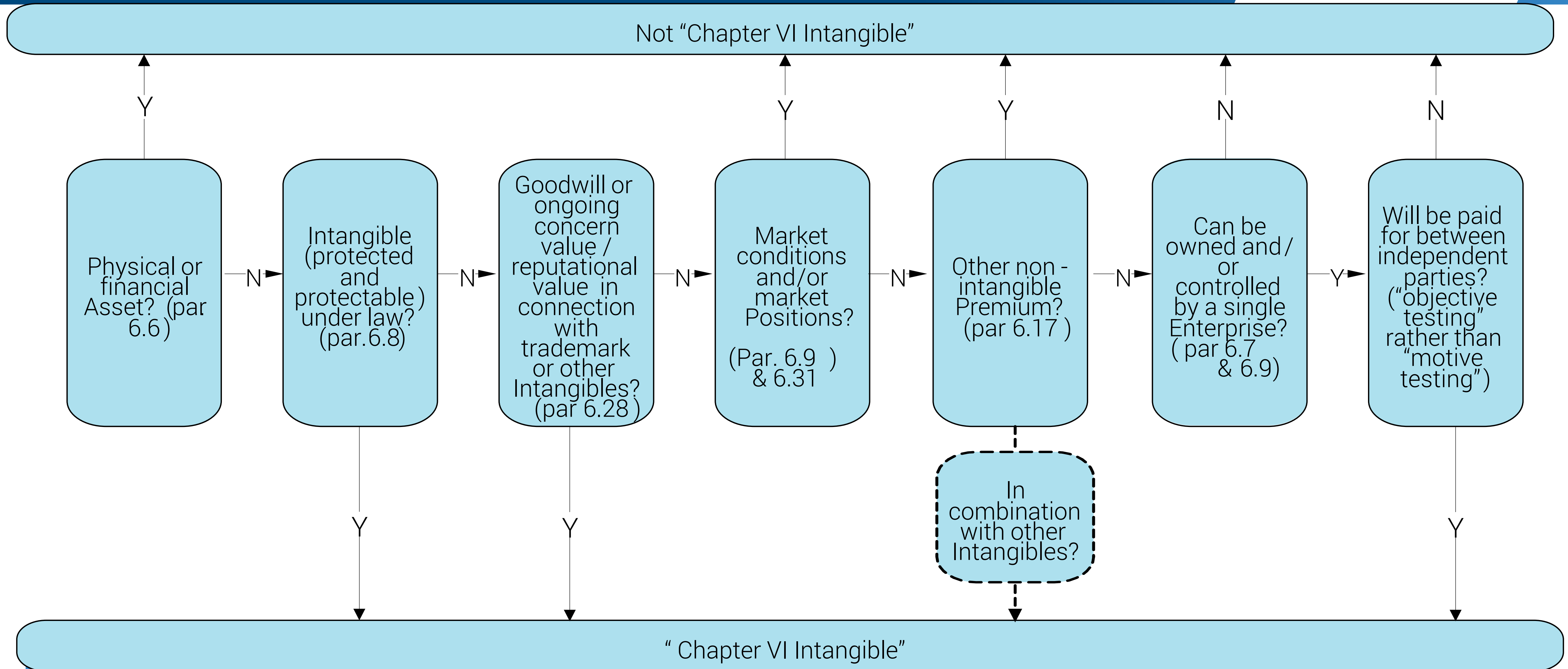

Different angles of looking at IP

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IP®Matrix

	Label	Identification	Owner	Valuation
IP Management	Label	Identification	Owner	Valuation
Accounting	Label	Identification	Owner	Valuation
Tax/Transfer Pricing	Label	Identification	Owner	Valuation
IP Law	Label	Identification	Owner	Valuation
Antitrust	Label	Identification	Owner	
Bankruptcy			Owner	
Special				Valuation Software

There are different interpretations of variables across a variety of professionals.

It covers 4 variables:

- **Label** (What is the label? Example: a patent)
- **Identification** (How do you identify an intangible? Example: a logo on a sport shoe)
- **Owner** (Who owns the intangible? Example: a person who has registered the trademark)
- **Valuation** (What is the value? Example: when a transfer of intangibles happens the value needs to be determined)

An IP lawyer has different definitions of these variables than a TP professional or an accountant.

