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IRS Settles \$3.4 Billion Transfer Pricing Dispute

The Internal Revenue Service announced on September 11, 2006 that it reached a \$3.4 billion settlement with Glaxo SmithKline Holdings (Americas) Inc. & Subsidiaries (LSE and NYSE: GSK), a U.K.-based developer and manufacturer of pharmaceuticals with operations in the U.S. This settlement concludes the single largest tax dispute in the history of the IRS.

Under the terms of the settlement, GSK has agreed to pay the IRS approximately \$3.4 billion in back taxes and interest to resolve transfer pricing issues for tax years 1989 through 2005. Also, as part of the settlement, GSK agreed to abandon its counterclaim against the IRS for a refund of \$1.8 billion in overpaid income taxes. In sum, GSK conceded over 60 percent of the total amount of disputed U.S. profits in the case, which was scheduled to go to trial on October 16, 2006.

The case primarily involved intercompany transactions between GSK and its foreign affiliates relating to the sale of various GSK "heritage" pharmaceutical products (principally the ulcer drug *Zantac*) in the United States. In the case, the IRS contended that GSK's U.S. affiliate should have retained a larger share of the profits attributable to the U.S. distribution of GSK's heritage products since GSK's U.S. affiliate helped to develop valuable sales and marketing intangibles; the IRS also contended that GSK's payment to its U.K. parent for product intangibles and trademarks owned and developed by the U.K. entity was too high.

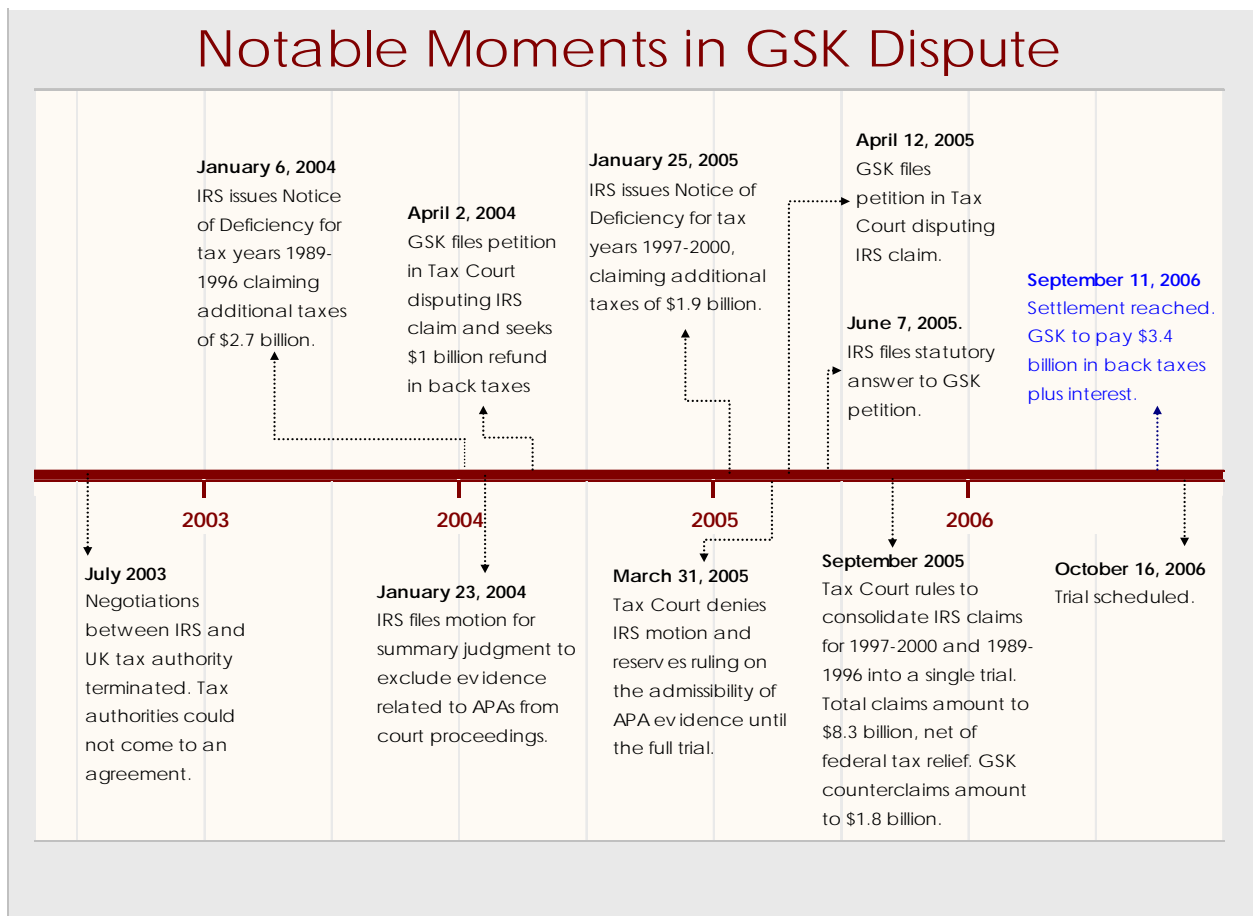
GSK, however, contended that the IRS had improperly applied the "commensurate with income" standard to the disputed royalty rates, which GSK alleged appropriately reflected the value of the patents owned by the U.K. GSK also filed a counterclaim against the IRS for tax years 1991 to 1993, claiming that the IRS had discriminated against it by granting former competitor Smith Kline Beecham Corp. an Advance Pricing Agreement ("APA") for *Tagamet*, while denying Glaxo an APA for *Zantac*, a competing product. Both the royalty and APA issues had been slated to be heard in U.S. Tax Court on October 16, but litigation was averted by the settlement between GSK and the IRS.

