INTERNATIONELLA HANDELSHÖGSKOLAN
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Den globala effekten av Glaxo-fallet

Internprissättningskonflikterna ökar mellan OECD och USA

Magisteruppsats inom det Affärsrättsliga programmet med internationell inriktning

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The Global Effect of the Glaxo Case

The Increase of Transfer Pricing Conflicts between the OECD and the US

Master's Thesis within the International Master Program of Commercial and Tax Law

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Sammanfattning

Denna magisteruppsats jämför OECD:s rekommendationer gällande internprissättning med de amerikanska internprissättningsreglerna. I uppsatsen fokuserar författarna på internprissättningsproblematiken gällande immateriella tillgångar i läkemedelbranschen, med särskilt fokus på den typ av immateriella tillgångar som uppstår genom försäljning och marknadsföring (marketing intangibles). USA använder sig av områden där rättsläget är osäkert för att öka sina skatteintäkter. För att illustrera detta beskrivs och analyseras Glaxo-fallet. USA visar på så sätt lite hänsyn till ett av OECD:s viktigaste mål; att skapa en universellt harmoniserad tolkning och tillämpning av internprissättning för att motverka dubbelbeskattning och öka möjligheten för multinationella företag att förutse och planera sin skatt. Syftet med denna magisteruppsats är att förklara och analysera varför den amerikanska skattemyndigheten (IRS) valde en ny inställning till marketing intangibles i Glaxo-fallet, utvärdera den globala effekten av Glaxo-fallet och diskutera hur liknande situationer bör hanteras i framtiden.

OECD är det mest lämpliga instrumentet för att skapa en internationell konsensus på internprissättningsområdet. Eftersom internprissättning av transaktioner som involverar immateriella tillgångar och särskilt marketing intangibles utgör ett osäkert område med endast lite vägledning från OECD finns det stort utrymme för länder att skapa egna regler och rättspraxis på området. När länder som USA tar saken i egna händer och skapar sina egna regler inom internprissättning tenderar de att sätta sina egna intressen i första rummet. Konsekvensen blir en internationell internprissättningsmiljö där konkurrensen om de multinationella företagens vinster är stor, vilket skadar den internationella handeln och investeringsviljan hos företag. Det är just detta som skett i Glaxo-fallet.

Resultatet av Glaxo-fallet blev en ny inställning till hanteringen av denna typ av transaktioner, något som USA länge eftersökt för att lösa problemet med en minskande skattebas. Den nya amerikanska inställningen får konsekvenser för alla multinationella företag med företag i intressegemenskap i USA och distributörer utanför USA. USA sänder nu ut en signal att värdet av en produkt inte styrs utav de år av forskning och utveckling som krävdes för att skapa ett patent av det brittiska moderbolaget i Glaxo-fallet. Istället är det de immateriella tillgångar som uppkommer av försäljnings- och marknadsföringsaktiviteter som tillför en produkt det egentliga värdet. I Glaxo-fallet innebar detta att en majoritet av vinsten av försäljningen av läkemedlet Zantac skulle hänföras till det amerikanska dotterbolaget och därmed beskattas i USA. Inställningen innebär att distributörer utanför USA kan komma att påverkas genom att värdet de tillfört genom forskning och utveckling eller andra viktiga funktioner kan bli mindre betydelsefullt än värdet som tillförs av marknadsföring. Läkemedelsbranschen är beroende av

immateriella tillgångar för att kunna fungera och forskning och utveckling är den mest betydelsefulla värdeskapande funktionen inom industrin. Företag i läkemedelsbranschen är dessutom mycket benägna att hamna i blickfånget för internprissättningsrevisioner. Om den nya amerikanska inställningen vinner mark är det mycket troligt att konsekvenserna blir allvarliga både för läkemedelsindustrin och för samhället i stort.

I denna magisteruppsats har författarna antagit tre huvudsakliga slutsatser med rekommendationer. Den första är att OECD:s medlemsländer måste respektera principen om en neutral inställning till internprissättning. Som en andra slutsats kan sägas att skattemyndigheter måste beakta de affärsmässiga skälen till de transaktioner som företas av multinationella företag och förstå multinationella företags behov av förutsebarhet beträffande beskattning. Slutligen ligger ett internationellt samarbete i alla länders intresse och en internationell konsensus gällande tolkning och tillämpning av internprissättning skapar balans och motverkar dubbelbeskattning.

Master's Thesis in International Tax Law

Title:	The Global Effect of the Glaxo Case – The Increase of Transfer Pricing Conflicts between the OECD and the US
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Date:	2008-01-07
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Abstract

This master's thesis compares the OECD transfer pricing recommendations with the transfer pricing rules of the US. The main focus is the ethical pharmaceutical industry and intangible property, in particular marketing intangibles. The Glaxo case is used to illustrate how the US takes advantage of areas of uncertainty to increase the country's tax revenue. The US shows little consideration for the OECD's objectives of having a set of universally applicable transfer pricing rules. The purpose of this master's thesis is to explain and analyze why the IRS took a new approach on marketing intangibles in the Glaxo case, evaluate the global effect of the Glaxo case, and discuss how similar situations should be dealt with in the future.

The natural forum to achieve universally harmonized transfer pricing rules is the OECD. When the OECD fails to provide adequate recommendations, the US and other countries take matters into their own hands by constructing rules deviating from the recommendations of the OECD. These rules tend to put the countries' interests first creating a competitive international transfer pricing community harmful to MNEs. The consequence is a negative effect on global trade and investment.

In the Glaxo case the US took advantage of the area of uncertainty regarding intangible property and marketing intangibles to serve its own purpose and came up with a new approach on marketing intangibles. This approach has consequences for all MNEs with affiliates in the US and distributors outside the US. The new approach states that the value of a product is attributable to the marketing activities conducted by a US subsidiary rather than to R&D carried out by a UK parent. The new approach may affect distributors outside the US since the value they have can be allocated to a US affiliate conducting marketing and sales activities. The ethical pharmaceutical industry depends on intangible property and R&D is the most important value-driver in this industry. In addition, the characteristics of the ethical pharmaceutical industry are such that ethical pharmaceutical companies are priority targets of the IRS's audits. If the IRS's new approach prevails, the negative consequences for the ethical pharmaceutical industry as well as the society as a whole may be severe.

There are three main conclusions and recommendations in this master's thesis. First, the Member countries of the OECD have to respect the principle of transfer pricing as neutral concept. Second, tax authorities must take into consideration the sound business reasons of MNEs and understand their need for tax predictability. Finally, it is in the interest of all countries to cooperate and establish a uniform interpretation and application of transfer pricing thereby avoiding double taxation and creating a balance in the international transfer pricing community.

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Yours Gratefully,

Sara Gustafsson & Camilla Hallbäck

Abbreviations

APA	-	Advanced Agreement Procedure
CFA	-	Committee on Fiscal Affairs (OECD)
CFC	-	Controlled Foreign Corporation
CPI	-	Comparable Profits Interval
CPM	-	Comparable Profits Method
CUP	-	Comparable Uncontrolled Price
CUT	-	Comparable Uncontrolled Transaction
FDA	-	Food and Drug Administration
GAO	-	General Accounting Office
GSK	-	GlaxoSmithKline
IFA	-	International Fiscal Association
IRC	-	Internal Revenue Code
IRS	-	Internal Revenue Service
MAP	-	Mutual Agreement Procedure
MNE	-	Multinational Enterprise
OECD	-	Organisation for Economic Co-operation and Development
R&D	-	Research and Development
TNMM	-	Transactional Net Margin Method
UK	-	United Kingdom
USD	-	US Dollar
US	-	United States

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1 Introduction

1.1 Background

Globalization and international trade continue to increase and the flow of imports and exports of goods and services in the world have doubled in the last 10 years.[1] Today, over 70 percent of cross-border trade in the world takes place between related enterprises.[2] This increase in international trade boosts cooperation across borders between companies in the same group. The business term used to describe the price that one segment of an organization charges for "a product or service it supplies to another segment of the same organization" is transfer pricing.[3] There are many business related reasons to why an organization charges transfer prices on goods and services whether it be the allocation of resources between different segments, performance evaluation, or supply chain management.[4] The legal problems occur when segments of an organization are situated in different countries and an incentive for tax authorities to investigate whether or not transfer prices are set "correctly" arises. As a result of the growth of multinational enterprises (MNEs)[5] both tax authorities and the enterprises themselves face increasingly difficult taxation problems.[6]

Member countries of the Organisation for Co-operation and Development (OECD) were encouraged to implement the arm's length principle as a means to solve the problem of establishing a correct transfer price for MNEs and tax authorities by the OECD Committee of Fiscal Affairs (CFA).[7] The arm's length principle is laid down in Article 9.1 of the OECD Model Tax Convention on Income and on Capital (the Model Convention) and is considered the international standard OECD Member countries have agreed to use when determining transfer prices for tax purposes.[8] According to the arm's length principle, the price in a controlled transaction should be the same as "the price which would have been agreed upon between unrelated parties engaged in the same or similar

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1 World Trade Organization, International Trade Statistics, Time series on merchandise and commercial service trade, exports and imports between 1996 and 2006.

2 Hamaekers, Hubert, "The Arm's Length – How Long?", International Transfer Pricing Journal, Issue 2, March/April 2001, p. 30.

3 Horngren, Charles T., Stratton, William O., Sundem, Gary L. , *Introduction to Management Accounting, Introduction to Management Accounting*, 13th Ed., Pearson Prentice Hall International Inc., Upper Saddle River, New Jersey 2005, p. 440.

4 Id., pp. 440-441.

5 Multinational enterprises (MNEs) can be defined as "groups of associated enterprises operating across national frontiers", (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Paris 1979, Preface, Para 1.

6 (1995) OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris 1995, Preface, Para. 1.

7 (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Preface, Para. 6.

8 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Glossary "Arm's length principle".

transactions under the same or similar conditions in the open market".[9] The objective of the arm's length principle is dual. It serves both to secure an appropriate tax base in each jurisdiction and to avoid double taxation, and thereby to decrease the risk of conflict between tax authorities and to promote global trade investment.[10] Transfer pricing is, according to the OECD, a neutral concept treating related party dealings equally with unrelated party dealings.[11]

The first transfer pricing rules of the United States (US), and the rest of the world, date back to the First World War, entitling the Commissioner of Tax to allocate income and among affiliated corporations.[12] However, the arm's length standard, a standard benchmark allowing the tax authority to adjust deviant prices, was not introduced until the 1930's.[13] The reason behind the arm's length standard was US fears of corporate income being shifted to low tax jurisdictions.[14] The US, although a Member country of the OECD claiming to follow the recommendations of the organization, applies transfer pricing rules that differ from the recommendations of the OECD.[15] Most significantly, the US does not have the OECD's neutral view on transfer pricing and the transfer pricing policies of MNEs are often met with suspicions of tax fraud.[16] The US has led the way on the area of transfer pricing through strict documentation requirements and harsh penalties and other countries have followed tail.[17] The US has become the most "significant current global influence on international taxation issues generally, and transfer pricing in particular."[18]

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[9] (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Preface, Para. 2.

[10] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Preface, Para. 7.

[11] (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Preface, Para. 3.

[12] Hamaekers, Hubert, "Arm's Length – How Long?", p. 30 with reference to The 1917 War Revenue Act, 40 Stat. 300, Regulation 41, Articles 77-78.

[13] Id., p. 30 with reference to the 1935 Treasury Regulations, section 45-1 (b).

[14] Hamaekers, Hubert, "Arm's Length – How Long?", p. 30.

[15] Please see for instance the discussion in chapter 2 concerning the US Regulations that served as a catalyst for the OECD that later issued a compiled version of their previous reports on transfer pricing as a response. Other factors discussed in chapter 2 supporting this statement are for instance the US use of alternative methods other than the methods recommended by the OECD, the use of the commensurate with income standard and hindsight.

[16] Please see e.g. written testimony of Commissioner of Internal Revenue Mark Everson, IRS Commissioner testifies before Senate Committee on Finance on Compliance Concerns Relative to Large&Mid-size Businesses, IR-2006, June 13, 2006.

[17] The (1993) Reports of the Task Force of the OECD Committee on Fiscal Affairs in US Transfer Pricing Regulations, Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations can illustrate the US applying new transfer pricing practices forcing the OECD and the Member countries to react and respond. See also Hamaekers, Hubert, "The Arm's Length – How Long?", pp. 31-32.

[18] Markham, Michelle, *The Transfer Pricing of Intangibles*, Kluwer Law International, The Hague 2005, p. 4.

The US non-neutral view on transfer pricing is largely a result of MNEs, mainly pharmaceutical companies, moving intangible property abroad to low tax jurisdictions.[19] The US focus on audits of transfer pricing in the pharmaceutical industry and intangible property started decades ago with several large and important cases where the Internal Revenue Service (IRS) failed to reallocate intangible property to the US.[20] After making these unsuccessful attempts the IRS took a new approach on marketing intangibles in the Glaxo case, settled in 2006.[21] The new approach on marketing intangibles proved successful in the US and it remains to be seen what effects the Glaxo case will have on the transfer pricing practices of both tax authorities and MNEs in the rest of the world.

1.2 Purpose and Approach

Transfer pricing rules go beyond borders and in order for such rules to serve their purpose their application has to be uniform. The natural forum to achieve this goal is the OECD. However, when the organization fails to provide an answer to an issue of uncertainty, such as with the value attributable to marketing intangibles in the Glaxo case, there is room for country specific interpretations. This creates non-conformity and disagreement between tax authorities resulting in double taxation harmful to MNEs and global trade investments. When the rules are unclear countries, in particular the US, tend to put their own interest first.

The purpose of this master's thesis is to explain and analyze why the IRS took a new approach on marketing intangibles in the Glaxo case, evaluate the global effect of the Glaxo case, and discuss how similar situations should be dealt with in the future.

1.3 Method

Two methods are applied in this master's thesis; the traditional legal method and elements of the comparative method. The traditional legal method refers to the study of legal sources used to establish the applicable legal situation.[22] This method is used when examining the US transfer pricing rules. The comparative method is used to compare various countries' legal systems.[23] This master's thesis is comparative in the sense that it

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[19] Industry Director Directive on Section 936 Exit Strategies, John Risacher, Memorandum for Industry Directors Director, Field Specialists Director, Prefiling and Technical Guidance Director, International Compliance Strategy and Policy, LMSB Control No.: LMSB-04-0107-002, Impacted IRM 4.51.2, February 2, 2007.

[20] G.D. Searle & Co v Commissioner of Revenue, 88 T.C. NO. 16, 88 T.C. 252 Tax Ct Rep. (CCH) 43,625. Docket No. 128 36-79, filed on February 4, 1984, Eli Lilly and Company and Subsidiaries v Commissioner of Internal Revenue, 84 T.C. No. 65, 84 T.C. 996, Tax Ct. Rep. (CCH) 42,113, docket No. 5113-76, filed on May 28, 1985 and Merck & Co., inc., v the United States, 24 Cl.Ct.73, 68 A.F.T.R.2d 91-5524, 91-2 USTC P 50,456, Docket No. 283-88T, filed on September 10, 1991.

[21] Schmid, Alfons R., "Tax Treatment of Services: Does the Value of Patents and Technical Know-How Prevail over the Value of Marketing Efforts?", International Transfer Pricing Journal, Issue 1, January/February 2005, p. 16.

[22] Zweigert, Konrad, Kötz, Hein, *Introduction to comparative law*, Oxford University Press, Oxford and New York 1998, pp. 35-36.

[23] Id., p. 2.

treats the comparison between the US transfer pricing rules and the transfer pricing recommendations of the OECD. Since the OECD is not a binding legal system, this master's thesis is not comparative in the sense that it compares two legal systems but rather that it contains comparative elements. A comparative study is best done when the authors lay out the essentials of the legal systems and use this material to critically compare the legal systems, ending up with a conclusion on which policy to adopt.[24] This approach is used in this master's thesis.

The OECD Model Convention and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines) are not legally binding upon the Member countries.[25] However, when writing a master's thesis on transfer pricing from an international perspective, these sources are of great importance. Tax treaties between Member countries follow the pattern and, in most cases, the main provisions of The Model Convention indirectly making them part of the Member countries' national tax legislations.[26] The importance of the Model Convention is best displayed by its widespread use outside the arena of the OECD.[27]

The Model Convention does not explain the concept of transfer pricing. This emphasizes the importance of the Guidelines where the term is described and explained. Scholars such as Eden and Calderón back up the validity of the OECD Transfer Pricing Guidelines as a legal source.[28] In this regard, the Guidelines is used by so many countries (both members and non-members of the OECD) that it, for the purpose of transfer pricing, must be viewed as a source within "soft law".[29]

The US transfer pricing rules are examined in this master's thesis. Some scholars claim it is difficult if not impossible to accurately understand a foreign legal system unless you first understand the cultural, social, and economic aspects of life within that system.[30] Others

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[24] Zweigert, Konrad, Kötz, Hein, *Introduction to comparative law*, p. 6.

[25] The OECD recommends the governments of its Member countries to conform to the Model Tax Convention on Income and Capital as interpreted by the Commentaries thereon when entering into new bilateral or multilateral agreements or revising existing ones, this according to the Recommendation of the OECD Council Concerning the Model Tax Convention on Income and on Capital (the OECD Recommendation 1997), part I. OECD Member countries and taxpayers are encouraged to follow the contents of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations according to the Preface, Para. 16. The conclusion must therefore be that neither the Model Tax Convention on Income and Capital nor the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations are legally binding upon the Member countries.

[26] OECD Commentary on the OECD Model Tax Convention on Income and Capital, Introduction, Para. 15.

[27] Id., Para. 16.

[28] See for instance Eden, Lorraine, *Taxing Multinationals: transfer pricing and corporate income taxation in North America*, University of Toronto Press, Toronto 1998 and Calderón, Jose, "The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law?", International Tax Review Intertax, Vol. 35, Issue 1, 2007.

[29] Eden, Lorraine, *Taxing Multinationals: transfer pricing and corporate income taxation in North America*, p. 96 and Jose Calderón, "The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law?", p. 5.

[30] Zweigert, Konrad, Kötz, Hein, *An Introduction to comparative law*, p. 35-36 with reference to Rabel, *Aufgabe und Notwendigkeit der Rechtsvergleichung* (1925) and *Die Fachgebiete des Kaiser-Wilhelm-Gesellschaft zur Förderung der Wissenschaften III* (1937) 77, reprinted in Gesammelte Aufsätze III (ed. Leser, 1967) 1 and 180.

believe it is possible to make valid points regarding foreign law without actually being a part of the legal system at hand.[31] It is the viewpoint of the authors of this master's thesis that it is necessary to have a certain degree of understanding of the above mentioned issues in order to comprehend and relate to the legal issues at hand. Although the authors have faced some problems finding primary sources due to their lack of legal training in the US system, the authors do find it possible to compare and contrast this transfer pricing issue at a master's thesis level. The main reason for this is the international nature of transfer pricing.