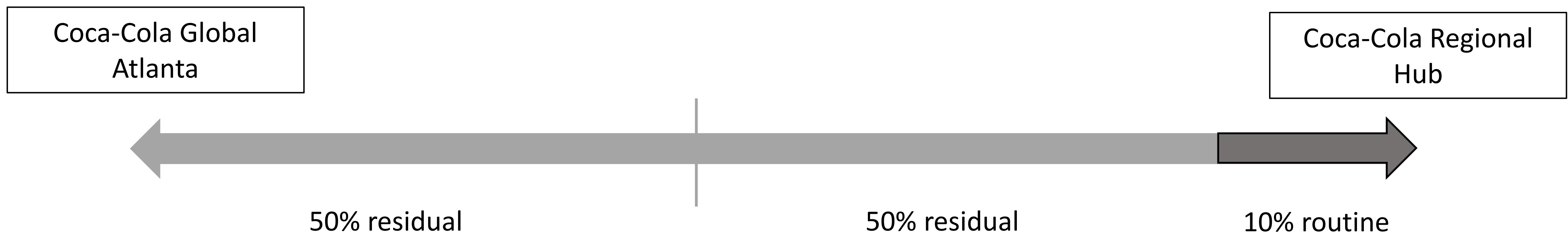
Functional analysis of the participants in the Coca-Cola value chain

The Company's headquarters in Atlanta	Regional 1 Foreign subsidiaries and branches (licensees)	Regional 2 Authorized Bottlers**	Local Retail/Distributors
Syrup concentrate development Ownership of the IP DEMPE Functions Licensing the IP rights to foreign licensees HQ activities	Production of syrup concentrate Sale of the concentrates and syrups to authorized bottlers Marketing activities*	Convert concentrate into finished beverage products for sale to distributors and retailers	Purchase of finished product from bottlers Local sales activities

* Marketing activities are performed by a 3rd party on behalf of the Coca-Cola enterprise and charged to the hubs.
**Coca-Cola maintains business relations with 3 types of bottlers: (i) bottlers in which it has no ownership interest (ii) bottlers in which it has a noncontrolling ownership interest and (iii) bottlers in which it has a controlling ownership interest.

Tax audit – the 10-50-50 approach

- The Coca-Cola company and the IRS entered in a royalty closing agreement for the years 1987-1995 on how to allocate the profit between the licensees and the HQ.
- They agreed on an approach that granted the licensees with a routine return equal to 10% of sales;
- The residual profits would be split evenly, with the royalty rate set to 50% of residual profits;
- After 1995, the closing agreement wasn't renewed, but Coca Cola had "prospective penalty protection" both during the term of the agreement and for the tax years after 1995 as long as it followed the agreed methodology.
- For the years 1996-2006, the IRS has accepted Coca-Cola's application of the 10-50-50 formula and made no adjustments to the royalties.



The IRS approach (CPM approach)

Assuming that:

Sales: $1 billion

Production cost of the concentrate: 17.5% sales + 2.5% (reasonable return for a contract manufacturer)

Selling costs of the concentrate: 27.5% sales + 2.5% (reasonable return for the distribution function)

Advertising (3rd party): 10% sales

Costs: 60% sales

Residual profit: 40% sales

- The IRS changed its position for the years 2007-2009 under audit, arguing that the routine return should have been of 5% instead of 10%
- And the royalty rate should reflect 100% of the residual profit – in this case **40% of sales**
- The IRS approach is to allocate the total residual value to the US parent based on the fact that it has ownership of all intangible assets.

