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The Coca-Cola Company and Subsidiaries,

Petitioner

v.

Commissioner of Internal Revenue

Respondent

Electronically Filed
Docket No. 31183-15

Motion for Reconsideration of Findings or Opinion Pursuant to Rule 161

SERVED 06/02/21

UNITED STATES TAX COURT

THE COCA-COLA COMPANY and SUBSIDIARIES, Petitioner,	)	Docket No. 31183-15
v.	)	Judge Lauber
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	Filed Electronically

PETITIONER'S MOTION FOR RECONSIDERATION OF THE COURT'S NOVEMBER 18, 2020, OPINION

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PETITIONER'S MOTION FOR RECONSIDERATION OF THE COURT'S NOVEMBER 18, 2020, OPINION

Petitioner The Coca-Cola Company and Subsidiaries ("Coca-Cola" or "the Company") respectfully moves this Court, pursuant to Tax Court Rules 50 and 161, for reconsideration of the Court's November 18, 2020, opinion (Docket No. 740), *Coca-Cola Co. v. Commissioner*, 155 T.C. No. 10 (2020) ("Op."), for the reasons explained below. Pursuant to Rule 50(a), Coca-Cola has provided Respondent with notice of this motion.[1]

INTRODUCTION AND SUMMARY OF ARGUMENT

The IRS is attempting to impose billions of dollars in additional taxes on Coca-Cola in this case under a different tax calculation method than that on which Coca-Cola justifiably relied and which the IRS audited and approved for over a decade before retroactively requiring Coca-Cola to use a new and different method for tax years long past. The IRS's attempt is arbitrary, capricious, and unconstitutional. The Court's November 18, 2020, opinion in this unprecedented tax case raises fundamental questions of tax, administrative, and constitutional law warranting further consideration by this Court, or by the full Tax Court.

[1] Coca-Cola also is separately moving in the alternative for reconsideration of the Court's November 18, 2020, opinion by the full Tax Court, for the reasons stated in this motion.

Though the IRS and the Court treated this case like any other tax audit case, Coca-Cola believes that neither the IRS nor the Court has ever confronted a case like this one, where the IRS entered into a Closing Agreement with a taxpayer that granted forward-looking protection indefinitely (absent a material change in the facts or relevant tax law) and that the IRS and the taxpayer followed for more than a decade before the IRS switched its position without any notice or change in the facts or law. The IRS led the Court astray from the outset of this case, when the IRS first denied even the *relevance and admissibility* of its unusual 1996 Closing Agreement with Coca-Cola, which by that time had governed the tax relationship between the Company and the IRS for almost a quarter century.[2] Every argument made by the IRS about the Closing Agreement thereafter, and therefore every argument by the IRS about its unlawful switch and retroactive imposition of tax liability on Coca-

[2] *See* Resp't's Mot. in Lim. to Exclude Irrelevant and Inadmissible Evid. Relating to the 1996 Closing Agreement ¶ 18 (Feb. 20, 2018) ("The 1996 Closing Agreement has no relevance to the central issues before the Court—whether respondent's adjustments to petitioner's income for the 2007-2009 tax years are arbitrary, capricious or unreasonable and whether petitioner reported arm's length royalties for the years at issue."); *id.* ¶ 22 ("Petitioner contends that the Closing Agreement is relevant to the issues before the Court because petitioner relied on its consistent application by the parties in post-1995 tax years, including in forgoing a dividend offset election under Rev. Proc. 99-32. Petitioner's 'reliance' on respondent's actions regarding the transfer prices petitioner computed under the Closing Agreement formula in prior years is irrelevant."); *id.* ¶ 34 ("Petitioner's attempt to use the Closing Agreement to dispute the merits of respondent's section 482 adjustments is not permissible under Fed. R. Evid. 408.").

Cola, led the Court deeper and deeper into a thicket of legal, regulatory, and constitutional error.[3]

The Court has the opportunity to correct these fundamental errors now, and with the utmost respect, Coca-Cola asks the Court to reexamine its opinion in this nationally important, precedential tax case, in light of the substantial legal and constitutional arguments below. The Court can do so at this time without prejudice to either the IRS or the Court, while it awaits an opinion in *3M Co. v. Commissioner*, No. 5816-13, and before there is a final decision appealable to the United States Court of Appeals for the Eleventh Circuit.

The first question of fundamental importance is 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. The second fundamental question is whether the IRS and the Court erred in determining that the

[3] Some commentators have even remarked that, in refusing to credit the Supply Points for bearing the costs of marketing expenses (where they did not also directly undertake those activities), the Court effectively adopted Organisation for Economic Co-operation and Development guidance that has not been incorporated into current U.S. regulations. *See* Ryan Finley, *After Coca-Cola, Practitioners See DEMPE as Part of U.S. Law*, 102 Tax Notes Int'l (TA) 1133 (May 24, 2021).

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." Op. 156; *see* Op. 119 (finding CPM applicable because Coca-Cola was "the owner of the valuable intangibles").

Given the critical importance of each of these issues, Coca-Cola respectfully urges the Court to reconsider its opinion in light of the arguments made below.

I. As to the first question, the foundation of American society is the promise of the rule of law that Americans will be treated by their government rationally, reasonably, non-arbitrarily, and consistent with the Constitution and its animating values. This is what it means that America's is "a government of laws and not of men." Mass. Decl. of Rights, pt. 1, art. 30 (John Adams). When the government changes its position on the law after the fact and imposes its changed position of law on a party who has relied on the government's previous position, that party has not been subjected to a government of laws, but rather, to one of men. Such arbitrary government action understandably erodes the People's trust in their government. And when Americans no longer can trust their government, it will cease to be a government of and by the People. As then-Judge Kavanaugh explained—in the context of an even less offensive government attempt to impose a changed position of law on a party that had detrimentally relied—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." *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). After all, "[t]he rule of law constrains the governors as well as the governed." *Id.*

The IRS is attempting to get away with such a "serious due process violation" here. It is trying to retroactively impose billions of dollars in additional tax liability on Coca-Cola based upon a different tax calculation method from the one it had previously agreed was the appropriate method for Coca-Cola to use. The IRS's actions here call into question that fundamental constitutional promise of American government—that our government will not treat Americans arbitrarily and capriciously. The Supreme Court has made clear that all governmental entities and agencies—including the IRS—are ultimately accountable to the People under this principle. "If men must turn square corners when they deal with the government, it cannot be too much to expect the government to turn square corners when it deals with them." *Niz-Chavez v. Garland*, 141 S. Ct. 1474, 1486 (2021) (Gorsuch, J.).

The IRS breached its trust with Coca-Cola, and this breach of trust alone warrants the Court's further consideration. If reaffirmed, the Court's November 18, 2020, opinion holding that the IRS was free to retroactively impose its new transfer-pricing method on The Coca-Cola Company will have profound implications. Among those implications will be that the Tax Court will have declared 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. The IRS has imposed billions of dollars of additional taxes, and promises to impose billions upon billions more, on Coca-Cola. This, even though the IRS approved and encouraged Coca-Cola to calculate its taxes using the 10-50-50 method and for more than a decade repeatedly audited and approved the Company's taxes to ensure the Company's compliance with the 10-50-50 method to calculate the Company's taxes before switching its position without notice. Allowing the IRS's adjustments to stand would undermine taxpayers' trust twice over, were the Court to place its judicial imprimatur on the IRS's arbitrary, capricious, and unconstitutional action.

Of course, the IRS was entitled to change its position prospectively on the appropriate method for calculating Coca-Cola's taxes, provided the new method was consistent with a proper application of the governing Treasury Regulations. What the IRS was not permitted to do under either basic principles of administrative law or the Constitution, however, was change its view of the appropriate transfer-pricing method after Coca-Cola reasonably relied on the IRS's course of conduct affirming that the 10-50-50 method was the lawful and appropriate method, and then impose a new method and billions of dollars of additional tax liability after Coca-Cola had relied on the previous IRS-approved method for the tax years in question.

It has long been settled that an agency acts arbitrarily and capriciously, and thus unlawfully, when it changes position in a way that interferes with legitimate reliance interests created by the agency. Both the Constitution and the arbitrary-and-capricious standard prohibit riding roughshod over government-created reliance interests. The IRS may have ample discretion to change its tax calculation methods, but it may not do so to the taxpayer's detriment after the taxpayer reasonably relied on the IRS's approval of another method and a subsequent course of conduct approving that particular method for the tax years at issue.

A highly unusual combination of circumstances distinguishes this case from the typical IRS audit. The IRS's 1996 Closing Agreement with Coca-Cola did far more than merely resolve past tax disputes. The 1996 Closing Agreement granted Coca-Cola forward-looking protection indefinitely, as long as there was no material change in the facts or the law, of which there were none. And the Closing Agreement in fact governed the two parties' relationship for two decades.

That Agreement accepted the 10-50-50 method for tax years 1987 to 1995; declared—without limitation—that that method produced "arm's length" results as required by the applicable Treasury Regulations; and provided Coca-Cola indefinite prospective penalty protection for underreporting income, absent a material change in facts or law, provided the Company used the 10-50-50 method to calculate its taxes going forward. Thereafter, over the course of successive audit cycles for more than a decade, the IRS audited Coca-Cola to ensure that it was complying with the agreed-upon 10-50-50 method. All the while, the prospective penalty protection effectively prevented Coca-Cola from using any method other than the 10-50-50 method, because of the exorbitant penalties Coca-Cola would have risked incurring had it used a different method.

Not once in the countless interactions the IRS had with Coca-Cola during that decade-plus of compliance audits did the IRS ever suggest to Coca-Cola that the agreed-upon 10-50-50 method was not the lawful, arm's-length method the IRS agreed it was in 1996. To the contrary, as the Court recognized at summary judgment, "the IRS examined [Coca-Cola's] returns for each of the ensuing 11 years and concluded that 'the continuing application of the closing agreement's terms and conditions to the post-1995 years seems appropriate.'" *Coca-Cola Co. v. Commissioner*, 149 T.C. 446, 449 (2017) (quoting Ex. 246-J at EXHJ00004503 (IRS Notice of Proposed Adjustment)). In fact, "the IRS limited its 1996-2006 examinations to determining whether the royalty amounts petitioner received from its supply points were consistent with the closing agreement." *Id.* Indeed, as the Court explained, for two decades, "[e]xplicitly or implicitly, the IRS approved use of the 10-50-50 method by all of petitioner's supply points throughout the world from 1987 through 2006." *Id*. at 457. Nor did the IRS ever suggest that it might demand a new method (without any warning or explanation, no less), and retroactively impose that new method in calculating Coca-Cola's tax liability for past tax years.

As a result of the IRS's agreement and conduct, Coca-Cola organized the Company and structured its affairs according to its agreement with the IRS and the IRS's course of conduct for more than a decade—detrimentally, it turns out, to the tune of the assessment of billions and billions of dollars in unforeseen and unforeseeable taxes. As the Court itself recognized, Coca-Cola "urge[d] that it relied to its detriment on a belief that the IRS would adhere to the 10-50-50 method indefinitely." Op. 98. Coca-Cola's point is that the IRS's "section 482 reallocations [are] arbitrary and capricious," Op. 10,[4] because the IRS "pulled the rug out from under it," Op. 97, by "abandoning the 10-50-50 method, [after] having acquiesced in the use of that method during five prior audit cycles spanning a decade," Op. 10-11.[5]

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[4] Unless otherwise indicated, (1) all "section" references are to the Internal Revenue Code of 1986, as amended and in effect during the years at issue, and (2) all references to "Treas. Reg." are to the Federal income tax regulations in effect during the years at issue.

[5] The IRS well understood that Coca-Cola had reasonably relied on the 1996 Closing Agreement, which is why it vociferously argued from the get-go that Coca-Cola's reliance was "irrelevant." *See supra* pp. 1-2 & n.2; *see also* Resp't's Mot. in

Viewed against its continuous and consistent course of conduct for over a decade, the IRS's change in methods here ultimately amounts to a "bait and switch" so unfair that it contravenes the constitutional principles that undergird and parallel the arbitrary-and-capricious standard. Reflecting the same deep-rooted insight, due process and other fundamental constitutional protections likewise shield regulated parties' reasonable reliance interests from government abridgement without fair notice and reason. These protections prohibit the government from imposing liability or other adverse consequence on its citizens by retroactively applying a new rule to past conduct and actions that were taken in justifiable reliance on the government's previously existing rule.