Federal tax laws in the US are included in the Internal Revenue Code[32] (IRC). The sections in the IRC must be read in the context of the whole IRC together with case law for interpretation.[33] Section 482 IRC contains the legal foundation for US transfer pricing allocations. Due to the section's wide scope, the Treasury Department of the IRS has issued a comprehensive set of transfer pricing regulations (the Regulations) providing the official interpretation of the IRS.

1.4 Delimitations

This master's thesis only discusses transfer pricing from the perspective of cross-border transactions. Although other types of intangible property may be brought up in comparisons, the focus is first and foremost on marketing intangibles and patents. Marketing intangibles are created through services performed within the group. This master's thesis only focuses on the marketing intangibles as such and not on the transfer pricing problems that may arise in relation to the services performed. Further, it falls outside the scope of this master's thesis to discuss transfer pricing as a business term. The master's thesis only uses an in-depth discussion regarding the US transfer pricing rules and the transfer pricing recommendations of the OECD and the comparison cannot be seen as exhaustive. More general conclusions may be drawn from other tax jurisdictions in the world, but only to reinforce important points and not to be comparative in a larger sense. The master's thesis primarily elucidates the problems with transfer pricing from the ethical pharmaceutical companies' point of view. Primary sources are used as much as possible but the authors' lack of legal training in regards to the US legal system has sometimes been a barrier to an in-depth study. Furthermore, generic drugs are mentioned but the primary focus is put on ethical pharmaceutical companies conducting research and development (R&D) and producing innovative drugs. Finally, since the Glaxo case discussed throughout this master's thesis resulted in a settlement, most relevant documents are not available to the public. The authors have therefore been obligated to rely on secondary sources and are aware of the influence this may have had on the analysis of the transfer pricing problem at hand.

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[31] Zweigert, Konrad, Kötz, Hein, *An Introduction to comparative law*, p. 35-36 with reference to Rabel, *Aufgabe und Notwendigkeit der Rechtsvergleichung* (1925) and *Die Fachgebiete des Kaiser-Wilhelm-Gesellschaft zur Förderung der Wissenschaften III* (1937) 77, reprinted in Gesammelte Aufsätze III (ed. Leser, 1967) 1 and 180.

[32] 26 U.S.C Title 26 Internal Revenue Code.

[33] Information from the website of the IRS.

1.5 Terminology

This master's thesis contains a number of expressions in need of further explanation.

When writing this master's thesis the authors have chosen to focus on the ethical pharmaceutical industry. The term "ethical" for the purpose of this thesis comprises three aspects of the industry. First, the ethical pharmaceutical industry is adherent to internationally accepted standards of good conduct to assure its products' efficacy, safety, and quality. Second, the industry's stakeholders and investors rely on the strategic principle of ethical behavior since the industry is especially confronted with the challenges of emotive profit-affecting consequences due to the nature of the industry. Third, another aspect of the industry described in this master's thesis is the research focus of the ethical pharmaceutical industry, since one of the industry's main concerns is the R&D required to supply new products.[34]

For the purpose of this master's thesis, the expression global trade encompasses trade performed on a worldwide basis among MNEs.

The term innovative drug is used frequently in this master's thesis. With the term the authors imply a unique, patented drug resulting from years of research. A generic drug is a drug produced without a patent protection and it is commonly a copy of an innovative drug. A generic drug is often produced when the patent of an innovative drug has expired.

When discussing the legal framework of the countries involved in this master's thesis, mainly the US, the authors are aware of the shortcomings of the term "legislation". Since it falls outside of the scope of this master's thesis to elaborate on the fundamentals of the legal systems of the jurisdictions at hand, the term will simply confine legislation, regulations and case law.

1.6 Outline

This master's thesis consists of nine chapters where the following six chapters are descriptive and the last two consist of analysis, conclusions, and recommendations.

Chapter 2 provides a comparative overview of the two major actors on the arena of international transfer pricing; the OECD and the US. This chapter explains the fundamental differences between the transfer pricing rules of the US and the transfer pricing recommendations of the OECD. The purpose of this chapter is to display the conflict between the rules and recommendations and to highlight the power-struggle created. Chapter 3 provides the essential characteristics and key value-drivers of the ethical pharmaceutical industry. In this chapter, the purpose is to describe the ethical pharmaceutical industry in order to explain why intangible property is of particular importance within this industry and to understand the problems transfer pricing rules impose on this industry in general. Chapter 4 includes a description of cases involving pharmaceutical companies and other measures taken by the IRS to allocate income attributable to intangible property to the US under section 482 IRC. The purpose of this chapter is to show the IRS's many unsuccessful attempts to come to terms with the migration of intangible property. This chapter also aims at explaining why the treatment of intangible property is still an area of uncertainty. Chapter 5 first describes the IRS's view on

[34] Wündisch, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, 2nd Ed., International Bureau of Fiscal Documentation, Amsterdam 2003, Para. 13.

tax audits. The chapter moves on to describe the Glaxo case, the largest fiscal dispute of all time. The facts of the case are presented as well as the standpoints of the parties involved. The purpose of this chapter is to explain why ethical pharmaceutical companies are priority targets of the IRS's tax audits and to show that the IRS does not have a neutral view on transfer pricing. The purpose is further to introduce the Glaxo case and the problem constituting the core of this master's thesis: the conflict of interest of the value attributable to marketing intangibles. Chapter 6 provides an overview of intangible property for transfer pricing purposes with special attention to marketing intangibles. In this chapter, the purpose is to highlight intangible property as an area of uncertainty. The purpose is also to connect the US and OECD views on intangible property to the Glaxo case and the issue of marketing intangibles. Chapter 7 discusses the present transfer pricing community's race to the top and the new transfer pricing developments in Germany. The purpose of this chapter is to show how the US, by going its own way, is steering the transfer pricing developments in a direction not intended by the OECD and that other countries are following tail.

In chapter 8 the first two points of the purpose of this master's thesis are analyzed: the new approach of the IRS and the global effect of the Glaxo case. The purpose of this chapter is, based on chapters 2 to 7, to identify key conclusions required for the discussion in the final chapter on what needs to be done in the future. Finally, chapter 9 contains conclusions and recommendations on what needs to be done in the future. The three conclusions and recommendations are the need for neutrality, the need for tax predictability, and the need for uniform application and interpretation of transfer pricing rules.

2 An Overview of Transfer Pricing in the OECD and the US

2.1 Introduction

This chapter provides a comparative overview of the two major actors on the arena of international transfer pricing; the OECD and the US. This chapter explains the fundamental differences between the transfer pricing rules of the US and the transfer pricing recommendations of the OECD. The purpose of this chapter is to display the conflict between the rules and recommendations and to highlight the power-struggle created.

2.2 The Transfer Pricing Recommendations of the OECD

2.2.1 Background

In order to explain the importance of the OECD in the area of international transfer pricing, some brief background information is necessary. The OECD was established in 1961 and consists of 30 Member countries.[35] The organization "brings together the governments of countries committed to democracy and the market economy from around the world".[36] Apart from the Member countries, the organization also encompasses views from over 100 other countries and economies, both in developing and developed countries.[37] The OECD has sought to insert internationally accepted "rules of the game" to achieve a common approach to the ways Member countries conduct international taxation.[38] The main tool in this process is the OECD Model Convention.[39] Based on this information it is safe to say that the strength of the OECD, in regards to the tax aspects relevant for this master's thesis, lies in its power to influence the Member countries and their legislations.

The recommendations of the OECD in the area of transfer pricing are not binding upon the Member countries, but merely function as suggestions on how to form national legislation in order to achieve the goals set out by the organization.[40] The remaining parts of this section on the recommendations of the OECD are dedicated to highlighting the strength and importance of the organization.

2.2.2 Reports from the OECD

There are many important sources to take into account when explaining and analyzing the transfer pricing recommendations of the OECD. The Model Convention is the main legal

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[35] Information from the website of the OECD.

[36] Id.

[37] Id.

[38] (1993) Reports of the Task Force of the OECD Committee on Fiscal Affairs in US Transfer Pricing Regulations, Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations, Executive Summary, Para. 5.

[39] Id.

[40] Please see chapter 1.3 for a discussion on the legal status of the OECD.

document on tax issues issued by the organization with the purpose to influence the way Member countries deal with international taxation.[41] Article 9 of the Model Convention contains a provision exemplifying how transfer prices should be dealt with by MNEs.

The OECD Committee on Fiscal Affairs (CFA) addressed problems relating to transfer pricing in several reports. The main report on this area is the (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises (the 1979 Report) dealing specifically with the principles found in Article 9 of the Model Convention. Article 9 provides:

"1. Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differs from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, has not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State B and taxes accordingly B profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other."

Another important report from the OECD is the (1984) Report of the Committee on Fiscal Affairs on Transfer Pricing and MNEs – Three Taxation Issues (the 1984 Report) where the CFA addressed problems in specific areas related to transfer pricing. The OECD released the OECD transfer pricing Guidelines in the mid-1990's with the intention that the Guidelines would be "a revision and compilation of previous reports."[42]

One reason why the OECD issued the Guidelines in 1995 was the release of the US transfer pricing Regulations[43] in 1994.[44] The OECD feared that the harmonization of

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[41] (1993) Reports of the Task Force of the OECD Committee on Fiscal Affairs in US Transfer Pricing Regulations, Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations, Executive Summary, Para. 5.

[42] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Preface, Para. 13.

[43] The Treasury Department of the IRS published the Code of Federal Regulations (CFR). The US transfer pricing Regulations can be found in CFR, Title 26, section 1.482.

[44] The OECD revised its old reports and compiled them into the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations after the US Regulations were finalized according to Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 32. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations also draw upon the OECD discussions in the (1993) Reports of the Task Force of the OECD Committee on Fiscal

national rules and practices on transfer pricing achieved among its Member countries could be interrupted when the US Regulations started affecting companies dealing with the country.[45] A task force within the OECD (not including the US) produced the (1993) Reports of the Task Force of the OECD Committee on Fiscal Affairs on US Transfer Pricing Regulations (the 1993 Report) with the purpose to provide the US with the opinions of other OECD Member countries on the proposed transfer pricing rules.[46] After the introduction of the US final Regulations in 1994, the OECD drew upon the 1993 Report when compiling its previous material into what would become the Guidelines.[47] According to the OECD, the findings in the 1993 Report needed to be transformed into a larger report covering more than just the US view on transfer pricing.[48]

2.2.3 Transfer Pricing Principles and Methods of the OECD

The main objective of the OECD when issuing the Guidelines was to restore a collective view on transfer pricing and once again underline the main transfer pricing principle adopted by the OECD: the arm's length principle.[49] The US applies the same principle, but refers to it as the arm's length standard.[50] The arm's length principle is embodied in Article 9.1 of the Model Convention as well as in the 1979 Report.[51] According to the arm's length principle, controlled transactions should be priced the same way as uncontrolled transactions. The principle continues to be endorsed by the OECD Member countries making it the international standard for establishing a correct transfer price.[52]

The OECD is careful when pointing out that the concept of transfer pricing is neutral and that "the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes."[53] The title of the OECD Guidelines also suggests

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Affairs in US Transfer Pricing Regulations, Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations, according to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Preface, Para. 14.

45 (1993) Reports of the Task Force of the OECD Committee on Fiscal Affairs in US Transfer Pricing Regulations, Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations, Executive Summary, Para. 2.

46 Id., Para. 3.

47 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Preface, Para. 14.

48 Id.

49 Id., Paras. 14-15.

50 Treas. Reg. Sec. 1.482-1(b).

51 See for instance the (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Preface, Para. 2.

52 Please see the (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Preface, Para. 2 together with the Model Tax Convention on Income and on Capital, Art. 9 and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Preface, Para. 15.

53 (1979) Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises, Preface, Para. 3.

neutrality in that the report is aimed at both tax authorities and MNEs. The report is also intended to guide tax authorities and MNEs in establishing correct transfer prices.[54] This is supported by the statement in the Guidelines that "OECD Member countries are encouraged to follow these Guidelines in their domestic transfer pricing practices, and taxpayers are encouraged to follow these Guidelines in evaluating for tax purposes whether their transfer pricing complies with the arm's length principle."[55]

The Guidelines encourages tax administrations to "take into account the taxpayer's commercial judgement about the application of the arm's length principle in their examination practices and to undertake their analyses of transfer pricing from that perspective."[56] From the perspective of MNEs it should be added that they often conduct business with the intention of establishing and preserving a good relationship with the tax authority.[57] Tax planning is only one small consideration that needs to be taken into account in the everyday business of an MNE.[58]

The OECD recommends various transfer pricing methods to establish whether conditions imposed by parties in a controlled transaction are consistent with the arm's length principle.[59] It is clearly stated in the Guidelines that the methods should be applied on a case-to-case basis depending on the situation at hand, and a taxpayer should not be restrained from using other methods or combining methods as long as documentation is provided.[60] The Guidelines does not recommend that a taxpayer is required to perform an analysis under more than one method.[61] The methods recommended by the OECD are divided into traditional transaction methods accounted for in Chapter II of the OECD Guidelines and "other methods" set out in Chapter III. Since traditional transaction methods provide the most direct way to establish whether an arm's length price has been used in a transaction, they are preferable to other methods.[62] In situations where there are no or few comparables available, exceptional cases that is, the methods of Chapter III can be used.[63] The traditional transaction methods prescribed by the OECD are the comparable uncontrolled price method (CUP), the resale price method, and the cost plus

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54 IBFD online database, under the heading "Country Analyses" and the sub-heading "Introduction to Transfer Pricing", "Transfer Pricing from a Business Economics Perspective", written by Prof. Dr Hubert Hamaekers.

55 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Preface, Para. 16.

56 Id.

57 IBFD online database, under the heading "Country Analyses" and the sub-heading "Introduction to Transfer Pricing", "Transfer Pricing from a Business Economics Perspective", written by Prof. Dr Hubert Hamaekers.

58 Id.

59 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 1.68.

60 Id.

61 Id., Para. 1.69.

62 Id., Para. 2.49.

63 Id.

method.[64] The "other methods" are the profit split method and the transactional net margin method (TNMM).[65]

2.3 The Transfer Pricing Rules of the US

2.3.1 Background

To fully understand why the OECD is so protective of its achieved harmonized interpretation of transfer pricing principles and methods, it is vital to learn more about the US transfer pricing rules. Ever since the 1980's the US approach to transfer pricing has been framed with suspicion among politicians that foreign MNEs are using transfer pricing to reduce the tax burden of their US-based subsidiaries.[66] Politicians claimed, and still claim, that foreign companies in the country pay less income tax than comparable US groups.[67] A decision to strengthen the rules on transfer pricing was made, based on the advanced tax planning by US MNEs.[68] US pharmaceutical companies were using provisions in the legislation[69] on tax-free transfer of intangibles to foreign affiliates; the companies spent a lot of money on R&D in the US and transferred the patents resulting from the research to tax havens such as Costa Rica and Puerto Rico.[70] The US response consisted of an addition to the US national transfer pricing rule, section 482 IRC, resulting in the possibility to make periodical revisions and adjustments if necessary, the so-called commensurate with income standard.[71] In 1992 the US Treasury Department issued and published the proposed transfer pricing Regulations under section 482 of the IRC.[72] The Regulations was met by heavy criticism from OECD Member countries.[73] In particular, the adoption of a new method for establishing an arm's length price for intangible property (the present Comparable Profit Method (CPM), previously called Comparable Profit

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64 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter II.

65 Id., Chapter III.

66 Hamaekers, Hubert, "Arm's Length – How Long?", p. 31.

67 IBFD online database, under the heading "Country Analyses" and the sub-heading "Introduction to Transfer Pricing", "Introduction", written by Prof. Dr Hubert Hamaekers.

68 For the pharmaceutical industry, the case of Eli Lilly (Eli Lilly and Company and Subsidiaries v Commissioner of Internal Revenue, 84 T.C. No. 65, 84 T.C. 996, Tax Ct. Rep. (CCH) 42,113, docket No. 5113-76, filed on May 28, 1985) is illustrative.

69 Section 351 IRC, later replaced by section 361 IRC.

70 Hamaekers, Hubert, "Arm's Length – How Long?", p. 31. Please also see for instance the Eli Lilly case further discussed in chapter 4.

71 Id.

72 IBFD online database, under the heading "Country Analyses" and the sub-heading "US", "Legislation", "Texts of Relevant Provisions", "Proposed Sec. 482 Regulations 24 January 1992", text of document released by the IRS.

73 (1993) Reports of the Task Force of the OECD Committee on Fiscal Affairs in US Transfer Pricing Regulations, Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations, Executive Summary, Para. 10.

Interval (CPI)) and the periodic post-transfer adjustments to realize the effect of the commensurate with income standard.[74]

The final Regulations was issued and published in 1994 and covers almost the whole area of transfer pricing, not only intangibles. The Regulations is also accompanied by vast documentation requirements connected to harsh penalties should the prices be adjusted.[75] In 2006, the Treasury Department issued certain new Temporary Regulations to "provide guidance regarding the treatment of controlled services transactions under section 482 and the allocation of income from intangibles, in particular with respect to contributions by a controlled party to the value of an intangible owned by another controlled party."[76]

2.3.2 Transfer Pricing Legislation and Regulations in the US

Federal tax laws in the US are included in the IRC. The sections in the IRC must be read in the context of the whole IRC together with case law for interpretation.[77] The legal support for the fiscal authorities to make transfer pricing adjustments is found in section 482 IRC. Since 1921, a version of section 482 IRC has existed in the US Internal Revenue provisions.[78] Section 482 IRC states:

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

The purpose of section 482 IRC is "to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions."[79] The provision aims at making sure controlled taxpayers are treated equally to uncontrolled taxpayers by ensuring the controlled taxpayer's income is in fact the true taxable income.[80] Section 482 IRC allows the US tax administration to allocate "income, deductions, credits, allowances, basis, or any other item or element affecting taxable income" either through making an increase or decrease of the amount allocated if

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[74] (1993) Reports of the Task Force of the OECD Committee on Fiscal Affairs in US Transfer Pricing Regulations, Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations, Executive Summary, Para. 10.

[75] Hamaekers, Hubert, "Arm's Length – How Long?", pp. 31-32.

[76] Final and Temporary Regulations, T.D. 9278, Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangibles; and Apportionment of Stewardship Expense, Internal Revenue Bulletin 2006-34, August 21 2006, Summary.

[77] Information from the website of the IRS.

[78] McDaniel, Paul R., Ault, Hugh J., Repetti, James R., *Introduction to United States International Taxation*, 5th Ed., Kluwer Law International, The Hague 2005, p. 145.

[79] Temp. Treas. Reg. Sec. 1.482-1T(a)(1).

