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A European View on Transfer Pricing After Glaxo

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One could say that modern transfer pricing thinking was ignited by the issuance of the U.S. White Paper in 1988: both the Internal Revenue Service ("the IRS") and U.S. business drew the consequences of the fact that they had encountered the limits of the "old" approaches, dating from the days that CUPs ("comparable uncontrolled prices") and gross margins still existed in sufficient numbers and traceable form. Its publication led to a valuable and in-depth discussion, focusing on intangibles in particular. The reaction from the European side was mainly one of "wait-and-see".

But then, something unexpected happened. Before Europe had really formed its opinion about the ongoing discussions in the U.S. practice, a brand new phenomenon emerged: CPM, the comparable profits method. With the speed of lightning, it was not only incorporated into the U.S. Regulations, but it also very quickly acquired unanimity amongst practitioners in the U.S. As a "testing mode", it served perfectly the political agenda of those days (foreign multinationals should pay tax on their U.S. operations like "our own companies"): what counts is whether or not, as a multinational from abroad, one fits the profit profile of the average home country comparable party. Furthermore, the regulations made it very clear to companies that they had better comply or else run into serious penalty consequences.

Europe was stunned. A new approach had been designed, without as much as a hint of what was to come, and without any apparent interest in what had heretofore preoccupied European practitioners: how do you *set* prices for transactions within a group of companies? As a reaction, a frantic pace of activity erupted within the OECD context, leading to a surprisingly quick response in the form of the OECD Transfer Pricing Guidelines of 1995. What these boiled down to can be described as twofold.

First, as a united manifestation of adherence to the guiding principle of "dealing at arm's length", and second as a desperate attempt to offer a serious alternative to the solution developed (and embraced) by the U.S., a new "method" in transfer pricing was proposed, consisting of a *transactional* response to the CPM. The emphasis on the *transactional* character of the method served to accommodate the need in the European practice for solutions that enable parties to *set* prices, rather than only to *test* them. The attempt turned out to be rather successful: it generated TNMM, the "transactional net margin method". The rest is history.

From that moment on, one country after another discovered that transfer pricing is an issue, and consequently imposed its own rules on how international business was to behave inside the borders of its territory.

In the relatively short history of modern transfer pricing in Europe, the year 2006 may certainly be considered as a remarkable year, with significant transfer pricing developments. Beside the extended regulatory framework, meaning an increasing number of European countries with documentation regulations[1] and advance pricing agreement ("APA") programmes,[2] developments took place also at the multilateral level, both in the context of the European Union and at the OECD.

The adoption by the EU Council of a "code of conduct on transfer pricing documentation for associated enterprises in the EU", in June 2006, can be viewed as a minor revolution. The code of conduct creates a platform that allows multinational enterprises ("MNEs") with operations in Europe to constitute a single pan-EU transfer pricing documentation report instead of a series of different documentation reports by country. This comes with the explicit view to achieve more transparency and consistency, and to lower compliance costs for MNEs. In parallel to the EU developments, in 2006, the OECD issued discussion papers on transactional profit methods[3] and on comparability issues.[4] After more than a decade of existence of the principles,[5] both papers reflect the OECD's wish "*to monitor existing principles, updating guidance, testing the concepts in new situations and extending their application to new areas*".[6]

These recent developments (the EU Commission Code of Conduct on Transfer Pricing and debates within the OECD about the Guidelines) can be interpreted as defining the outlines of a new playing field for transfer pricing in Europe.

Beside these developments, 2006 is a remarkable year, because transfer pricing made the headlines in the U.S. It is relatively rare that transfer pricing does achieve that stature, but, due to the hidden character of the topic, it is even more rare that a U.S. transfer pricing dispute makes the European headlines. Thus the announcement of a recent settlement between the GlaxoSmithKline Group and the IRS involving a payment of tax due to transfer pricing adjustments, of U.S.$3.1 billion has created a significant precedent in Europe.

It might be a bit early to draw conclusions about the ultimate impact of this outcome of a long-lasting dispute; however, with this article, we would like to offer:

1. a better understanding of the facts and circumstances of the case, and
2. to share, from our perspective in Europe, preliminary conclusions that could tentatively be derived.

We wish to point out in this respect that the article below uses publicly available information only.

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I. The Glaxo Case: Facts and Circumstances

A. Background to the Dispute

In September 11, 2006, GlaxoSmithKline ("Glaxo") announced that it had settled a long and, as it looks from the outside, in many ways "ugly" transfer pricing dispute with the U.S. IRS. The settlement resolved all of the issues that were in dispute in this case. Under the agreement, the final net cash cost to Glaxo will be approximately $3.1 billion, which covers federal, state, and local taxes, interest, and also the benefit of tax relief on the payments made. The settlement ends the dispute for the period 1989-2000, which was due to go to trial in February 2007, and also covers the subsequent years 2001-2005.