To the same essential effect, then-Judge Kavanaugh's opinion in *PHH Corp.* is again instructive. There, he illustrated the constitutional prohibition in a different, and less problematic, context than that before this Court now:

> 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

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Lim. to Exclude Irrelevant and Inadmissible Evid. Relating to the 1996 Closing Agreement ¶ 22 (Feb. 20, 2018) ("Petitioner contends that the Closing Agreement is relevant to the issues before the Court *because petitioner relied on its consistent application by the parties in post-1995 tax years*, including in forgoing a dividend offset election under Rev. Proc. 99-32. *Petitioner's 'reliance' on respondent's actions regarding the transfer prices petitioner computed under the Closing Agreement formula in prior years is irrelevant*." (emphases added)).

> ticket. No one would seriously contend that the officer had acted fairly or in a manner consistent with basic due process in that situation.

PHH Corp., 839 F.3d at 49. Here, 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.

II. Respectfully, reconsideration is also warranted concerning the Court's interpretation and application of the applicable Treasury Regulations governing transfer pricing. The Court endorsed the IRS's use of Dr. Scott Newlon's comparable profits method ("CPM") to adjust Coca-Cola's tax returns. Not even the IRS disputes that Dr. Newlon's CPM was permissible only if the Supply Points owned no significant intangible assets contributing to the Company's revenue and profits. Under the Treasury Regulations, Dr. Newlon's CPM is an inappropriate method for use in the case of Coca-Cola's foreign affiliate Supply Points because it does not account for the substantial contribution that their intangible assets make to the generation of Coca-Cola's revenue and profits. Coca-Cola's Supply Points own vast and invaluable intangible assets that are not only critical but indispensable to Coca-Cola's generation of revenue and profit. Indeed, Coca-Cola's entire business model is built around the intangible assets owned both by the Company and by its many affiliates.

As this Court put it, "Coca-Cola is the best known brand in the world, recognized by more of the planet's 7.7 billion inhabitants than any other English word but 'OK.'" Op. 7-8. But no brand is so powerful that its popularity endures without constant nurturing through substantial marketing efforts. And indeed, Coca-Cola has long relied on Supply Points around the globe to take responsibility for the customized local marketing required to promote Coca-Cola's products and the lifestyles they represent, as well as to produce concentrate. These extensive marketing efforts involve determining what brand should be sold, in what channel, for what price, in what packaging, and for what occasion—all depending on the country and culture—and then developing and executing marketing and advertising campaigns to promote the products accordingly. One of Coca-Cola's experts, Dr. Robert Willig, conservatively calculated the Supply Points' marketing intangible development costs to be around $9.4 billion during 2007-2009 alone. *See* Ex. 7251-P (Willig Opening Report) at Ex. 12.

These marketing efforts and investments are not only critical, but indispensable to Coca-Cola's success in markets around the globe, and they contribute substantially to both the value of Coca-Cola's brands and the value of the Supply Points' licenses to use Coca-Cola's brands. As the record makes clear, the Supply Points bear the considerable risk for these substantial marketing efforts and investments.

Under the Treasury Regulations, they are entitled to, and must be afforded, their fair share of the reward for their marketing efforts and investment risk.

Respectfully, the Court's reasoning that the Supply Points were not entitled to credit for their valuable intangibles misconstrued the governing Treasury Regulations. The regulations *require* the IRS and the Court to take account not only of Coca-Cola's trademarks, but also of the Supply Points' licenses to use those trademarks. *See* Temp. Treas. Reg. § 1.482-4T(f)(3)(i)(A), T.D. 9278, 71 Fed. Reg. 44,466, 44,476 (Aug. 4, 2006). In fact, even if the Supply Points had no licenses, the regulations still would require compensation for their significant contributions to Coca-Cola's brands and their substantial goodwill. The Court's contrary conclusion arbitrarily denies the economic reality of Coca-Cola's relationship with its Supply Points and contravenes both the Treasury Regulations and the caselaw.

Even assuming that using a CPM were appropriate, Dr. Newlon's CPM is flawed because it rests on the asserted comparability of Bottlers and Supply Points. Comparing Supply Points to Bottlers is like comparing oranges to orangutans. The assets of Bottlers and Supply Points are entirely different. While the Bottlers are highly capital-intensive—investing in tangible property like bottling lines, warehouses, trucks, coolers, etc., which all appear on the Bottlers' financial statements—the Supply Points are almost the opposite, relying instead primarily on intangible assets like investments in local consumer marketing that do not show up on their balance sheets. Dr. Newlon's erroneous comparison made it wrongly appear like the Supply Points had outsized returns on their assets. But those outsized returns were a mirage created by Dr. Newlon's application of the CPM in a way that erroneously zeroed out the Supply Points' most important assets and investments.

Under Dr. Newlon's CPM, adopted by the IRS, the Supply Points' compensation would be the same regardless of how much they spent on marketing—whether $1 or $1 billion. Conversely, under Dr. Newlon's CPM, had the Supply Points fitted their plants with platinum-plated pipes, they would have been entitled to derive larger profits and pay reduced royalties. The Treasury Regulations and common sense both prohibit such a result. When the errors in Dr. Newlon's CPM are corrected, his CPM collapses under the Treasury Regulations, and the IRS's billions of dollars in tax adjustment all but disappear.

LEGAL STANDARD

The Court enjoys substantial discretion to reconsider findings of fact and conclusions of law under Tax Court Rule 161. Reconsideration is warranted in a variety of circumstances, including where (1) "there is a substantial error or unusual circumstances," *Bedrosian v. Commissioner*, 144 T.C. 152, 156 (2015); (2) "the Court did not give prior adequate consideration to the possible ramifications of its opinion," *Frank Sawyer Tr. of May 1992 v. Commissioner*, T.C. Memo. 2014-128, at *5; *see CWT Farms, Inc. v. Commissioner*, 79 T.C. 1054, 1057 (1982), *aff'd*, 755 F.2d 790

(11th Cir. 1985); or (3) a party presents "new arguments on [a] point [that are] convincing," *Straight v. Commissioner*, No. 23658-94, 1999 WL 33587419, at *1 (T.C. May 6, 1999).[6]

All of these factors favor the Court's reconsideration of its opinion here. The questions presented by this motion are undeniably important. In this case, the resolution of these questions will decide the IRS's authority to impose billions of dollars of tax liability on Coca-Cola and invite the imposition of unwarranted taxes on countless other multinational business taxpayers. As summarized above and explained below, there are compelling reasons for revisiting the Court's opinion. And because a final decision in this case awaits an opinion in *3M Co. v. Commissioner* and likely further briefing and an additional opinion from this Court, reconsideration will not prejudice either party or the Court.

[6] The Court's discretion extends equally to motions for reconsideration filed outside the default 30-day window envisioned by Rule 161. *See, e.g.*, *Bedrosian*, 144 T.C. at 155 ("[T]he Court may grant leave to file an untimely motion."); Order at 1, *Eaton Corp. v. Commissioner*, No. 5576-12 (T.C. June 29, 2016) (granting leave to file motion for reconsideration concerning opinion issued three years earlier); *see also LaBow v. Commissioner*, 763 F.2d 125, 129-30 (2d Cir. 1985) (Tax Court abused its discretion in denying untimely Rule 161 motion). That is particularly true here, where the Court's opinion and decision in this case await further proceedings based on the forthcoming *3M* opinion.

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.

The prohibition against arbitrary-and-capricious decisionmaking—and the constitutional principles that undergird it—preclude any agency from engendering reasonable reliance interests and then imposing retroactive liability upon a party who acts in accordance with those reasonable reliance interests. In concluding that the 10-50-50 method was the lawful, proper, and IRS-approved method for calculating its taxes for the years at issue, Coca-Cola reasonably relied on the IRS's course of conduct for a decade and a half, beginning in 1996 and continuing through at least 2010—encompassing not only the Closing Agreement but also more than a decade of continued acceptance and approval of the 10-50-50 method through five audits.

As the Court explained, "the IRS examined petitioner's returns for each of the ensuing 11 years [after the Closing Agreement was entered into] and concluded that 'the continuing application of the closing agreement's terms and conditions to post-1995 years seems appropriate.'" *Coca-Cola*, 149 T.C. at 449. In fact,

> [T]he IRS limited its 1996-2006 examinations to determining whether the royalty amounts petitioner received from its supply points were consistent with the closing agreement. With one minor exception the IRS answered that question in the affirmative, making no adjustments to the royalty payments that petitioner received from its supply points during 1996-2006. All of these royalties were computed under the 10-50-50 method.

Id. Thus, "[e]xplicitly or implicitly, the IRS approved use of the 10-50-50 method by all of petitioner's supply points throughout the world from 1987 through 2006." *Id.* at 457.

As this Court recognized, Coca-Cola "urges that it relied to its detriment on a belief that the IRS would adhere to the 10-50-50 method indefinitely." Op. 98. Coca-Cola's point is that the IRS's "section 482 reallocations [are] arbitrary and capricious," Op. 10, because the IRS "pulled the rug out from under it," Op. 97, by "abandoning the 10-50-50 method, [after] having acquiesced in the use of that method during five prior audit cycles spanning a decade," Op. 10-11.

While the IRS may have been allowed to require Coca-Cola to use a different transfer-pricing method prospectively (provided it was lawful, *but see infra* pp. 49-73), the IRS was prohibited from effectively baiting Coca-Cola into using the 10-50-50 method, repeatedly auditing and approving the Company's use of that method in successive audit cycles for over a decade, and then imposing billions of dollars in retroactive tax liability on Coca-Cola for having used that approved method instead of the IRS's new method. And this, without the IRS ever having given Coca-Cola prior notice that it no longer believed the 10-50-50 method was lawful until after the conclusion of the tax years at issue. Third Stip. of Facts ¶ 338.

A. Well-established principles require agencies to respect and account for a regulated party's reasonable reliance interests created by the government.

As the Court recognized, the IRS's section 482 determinations must be set aside if they are "arbitrary, capricious, and unreasonable." Op. 89 (citation omitted). The prohibition against arbitrary-and-capricious decisionmaking is one of the law's most important bulwarks against unlawful—and unconstitutional—government action. While perhaps most discussed in the context of judicial review under the Administrative Procedure Act, the standard applies in many different contexts, including—as this Court recognized—to determinations under section 482. Op. 93. And in every context that it is used, the "ordinary" understanding of "arbitrary and capricious" embodies certain fundamental principles, including the twin ideals that government will act reasonably toward its citizens and that its citizens can take their government at its word. *See FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 516 (2009) (discussing "arbitrary or capricious in the ordinary sense"). That ability to rely on the government's words and actions protects the regulated public against "unfair surprise," particularly where (as here) an agency attempts to apply a newly formulated position to past conduct. *Christopher v. SmithKline Beecham Corp.*, 567 U.S. 142, 156 (2012).

Of course, an agency may change its position when circumstances warrant. But when it does so, it "must . . . be cognizant that longstanding policies may have 'engendered serious reliance interests,'" including those that arise from the agency's course of conduct. *Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2126 (2016) (citation omitted); *see id*. at 2123, 2126 ("serious reliance interests" were created by agency's "decades-old practice" (citation omitted)). An agency's failure to account for such reliance interests is per se arbitrary and capricious. *Id*. at 2126; *see, e.g.*, *Fox Television*, 556 U.S. at 515 ("It would be arbitrary or capricious to ignore such matters."); *National Lifeline Ass'n v. FCC*, 921 F.3d 1102, 1114 (D.C. Cir. 2019) (vacating order because, among other things, agency did not "take into account the reliance interests of [parties] that had crafted business models and invested significant resources" based on its prior "policy of forbearance"); *National Ass'n of Indep. Television Producers & Distribs. v. FCC*, 502 F.2d 249, 255 (2d Cir. 1974) ("Having justifiably relied on the Commission's prior policy, petitioners are entitled to more opportunity to adjust to the new rule."). As this Court correctly recognized, in other words, an agency—including the IRS in making transfer-pricing decisions—can "voluntarily limit [its] discretion" through its course of conduct, even if it otherwise had the discretion to take a particular act. Op. 93; *see* Op. 97-98.

These principles embodied in the arbitrary-and-capricious standard as it is used throughout the law—including as it is embodied in the prohibition against arbitrary-and-capricious decisionmaking under section 482—are grounded in core constitutional values. "The Due Process Clause limits the extent to which the Government may retroactively alter the legal consequences of an entity's or person's past conduct," particularly "[w]hen a government agency officially and expressly tells [that party] that [it is] legally allowed to do something." *PHH Corp.*, 839 F.3d at 46, 48 (Kavanaugh, J.). "The Due Process Clause does not allow *retroactive* application of" "an 'abrupt departure' from a consistent, longstanding position." *Id*. at 48 (citation omitted).