[80] Id.

the taxpayer has not reported its true taxable income.[81] The section is directly addressed to the fiscal authorities and may not be invoked by the taxpayer.[82] The scope of the section is broad; it applies to both international and domestic transactions and does not require any finding that the related parties are purposely avoiding tax.[83] Due to this wide scope, the IRS has issued the comprehensive transfer pricing Regulations providing the official interpretation of section 482 IRC.[84]

The arm's length principle, referred to in the US legislation as the arm's length standard, is to be used as the benchmark when determining the true taxable income of a controlled taxpayer.[85] According to the IRS, this means a controlled taxpayer will be compared to an uncontrolled taxpayer dealing at arm's length.[86] The US transfer pricing Regulations contains specific methods to evaluate whether transactions are at arm's length and, if they are not, to calculate the arm's length price.[87] There are three transaction-based methods (the comparable uncontrolled price method, the resale price method, and the cost plus method) and two profit-based methods (the comparable profit method and the profit split method).[88] The Regulations differs, unlike the OECD Guidelines, between appropriate methods for tangible and intangible property.[89] Other than that, there is no strict priority of methods when determining a price at arm's length. A taxpayer cannot, according to the US Regulations, choose any method that seems appropriate; the best method rule must be abided by. The US Regulations states that "[t]he arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result."[90] When determining which method to use in accordance with the best method rule it is important to look at the degree of comparability between the uncontrolled and the controlled transaction, taking into account all the factors that could affect the price or the profit.[91] The Regulations does not require the comparable transactions to be identical but they have to be sufficiently similar to provide a reliable measure of an arm's length price.[92]

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[81] Treas. Reg. Sec. 1.482-1(a)(2).

[82] McDaniel, Paul R., Ault, Hugh J., Repetti, James R., *Introduction to United States International Taxation*, pp. 145-146.

[83] Id., p. 145.

[84] In this master's thesis, the term "treasury Regulations" is equal to the term "US transfer pricing Regulations" (the Regulations) or "final Regulations" (of 1994).

[85] Treas. Reg. Sec. 1.482-1(b).

[86] Treas. Reg. Sec. 1.482-1(b)(1).

[87] Treas. Reg. Sec. 1.482-2 through 1.482-6 (complemented by Temp. Reg. Sec. 1.482-2T, Temp. Reg. Sec. 1.482-4T, Temp. Reg. Sec. 1.482-6T) and Temp. Reg. Sec. 1.482-9T.

[88] Id.

[89] Please see Treas. Reg. Sec. 1.482-1 compared to Treas. Reg. Sec. 1.482-4.

[90] Treas. Reg. Sec. 1.482-1(c)(1).

[91] Treas. Reg. Sec. 1.482-1(d)(1).

[92] Treas. Reg. Sec. 1.482-1(d)(2).

One major difference between the transfer pricing recommendations of the OECD and the rules of the US is that section 482 IRC requires transfer prices for sales or licenses of intangible property to be "commensurate with the income attributable to the intangible."[93] The effects of the commensurate with income standard are described in the US transfer pricing Regulations under section 1.482-4(f)(2) on "periodic adjustments". Consideration for intangibles that are transferred in arrangements exceeding one year can be adjusted according to the general principle of periodic adjustments to be commensurate with the income attributable to the intangible property.[94] The adjustments must be made in consistency with the arm's length standard and the provisions in section 1.482-1.[95] A price determined to be at arm's length during a taxable year is not necessarily going to be considered as arm's length the following year and the tax authority are allowed to make an adjustment.[96] For a periodic adjustment during the subsequent year under the commensurate with income standard in section 482 IRC, there is no requirement that the statute of limitations is still open for the original transfer year.[97] The commensurate with income standard together with the possibility of making periodic adjustments have been criticized for opening up a possibility for hindsight; the standard is not per se inconsistent with the arm's length principle, but it requires making an evaluation of arm's length consistency at a later point in time instead of the time of transaction.[98] The commensurate with income standard is also criticized for increasing the risk of disputes not only between the taxpayer and tax authorities, but between tax authorities of different countries.[99] The OECD's view is strictly against hindsight and the Guidelines provides a solution to the problem.[100] The tax authority should look at whether the taxpayer made adequate assumptions in terms of comparability at the time of the transaction without using hindsight.[101] Many countries avoid the commensurate with income standard due to the risk of hindsight.[102] The main objective of the standard was to stop US companies, mainly pharmaceutical companies, from transferring intangible property to their foreign subsidiaries, often operating in countries with lower tax resulting in a deferral of US taxes

[93] Section 482 IRC.

[94] Treas. Reg. Sec. 1.482-4(f)(2)(i).

[95] Id.

[96] Id.

[97] Id.

[98] Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 34.

[99] Wündish, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Appendix H: US Transfer Pricing of Intangibles, Paras. H22 and H24.

[100] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paras. 1.51 and 6.28-6.35.

[101] Id., Para. 6.32.

[102] Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 34.

by using a royalty rate that understated the value of the intangible.[103] This was possible due to the difficulty of establishing a correct arm's length price for intangibles.[104]

An important point to be made for the purpose of the pharmaceutical industry is that the commensurate with income standard can be used by the competent authority to establish that the initial transfer price of an innovative drug was incorrect simply because the drug became more profitable during the course of time than first expected.[105]

2.4 Salient Points

The OECD is an important forum for bringing together the rules and practices within transfer pricing in various countries, both members and non-members of the organization. The OECD possesses a great tool in the power to influence the international transfer pricing community and create uniform rules and practices.

There are two main features pervading the OECD view on transfer pricing. The first aspect is the neutrality of transfer pricing; the fact that most MNEs are striving to conduct their business in a proper manner with sound business related reasons for their transactions. The second aspect, which is connected to the first aspect, is that most MNEs have the objective to maintain a healthy relationship with the local tax authority.

US transfer pricing rules and practices are not adhering to the neutral view, which could be expected from a Member country of the OECD. The US transfer pricing rules are framed with suspicion and fear of MNEs working hard to evade tax. The rules are therefore deviating from the OECD's recommendations in some important aspects, including the possibility to use the commensurate with income standard for intangible property. The standard has been heavily criticized by other OECD Member countries for creating a risk of hindsight. The US rules have a major effect on the international transfer pricing community since many countries are affected by the US rules in their global trade. The strict documentation requirements and harsh penalties are a real threat to many MNEs. The US has paved the way for countries to revise the rules on transfer pricing creating a non-uniform application of the arm's length principle.

[103] Schadewald, Michael S., Misey, Robert J. Jr., *Practical Guide to U.S. Taxation of International Transactions*, 5th Ed., Chicago 2005, Para. 502.07 together with Obrien, James M., Oates, Mark A., "Puerto Rico Transfer Pricing Emerges… Again… As an Emerging Issue", International Tax Journal, March-April, 2007, pp. 27-28.

[104] Id.

[105] Wündish, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Appendix H: US Transfer Pricing of Intangibles, Para. H26.

3 The Characteristics of the Ethical Pharmaceutical Industry

3.1 Introduction

This chapter provides the essential characteristics and key value-drivers of the ethical pharmaceutical industry. In order for the reader to properly understand the transfer pricing issues in this master's thesis, it is essential to first receive a deeper understanding of the ethical pharmaceutical industry. The purpose of this chapter is to describe the ethical pharmaceutical industry in order to explain why intangible property is of particular importance within this industry and to understand the problems transfer pricing rules impose on this industry in general.

3.2 The Four Pillars of the Ethical Pharmaceutical Industry

3.2.1 Background

There are certain requirements in order for the ethical pharmaceutical industry to function at its best; the four pillars. They can be described as value-drivers and they are important when determining where value is created in this particular industry. The four pillars of the ethical pharmaceutical industry are access to capital, support to R&D, a strong intellectual property regime, and a market that facilitates the value for innovation.[106] Complying with transfer pricing rules is particularly difficult in the ethical pharmaceutical industry, mainly due to two reasons. First, cross-border transactions are essential for a pharmaceutical group in order to make the best use of its worldwide manufacturing and marketing capacities.[107] Second, the industry is characterized by unique products produced at high costs for R&D and high risks, making it difficult to find comparable uncontrolled transactions to determine a price at arm's length.[108]

3.2.2 The First Pillar: Access to Capital

The ethical pharmaceutical industry is unique because of the contradictory expectations of the public and the investors.[109] The public expects the industry to supply products to cure diseases and improve the quality of life.[110] The general expectation is that there ought to be a cure for every disease and abnormal condition.[111] This cure is most likely to be achieved by a drug and if this drug is not yet available the public expects it to be discovered.[112] The drug has to be safe and effective and it should be available to as many patients as

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106 Pharmaceutical Research and Manufacturers of America, 2007 Annual Report, p. 4.

107 Wündish, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Para. 239.

108 Please see chapter 3.

109 Wündisch, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Paras. 26-27.

110 Id., Para. 26.

111 Id.

112 Id.

possible.[113] The investors on the other hand expect the companies to be profitable and on top of the game in regards to competition.[114]

Many may argue that the industry's twofold expectations are morally wrong and that the main objective should always be to cure and prevent disease at any cost. However, when looking at the time and cost-consuming business of bringing a successful drug to the market, it becomes clear that the investors play a crucial part. It is close to impossible to predict the outcome of research, and a high proportion of R&D activities do not result in a marketable drug, making it impracticable and unsound business behavior to borrow money to a large extent.[115]

On average, it takes twelve years to bring a successful pharmaceutical product from the laboratory to the consumer.[116] Out of 10,000 compounds entering preclinical testing only five advance to human testing.[117] Eventually, only one of these five compounds is approved and released on the market.[118] Time is not the only obstacle in the way of finding a new compound; the cost is also essential to this process. When taking into account the vast number of compounds that never reach the market, to produce a new compound costs on average USD 802 million.[119] This cost is even higher in the US because of the rigorous new drug approval system.[120] On average only three out of ten prescription drugs on the US market generate revenues that exceed the costs of R&D.[121]

Having considered the statistics above, it is clear that producing a drug and releasing it on the market is a costly business and the financial risks are high for companies in the pharmaceutical industry, perhaps even higher than in most other industries.

3.2.3 The Second Pillar: Support to R&D

In order to keep its market position, a pharmaceutical company has to defend its position by producing a succession of improved products, at least until the patent protection expires, as well as to invent pioneer drugs. [122] The result is large expenditures on R&D. US pharmaceutical companies spend on estimate 19.4 percent of their domestic sales on R&D.[123] The R&D expenditures are continually increasing.[124] The high cost of current

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113 Wündisch, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Paras. 25-26.

114 Id., Paras. 27 and 32.

115 Id., Para. 82.

116 Pharmaceutical Research and Manufacturers of America, 2007 Annual Report, p. 12.

117 Pharmaceutical Research and Manufacturers of America, "What goes in the costs of prescription drugs? …and Other Questions About Your Medicines", Washington 2005, p. 2.

118 Avanir Pharmaceuticals, Development Process: The Drug Development and Approval Process, 2002.

119 DiMasi, J.A., "Tufts Center for the Study of Drug Development Pegs Cost of a New Prescription Medicine at $802 Million", Press release, November 30, 2001.

120 Avanir Pharmaceuticals, Development Process: The Drug Development and Approval Process, 2002.

121 Pharmaceutical Research and Manufacturers of America, "What goes in the costs of prescription drugs? …and Other Questions About Your Medicines", p. 2.

122 Wündisch, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Para. 56.

123 Pharmaceutical Research and Manufacturers of America, Pharmaceutical Industry profile 2007, Key facts.

R&D must be paid for with current receipts.[125] This can be seen as general practice for many industries but it is an important feature of the ethical pharmaceutical industry in particular.[126] Many R&D projects do not lead to any profitable results and the time it takes to actually find a marketable product is considerable.[127] The result is that all profitable products must contribute to fund R&D projects, whether derived from it or not.[128]

Pharmaceutical compounds can be divided into different categories, such as cardiovascular products, anti-asthmatics, anti-inflammatories, cancer-treatments, and it is not likely that a group conducts R&D in more than a few categories.[129] Not all medicines within a category compete with each other, but a successful product sooner or later faces competition from another product with less side effects or a product that gives a more satisfactory result.[130] The emphasis is always on introducing new products that are better and more effective than the existing products on the market.[131] The most successful products are those that effectively prevent or cure disease in as many countries at the same time as possible.[132] The number of medicines available on the market is continually increasing and the share of the market taken by a particular drug is constantly under pressure.[133]

The international nature of the ethical pharmaceutical industry is an effect of the high cost of R&D and the high risks. In order to make a profitable return on investment, ethical pharmaceutical companies must set up subsidiaries in countries around the world.[134] Mergers, acquisitions, and co-marketing agreements are also common.[135] On average, a major group is likely to produce few innovative drugs per year, and there is often a need to complement capabilities of one company with the capabilities of another.[136] A smaller company may own rights to an innovative drug but lack the capacity to market it and a large group may have excess sales and marketing capacity due to a downturn in innovation.[137] Without merging and cooperating with other ethical pharmaceutical

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124 Pharmaceutical Research and Manufacturers of America, Pharmaceutical Industry profile 2007, p. 2.

125 Wündisch, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Para. 81.

126 Id., Para. 81.

127 Id., Para. 82.

128 Id., Para. 83.

129 Id., Para. 35.

130 Id., Para. 37.

131 Id., Para. 36.

132 Id.

133Id.

134 Siciliano Borges, Alexandre, Comparability in the Pharmaceutical Industry for Transfer Pricing Purposes, Leiden University School of Law, 2002, Para. 2.14.

135 Id.

136 Wündisch, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Para. 72. One study says that the average is three innovative drugs per group a year that are approved to be released on the market, another that the number is between zero and eight. A third study concludes that only one innovative drug per year is produced.

137 Id., Para. 68.

companies, a pharmaceutical company that is innovative in research but lacks the capacity to develop its products into marketable pioneer drugs risks loosing great business opportunities to its competitors.[138]

An ethical pharmaceutical company spends roughly 10 to 25 percent of its total revenue on R&D.[139] Even when an innovative drug is developed and approved there is no guarantee that the drug will sell in volume.[140] A marketable drug may also sell in volume to begin with but soon face competition from more efficient products, or unknown side effects may be detected.[141] Of course the situation may occur where the sales of an innovative drug is slow in the beginning but rises above the anticipations after minor improvements have been made to it or after a marketing campaign.[142] With this background, it is safe to say that R&D is the most important value-driver of the ethical pharmaceutical industry.

3.2.4 The Third Pillar: Strong Intellectual Property Regimes

Given the extraordinary challenge of bringing a successful compound to the market, involving high costs and risks and vast amount of time spent, a strong protection of intellectual property rights is required.[143] It is important for ethical pharmaceutical companies to protect the few innovative compounds that are successful and to market them in an environment where the competition is restricted for as long as possible to ensure profit.[144] The ethical pharmaceutical industry is interested in protecting inventions (patents), industrial design and logos, trademarks, domain names, and technology know-how.[145]

Perhaps the most important intellectual property right is a strong patent protection. Strong patent protection helps investors to accept the long process of developing a new drug.[146] Failure to provide adequate patent protection will result in lower profits for ethical pharmaceutical companies and thus over time lower the incentive to innovate new products.[147] When a drug can no longer be produced and sold with patent protection it becomes a generic drug and anyone is allowed to copy and sell the compound's generic substance.[148] The effect on a pioneer drug is severe when the patent expires and the

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138 Wündisch, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Para. 68.

139 Id., Para. 80.

140 Id., Para. 75.

141 Id.

142 Id.

143 Pharmaceutical Research and Manufacturers of America, Pharmaceutical Industry Profile 2007, p. 11.

144 Hejazi, Jamal, "Transfer Pricing within the North American Pharmaceutical Industry: Has There Been a Structural Shift in Risk?", International Transfer Pricing Journal, Issue 1, January/February, 2006, p. 11.

145 Wündisch, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Para. 85.

146 Pharmaceutical Research and Manufacturers of America, Pharmaceutical Industry Profile 2007, p. 12.

147 Hejazi, Jamal, "Transfer Pricing within the North American Pharmaceutical Industry: Has There Been a Structural Shift in Risk?", p. 11.

148 Wündish, Karl, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, Paras. 43-44. Generic companies do not have to bear the costs and risks of R&D or the heavy costs of getting regulatory approval for the compound and they can therefore produce and sell generics at a comparatively low price. Since the

product is faced by competition from generic products. Only two months after the patent on Prozac expired, the branded version lost almost 80 percent of its sales to generic products.[149] In the US the value of the market for generic drugs is steadily increasing and today generics have 57 percent of the US prescription drug market.[150]

The fact that there is a strong correlation between a strong patent law and pioneer drugs becomes clear when looking at the situation in the US. US MNEs are net performers of R&D in comparison with the rest of the world.[151] The US also has one of the world's strongest intellectual property regimes and approximately 70 percent of the new drugs that enter the market every year are produced in the US.[152] The importance of a strong intellectual property regime is perhaps best understood when looking the passing of Bill C-22 in Canada. Bill C-22 included stricter rules on patent protection. Before the passing of Bill C-22, Canadian protection had not been strong enough forcing pharmaceutical companies to perform R&D activities in other jurisdictions and many took place in the US.[153] The stronger protection for intellectual property increased R&D spending by 700 percent from 1987 to 2007.[154]

Protection of trademarks, brands and domain names is also important, especially after a patent has expired. An ethical pharmaceutical company can decrease the loss in sales of a product when the patent expires by building up the consumers' confidence in the drug and their loyalty towards the product through marketing.[155] Marketing must therefore be seen as another important value-driver. A common problem here is that governments are pharmaceutical companies' biggest clients. In some countries there is a legal obligation imposed or pressure by authorities on physicians to prescribe the cheapest drug available, usually a generic compound.[156]

3.2.5 The Fourth Pillar: A Market that Facilitates the Value for Innovation

In order for the industry to cure and help as many people around the world as possible, countries must create a functioning market where prices are kept affordable and legal

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medical effects are already made known to the public, the producer of a generic drug does not have to spend as much on marketing.

149 Wündish, Karl*, International Transfer Pricing in the Ethical Pharmaceutical Industry*, Para. 44 with reference to Dyer, G., "Death of new drugs worries pharma sector", Financial Times, April 30, 2002.

150 Pharmaceutical Research and Manufacturers of America, 2007 Annual Report, p. 20.

151 Musselli, Andrea, Marchetti Hunter, Donatella, "Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues", International Transfer Pricing Journal, IBFD Journals, May/June 2007, p. 172.

152 Pharmaceutical Research and Manufacturers of America, 2007 Annual Report, p. 5.

153 Hejazi, Jamal, "Transfer Pricing within the North American Pharmaceutical Industry: Has There Been a Structural Shift in Risk?", p. 9.

154 Id.

155 Wündisch, Karl, *International Transfer Pricing in the Pharmaceutical Industry*, Para. 99.

156 Id.

obstacles and uncertainties are kept to a minimum.[157] One way is to create more certainty regarding transfer pricing rules in order to decrease the risk of double taxation.

