TRANSFER PRICING SEVEN YEARS AFTER GLAXO SMITH KLINE

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ABSTRACT

After the historic 2006 Glaxo Smith Kline settlement on transfer pricing, the Internal Revenue Service, the courts and international trade organizations have been working to develop a rational approach to this important issue. Court case decisions have been issued, regulations have been revamped and international trade organizations have proposed solutions. This paper explores these issues and evaluates the current state of transfer pricing. The priorities of the paper are the two issues left unanswered by the Glaxo Smith Kline settlement – stock-based compensation and the valuation of buy-in agreements. These issues are still very complex and not easily resolved. **JEL Classification:** M410

INTRODUCTION

On September 11, 2006, Glaxo Smith Kline (GSK) and the Internal Revenue Service (IRS) agreed to a $3.4 billion settlement, the largest in IRS history. The issue was transfer pricing. Since GSK, several transfer pricing issues arose under the 1995 Sec. 482 regulations. Two important issues were how do deal with stock-based compensation and the valuation of buy-in agreements. The purpose of this paper is to explore the changes in the transfer pricing/intangible asset area since GSK, particularly regarding stock-based compensation and buy-in agreements. First the GSK settlement is briefly reviewed. Next two intangible asset/transfer pricing tax cases are explored. The IRS's efforts are analyzed and finally the international authorities contributions are revealed.

Review of Glaxo Smith Kline

GSK and the IRS argued for fourteen years over the correct transfer prices the U.S. subsidiary paid to its United Kingdom parent for several drugs. The primary argument was over the value of research and development (R&D) vs. marketing and selling expenses. The argument came to a head when Glaxo Wellcome (the company that originated the drug Xantac) merged with SmithKline Beecham (the company that originated the drug Tagamet). The advance pricing agreement (APA) for Tagamet became available to GSK and company management accused the IRS of discriminatory practices in the APA process. The IRS had previously been criticized for treating inbound and outbound transfer pricing APA cases differently – depending on which resulted in higher income taxes.

After the text of the APA was made public, it was revealed that the outbound transfer price for Tagamet was 64% of the net trade sales (defined as sales less returned items, allowances, and any cash discounts up to 2% of sales). The 36% reduction from the net trade sales amount consisted of 28% as a marketing commission, 5% for the Tagamet trademark and 3% for the SmithKline Beecham trade name. The APA referred to this pricing formula as the "resale price method and the section 936 cost-sharing payment."

Internal Revenue Code and Regulations Background

Sec. 482 governs transfer pricing for income tax purposes. According to Reg. Sec. 1.482-1(b)(1) in determining taxable income, "the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." In 1986, Congress amended Sec. 482 to explicitly recognize transfers of intangible assets. Congress amended the section to state: "in the case of any transfer … of intangible property … the income with respect to such transfer … shall be commensurate with the income attributable to the intangible."

Under Reg. Sec. 1.482-7(a)(1) the participants in cost sharing arrangements for intangible asset development are required to split the costs based on the reasonably anticipated benefits. Under Reg. Sec. 1.482-7(a)(2) if the participants do not split the development costs based on the anticipated benefits, the IRS has the authority to redo the allocations. Finally Reg. Sec. 1.482-7(d)(1) defines intangible development costs as "all of the costs incurred … related to the intangible development area … as defined in Reg. Sec. 1.482-5(d)(3) other than depreciation or amortization expense." For purposes of this paper, the definition in the prior sentence is called the "all costs rule".

REVIEW OF COURT CASES – *XILINX AND VERITAS SOFTWARE*

Two intangible asset/transfer pricing court cases have been decided since the GSK settlement. Both decisions were for the taxpayers and are reviewed. *Xilinx* involves stock-based compensation and *VERITAS Software* contains buy-in payment issues.