For Glaxo and the IRS, this is the end of long discussions, procedures, and negotiations that started 14 years earlier.

The tax audit of GlaxoSmithKline Holdings (Americas) Inc., then Glaxo Americas Inc. ("Glaxo U.S."), was initiated by the IRS in 1992. Twelve years later, on January 6, 2004, the IRS issued a tax deficiency notice of $2.7 billion having made $5.6 billion in Section 482 transfer pricing adjustments for the period 1989 to 1996.

In the meantime,

- Glaxo requested an APA with the IRS on June 30, 1994, that the IRS refused. In parallel, on August 11, 1992, SmithKlineBeecham ("SmithKline"), Glaxo's competitor at that time and subsequent merger partner, had requested an APA with the IRS, which was executed on June 28, 1993. The SmithKline APA was a legal determination that provided for a transfer pricing methodology based on the resale price method and determined that a specific gross margin provided an arm's length return for the marketing and selling activities performed by SmithKline with respect to Tagamet, separate and apart from additional margins for its ownership of trademarks and trade names. The specified gross margin was applied to Tagamet selling and marketing activities from 1987 through the expiration of the Tagamet patent in 1994.
- Glaxo requested relief from the IRS and the U.K. Inland Revenue in December 1999. But those discussions broke down in January 2004 when it became apparent that the Inland Revenue supported Glaxo's position that no additional taxes were due to the IRS.

After receiving the IRS' tax deficiency notice, Glaxo filed in April 2, 2004 its Tax Court petition after receiving the IRS's deficiency notice (covering years 1989-1996).

- Glaxo said the IRS erred in increasing its income by $4.5 billion for costs of goods sold, $1.9 billion for royalties, and $1.4 billion for interest income involving intercompany transactions for Glaxo "heritage products". The company also asserted a claim for a $1 billion tax refund, saying that the IRS discriminated against it by granting former competitor SmithKline an APA for Tagamet, while denying Glaxo an APA for Zantac a competing product.

Glaxo filed an additional Tax Court petition in April 12, 2005 (covering the years 1997-2000).

B. The Facts

The products covered by the investigation of the IRS were twenty Glaxo Heritage products. Six products (shown in Table 1) out of the twenty represented 97 percent of the transfer pricing adjustment:

Product	Description	Discovery Date	Worldwide launch	U.S. launch
Ventolin	First inhalable asthma products	1966	1969	1981
Zantac	Advanced treatment for peptic acid disease	1976	1981	1983
Ceftin	Advanced oral antibiotic	1976	1987	1988
Zofran	First effective treatment for chemotherapy induced nausea and vomiting	1983	1990	1991
Imigan	First effective migraine treatment	1984	1991	1993
Serevent	First effective long acting asthma treatment	1983	1990	1994

Among the six products, Zantac represented 77 percent of the adjustment. Zantac is a leading histamine H2 receptor antagonist, following a similar drug, Tagamet, onto the U.S. market. Tagamet was manufactured by (then) Glaxo competitor SmithKlineBeecham. Zantac became the best selling prescription drug in 1986 and was a major contributor in Glaxo becoming one of the three leading pharmaceutical manufacturers in the world.

During the years at issue (1989-1996), Glaxo U.S. was the distributor of the Glaxo Heritage products, discovered and patented by the Glaxo group in the U.K. (GlaxoSmithKline Plc, "Glaxo U.K.").

Glaxo provides the following description[7] of the split of functions between Glaxo U.S. and Glaxo U.K. and its non-U.S. affiliates during the years under audit. According to their petition, Glaxo U.K. and its non-U.S. affiliates:

- discovered all the products through its research
- patented all of the products
- conducted virtually all pre-clinical development on all the products
- invented the technology for manufacturing the active ingredient and conducted all primary manufacturing of the products
- obtained regulatory approvals for all the products outside the U.S. before they were approved in the U.S.
- designed worldwide marketing platforms for the products
- first launched all the products outside of the U.S.
- selected, approved and owned the applicable trademarks and trade names for the products
- determined the co-promotion strategy for Zantac's launch in the U.S., using the sales force of Hoffman-LaRoche to supplement Glaxo's U.S. inadequate sales forces (same strategy applied in the other countries)
- directly reimbursed virtually all development expenses through approximately 1984 including covering the U.S. FDA approvals of Zantac, among other products.

