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Subject: Hi Richard, here is the article. Thanks for all your help with the UK accounting questions.

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Bermuda Triangle **How Merck Saved** **\$1.5 Billion Paying** **Itself for Drug Patents**

Partnership With British Bank
Moved Liabilities Offshore;
Alarmed U.S. Cracks Down

'The Art of Tax Avoidance'

By **JESSE DRUCKER**
September 28, 2006; Page A1

SOUTHAMPTON, Bermuda -- **Merck & Co.**'s medications Zocor and Mevacor have been used by millions of people to help lower their cholesterol. But Merck also used the drugs to lower something else: its U.S. tax bill.

Thirteen years ago, Merck set up a subsidiary with an address in tax-friendly Bermuda, in partnership with a British bank. Merck quietly transferred patents underlying the blockbuster drugs to the new subsidiary, according to documents and people familiar with the transaction. Merck then paid the subsidiary for use of the patents.

The arrangement in effect allowed some of the profits to disappear into a kind of Bermuda triangle between different tax jurisdictions. The setup helped Merck slash \$1.5 billion off its federal tax bills over roughly the next 10 years.

Now, the complicated transaction -- never publicly disclosed -- has sparked one of the largest tax disputes ever involving a U.S. corporation. The Internal Revenue Service is challenging the tax benefits from the arrangement, which the company code-named "Project Ryland," after a fancy restaurant near the company's New Jersey headquarters. Merck anticipates it will be ordered to hand over a total of \$2.3 billion in back taxes, interest and penalties, according to its filings with the Securities and Exchange Commission, which give the amounts in dispute but virtually no other details.

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Merck says it did nothing wrong and that the deal was simply a way of raising financing for its 1993 acquisition of a pharmacy-benefits management firm, Medco Containment Services Inc. "We believe the partnership transaction is in full compliance with IRS rules and regulations and we vigorously disagree with the proposed IRS adjustments," says Merck spokesman Raymond Kerins, who declines to discuss details of the dispute.

The IRS won't discuss its objection to the Merck partnership. But it is pursuing actions against **Dow Chemical Co.** and **General Electric Co.** over similar arrangements they set up within a few months of the Merck deal. Those, federal tax authorities have argued, weren't real partnerships with foreign banks but just well-disguised loan agreements, designed to avoid taxes by maneuvering between the tax laws of different countries, with no economic substance.

SAVINGS PLAN

How drug maker Merck's tax-saving partnership worked with U.K. bank Abbey National PLC:

- Merck sets up MSD Technology LP and contributes its patents for Zocor and Mevacor.
- Abbey unit buys a portion of MSD for cash; the majority is owned by Merck subsidiaries.
- Merck pays MSD royalties to use patents it formerly owned.
- On MSD's books, some taxable income is technically allocated to Abbey, reducing Merck's tax liability.
- Abbey isn't taxed by the U.K. on the allocation. It also receives smaller, taxable cash payments from MSD.
- MSD indirectly loans Merck back much of the money Merck paid it for patent use.
- Merck pays interest but largely recaptures it when the partnership is liquidated.

The Second U.S. Circuit Court of Appeals last month reversed a trial court and declared that foreign banks in the GE deal were not "bona fide equity partners," a victory for the government in its battle over \$62 million in back taxes. GE is seeking a rehearing. Meanwhile, in a little-noticed dispute in U.S. District Court in Baton Rouge, La., the IRS claimed last year that Dow improperly lowered its tax bill by about \$130 million by shifting income, through a partnership, to a consortium of German, Dutch, U.K. and Belgian banks. Dow says the arrangement was legitimate financing and is suing the government to try to keep the money.

As part of that case, the Justice Department says in a court filing it anticipates taking "extensive discovery" from investment bank **Goldman Sachs Group Inc.**, which helped structure both the Dow and Merck deals. Goldman spokesman Peter Rose said, "We take enormous efforts to ensure our transactions comply with applicable tax laws."

The cases are part of an attempt by U.S. authorities to crack down on what is often called "tax arbitrage." The usual strategy: lower a company's tax bills by structuring transactions so certain types of income or expenses are classified as one thing by the IRS, but something very different by another country's tax regulators.

Often the strategies are aided by overseas banks or nonprofit organizations that use complex legal structures to effectively share their tax advantages with U.S. companies. U.S. and U.K. banks also have teamed up to devise structures that lower each other's taxes. IRS Commissioner Mark Everson warned a U.S. Senate panel in June that strategies like those are "on the rise."

Mr. Everson named tax arbitrage as among the most significant enforcement problems the agency faces. He said the IRS has formed a team to consider crafting

new international treaties, as well as performing tax audits that would simultaneously look at a company's tax obligations in multiple countries.

Proponents of the deals say it's only smart business to take advantage of U.S. loopholes and the differences among tax rules around the world. Technology and pharmaceutical companies, for instance, are aggressively shifting intellectual-property assets to countries with far lower tax rates, such as Singapore and Ireland.

Merck's potentially costly dispute with the IRS comes as the company battles more than 14,000 lawsuits related to its now-withdrawn Vioxx pain reliever, with its projected liability topping \$4 billion. Like other big drug makers, Merck's biggest sellers are losing patent protection while its newer drugs are not expected to make up the lost revenue.

Many of the strategies like the ones used by Merck, Dow and GE were inspired by one man.

In 1988, longtime tax attorney and New York University law school professor R. Donald Turlington published an influential article in the proceedings of a tax conference. Subtitled "The Art of Tax Avoidance," the article began with a 1931 quote from the late Chicago Mafia boss Al Capone: "A good lawyer with a briefcase can steal more than ten men with machine guns."