Xilinx, Inc. v. Comm., 105 AFTR 2d 2010-1490 (CA9) 3/22/2010

The *Xilinx* Tax Court case was decided on 8/30/2005 (before GSK) but then timely appealed by the IRS. In 2009, the Ninth Circuit of the U.S Court of Appeals reversed and remanded the Tax Court's decision. However in 2010 the Ninth Circuit withdrew their opinion and affirmed the Tax Court's opinion. The question before the courts in Xilinx was: should employee stock option (ESO) costs be part of intangible asset development cost-sharing arrangements for transfer pricing purposes?

Xilinx, Inc. is a U.S. parent with two wholly-owned Irish subsidiaries who owned Xilinx Ireland (XI). XI completed both sales and R&D in the programmable logic device area. In April 1995, Xilinx and XI signed an R&D cost-sharing agreement that established the percentages each company was to pay based on anticipated benefits of any new technology developed. Costs related to ESO's were not included in the agreement.

In 2000 and 2002, the IRS issued notices of deficiency relating to 1996 to 1998 and 1999, respectively, with deficiencies totaling $106 million and penalties totaling $21 million. The IRS determined that Xilinx should share its ESO costs with XI using spread theory where cost is based on the difference between the stock market price on the exercise date and the actual exercise price. The deficiency and penalties related to 1996 were later released since the stock options were granted before the date of the cost-sharing agreement. The IRS also decided in 2004 to use grant date theory to determine the cost of the ESO's. The adjusted deficiency for 1997 to 1999 was $77.7 million.

The IRS made four main arguments concerning intangible asset development costs:

(1) Unrelated taxpayers implicitly use either the spread or grant date to value the ESO costs. Both the IRS and Xilinx agreed that unrelated taxpayers do not explicitly recognize the cost of ESOs in cost sharing arrangements using either spread or grant date value costs.

(2) The application of Reg. Sec. 1.482-7 automatically produced arm's-length results even without showing any type of comparability analysis. ESO costs should be included even if they are not arm's length.

(3) Congress intended to replace the arm's-length standard and its use of comparable transactions with the commensurate-with-income standard and the use of internal measures of cost and profit.

(4) The Tax Court could not find any tangible proof to support the implicit-use argument.

The second and third arguments revolved around the arm's-length standard and whether it took precedence over the regulations or the commensurate-with-income standard. The Tax Court looked at the 1986 Joint Committee Notes, regulation changes from 1986 to 1999, and court cases over the applicable years. Nothing was found to infer that the arm's-length standard was not the overriding principle. Since no comparable transactions (theoretical or practical) could be found, the Tax Court concluded that requiring Xilinx to share the ESO cost was inconsistent with the arm's-length standard.

In proposed regulations issued on July 29, 2002, the IRS added language to Reg. Sec. 1.482-7(d)(1) specifically stating that stock-based compensation must be taken into account when determining the cost of compensation for cost-sharing arrangements. This change was not relevant since the tax years under questions (1997 to 1999) were judged based on the regulations in affect during those years. The Tax Court conclusion pointed out that Xilinx was "required to be compliant, not prescient". (Prior discussion based on Tax Court case – *Xilinx Inc. & Subsidiaries vs. Commissioner*, 125 TC 37, 8/30/2005.)

Upon appeal the Ninth Circuit focused on two regulations, Reg. Sec. 1.482-1(b) (arm's-length standard) and Reg. Sec. 1.482-7(d)(1) (all-costs rule), and the U.S.-Ireland Tax Treaty. The IRS made one primary argument: ESO's are an intangible development cost that must be shared under the all-costs rule even if unrelated parties would not share the cost. As in the Tax Court case the IRS argued that the all-costs rule automatically resulted in arm's-length results even if comparable transactions were not present. In the 2010 opinion which affirmed the Tax Court's decision each judge did his own opinion. In the main opinion, the appeals court found that the arm's-length standard should take precedence over the more specific all-costs rule because it achieved the purpose of bringing parity between taxpayers involved in uncontrolled and controlled transactions. The main opinion also looked to the U.S.-Ireland Tax Treaty which endorsed the arm's-length standard.

