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Having to pay more than U.S.$3 billion of tax to settle[1] a dispute with a tax authority – the biggest such payment ever – would be bad enough for any taxpayer, even one the size of GlaxoSmithKline; what really sends a shiver down the spine of many U.K. tax directors is that, unless the U.K. government has a change of heart, this is *double taxation*.

We all know in theory what double taxation means, but for most of us significant double taxation is fortunately a rarity we seldom come across in practice. So it is worth spelling out what it means: this company has had to pay U.S. taxes on a large chunk of the profits it earned since 1989, even though those same profits have *already suffered* U.K. tax. Tax rates have varied over the years, but roughly speaking this means that the U.K. and U.S. governments have each taken one third of the profits in question, leaving only the last third to the group that made those profits.

I. Double Taxation

Based on informal discussions with a number of leading U.K. tax directors, this is the aspect of the Glaxo case that is of most concern to them. The case also raises some important technical issues, which we will come back to, but it is the failure of mutual agreement procedures (MAP) under the U.K.-U.S. double tax agreement (DTA) that we will consider first.

The dispute between Glaxo and the IRS had been brewing for many years. It started as an enquiry by the IRS into the profits returned by Glaxo's U.S. subsidiaries in the late 1980s. The IRS felt that the transfer pricing used by Glaxo had under-rewarded these subsidiaries for their role in U.S. marketing of the drugs developed in Glaxo's U.K. laboratories. When it became clear to Glaxo that the IRS would insist on adjusting U.S. profits, the company invoked its right under the DTA to oblige the competent authorities of the U.K. and U.S. to enter into negotiations under MAP to come to a common agreement as to the arm's length transfer pricing.

No doubt[2] Glaxo hoped that the U.K. tax authorities (HMRC) would help convince the IRS that they were being unreasonable and should wholly or partially back down. One assumes that Glaxo preferred to maximise the portion of its profits taxable in the U.K. and minimise the U.S. portion. The worst case scenario *should* have been that the IRS would have succeeded in convincing HMRC that a transfer pricing adjustment to increase U.S. profits is justified and, crucially, that there should therefore be a corresponding adjustment to reduce U.K. taxable profits by the same amount.

Unfortunately, neither of those scenarios happened. As most readers will know, the MAP article of the DTA only requires that the competent authorities "endeavour" to resolve "any difficulties or doubts arising as to the interpretation or application of" the DTA. They have to *try* to come to an agreement, in order to avoid the taxpayer suffering double taxation. But they do not have to agree; they can, and in this case did, fail to reach common ground.

The potential for such an unsatisfactory outcome is not new, and there have been previous failures of MAP, but competent authorities in the U.K., the U.S. and many other countries have generally taken very seriously the spirit of the DTA, which is that taxpayers should not suffer double taxation. In the vast majority of cases, tax authorities have done what it takes to achieve this objective; at times making concessions they may have felt were not technically justified in order to bridge a gap with the other authority. That this did not happen in such a high profile case involving such a large sum of money as Glaxo is a real bombshell.

A. MAP Broken?

What many UK tax directors are wondering is whether the U.K.-U.S. competent authority process is "broken". That is, having done the unthinkable once, will the competent authorities find it easier in the future to leave a taxpayer stuck with double taxation? Views on this vary, although everyone agrees it is impossible to be sure at this stage. There is some speculation that the failure of MAP in Glaxo may have arisen because the U.K. competent authority was not as aggressive as the U.S. competent authority and was not able to match the resources brought to bear by the IRS, yet was unwilling to concede a corresponding adjustment as they considered the IRS was wrong. However, the majority view is that Glaxo is more likely an aberration, that HMRC does generally do what it reasonably can to protect the interests of U.K. taxpayers whilst avoiding double taxation, and that both HMRC and the IRS still appear committed to trying to make it work wherever possible. Therefore, it is too early to pronounce MAP broken, though a few more failures may cause more widespread disquiet.

Nevertheless, the prospect of suffering double taxation on such a scale, with the consequent hike in the group's effective tax rate, is a tax director's worst nightmare. Many are now highly concerned about the perverse arrangement under which not only are the two tax authorities permitted to fail to come to an agreement, but also neither of them will suffer direct adverse consequences if this happens. It cannot be right that they can simply shrug their shoulders and agree to disagree, leaving someone else (the taxpayer) to pay the price of that failure. With such poor incentives, it is a testament to the good faith with which competent authorities have generally exercised their responsibilities that MAP failure is as rare as it is.