On the other hand, Glaxo U.S. functions and responsibilities are described as follows:

- provided development assistance for FDA approvals
- did secondary manufacturing
- applied to the U.S. market the marketing platforms established by Glaxo U.K.
- introduced the products in the U.S.

- conducted selling activities, principally using sales forces to detail the products to physicians.

In terms of inter-company transactions, Glaxo U.S. was purchasing the active ingredients from Glaxo U.K.; and was the licensee of Glaxo U.K. being granted the rights to distribute the Glaxo products.

For price and licence fee determination, Glaxo used a resale minus pricing methodology, under which the Group left Glaxo U.S. with a gross profit margin for the product portfolio of 55 percent for the years at issue.[8]

C. The Dispute

In the IRS deficiency notice, the IRS argues that Glaxo U.S. was not entitled to deduct royalties it paid for trademarks and other marketing intangibles because it was the owner for tax purposes of the trademarks and other marketing intangibles licensed from Glaxo Group Ltd.: "*You were the owner of the trademarks and marketing intangibles since you were the developer of said intangibles and because the economic substance of your dealings with Glaxo Group Ltd and related entities at the time the licensed drugs were first sold in the U.S. establishes the existence of an imputed royalty-free licence or other transfer of the U.S. trademarks and other marketing intangibles at that time*" the notice said.

To determine the arm's length remuneration for Glaxo U.S., the IRS used a profit split method[9] and assessed the respective contribution of Glaxo U.S. on one hand and Glaxo U.K. and it affiliates on the other hand, as demonstrated in Table 2:

US$ billions	1989-1996	1997-2000	Total
Combined operating profit	12.7	8.3	21.0
Routine returns	(2.4)	(1.1)	(3.5)
Residual profit	10.3	7.2	17.5
U.S. share	x76.7%	x73.6%	75.4%
U.S. profit	7.9	5.3	13.2
Less: U.S. actual	(2.3)	(2.6)	(4.9)
Adjustment	5.6	2.7	8.3

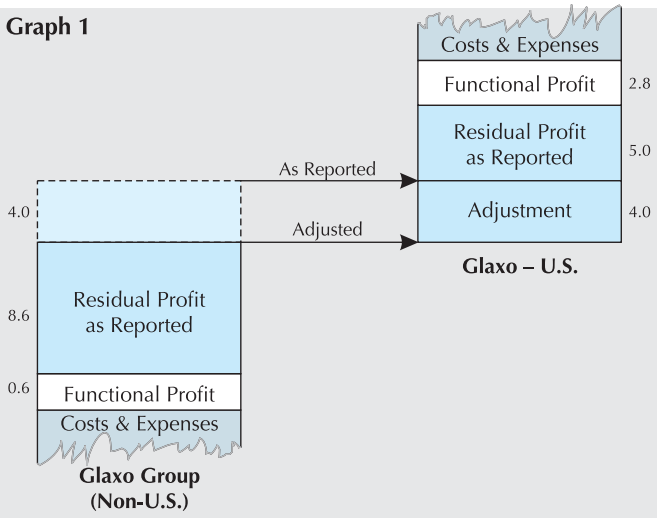
In total, from an overall split of around 30-70 between the U.S. and the group, the proposed adjustment from the IRS lead to an overall split of around 80-20 in favour of the U.S.[10]

It is not clear in the available disclosures from the case how the IRS estimated the respective contributions of the parties, and whether the IRS has based its evaluation on qualitative arguments or on some quantification and financial data.

It is also difficult to link the final outcome to an overall split of the income over the total range of years. Assuming, however, that approximately one-half of the amount involved corresponds to tax on transfer pricing adjustments over the initial period, we may have some impression.

It suggests that the settlement achieved between the IRS and the Glaxo group over the period 1989-2000 resulted in an actual split of around 60-40 between Glaxo U.S. and Glaxo U.K., as shown in Graph 1.

Graph 1



II. The European Perspective

This U.S. case shows us, in Europe, that the essence of transfer pricing and the inherent characteristics of the topic are not U.S.-specific: the case is a good example of the universal character of the subject. In that respect, we, in Europe, can learn a lot. Among the findings and lessons, we believe that the three listed below are of particular importance:

- that the lack of a consistent set of definitions, leading to differences of interpretation and perception between the taxpayer and the tax administration, are most of the time at the origin of TP disputes
- that marketing is not only a key business issue at the very heart of a group's strategy, but the recognition and allocation of intangibles concerned has become a major transfer pricing issue
- that new analytical tools and innovative approaches to transfer pricing may be useful for MNE's, especially in light of the significant transfer pricing challenges they are facing.