In the article, Mr. Turlington laid out ways companies could lower their taxes by exploiting a loophole in the way income was allocated within partnerships for tax purposes. He focused on the concept of depreciation, a key tool to lowering taxes.

For example, in the U.S. a factory is considered to have a finite life of 39 1/2 years and loses its value gradually during that life. An owner is allowed to deduct a portion of its cost each year, so if the factory cost \$39.5 million, the company can deduct \$1 million a year from the plant's taxable income. But after that, a company can end up with considerable income from the asset and no offsetting deductions. In the case of pharmaceutical patents, tax write-offs generally are used up during research and development.

Mr. Turlington pointed to a way around such problems by putting the already-depreciated asset into a partnership, and allocating some of its taxable income to a member of the partnership that for one reason or another wouldn't mind shouldering it. That could reduce the tax bill for the company contributing the assets.

Closing the Loophole

Mr. Turlington called on the government to close this loophole, and in December 1992, the U.S. Treasury Department decided to do just that, proposing an "anti-abuse" regulation. But before the government finalized the new regulations a year later, several companies moved to shift assets and establish partnerships to exploit the loophole.

Mr. Turlington himself helped structure the Merck deal, counseling Goldman Sachs on the transaction, despite his call for the law to be changed.

Merck, GE and Dow Chemical also were aided by some of the country's most prominent partnership tax lawyers, who also once served in high government tax

posts. William Nelson, a former IRS chief counsel, advised Merck and GE on their deals, according to people with knowledge of his involvement. The firm he founded with William McKee, a former University of Virginia law professor and U.S. Treasury Department tax legislative counsel, litigated the GE dispute with the government at trial. The firm also is representing Dow in the litigation over its disputed partnership. Mr. Nelson and Mr. McKee declined to comment on the Merck deal.

In July 1993 -- about six months after the government identified the partnership loophole -- Merck announced a \$6 billion deal to acquire Medco, the pharmacy-benefits manager. It had cash on hand to fund only part of the giant purchase, and said at the time it would need additional financing.

Sometime before the Medco deal was announced, a Goldman banker named David Ackert, along with Mr. Turlington, presented Merck officials with the partnership idea as a way to raise financing and enjoy significant tax savings. Mr. Ackert, who no longer works for Goldman Sachs, referred questions to the investment bank.

At the time, Merck's Mevacor and Zocor were two of the company's biggest-selling drugs. Merck no longer had deductions to write off against the patents, according to a person familiar with the matter.

A few weeks before the Medco deal was announced, Merck transferred ownership of the patents to a new Delaware subsidiary, MSD Technology LP, and then registered other Merck subsidiaries that were partners in MSD to do business in Bermuda, according to U.S. patent records and Bermuda company records.

For its deal to work, Merck needed a partner willing to absorb taxable income. It chose a midsized British bank, a unit of **Abbey National PLC**. The negotiations with Abbey took place in London, Toronto and Bermuda, according to people familiar with the talks. They were held overseas to forestall any issue about whether the partners and the partnership were doing business in the U.S., which could jeopardize the deal's tax treatment. Merck and Abbey's lawyers and investment bankers hammered out much of the complex structure between bowls of fish chowder at Bermuda's posh Southampton Princess hotel.

According to a document filed in an unrelated lawsuit, Abbey took a limited partnership interest in MSD. The arrangement, according to people familiar with the situation, involved Abbey contributing several hundred million dollars in cash to the partnership in exchange for a minority stake. Merck then began paying royalties to the MSD partnership to use the patents covering the anti-cholesterol drugs, these people said.

In effect, Merck was paying itself -- its subsidiaries still owned a majority of MSD -- for the right to use drugs its own scientists had developed. The royalties it paid then largely went straight back into its own coffers, as much of the money was lent to Merck through another subsidiary, according to the people familiar with the transaction. A subsidiary of MSD collected the interest, most of which effectively was returned to Merck when the partnership was liquidated.

The convoluted arrangement gave Merck a sizable tax reduction for roughly a decade. On MSD's internal books -- and only there -- a portion of the incoming royalty payments were allocated as taxable income to Abbey. That reduced Merck's tax liability.

Crucial Element

In a crucial element of the deal, Abbey wasn't liable for those taxes either, because U.K. authorities didn't recognize tax allocations within the books of U.S. partnerships.

In return for its initial cash contribution, Abbey received a stream of payments from MSD. Mr. Turlington and companies that have set up similar transactions liken the payments to preferred dividends. The government has called deals like these loan agreements, not partnerships with the foreign banks, and argued that the cash payments to the banks are really loan interest. In that case, the tax burden can't legally be shifted.

Mr. Turlington, now retired, says the Merck deal with Abbey was a tax-advantaged way to raise significant capital, and not simply a tax-saving measure. "In my mind the question with a deal like Merck was, and still should be, 'Can a taxpayer who decides to do something for a legitimate business reason, like raising [money], do it in a way that's tax efficient by taking advantage of a rule that the government wrote?'" He added: "Merck's obligation is to do the best it can for its shareholders. If you were going to write that Merck is under some higher social obligation to maximize its taxes, that would probably catch Merck by surprise."

The deal also had another benefit: The money raised from Abbey wasn't recorded as debt, so didn't jeopardize the company's stellar credit rating.

Abbey, which has since been purchased by Spain-based Banco Santander Central Hispano SA, said it had no comment on the transaction.

In April 2004, the IRS gave Merck a preliminary notice that it was disputing the company's taxes for four years beginning in 1993, the year the Bermuda partnership was established. Late last year, the tax agency finalized that decision for 1993, and proposed disallowing tax benefits from the following three years, according to Merck's SEC filings. Merck says in the filings that it expects similar final notices for subsequent years.

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