The Fifth Amendment Takings Clause likewise protects parties against interference with reasonable, investment-backed expectations such as those created in Coca-Cola by the IRS. *See Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1011 (1984); *see also Eastern Enters. v. Apfel*, 524 U.S. 498, 523-24 (1998) (plurality opinion). These principles are deeply rooted in the Constitution and give concrete form to the bedrock postulate that citizens in a system governed by the rule of law must have fair notice of what conduct is expected and what conduct is prohibited.

Both the arbitrary-and-capricious standard and the Constitution place sharp limits on an agency's ability to apply a newly determined position retroactively. Basic principles of notice and fair dealing prevent an agency from using its adjudicative powers to "upset[] settled expectations with a new rule," *De Niz Robles v. Lynch*, 803 F.3d 1165, 1176 (10th Cir. 2015) (Gorsuch, J.), "penaliz[e] persons for past conduct," *id.*, or impose "new liability . . . on individuals for past actions which were taken in good-faith reliance on [agency] pronouncements," *NLRB v. Bell Aerospace Co. Div. of Textron Inc.*, 416 U.S. 267, 295 (1974); *see Heckler v. Community Health Servs. of Crawford Cnty., Inc.*, 467 U.S. 51, 60 n.12 (1984) ("[A]n administrative agency may not apply a new rule retroactively when to do so would unduly intrude upon reasonable reliance interests."); *Velasquez-Garcia v. Holder,* 760 F.3d 571, 578-84 (7th Cir. 2014); *Miguel-Miguel v. Gonzales,* 500 F.3d 941, 950-53 (9th Cir. 2007).

In short, it has long been settled that the government cannot engender reasonable reliance interests in one interpretation of the law and then hold a party liable for its past conduct under a different interpretation of the law. When an agency does so, its action is arbitrary and capricious—not only in the "ordinary sense," *Fox*, 556 U.S. at 516, but in the way that section 482, the Administrative Procedure Act, other statutes, and the Constitution itself prohibit. The stipulated facts and record establish that that is exactly what the IRS did to Coca-Cola here.

B. The IRS's change in position and retroactive imposition of Dr. Newlon's CPM was arbitrary and capricious.

The IRS's complete disruption of Coca-Cola's settled reliance interests in the lawfulness and appropriateness of the 10-50-50 method for calculating its taxes offends these firmly established principles. While a taxpayer in the ordinary case might not develop reasonable reliance interests in a particular transfer-pricing method or other rule, the concatenation of exceptional circumstances in this case is far from ordinary—if, as Coca-Cola believes, it is not altogether unique.

Here, the IRS took two sets of actions that, taken together, unmistakably engendered reasonable reliance interests on Coca-Cola's part that it could continue relying on the 10-50-50 method set forth in the 1996 Closing Agreement in the calculation of its taxes. First, the 1996 Closing Agreement itself represented that the 10-50-50 method was "arm's length" as required by the Treasury Regulations; the IRS induced Coca-Cola to use the 10-50-50 method upon pain of potentially Draconian penalties; and it granted Coca-Cola penalty protection so long as it did continue to apply that method, as opposed to a different method. Second, the IRS audited Coca-Cola's returns solely for compliance with the 10-50-50 method over the next five audit cycles, thereby continuing to confirm that the 10-50-50 method was the appropriate method for Coca-Cola to use in calculating its taxes.

The IRS's unexpected change in position was arbitrary and capricious for yet another reason, as well: While the IRS applied Dr. Newlon's new method to the six Supply Points at issue here, it continued to approve the Company's use of the 10-50-50 method for other Supply Points in the very same returns, for the very same years. In other words, the IRS simultaneously took inconsistent positions—an irrational move that violates the well-established rule that agencies must explain their changes in position and cannot rely on internally inconsistent reasoning.

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.

The IRS repeatedly and continually induced Coca-Cola to use the 10-50-50 method and thus created reasonable reliance interests in the continued application of that method—interests that the agency could not then simply disregard. *See, e.g.*, *Encino Motorcars*, 136 S. Ct. at 2123, 2126 ("serious reliance interests" were created by agency's "decades-old practice" (citation omitted)). To disregard these interests is per se arbitrary and capricious. *See supra* pp. 18-20 (citing cases). Those inducements came in two forms: the 1996 Closing Agreement and the IRS's repeated audits for compliance with the 10-50-50 method for more than a decade following the Closing Agreement. Taken together, the IRS's likely unprecedented combination of actions here unquestionably engendered reasonable reliance interests on Coca-Cola's part that it could continue applying the 10-50-50 method.

a. Start with the 1996 Closing Agreement. While closing agreements generally apply only to past tax years, the 1996 Closing Agreement was extraordinary, if not unique, in that its critical provisions were also forward-looking, governing the future tax relationship between Coca-Cola and the IRS. The Closing Agreement expressly incorporated the IRS's determination that the 10-50-50 method produced "arm's length" results. Ex. 242-J at 3 (1996 Closing Agreement). That term is talismanic in the transfer-pricing context. Section 482, as consistently interpreted by the IRS, requires the IRS to adopt a method that approximates income from "a taxpayer dealing at arm's length with an uncontrolled taxpayer." Treas. Reg. § 1.482-1(b)(1). The IRS must apply the arm's-length standard "in every case." *Xilinx, Inc. v. Commissioner*, 598 F.3d 1191, 1196 (9th Cir. 2010); *see* A Study of Intercompany Pricing Under Section 482 of the Code, I.R.S. Notice 88-123, 1988-2 C.B. 458, 459-61 (tracing the history of the arm's-length standard).

The IRS's conclusion and agreement in the Closing Agreement constitute a legal determination that the 10-50-50 method satisfied the arm's-length standard. The IRS's declaration that the 10-50-50 method was the appropriate and lawful tax method for Coca-Cola to use in calculating its taxes was profoundly important. It meant that the 10-50-50 method was the right method: As Dr. Newlon conceded at trial, "if . . . the 10-50-50 was the right transfer pricing method, then the facts wouldn't be consistent with the CPM being the right transfer pricing method." Tr. (Newlon) 8336:11-14. As Steve Whaley, Coca-Cola's former vice president and general tax counsel, testified at trial (without contradiction), such a determination and agreement by the IRS is "very, very critical" to deciding how a company will operate. Tr. (Whaley) 1631:7. And as this case demonstrates, transfer-pricing determinations can have enormous financial consequences for companies.

The standards established by section 482 and its implementing regulations are marked more by their ambiguity than by their clear guidance to taxpayers. So where, as here, the IRS has said that a particular transfer-pricing method complies with section 482 and memorialized that conclusion in an agreement with the taxpayer, the taxpayer may understandably place great weight on that determination in structuring its operations. That agreement unquestionably creates in the taxpayer reasonable reliance interests in the IRS's approval of that transfer-pricing method, unless and until the IRS gives notice that it has changed its position or relevant circumstances have decisively changed. *See also infra* pp. 35-36 (discussing *Estate of McLendon v. Commissioner*, 135 F.3d 1017, 1024-25 (5th Cir. 1998)).

Further, the Closing Agreement also contained another unusual, if not unique, forward-defining feature: a safe harbor from potential accuracy-related tax penalties provided that Coca-Cola continued to apply the 10-50-50 method in future years. The agreement stated unambiguously that, "[f]or taxable years after 1995," Coca-Cola would be shielded from accuracy-related penalties if it used the 10-50-50 method, unless "the material facts and circumstances or relevant Federal tax law change." Ex. 242-J at 20-21 (1996 Closing Agreement). The Closing Agreement even extended that penalty protection not only to the then-existing Supply Points, but also to Coca-Cola's "future" Supply Points, underscoring that the parties intended their agreement to govern their mutual tax positions into the future, absent material changes in the facts and circumstances or changes in the law. *Id*. at 20. Of course, there were never any changes in the facts or circumstances or in the relevant federal tax law, and the IRS never gave Coca-Cola notice of such changes during the tax years in question.

Hence, so long as Coca-Cola applied the 10-50-50 method, the Closing Agreement guaranteed that it would not be subject to additional penalties for any alleged underreporting of income. Conversely, if Coca-Cola had used a different method from the agreed-upon 10-50-50 method for the tax years in question, it would have risked substantial tax penalties. Accuracy-related penalties can run up to 40% of liability, section 6662(h)—in this case, for instance, possibly into the billions of dollars. The forward-provided protection from such penalties created "a strong disincentive to change." Tr. (Hawkins) 9281:8-9. Indeed, Coca-Cola reasonably believed it should follow the 10-50-50 method—even if it might otherwise have adopted more beneficial arrangements with its Supply Points—because the risk and magnitude of penalties associated with departing from the 10-50-50 method were simply too great. *See id.* at 9281:14-21; Tr. (Whaley) 1652:9-22.

Accordingly, Coca-Cola faithfully applied the 10-50-50 method (except, as instructed in the Closing Agreement, where a competent authority proceeding or advance pricing agreement required a different method), *see* Third Stip. of Facts ¶ 310, and forwent financially valuable tax-planning opportunities such as offshore migration of intellectual property and cost sharing, Tr. (Hawkins) 9281:14-21; Tr. (Whaley) 1651-52, to "make certain [it was] abiding by" the Closing Agreement, *id.*

at 1652:7-8. The IRS put Coca-Cola in this Catch-22, and now seeks to impose billions of dollars of retroactive tax liability on Coca-Cola for calculating its taxes for more than a decade in exactly the way the IRS agreed the Company should.

b. The Court refused to consider the IRS's determination in the Closing Agreement that the 10-50-50 method was "arm's length" solely because this critical and undisputed determination was incorporated within one of the recitals in the Closing Agreement. But that is a natural place for such a determination to appear in a closing agreement and it was error for the Court to have rejected the IRS's arm's-length determination just because it appeared as a recital in the Closing Agreement. While not necessarily binding wherever they happen to appear in a closing agreement, such recitals "may provide *definitive evidence of the intent of the parties*, particularly where there is no language in the operative portion of the contract which conflicts with the intent expressed in the recitals." *American Nat'l Bank of Jacksonville v. FDIC*, 710 F.2d 1528, 1534 (11th Cir. 1983) (emphasis added). But here, there is not even any need for further evidence of the parties' intent. The IRS has never disputed that it agreed in the Closing Agreement that the 10-50-50 method was "arm's length" and produced "arm's length" results, as required by the Treasury Regulations. And of course, it could not dispute this point, because to do so would be to admit that it approved in 1996, and in every audit cycle for over a decade afterward, Coca-Cola's use of an unlawful method under section 482 for calculating the Company's taxes. Accordingly, it is unsurprising that nothing in the Closing Agreement conflicts with the recital that the 10-50-50 method produces arm's-length results.

Next, the Court viewed the forward-providing penalty-protection provision for use of the 10-50-50 method as "show[ing] that the parties knew how to make the closing agreement conclusive for future years when they wished to do so." Op. 97. But that is exactly the point: The penalty-protection provision, which also applied to Coca-Cola's "future" Supply Points, demonstrated that the parties understood that Coca-Cola would continue to use the 10-50-50 method into the future. Similarly, the IRS's approval of the 10-50-50 method as the lawful and appropriate "arm's length" method that Coca-Cola could use also created reasonable expectations on Coca-Cola's part as to the propriety of that method going forward. This understanding is only confirmed by the fact that the IRS actually audited and approved Coca-Cola's use of the 10-50-50 method for over a decade after the 1996 Closing Agreement was signed and *never once* voiced any objection to it.[7]

[7] The IRS's position from the beginning of the case was that it did not "require [Coca-Cola] to use the Closing Agreement methodology in years after 1995; it merely chose not to challenge petitioner's use for the years 1996 through 2006." Resp't's Mot. in Lim. to Exclude Irrelevant and Inadmissible Evid. Relating to the 1996 Closing Agreement ¶ 27 (Feb. 20, 2018). That position points up the untenability of the IRS's reading of the Closing Agreement. Of course, the Closing Agreement did not expressly require Coca-Cola to use the 10-50-50 method, and Coca-Cola has never contended that it did. But that is to say nothing at all as to whether

Thus, the question is not whether the Closing Agreement contractually bound the IRS to accept the 10-50-50 method in later years or prevented it from changing its position prospectively, but rather whether it created reasonable reliance interests on the part of Coca-Cola. The combination of (i) the Closing Agreement's statement that the 10-50-50 method produced arm's-length results (as required by section 482); (ii) its prospective grant of penalty protection; (iii) the IRS's course of conduct year after year for more than a decade in continually approving Coca-Cola's use of that method; and (iv) the absence of any material changes in fact or law, made it more than reasonable for Coca-Cola to continue applying the 10-50-50 method.