In general, the GSK case reflects the increasing amount of attention paid to transfer pricing by the IRS and other tax authorities in recent years. The GSK case also highlights the increased difficulty multinationals face in allocating assets and income attributable to intangible property in today's complex regulatory environment, taking into account both legal title and economic ownership.

In fact, Mark W. Everson, Commissioner of the IRS, acknowledged that "[T]ransfer pricing is one of the most significant challenges for [The IRS] in the area of corporate tax administration. . . . The settlement of [the GSK] case is an important development and sends a strong message of our resolve to continue to deal with [transfer pricing issues] going forward."

Thus, as the GSK case has demonstrated, the threat of a large transfer pricing adjustment is quite real. It is only prudent that multinationals with operations in the U.S. carefully evaluate their intercompany pricing strategies, particularly with respect to transactions involving transfers of intangible assets, in order to manage such risk. Furthermore, the GSK case emphasizes the importance of investing in quality transfer pricing documentation. While the GSK settlement – at \$3.4 billion – was the single largest in IRS history, the settlement could have been substantially larger had GSK not prepared sufficient documentation of the subject transactions.

According to U.S. tax law, a taxpayer whose transfer prices are grossly misstated can face penalties of up to 40 percent of the underpayment of tax, incremental to the additional taxes owed, if the taxpayer cannot provide documentation to demonstrate that a good faith effort had been made to set appropriate transfer prices. Thus, taxpayers should invest in quality documentation to minimally mitigate their risk of penalties, even in the event that the IRS deems an adjustment necessary to the taxpayer's transfer prices.



Historical Background of the Case

R&D for *Zantac* has historically been conducted in the U.K, though the drug has been heavily marketed in the United States by GSK's U.S. affiliate. In the case, the IRS contended that the drug's value was derived primarily from sales and marketing efforts undertaken by GSK's U.S. affiliate rather than from R&D, since *Zantac* was not a "pioneer" drug. The IRS contended that while R&D might explain the success of a "pioneer" drug, the success of later entrants into the market is primarily attributable to their sales and marketing efforts. GSK, however, argued that the drug's success was largely attributable to R&D, since *Zantac* was sufficiently differentiated from its competitors to substantiate the value of the U.K. patent.

In its analysis, the IRS used a residual profit method to calculate the income attributable to GSK's U.S. operations. The IRS adjusted GSK US' cost of goods sold for *Zantac* to a level appropriate for a contract manufacturer to have paid, and reduced GSK US' royalty payment to GSK UK for patent protection in the U.S. to the rates set forth in an initial License Agreement. In doing so, the IRS effectively transferred the majority of the profit from the sale of *Zantac* to GSK US.

Consequently, GSK applied for relief from double taxation from the U.S. and U.K. tax authorities for the subject income under the Competent Authority procedure. However, negotiations between the tax authorities were terminated in 2003 when they failed to reach an agreement over the disputed income.

Also under dispute was the IRS' application of the "commensurate with income" standard, which requires that royalty rates be analyzed annually to determine whether adjustments are necessary to reflect divergences between actual and expected profits earned from the use of an intangible. In accordance with the commensurate with income standard, GSK US had increased its royalty payment to GSK UK for *Zantac* over time to reflect increased profits earned by the U.S. entity from sales of the drug as well as the corresponding increase in the value of the U.K.-owned patent license.

However, the IRS disallowed these increases, contending that the royalty rate set forth in the initial License Agreement between GSK US and GSK UK was arm's length, or consistent with the prices and terms that would have been charged by unrelated parties had they engaged in the same transaction under the same circumstances. The IRS also argued that the value of the patents had not increased sufficiently to necessitate an increase in the royalty rate.

Furthermore, the IRS contended that GSK US could not deduct royalties paid to its UK parent for trademarks and other marketing intangibles because GSK US contributed to the development of those intangibles. The IRS' argument was based on the Developer-Assister rules, which stipulate that a controlled taxpayer that provides assistance to an intangible asset owner in developing or enhancing that intangible may be entitled to consideration for such assistance. GSK, however, asserted that the Developer-Assister rules were not applicable since it did not spend an inordinate amount on advertising and marketing of the drug, and hence did not materially contribute to the development of the intangibles. Further, GSK US argued that it had not engaged in more advertising and marketing than the average pharmaceutical product distributor.

While prior economic research contesting the contribution of marketing intangibles to extraordinary profits for patented drugs substantiated GSK's position in the dispute, GSK indicated that it sought the settlement to avoid the uncertainty and cost of future litigation.

GSK also reported that the settlement would not have a significant impact on its reported earnings or tax rate, since it had already provisioned for the dispute and settlement.

For further information:

"IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute", IR-2006-142, Sept. 11, 2006. <http://www.irs.gov/newsroom/article/0,,id=162359,00.html>

"Glaxo Holdings Will Pay IRS \$3.4 Billion", Sept. 11, 2006.
http://news.yahoo.com/s/ap/20060911/ap_on_bi_ge/irs_glaxo_1

"Glaxo Settles Transfer Pricing Dispute with IRS", Sept. 11, 2006.
<http://www.gsk.com/ControllerServlet?appId=4&pageId=402&newsid=890>

GlaxoSmithKline PLC Form 20-F filed with the SEC for the fiscal year ended Dec. 31, 2005.
<http://www.sec.gov/Archives/edgar/data/1131399/000102123106000123/b822393.htm>

Colker, David and Kim, Sang. "GlaxoSmithKline v Commissioner: How Should \$10.6 Billion of Income in Dispute be Allocated Between Patents and Marketing Intangibles?". *Business Tax Online News*, May 1, 2004.
<http://www.dlapiper.com/global/publications/detail.aspx?ref=snapshot&pub=171>