Boosting the knowledge economy: the role of taxation in businesses’ choice of location of intangible property

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Abstract

The changes to the identification and taxation of intangible property in the United Kingdom 2002 Finance Bill were said to be needed in order to clear up the confused and ad hoc rules applicable to intangibles. The Regulatory Impact Statement that accompanied the changes in Schedule 29 indicated inter alia that “[w]ithout reform, the UK would continue to treat intangible assets less favourably than many other countries to the disadvantage of companies based here.” The changes were welcomed and, despite early amendments required to deal with unforeseen consequences of the changes, appear to have been effective in improving the coherence and simplicity of the taxation of intangibles. This paper asks the question whether the reforms have made the UK a more attractive place to do business using intangibles.

Various sources suggest that the location of intangible property is an important choice by taxpayers when they have an opportunity to shift the location of such assets. This paper will identify the types of intangibles likely to be involved and will note the work of writers such as Arias, Henshall, Forbes, Hardgrove et al. and Walsh who are strong advocates for the proper identification and tax effective location of intangible property. The paper will conclude from this that choice of location of intangibles for tax reasons is a deliberate strategic decision on the part of businesses.

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1 This paper is based on an earlier version given at the Tax Research Network Annual Conference University of Southampton (UK) in September 2006. The comments of delegates at that conference are gratefully acknowledged. Correspondence with the authors should be directed to m.walpole@unsw.edu.au.


6 Michael W. Hardgrove, and Alex Voloshko, “Maximize your global IP”, [April, 2003], Journal of Accountancy, 43 – 47.

The paper recognises that tax is not the sole motivation for choices made in the location of intangible property, through, for example the work of Tsiopulos et al\textsuperscript{8}. The paper also recognises that some tax rules make the relocation of certain intangibles impracticable, noting the work in this area of Grubert\textsuperscript{9}, whose economic modelling suggests that in the US “marketing intangibles” cannot be used in international transfer pricing because of the efficacy of the US CFC provisions. For this reason the paper suggests that another indicator of the effectiveness of tax changes in boosting the creation of intangible property may be the growth of new intangible property.

In light of this, the question will be asked whether and what intangibles businesses do have incentives to move around and, in particular, whether the recent changes in the UK have resulted in a change of behaviour on the part of UK corporations. It will identify ways in which this change in behaviour can be measured and what early indications there are of any change in the choice of UK as a location for corporations to hold their intangible assets.

\textit{Introduction}

In the 2002 Finance Act the United Kingdom (UK) parliament introduced several radical changes to the UK approach. This took place after a commendably thorough and lengthy period (starting in 1998) of consultation with taxpayers and representative bodies, and was undertaken because of a perceived need to modernise the tax system and promote innovation. The changes described took effect for assets created or acquired after the commencement date of 1 April 2002\textsuperscript{10}. The old rules continue to apply to assets (“pre commencement assets”) created or acquired prior to the commencement date of 1 April 2002.\textsuperscript{11}

During the lengthy, and busy, consultation period. A total of six consultation documents were issued.\textsuperscript{12} In its Technical Note entitled \textit{Reform of the Taxation of Intellectual


\textsuperscript{9} Harry Grubert, “Intangible income, intercompany transactions, income shifting, and the choice of location” (March 2003) 56 (1) \textit{National Tax Journal}, 221- 242.

\textsuperscript{10} Paragraph 117, Schedule 29 \textit{Finance Act 2002 UK}.

\textsuperscript{11} Shipwright has commented of this that adding this boundary date does not contribute to tax simplification. See Shipwright, A., “Gains and losses from intangible fixed assets of company – section 84 and Schedules 29 and 30” in [2002] No. 4, \textit{British Tax Review}, 301 – 314 , 302.

Property Goodwill and other Intangible Assets (the June 2000 Technical Note) the UK Inland Revenue explained that “…to promote modernisation and innovation, the Government is considering a reform of the taxation of intellectual property, goodwill and other intangibles.”

This would:

- modernise the existing rules giving relief for expenditure on intellectual property; and
- introduce a new relief for purchases of goodwill and other intangibles (with profits on sale taxed as income).

The motivation for this was said to be that the modern economy is knowledge driven and that:

Knowledge is important to all industries, “low tech” and “high tech”, because it is crucial to innovation and the ability to create and exploit new products and markets. Intangible assets are an important resource in the knowledge based economy, so it is important that the tax system treats them in an up to date way. Modernisation in this area will help to meet the Government’s aims of ensuring that the UK is an attractive place in which to do business, and that UK businesses can compete successfully.