The IRS was not required to agree to any of these forward-defining terms in 1996. But once it did so, under law it had to take account of the reasonable reliance interests it created in Coca-Cola.

c. The IRS's course of conduct for more than a decade after executing the 1996 Closing Agreement confirmed and reinforced Coca-Cola's reliance interests in the mutual understanding between the Company and the IRS that the 10-50-50 method produced arm's-length results and was the appropriate calculation method for Coca-Cola to use. Large global companies like Coca-Cola are under virtually

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the 1996 Closing Agreement and the IRS's consistent course of conduct over the next decade and a half created reasonable reliance interests on the part of Coca-Cola that the IRS could not simply ignore in switching its position with no notice or explanation.

constant federal oversight for tax compliance. Yet, for tax years 1996 to 2006, the IRS never "disturb[ed] the application of the [10-50-50] method itself." Tr. (Whaley) 1644:20-22. To the contrary, the IRS audited Coca-Cola to ensure its compliance with the 10-50-50 method, "initiated adjustments of [Coca-Cola's] intercompany reporting to more closely reflect the Closing Agreement methodology," and affirmatively made "royalty income adjustments equal to the 10-50-50 Amounts." Third Stip. of Facts ¶ 313; *see id.* ¶¶ 310, 314-24(e); Tr. (Whaley) 1644:12-25; Exs. 3290-P, 3291-P, 7021-P (Expense Closing Agreements). Each of those audits thus reaffirmed what the Closing Agreement explicitly declared—that the 10-50-50 method produced arm's-length results under section 482 and was the appropriate method for Coca-Cola to use.

Indeed, this Court recognized that, "[e]xplicitly or implicitly," the IRS approved use of the 10-50-50 method "from 1987 through 2006"—for two decades. *Coca-Cola*, 149 T.C. at 457. During the 2007-2009 tax years at issue here, the Court acknowledged, "the IRS continued to approve royalty payments calculated under the 10-50-50 method, having informed petitioner that 'the continuing application of the closing agreement's terms and conditions to post-1995 years seems appropriate.'" *Id*. at 456 (quoting Ex. 246-J at EXHJ00004503 (IRS Notice of Proposed Adjustment)); *see also, e.g.*, Tr. (Hawkins) 9272:21-23 (explaining that the 10-50-50 method "was affirmatively applied by the . . . IRS" during the 2005-2006 audit); Tr.

(Whaley) 1634:21-22 (stating that every audit cycle was "reconfirmation" of the Closing Agreement). The IRS could not have approved Coca-Cola's use of the 10-50-50 method for even one year, let alone two decades, unless it had determined that the 10-50-50 method was a lawful and appropriate method for use in calculating the Company's taxes under section 482. And Coca-Cola reasonably relied upon these successive audits as "confirmation" of the Closing Agreement's core determination that the 10-50-50 method produced arm's-length results, just as that method did. Tr. (Whaley) 1854:15; *see id.* at 1634:3-22.

2. The IRS's sudden and unwarned change in position was arbitrary and capricious.

a. The IRS's switch was unquestionably arbitrary and capricious. The combination of extraordinary circumstances here—the uniquely forward-defining nature of the 1996 Closing Agreement and the IRS's subsequent course of conduct over five audit cycles—readily distinguish this case from other transfer-pricing cases. The IRS's highly unusual actions here indisputably created powerful reliance interests on Coca-Cola's part in the continued lawful application and acceptance by the IRS of the 10-50-50 method. As the Supreme Court has explained, once such "serious reliance interests" are created, they "*must* be taken into account," *Encino Motorcars*, 136 S. Ct. at 2126 (emphasis added) (citation omitted), and it is "arbitrary and capricious to ignore" them, *DHS v. Regents of the Univ. of Cal.*, 140 S. Ct. 1891, 1913 (2020) (citation omitted). But the IRS altogether ignored Coca-Cola's reliance interests when it changed from the 10-50-50 method to Dr. Newlon's method, even while it continued to approve use of the 10-50-50 method as to other Supply Points.

The IRS gave Coca-Cola no prior notice of its intent to change transfer-pricing methods. As this Court observed, Coca-Cola "cannot have had actual or constructive notice of a fact during 2007-2009 when the communication that put it on notice of that fact did not occur until 2011," "well after [Coca-Cola] filed its tax returns for 2007-2009." *Coca-Cola*, 149 T.C. at 456 & n.3. Nor did the IRS give Coca-Cola any chance to conform its tax arrangements to the IRS's newly minted transfer-pricing method. *See* Third Stip. of Facts ¶¶ 338-43.

The IRS even stipulated:

> At no time prior to [Coca-Cola]'s filing its 2009 Federal income tax return on September 1, 2010, did any IRS employee advise any of [Coca-Cola]'s employees, in writing or otherwise, that the IRS would no longer accept [Coca-Cola]'s application of the methodology set forth in the Closing Agreement relating to the Foreign Affiliates that are covered by the Closing Agreement and are subject to the notice of deficiency . . . .

Id. ¶ 338. The IRS could have easily given Coca-Cola notice of its changed legal position on whether the 10-50-50 method complied with section 482 during one of its many audits. The IRS and its agents had countless interactions with Coca-Cola and its employees over more than a decade of audits. In fact, the IRS to this day has steadfastly refused to identify any changes in the material facts and circumstances or the law that it believes justified its rejection of the 10-50-50 method and replacement by the CPM—and of course there were none.

If the IRS had sought to "account" for Coca-Cola's "serious reliance interests," *Encino Motorcars*, 136 S. Ct. at 2126 (citation omitted), by providing notice of its intent to radically change methods to Dr. Newlon's CPM, Coca-Cola would have taken steps to alter its transfer-pricing arrangements. For example, Coca-Cola could have restructured those arrangements to respond to the IRS's new approach, modified its intercompany agreements to remedy the supposed defects the IRS identified, or entered into more advance pricing agreements to protect its interest in the continued application of the 10-50-50 method for future years. But the IRS did not give Coca-Cola the required notice, account for the Company's IRS-created reliance interests, or give Coca-Cola an opportunity to modify its transfer-pricing arrangements to respond to the IRS's required new method. Instead, in response to all of the tax planning Coca-Cola undertook in reasonable reliance on the IRS's longstanding approval of the 10-50-50 method, the IRS simply and abruptly changed its position, refused to give the reasons for the sudden switch, and imposed billions of dollars in retroactive tax liability on the Company. Indeed, the IRS took the unusual step of designating this case for litigation, meaning that it would refuse to engage in settlement discussions with Coca-Cola, much less explain the reasons for its capricious switch. *See also infra* pp. 37-40.

The IRS's application of its new method retroactively—to past conduct and tax years—despite Coca-Cola's reasonable reliance on the continued appropriateness of the 10-50-50 method, violated the fundamental guarantees that prohibit arbitrary government action. *See, e.g.*, *ARA Servs., Inc. v. NLRB*, 71 F.3d 129, 135 (4th Cir. 1995) (rules that "represent[] an 'abrupt break with well-settled policy'" may not be applied to past conduct (citation omitted)); *De Niz Robles*, 803 F.3d at 1169-80; *Velasquez-Garcia*, 760 F.3d at 578-84; *Miguel-Miguel*, 500 F.3d at 950-53; *Epilepsy Found. of Ne. Ohio v. NLRB*, 268 F.3d 1095, 1102-03 (D.C. Cir. 2001); *McDonald v. Watt*, 653 F.2d 1035, 1042-46 (5th Cir. Unit A Aug. 1981). Where, as here, an agency is not "seeking to enforce the law as it is but instead . . . to implement its own (current but revisable) vision of what the law should be," it is "hard to see how requiring prospectivity would be contrary to any statutory design or to legal and equitable principles." *De Niz Robles*, 803 F.3d at 1176 (cleaned up).

b. There is a vast difference between an agency's permissible announcement of a new approach in adjudication and an agency's retroactive switch from an existing rule after a party has relied on the preexisting rule to its detriment. As Judge Friendly put it, "a decision branding as 'unfair' conduct stamped 'fair' at the time a party acted[] raises judicial hackles," and "the hackles bristle still more when a financial penalty is assessed for action that might well have been avoided if the agency's changed disposition had been earlier made known, or might even have been taken in express reliance on the standard previously established." *NLRB v. Majestic Weaving Co.*, 355 F.2d 854, 860 (2d Cir. 1966) (Friendly, J.). An agency acts arbitrarily and capriciously and abuses its discretion when it "attempt[s] to establish a new standard" and "apply[] it . . . by the adjudicatory process" to someone who relied on prior agency guidance. *Ruangswang v. INS*, 591 F.2d 39, 46 (9th Cir. 1978); *accord Patel v. INS*, 638 F.2d 1199, 1205 (9th Cir. 1980). Just so here. The problem is not that the IRS audited Coca-Cola after the fact (and in that sense "retroactively"), but that the IRS retroactively imposed a massive tax liability based on a new and previously unannounced standard with no warning, after having induced Coca-Cola to rely to its detriment on a different method. That kind of bait and switch is the epitome of agency arbitrariness and caprice.

The IRS may retroactively revoke decisions upon which a taxpayer has detrimentally relied only in very limited circumstances. *See, e.g.*, *Dixon v. United States*, 381 U.S. 68, 72-73 (1965). That "rule applies only where the [IRS] revokes a prior ruling that is contrary to the Internal Revenue Code." *McLendon*, 135 F.3d at 1024 n.15. Here, the IRS has not argued—and cannot contend—that its adoption and repeated endorsement and approval of the 10-50-50 was contrary to law. *See infra* pp. 49-73. Instead, the exceptional combination of the IRS's actions here—(1) its representation in the 1996 Closing Agreement that the 10-50-50 method was "arm's length"; (2) its continued reaffirmation of that determination through more than a decade of audits for compliance with the 10-50-50 method; and (3) its application of the 10-50-50 method (or something more favorable to the Supply Points) to other Supply Points during the very tax years here at issue—completely distinguishes this case and compels application of a different rule.

As the Fifth Circuit has explained, the IRS "may not retroactively abrogate a ruling in an unclear area with respect to any taxpayer who has relied on it." *McLendon*, 135 F.3d at 1024. That rule flows directly from the basic administrative law principles discussed above—and as the Supreme Court has instructed, absent some "justification," courts must not "carve out an approach to administrative review good for tax law only." *Mayo Found. for Med. Educ. & Rsch. v. United States*, 562 U.S. 44, 55 (2011). Like the taxpayer in *McLendon*, Coca-Cola "structure[d] [its] transaction[s] to comply with applicable law," relying on the IRS's representations. *McLendon*, 135 F.3d at 1025. Contravening those representations now is an "intolerable" "tactic." *Id.* "Where the [IRS] has specifically approved a [particular] methodology, . . . [it] will not be heard to fault a taxpayer for taking advantage of the tax minimization opportunities inherent therein." *Id.*[8]

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[8] The unique circumstances of this case also distinguish it from *Knight-Ridder Newspapers, Inc. v. United States*, 743 F.2d 781 (11th Cir. 1984). There, the court held that the IRS had discretion to require two subsidiaries of the taxpayer to change from the cash method of accounting to the accrual method, even though the IRS had previously accepted the subsidiaries' use of the cash method, observing that "the use of a method in one year cannot bind [the IRS's] hands in perpetuity." *Id.* at 793. In

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.

Further confirming the IRS's arbitrariness and capriciousness, the IRS did not even apply its new legal position consistently to Coca-Cola. Failing to treat like situations alike is a hallmark of arbitrary-and-capricious action. *See, e.g.*, *ANR Storage Co. v. FERC*, 904 F.3d 1020, 1024 (D.C. Cir. 2018) (agency "must give a 'reasoned analysis' to justify the disparate treatment of regulated parties that seem similarly situated, and its reasoning cannot be internally inconsistent" (citation omitted)); *LePage's 2000, Inc. v. Postal Regul. Comm'n*, 674 F.3d 862, 866 (D.C. Cir. 2012) (per curiam). "It is textbook administrative law that an agency must provide a reasoned explanation for departing from precedent or treating similar situations differently." *West Deptford Energy, LLC v. FERC*, 766 F.3d 10, 20 (D.C. Cir. 2014)

Knight-Ridder, however, the taxpayer relied solely on the IRS's passive acceptance of the cash method in prior years. Here, by contrast, Coca-Cola affirmatively and reasonably relied on the combination of circumstances discussed above as a basis for continuing to apply the 10-50-50 method—until, at a minimum, the IRS gave it notice otherwise—including the IRS's affirmative declaration in the Closing Agreement that the 10-50-50 method produced an "arm's length" result. Moreover, in *Knight-Ridder,* there was a material change in factual circumstances—the taxpayer's acquisition of the subsidiaries—that precipitated the change in methods. *Id.* at 784. Here, the IRS has never identified any material change in facts or law warranting a change in transfer-pricing methods. *See supra* pp. 31-32. And the court in *Knight-Ridder* did not even evaluate the taxpayer's reliance interests in light of the authorities discussed in this brief.