In a concurring opinion, the second of three judges agreed with the majority opinion that the ESO's should not be included in Xilinx's cost-sharing arrangement but was not entirely convinced that the general arm's-length standard outweighed the specific all-costs rule. All three judges agreed that the wording in the regulations was ambiguous. Consequently in the concurring opinion the decision to not include the ESO costs was based on the ambiguity in the regulations and the prevailing business practices.

In the dissenting opinion, the judge agreed with the IRS that the specific wording of the all-costs rule outweighed the general wording of the arm's-length standard. However, the dissenting opinion did not agree with the IRS' reasoning. According to the dissenting opinion the all-costs rule is designed for intangible asset development costs so, right or wrong, it should be used for ESO's. The dissenting judge wrote that it is up to Congress to write the tax law to prevent unfair results such as double taxation.

The *Xilinx* case decisions give taxpayers in the Tax Court and Ninth Circuit some certainty regarding ESO's granted prior to August 26, 2003. Taxpayers in other circuits could also rely on the decisions although they should be aware that the other circuits are not required to follow the Ninth Circuit. In addition the decisions cast some doubt on tax regulations which require stock-based compensation to be included as intangible asset development costs. Taxpayers might have some basis to contest the cost-sharing regulations. (Oates & O'Brien 2010)

***VERITAS Software Corp. & Subsidiaries, et al. v. Commissioner*, 133 TC 297, 12/10/2009**

VERITAS Software Corp. (VERITAS US) does both upstream and downstream activities for advanced storage-management software products and services. In 1999 VERITAS US transferred its existing intangibles to a wholly-owned Irish subsidiary called VERITAS Ireland. The intangibles were transferred as part of the cost-sharing arrangement known as the Agreement for Sharing Research and Development Costs (RDA) and the Technology License Agreement (TLA). The TLA contained details on a lump-sum buy-in payment amount VERITAS Ireland would pay to VERITAS US for the right to use all the intangibles listed in the agreement. The buy-in payment totaled $124 million after adjustment and was paid during 1999 and 2000.

In 2006, the IRS issued a notice of deficiency to VERITAS for $758 million plus Sec. 6662 penalties based on the adjusted audited value of the buy-in agreement with VERITAS Ireland in the 1999 and 2000 tax years. The IRS originally set the buy-in payment at $2.5 billion but later (in 2008) reduced it to $1.675 billion in a pre-trial motion. Pre-trial stipulations also determined that the buy-in payment value was limited to the value of preexisting intangibles as provided in Reg. Sec. 1.482-7(g)(2).

The IRS argued that the proper method for valuing the buy-in payment was the income method. The IRS expert discounted the aggregate future cash flows expected for royalties under the cost-sharing arrangement assuming that the preexisting intangibles had a perpetual life and a 22.22% royalty rate. The IRS expert referred to the pre-existing intangibles as platform contributions, a term that was not introduced into the regulations until 2007. The IRS expert who did the final calculations does not appear to have been involved until sometime in late 2006 or early 2007.

The Tax Court rejected the income method that it called the "akin-to-a-sale" theory. The Tax Court had issues with the following items:

- The IRS's change of the buy-in adjustment from $2.5 billion to $1.675 billion with no explanation.
- The IRS expert's use of terms and theory from regulations that were not proposed until 2007 and did not go into effect until 2009.
- The IRS expert's aggregation of the transactions and use of the akin-to-a-sale theory without establishing that it produced the "most reliable means of determining the arm's-length consideration for the controlled transactions".