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B. Avoidance?

There are those who will suggest that it is easy for tax directors to avoid this fate: they should simply stop adopting aggressive transfer pricing policies. The problem is that this is very much in the eye of the beholder. To some U.S. eyes,[3] Glaxo's transfer pricing policies are just another example of abusive avoidance of U.S. tax, yet clearly the U.K. competent authority saw it entirely differently. If the pricing was so obviously wrong, surely the IRS should not have found it difficult to persuade HMRC to agree and therefore to allow a corresponding adjustment. The failure of MAP in Glaxo's case is a graphic illustration of the difficulty faced by tax directors the world over in trying to arrive at a pricing policy that will be acceptable to the tax authorities at both ends of the transaction.

C. Advance Pricing Agreements

In some cases, tax directors may become keener to put in place APAs, because this will at least ensure no double taxation and will also help prevent long-running disputes, which are costly in terms of professional fees and internal time. APAs are of course also time-consuming and costly to do. Moreover, tax authorities may not always agree to enter into APA negotiations, as was the case with Glaxo itself. Therefore, although the experience of Glaxo may be sufficient to tip the balance for a tax director who has already been wavering over the pros and cons of seeking an APA, this is not a practical solution for many multinationals.

D. Binding Arbitration

It is becoming increasingly evident that what is needed is some form of binding arbitration requirement, rather than the current quaint "we'll try to help you out if we can" arrangement. Double taxation is in the long-term interests of no-one. There should be a requirement that the competent authorities *must* reach agreement and provision for some sort of independent body to impose an answer (on a reasonable timetable) if they cannot reach agreement.

There is already some precedent for this. The EU Arbitration Convention has applied between EU members since 2005, and is generally considered to have been successful (even though it is little used, that may well be a signal of its success, as tax authorities prefer to make concessions in MAP rather than risking an even less favourable outcome if they leave the question open to a higher authority). More recently, on June 1, 2006, Germany and the U.S. signed a protocol to amend their DTA to add, among other things, a mandatory binding arbitration provision. The U.S. has said[4] that this will become a "basic principle in future US treaty negotiations".

And the OECD has for the last few years had a project considering ways of Improving the Process for Resolving International Tax Disputes. In February this year they released a public discussion draft of a report entitled "Proposals For Improving Mechanisms For The Resolution Of Tax Treaty Disputes". Thankfully, this does propose adding binding arbitration to the Model Tax Convention, which forms the basis of many DTAs. Specifically, it proposes adding the following paragraph to the MAP article:

> 5. Where, under paragraph 1, a person has presented a case to the competent authority of a Contracting State and the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the presentation of the case to the competent authority of the other Contracting State, any unresolved issues arising from the case shall be submitted to arbitration if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if any person directly affected by the case is still entitled, under the domestic law of either State, to have courts or administrative tribunals of that State decide the same issues or if a decision on the same issues has already been rendered by such a court or administrative tribunal. The arbitration decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.

There is likely to be some further discussion about the precise nature of any arbitration procedures. The U.S. favours what is known as "baseball arbitration", under which the arbitrator has a binary choice between the positions suggested by each country. The idea is that the arbitrator will choose the "bid" that is the most reasonable, so the process will discourage the adoption of extreme positions. The model in the EU arbitration convention is that the arbitrator may choose any answer, including one that is a middle ground between the two positions. The taxpayer remains free to accept the position or not but if they reject the arbiter's decision they face litigation and possible double taxation if they lose.

However, one would imagine that Glaxo would have been thankful to have been able to invoke either kind of binding arbitration, rather than having to litigate and, ultimately, to suffer double taxation. It is therefore to be hoped that any disputes over procedures do not prevent the prompt introduction of binding arbitration.