A. Differences of Interpretation and Implementation: the Origin of Transfer Pricing Disputes

In a transfer pricing dispute, differences of interpretation and perceptions of what creates value within a group may be at the origin of severe conflicts between the taxpayer and the tax administration. The Glaxo case offers in this respect a good example of huge divergences in opinion of what drove value in the group, and more generally in the industry.

From what we understand, the IRS did not challenge the description of the group concerning the respective activities and functions performed by the parties to the transaction. The situation as described above is a factual situation which is not based on any subjective assessment: Glaxo U.K. had indeed been involved in the identification of the active ingredient for Zantac; Glaxo U.S. had also indeed been involved in the sales of the products; and Zantac was introduced second to the U.S. market after SmithKline's Tagamet.

What is different is rather the interpretation of the facts and the perceptions about the importance of the activities and functions respectively performed by Glaxo U.S. and Glaxo U.K..

To illustrate this difference in perceptions, in Table 3 overleaf we have gathered some arguments[11] from the IRS and Glaxo statements in the record, and we have put them in perspective; we see that starting from the same factual context differences in interpretation and perceptions lead to quite different assessments from two sides.

	Facts	IRS interpretation	Glaxo interpretation
Glaxo U.S. role	Glaxo U.S. was in charge of the development of the sales in the U.S. market.	Glaxo U.S. implemented a complicated strategy for the growth of a fully-integrated business.	Glaxo U.S. was the local distributor of the group, acting pursuant to Glaxo UK strategy. Glaxo U.K. designed the world-wide marketing platforms for the products and determined the co-promotion strategy for Zantac's launch in the U.S.
Product	Tagamet was the first anti-ulcer drug that directly blocked acid production. Zantac was second to the market, first launched in 1981, first launched in the U.S. in 1983.	Since Zantac followed SmithKline's Tagamet on to the market, it was not a pilot drug and did not offer a marked enhancement of pre-existing treatments.	Zantac won regulatory approval for a twice-daily dose, and at a lower total dosage in milligrams, with fewer side effects. The IRS even quoted the Chairman of SmithKline over the relevant period, George Wendt: "*Tagamet really lost the advantage to Glaxo in development…Physicians drew the obvious interference: Zantac appeared to be a more potent and longer-lasting agent*"
Strategy	The number of employees in the sales departments of Glaxo increased at a rate in excess of the expansion of the R&D.	This trend shows that Glaxo relied less on the design and effectiveness of the products by implementing a redeveloped sales strategy.	The nature of sales and distribution they maintain is labor-intensive and requires many employees across a geographical area. On the contrary, the R&D departments are centralized and employ specialist experts.
Critical success factor		Zantac's outstanding sales performance was substantially attributable to the marketing employed in the US, with a sales strategy to position Zantac at the forefront of the market. The IRS even quoted Glaxo's Chairman Sir Paul Girolami: "*any product which makes money doesn't sell itself …you've got to sell it and sell it hard, because if you don't it won't be sold, however good it is*".	As a pioneer drug, the value of Zantac should be allocated to research and development.

Like many other transfer pricing disputes, the Glaxo case is very representative of the misunderstandings between taxpayers and tax administrations in relation to the interpretations and perceptions about value creation within a firm. We note that these aspects are in general not the only drivers of transfer pricing disputes: questions related to which entity finances capital and is responsible for associated risks, issues with respect to the documentation of the facts and circumstances, as well as the transfer pricing system and structuring play an important role as well.

B. Marketing and Transfer Pricing

Beside the amounts at stake, one of the reasons why the case raised so much interest in the European transfer pricing community is the discussion concerning marketing intangibles, which goes beyond the pharma industry itself.

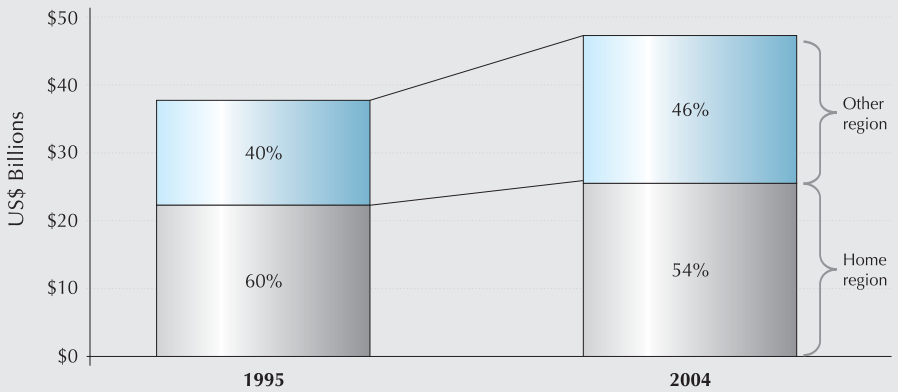
Interest in Europe was high, with respect to this concept for three reasons:

1. Marketing is a key business function, at the origin of value for MNE groups;
2. Guidance in the European regulations, as well as in the OECD guidelines, is not very detailed; and,
3. European tax administrations are starting to use this concept in the course of their audits.