3.3 Salient Points

The very foundation for the ethical pharmaceutical industry to function at its best, the four pillars and key value-drivers, are access to capital, support to R&D, a strong intellectual property regime, and a market that facilitates the value for innovation. Access to capital is essential because of the high costs of developing an innovative drug and releasing it on the market. Without support to R&D the innovative drugs will never be discovered making R&D the most important value-driver. A strong protection of intellectual property is vital to protect the few products that reach the market from generic drugs and to protect the investors' interests. Further, marketing activities are involved in the mentioned pillars and must be seen as an important value-driver. Finally, the uncertainties occurring when a market does not facilitate the value for innovation such as a non-uniform approach on transfer pricing is harmful on global trade and investment.

[157] Pharmaceutical Research and Manufacturers of America, 2007 Annual Report, p. 5.

4 Migration of Intangible Property

4.1 Introduction

This chapter includes a description of cases involving pharmaceutical companies where the IRS has tried to allocate income from intangible property to the US under section 482 IRC. This chapter further explains other measures taken by the IRS to allocate income attributable to intangible property to the US. The purpose of this chapter is to show the IRS's many unsuccessful attempts to come to terms with the migration of intangible property which may explain why the IRS took a different approach in the Glaxo case, described in chapter 5. This chapter also aims at explaining why this issue is still an area of uncertainty.

4.2 The Use of US Possessions to Lower Tax Burden

Up until 1996 the IRC provided tax incentives for US corporations to invest in the US possessions Puerto Rico, Guam, the Virgin Islands and Northern Marianas.[158] Section 931 IRC (1954) included a very favorable tax exemption on income including dividends that a US parent received from a possession company in Puerto Rico. Section 931 IRC was later replaced by section 936 IRC (1976).[159] Section 936 IRC was applicable to the same situations but provided a favorable tax credit instead of an exemption for the US possession source income. A corporation had to be organized in the US, derive 80 percent or more of its gross income from US possessions, derive 75 percent or more of its gross income from the active conduct of trade or business in the US possessions, and file for treatment as a possessions by the IRS. With the purpose of increasing local production, possessions adopted tax incentive regimes and granted complete or partial exemption from taxation for a term of years.[160] The most successful one was the Puerto Rican "Operation Bootstrap" beginning in 1948.[161] The US tax credit was eliminated for years beginning after December 31, 1995 mainly because it resulted in large portions of income earned by US subsidiaries being exempted from tax.[162] The elimination limited the possibility to manufacture low-taxed profits within a group.[163] As a result of the elimination, taxpayers began restructuring their operations in order to preserve low levels of taxation on income, mainly by restructuring the US possession companies into controlled foreign corporations (CFCs).[164]

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158 Obrien, James M., Oates, Mark A., "Puerto Rico Transfer Pricing Emerges… Again… As an Emerging Issue", p. 22.

159 Tax Reform Act of 1976, Pub. L. No. 90 Stat. 1520 (1976) established possession tax credit under section 936 IRC.

160 Obrien, James M., Oates, Mark A., "Puerto Rico Transfer Pricing Emerges… Again… As an Emerging Issue, International Tax Journal", p. 22.

161 Id.

162 Small Business Job Protection Act of 1996 (H.R. 3448) and Industry Director Directive on Section 936.

163 Small Business Job Protection Act of 1996.

164 Industry Director Directive on Section 936 Exit Strategies. The extent of the tax credit had been limited through various acts before the final elimination.

Most of the possession tax credit was earned by the pharmaceutical industry.[165] An essential amount of Puerto Rico's domestic income derived from manufacturing activities.[166] Pharmaceutical companies accounted for about 40 percent of Puerto Rico's income from manufacturing in 1989, and in 2002 income from manufacturing conducted by the pharmaceutical industry rose to 70 percent.[167]

Under a typical structure, a US pharmaceutical company set up a wholly owned subsidiary (a possession company) in Puerto Rico with the sole business purpose of manufacturing the parent company's pharmaceutical products.[168] The Puerto Rican subsidiary was made the owner of intellectual property such as valuable patents on innovative drugs.[169] The US parent conducted the marketing activities and profits deriving form these activities were fully taxed in the US.[170] Profits from the manufacturing of the drugs were subject to tax credit under section 936 IRC. The section 936 IRC tax credit also included income attributable to the manufacturing process and, most importantly, intangible property involved in the manufacturing activities such as patents and know-how. The Puerto Rican tax credit granted a partial or complete tax credit on the same income against Puerto Rican taxes.[171] The result of these two tax credits was that a large portion of income was completely exempted from tax.[172]

There are three important cases that show the IRS's failure to come to terms with the tax evasion, all involving a pharmaceutical company setting up a possession company and allowing the possession company to take into account the ownership of intangible property when determining a transfer price under section 482 IRC. These cases are discussed below.

4.3 Cases: Avoiding US Taxation of Intangible Property

4.3.1 Eli Lilly Co v Commissioner of Internal Revenue

In *Eli Lilly Co v Commissioner of Internal Revenue*[173] (the Eli Lilly case) the US parent set up a wholly owned possession company in Puerto Rico qualifying for the tax benefits of section 931 IRC. The US parent transferred the ownership of two patents on prescription pain-relieves, Davon and Davon-N, which were the most prescribed pharmaceuticals in the US during the period of 1960 through 1973, and related manufacturing know-how to its

165 GAO Report, "Puerto Rico: Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit", released on June 23, 2006, GAO-06-541, Chapter 5.

166 Id., Background.

167 Id.

168 Industry Director Directive on Section 936 Exit Strategies.

169 Id.

170 Id.

171 The Puerto Rican Industrial Incentive Act of 1963, 1954 P.R. Laws Ann. Tit. 13, Sections 252-252j.

172 Industry Director Directive on Section 936 Exit Strategies.

173 Eli Lilly and Company and Subsidiaries v Commissioner of Internal Revenue, 84 T.C. No. 65, 84 T.C. 996, Tax Ct. Rep. (CCH) 42,113, docket No. 5113-76, filed on May 28, 1985, at 1007-1008.

Puerto Rican subsidiary.[174] The Puerto Rican subsidiary manufactured the pain-relieves and sold them to the US parent company.[175] The US parent undertook all the marketing activities in the US and bore all the costs related to litigation.[176] This business structure enabled an extensive decrease of taxation within the Eli Lilly group. The Tax Court did not agree with the IRS having the authority to reallocate income attributable to the intangible property from the subsidiary back to the US parent and held that the income from the intangibles should accrue to the Puerto Rican subsidiary.[177] The Tax Court, nevertheless, concluded that the US parent negotiating at an arm's length would not have transferred valuable intangibles without receiving a royalty or other kind of payment in return.[178] Because of the absence of such an agreement it was possible to divert income and avoid tax.[179]

4.3.2 G.D. Searle & Co v Commissioner of Revenue

In G*.D. Searle & Co v Commissioner of Revenue*[180] (the Searle case) a US parent set up a wholly owned affiliate, SCO, in Puerto Rico both for business reasons as well as to take advantage of the tax exemption in section 931 IRC and the Puerto Rican tax exempt.[181] The US parent transferred five out of seven of its major product lines to SCO, including patents, technical data, licenses, copyright and trademarks related to the transferred products.[182] SCO produced the products and sold them directly to independent sellers in the US.[183] The US parent conducted all marketing activities and sales administration for a service charge.[184] The IRS claimed that, under section 482 IRC, SCO was established solely for tax purposes and wanted to allocate 92 percent of the affiliate's profit to the US.[185] The IRS argued that section 482 IRC had to be applied in order to place the US parent and SCO in the position of unrelated parties dealing at arm's length and to correct the distortion of the US parent's taxable income.[186] The US Tax Court held that tax considerations had indeed been of major concern when the affiliate was established, however, SCO was created for business

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174 Eli Lilly and Company and Subsidiaries v Commissioner of Internal Revenue, 84 T.C. No. 65, 84 T.C. 996, Tax Ct. Rep. (CCH) 42,113, docket No. 5113-76, filed on May 28, 1985, at 1037.

175 Id.

176 Id., at 1051-1055.

177 Id., at 1115.

178 Id., at 1130.

179 Id.

180 G.D. Searle & Co v Commissioner of Revenue, 88 T.C. NO. 16, 88 T.C. 252 Tax Ct Rep. (CCH) 43,625. Docket No. 128 36-79, filed on February 4, 1984.

181 Id., pp. 270-273.

182 Id., pp. 276-277.

183 Id., pp. 277-278.

184 Id., p. 301.

185 Id., pp. 338-341.

186 Id., p. 341.

purposes and not solely for tax avoidance.[187] SCO was to be regarded as the rightful owner of the intangible property and its ownership cannot be disregarded.[188] The US Tax Court concluded that the IRS had abused its discretion under section 482 IRC to allocate income to the US parent.[189]

4.3.3 Merck & Co v the United States

In *Merck & Co v the United States*[190] (the Merck case) a US parent company transferred an exclusive right to sell and manufacture certain pharmaceutical products to its Puerto Rican possession company.[191] The possession exported the pharmaceutical products to foreign affiliates outside the US.[192] The IRS wanted to impute a seven percent royalty under section 482 IRC based on that the US parent company conducted ongoing R&D and marketing activities for the intangible property related to the pharmaceutical products.[193] The court held that the IRS's allocation of profit to the US under section 482 IRC was not persuasive.[194] The court stated that "[t]he fact that Merck's management was diligent and creative, and used sophisticated tax planning to reduce its overall tax liabilities, in itself does not constitute prohibited tax avoidance or evasion. Merck's decision to locate production facilities in Puerto Rico, and its decision to position its sales efforts in foreign markets in local companies, were based on sound business reasons."[195] On IRS's argument that Merck was merely evading taxes the court held that "[a] taxpayer that does not take the tax laws into consideration when structuring complex transactions not only is naïve but probably is out of business."[196] The court agreed with Merck that IRS's allocation under section 482 was "arbitrary, capricious and unreasonable" under the applicable law, and held that the IRS had not showed that an allocation of a seven percent royalty or any other allocation would be appropriate.[197]

4.4 The Cost-Sharing Method and the Profit Split Method

In an attempt to address the arguments held by the IRS in the Eli Lilly case and the Searle case, section 936(h) IRC was passed.[198] Section 936(h)(5) IRC provided two methods for

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187 G.D. Searle & Co v Commissioner of Revenue, 88 T.C. NO. 16, 88 T.C. 252 Tax Ct Rep. (CCH) 43,625. Docket No. 128 36-79, filed on February 4, 1984, pp. 263-267.

188 Id., p. 341.

189 Id., Headnote.

190 Merck & Co., inc., v the United States, 24 Cl.Ct.73, 68 A.F.T.R.2d 91-5524, 91-2 USTC P 50,456, Docket No. 283-88T, filed on September 10, 1991.

191 Id., Appendix at 16 a.

192 Id., Appendix at 14 c.

193 Id., Opinion.

194 Id., Disposition.

195 Id.

196 Id.

197 Id.

198 H.R. REP. NO.760, 97th Congress, 2d Session 504 (1982). Section 936(h) became effective after December 1, 1982.

allocating income attributable to intangible property in order to prevent possession corporations from earning profit on transferred intangible property without bearing any of the ongoing costs for R&D within the multinational group. The methods, the cost-sharing method and the profit split method, entitled the possession corporation to earn income on intangible property only if it contributed to the group's R&D expenses.[199] Section 936(h) IRC was successful as it drastically reduced IRS's transfer pricing litigations involving section 482 IRC possession corporations.[200] The additions to the section did not provide strong enough protection from tax evasion and section 936 IRC was finally revoked.[201]

4.5 Further Attempts to Prevent Migration of Intangible Property

The revocation of section 936 IRC did not have the intended effect upon US tax revenue. In 2007, shortly after the revocation of section 936 IRC, transfer pricing issues related to Puerto Rico became a hot political topic again.[202] In response to a request from the United States Senate Committee on finance, the General Accounting Office (GAO) issued the GAO Report "Puerto Rico: Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit"[203].[204] The GAO Report concluded that the majority of companies that remained their operations in Puerto Rico after the revocation of section 936 IRC were operating as CFCs and not as US companies.[205] A Congressional Quarterly article from September 2006 reveals that this came as a shock to the Congress which had expected that "about $2.7 billion in previously untapped taxes on corporation profits was projected to flow from all U.S. territories to the Treasury."[206] The article states that the reason for the increased profitability was an improper shifting of income deriving from intangible property.[207] In order to come to terms with the tax evasion through the use of CFCs, the IRS recently issued an Industry Directive with audit guidelines addressing the issue. [208]

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[199] The profit split method and the cost-sharing methods provided in section 936(h)(5) have similar wording but are not the same as the profit split method and the cost-sharing method in the 1994 final US Treasury Regulations.

[200] Obrien, James M., Oates, Mark A., "Puerto Rico Transfer Pricing Emerges… Again… As an Emerging Issue", pp. 28-29.

[201] Small Business Job Protection Act of 1996 and Industry Director Directive on Section 936 Exit Strategies.

[202] Obrien, James M., Oates, Mark A., "Puerto Rico Transfer Pricing Emerges… Again… As an Emerging Issue", p. 29.

[203] GAO Report, "Puerto Rico: Fiscal Relations with the Federal Government and Economic Trends during the Phaseout of the Possessions Tax Credit".

[204] Id., Letter to: The Honorable Chairman Charles E. Grassley and The Honorable Ranking Minority Member Max Baucus, United States Senate Committee on Finance, May 19, 2006.

[205] Id., Chapter 5.

[206] Barshay, J., "An Island of Avoidance", Congressional Quarterly, Vol. 64, Issue 35, September 15, 2006, pp. 2446-2455.

[207] Id.

[208] Industry Director Directive on Section 936 Exit Strategies.

The Industry Directive's main target is pharmaceutical companies that transferred the operations of former section 936 IRC subsidiaries, including valuable intangible property, "to CFCs upon or in anticipation of the expiration of the section 936 possessions tax credit, and provides insight into evolving IRS thinking regarding a much broader set of intangible migration transactions."[209]

The Industry Directive aims at carefully scrutinizing and examining the nature of all transferred intangible property.[210] According to the IRS, US transferors of intangible property, especially marketing intangibles and workforce, wrongly claim that the intangible property should fall under tax exemptions in the IRC.[211] The Industry Directive further states that it may be appropriate to consider whether foreign goodwill and going concern value are in fact foreign and thus not subject to tax in the US.[212] The CFC must pay a royalty to the US parent in accordance with section 482 IRC when granting a license to use intangible property.[213] Rather than licensing intangible property to the new CFC, the US parent may transfer intangible property tax free as goodwill or going concern value.[214] The first situation does not result in tax deferral from the US. In the second situation the Industry Directive states that the US parent will, for tax purposes, be regarded to have sold intangible property in exchange for arm's length contingent annual payments.[215]

The indications are strong that the last battle has not been fought in the IRS's struggle with marketing intangibles and the pharmaceutical industry. The Industry Directive may, in addition to the new approach taken on marketing intangibles in the Glaxo case, have a far-reaching impact on future IRS audits of intangible migration transactions.[216]

4.6 Salient Points

The IRS has made several unsuccessful attempts to prevent the migration of intangible property from a US parent to a possession subsidiary by reallocating income under section

[209] Information from the website of PricewaterhouseCoopers.

[210] Industry Director Directive on Section 936 Exit Strategies.

[211] Id. Please see the section on Planning and Examination Guidelines: Potential Issues: 3: Taxation under Section 367(d) for Any Intangibles Transferred to the New CFC. A common way to avoid US taxation when restructuring is to transfer the tangible property owned by the possession corporation free of tax to the new CFC in accordance with sections 351 IRC or 361 IRC. Intangible property cannot be transferred tax free under these sections except for goodwill and going concern value to a foreign corporation, see section 367(d) IRC. The directive aims at preventing such transfers.

[212] Id. Please see the section on Planning and Examination Guidelines: Potential Issues: 3: Taxation under Section 367(d) for Any Intangibles Transferred to the New CFC.

[213] Id. Please see the section on Planning and Examination Guidelines: Potential Issues: 1. Determination of Arm's Length Royalty to the US Licensor.

[214] Section 351 IRC or 361 IRC together with section 367(d) IRC.

[215] Industry Director Directive on Section 936 Exit Strategies. Please see the section on Planning and Examination Guidelines: Potential Issues: 3: Taxation under Section 367(d) for Any Intangibles Transferred to the New CFC.

[216] Information from the website of PricewaterhouseCoopers.

482 IRC. The IRS's main target was pharmaceutical companies such as Eli Lilly, Searle and Merck.

Admitting its failure, the IRS approached the problem of migration of intangible property by introducing the profit split method and the cost-sharing method in the new section 936(h) IRC. In addition, section 936(h) IRC required that, in order to be entitled to income from intangible property, a possession company had to contribute to the R&D activities performed by the group. The IRS was successful in that the measures taken reduced transfer pricing litigations involving the migration of intangible property. Unfortunately the passing of section 936(h) IRC did not result in an increase in US tax revenue as expected by the Congress. The reason was that MNEs restructured their groups and transformed the possession companies into CFCs, thereby avoiding US taxation. As a result, section 936 IRC was abolished.

In 2007, the IRS made a third attempt to come to terms with the migration of intangible property by issuing the Industry Directive. The Industry Directive aims at intangible property transferred by US pharmaceutical companies to possessions such as Puerto Rico. It remains to be seen if the IRS has finally succeeded.

5 The IRS's Response to Political Concern and the Glaxo Case

5.1 Introduction

This chapter first describes the IRS's view on tax audits of companies in the pharmaceutical industry and then moves on to describe the Glaxo case, the largest fiscal dispute of all time. The facts of the case are presented as well as the standpoints of the parties involved. The purpose of this chapter is to explain why ethical pharmaceutical companies are likely to be audited by the IRS showing that the IRS does not have a neutral view on transfer pricing. The purpose is further to introduce the Glaxo case and the problem constituting the core of this master's thesis: the conflict of interest over the value attributable to marketing intangibles further elaborated upon in chapter 6.

5.2 The IRS's View on Tax Audits

It should be emphasized that a large number of the pharmaceutical companies are tied to the US and bound by the US transfer pricing provisions one way or another, for instance 70 percent of the new drugs that enter the market every year are produced in the US.[217] The ethical pharmaceutical industry has been the target of many IRS audits and this is not likely to change in the future. The nature of intercompany transactions in the pharmaceutical industry involving innovative drugs is such that the transactions are likely to be audited by the IRS. The US approach on tax audits is to closer examine transactions involving high risks.[218] One of the most current issues for the IRS is the migration of intangible property and the underreporting of the value of intangibles.[219]

In a written testimony before the Senate Committee on Finance following the Glaxo settlement, the IRS Commissioner highlights the transfer of intangible property outside of the US as high-risk compliance issue for the IRS and that this behavior has seen a significant increase in recent years.[220] The IRS Commissioner continues by stating that "[t]axpayers, especially in the high technology and pharmaceutical industries, are shifting profits offshore through a variety of arrangements that result in the transfer of valuable intangibles to related foreign entities for inadequate consideration."[221] The IRS Commissioner also says that "[t]axpayers often manipulate the price of related transactions so that the income of an economic group is ostensibly earned in a low tax jurisdiction, or in no jurisdiction, rather than in the United States, thus lowering the enterprise's worldwide tax burden."[222] The IRS Commissioner makes his opinion quite clear that pharmaceutical

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217 Pharmaceutical Research and Manufacturers of America, 2007 Annual Report, p. 5.