- The perpetual life assumption for the transferred intangibles.
- The following terms in calculating the discount rate: the yield on the 20-year U.S. Treasury bonds as of March 31, 2000, without adjustment for T-bills to determine the equity risk premium and the industry beta. The expert's final discount rate was 13.7%.
- The IRS expert's use of an unsupported growth rate for 2001 through 2005 that would have resulted in $1.9 billion in losses.
- The IRS buy-in payment amount including values for distribution channels, customer lists, and customer bases when none existed. The IRS also included values for access to VERITAS US R&D and marketing teams when there was insufficient evidence to indicate these items had value or were transferred. (Access to R&D and marketing teams is now referred to as assembled workforce and is included in the current regulations.)
- The IRS expert's inclusion of the rights to future co-developed intangibles in the buy-in payment when the 1999 – 2000 regulations did not include these rights. (This is part of the platform contributions included in the current regulations.)
- VERITAS US argued that the comparable uncontrolled transaction (CUT) method was the proper method to value the buy-in payment. VERITAS US did business with numerous other unrelated parties. From 1997 to 2006 the sale of software to the unrelated parties was governed by original equipment manufacturer (OEM) agreements. The software was sold under the OEMs either bundled with the operating systems or unbundled as an option. The petitioner's expert chose seven of the OEM agreements based on the availability of numbers and calculated a royalty rate of 20% with a useful life of two to four years.

The Tax Court agreed with the use of the CUT method but determined that the unbundled OEM agreements were the most comparable to the controlled transactions based on the comparability standards in Reg. Sec. 1.482-1(d). VERITAS US had ninety unbundled OEM agreements from 1997 to 2006 with an average royalty rate of 32%. The Tax Court decided on a useful life of four years with a sliding royalty rate from Years one to four of 32%, 21%, 14% and 10%, respectively. Finally, the Tax Court used the company-specific beta of 1.935 and computed a discount rate of 20.47%.

The IRS did not acquiesce to the Tax Court's decision. The IRS said it would continue to aggregate interrelated transactions when it provided the most reliable measure of an arm's-length result. The IRS also defended its use of the expected future value of intangibles in the buy-in payment, i.e. the platform contribution (Editors 2011).

THE U.S. TREASURY DEPARTMENT AND INTERNAL REVENUE SERVICE HAVE BEEN BUSY

The Treasury Department and its Internal Revenue Service have been hard at work developing policies and instituting organizations changes to meet the challenges of the transfer pricing issue. These policies and changes are described in the following sections.

Coordinated Issue Paper

As part of its objective to coordinate and resolve complex and significant issues, the IRS issues coordinated issue papers. These documents provide guidance to field examiners and attempt to ensure uniform application of the law.

The IRS issued a coordinated issue paper on Sec. 482 cost sharing arrangement buy-in adjustments in September 2007 (Internal Revenue Service 2013a).

The coordinated issue paper discussed an initial buy-in and a subsequent acquisition buy-in. For an initial buy-in the paper indicated that the income method was the best method for determining the arm's-length charge for an initial buy-in. The paper indicated that the acquisition price was the best method for a subsequent acquisition buy-in. The issue paper was not identical to the 2009 cost-sharing temporary regulations, but the logic was similar to those regulations. The Tax Court's decision in VERITAS Software Corp. discussed above was a direct challenge to the conceptual framework that the IRS has developed for determining an arm's-length "buy-in" for pre-cost-sharing technology.

Treasury Regulations Involving Transfer Pricing of Intangibles

Both during and since the GSK proceedings, Treasury has been busy updating the regulations under Sec. 482 to address transfer pricing of intangibles. Temporary regulations were issued in 2006 (Treasury Department 2006) Final regulations were issued in 2009 (Treasury Department 2009). Additional final regulations were issued in 2011 (Treasury Department 2011) Reg. Sec. 1.482-7 - Methods to determine taxable income in connection with a cost sharing arrangement and Reg. Sec. 1.482-9 - Methods to determine taxable income in connection with a controlled services transaction now contain the primary regulatory provisions related to the transfer pricing of intangibles. Many of the details in the regulations were discussed above in the analysis of the court cases.

The regulations (Treasury Department 2011) provide a great deal of guidance on the methods required to value cost-shared intangibles. The allowable methods are:

- The comparable uncontrolled transaction method or the comparable uncontrolled services price method;
- The income method;
- The acquisition price method;
- The market capitalization method;
- The residual profit spit method; or
- Unspecified methods.