U.S. and European MNEs have a common trend in spending an increasing amount on marketing and advertising their products throughout the world; according to *Advertising Age's* 19th annual Global Marketing report, "*the Top 100, an elite group of marketers that drive just over a quarter of the world's total media and that spend those dollars on three continents or more, notched $94 billion in worldwide media in 2004*". This explosion of marketing spending can be observed in the electronics, pharmaceuticals, cleaners, automotive, and personal care sectors more in particular, but is a general trend.

In line with this trend and the globalisation, it can be observed that an increasing part of the MNE's advertising and marketing spending takes place outside their home country, as shown in Graph 2:

Graph 2: Global 25 Marketers (Advertising Spending in Billions US$)



Source: Advertising Age Global Marketing Reports (1995 and 2004 Editions)
Note: Based on the same 25 companies included in top 50 global marketers for both 1995 and 2004.

If the trend towards marketing is global, the U.S. continues to be the geographic volume leader of the Top 100 with 49 percent of its spending. More specifically, the report notes that "*pharmaceutical advertising is fully U.S.-driven, the group of 11 Top 100 members in the category spending an average 80 percent of their media in the U.S., mostly in direct-to-consumer advertising.*"

It is thus not surprising that the biggest transfer pricing dispute around marketing, more specifically marketing intangibles, has taken place in the U.S, in the pharmaceutical sector. We note that the fact that marketing spending

increases and that the largest share is in the U.S. does as such not give any indication with regard to the existence, let alone the size, of marketing intangibles. More serious analysis of market factors in different countries and the effect of different market approaches would be required for that, as well as specific analysis of which party, inside a group, carries responsibility, strategically and financially, for the decisions in this respect.

Inasmuch as the issue is relatively new, also in Europe, transfer pricing practitioners were expecting from this case some guidance to better understand the issues surrounding the concept of "marketing intangibles". This guidance was all the more welcome, as very little in Europe is available on the subject: most European regulations do not specifically tackle the issue. In an effort to address the specific issue of the remuneration of marketing activities undertaken by enterprises not owning trademarks or trade names, the OECD Guidelines provide only limited guidance on the subject, making a clear distinction between a marketer acting as a service provider and a marketer entitled to share an additional return attributable to the marketing intangibles.[12] The OECD Guidelines identify that the "*substance of the rights*"[13] of the parties to the transaction will essentially drive a company in the first or second category, and points out that the evaluation of a marketing intangible itself is a difficult exercise: "*it can be difficult to determine what these expenditures have contributed to the success of a product. […] For instance, it can be difficult to determine what advertising and marketing expenditures have contributed to the production or revenue, and to what degree. […] More fundamentally, in many cases higher returns derived from the sale of trademarked products may be due as much to the unique characteristics of the product or its high quality as to the success of advertising and other promotional expenditures. The actual conduct of the parties over a period of years should be given significant weight in evaluating the return attributable to marketing activities*."[14] What we can derive from the OECD message on the subject is that the OECD seems implicitly to recognise the existence of marketing intangibles and to observe the intrinsic difficulties of the subject. We can regret the lack of a tentative definition of "marketing intangibles" in the Guidelines, as well as the fact that this subject does not appear to be among the current top priorities of the OECD.[15]

Despite the lack of substance in the regulations and the OECD Guidelines, the tax administrations in Europe, following the U.S. trend, progressively try to handle the subject, and we witness transfer pricing audits based on marketing intangibles in certain industries. For example, in France, after initially targeting subsidiaries of foreign groups with limited functions (such as low-risk distribution activities), the French Tax Administration now targets more complex relationships involving value-added activities and responsibilities on both sides of the transaction (in France and in the country of the transacting party).