(cleaned up). And "[t]he need for an explanation is particularly acute when an agency is applying a multi-factor test through case-by-case adjudication." *LeMoyne-Owen Coll. v. NLRB*, 357 F.3d 55, 61 (D.C. Cir. 2004).

Here, the IRS departed from these fundamental administrative-law requirements. Although the IRS rejected its own, approved 10-50-50 method for the six Supply Points at issue in this case, it continued to approve and accept the 10-50-50 method for Coca-Cola's other Supply Points—without even trying to explain the inconsistency. *See* Coca-Cola Opening Br. 6 n.7; Coca-Cola Pretrial Mem. 4 n.5, 13, 15, 68. The IRS did not (and could not) explain how its treatment of other Supply Points under the 10-50-50 method and its application of Dr. Newlon's new method to the six Supply Points at issue here could both capture the arm's-length standard under section 482. That inconsistency itself renders the IRS's action arbitrary and capricious.

The IRS's inconsistent positions are especially arbitrary here given the agency's designation of this case for litigation. Under its own guidelines, the IRS may designate a case for litigation—precluding settlement of the issue and requiring "a full concession by the taxpayer" to resolve the issue before the IRS—where a case "present[s] recurring, significant legal issues affecting large number of taxpayers" and "there is a critical need for enforcement activity with respect to such issues." IRM 33.3.6.1(1), (2) (Aug. 11, 2004). The Internal Revenue Manual provides that designation may be appropriate to "provide guidance for the resolution of industry-wide . . . issues," *id.* 33.3.6.1(1), and that the IRS "will consider whether the issue is one of first impression or otherwise involves unique or unusual circumstances," *id.* 33.3.6.1(3). What's more, the Manual provides that "[e]fforts should be made to discover the existence of facts that could adversely affect the desirability of designation, *such as an agreement with the Service in an earlier year with the taxpayer contrary to the position now proposed*." *Id.* 33.3.6.3.1(1)(b) (emphasis added). Yet here the IRS approved Coca-Cola's use of the 10-50-50 method for two decades, in accordance with the 1996 Closing Agreement, before switching its position without notice or explanation, and then failed to take consistent positions even as to the same company for the same tax years, let alone an entire industry. And it did all this, all the while denying even the relevance and admissibility of its "contrary" Closing Agreement with Coca-Cola. *See supra* p. 2 & n.2, 9 n.5.

The IRS's "failure to come to grips with conflicting precedent" was "an inexcusable departure from the essential requirement of reasoned decision making." *Snohomish County v. Surface Transp. Bd.*, 954 F.3d 290, 303 (D.C. Cir. 2020) (citation omitted). The agency's reasoning was "internally inconsistent," *ANR Storage*, 904 F.3d at 1024—it treated different Supply Points differently for no apparent reason. As Justice Holmes put it, "the tendency of the law must always be to narrow the field of uncertainty." Oliver Wendell Holmes, *The Common Law* 127 (1881).

The IRS's actions here "do the opposite." *Ramaprakash v. FAA*, 346 F.3d 1121, 1130 (D.C. Cir. 2003) (Roberts, J.).

C. The IRS's bait and switch violates the Constitution of the United States.

The IRS's arbitrary and capricious conduct is so egregious that it violates the Constitution as well. When the government engenders predictable reliance on its interpretation and articulation of the law, it is central to due process and indeed the rule of law that citizens may order their affairs in reasonable reliance on the government's word and course of conduct. The government may not impose after-the-fact liability based on conduct that was lawful and justified by reasonable reliance on what the government had previously said the law was. *See PHH Corp.*, 839 F.3d at 46-49 (citing numerous cases, including *Raley v. Ohio*, 360 U.S. 423, 438-39 (1959)).

The same sorts of governmental conduct that give rise to reasonable reliance interests for purposes of the arbitrary-and-capricious standard can, as they do here, also give rise to constitutionally cognizable reliance interests. *See, e.g.*, *Williams v. Barry*, 708 F.2d 789, 792 (D.C. Cir. 1983) (recognizing that "the consistent, positive action of government officials" can create constitutionally cognizable reliance interests (citation omitted)). Thus, the IRS's extensive, continuous, and unvarying course of conduct approving the 10-50-50 method—the Closing Agreement and the IRS's approval and reliance on the 10-50-50 method for more than a decade over five successive audit cycles—created reliance interests protected by the Due Process Clause of the Fifth Amendment. The IRS was barred from imposing tax liability on Coca-Cola based on a new method of which it failed to provide any notice. *See FCC v. Fox Television Stations, Inc.*, 567 U.S. 239, 253-54 (2012); *see also Christopher*, 567 U.S. at 156 n.15 (collecting cases for the proposition that "agencies should provide regulated parties fair warning of the conduct a regulation prohibits or requires" (cleaned up)). Nor may an agency "apply a new rule retroactively when to do so would unduly intrude upon reasonable reliance interests." *Community Health Servs.*, 467 U.S. at 60 n.12.

The Supreme Court has enforced this basic principle of fair government in a variety of contexts, including in circumstances far less egregious than those here. In *United States v. Pennsylvania Industrial Chemical Corp.*, 411 U.S. 655, 674 (1973), for example, the Court held that "traditional notions of fairness" precluded the government from proceeding with an enforcement action under a water-pollution statute when the agency administering the statute had previously adopted regulations construing the statute as permitting the corporation's discharge. The Court explained that, even if the government now contended that the agency's prior interpretation of the statute had been erroneous, the corporation had the right to defend itself by showing that it acted "in reliance on the consistent, longstanding administrative construction of" the statute and that "the deposits in question were made in good-faith belief that they were permissible under law." *Id.* at 673.

Similarly, in *Fox Television*, the Supreme Court held that enforcement of the FCC's newfound indecency policy violated due process. 567 U.S. at 254. The case centered on the FCC's enforcement of a statutory prohibition on broadcasting "obscene, indecent, or profane language." *Id.* at 243 (quoting 18 U.S.C. § 1464). Although the FCC had possessed that statutory authority since 1948, the agency "did not begin to enforce § 1464 until the 1970's," finding at that time that "George Carlin's 'Filthy Words' monologue was indecent" but then for many years "not go[ing] beyond the narrow circumstances" of its "Filthy Words" ruling. *Id*. at 244-45. When the FCC finally provided further guidance in 2001, it was in the form of "a policy statement" only vaguely describing "three factors" to determine "what it considered patently offensive." *Id.* at 246.

"It was against this regulatory background" that the FCC issued Notices of Apparent Liability to Fox Television Studios and ABC Television Network. *Id.* at 247. "Reversing a decision by its enforcement bureau, the [FCC] found the use of the F-word actionably indecent," and "reversed [its] prior rulings that had found fleeting expletives not indecent." *Id.* at 248.

The Supreme Court held that the FCC's switch in position violated the networks' due process rights. *Id.* at 254-58. "A fundamental principle in our legal system," the Court instructed, "is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required." *Id.* at 253. The Court explained that, "[e]ven when speech is not at issue," the government's ability to change its policies is limited by "two connected but discrete due process concerns": "first, that regulated parties should know what is required of them so they may act accordingly; second, precision and guidance are necessary so that those enforcing the law do not act in an arbitrary or discriminatory way." *Id.* And, the Supreme Court continued, those concerns were implicated by the FCC's Notices of Apparent Liability because the agency's "regulatory history" made clear "that the [FCC] policy in place at the time of the broadcasts gave no notice to Fox or ABC that a fleeting expletive or a brief shot of nudity could be actionably indecent; yet Fox and ABC were found to be in violation." *Id.* at 254. The Court thus concluded that the agency had violated the networks' due process rights, as "would be true with respect to a regulatory change this abrupt on any subject." *Id.*; *see id.* at 254-58.

Similar principles apply under other pillars of constitutional protection, such as the Fifth Amendment Takings Clause. That clause protects property-based reliance interests created by an agency's actions, including the agreements into which an agency enters (such as the Closing Agreement) and an agency's reaffirmation of those agreements through its consistent course of conduct. For example, in *Ruckelshaus v. Monsanto*, the Supreme Court held that EPA rules promising confidential treatment for trade secret pesticide safety data submitted to the agency for regulatory purposes created "a reasonable investment-backed expectation" that required compensation in the event of EPA disclosure of that information. 467 U.S. at 1011.

Likewise, in *Eastern Enterprises*, the Court held that new legislation could not be applied retroactively under the Takings Clause to require a company which had once owned a coal mining business to pay healthcare benefits to over 1,000 former employees of that business. 524 U.S. at 524 (plurality opinion). The Court delineated three factors to consider—the severity of the economic impact of new regulation, the substantiality of the interference with reasonable investment-backed expectations, and the character of the governmental action. *Id.* at 523-24. Buttressing the overlap between these lines of constitutional authority, other Justices applied similar reasoning but framed the inquiry in terms of the Due Process Clause rather than the Takings Clause. *See id.* at 539 (Kennedy, J., concurring in the judgment and dissenting in part); *id.* at 558 (Breyer, J., dissenting).

The Constitution also protects private parties' agreements with the government. The Supreme Court has recognized that even a new statute "that retroactively repudiates the Government's contractual obligation may violate the Constitution." *Cherokee Nation of Okla. v. Leavitt*, 543 U.S. 631, 646 (2005). "[C]ontractors [a]re entitled to rely on the Government's promise to pay." *Salazar v. Ramah Navajo Chapter*, 567 U.S. 182, 193 (2012). In *United States v. Winstar Corp.*, 518 U.S. 839 (1996), for example, the government had agreed to a certain accounting method for savings-and-loan institutions, or S&Ls, regarding supervisory goodwill and capital credit. The government subsequently repudiated that agreement due to later-enacted legislation. Citing "due process" and "constitutional questions," the Supreme Court rejected the government's bait and switch and accordingly directed that the S&Ls be allowed to recover billions of dollars in damages. *Id.* at 875-76 (plurality opinion); *see also Cienega Gardens v. United States*, 331 F.3d 1319, 1334 (Fed. Cir. 2003) (Takings Clause case "comparable to *Winstar*").

Even when Congress legislates, it must abide by these constitutional principles. Just last Term, for example, the Supreme Court enforced the government's statutory promise to make $12.7 billion in payments to health insurers under the Affordable Care Act. *Maine Cmty. Health Options v. United States*, 140 S. Ct. 1308 (2020). After the insurers had performed their part of the bargain, the agency switched positions and denied that payment was due, pointing to subsequent appropriations legislation that failed to provide adequate funding for the program. The Supreme Court flatly rejected the agency's position, saying that abrogation of the government's commitment "would raise serious questions whether the appropriations riders retroactively impaired insurers' rights to payment." *Id.* at 1324 (citing *Landgraf v. USI Film Prods.*, 511 U.S. 244, 265-66, 280 (1994)).

What the IRS has done in this case in imposing $3.3 billion in additional tax liability is more constitutionally troubling than the agency action in any of these cases. In *PHH Corp.*, for example, the D.C. Circuit invalidated the Consumer Financial Protection Bureau's switch in position imposing no damages or civil penalties but merely injunctive relief and a requirement that the company disgorge illegally obtained kickback payments amounting to only about 3% of the tax liability at issue in this case. *See* 839 F.3d at 12, 41; Brief of Respondent CFPB at 1, 17, *PHH Corp.*, 839 F.3d 1 (D.C. Cir. 2015) (No. 15-1177), 2015 WL 6774568. In *Fox Television*, the Supreme Court invalidated FCC Notices of Apparent Liability in the amount of (at most) $1.24 million because the FCC's vague standards failed to give the networks notice of what was expected. 567 U.S. at 254-58. The Court declared that the same due process problems would arise "with respect to a regulatory change this abrupt *on any subject*." *Id.* at 254 (emphasis added). Here, the IRS's regulatory change was far more abrupt and severe than that in *Fox Television*, which involved mere regulatory vagueness and lack of notice. In this case, the IRS specifically approved and accepted Coca-Cola's use of the 10-50-50 method and encouraged and induced over a decade of the Company's reasonable reliance on that method. The IRS knew (and verified through five audit cycles) that Coca-Cola continued to structure its worldwide operations on the 10-50-50 method.