218 Ernst&Young 2005-2006 Global Transfer Pricing Survey Tax Authority Interviews: Perspectives, Interpretations and Regulatory Changes, p. 10.

219 Id.

220 Written Testimony of Commissioner of Internal Revenue Mark Everson, IRS Commissioner testifies before Senate Committee on Finance on Compliance Concerns Relative to Large & Mid-Size Businesses.

221 Id.

222 Id.

groups are trying to shift their profits abroad to avoid taxes in the US. The IRS has made several unsuccessful attempts to put an end to what they view as tax evasion.[223]

In the Glaxo case the IRS takes a new approach when determining the transfer price of intangible property stating that the value of intangible property is attributable to US marketers when performing the services that Glaxo US did.[224] In the written testimony to the Senate of finance the IRS Commissioner comments on the settlement in Glaxo as an important development in one of IRS's most significant challenges in the area of corporate tax that "sends a strong message of our resolve to continue to deal with this issue going forward."[225] When a tax authority acts in this way to increase a country's tax revenue from MNEs, it is often in response to political concerns about inadequate tax revenue from foreign corporations.[226]

5.3 The Glaxo Case

5.3.1 The Facts of the Glaxo Case

On September 11 in 2006, one of the world's leading research-based pharmaceutical and healthcare companies, GlaxoSmithKline (Glaxo)[227], and the IRS settled a 16 year long tax dispute.[228] The main issue in the case deals with the amount of profit to be attributable to a US subsidiary (Glaxo US) distributing and marketing the finished products of a foreign group.[229] The intercompany payments from the Glaxo US to the United Kingdom (UK) parent (Glaxo UK) took into account the intangibles of products developed by Glaxo UK, which the IRS opposed. Mainly at issue was the heartburn medication Zantac launched by Glaxo UK in 1981 and a few years later became the biggest selling drug in the world.[230] The

223 Please see for example G.D. Searle & Co v Commissioner of Revenue, 88 T.C. NO. 16, 88 T.C. 252 Tax Ct Rep. (CCH) 43,625. Docket No. 128 36-79, filed on February 4, 1984, Eli Lilly and Company and Subsidiaries v Commissioner of Internal Revenue, 84 T.C. No. 65, 84 T.C. 996, Tax Ct. Rep. (CCH) 42,113, docket No. 5113-76, filed May 28, 1985, and Merck & Co., inc., v the United States, 24 Cl.Ct.73, 68 A.F.T.R.2d 91-5524, 91-2 USTC P 50,456, Docket No. 283-88T, filed on September 10, 1991.

224 Schmid, Alfons R., "Tax Treatment of Services: Does the Value of Patents and Technical Know-How Prevail over the Value of Marketing Efforts?", p. 16.

225 Written Testimony of Commissioner of Internal Revenue Mark Everson, IRS Commissioner testifies before Senate Committee on Finance on Compliance Concerns Relative to Large & Mid-Size Businesses.

226 Mansori, Kashif S., Weichenrieder, Alfons J., "Tax Competition and Transfer Pricing Disputes", October, 1999, Abstract.

227 Information from the website of GlaxoSmithKline about the merger. Glaxo merged with SmithKline in 2001. Due to the fact that the main part of the dispute in the Glaxo case took place before the merger, the company will be referred to as Glaxo or the Glaxo group.

228 IRS Press Release, IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute, IR-2006-142, Sept. 11, 2006, Washington September 11, 2006.

229 Musselli, Andrea, Marchetti Hunter, Donatella, "Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues", p. 165.

230 Randle, Keith, Rainnie, Al, "Creativity and control in a Pharmaceutical R&D Company: The Case of Glaxo Research and Development", Working paper series UHBS 1994:7, Human Resource Group Paper 2, University of Hertfordshire Business School, p. 1.

adjustments made by the IRS in the deficiency notice to Glaxo US involved six products and Zantac alone represented 77 percent of the adjustments.[231]

The Glaxo group's headquarters was located in the UK, where most R&D was performed, and its operations, including sales and marketing, was located in the US.[232] The intercompany transactions under audit by the IRS involved the license granted by Glaxo UK to Glaxo US to distribute Glaxo's products in the US.[233] Glaxo US purchased the active ingredients from Glaxo UK.[234] When determining the transfer prices and the license fee Glaxo US used a resale-minus method and kept 55 percent of the gross profit margin.[235]

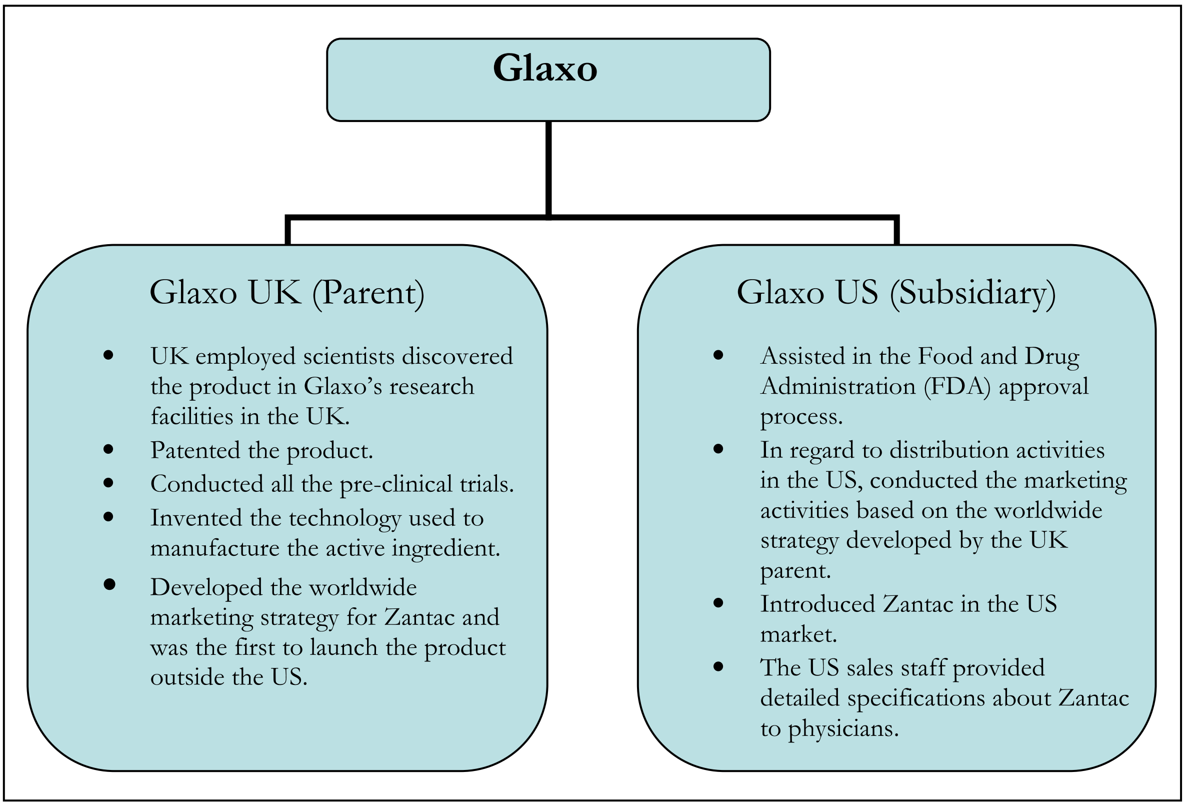

Figure 1. The economic functions performed by the UK parent and the US subsidiary in the Glaxo group.[236]

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[231] Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo, Tax Planning International Transfer Pricing", International Information for International Business, The Bureau of National Affairs, Washington D.C. November, 2006, p. 3.

[232] Information from the website of GlaxoSmithKline about the company.

[233] Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo", p. 3.

[234] Id.

[235] Id., p. 4.

[236] The functions performed are taken from Musselli, Andrea, Marchetti Hunter, Donatella, "Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues". Some of the functions conducted by Glaxo UK may in fact have been conducted by other foreign affiliates. For US tax purposes this is irrelevant.

Under the settlement agreement, which is the largest and longest in the history of the IRS, Glaxo agreed to pay the IRS approximately USD 3.4 billion including interest and to abandon its claim for a tax refund of USD 1.8 billion. The settlement covered transfer pricing adjustments in the period 1989-2001, and was due to go to trial in the beginning of 2007. The tax dispute in the period 1989-2001 involved intercompany transactions between Glaxo and certain foreign affiliates. The settlement also included an agreement between the IRS and Glaxo concerning transfer pricing issues in the subsequent years 2001-2005.[237]

The tax refund claim that Glaxo had to abandon was a discrimination claim against the IRS for rejecting Glaxo's advanced pricing agreement request.[238] Glaxo filed a request for an advanced pricing agreement (APA) in 1994 that the IRS refused. One year earlier the IRS had concluded an APA with Glaxo's competitor at the time, SmithKline, concerning a competition drug to Zantac.[239] An APA would have enabled Glaxo to reach an agreement on the transfer pricing method to be applied on the transactions and maybe even agree on what transfer price to charge, and hence avoid ending up in this outstretched tax dispute.[240]

Under the settlement Glaxo agreed to pay more than 60 percent of the total amount of tax that was at issue in the dispute.[241] If the IRS had prevailed in court Glaxo could have owed USD 14-15 billion in taxes.[242]

5.3.2 The Standpoint of the IRS

The IRS took a new approach on marketing intangibles in the Glaxo case claiming that the marketing activities conducted by Glaxo US should account for more than the patent owned by Glaxo UK.[243] The IRS's approach in the Glaxo case can affect the taxation of distributors outside the US, not only in the pharmaceutical industry. If the foreign companies are stripped of functions and risks involved in intangible property they have created; the value they have added to a product will instead be allocated to a US affiliate.[244]

The IRS applied the profit split method to the transactions involved instead of the resale-minus method that Glaxo had applied. From an overall split with the resale-minus method allocating about 70 percent of the profit to Glaxo UK and 30 percent of the profit to Glaxo US, the proposed adjustments by the IRS split the profit with 80 percent to Glaxo US and only 20 percent to Glaxo UK. The settlement resulted in a 60-40 split in favor of the US. The reason for these huge differences in allocation of profit between the UK and

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237 IRS Press Release, IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute.

238 Butani, Mukesh, "Mother of all tax settlements".

239 Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo", p. 3.

240 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 4.1 and Chapter IV(F).

241 IRS Press Release, IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute.

242 Dalrymple, Mary, IRS, "Glaxo agree on big settlement", Deseret News, Associated Press, Salt Lake City September 12, 2006, the article was provided by ProQuest Information & Learning Company.

243 Schmid, Alfons R., "Tax Treatment of Services: Does the Value of Patents and Technical Know-How Prevail over the Value of Marketing Efforts?", p. 16.

244 Musselli, Andrea, Marchetti Hunter, Donatella, "Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues", p. 172.

the US can be traced back to contradictory understandings of what creates and drives value in the ethical pharmaceutical industry in general and in this group in particular.[245]

The IRS contested the increases in the royalty rate that Glaxo US made in relation to the increases in sales, and held that the initial royalty rate was the correct arm's length royalty and that there was not an increase of the value of the licensed patents to justify the increased royalty rate (contradictory to the commensurate with income standard). The increased sales derived from marketing activities performed by Glaxo US. The IRS also held that under "the developer-assister rule" a taxpayer who has contributed to the development of intangible property is not entitled to deduct royalties paid to the developer of the intangible property. Glaxo US had provided assistance to the owner of the intangible property in connection with the development and enhancement of the products.[246]

In the tax dispute the IRS claimed that, at the time when Zantac was to be introduced on the US market, Glaxo UK did not own any valuable intangible. This was due to the high uncertainty related to the distribution of Zantac.[247] The difficulty to predict the value of intangible property at the time when the transactions take place is a common problem when a new drug is to be released on the market. This is due to the high risks involved and the unpredictability of the market demand, as described in the previous chapter. The US transfer pricing Regulations does not deal with this situation at all. The IRS chose to look at the situation as it was at the time of the release of the product on the market and concluded that at this time Glaxo UK did not own a valuable intangible.[248] The fact that Zantac soon became a huge blockbuster drug was disregarded.

The IRS further claimed that Zantac was not a pioneer drug but merely an improvement of SmithKline's predecessor Tagamet and that Zantac's huge success was all due to the marketing efforts made by the US subsidiary and not to the unique qualities of the product.[249] The IRS looked at the increasing number of sales representatives in the US over the years to support this claim.[250] The increasing number of sales representatives showed that Zantac's success in sales was attributable to sales and marketing activities conducted in the US.[251] The IRS also looked at the contractual terms and stated that the risk and high returns were shifted to Glaxo US by guaranteeing the parent company a fixed rate of return.[252]

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245 Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo", p. 4.

246 Colker, David, Kim, Sang, "GlaxoSmithKline v Commissioner: How Should $10.6 Billion of Income in Dispute be Allocated Between Patents and Marketing Intangibles?".

247 Musselli, Andrea, Marchetti Hunter, Donatella, "Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues", p. 165.

248 Id., p. 171.

249 Id., p. 165.

250 Butani, Mukesh, "Mother of all tax settlements".

251 Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo", p. 5.

252 Butani, Mukesh, "Mother of all tax settlements".

5.3.3 The Standpoint of Glaxo

Glaxo US held that the royalty payments made to Glaxo UK reflected the value of the patents owned by Glaxo UK and that the IRS had not applied the commensurate with income standard correctly on the royalty payments. According to the commensurate with income standard a royalty rate shall be adjusted each year to reflect market conditions. Glaxo US paid a royalty rate of a percentage on sales and as the sales increased the royalty rate increased, hence reflecting the increased value of the patent license.[253]

In response to "the developer-assister rule" invoked by the IRS, Glaxo US said that the IRS had to prove that the company spent considerably more money on marketing activities for a number of years than the average distributor of pharmaceutical products.[254]

Glaxo argued that R&D in itself is a significantly valuable component.[255] Marketing is a crucial element in the pharmaceutical industry in order for pharmaceutical companies to be profitable.[256] Glaxo further claimed that Zantac was a pioneer drug based on it having fewer side effects and requiring fewer doses.[257] The drug's tremendous success was a result of extensive R&D performed by Glaxo UK.[258]

The discrimination claim against the IRS for rejecting an APA in 1994 was based on inconsistent treatment of Glaxo to similar taxpayers. The IRS concluded an APA in 1993 with SmithKline related to the Zantac competitor drug Tagamet. The APA between SmithKline and the IRS stated that the resale price method and a specific gross margin were applicable on the transactions involving marketing and selling activities. An APA would have enabled Glaxo to obtain a prospective legal determination from the IRS. Glaxo merged with SmithKline in 2001 and obtained information concerning this matter that, under other circumstances, would have been confidential.[259]

Glaxo US claimed in a press release that "it was confident of the strength of its position" but that it was in the best interests of the shareholders to reach a settlement and thereby remove costs and risks involved in a future litigation.[260] However, from the size of the settlement it is possible to argue that Glaxo's defense lawyers believed they would loose in

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253 Colker, David, Kim, Sang, "GlaxoSmithKline v Commissioner: How Should $10.6 Billion of Income in Dispute be Allocated Between Patents and Marketing Intangibles?".

254 Id.

255 Butani, Mukesh, "Mother of all tax settlements".

256 Wündisch, Karl, *International Transfer Pricing in the Pharmaceutical Industry*, Para. 121.

257 Butani, Mukesh, "Mother of all tax settlements".

258 Id.

259 Colker, David, Kim, Sang, "GlaxoSmithKline v Commissioner: How Should $10.6 Billion of Income in Dispute be Allocated Between Patents and Marketing Intangibles?". Glaxo merged with SmithKline in 2001 according to the information from the website of GlaxoSmithKline about the merger.

260 GlaxoSmithKline Press Release, GSK settles transfer pricing dispute with IRS, London and Philadelphia September 11, 2006.

court because the efforts made to market the drugs in the US would account for more of the profit than the R&D performed in Europe.[261]

Without stating whether the transfer prices in Glaxo were correct according to the arm's length principle, it is clear that Glaxo did not attempt to avoid taxes in the US in the situation where a corporation is allocating income to a low tax jurisdiction. In fact, several scholars have claimed that the transfer prices set by Glaxo were in accordance with the arm's length principle.[262] Instead, the Glaxo case can be described as a battle between the tax authorities over the right to tax the tremendous profits from Zantac sales in its own country, resulting in the largest fiscal dispute of all time.[263] The US and the UK tax authorities did not reach a mutual agreement regarding the allocation of income in the Glaxo case; despite the fact that both countries claim they apply the same OECD principles to assess a price at arm's length.[264] The failure to reach a mutual agreement may have an impact on the allocation of income and cooperation between tax authorities in the future.

5.4 Salient Points

Ethical pharmaceutical groups have been the target of many audits conducted by the IRS. Currently, an issue of high priority for the IRS is the migration of intangible property and the underreporting of the value of intangible property. Furthermore, the IRS focuses on transactions involving high risks. The nature of the ethical pharmaceutical industry is such that it is likely to continue to be a priority target of tax audits in the future.

In 2006 the world's largest and longest tax dispute ended in a settlement between the IRS and the Glaxo group. In the Glaxo case the IRS took a new approach on the value attributable to marketing intangibles claiming that the huge success of several ethical pharmaceutical products resulted from marketing activities carried out by Glaxo US, and was not a result of R&D performed by Glaxo UK. Marketing intangibles should, according to the IRS, account for more of the value than other intangible property rights such as patent protection.

The new approach taken by the IRS in the Glaxo case may affect distributors outside the US in that the value they have created by conducting R&D and other functions can be allocated to a US affiliate conducting marketing and sales activities.

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[261] Information from the website ustransferpricing.com, IRS and GlaxoSmithKline Settle Transfer Pricing Dispute for $3.4 Billion - Significant Implications for Transfer Pricing of Intangibles.

[262] Please see for instance Musselli, Andrea, Marchetti Hunter, Donatella, "Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues", p. 165.

[263] Id., pp. 172-173.

[264] Id., p. 172.

6 Intangible Property

6.1 Introduction

This chapter provides an overview of intangible property for transfer pricing purposes with special attention to marketing intangibles. The existence of marketing intangibles was one of the main issues in the Glaxo case. The treatment of marketing intangibles has also been an area of uncertainty for many countries. To fully understand the effect of the case and to properly discuss its impact on transfer pricing in the future, it is essential to understand the complex issue of intangible property and the transfer pricing issues that are connected to them. The purpose of this chapter is to connect the US and OECD views on intangible property to the Glaxo case and the issue of marketing intangibles to provide a platform for understanding what transfer pricing issues of controversy were raised after the Glaxo case.