For these reasons, we, in Europe, had hoped to learn from the deliberations between Glaxo and the IRS. We must conclude, however, on the technical side, even though all the details of the case are not publicly available, that this case does not provide much guidance in terms of defining marketing intangibles and what their arm's length remuneration should be:

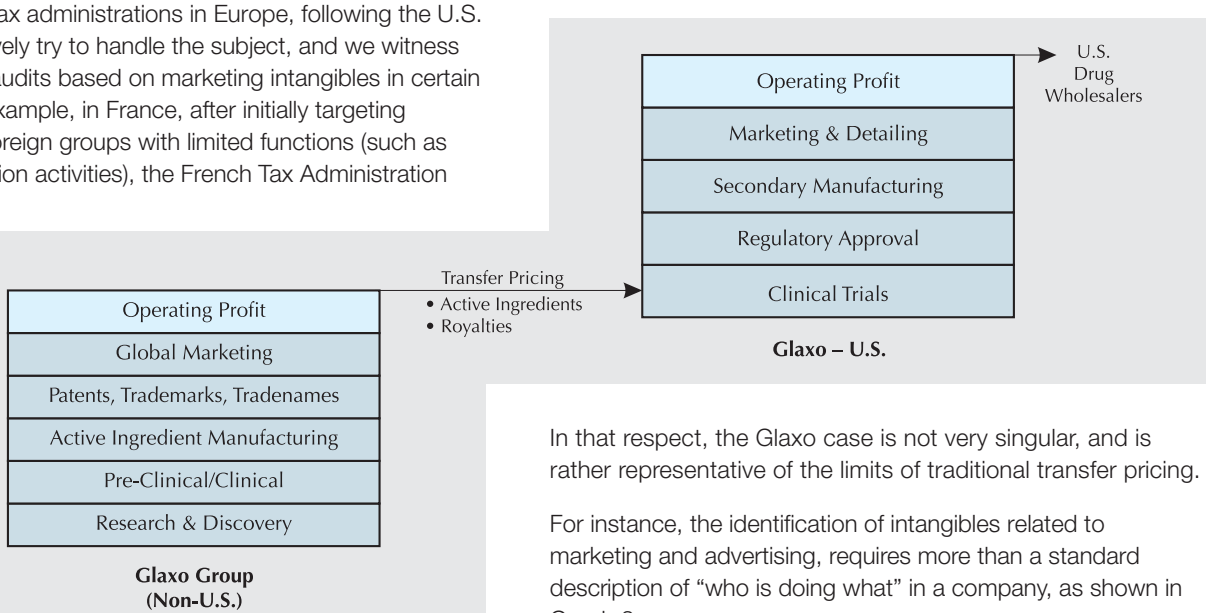
- with respect to the identification of marketing intangibles, as we noted above, the facts and circumstances provided by both Glaxo and the IRS involved a "static" description of the activities performed, whereas the subsequent evaluation of their importance in the value chain, both from Glaxo and from the IRS perspectives, is not obvious.
- with respect to the valuation of marketing intangibles, it would be useful to review the economic analysis performed by the IRS to assess the arm's length compensation for marketing intangibles. To the best of our knowledge, it does not appear that the profit split used by the IRS, notably the allocation of residual profit between the U.S. and the U.K., is based on a sophisticated quantification. From the visible facts of the case there seems to be very little reason to assume that there is any justification of a significant value of marketing intangibles (if any) in the U.S.

This case shows us, however, that, with the increasing complexity of business worldwide and the increasing integration of MNEs, transfer pricing tools need to follow that path and evolve as well. The marketing intangibles concept should be tackled with new and innovative concepts, not only the traditional approaches.

C. New Tools and Innovative Approaches

The Glaxo case illustrates the inherent difficulties of the subject of transfer pricing, with room for different interpretations between the taxpayer and tax administrations, as well as the specific technical problems of identifying and quantifying intangibles, in particular those relating to marketing and advertising spending.

Graph 3



In that respect, the Glaxo case is not very singular, and is rather representative of the limits of traditional transfer pricing.

For instance, the identification of intangibles related to marketing and advertising, requires more than a standard description of "who is doing what" in a company, as shown in Graph 3.

Additional analyses[16] are required:

- the identification of the industry's value drivers and the critical success factors should be a starting point for understanding the relative contribution of each function within a MNE.
- the "functional" analysis of MNE group entities is not always sufficient to derive their respective roles and responsibilities. A value chain analysis, reflecting how value is created in the group, should be compiled, and the responsibility profiles of the entities involved in the joint process of value creation should be identified, in line with commonly used and recognised management control concepts.

Concerning the quantification of marketing intangibles, the IRS seems to have used a profit split approach in the course of its evaluation for the Glaxo case. Lacking detailed information about how the IRS applied the profit split method, we would argue that this method cannot be reliably applied without an in-depth economic analysis. For instance, the determination of the respective contribution of the parties to the transaction is not a standardised exercise based on arbitrary allocation keys, but should involve more sophisticated economic valuations and related analyses.[17]

Finally, the Glaxo case shows us the IRS leaving the field of CPM (the unilateral "testing mode") and undertaking a multilateral approach, where insight into the commercial and financial relations between the parties involved is required. Understanding industry and company value chains and company responsibility characterisations becomes essential, and the need for in-depth economic analysis increases. In other words, the Glaxo case calls for more complete and precise mapping of the "circumstances" of the tested intra-group transactions. "Relational arm's length" pricing is based on an understanding of the underlying circumstances of the tested transactions (the types of relationships, the investment impact) to identify the most accurate comparability criteria.