Moreover, many of the cases discussed above (such as *Winstar*, *Cherokee Nation*, and *Maine Community Health Options*) involved subsequent legislation enacted by the Congress of the United States. Arguably, all citizens must account for the possibility that Congress will change the law—but, as these cases underscore, even Congress faces constitutional limits on its ability to impose retroactive liability that will interfere with or nullify the settled expectations of private parties. *See, e.g.*, *Vartelas v. Holder*, 566 U.S. 257, 266 (2012) ("The presumption against retroactive legislation . . . 'embodies a legal doctrine centuries older than our Republic.'" (citation omitted)). Given these concerns, the Supreme Court has required Congress to "make its intention clear" to "ensure that Congress itself has determined that the benefits of retroactivity outweigh the potential for disruption or unfairness." *Landgraf*, 511 U.S. at 268. The IRS's switch in position here suffers from all the vices of retroactive legislation and enjoys none of the virtues of congressional authorization—let alone any "clear congressional intent authorizing retroactivity." *Id.* at 272.

In the end, this case therefore presents an even starker example of an unconstitutional bait and switch than the decisions discussed above and, Coca-Cola believes, any such case that has ever made its way to the Supreme Court.

Ultimately, this Court need not cast its reconsideration in constitutional terms. The Court can and should consider the non-constitutional arguments first—whether the IRS's actions are arbitrary and capricious, *see supra* pp. 16-39, and whether the IRS's new method violates the Treasury Regulations, *see infra* pp. 49-73. *See generally Ashwander v. Tennessee Valley Auth.*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring) ("[I]f a case can be decided on either of two grounds, one involving a constitutional question, the other a question of statutory construction or general law, the Court will decide only the latter."); *Gulf Oil Co. v. Bernard*, 452 U.S. 89, 99 (1981); *Three Affiliated Tribes of Fort Berthold Rsrv. v. Wold Eng'g, P.C.*, 467 U.S. 138, 157 (1984); *United States v. Madera*, 528 F.3d 852, 859 (11th Cir. 2008). Each is a more-than-sufficient basis to reject the IRS's imposition of the additional taxes on Coca-Cola. Whether this Court rejects the IRS's attempt to impose the CPM on Coca-Cola because the IRS's efforts to bring this case before the Court are unconstitutional or because those efforts are "merely" arbitrary and capricious, the IRS's unlawful retroactive imposition of these taxes cannot be allowed to stand.

Just as "men must turn square corners when they deal with the Government," "the Government should turn square corners in dealing with the people." *Regents*, 140 S. Ct. at 1909 (cleaned up). The IRS is no more exempt from this indispensable command of fair and honest government than any other agency or official, or for that matter, the United States Congress. This Court should accordingly reconsider its decision and hold that, even if the IRS could justify the use of Dr. Newlon's CPM under the Treasury Regulations and other tax principles (and it cannot, as discussed next), the IRS's attempt to retroactively impose that new method for the tax years at issue—with no notice and after repeated representations that the 10-50-50 method was appropriate—is unlawful. The IRS's bait and switch has no place in our form of government.

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.

Even if the IRS's bait and switch were lawful, the Court should reconsider its ruling that the IRS's new method to be used in calculating Coca-Cola's taxes is a permissible method. It is not. The IRS's new method, Dr. Newlon's CPM, and the Court's endorsement of it inarguably contravene the governing Treasury Regulations and disregard the economic substance of Coca-Cola's relationship with its Supply Points.

The IRS's multi-billion-dollar adjustment, which the Court approved, depends on using Dr. Newlon's comparable profits method instead of the 10-50-50 method the IRS had approved for decades. All agree that Dr. Newlon's CPM applies only if no intangible assets contribute to a company's revenue and profits. Here, however, the Supply Points own significant intangible assets, and they used those significant intangible assets to drive the sales of Coca-Cola's products, bringing inestimable value not only to the Supply Points' licenses but also to Coca-Cola's brands. The governing Treasury Regulations required the IRS—and the Court—to account for those intangible assets in the final transfer-pricing decision. Neither did.

Coca-Cola is a brand known and loved in every corner of the world, with a varying menu of recognizable products offered from region to region. But those offerings, their success, and the success of Coca-Cola depend on local development and marketing efforts across the globe. It is the Supply Points that play this critical role in the continued success of Coca-Cola by manufacturing the Coca-Cola concentrate and undertaking the responsibility for the necessary and extensive local marketing under their licenses to use Coca-Cola's trademarks. The IRS's own experts acknowledged that Coca-Cola relies on the Supply Points' sustained local marketing contributions to maintain the brands and their value worldwide. *See, e.g.*, Tr. (Newlon) 8098, 8228-30, 8232; Tr. (Ailawadi) 8718-19, 8861-62. The marketing efforts for which the Supply Points took responsibility and bore the risk involve determining what products to sell, under which brands, in which channels, for what price, in what packaging, for what occasions—all depending on country or cultural preferences—and then developing and running advertising campaigns to promote the products accordingly. Tr. (Kent) 184-85, 188-89. And as the record makes clear, the Supply Points bore the costs of local marketing in the regions for which they were responsible. Coca-Cola's expert, Dr. Willig, conservatively calculated the Supply Points' marketing intangible development costs to be around $9.4 billion during 2007-2009 alone, for example. *See* Ex. 7251-P (Willig Opening Report) at Ex. 12; *see also infra* pp. 71-73.

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.

The Court contravened the governing Treasury Regulations in three ways by failing to recognize that the Supply Points owned valuable intangibles that are required to be incorporated into the transfer-pricing analysis.

1. The Court contravened the Treasury Regulations by failing to account for the Supply Points' licenses to use Coca-Cola's trademarks.

The Court recognized that the Supply Points' agreements with Coca-Cola "granted the supply points the rights to produce and sell concentrate in accordance with [Coca-Cola's] specifications." Op. 42. Indeed, the Court acknowledged that "[t]he supply points were authorized to use [Coca-Cola's] intangible property in connection with their production and selling rights." *Id.* But the Court erred in failing to account for those licenses in its transfer-pricing analysis on the legally erroneous ground that Coca-Cola "was the registered legal owner of virtually all trademarks and other intangible assets." Op. 156; Op. 119 (finding CPM applicable because Coca-Cola was "the owner of the valuable intangibles"). This reasoning misconstrues and contravenes the governing regulations, which require recognizing the Supply Points' licenses and the Supply Points' investments to increase the value of those licenses.

The Treasury Regulations make clear that licenses to use intellectual property, like a trademark, are intangible assets distinct from the underlying intellectual property itself: "The legal owner of an intangible . . . , or the holder of rights constituting an intangible pursuant to contractual terms (such as the terms of a license) . . . , will be considered the sole owner of the respective intangible . . . unless such ownership is inconsistent with the economic substance of the underlying transactions." Temp. Treas. Reg. § 1.482-4T(f)(3)(i)(A), 71 Fed. Reg. at 44,484. In other words, the regulations explicitly "contemplate[] the identification of a single owner for each discrete set of rights that constitutes an intangible"—including "a license or other right to use an intangible" as a separate "item of intangible property." T.D. 9278, 71 Fed. Reg. at 44,476.

The Treasury Department introduced this explicit dual-intangible framework to address concerns about "'all or nothing' results" (of exactly the kind the Court endorsed in its November 18, 2020, opinion) from failing to allocate "[t]he income attributable to an intangible," like a trademark, "in accordance with each party's contributions to the development or enhancement of that intangible and its ownership interests (if any)." Treatment of Services Under Section 482; Allocation of Income and Deductions from Intangibles, 68 Fed. Reg. 53,448, 53,449 (Sept. 10, 2003). This of course makes perfect sense. More than one controlled taxpayer can (and often does) invest in, and realize income from, intellectual property like a trademark and any licenses to use that trademark. The regulations thus reward a licensee for its investments in marketing by treating the licensee as the "owner" of the license and recognizing its marketing efforts as increasing the value of its own property (the license). Put simply, the Treasury Regulations say that a licensee is entitled to keep the premium profits when its marketing efforts result in increased sales.

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," Op. 157, is thus legal error. It is true that the Supply Points did not have or share ownership of Coca-Cola's "crown jewels"—the trademarks themselves. Op. 159. But that's irrelevant. The Supply Points are Coca-Cola's licensed alchemists, who turn those jewels into liquid and revenue. Second Stip. of Facts ¶¶ 146-152; Exs. 82-J through 88-J. The regulations take the Supply Points' marketing investments for exactly what they are—efforts that increase the value of their own licenses. The regulations entitle the Supply Points to compensation for that increased value to their licenses, *see* Temp. Treas. Reg. § 1.482-4T(f)(4)(ii), Example 4, 71 Fed. Reg. at 44,485; *see also id.* § 1.482-4T(f)(4)(i) & (ii), 71 Fed. Reg. at 44,485; *infra* pp. 54-58, and it was error to deny them that compensation.

2. The Treasury Regulations likewise required compensation for the Supply Points even if all they did was add value to Coca-Cola's trademarks.

It was further error not to recognize that the Treasury Regulations would still demand compensation, even if all the Supply Points did was "add[] value to the trademarks and brands that [Coca-Cola] owned." Op. 169. The Supply Points paid for, and bore the risk of, the marketing expenses for their particular regions. *See infra* pp. 63-66. By approving the IRS's use of Dr. Newlon's CPM, the Court approved a method that by design, but in conflict with the Treasury Regulations, does not compensate for adding to brand value. *See infra* pp. 69-73.

The Treasury Regulations recognize that marketing activities may "increase the value" not only of a "license to use [a] trademark," but also of "the [underlying] trademark" itself. Temp. Treas. Reg. § 1.482-4T(f)(4)(ii), Example 4, 71 Fed. Reg. at 44,485; *see also id.* § 1.482-4T(f)(4)(i) & (ii), 71 Fed. Reg. at 44,485. Thus, where a licensee makes marketing expenditures, it is entitled to reap the benefits of those contributions, whether (a) because it has increased the value of its own license, which is "of sufficient duration" that the licensee can expect to see "increased sales or revenues," or (b) because it has increased the value of the licensor's trademark (where the license is not of sufficient duration) and thus is entitled to separate compensation. *Id.* § 1.482-4T(f)(4)(ii), Example 4, 71 Fed. Reg. at 44,485. That result follows from the regulations' commonsense recognition that "it is unlikely that . . .

an uncontrolled taxpayer operating at arm's length would engage in the incremental marketing activities to develop or enhance an intangible owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of a future benefit." *Id.* § 1.482-1T(d)(3)(ii)(C), Example 4, 71 Fed. Reg. at 44,482.

Accordingly, where, as here, the parties' "course of conduct" shows that the taxpayer makes a significant investment in marketing, the Court must afford the controlled taxpayer "an appropriate portion of the premium return" and "may impute one or more agreements" in order to do so. *Id.* Any imputed contractual terms, of course, must be "consistent with the economic substance of the [parties'] transaction[s]." Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2); *see id.* § 1.482-1(d)(3)(ii)(B)(1).

Courts have endorsed and consistently applied these principles. *See, e.g.*, *DHL Corp. v. Commissioner*, 285 F.3d 1210, 1222 (9th Cir. 2002); *Amazon.com, Inc. v. Commissioner*, 148 T.C. 108, 199-202 (2017), *aff'd*, 934 F.3d 976 (9th Cir. 2019); *Medieval Attractions N.V. v. Commissioner*, 72 T.C.M. (CCH) 924, 959 (1996). In *DHL Corp.*, for example, the Ninth Circuit explained that where "the value of the DHL trademark was created only by virtue of the sustained and combined efforts of both DHL and DHLI," DHLI had to be considered "the developer of the international trademark" or, at a minimum, as a partner that "provided assistance to DHL's development" of that trademark. 285 F.3d at 1224. Either way, the analysis had to reflect the value of DHLI's contributions, whether as developer or assister. *See id.* at 1221-24 & n.13.[9]

The IRS has even applied these very principles in another matter involving Coca-Cola. There, the IRS explained that "legal ownership of intangible property alone is not enough to assure supra-normal return. The more important considerations are allocations of income consistent with expected commercial behaviors and principles, and the relative responsibilities for intangible development costs and risks necessary to develop the intangible." Ex. 2921-P at CCADMIN0121226-27 (Sept. 11, 2012, Notice of Proposed Adjustment); Seventeenth Stip. of Facts ¶ 2851. Applying that standard, the IRS allocated profits from Canadian sales to Coca-Cola, even though Coca-Cola's Canadian affiliate, and not Coca-Cola, was the registered owner of the relevant trademarks in Canada. Ex. 2921-P.