Reg. Sec. 1.482-7 discusses cost-sharing arrangements and platform contribution transactions. Controlled participants must share intangible development costs in proportion to their reasonably anticipated benefits. A cost-sharing arrangement is an arrangement by which controlled participants share the costs and risks of developing cost shared intangibles in proportion to their reasonably expected benefits. In a platform contribution transaction (PCT) each PCT payor is obligated to make arm's-length payments to each PCT payee that provides a platform contribution for the rights to share in the contribution. A platform contribution is a resource, capability, or right that a controlled participant has developed, maintained, acquired externally to the intangible development activity that is reasonably anticipated to contribute to developing cost shared intangibles. The cost sharing buy-in payments discussed under the coordinated issue paper are PCT's.

The cost sharing regulations are extensive and difficult to apply. Due to the substantial economic results, multinational corporations and the IRS will continue to use the regulations to their benefit when possible. Other authors have suggested that these regulations will only have impact on new contributions to cost-sharing arrangements – new platform contributions. In these cases complying with the regulations requires extensive (and costly) up-front valuation work that is then subject to periodic adjustments (Kochman & Smiley 2009).

Substantial Valuation Misstatement Penalty on Transfer Pricing

The penalty provisions of the Internal Revenue Code and its related regulations help the IRS to "walk softly and carry a big stick." The strategy is to make tax evasion so expensive that taxpayers avoid the result by complying with the provisions of law. The accuracy-related penalties are to encourage taxpayers to properly value property and services and avoid litigation related to these valuations. Sec. 6662 and Reg. Section 1.6662-6 impose the accuracy-related penalty for substantial valuation misstatement to related party transactions that fail the arm's-length standard for pricing property and services. Under Reg. Sec. 1.6662-6(a) and (b) the 20% substantial valuation misstatement penalty applies when the price reported is 200% or more (or 50% or less) than the arm's length price. Under Reg. Sec. 1.6662-6(c) and (f) the net adjustment penalty is imposed on excessive net Sec. 482 adjustments. The 20% substantial valuation misstatement penalty applies when the net Sec. 482 adjustment for a tax year exceeds the lesser of $5 million or 10% of the taxpayer's gross receipts. The 40% gross valuation misstatement valuation penalty applies when the net Sec. 482 adjustment exceeds the lesser of $20 million or 20% of the taxpayer's gross receipts.

Exceptions to these penalties apply if substantial calculation and documentation requirement are satisfied. As with most of these provisions, the words "reasonable" and "facts and circumstances" are constantly used in these regulations. These words inevitably lead to a great deal of litigation.

These provisions are not new. The most recent regulations were issued in 1996.

International Realignment

The IRS announced its new efforts to deal with transfer pricing in July 2011 (Internal Revenue Service 2011). In one effort to enhance transfer pricing compliance, the IRS moved their Advance Pricing Agreement Program (APAP) from the office of IRS Chief Counsel to the Large Business and International (LB&I) division. The program is now under the Transfer Pricing Director with the international operation of the LB&I.

The IRS Mutual Agreement Program (MAP) has been moved to the same office within the LB&I. The MAP's primary function is to deal with transfer pricing disputes with U.S. treaty partners. As a result both the APAP and the MAP are under the direction of a single executive. With expected increased staffing, this combined function should allow the IRS to reduce the time needed to complete advance pricing agreements and to resolve transfer pricing disputes with treaty partners. The Office of Chief Counsel will remain a vital partner in the analysis and resolution of legal issues.

In recognition of the increasingly global environment, the IRS is moving its competent authority and international coordination functions to an International Assistant Deputy Commissioner. This Commissioner will:

- coordinate international activities across all IRS operating divisions,
- oversee the IRS Exchange of Information program and IRS participation in the Joint International Tax Shelter Information Centre (JITSIC),
- manage the activities of the IRS Tax Attaches in the agency's foreign posts of duty,
- coordinate IRS participation at the Organisation for Economic Cooperation and Development (OECD) and other non-governmental organizations, and
- pursue competent authority agreements with treaty partners on issues other than transfer pricing. Internal Revenue Service (2012a)

Advance Pricing and Mutual Agreement Report

The Advance Pricing Agreement (APA) Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner as an alternative to the traditional adversarial process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method. The APA Program provides an alternative dispute resolution mechanism for taxpayers and the IRS to resolve complex international transfer pricing cases (Internal Revenue Service 2012b).