Completion of these changes by the OECD are only half the battle, however. The new paragraph will not be effective in relation to any particular DTA unless and until the DTA is changed to add the new paragraph, either by way of a bilateral protocol or by incorporating it when a DTA is next renegotiated. Arguably, U.K. multinationals concerned about the failure of MAP in Glaxo's case should lobby government to implement a programme seeking to add binding arbitration to all the U.K.'s DTAs as a matter of urgency. DTAs with EU countries and with smaller trading partners are perhaps a lower priority, but we can't afford to wait for the next full renegotiation of the DTAs with the likes of the U.S., Canada, Japan, Australia and other non-EU economies in which U.K. PLCs have major investments.

II. Technical Issues

Let's turn to some of the technical transfer pricing issues raised in Glaxo. Here, we are reduced to guesswork, because the case has been settled out of court, so we do not have the full facts. However, the case is widely considered to boil down to the question of whether the profits made by Glaxo in the US were primarily attributable to:

a. The U.K. research and development activities from which arose the patented drugs that gave rise to the majority of Glaxo's US sales revenue; or
b. The U.S. marketing and distribution activities that sold those drugs.

Glaxo's transfer pricing apparently resulted in Glaxo U.K. making the majority of the profits from U.S. sales, on the grounds that the drugs developed by the U.K. R&D function are the main reason why Glaxo had such high sales in the U.S. The IRS apparently contended that the drugs were not actually that special and that most of the success in the U.S. is attributable to the U.S. marketing and sales.

Perhaps one way to think about the disagreement is by considering Zantac and Tagamet. In the 1980s, long before its takeover by Glaxo in 2000, SmithKline launched a novel anti-ulcer drug called Tagamet. Glaxo subsequently launched Zantac, claiming it had several significant benefits over Tagamet, such as fewer doses per day and lower dosage. Zantac soon overtook Tagamet to become the biggest selling drug in the world, representing more than half Glaxo's total sales revenue at times.

At the risk of oversimplification, it would seem to be implicit in the IRS position that if the drugs had been the other way around and it had been Glaxo's marketing and sales team that was selling Tagamet, Glaxo would still have outsold SmithKline. Conversely, it would seem to be implicit in Glaxo's position that Zantac was such a superior drug that if SmithKline were the ones who were selling Zantac they would have outsold Glaxo.

Viewed in this way, it would seem that to support their case the IRS would have to prove that the Glaxo U.S. sales and marketing operation had unique techniques, or know how, or procedures, or other ways of performing their role, that would explain why Zantac became the top-selling drug. What is surprising is that the public reports of the case show very little evidence being put forward by the IRS to this effect. The IRS found some statements by Glaxo about the importance of sales and marketing, but sales and marketing are important to virtually every business. This seems a far cry from proving that there was something so exceptional about Glaxo U.S.'s sales capability that they would have been able to persuade an unrelated patent holder to let them keep most of the profits from selling Zantac.

Was the IRS case really as flimsy as it seems or were there undisclosed facts and expert witness statements that they would have employed if the case had been completed? Or, worse, did they genuinely believe that they did not have to show that there was something exceptional about Glaxo's U.S. marketing function? If the latter is true, perhaps they are arguing that any competent sales and marketing function is entitled to more than a routine return on its activities? There are hints in the current proposed new temporary services regulations that this is exactly what the IRS thinks.

It is difficult to judge the real basis of the IRS's case. Most reports of the case have focused on comparing marketing and R&D functions, but there are some indications to suggest that it was also important who bore the risk of R&D and marketing.

The IRS is reported as having claimed that although R&D is normally a high-risk venture in the absence of a guaranteed end product, the licence agreement under which Glaxo U.K. supplied trademark products to Glaxo U.S. did not involve material risk for Glaxo U.K., as contractually Glaxo U.S. would have to pay a fixed sum regardless of the product supplied. It is difficult to know quite what that means, but one interpretation would be that Glaxo U.S. effectively bore the entrepreneurial risk of the U.K. R&D. If that conclusion was borne out by the facts (which is far from clear), the IRS case would seem a lot stronger.

A. Tendency to Ignore Risk

One of the lessons drawn by some in the U.K. is that there is a tendency by tax authorities to focus their analysis of transfer pricing on the functions being performed, but to give insufficient attention and weight to risks or assets. Perhaps this reflects the fact that the Glaxo case originated in years when transfer pricing rules and analysis were somewhat less sophisticated than they are now. Nevertheless, some taxpayers and advisers may decide to revisit their transfer pricing documentation, to be more explicit in explaining the importance of assets and risks.