Here, these principles require the Supply Points to be compensated for the value of their contributions to Coca-Cola's brands. To the extent the Supply Points enhanced the value of their own licenses, their marketing "activities do not constitute a contribution for which an allocation is warranted." *See* Temp. Treas. Reg. § 1.482-4T(f)(4)(ii), Example 4, 71 Fed. Reg. at 44,485. Instead, the Supply Points reap the

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[9] Although *DHL* was decided under the "developer-assister" principles in earlier regulations, the regulations applicable here reflect a similar principle. *See* Temp. Treas. Reg. § 1.482-4T(f)(4), T.D. 9278, 71 Fed. Reg. 44,466, 44,485 (Aug. 4, 2006).

benefits of their contributions to the brands' success by continuing to exploit their (ever more valuable) licenses. And to the extent the Supply Points enhanced the value of Coca-Cola's trademarks, then those contributions warrant an allocation to the Supply Points, not Coca-Cola. *See id.* § 1.482-4T(f)(4)(i), 71 Fed. Reg. at 44,485; *id.* § 1.482-1T(d)(3)(ii)(C), Example 4, 71 Fed. Reg. at 44,482; *see also* J.C. Armitage, H.D. Schafroth, E.J. Stevens, & H.D. Rosenbloom, *Coke Concentrate: A Recipe for Understanding the IRS's Biggest Win in 40 Years*, 28 Int'l Transfer Pricing J. 87, 94 (Mar./Apr. 2021) ("It does seem inexplicable that the supply points would agree to incur these expenses without some return."). Either way, the Court erred in refusing to credit the Supply Points' investments.[10]

The Court did not have to look far to find a method that would have appropriately considered and accounted for the Supply Points' investments. The Treasury Regulations provide that where both parties have intangible property, "the relative value of nonroutine intangible property contributions may be estimated by the capitalized cost of developing the intangible property and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each

[10] Whether Coca-Cola and the Supply Points "enter[ed] into a 'qualified cost sharing arrangement,'" Op. 153 (citation omitted), is immaterial. The point of the economic substance inquiry is that the parties need not have, and the Court itself may need to impute, agreements recognizing the way the parties have structured their expectations and transactions. *See, e.g.*, Temp. Treas. Reg. § 1.482-1T(d)(3)(ii)(C), Example 4, 71 Fed. Reg. at 44,482.

intangible." Temp. 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). And here, Coca-Cola's experts—and only Coca-Cola's—offered such methods for assessing the parties' investments. *See* Ex. 7102-P (Cragg Transfer Pricing Report) (applying residual profit split method and dividing residual profits using the capitalized costs of the parties' historical investments). As previously noted, for example, Dr. Willig calculated the Supply Points' marketing intangible development costs to be around $9.4 billion during 2007-2009 alone. *See* Ex. 7251-P (Willig Opening Report) at Ex. 12. In contrast, Dr. Newlon's CPM, which the Court adopted, assesses only investments in tangible assets and is therefore by design incapable of crediting the Supply Points' investments in their intangible assets, as required by the regulations. *See infra* pp. 69-73.

3. The Court's failure to account for the Supply Points' ownership of goodwill also contravened the Treasury Regulations.

The Court also erred in dismissing the Supply Points' ownership of significant goodwill as irrelevant to the transfer-pricing analysis. In the Court's view, "ordinary corporate goodwill" is irrelevant because it is not "an 'intangible asset' for purposes of analysis under sec. 1.482-4(b)." Op. 159 n.47. That conclusion, too, misunderstands the scope of Treasury Regulation section 1.482-4(b) and the nature of goodwill under the caselaw. And it writes out of the required analysis an asset that contributes significantly to the local marketing of Coca-Cola products worldwide.

The Internal Revenue Code and Treasury Regulations make clear that goodwill is a valuable intangible as a general matter. *See, e.g.*, section 197(d)(1)(A); Treas. Reg. § 1.197-2. Thus, absent some exception, goodwill must factor into the transfer-pricing analysis. *See* Treas. Reg. § 1.482-1(d)(3)(i) (transfer-pricing analysis must "include consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles"). Because no exception applies here, the Court was required to take the Supply Points' goodwill into account.

Contrary to the Court's conclusion, Treasury Regulation section 1.482-4(b) does not change that result. As the Ninth Circuit recognized in *Amazon.com*, under Treasury Regulation section 1.482-4(b) (as it provided then and during the time relevant here), goodwill *transferred* from a U.S. company to its foreign subsidiary did not count as an intangible upon transfer, so the regulations did not require a U.S. company transferring goodwill overseas to receive a taxable royalty on account of the transfer. 934 F.3d at 979-80, 993. That was because Treasury Regulation section 1.482-4(b), which supplied the framework for answering that particular question, did not include "goodwill and going concern value" in its list of intangibles. 934 F.3d at 991. That result was also consistent with Congress' intent, reflected in legislative history, that the value of goodwill should not be subject to tax upon transfer. *Id.* at 979-80, 993.

This case involves a different question. Here, the Supply Points already had and continued to invest in their own goodwill, which belonged to them and not to Coca-Cola. As the IRS recognized in 1984 of Coca-Cola's Irish Supply Point, that goodwill "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." Ex. 46-J-C at TCCC-00002100 (1984 IRS Letter Ruling Regarding Transfer of Irish Branch Assets). That goodwill has substantial value for which the Supply Points, and not Coca-Cola, are entitled to compensation. *See generally* Treas. Reg. § 1.482-1(d)(3)(i).

Treasury Regulation section 1.482-4(b) does not say otherwise, because there is no transfer of goodwill to which section 1.482-4(b) might apply. The Court's application of Treasury Regulation section 1.482-4(b), and thus its failure to factor the Supply Points' goodwill into the transfer-pricing analysis, was legal error. In fact, by failing to credit the Supply Points with their goodwill in adopting Dr. Newlon's CPM, the IRS and the Court essentially treated the goodwill as Coca-Cola's intangible, for which the Supply Points owed Coca-Cola compensation—contrary to Treasury Regulation section 1.482-4(b) and *Amazon.com*, which did not require compensation for an overseas transfer of goodwill.

B. The Court's contrary reasoning is incompatible with the Treasury Regulations, the caselaw, and economic substance.

To support its conclusion that the Supply Points lacked valuable licenses and were not otherwise entitled to the revenues from their substantial marketing expenditures, the Court also offered a number of other reasons that ultimately are inconsistent with the Treasury Regulations, the caselaw, and the economic substance of Coca-Cola's relationship with the Supply Points.

1. The Court first relied on the so-called *Danielson* rule to conclude that the Supply Points did not have any valuable marketing intangibles because, it reasoned, there was no written contract recognizing those intangibles. *See* Op. 160-66; *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967) (en banc). But the *Danielson* rule applies where a taxpayer argues against the form of its contracts, not where, as here, the IRS is the party arguing against the form of the contract. Here, Coca-Cola is adhering to the form of its contracts, the form being a license requiring royalty payments based on a combination of sales and operating income. The Court's error was failing to recognize that those licenses are themselves valuable intangibles. *See supra* pp. 51-53. In fact, applying *Danielson* here, where the economic substance is consistent with the 10-50-50 method and the parties' form, actually violates the Treasury Regulations, which require "contractual terms" to "be respected if such terms are consistent with the economic substance of the underlying transactions." Treas. Reg. § 1.482-1(d)(3)(ii)(B)(1).

Moreover, the *Danielson* rule does not stand in the way of contract interpretation, *e.g.*, *Tseytin v. Commissioner*, 698 F. App'x 720, 723 (3d Cir. 2017) (discussing *Amerada Hess Corp. v. Commissioner*, 517 F.2d 75, 85-86 (3d Cir. 1975)), and it does not apply where a contract is ambiguous or silent, *e.g.*, *Patterson v. Commissioner*, 810 F.2d 562, 572 (6th Cir. 1987), or where there is no contract, *e.g.*, *North Am. Rayon Corp. v. Commissioner*, 12 F.3d 583, 588-89 (6th Cir. 1993). This understanding of the *Danielson* rule accords with the Treasury Regulations' instruction to impute contractual terms "[i]n the absence of a written agreement." Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2); *see also* T.D. 9278, 71 Fed. Reg. at 44,478 (terms consistent with economic substance should be imputed if "[c]ontrolled taxpayers fail to specify contractual terms for the transaction"). Thus, the *Danielson* rule had no part to play even to the extent the Court viewed the agreements between Coca-Cola and the Supply Points as ambiguous about which party bore the costs of local marketing.

Last, the *Danielson* rule does not apply to contracts between related parties like Coca-Cola and its Supply Points anyway. *See, e.g.*, *Illinois Tool Works Inc. v. Commissioner*, T.C. Memo. 2018-121, at *49-50. The rule is based on several policy considerations: avoiding unilateral reformation resulting in unjust enrichment; promoting predictability; and protecting the IRS from having to litigate against multiple parties to collect a single tax. *Danielson*, 378 F.2d at 775. But "[w]here those underlying policy considerations" don't apply, neither does the rule. *Hospital Corp. of Am. v. Commissioner*, 72 T.C.M. (CCH) 1581, 1592 (1996) (citing cases). And here, applying the *Danielson* rule would not only not serve any of these policies, it would affirmatively disserve them. *See supra* pp. 16-48. Related parties like Coca-Cola and its Supply Points often enter into informal, incomplete, or otherwise ambiguous contracts, *see* Op. 40-41, 47-48, and the 1996 Closing Agreement and the IRS's behavior over a decade of audits led Coca-Cola to reasonably believe that there was no reason to formalize those agreements. *See supra* pp. 23-31.

2. a. The Court also reasoned that the Supply Points did not bear risk with respect to their marketing expenses, and so should not be credited with them, because they "had no legal obligation" to make them. Op. 170. Even leaving aside the agreements that actually did require the Supply Points to pay marketing expenses, *see* Ex. 7020-P (Atlantic-Export agreement); Ex. 242-J (1996 Closing Agreement); Exs. 3290-P, 3291-P, 7021-P (Expense Closing Agreements), the Court's reasoning conflicts with the Treasury Regulations here, too.

The natural inference where a party spends money without a "legal obligation" is that it does so for its own benefit. The regulations reflect that intuition. They instruct that a party "operating at arm's length" is unlikely to "engage in . . . incremental marketing activities to develop or enhance an intangible owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of a future benefit," even if no binding legal agreement evidenced that arrangement beforehand. Temp. Treas. Reg. § 1.482-1T(d)(3)(ii)(C), Example 4, 71 Fed. Reg. at 44,482. Indeed, the point of the economic substance analysis is to impute, based on the parties' "course of conduct," *id.*, terms that may not exist in "the absence of a written agreement," Treas. Reg. § 1.482-1(d)(3)(ii)(B)(2). Here, the Supply Points bore significant marketing expenses as well as the risk of those expenses, requiring the IRS and the Court to "impute one or more agreements . . . which would afford [them] an appropriate portion of the premium return." Temp. Treas. Reg. § 1.482-1T(d)(3)(ii)(C), Example 4, 71 Fed. Reg. at 44,482. But the Court did not do so. Nor was the Court correct, Op. 168, that advertising expenses cannot create or add to the value of intangible assets. The IRS has argued, and this Court has accepted, that such expenses most certainly can. *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).

b. In disregarding the risks borne by the Supply Points, the Court suggested that the Supply Points' marketing expenses had "no grounding in operational reality." Op. 132; *see also* Op. 129, 131-32, 152. The Court concluded that "[t]he supply points had nothing to do with consumer marketing," and so could not be credited with marketing expenditures. Op. 167. Nothing could be further from the truth. And, with respect, this was clear error. As extensive and undisputed testimony established, the Supply Points contemporaneously bore the marketing expenses associated with their regions; they were not assessed charges after the fact based on their revenues or profitability. Moreover, as the Court recognized, the employees of the Brazilian, Chilean, and Egyptian Supply Points performed "marketing, sales, and finance." Op. 25.