6.2 The OECD and US View on Intangible Property

6.2.1 Background

One of the main forces behind economic activity and growth in an MNE is intangible property.[265] In order for companies to stay internationally competitive when trade and investment globalize, intangible property is becoming increasingly important.[266] Information and communication technologies advance rapidly and contribute to this importance.[267] As stated above, the pharmaceutical industry is a unique multinational industry with unique and valuable intangibles making transfer pricing a major concern for the industry which attracts the attention of tax authorities.[268] Intangible property poses a specifically difficult problem for MNEs and tax authorities when determining a correct transfer price; the problem of identifying comparables.[269] It is also often difficult to establish the value of intangible property.[270]

In a collection of 33 branch reports submitted to the International Fiscal Association (IFA) in the 2007 Kyoto Congress on Transfer pricing and intangibles (The IFA Report), some conclusions are of interest for this master's thesis.[271] The IFA Report also contains a

265 Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 19.

266 Id.

267 Id.

268 Please see chapter 3.

269 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 6.13.

270 Id.

271 Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles. When a specific branch report is used, it is named after the country it represents; an example of this is the US branch report referred to as "the US Report" in this master's thesis. The report in its entity is called "the IFA Report" and the collected branch reports are referred to as "the General Report".

General Report focusing on summarizing the most important points of each branch report and the standpoint of the OECD Guidelines.[272]

According to the General Report, most countries do not separate the treatment of intangible property from that of tangible property or services for the purpose of transfer pricing.[273] All countries have in common the opinion that it is difficult to establish an arm's length price for intangible transactions.[274] The UK Report states that questions of intangible property are "perhaps the most complex in transfer pricing" and the US Report concludes that issues of transfer pricing relating to intangibles are difficult to resolve due to the their "highly factual nature".[275] In this discussion it is essential to pay attention to the US rules since, both from the fiscal administrations' and the taxpayers' point of view, cross-border transactions of intangibles have received more attention in the US than in any other jurisdiction in the world.[276] As an example of the complexity of transfer pricing issues relating to intangibles several of the IFA branch reports refers to the Glaxo case.[277] This underlines the importance of the Glaxo case in the international transfer pricing community.

The IFA branch reports confirm the impact of the OECD Guidelines on the interpretation and administration of transfer pricing rules both in countries that are members of the organization and countries that are not.[278] Generally, differentiating opinions in the perception and interpretation of what creates value within a group can be the source of controversial conflicts between a taxpayer and a tax authority.[279] The Glaxo case illustrates the conflicts that can arise when opinions differ regarding what functions the value can be derived from in a group and in an industry as a whole.[280]

6.2.2 The Definition of Intangible Property

One of the findings in the General Report is that most countries contributing with a branch report do not have a precise definition of intangible property in their legislations; instead they often refer to the OECD Guidelines.[281] The OECD Guidelines addresses the problems of transfer pricing and intangible property in Chapter VI "Special Considerations

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[272] Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, pp. 19-38.

[273] Id., p. 21.

[274] Id.

[275] Id., pp. 20-21.

[276] Markham, Michelle, *The Transfer Pricing of Intangibles*, p. 4.

[277] Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 21.

[278] Id. For a discussion on the legal status of the OECD, please see Chapter 1.3.

[279] Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo, Tax Planning International Transfer Pricing", p. 4.

[280] Id.

[281] Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 22.

for Intangible Property". The Guidelines emphasizes that "[p]articular attention to intangible property transactions is appropriate because the transactions are often difficult to evaluate for tax purposes."[282] The Guidelines defines "intangible property" as a term including "rights to use industrial assets such as patents, trademarks, trade names, designs or models" but it also includes "literary and artistic property rights, and intellectual property such as know-how and trade secrets."[283] The Guidelines differs between two main types of commercial intangibles: trade intangibles and marketing intangibles.[284] Trade intangibles are defined as "commercial intangibles other than marketing intangibles" and are often a result of R&D, such as with patents.[285] Marketing intangibles, according to the Guidelines, include "trademarks and tradenames that aid in the commercial exploitation of a product or service, customer lists, distribution channels, and unique names, symbols, or pictures that have an important promotional value for the product concerned."[286]

The US transfer pricing Regulations contains a detailed definition of intangible property, encompassing a list of items such as patents, trademarks, copyrights and other legally protected intangible property rights as intangible property for transfer pricing purposes.[287] The contractual rights from a legally protected intangible are treated like intangible property, such as a license to use a patent.[288]

As stated in the General Report, the OECD defines intangible property without indicating the outer limits and the definition may be vaster than the items listed in the Guidelines.[289] The US Regulations makes an attempt to be more specific than the OECD and adds to the list of items: "an item is considered similar to those listed … if it derives its value not from its physical attributes but from its intellectual content".[290] The problem with defining intangible property is identifying it in real situations.[291] The General Report suggests that the unsuccessful attempt to set up a Mutual Agreement Procedure (MAP) between the US and the UK in the Glaxo case could be boiled down to the failure to reach common grounds on the definition and understanding of intangible property for transfer pricing purposes.[292] Along the same path, the origins of many or most transfer pricing disputes

282 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 6.1.

283 Id., Para. 6.2.

284 Id., Para. 6.3.

285 Id.

286 Id., Para. 6.4.

287 Treas. Reg. Sec. 1.482-4(b).

288 Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 633.

289 Id., p. 22.

290 Treas. Reg. Sec. 1.482-4(b)(6).

291 Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 23.

292 Id.

between taxpayers and tax authorities can be traced back to differences in interpretation and perception due to the inconsistency of existing definitions.[293]

The value attributable to marketing intangibles has long been disputed and many hoped that the Glaxo case would solve this issue.[294] The Glaxo case was of interest in Europe mainly due to three reasons; first, marketing is a key business function for MNEs, second, the OECD Guidelines as well as national legislations do not contain detailed rules on this topic, and third, tax authorities in Europe have slowly started to adopt the same approach as the IRS on marketing intangibles.[295] There is a general trend among US companies and European companies to increase their spending on marketing and advertising and this trend is particularly noticeable in certain sectors including the pharmaceutical industry.[296] In 2004, pharmaceutical companies comprised 11 percent of the top hundred companies that spent the highest amount on marketing and 80 percent of the amount spent on marketing by these pharmaceutical companies was spent in the US.[297] In addition, out of the amount spent on advertising and marketing by the top hundred companies, almost half of the amount was spent in the US.[298] When looking at these facts, it is perhaps no wonder why the world's largest transfer pricing dispute involved a pharmaceutical company, marketing intangibles and why it took place in the US.[299]

6.2.3 The Ownership of Intangible Property

An issue indirectly connected to the Glaxo case, and of importance when discussing sources of transfer pricing conflicts in the future, is ownership of intangible property. According to the General Report, one member of a group normally holds the ownership of intangible property.[300] Should another member of the group develop the intangible property or enhance its value, the owner must pay arm's length compensation to the assisting party.[301] In some cases two or more parties may own an intangible, especially under a so-called cost-sharing agreement.[302] To establish the ownership of intangible property, three considerations can normally be made: legal ownership, economic ownership, and ownership by agreement.[303] Different countries emphasize different types

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293 Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo, Tax Planning International Transfer Pricing", p. 4.

294 Id., pp. 5-6.

295 Id.

296 Id. With reference to Advertising Age's 19th Annual Global Marketing Report.

297 Id. With reference to Advertising Age's 19th Annual Global Marketing Report.

298 Id. With reference to Advertising Age's 19th Annual Global Marketing Report.

299 Id.

300 Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 25.

301 Id.

302 Id.

303 Id.

of ownership; for instance the US puts most emphasis on legal ownership.[304] There is no generally accepted definition of economic ownership in the OECD Guidelines. The US treats the developer as the economic owner for transfer pricing purposes when an intangible is not legally protected.[305] In the proposed US transfer pricing Regulations, the owner of an intangible was determined by the "economic ownership test" namely the party bearing the largest share of the costs of its development.[306]

The new Temporary Regulations, issued in 2006, attempts to patch up the legal framework to cover situations where related parties of a group develop or enhance the value of an intangible in order to be attributed their fair share of that income.[307] Before the Temporary Regulations, three principles applied when determining the ownership of intangible property for transfer pricing purposes in the US. First, the legal owner is the owner of legally protected intangibles, such as a patent.[308] Second, the contractual owner holds a contractual interest in an item of intangible property and is treated as owning the contractual interest.[309] Third, where there is no legal or contractual owner the intangible is owned by the party in control of it, based on all relevant facts and circumstances.[310] In the preamble to the proposed Temporary Regulations of 2006, the IRS states that the former section 1.482-4(f)(3) was refined in order to reduce "the potential for inappropriate, all-or-nothing results."[311] As a result, the first three principles can now be overridden through a fourth principle of economic substance set out in the new US Temporary Regulations, should a determination of the ownership be "inconsistent with the economic substance of the underlying transactions."[312]

According to the US Report, the reason why the IRS worried about the former section 1.482-4(f)(3) leading to inappropriate results was the possibility of the taxpayer to argue that "if a US affiliate of a non-US multinational enterprise performs services that enhance the value of an item of intangible property, it would only be entitled to compensation for its services, and not be entitled to a share of the income attributable to the intangible,

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304 Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 25.

305 Boos, Monica, *International Transfer Pricing: The Valuation of Intangible Assets*, Kluwer Law International, The Hague 2003, p. 113.

306 Markham, Michelle, *The Transfer Pricing of Intangibles*, p. 49.

307 Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 635.

308 Id. With reference to the US transfer pricing Regulations.

309 Id.

310 Id.

311 Final and Temporary Regulations, T.D. 9278, Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangibles; and Apportionment of Stewardship Expense, Internal Revenue Bulletin 2006-34, August 21 2006, section B.2.

312 Temp. Treas. Reg. Sec. 1.482-4T(f)(3). The term "economic substance" was included in the US Regulations before the new Temporary Regulations were introduced, see Treas. Reg. Sec. 1.482-1(d)(3)(ii)(C)(example 3). The new Temporary Regulations introduced the override principle set out in Temp. Treas. Reg. Sec. 1.482-4T(f)(3), which also included the term "economic substance" but gave it a developed scope.

unless it had exclusive long-term rights to the intangible in the US market."[313] According to the same report, it seems as if the IRS had in mind that, at least in the situations when there is a long term licensed right to use an intangible or a distribution right in the US of a US affiliate which leads to an enhanced value of the intangible, the IRS is entitled to a piece of the transfer pricing cake.[314] The US Report adds that this was precisely the argument made by the IRS in the Glaxo case where the IRS claimed that "the extraordinary marketing efforts of GSK's US affiliate had contributed substantially to the value of both licensed product intangibles and marketing intangibles and that the US affiliate should be entitled to a substantial portion of the resulting intangible value."[315] The question remains if the attempt to patch up the US transfer pricing Regulations will actually serve any purpose for the taxpayers. Words such as "economic substance" are not defined by the Regulations and the US Report predicts they will be the "source of high stakes transfer pricing controversy for the foreseeable future" when determining the right to income attributable to marketing intangibles.[316]

6.2.4 Special Attention to Marketing Intangibles

The US approach on marketing intangibles has been accounted for above in this chapter and in chapter 5. Marketing intangibles is an area of uncertainty, mainly because the OECD has failed to provide adequate guidance. The OECD's attempt to deal with the issue of marketing intangibles is accounted for in paragraphs 6.36-6.39 of the Guidelines.

The OECD Guidelines acknowledges that the problem with marketing intangibles is to identify the value created by marketing activities, i.e. to establish the value of the marketing intangibles.[317] The value will change in accordance with the extent and efficiency of the marketing activities in a particular market.[318] The difficulty lies in identifying what marketing activity have contributed to what profit and in identifying the degree of contribution.[319] The Guidelines deals with the situations involving the allocation of high profits deriving both from the unique characteristics and high quality of the products as well as from successful marketing activities such as in the Glaxo case.[320] In this situation the Guidelines suggests that "[t]he actual conduct of the parties over a period of years should be given significant weight in evaluating the return attributable to marketing activities."[321]

The OECD Guidelines further acknowledges that problems may arise in regards to determining an arm's length compensation when a company undertakes marketing activities for products it does not own the trademark to, such as the case with the US

313 Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 635.

314 Id.

315 Id. Please note that the quote is taken from footnote 18 of the US Report.

316 Id., p. 637.

317 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 6.36.

318 Id., Para. 6.39.

319 Id.

320 Id.

321 Id.

subsidiary in the Glaxo case.[322] The main issue of concern is identified by the Guidelines as "whether the marketer should be compensated as a service provider, i.e., for providing promotional services, or whether there are any cases in which the marketer should share in any additional return attributable to the marketing intangibles."[323] When the company performing the marketing activities is reimbursed for its expenditures and experience an increase in profit clearly connected to the marketing activities, this is in many cases sufficient compensation.[324] In this situation the company should be treated as a service provider.[325] In the other situation where a company performing marketing activities bears the cost of these activities, the company is entitled to a share of the profit from the performed activities.[326] The size of the share depends on the substance of the rights of the company performing the marketing functions.[327] The Guidelines gives the example of an exclusive long term contract beneficial for the company performing the marketing activities' turnover and market share, to justify a lower compensation.[328] A higher compensation should be received when the company performing the marketing activities bears extraordinary expenditures related to the marketing activities.[329] The distributor's share should be determined in accordance with the share independent parties receive in comparable circumstances.[330]

6.3 Determining a Transfer Price for Intangible Property

6.3.1 Background

When determining a transfer price for transactions involving intangible property, the majority of the countries in the IFA Report use the same methods for pricing tangible property as they do for pricing intangible property with the US as an exception.[331] The OECD Guidelines is also in favor of using the same principles and methods for both tangible and intangible property.[332] Out of the 33 branch reports, 27 countries follow the

322 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 6.36.

323 Id.

324 Id., Para. 6.37.

325 Id., Para. 6.36.

326 Id., Para. 6.38.

327 Id.

328 Id.

329 Id.

330 Id.

331 Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 31.

332 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 6.13.

methods recommended by the OECD.[333] One of the countries that clearly stands out in this crowd is the US.[334]

6.3.2 The OECD

For the purpose of transfer pricing of intangible property the OECD Guidelines recommends using either the traditional transaction methods; the comparable uncontrolled price (CUP) method, the resale price method, the cost plus method, or "other methods"; the profit split method and the transactional net margin method (TNMM).[335] The two latter methods are to be used when traditional transactional methods cannot be applied alone or cannot be applied at all.[336]

For situations involving highly valuable intangible property, which is often the case in the pharmaceutical industry, the Guidelines recommends the profit split method to be applied, but recognizes that some problems may occur when applying this method.[337] The profit split method was also applied by the IRS in the Glaxo case.[338] The Guidelines includes information on how to determine a price at arm's length when the value of the intangible property is unknown or highly uncertain at the time of the transaction.[339] According to the Guidelines, when the value of an intangible at the time of the transaction is highly uncertain, the arm's length pricing should be resolved by both tax authorities and taxpayers in the same manner as independent companies would have done in a comparable situation.[340] The Guidelines suggests several alternatives on how two independent parties would go about this problem. The first example suggests that independent companies take into account all economic factors to establish an anticipated benefit from the intangible property, including to what extent competing developments are foreseeable and predictable.[341] This comparable is adequate in the situation where the pricing based on anticipated benefits will account for the high risks involved in the transaction.[342] In the situation where an independent company cannot set a price on a product that will provide adequate protection against the risks associated with the uncertainty of the value of the intangible, it may use short term agreements or include price adjustment clauses in the agreement.[343] The Guidelines gives the example that a royalty rate can increase or decrease

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333 Cahiers de Droit Fiscal International by the International Fiscal Association, 61st Congress of the International Fiscal Association, Kyoto 2007, Volume 92a, Subject 1 Transfer Pricing of Intangibles, p. 31.

334 Id.

335 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapters 2-3.

336 Id., Para. 3.1.

337 Id., Para. 6.26.

338 Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo, Tax Planning International Transfer Pricing", p. 4.

339 As will be further explained below, the main difference was that in the Glaxo case the IRS did not take into account that the value of the intangible property was unknown at the time the controlled transactions started within the group, and the US Regulations does not deal with this situation.

340 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 6.28.

341 Id., Para. 6.29.

342 Id., Para. 6.30.

in accordance with the increase or decrease in sales of the licensee.[344] A third alternative according to the OECD, with the purpose to protect the company from the high risks associated with an unknown value of an intangible property, is that an independent company agrees to bear the risks to a certain degree.[345] If major unforeseen developments occur and change the fundamental assumptions on which the price was determined, there is a joint understanding between the parties to renegotiate the price.[346] The OECD gives the example of a royalty-based rate on sales for a patented drug turning out to be vastly excessive due to an unexpected development of an alternative low-cost treatment.[347]

6.3.3 The US

The US methods to determine an arm's length price for intangible property include the comparable uncontrolled transaction (CUT) method, the comparable profit method (CPM), the profit split method, and unspecified methods.[348] There are two types of profit split methods, the comparable profit split and the residual profit split.[349] The methods must comply with the general provisions in section 1.482-1 including the best method rule, the comparability analysis, and the arm's length range.[350] There is not a strict priority of methods when determining the price at arm's length. However, as explained in chapter 2, the US Regulations states that "[t]he arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result."[351] When determining the best method rule it is important to take into account the degree of comparability between the uncontrolled and the controlled transaction, taking into account all the factors that could affect the price or the profit.[352] The Regulations does not require the comparable transactions to be identical but they have to be sufficiently similar to provide a reliable measure of an arm's length price.[353] When dealing with intangible property for transfer pricing purposes in the US, the arm's length consideration must be "commensurate with the income attributable to the intangible."[354]

A taxpayer may also use a method not specified under the US transfer pricing Regulations as long as the method complies with the principles of section 1.482-1.[355] When using an

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343 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 6.30.

344 Id.

345 Id., Para. 6.31.

346 Id.

347 Id.

348 Treas. Reg. Sec. 1.482-4(a).

349 Treas. Reg. Sec. 1.482-6(c)(2) and (3).

350 Treas. Reg. Sec. 1.482-4(a) with reference to Treas. Reg. Sec. 1.482-1(c) and (d).

351 Treas. Reg. Sec. 1.482-1(c)(1).

352 Treas. Reg. Sec. 1.482-1(d)(1).

353 Treas. Reg. Sec. 1.482-1(d)(2).

354 Treas. Reg. Sec. 1.482-4(a).

355 Treas. Reg. Sec. 1.482-4(d)(1).

unspecified method, the taxpayer must take into account the general principle that "uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it."[356] The unspecified method must in addition provide the most reliable result under the best method rule to be applied at all, meaning its reliability will be decreased if it is supported by internal data instead of uncontrolled comparables in accordance with the comparability standard in section 1.482-1(d).[357]

While the Guidelines recognizes that it can be difficult to find comparables for transactions involving intangible property, the Regulations requires that "the controlled and uncontrolled transactions involve either the same intangible property or comparable intangible property".[358] The Regulations further states that an intangible property involved in an uncontrolled transaction is considered comparable to an intangible property in a controlled transaction when both intangibles are "used in connection with similar products or processes within the same general industry or market" and both intangibles have "similar profit potential".[359] These particular rules concerning intangible property complicate the transfer pricing matter for transactions in industries such as the pharmaceutical industry even further.