B. Relevance to Other Industries

It is tempting to conclude that Glaxo is probably fact-specific, so has little relevance to other taxpayers. However, it is known that IRS officials are making bullish statements about wanting to apply the same sort of attack to other taxpayers. Is it just pharmaceutical companies that should be sweating?

Well, it depends what you think Glaxo was about. At its broadest, it can be interpreted as an attempt to challenge the fundamental assumptions underlying a transfer pricing policy and argue that functions should not be dismissed as being routine services that deserve a low return (such as a small distribution margin or a cost plus fee) if in fact the functions are more valuable than that. Viewed in that way, it arguably means that any multinational whose transfer pricing involves characterising one participant in a transaction as being, say, a simple distributor or simple service provider should be reconsidering whether tax authorities could argue that this is too one-sided an analysis.

Whether the IRS was wrong or right to do this in Glaxo's case, tax authorities may draw the lesson that with sufficient determination it is possible to mount this kind of challenge successfully. They may therefore be spurred to try a similar approach. This case should therefore give pause for thought not just to pharmaceutical companies.

In fact, most drug companies have examined their transfer pricing policies in the light of Glaxo's experience and most appear to be concluding that their facts and their pricing policy are very different from those of Glaxo in the years covered by this case (at least as far as can be determined from the reports of the case). This does not necessarily mean they can relax, but nor does it seem likely that the IRS can simply brand other drug companies as being the same as Glaxo and collect extra tax without further ado.

C. Future Trends

The problem is that companies often adopt simple characterisations because these are the only ones for which it is easy to set a price. Applying transfer pricing rules and finding comparable data is usually very difficult, so conclusions are sometimes influenced by what methods can be applied and what methods are acceptable to tax authorities.

If you accept that a simple at risk distributor is not in fact simple and that its marketing techniques entitle it to a non-routine share of profits, you are often going to conclude that the only one of the five transfer pricing methods that can reflect valuable contributions from both parties to the transaction is the profit split method. That presents a dilemma, as profit split is the method that many tax authorities are most sceptical of, because there is rarely any data to prove what the arm's length split of profits should be, so applying it can often be very arbitrary.

Perhaps in five years time we will see the Glaxo case as one of the catalysts for a move to recognising profit split method as the most commonly appropriate method, rather than the last resort in cases where non-routine functions and risks are carried by more than one side.

D. Application to Other Countries

Although the Glaxo case concerned a U.K. company with a U.S. subsidiary, there is little to suggest that the technical arguments applied by the IRS are only applicable to British companies. Nor is there much to suggest that these are arguments that can only be wielded by the IRS. Indeed, although the case arguably does not introduce any new principles, it seems probable that the high profile success of the IRS may encourage other tax authorities (including HMRC) to apply similar challenges with similar determination in their own countries.

It would be richly ironic if the IRS finds itself being asked by a U.S. multinational to give a corresponding adjustment to reduce U.S. profits as a result of suffering a transfer pricing adjustment in another country, based on the same arguments as the IRS have used to bludgeon Glaxo.

III. Conclusion

It is difficult to know what precise impact this case will have over the next few years. Perhaps it will help to provide the impetus needed to introduce binding arbitration on a widespread basis. Perhaps it will lead us into a world where profit split analysis is the norm. Perhaps it will rebound on the IRS in its impact on U.S. multinationals. For certain it will be fascinating to watch.

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1 On September 11, 2006, the U.K. multinational, GlaxoSmithKline and the IRS announced that they had agreed an out-of-court settlement which brought an end to Glaxo's litigation in relation to a transfer pricing assessment raised by the IRS. The cost to Glaxo is U.S.$3-4 billion, depending on how it is measured.

2 For the avoidance of doubt, the author of this article has no knowledge of the dispute or of Glaxo's transfer pricing, other than the information in the public domain.

3 For instance, see the press release by US Senator Carl Levin on September 26, 2006 setting out his statement to the Subcommittee on Federal Financial Management, Government Information, and International Security Hearing on 'Deconstructing the Tax Code: Uncollected Taxes and Issues of Transparency'.

4 Hal Hicks, International Tax Counsel to the US Treasury, speech to International Tax Conference, Washington, June 5, 2006 (published on OECD website).