Coca-Cola Global Atlanta

Coca-Cola Regional Hub

5% routine

Court cases on intangibles - DHL Visualization

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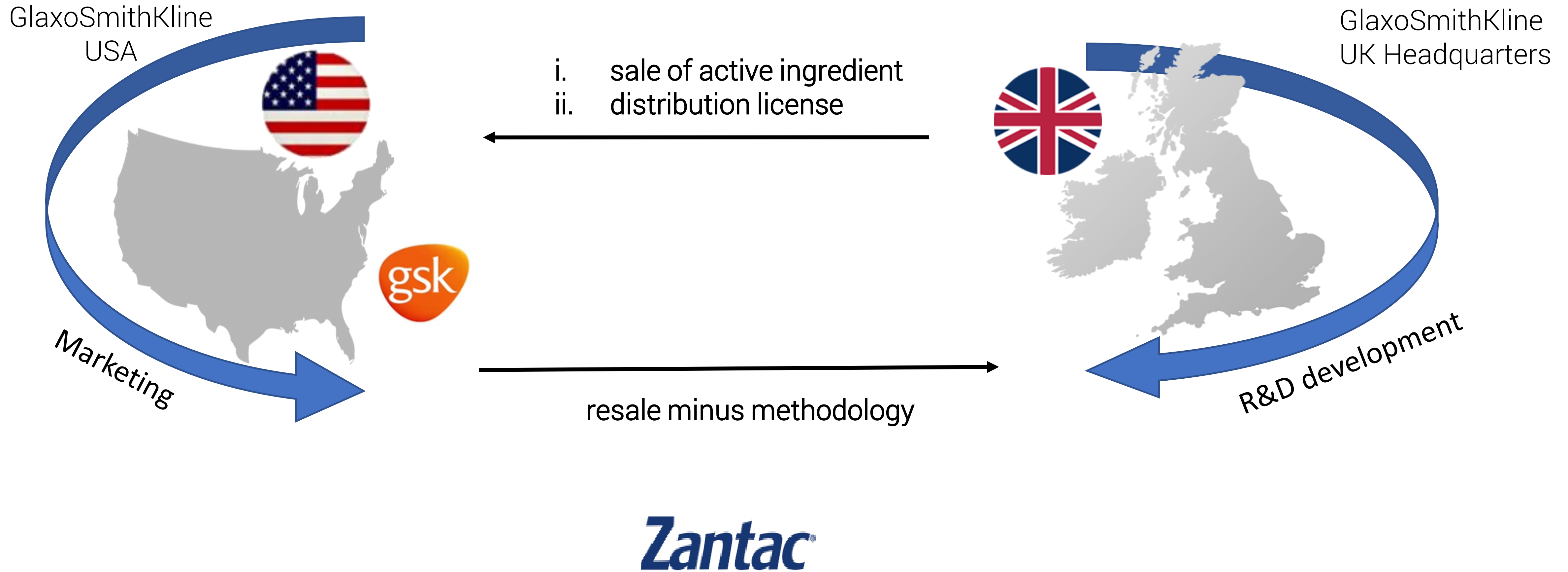
Court cases on intangibles - DHL

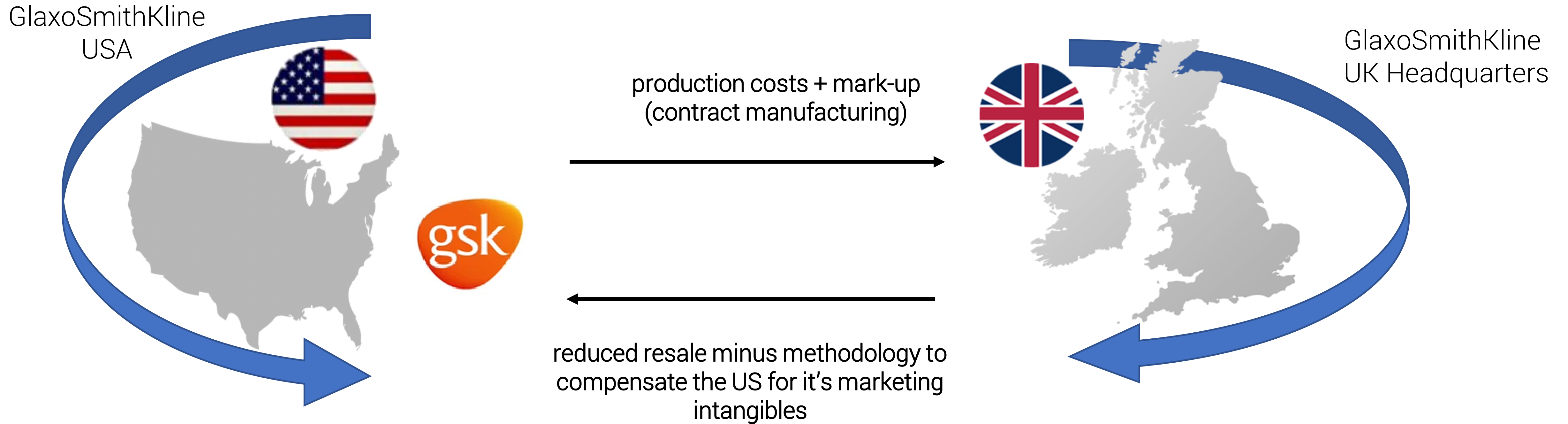
- In DHL Corp. v. Commissioner the Trial court's decision was based on the premise that the US affiliate owned the marketing intangibles even though the Hong Kong affiliate incurred significant advertising expenses.