The Regulations, unlike the OECD Guidelines, does not deal with the situation where the value of an intangible is unknown at the time of the transaction.[360] In the Glaxo case the IRS held that since the value of the intangible property was highly uncertain at the beginning of the transactions, the value should be regarded as to have been created by marketing activities in the US.[361]

6.3.4 Profit Split

The profit split method was used by the IRS to determine the allocation of profit in the Glaxo case.[362] For situations involving highly valuable intangible property, such as with the pharmaceutical industry, the Guidelines recommends the profit split method to be applied, but recognizes that some problems may occur when applying this method.[363] Although the US Regulations designates a number of methods, including unspecified methods, to apply

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356 Treas. Reg. Sec. 1.482-4(d)(1).

357 Id.

358 Treas. Reg. Sec 1.482-4(c)(2)(iii)(A).

359 Treas. Reg. Sec. 1.482-4(c)(B)(1).

360 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paras. 6.28-6.35.

361 Musselli, Andrea, Marchetti Hunter, Donatella, "Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues", p. 171.

362 Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo, Tax Planning International Transfer Pricing", p. 4.

363 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Para. 6.26.

to intangible property, the nature of the pharmaceutical industry is such that the profit split method is often applied due to the lack of comparables.[364]

The profit split method investigates whether transactions between controlled parties are at arm's length by looking at the allocation of the combined operating profit or loss attributable to controlled transactions by reference to the relative value of each party's contribution.[365] The most narrowly identifiable business activity for which data exists that includes the controlled transactions is used to establish the profit or loss to be split.[366] The US profit split method and the OECD profit split method are similar but not identical.[367] While the essential part of the US profit split method is the split of profit in accordance with the proportion of the associated enterprises' contribution, this is only one aspect of the OECD profit split.[368]

The profit split method has been criticized for being on the outer limits of the arm's length principle since it relies to a large extent on external data instead of unrelated party comparables.[369] However, several tax experts are in favor of using the method.[370] One of the strengths with the method is the fact that a realized profit is split instead of allocating a profit that may not have been realized.[371] Further, the method does not rely to a large extent on external comparables making it applicable to situations where comparables cannot be found.[372] The use of a sound profit split may reduce some of the problems in the area of transfer pricing.[373] Whether or not in favor of the profit split method, it seems as if the method is here to stay. In order for the method to be applied properly, it is vital that the traditional functional analysis identifying "who is doing what" in an MNE is complemented by a value-chain analysis to establish where value is created in the group and the industry as a whole.[374]

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364 Markham, Michelle, "Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?", University of Western Law Review, 2004.

365 Treas. Reg. Sec. 1.482-6(a).

366 Id.

367 Markham, Michelle, "Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?".

368 Id.

369 Id.

370 Please see for instance Hamaekers, Hubert, "The Arm's Length – How Long?", p. 37-38, Markham, Michelle, "Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?", and Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo, Tax Planning International Transfer Pricing", p. 7.

371 Hamaekers, Hubert, "The Arm's Length – How Long?", p. 37.

372 Markham, Michelle, "Transfer Pricing of Intangible Assets in the US, the OECD and Australia: are Profit Split Methodologies the Way Forward?".

373 Hamaekers, Hubert, "The Arm's Length – How Long?", p. 38.

374 This view is supported by Fris, Pim, Gonnet, Sébastien, "A European View on Transfer Pricing after Glaxo, Tax Planning International Transfer Pricing", pp. 6-7.

6.4 Salient Points

The transfer pricing of intangible property is a major transfer pricing issue in the pharmaceutical industry since this industry often deals with highly valuable and unique intangible property across borders, which draws the attention of tax authorities. The issue of intangible property is complex and highly factual, making it an area of uncertainty for many countries.

Areas that can lead to controversies and disputes when dealing with intangible property for transfer pricing purposes are the definition of intangible property and the determination of ownership of intangible property. When the view on these areas differs from country to country, there is a particularly high risk of transfer pricing disputes. Another difficulty facing the industry is the complexity of determining the value of the intangible and establishing an arm's length price. Marketing intangibles can cause all of the above mentioned problems in an ethical pharmaceutical company. This was illustrated in the Glaxo case where the IRS decided to attribute more value to the marketing activities performed in the Glaxo group rather than to the R&D performed. Establishing the value of marketing intangibles is problematic and the value will change in accordance with the extent and efficiency of the undertaken marketing activities. The difficulties lie in establishing the degree of contribution by a marketing activity and identifying what marketing activity has given rise to what profit. For situations similar to the Glaxo case the Guidelines suggests that significant weight should be given to the actual conduct of the parties over a period of years when determining the value attributable to marketing intangibles.

Adding to this problem, there are differences in the application and interpretation regarding intangible property, particularly the methods applied, between the US and the OECD. The most appropriate method to use for these types of transactions is the profit split method. A sound profit split should include a value-chain analysis in addition to the traditional functional analysis.

7 A Race to the Top: the German Example

7.1 Introduction

This chapter discusses the present, competitive, transfer pricing community's race to the top and the new transfer pricing developments in Germany. The purpose of this chapter is to show how the US, by going its own way, is steering the transfer pricing developments in a direction not intended by the OECD and how this affects other countries.

7.2 A Race to the Top

It seems as if now more than ever, tax authorities are participating in a race to the top regarding the treatment of transfer pricing policies of MNEs.[375] In the recent transfer pricing developments, the US has stayed ahead and functioned as a guiding star for many countries.[376] The "increasingly sophisticated, comprehensive and Draconian" US transfer pricing rules are affecting and steering countries trading with the US and their legislations; placing a heavy burden on the shoulders of the MNEs.[377] Even though a member of the OECD, the US has more than once acted outside of the recommendations of the organization in terms of the application of transfer pricing methods, the need to focus on abusive cases, and the interpretation of the arm's length principle.[378]

Factors suggesting that tax authorities are armoring themselves to deal with MNEs in the future are (among others) the introduction or revision of tax laws governing transfer pricing, including stricter penalties and vaster documentation requirements but also more transfer pricing audits leading to more adjustments of prices.[379] The new attitude, approach, and legislation of the tax authorities affect the behavior of MNEs trying to predict risks and comply with the new expectations.[380] Tax authorities are also making rapid efforts to become more specialized within transfer pricing; the gathering of data is becoming more sophisticated enabling tax authorities to better enforce efforts and more specialists are being trained and recruited to increase the possibility to examine more complex transactions.[381] Ernst&Young concluded in the Global Transfer Pricing Survey from 2005-2006 that not only is there a growing divergence on the area of transfer pricing between MNEs and governments but also between governments themselves.[382] The survey's

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[375] Ernst&Young 2005-2006 Global Transfer Pricing Surveys, Global Transfer Pricing Trends, Practices and Analysis, November 2005, p. 6.

[376] Hamaekers, Hubert, "The Arm's Length – How Long?", p. 31.

[377] Markham, Michelle, *The Transfer Pricing of Intangibles,* p. 4.

[378] (1993) Reports of the Task Force of the OECD Committee on Fiscal Affairs in US Transfer Pricing Regulations, Tax Aspects of Transfer Pricing Within Multinational Enterprises: The United States Proposed Regulations, Executive Summary, Paras. 10-15 and 18.

[379] Ernst&Young 2005-2006 Global Transfer Pricing Surveys, Global Transfer Pricing Trends, Practices and Analysis, November 2005, p. 4.

[380] Ernst&Young 2005-2006 Global Transfer Pricing Survey Tax Authority Interviews: Perspectives, Interpretations and Regulatory Changes, p. 5.

[381] Id.

[382] Id.

Executive Summary ends with the somewhat ominous statement: "it is becoming clear that the seas ahead will be quite stormy."[383]

7.3 Germany

One of the countries objecting the most to the deviating behavior of the US was Germany.[384] However, during the course of 2007, Germany introduced new draft legislation on business restructurings.[385] This new legislation is a step in the process of decreasing the German corporate tax rate from 25 to 15 percent.[386] The new legislation is clearly placing Germany in the same folder as the US in the chase of more tax revenue through aggressive transfer pricing rules.

The German legislation includes the introduction of a commensurate with income standard similar to the US standard and the principle of "prudent business manager standard" which is an interpretation of the arm's length principle.[387] The focus of the legislation is on the taxation of business restructurings, defined as relocation of entrepreneurial functions including opportunities and risks.[388] The taxpayer is required to determine a compensation for "the function as a whole" by a valuation of "the transfer package".[389] There is an assumption that compensation in form of an exit charge must be made if future profit is reduced because of the relocation.[390] Not only intangible property is included in the definition, but also tangible property, opportunities, risks, and other advantages.[391] The principle of prudent business management is a principle adopted by the German Supreme Courts and now introduced through the new legislation; it is not found in any other jurisdiction than Germany nor is it included to a larger extent in the OECD Guidelines.[392] The principle allows for the hypothetical arm's length test to be used when there are no existing comparables applicable from third-party relations.[393] The midpoint of the full price

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383 Ernst&Young 2005-2006 Global Transfer Pricing Survey Tax Authority Interviews: Perspectives, Interpretations and Regulatory Changes, p. 5.

384 See for instance Hamaekers, Hubert, "The Arm's Length – How Long?", p. 31.

385 "Transfer Pricing Provisions of German Draft Business Restructuring Law", Tax Management Transfer Pricing Report, Vol. 15, No. 22, p. 835.

386 Kroppen, Heinz-Klaus, Rasch, Stephan, Eigelshoven, Axel, "Germany's Draft Law on Business Restructurings, Tax Management Transfer Pricing Report", Vol. 15, No. 22, p. 841.

387 Tropin, Mitchell J., "German Legislature Approves Bill Introducing 'Commensurate With Income,' Other Changes", Tax Management Transfer Pricing Report, Vol. 16, No. 7, p. 221.

388 Kroppen, Heinz-Klaus, Rasch, Stephan, Eigelshoven, Axel, "Germany's Draft Law on Business Restructurings", p. 841.

389 Id.

390 Id., p. 842.

391 Id.

392 Id.

393 Id.

range of what two prudent business managers would have agreed upon is the taxpayer's arm's length price, unless there is reason to use another value within this range.[394]

Some objections have been made about the new legislation, including the increased risk of double taxation. The new German legislation broadens the definition of intangible property and skews the focus from transfer pricing as a neutral concept since it does not differ between transactions without economic substance and transactions with an actual valid business related reason for undertaking a business restructuring.[395]

7.4 Salient Points

Draconian US transfer pricing rules are causing other countries to follow tail, especially in the absence of OECD recommendations. Many countries are introducing stricter documentation requirements, harsher penalties for non-compliance, and more tax experts are hired by tax authorities. Germany is an example of a country formerly criticizing the US transfer pricing approach. During the course of 2007, Germany has, however, introduced rather aggressive transfer pricing rules on business restructurings. There are several similarities between US transfer pricing rules and the new German legislation, such as the commensurate with income standard and a non-neutral view on transfer pricing.

394 Kroppen, Heinz-Klaus, Rasch, Stephan, Eigelshoven, Axel, "Germany's Draft Law on Business Restructurings", p. 842.

395 Id., p. 846.

8 Analysis

8.1 Introduction

This master's thesis has provided the essential information on the rules of the US and the recommendations of the OECD, especially in regards to marketing intangibles, as well as the facts and circumstances of the Glaxo case and the road that led there. After tying these knots together a platform is built from where it is possible to acknowledge certain transfer pricing issues of controversy arising as a consequence of the Glaxo case or rather the lack of answers from the settlement. These issues serve as markers of what the transfer pricing issues of tomorrow will be. The common denominator of the issues is that they arose due to a lack of guidance from a uniform set of rules or recommendations.

The OECD has long served as the instrument to achieve uniformity, but when the organization is unclear or all together silent on an issue of growing interest such as the allocation of value attributable to marketing intangibles, there is room for different interpretations among tax authorities. The damages to the uniformity of international transfer pricing rules are particularly noticeable when influential countries such as the US, and now Germany, are able to enforce their own aggressive transfer pricing rules and other countries either suffer losses in tax revenue or follow tail. These rules are able to reach a normative status in the international transfer pricing community due to the lack of proactive measures of the OECD. The global race to the top characterized by an aggressive approach to transfer pricing takes place at the expense of neutrality and ultimately harms international trade.

In this chapter, the first two points of the purpose of this master's thesis are analyzed: the new approach of the IRS and the global effect of the Glaxo case. The purpose of this chapter is to identify key conclusions required for the discussion in the final chapter on what needs to be done in the future.

8.2 The New Approach of the IRS

8.2.1 The Fears of the OECD Confirmed

One of the main points made in this master's thesis is that the OECD has long feared that the objective of having universally harmonized transfer pricing rules and practices is distorted due to the US tendency of taking matters into own hands.

In the Glaxo case, the IRS took a new approach when attributing a large portion of the profit to the US. The IRS held that the marketing and sales activities performed by the US subsidiary created substantial value attributable to the pharmaceutical products. The UK tax authority applied the traditional OECD approach, that a large portion of the profit was attributable to the UK owner of the patent. Consequently, the Glaxo group suffered from double taxation; the core consequence the arm's length principle aims at eliminating.

The Glaxo case is about two disputes; the dispute between the company and the IRS regarding the size of the taxable income in the US and the conflict of interest between the US and UK tax authorities. It is first and foremost the latter conflict that gives rise to double taxation. In the Glaxo case, the IRS took an important step to develop an area of transfer pricing that has long been unclear. Unfortunately, it seems as if the US takes advantage of areas of uncertainties, in this case intangible property, with the purpose of increasing the country's tax revenue. The US disregards the distortion this creates and does not take into account factors such as sound commercial judgment and protection of the collective international interest of cooperation among tax authorities to create universally harmonized transfer pricing rules. The UK on the other hand upheld the OECD approach on this matter, but most likely with the country's own interests as a main priority. Considering the huge amount of profit involved in the Glaxo case, submitting to the IRS approach on intangible property would have resulted in substantial loss of tax revenue for the UK. Consequently, the Glaxo group was caught in the middle of the tax authorities' disagreement. The failure to solve the problem through a MAP can be blamed on the tax authorities putting their countries' own interests first. It is evident that the OECD's fear is justified.

8.2.2 A Contradictory Approach

The US approach to the concept of transfer pricing is framed with suspicion that MNEs are working hard to avoid taxation in the US and has been so for a long time. Before the Glaxo case the IRS made several unsuccessful attempts to allocate income from intangible property in the pharmaceutical industry to the US under section 482 IRC. After realizing the failure in these cases, the IRS approached the matter by introducing the cost-sharing method and the profit split method hoping this would increase tax revenue to the US. This approach proved to be somewhat successful, but did not ease all US suspicions of MNEs evading tax through transfer pricing.

From recent US developments it is clear that the IRS has not completely abandoned its attempts to attack intangible property abroad. The IRS Industry Directive aims at carefully scrutinizing and examining the nature of all transferred intangible property outside the US, especially within the pharmaceutical industry. An interesting point to be made is that the Industry Directive was passed in the beginning of 2007, only months after the settlement of the Glaxo case. On the one hand there is a US directive with the aim of shifting intangible property such as patents and know-how to the US. On the other hand the message from the Glaxo case is that marketing activities should account for more of a product's value than R&D functions performed resulting in a patent. The legal situation is, to say the least, unclear. Should MNEs in their transfer pricing policies focus on value attributable to R&D or value attributable to marketing? Or should they simply allocate the most valuable intangible property, or even all intangible property, to the US in order to avoid problems with IRS? Since the ethical pharmaceutical companies are characterized by both R&D functions and marketing functions as the main value-drivers, the uncertainty and risks are particularly high within this industry.

It is clear that the IRS will continue to focus on intangible property in the future. Apart from the uncertainty these issues cause MNEs in their tax planning, the risk of audits and future transfer pricing disputes will most likely increase.

8.2.3 Is There a Need for a New Approach?

It would be naïve to claim that there are only disadvantages with the US leading the way in transfer pricing developments. Intangible property, in particular marketing intangibles, has for a long time been an area of uncertainty. The issue has been debated in the US as well as in Europe, and the OECD, the appropriate forum to provide additional guidance on the matter, has failed to proactively take on this task. Therefore, the expectations on the Glaxo case were high as the international transfer pricing community was hoping the case would provide useful guidance. After the parties reached a settlement there were still no answers and the question of the treatment of marketing intangibles is still hovering in the air. The fact that the Glaxo case received the attention it did sheds light on the need for a strong actor to take the initiative to develop transfer pricing rules in order for the rules to keep pace with the developments within international trade. It also shows the influence of the US on transfer pricing developments. The strong actor should, however, be the OECD.

The authors acknowledge that the IRS may have a point when allocating income attributable to marketing intangibles to the US in certain situations. It is the opinion of the authors that in cases when the cost of production is low and R&D is insignificant, the value of the product can be attributable to marketing activities carried out in the US. A large amount of the profit would then rightly be taxed in the US. However, these circumstances were not at hand in the Glaxo case. The outcome of a case such as the Glaxo case depends to a large extent on the key value-drivers of the particular industry and group in the dispute. The IRS made a mistake when attacking the issue of marketing intangibles through a pharmaceutical company due to the clear connection between a patent protection and the sales of an innovative drug. The loss in sales is remarkable when the patent expires; when the patent of Prozac expired, the drug lost 80 percent of its sales to the competing generic products. Therefore, it is faulty to argue that most of the value of an innovative drug is created through marketing activities rather than attributable to the owner of the patent.

There is a need for a new approach on intangible property and in particular marketing intangibles, or at least a clarification of how they should be treated. A uniform approach on this area is best achieved through the actions of the OECD. Should a single country lead the way, the uniform approach will most likely not be achieved. The new approach has to carefully consider the key value-drivers of the industry at hand. The reason for this is not only to show consideration for the MNEs but also to ensure that countries depending on production and manufacture do not lose tax revenues.

8.2.4 Is the IRS Shooting Itself in the Foot When Armoring for the Future?

In the short term perspective, the IRS is to some extent shooting itself in the foot when locating intangible property to the country of distribution rather than to the country where the R&D functions are performed. The US MNEs are net performers of R&D in comparison with the rest of the world. As stated in this master's thesis, a strong US legal protection for intangible property makes it favorable to conduct R&D activities in the US. If the IRS would have looked at the whole picture it is doubtful if they would have so strongly argued for the approach in Glaxo considering the risk that the US tax base may decrease.