As the IRS's own expert witness explained, the local "business units are primarily responsible" for "the marketing research" and "local media advertising," and "coordinat[ing] their own marketing with bottler marketing for all of the products that are sold" in their markets. Tr. (Ailawadi) 8718-19; *see also, e.g.*, Tr. (Kent) 234:20-235:4, 437:15-24; Tr. (Quincey) 634:21-636:23; Tr. (Smith) 1028:3-20; Tr. (Reyes) 875:14-876:6. In other words, the "matching principle" refers to the match between the Supply Point for a region and the marketing costs for that same region. *See, e.g.*, Tr. (Lee) 4002-03. *Contra* Op. 152. The finance teams at the business units worked with the Supply Points before the fact to ensure that the Supply Points understood and could bear those local marketing expenses. *See, e.g.*, Tr. (Kearney) 1899:5-16. The Supply Points then paid for the marketing efforts in their regions. *See, e.g.*, Tr. (Lee) 4002-05. And if the business units and Supply Points "g[ot] [those marketing decisions] wrong"—anything about "[b]rand, pack, channel, price, location, architecture"—then "there's a price to be paid. Either we leave a lot of profits on the table, either our market share does not develop properly, competition starts making in roads [sic] or the consumer starts straying away." Tr. (Kent) 211:22-212:3. In Brazil, for example, an ineffective marketing strategy focusing on just a couple of low-margin products resulted in low to nonexistent profit levels. *See* Tr. (Smith) 1032-35. The business unit resolved the issue only by reworking the strategy to market different products to upper- and middle-class consumers and low-income consumers. *See, e.g.*, *id.* at 1041. And the Egyptian Supply Point, as the Court recognized, "endured many years of economic underperformance," such that applying Dr. Newlon's CPM generated a reverse allocation *from* Coca-Cola to the Egyptian Supply Point. Op. 10.

The IRS does not dispute these points. This Court must not, either.

3. The Court next dismissed the Supply Points' licenses on the ground that the Supply Points' agreements with Coca-Cola were terminable at will and conferred no territorial exclusivity. *See* Op. 172-75. That reasoning also contravenes the Treasury Regulations. The regulations require the Court to consider numerous factors to evaluate a controlled party's rights and to determine whether a controlled transaction was at arm's length. *See* 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); *id.* § 1.482-1(d)(3) (discussing factors). Here, the Court treated terminability and non-exclusivity as the only relevant factors. It neither assessed the other regulatory factors nor explained its analysis. *Contra Pine Mountain Pres. LLLP v. Commissioner*, 978 F.3d 1200, 1210 (11th Cir. 2020); *Medtronic, Inc. v. Commissioner*, 900 F.3d 610, 614 (8th Cir. 2018).

That omission was significant, because those other factors, particularly "[r]isks," Treas. Reg. § 1.482-1(d)(1)(iii), support a higher share of sales revenue for the Supply Points and therefore a lower royalty to Coca-Cola. If anything, the terminability and non-exclusivity of the licenses meant that the Supply Points bore greater risks that they would not reap the rewards of their investments, thus entitling them to greater compensation. *See id.* § 1.482-1(d)(3)(iii)(B); *infra* p. 68. Indeed, the IRS's own expert conceded that it is "fairly well-understood" that shorter, non-exclusive licenses earn smaller royalties. Tr. (Contreras) 9923:15, 9931:16-25; *accord* Tr. (Lasinski) 5908:4-15 (Coca-Cola expert) (shorter term length would have a "downward effect" on royalty).

The Court also was required to consider whether the parties' course of conduct showed that they anticipated continuing to do business beyond the agreements' stated 12-month terms. *See, e.g.*, Treas. Reg. § 1.482-1(d)(3)(ii)(B). Here, the primary Supply Points reasonably expected to continue working with Coca-Cola indefinitely, as the IRS's own ruling regarding goodwill acknowledged as to Coca-Cola's

Irish Supply Point. *See* Ex. 46-J-C at TCCC-00002100 (1984 IRS Letter Ruling Regarding Transfer of Irish Branch Assets). In fact, the Irish Supply Point (one of the two main Supply Points at issue) had operated under the same license agreement for nearly 30 years before the tax years at issue here. Second Stip. of Facts ¶¶ 146-49 (reflecting licenses beginning in 1984 (Exs. 82-J & Ex. 83-J) and 1987 (Exs. 84-J & 85-J)).

The Court further erred in simply assuming that Coca-Cola would terminate an agreement with the Supply Points in an uncontrolled scenario just because it legally could. To have drawn that conclusion, the Court would have needed to analyze, based on record evidence, "the manufacturing alternatives available to [the Company] at the time." *Bausch & Lomb Inc. v. Commissioner*, 933 F.2d 1084, 1093 (2d Cir. 1991). But there is no evidence that Coca-Cola could or would have terminated its relationship with the Irish or Brazilian Supply Points—the two Supply Points responsible for the lion's share of the revenue in the relevant tax years. *See, e.g.*, Op. 72. Had Coca-Cola wanted to terminate its relationships with its Supply Points, at a minimum it would have needed to assume the risk associated with future marketing spending. Even Dr. Newlon acknowledged that Coca-Cola would not have had the capacity to supply its markets had it terminated its Supply Points. *See* Tr. (Newlon) 8551:5-11, 8554:2-7; Op. 174.

4. Finally, the Court dismissed the Supply Points' marketing expenditures on the ground that the ServCos rather than the Supply Points performed the marketing. Op. 167. That was legal error as well, because the only question to be answered is which of the parties as between Coca-Cola and its Supply Points bore the risks. *See generally, e.g.*, Temp. Treas. Reg. § 1.482-1T(d)(3)(ii)(C), Example 4, 71 Fed. Reg. at 44,482; *id.* § 1.482-4T(f)(4)(ii), Example 4, 71 Fed. Reg. at 44,485; *supra* pp. 66-68. In other words, the central question in this case and the central question under the Treasury Regulations is who as between Coca-Cola and the Supply Points paid for the marketing expenses, not whether some party other than these conducted the actual marketing. The examples in the regulations make clear that the party that bears the cost of the marketing activities is entitled to the resulting increase in the value of its intangibles—even if that party pays someone else to perform those activities. *See* Temp. Treas. Reg. § 1.482-1T(d)(3)(ii)(C), Example 5, 71 Fed. Reg. at 44,482. And here, all agree that the Supply Points bore the cost of the relevant marketing functions, not Coca-Cola.

C. Dr. Newlon's CPM is the wrong method as a matter of law.

Because the Court erred in concluding that the Supply Points had no valuable intangible assets, it also erred in affirming the IRS's use of Dr. Newlon's CPM. The CPM is not even a reliable method in this case, much less "the most reliable measure of an arm's length result," as required by the Treasury Regulations, Treas. Reg.

§ 1.482-1(c)(1), if for no other reason than because it fails to account for the Supply Points' significant intangible assets.

1. As a matter of law, a transfer-pricing method cannot be reliable if it fails to account for the most important variables. *See id.* § 1.482-1(d)(1). When it comes to selling Coca-Cola products, the Company's brands—and the local advertising needed to maintain and promote them—are critically important. The brands and the marketing of those brands drive Coca-Cola's profits. So, the method the IRS directs be used and the method the Court approves cannot ignore the intangibles associated with that crucial local marketing.

Yet that is exactly what Dr. Newlon's CPM does, as both the Court and Dr. Newlon recognized. *See* Op. 115-20; Ex. 8294-R at 43 (Newlon Opening Report); *see also* Treas. Reg. § 1.482-5(b)(2) ("[I]n most cases" in which applying a CPM is appropriate, "the tested party . . . will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables."); *Medtronic, Inc. v. Commissioner*, T.C. Memo. 2016-112, at *114 (finding "misleading" a CPM analysis that "ignore[d] the value of the licensed intangibles"), *vacated on other grounds*, 900 F.3d 610. Dr. Newlon acknowledged that his denominator "does not include, for the bottlers or the supply points, any intangible asset value." Tr. (Newlon) 8347:10-13. Instead, under his analysis, profits result from a return on tangible assets alone—that is, only the cost of the materials used in the plant and the rate of depreciation. Ex. 8294-R at 43 (Newlon Opening Report); Tr. (Newlon) 8347-48. The Supply Points' investment in the Coca-Cola brands and all their hard-earned intangibles that make those brands recognizable in every corner of the world play no role in Dr. Newlon's CPM.

2. Finally, Dr. Newlon's application of the CPM to Coca-Cola would be legally erroneous even if using some type of CPM were proper in the first place, despite the key role played by intangibles. *See* Op. 186.

Dr. Newlon's CPM relies on the comparability of Supply Points and Bottlers. But that is an inapt comparison, as a proper application of the regulatory factors demonstrates. *See* Treas. Reg. § 1.482-1(d)(1) (requiring comparison of functions, contractual terms, risks, economic conditions, and property or services). Even Dr. Ednaldo Silva, who helped draft the U.S. transfer-pricing regulations as Senior Economic Advisor in the IRS Office of Chief Counsel, has harshly criticized the comparison of the Supply Points and Bottlers. *See* 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.

Most crucially, a return-on-assets-based CPM like Dr. Newlon's is reliable only if it takes into account "the asset composition employed (including the nature and quantity of tangible assets, intangible assets and working capital)." Treas. Reg.

§ 1.482-5(c)(2)(i); *see also id.* § 1.482-5(b)(4)(i) (a return-on-assets-based CPM is reliable only to the extent that "the composition of the tested party's assets is similar to that of the uncontrolled comparable"). Here, the Bottlers' business was capital-intensive as to real, physical assets (investing in tangible property like bottling lines, warehouses, trucks, coolers, etc.), whereas the Supply Points' business was not, relying heavily instead on intangibles. *See, e.g.*, Ex. 7101-P at 107 fig.9 (Cragg Opening Report); Ex. 7251-P (Willig Opening Report) at Exs. 4 & 5; Tr. (Cragg) 4567-70; Tr. (Brock) 2441-42; Tr. (Kearney) 1885; Tr. (Finan) 1397. It was clear legal error to apply a return-on-assets-based CPM, derived from a capital-intensive bottling business, to a supply-point marketing business that relies heavily on intangibles, rather than on tangible assets reflected in a balance sheet.

In any event, the Court's embrace of Dr. Newlon's CPM would be infected by legal error even if the Supply Points and Bottlers were comparable. Under the Treasury Regulations, profit level indicators must "measure relationships between profits and costs incurred or resources employed." Treas. Reg. § 1.482-5(b)(4). Thus, "it may be necessary to take into account . . . intangibles," regardless of whether they are "explicitly recorded in the financial statements," in assessing "operating assets," or "the value of all assets used in the relevant business activity of the tested party." *Id.* § 1.482-5(d)(6). Dr. Newlon's CPM did not adequately take the critical intangible assets into account—for either the Supply Points or the Bottlers. That error was dispositive.

To account for this one particular problem in Dr. Newlon's CPM (and leaving aside the other problems with Dr. Newlon's method), Dr. Willig folded both the Supply Points' and the Bottlers' intangibles into Dr. Newlon's CPM, holding everything else constant. The result was nearly a complete zeroing out of the IRS's retroactive adjustments to Coca-Cola's tax liability. Ex. 7521-P at 4 (Willig Opening Report).

Dr. Newlon's method is plainly not reliable.

* * *

The Court should reconsider its decision affirming the IRS's retroactive imposition of massive tax liability on The Coca-Cola Company. The decision ratifies the IRS's unlawful and unconstitutional bait and switch in which the Nation's tax administrator and enforcer induced Coca-Cola to rely on the 10-50-50 method in structuring its affairs, only to reverse course without warning or explanation and claim that Coca-Cola now owes the government billions of dollars for taxes the Company calculated using the precise method the IRS induced Coca-Cola to use and audited to ensure that it did use for over a decade. And the switch doesn't work on its own terms anyway because the tax calculation method the IRS switched to, and that the Court adopted, violates the Treasury Regulations several times over in the course of denying the economic substance of the relationship between Coca-Cola and its Supply Points that the regulations require the IRS and the Court to accept.

Norman Rockwell famously painted a boy sitting pensively alongside his dog on a log jutting out over water, with a fishing pole in one hand and a Coca-Cola in the other. Like many of Rockwell's paintings, the "boy fishing" captures what was a simpler time in America. Much has changed since then, and much for the better. But one thing that has not changed is that Americans still want to believe they can count on the good faith—and the words and actions—of their government. And of course, so fundamental in America is this belief, that Americans are legally and constitutionally entitled to believe and expect nothing less than this of their government.

The Court should grant reconsideration to address the fundamental legal and constitutional issues raised by the IRS's attempt to impose billions of dollars in additional tax liability on The Coca-Cola Company for calculating its taxes in *exactly* the way the IRS agreed the Company would in 1996 and for over a decade thereafter.

CONCLUSION

For the foregoing reasons, the Court should reconsider and set aside its November 18, 2020, opinion, or otherwise refer this motion for this Court's reconsideration to the full United States Tax Court for its review and consideration.

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Respectfully submitted,

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