Traditional transfer pricing analysis often ignores the dimension of the circumstances of the transactions, but they form the basis for understanding the price determination process. In reality, whether it is intra-group or between third-parties, the pricing process is influenced by:

- the type of relationship between the transacting parties, a transactional versus a long-term co-operative relationship, a one-off deal versus a partnership
- the importance of the investment at stake in a transaction or series of transactions in a long-term relation.

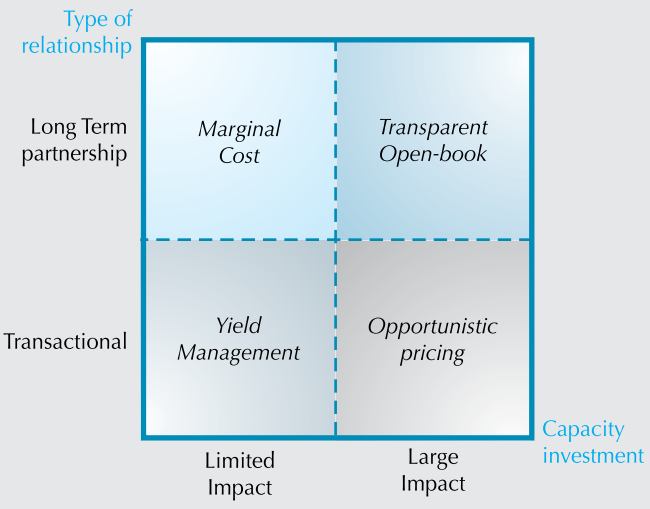
The "Market Pricing Matrix" shown in Diagram 1 illustrates the impact of capacity investments and types of relationships on the nature of pricing.

Entities within a multinational group of enterprises, certainly one like Glaxo, are involved in long-term co-operative types of operations with other entities in the group. The lesson from the matrix is that in such relationships, also independent parties pursue an "open-book" approach to the process of setting terms and conditions for their co-operation. Both parties are fully aware of the cost aspects involved and of the outcomes, once these facts become apparent. What parties derive from such joint entrepreneurial activities will follow from a bargaining process but ultimately depends on what each of them contributes, in relative terms, to the joint value creation and what is the outcome of their joint operations. This understanding can be recognised in certain approaches developed by the IRS in the early 1990s, such as the "commensurate with income" doctrine, which attracted considerable protest at the time from Europe, but which is nonetheless fully consistent with what the Market Pricing Matrix tells us.

Let us now look back for a moment at the original arguments from the IRS in the Glaxo case: "*You were the owner of the trademarks and marketing intangibles since you were the developer of said intangibles and because the economic substance of your dealings with Glaxo Group Ltd and related entities at the time the licensed drugs were first sold in the U.S. establishes the existence of an imputed royalty-free licence or other transfer of the U.S. trademarks and other marketing intangibles at that time.*" How can we reconcile the rationale underlying this statement with a philosophy that led to the "commensurate with income" reasoning? We have to be aware of the character of the relationship between parties that have the intention to work together constructively and long term in a mutual interest. That fits the thinking behind "commensurate with income", but it seems in open conflict with the reasoning behind the Glaxo adjustments.

Nevertheless, the transactional relationship context does indeed suggest the appropriateness of a profit split approach in this case; the valuation of the relative contribution of the U.S. subsidiary however seems to be rather generous. Justification for a more than 50 percent contribution from the sales subsidiary in the joint value creation by the global group can not be found in the information available to us. One may suppose that the outcome of this case was heavily influenced by factors other than a serious analysis of the commercial and financial relation between the parties involved. The procedural aspects of the dispute may well have exerted heavy pressure on the company involved. And that still looks as ugly as we thought in the beginning of this

Diagram 1



Market Pricing Matrix

article. Another possible factor may be that balance sheet considerations, possibly emphasised by new IFRS rules to be applied by Glaxo imposed serious consequences in terms of raised tax provisions, which could not be kept out of its P&L. Finally, it may also have been the case that Glaxo simply had no material interest in further defending its position, in view of adequate perspectives of compensating adjustments.

Whatever the real circumstances, it all adds up to the disappointing conclusion that 14 years of dispute have not generated any relevant insight in the phenomenon of marketing intangibles. Nevertheless, a few more positive conclusions may also be drawn.