Since 1999 the Advance Pricing Agreement (APA) Program has been required to issue annual reports. The report for 2013 was issued by the new Advance Pricing and Mutual Agreement (APMA) office. The APMA is the result of the merger of the APA program and the portion of the Office of the U.S. Competent Authority (USCA) that resolves transfer pricing cases under the mutual agreement procedures of the United States' bilateral income tax conventions (Internal Revenue Service 2013b).

In 2011 the agency completed 43 APAs, down from a total of 69 APAs in 2010. In 2012 the agency increased the number of APAs executed to 140 – an all-time high for any year. The average time to complete an APA decreased from 40.7 months in 2011 to 39.8 months in 2012. Part of the increased numbers was due to an increase in personnel. But there were also a record number of new APA applications filed – 126 applications. The new agency added personnel in 2011 resulting in a 50% increase in the number of employees. The agency continued to increase personnel in 2012 – adding approximately 70 staff and seven managers. There has been a significant focus on hiring economists. Two economist managers and 20 economists were added during 2013. The agency expects reduce the average processing time for APAs over the next few years due to increased resources.

A WORLDWIDE SOLUTION FROM THE ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT

With our business world becoming more and more global, the solutions provided by a single governmental entity are becoming less and less applicable. A global solution with all governmental units working together seems to be the rational approach to transfer pricing. The Organization for Economic Cooperation Development (OECD) is in the process of proposing such a solution for transfer pricing. The OECD issued a 2012 discussion draft containing a plan for developing safe harbors on transfer pricing (OECD 2012).

Since the basis of transfer pricing is to develop an "arm's-length" proxy for intercompany transfers, every group of companies attempts to set up a unique set of facts and circumstances that benefits that group of companies. The appropriate government entities then attempt to impose appropriate limitations to protect each of the entities' interests. The government entities have to set the limits because the economic ramifications are huge, but the resulting negotiations are time-consuming and expensive.

The OECD's approach is to set up a set of safe harbors that allow for a reasonable approach to transfer pricing that reduces compliance costs for taxpayers and resource use for governments. The goal of a safe-harbor approach would be to substitute simplifying rules for the current complex arm's-lengths computations. The OECD's approach will only work if the tax authorities in the various countries adopt the approach. This would require bilateral agreements between multiple taxing authorities.

In 2013, the OECD went a step further by releasing an action plan (OECD 2013). The purpose of the action plan is to reduce the use of tax structures by multinational companies who reduce their overall rate of tax by exploiting inconsistencies in different jurisdictional tax systems or artificially shifting profits to tax jurisdictions. One of the "main pressure areas" addressed in the project is the artificial splitting of ownership of intangibles.

The IRS is paying attention to the work of the OECD. In March 2013 the IRS issued IR 2013-30 requesting public comments regarding the development of a "model memorandum of understanding between Competent Authorities on certain transfer pricing issues" – specifically bilateral safe harbors for arm's-length compensation for routine distributions frequently at issue in transfer pricing cases (Internal Revenue Service 2013c).

CONCLUSION

The GSK out-of-court agreement left a vacuum since the agreement did not publicly disclose the agreement's circumstances. A court case would have carefully described the facts, circumstances and transfer-pricing law that led to the agreement. Court cases and new regulations now provide more assistance in determining a fair transfer price for intangibles.

The transfer pricing issue has been present for a long period of time. The globalization of business and increasing pressures to maximize profits are increasing the pressures on businesses and governmental entities to effectively use and control transfer pricing by multi-jurisdictional companies. A reasonable solution is not simple. Increased efforts by governmental units to impose restrictions are immediately countered by increased efforts by tax planners to reduce taxes by circumventing those restrictions. Any issue that involves such assumptions as "arm's length" and "commensurate with income" always results in extensive litigation if the economic consequences are large. A "safe-harbor" approach such as the solution being proposed by the OECD might be the best solution to this problem.

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