- A subsequent appeals decision adopted an economic ownership approach (50-50 split approach) on the premise that the Hong Kong affiliate had developed the value of DHL abroad. One problem is that there was no record as to who bore the marketing costs.

Court cases on intangibles - GlaxoSmithKline
Visualization of the GlaxoSmithKline position



Court cases on intangibles - GlaxoSmithKline Visualization of the settlement with IRS



- Marketing intangibles
- Applied the UK developed marketing platform to the US market

Zantac

- R&D development
- Developed the global marketing platform

Lessons learned

- Intangibles could be extremely hard to value, therefore valuation should be performed from different perspectives (ref. US cases mentioned above where the IRS takes 180° different positions on marketing intangibles, Swiss example);

- Commercial, transfer pricing and general corporate tax considerations of business models should be taken into account when addressing intangibles (e.g. securing your subsidiary with implicit guarantees);

- Court cases provide valuable practical implications for intangibles.

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Appendices

Taking control of the future

Alternative labelling of intangibles

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1. Product-related intangibles → Those intangibles that are embedded in a particular product.

2. Process-related intangibles → Those intangibles that are related to unique or valuable know-how used in specific business processes.

3. Market-related intangibles → Intangibles that are linked in such way that a company/product name is positioned and recognized in the market.

4. Hybrids → Intangibles that do not fit clearly within one of the above categories and exhibit characteristics of more than one group.

Tax audit – Coca Cola

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Issue: Whether taxpayer's foreign licensees paid an arm's length royalty rate for the use of product and marketing intangibles owned by the US parent (how residual profits should be allocated being the crucial factor)

IRS Position	Taxpayer's position
• US Parent owns all of the valuable intangible assets • Comparable Profits Method (TNMM) should be applied • Licensees' OP after payment of royalties should equal to 5% of sales • Royalty rate should exceed 40% (foreign licensees are not entitled to residual profit)	• Foreign licensees "economically" own the trademarks in their jurisdictions (marketing intangibles) • They are entitled to residual profit

The 10-50-50 approach (in hypothetical numbers)

Assuming that:

Sales: $1 billion

Production cost of the concentrate : 175 million (17.5% of sales)

Selling costs of the concentrate : 275 million (27.5% of sales)

Advertising (3rd party): 100 million (10% of sales)

Costs: 55% sales

Operating profit: 45% sales

45% - 10% (routine) = 35%

35% / 2 = **17.5%** (royalty rate)

- the IRS changed its position for the years 2007-2009 under audit, arguing that the routine return should have been of 5% instead of 10%
- and the royalty rate should reflect 100% of the residual profit – in this case **40% of sales**

Status of the Coca-Cola case

- In September 2015, Coca-Cola received a letter from the IRS with a bill for $3.3 billion in back taxes.
- On December 14th 2015 Coca-Cola filed a petition with the U.S. Tax Court ("The Coca-Cola Co. v. Commissioner, docket number 31183-15").
- The Tax Court granted a partial summary judgment in December 2017 regarding a foreign tax credit relating to a Mexican subsidiary.
- The rest of the case went to a trial in March 2017 that lasted roughly two months. **It is currently in the post-trial briefing process.**
- This case is important because it will consider whether the IRS' rejection of a closing agreement, which set forth a transfer pricing method and which Coca-Coca followed for years afterward, is a relevant factor in evaluating whether the IRS abused its discretion.