CLIENT ALERT:

RECENT TRANSFER PRICING CONTROVERSY

CAC Specialty™

COCA-COLA AND AIRBNB HAVE BEEN IN THE NEWS LATELY REGARDING THEIR TRANSFER PRICING.

Tax insurance can be used by multinationals to mitigate contingent tax exposures from related party transactions, including transfer pricing, valuation, and debt/equity treatment. The tax code is complex, and despite receiving tax advice from an attorney or accountant, the proper tax treatment of a transaction may be uncertain—because there is no clear guidance on the tax issue, the fact pattern is unique, or because the tax position requires a degree of judgment or an evaluation of intent. If the IRS disagrees with the company's tax position, the company may owe unanticipated and potentially significant additional taxes, interest and penalties. Tax insurance can make the insured whole in the event of a successful challenge by a taxing authority.

Transfer pricing involves establishing the price charged from one related or controlled entity to another. The Internal Revenue Code and Organization for Economic Co-operation and Development provide transfer pricing guidelines that are generally based on the arm's length principle—that related party transactions should reflect the price that would be charged if each company was independent and not under common control. If the arm's length standard is not adhered to, companies can artificially shift profits to low tax jurisdictions by simply changing the price charged to/from an affiliate.

The IRS and foreign taxing authorities are aware of this issue and are attacking it aggressively. Kenneth Wood, the former IRS Deputy Associate Chief Counsel stated at a hearing before the Committee on Ways and Means titled "Understand the Tax Gap and Taxpayer Noncompliance" that "[o]ver the last 30-plus years, transfer pricing has posed the greatest threat to the tax base." In addition, in April, the IRS released informal transfer pricing guidance tacitly signaling more scrutiny on transfer pricing documentation and transactions.

On November 18, the Tax Court published (here) its decision in Coca-Cola's transfer pricing case. The court sided with the IRS in determining that Coca-Cola incorrectly allocated a large portion of profits to its foreign affiliates. Coca-Cola now potentially owes $3.3 billion in tax deficiencies to the IRS for tax years 2007-2009 alone, and could potentially be liable for additional tax deficiencies for other tax years still under audit by the IRS. Two noteworthy discussion points in the opinion concerned the following:

1. **Profit.** The court focused on the fact that the gross profit margins of certain affiliates ranged between 75%-90% each year, as well as the fact that the affiliates, on average, had a mark-up of about 57%, which was seven times higher than what was determined by the IRS to be the arm's length value of the affiliates' activities. The court noted that the profitability of the affiliates dwarfed that of Coca-Cola, even though Coca-Cola owned all the intellectual property.

2. **Closing Agreement.** The court also discussed a 1996 closing agreement between Coca-Cola and the IRS for tax years 1987-1995. Coca-Cola followed the 1996 agreement for allocating profits for the tax years after the agreement was in place. The court found that the mere fact that Coca-Cola used the prior methodology was unpersuasive and that a prior closing agreement is not binding on the IRS.

On November 16, Airbnb released its Form S-1 in anticipation of going public. In the disclosure, Airbnb noted that they received a Draft Notice of Proposed Adjustment from the IRS for the 2013 tax year relating to the valuation of its international intellectual property that was sold to a non-U.S. subsidiary in 2013. The IRS proposed a tax deficiency of $1.35B, excluding penalties or interest, which exceeds the amount of Airbnb's tax reserve by over $1B.

The Coca-Cola case as well as the Airbnb S-1 exemplify that the IRS is auditing and litigating transfer pricing issues. With big wins, the IRS is equipped to continue to aggressively audit related party transactions where they believe the taxpayer deviated from the arm's length principle. Tax insurance allows companies to execute these transactions with complete tax certainty, and can be purchased either before or after the underlying transaction has been reported on the tax return and filed with the taxing authority. CAC Specialty has successfully placed numerous tax insurance policies for transfer pricing issues, including intercompany financing, profit margins, valuations, and royalties. If your company or client encounters a transfer pricing risk, CAC Specialty can provide an insurance solution to transfer that risk to the insurance market.

Further information about tax insurance can be found **here**.

Expanding what's possible for solving risk challenges – from the simple to the previously unsolvable.

CAC SPECIALTY'S TAX INSURANCE PRACTICE

CAC Specialty's Tax Insurance Practice, comprised of seasoned tax attorneys and former tax insurance underwriters, combines deep tax technical expertise, industry experience, and business acumen to craft innovative and unique tax insurance solutions so any client can quickly transfer the risk of the unanticipated and detrimental consequences of a successful challenge by a taxing authority—creating more certainty for sponsors, corporations and stakeholders.

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