In the long term perspective, the US wishes to be on top of the game. The IRS's approach in the Glaxo case can be deducted from the general trend among US and European companies to increase their spending on marketing and advertising. This indicates that more countries will adopt the approach of the IRS. Consequently, there will be more disputes similar to the Glaxo case in the future. According to the authors, the IRS is paving the way for a more aggressive approach to collect tax revenues.

The answer to the question is therefore that the IRS's new approach presently looks unfavorable to the country, but perhaps the Industry Directive will save the day. It seems to lie in the nature of the US to constantly remain in the front line of transfer pricing developments and the new approach of the IRS may be a way to prepare for the future. The approach in the Glaxo case may be the most favorable in the long run.

8.3 The Global Effect of Glaxo

8.3.1 The Effect on Distributors outside the US

A global effect of the IRS's new approach in the Glaxo case can be that foreign distributors are stripped of functions and risks involved in the intangible property they create. The value added to a product by conducting important functions such as R&D will be allocated to a US affiliate performing the marketing and sales activities. It is the opinion of the authors that the tax authority in the country of the foreign distributor will not accept the US allocation of profit and a situation of double taxation such as in the Glaxo case occurs. The consequences are unfortunate for MNEs; the uncertainty this situation creates together with the risk of double taxation is harmful to international trade and investment.

The ethical pharmaceutical industry is at great risk in this sense since most pharmaceutical MNEs are tied to the US one way or another and thereby affected by the US transfer pricing rules. The problems may, however, affect MNEs in several other industries as long as there is a related party in the US.

8.3.2 Race to the Top in a Non-Cooperative Environment

The authors believe that the approach taken by the IRS in the Glaxo case is here to stay. Just as many scholars have already concluded, the IRS's attitude in the Glaxo case may affect tax authorities' struggle to increase their respective tax bases. When other countries adopt this approach, this will add to the race to the top regarding the treatment of transfer pricing policies of MNEs. Following the US example, an increasing number of countries have introduced stricter regulatory provisions in their national legislations, including vast documentation requirements and harsh penalties, in order to compete for their piece of the transfer pricing tax cake. Non-cooperation among tax authorities where the aim of each tax authority is to increase its own tax revenue results in double taxation of MNEs, decreased international trade, and, consequently, a decrease in tax revenues for the involved countries. Cooperation between tax authorities can, on the contrary, increase tax revenues for countries involved.

The Member countries must strive to solve tax disputes by using the means provided by the OECD. The MAP and the APA are means available to solve transfer pricing disputes between taxpayers and tax authorities and between tax authorities. They both failed in the Glaxo case. It is of utmost importance that these measures are not disregarded by tax authorities when the transfer pricing dispute involves a substantial profit to allocate. In this sense, the Glaxo case illustrates the power struggle between two large economies trying to protect their tax base rather than dealing with the issue from the perspective of an MNE. In this master's thesis, the authors have stressed the importance of taking into account the key value-drivers of an industry when assessing the transfer pricing policy of an MNE.

Vast documentation requirements and harsh penalties may serve to secure tax revenue, but the aims do not justify the means when looking at the negative impact they have on international trade. It is the task of all OECD Member countries to abide by the recommendations set out by the organization or at least make proper use of the existing means of communicating an objection to the OECD recommendations.

8.3.3 Sound Business Reasons

An important difference between the US rules and the recommendations of the OECD is that the OECD encourages tax authorities to undertake their transfer pricing analyses from the perspective of the sound business reasons of the taxpayer when applying the arm's length principle. In the three court cases examined in this master's thesis besides the Glaxo case, the courts rejected the IRS's claim that the business structures including the US possessions were not made for valid business reasons. The question remains what the court would have said on this issue in the Glaxo case if the case had not been settled. When determining the arm's length price in a transaction, the industry as a whole needs to be taken into account, just as the reasons behind the transaction and the commercial judgment of the MNE. The use of a license agreement and the reimbursement through a royalty is the common practice of the ethical pharmaceutical industry. Adding to this, the key value-driver in the ethical pharmaceutical industry is R&D, even though marketing is important. It is clear that the IRS is not taking into account commercial judgment when claiming that marketing intangibles are more valuable than R&D. These types of considerations would hopefully have affected the outcome of the case, had the Glaxo group gone to court.

8.3.4 If You Cannot Beat Them, Join Them

As stated above, the aggressive US approach may have been the start of a race to the top where many countries made changes in their legislations in order to not lose tax revenue to countries such as the US. Some countries followed the US tail while others tried a new way of collecting more tax revenue from transfer pricing. An example of the latter is Germany. Apart from adopting features of the US transfer pricing legislation such as the commensurate with income standard, Germany has also created its own transfer pricing rules through the taxation of business restructurings. Germany is now enforcing an exit charge when an MNE attempts to restructure its business through stripping functions and placing them abroad. If the functions are shifted to the US it is clear, after the Glaxo case, that this gives rise to double taxation. For many years, Germany criticized the US tendency of creating its own transfer pricing rules and practices, many of them in direct conflict with the OECD. Since then, the attitude of Germany and other countries following this path seem to have gone from loud criticism to "if you cannot beat them, join them". Unfortunately, this is yet another evidence of the OECD loosing some of its power and influence. The purpose of the new German legislation is not at all to make global trade easier, it is simply to prevent profit from leaving the country via business restructurings and thereby finance a low corporate taxation. According to the authors, the bold German move can be seen as an expression of frustration over the slow pace of development in the OECD. The new legislation also provides the country with an opportunity to lower the corporate tax rate in order to attract more interest from international investors and ensure that existing companies remain in the country.

The objectives of the OECD are noble and most likely the best for both MNEs and tax authorities. Unfortunately the race to the top and "if you cannot beat them, join them"-mentality are now two of the developments of major concern within transfer pricing. If they are not stopped, it seems as if two alternative routes are mapped out at the moment. First, more countries will follow the US rules, such as the case with Germany, in order to avoid controversies with the leading actor on the market. Another alternative, also adopted by Germany, is the risk of an increasing number of countries introducing new interpretations of the arm's length principle in the complex cases where there are no comparables at all available. Germany's introduction of the prudent business manager principle to allow the hypothetical arm's length principle is an example of this.

Unfortunately it has already been predicted that this rule, if followed, will create legal certainty for the sake of the German tax authorities, but since no other jurisdiction (presently at least) is using the principle, it is bound to create international tax uncertainty and double taxation. This in turn can create a real threat to global trade through a setback in MNEs' willingness to trade and invest.

9 Conclusions and Recommendations

9.1 Introduction

The purpose of this master's thesis is to explain and analyze why the IRS took a new approach on marketing intangibles in the Glaxo case, evaluate the global effect of the Glaxo case, and discuss how similar situations should be dealt with in the future. From the analysis, based on the new approach of the IRS and the global effect of the Glaxo case, the authors have identified three key conclusions essential to discuss how similar situations should be dealt with in the future. These conclusions are the need for neutrality, the need for tax predictability, and the need for uniform application and interpretation of transfer pricing rules. Each section of this chapter provides a discussion on a conclusion followed by the recommendations by the authors.

9.2 What Needs to be Done in the Future?

9.2.1 The Need for Neutrality

The OECD stresses that transfer pricing is a neutral concept placing related party dealings equal to unrelated party dealings. The purpose of a neutral view is to allocate appropriate profit to the countries an MNE operate in and thereby secure that the countries do not lose tax revenues as well as that an MNE does not suffer from double taxation. The US view on transfer pricing is far from neutral as it is framed with suspicion that MNEs are deliberately evading US taxation. This view is not justified since it is proven that most MNEs are making an effort to have a healthy relationship with tax authorities and to comply with transfer pricing rules.

Perhaps the biggest problem with a non-neutral view on transfer pricing is that the tax authorities move away from the business perspective. Transfer pricing can be used by MNEs to ensure resources are spread through the group, thereby maximizing the profit. MNEs strive to maximize profits creates an increase in international trade and globalization. When segments of MNEs are located in different countries many tax authorities suspect that profit shifts are conducted in order for MNEs to evade tax. A large number of countries have therefore introduced strict documentation requirements and harsh penalties to protect the countries' tax base. It is of importance to ensure that MNEs do not conduct transactions or business restructurings solely for tax-driven reasons. However, it is equally or even more important to recognize that most MNEs conduct transactions or business restructurings for business-driven reasons. Many MNEs are making an effort to have a good relationship with tax authorities. This approach, favored by the OECD, must gain common ground. It is clear that tax authorities cannot keep pace with the speed of the ever evolving business world. There is a risk of tax authorities perceiving many of the transfer pricing methods, such as the profit split method, as complex and lack the capacity to apply these methods properly and uniformly. Tax authorities need to understand the motivations of MNEs. This will improve both their capacity to deal with complex cases and their ability to pin down the cases where tax evasion is actually at hand.

Due to the strong influence of the US on the world market, it is particularly important that the country adopts the neutral view on transfer pricing. When powerful countries such as the US and now Germany neglect the neutral view, several other countries will either risk losing tax revenue or follow tail. The latter will result in contradictory transfer pricing rules, a non-cooperative environment and hence in losses of tax revenues and a decrease in global trade and investment. It is in all countries' interest to avoid this situation and the fact that most MNEs operate in the US one way or another makes facilitating for international trade a crucial interest of the US.

The recommendation is therefore dual. First, the neutral view of the OECD must gain common ground among the Member countries of the organization. Naturally, this is achieved through the goodwill of the countries. The countries must ensure that their transfer pricing rules are in conformity with the concept of a neutral view on transfer pricing. Second, tax authorities must increase the existing considerations for the business motivations and sound business reasons of MNEs. The result of this approach is a decrease of cases where transfer pricing is confused with tax evasion. Tax authorities can thereby concentrate more time and efforts on the truly abusive cases.

9.2.2 The Need for Tax Predictability

International cooperation is vital to ensure a uniform interpretation and application of transfer pricing rules. As pointed out by the OECD, cooperation is beneficial to the business community because it creates certainty regarding international taxation. Tax predictability is important for the tax planning of MNEs. Tax predictability decreases the amount of profit an MNE must set aside for future tax disputes and the profit can instead be invested and hopefully result in an increase in tax revenues for countries.

It is doubtful that the Glaxo group could have predicted the IRS's attack on their transfer pricing policies. The standard conduct in the pharmaceutical industry is, and has been for a long time, to pay a royalty fee to the owner of the patent. The new approach on marketing intangibles in the Glaxo case came after the IRS had failed a number of times to allocate the value of intangible property to the US from a low tax jurisdiction. MNEs must be able to foresee a new approach and the means of the IRS to enforce a new approach should not be to drag a company in good faith to court with the purpose of cutting a larger piece of the global tax cake.

The US has to clarify fuzzy terms such as economic substance. These terms are added to the Regulations to patch up the legal framework when the IRS fails to come to terms with what the tax authority views as tax evasion. The authors acknowledge that it is often necessary to use legal terms with a wide scope and that it has some positive aspects, but the wide scope cannot intrude to a large extent on tax predictability. When basing a claim on a term with a broad scope, the IRS must carefully make sure the MNE could have reasonably foreseen the tax authority's interpretation of the term and its application on the situation at hand. Another way for the IRS to clarify fuzzy terms is to provide examples of when the term is applicable in the Regulations or through other means available. Fuzzy terms are used to increase tax revenue but they have the opposite effect. These terms result in tax disputes and create uncertainty for MNEs and thereby decrease global trade and investment.

The US must also cease to adopt contradictory approaches. The Industry Directive, passed by the IRS in the beginning of 2007, aims at carefully scrutinizing and examining the nature of all transferred intangible property outside the US, especially within the pharmaceutical industry. The Industry Directive was passed only months after the settlement of the Glaxo case. This sends a contradictory message to MNEs and the result is uncertainty on whether intangible property such as patents can be shifted to the US or if the value of a product resulting from years of R&D is attributable to marketing activities. Considering the harsh penalties for non-compliance with transfer pricing rules and the considerable amount

Glaxo had to pay after the settlement, MNEs may pay more tax than necessary for them to be on the safe side.

To create a functioning market where prices are kept affordable and legal obstacles and uncertainties are kept to a minimum is an important value-driver in the ethical pharmaceutical industry and it presupposes tax predictability. Ethical pharmaceutical groups have to operate internationally to be profitable due to the high risks and costs involved in bringing out successful innovative drugs on the market. By creating more certainty regarding transfer pricing rules the risk of double taxation is decreased. This enables the industry to cure and help as many people around the world as possible. The US distorts a functioning market through the use of the commensurate with income standard for intangible property since it can lead to hindsight. The US should therefore contribute by abolishing the commensurate with income standard. Adjusting a royalty charged for the use of intangible property in arrears creates tax uncertainty. The Glaxo group had allocated their profit with 30 percent to Glaxo US and with 70 percent to Glaxo UK. The settlement between the IRS and Glaxo resulted in an allocation of profit with 60 percent to Glaxo US and with 40 percent to Glaxo UK. The Glaxo group thus suffered double taxation. The value of an innovative drug is usually highly uncertain at the time of release on the market. If ethical pharmaceutical groups sense they are in danger of being faced by hindsight and large adjustments, the incentive to bring out innovative drugs on the market may decrease.

The recommendations of the authors are first that MNEs should always be able to reasonably foresee a new approach on transfer pricing. In order for this to happen, the authors recommend the US to clarify their transfer pricing rules and to apply the transfer pricing recommendations of the OECD. When the IRS wants to adopt a new approach on transfer pricing, it should be supported by the Member countries of the OECD as well as clearly deductible from the US code and the transfer pricing Regulations. Second, the IRS must avoid the use of fuzzy terms with a wide scope of application. Finally, the IRS must cease to adopt contradictory approaches on transfer pricing. Naturally, these recommendations apply to all OECD Member countries.

9.2.3 The Need for Uniform Interpretation and Application of Transfer Pricing Rules

The OECD is the most appropriate forum for creating a universal application and interpretation of transfer pricing in order to achieve the objectives of neutrality, tax certainty and the elimination of double taxation. The strength of the OECD lies in the fact that so many of the large economies in the world are members of the organization and comply with the organization's transfer pricing rules and in the organization's power to influence both members and non-members of the organization. The weakness lies in that the recommendations of the OECD on the area of transfer pricing is not binding upon the Member countries, but merely functions as suggestions on how to form legislation in order to achieve the goals set out by the organization. It is therefore up to the goodwill of the Member countries to cooperate to reach common ground on the interpretation and application of the rules.

The US remains leading within transfer pricing forcing the OECD and other countries to follow tail. One important reason is the country's historical role as a superpower, strong enough to stand on its own. It should not be forgotten that the US has a history of alienating itself from international cooperation and has been reluctant to actively take part in international conflicts unless it is in the interest of the country. Another important reason is that the OECD is not always acting to stay on top of the game, and the US may feel a need to take matters into its own hands. The development within the OECD regarding transfer pricing is not keeping pace with the increasing internationalization and matters are not dealt with proactively. The US approach may be a winning one at the moment, but the question remains what will happen should the country lose some of its status as a superpower. The US has nothing to lose from being more cooperative and the country may even increase its tax revenue as global investment increases.

International cooperation is vital for a prospering global trade. In order for the OECD to regain some of its lost power, it is important that the Member countries follow the objectives set out by the organization and always strive towards preventing double taxation. It is of utmost importance that the US, a country with tremendous influence on transfer pricing, abides by the universal approach. It must, in this context, be underlined that there are some difficulties inherent in this type of cooperation. Taxation is closely linked to the politics of a country and giving up the right to taxation is something that most countries are reluctant to do, even when it is for the greater good. Adopting universally applicable transfer pricing rules is not about giving up a country's right to taxation, it is a way to divide the transfer pricing tax cake in an appropriate manner.

Some of the areas where the US transfer pricing rules deviate from the OECD recommendations are methods to determine whether a transaction is made in accordance with the arm's length principle, the best method rule and the commensurate with income standard. The results of these differences are the same; they lead to tax uncertainty and the risk of double taxation for MNEs. The new German legislation contains the principle of prudent business management which cannot be found in any other countries' legislation, causing the same type of uncertainty as the deviating US rules. These examples function as important evidence and the benefits of having uniform transfer pricing application and interpretation. It has been stressed throughout this master's thesis that it should be the task of OECD to ensure the uniform approach. The example of intangible property is another area where the absence of the organization is leaving evident traces. The IFA Report clearly shows that many countries are lacking definitions of intangible property in their legislations making them turn to the OECD Guidelines for guidance on this area. However, the Guidelines leaves too much room for interpretation when dealing with the topic of marketing intangibles. The result is, and will continue to be, an increasing number of transfer pricing disputes involving marketing intangibles. The OECD must learn from this and cease its present passive behavior.

There are ways for taxpayers and tax authorities to solve disputes over areas of uncertainty within transfer pricing. The MAP and the APA are existing means provided by the OECD. A condition for these types of conflict-solving instruments to work as intended is that they are not overlooked by tax authorities as soon as the amount of money involved is significant.

The ethical pharmaceutical industry is characterized by transactions involving unique and highly valuable intangible property, making valuation and finding comparables difficult. The characteristics of the industry make profit split the most frequently applicable method to transactions involving this type of intangibles. The problem in the Glaxo case was not to determine the applicable method, nor was the amount of profit or the functions performed under dispute. The problem was centered on the split itself, i.e. to estimate the amount of profit attributable to the functions performed. Problems of this sort can be solved through the OECD providing sufficient guidance on how to accurately conduct a value-chain analysis. The OECD should include a model value-chain analysis to complement the functional analysis prescribed by the Guidelines. The value-chain analysis should emphasize the need to identify the specific value-drivers of the industry at hand. The benefit is that this would aid both MNEs and tax authorities when establishing an arm's length price according to the profit split method, something of great importance since the OECD recognizes that there are some problems applying this method. For the purpose of this master's thesis, it has been pointed out that had the IRS taken into account the key value-drivers, the four pillars, of the pharmaceutical industry in the Glaxo case, the outcome may have been different. There is a risk of tax authorities with fewer resources than the IRS not having the resources or capacity to fully evaluate the appropriateness of the method in a complex industry such as the pharmaceutical industry. Another risk inherent in the present application of the profit split method is that the view of tax authorities on what creates and drives value within a group or industry differs greatly. An OECD recommendation would therefore create the guidance needed by both tax authorities and MNEs when applying this complex method.

The recommendation of the authors is first and foremost that the OECD must act to take a stronger position and clarify areas of uncertainty before there is room for country-specific interpretation harming the international consensus on transfer pricing. This can be achieved by the OECD providing sufficient recommendations and guidance and thus become more proactive rather than reactive. Although the recommendations must be generally held, there room for country-specific interpretation must be minimized. The MAP and the APA should be able to mitigate potential conflicts. As the OECD increases its power to influence, it becomes less favorable for countries to take matter into own hands. The authors recommend the OECD to include a model value-chain analysis to complement the functional analysis prescribed by the Guidelines. The value-chain analysis should emphasize the need to identify the specific value-drivers of the industry at hand. This will ensure more consistency for both MNEs and tax authorities when establishing an arm's length price according to the profit split method.

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