III. Conclusions

The dispute involving Glaxo and the IRS, and its settlement, establishes a landmark case in modern transfer pricing history, notably because, to date, it is the largest transfer pricing dispute in IRS history.

However, an in-depth analysis of the case can indicate that the Glaxo case will be a landmark case also for the following reasons:

- it demonstrated, on a large scale, that a static presentation of the facts and circumstances of the activities of a firm, together with a rigid description of "who is doing what" in a group can lead to huge differences in interpretation and perception, opening a gap between a taxpayer and a tax administration which is then very difficult to bridge.
- it demonstrated that the issue of recognition and allocation of profit to the marketing function within a group remains one of the major transfer pricing issues MNEs have to face.
- it demonstrated also that the need for innovative approaches is required, both in terms of transaction characterisation and economic analysis, that enables the development of transfer pricing solutions based on a more appropriate interpretation of "arm's length" than is usually applied, by giving consistent attention to the relational aspects underlying the transactions.

Finally, this decision can also be seen as illustrative of a wider trend in transfer pricing in the U.S. practice. After a decade of relying extensively on the CPM approach, the IRS seems to return to more sophisticated concepts. It is as if the "compliance mode" that has reigned since 1994 has eclipsed most of the valuable discussions that were going on before the introduction of CPM. We see now that the real issues are returned to the table. This trend is also confirmed by the discussions concerning the draft cost sharing regulations and by the new services regulations.[18] The Glaxo case may well have set this trend. Let us hope that this time Europe is following up more closely the signals from the U.S. In this light we look forward to the contributions to the discussions opened by the OECD about the transactional profit methods (notably the profit split method)[19] and to application in practice of the masterfile concept in order to manage more effectively the transfer pricing challenges in a multilateral context.

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1 Most recently, new regulations are effective from 2006 in Denmark and Hungary, and announcements were given for new regulations effective from 2007 in Sweden and Spain.

2 Issuance of APA regulations has also accelerated during the last months. In France, possibilities for unilateral APAs have been legally formalised and the Czech Republic and Poland have new APA programmes since 2006.

3 OECD, Invitation to comment on Transactional Profit methods, February 28, 2006.

4 OECD, Comparability: public invitation to comment on a series of draft issues notes, May 10, 2006.

5 Transfer Pricing Guidelines for multinational enterprises and tax administrations.

6 Foreword, Caroline Silberztein, TP Review 06/07.

7 This information is extracted from the U.S. Tax Court petition of Glaxo of April 2, 2004 (BNA, April 14, 2004, "*Glaxo fights $7.8 Billion in Allocations, Seeks $1 Billion Refund for Discrimination*")

8 This information is extracted from the U.S. Tax Court petition of Glaxo of April 2, 2004 (BNA, April 14, 2004, "*Glaxo fights $7.8 Billion in Allocations, Seeks $1 Billion Refund for Discrimination*")

9 Source: 1989-1996 Notice of Deficiency attached as Exhibit A to Glaxo's April 2, 2004 U.S. Tax Court Petition; and 1997-2000 Notice of Deficiency attached as Exhibit A to Glaxo's April 12, 2005 U.S. Tax Court Petition.

10 BNA, April 14, 2004, "*Glaxo fights $7.8 Billion in Allocations, Seeks $1 Billion Refund for Discrimination*", and. Glaxo's April 2, 2004 U.S. Tax Court Petition.

11 For the purpose of the compilation of this table, we have used information from the following article, BNA, *GSK Holdings (Americas) Inc v. Com. Of IRS – Valuing Marketing: A Mock Judgment in Glaxo's Court Case*, M. Stirling, September 29, 2004.

12 OECD Guidelines, 6.36.

13 OECD Guidelines, 6.37.

14 OECD Guidelines, 6.38.

15 Foreword, Caroline Silberztein, TP Review 06/07.

16 BNAI Tax Planning International Transfer Pricing, *Real Transfer Pricing : A new paradigm for Transfer Pricing in Europe ?*, Fris-Gonnet, June 2006.

17 For a detailed description of the profit split methods, we refer the reader to Harlow Higinbotham, "Profit split methods" in Robert T. Cole's forthcoming Practical Guide to U.S. Transfer Pricing, Chapter 10. For the use of the profit split methods, see Emmanuel Llinares, *Intangibles, market structure and the use of profit split methods*, International Tax Review, January 2006.

18 IRS Final Temporary Rules (T.D. 9278) on Services Treatment Under Section 482, Allocation of Income and Deductions from Intangibles, Stewardship Expense, effective January 1, 2007.

19 OECD, Invitation to comment on Transactional Profit methods, February 28, 2006.

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