The UK Inland Revenue noted that despite the fact that “Intangible assets are a key element of the knowledge economy and an important source of competitive advantage for businesses” and despite the fact that “How companies manage and develop their intangible assets has become a crucial factor in determining their competitiveness in national and global markets” the UK tax system did not deal with intangibles in a “modern and effective way”. In particular, the UK rules at the time were, according to both Inland Revenue and the respondents to its consultation process, “…complex, inconsistent and out of date. For example, different classes of expenditure are written off for tax at different rates, or not at all, with no overarching rationale.” The UK Inland Revenue’s view of the consequences of this inconsistency and complexity was that “This causes competitive disadvantage to UK businesses in the global market place and may lead multinational companies to acquire and own their intangible assets and goodwill outside the UK.”

At the time of introduction of the 2002 Finance Bill and its fundamental changes to the tax treatment of intangibles via Schedules 29 and 30 the accompanying Regulatory Impact Statement included the claim that “[w]ithout reform, the UK would continue to

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15 Ibid.
16 Id, 5.
17 Ibid.
18 Ibid.
19 Ibid.
20 Ibid.
treat intangible assets less favourably than many other countries to the disadvantage of companies based here.”

It should be clear from the discussion below that the tax treatment of intangible property does influence the decisions made by corporations when it comes to their intangible property. The question that arises is whether there is a way of measuring the success of such measures as the changes made by the 2002 Finance Act.

**The importance of tax rules in locating intangibles**

A review of the literature suggests that tax heavily influences corporations in the choices they make in locating and relocating intangible property. Intangible property seems to have an increasingly important role in the asset management activities of the modern corporation.

According to Verlinden et al the intangibles within certain corporations “…can play a key role for a multinational group in ascertaining and maintaining its market position.” Verlinden et al’s work highlights the importance of intangibles. It also addresses the role in commerce of structuring to optimise the benefits (or at least minimise the disadvantages) of the application of legal and tax rules to transactions involving intangibles.

It is the defining feature of intangibles that leaves them open to relocation, reconstruction, reformulation and general manipulation by taxpayers in order to achieve desirable tax outcomes.

**The intangibles that might be involved**

It is important to identify the types of intangibles that can be used in tax effective structuring of transactions and relationships. A good source of definitions of the relevant intangibles is the Organisation for Economic Cooperation and Development’s (OECD’s) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The OECD Guidelines identify different categories of intangibles and list “trade intangibles” and “marketing intangibles” within the wider category of “commercial intangibles”. “Trade intangibles” include: Patents; Know-how; Designs; Models – for the production of goods; and Intangible rights that are business assets in themselves – such as software – used either to service customers or actually transferred to customers.

24 See OECD Transfer Pricing Guidelines, (above) para 6.3.
“Marketing intangibles”\textsuperscript{25} include: Trademarks; Trade names; Customer lists; Distribution channels; and Promotional names, symbols and pictures.

Know-how and trade secrets can be either trade intangibles or marketing intangibles depending on their application within a multi national enterprise.\textsuperscript{26}

Structuring entities in such a way that they might act as holding entities for certain intangibles can offer tax advantages. In this way one entity might hold an asset that is then used by other entities in the group. Sometimes the advantage may be that a payment for use of the asset will be deductible, and thus reduce the tax liability of the entity using the asset. In other circumstances the tax advantage (if the group of related entities is viewed as an economic entity on its own) may be that the entity allowing the use of the asset may be able to claim a tax deduction for depreciation of the asset. This might be particularly advantageous if that entity were situated in a jurisdiction with generous tax deductions for amortisation or other incentives for the productive use of certain assets.

On occasion, arrangements such as these are made even more advantageous by the special application of international tax rules, such as low final withholding tax rates on payments of licence fees or royalties. Sometimes the sole value of such arrangements may lie in the benefits to be found in such tax rules. The benefit may be found in double taxation agreements between countries, or in the domestic tax rules of the jurisdictions involved.

Given the types of advantage that can be obtained through tax planning, further consideration should be given to when the opportunity for tax planning arises and how intangibles may fit in. Businesses that turn their attention to tax planning will ordinarily consider tax on the occasion of a restructuring of the entity or group through the acquisition of a new business or a disposal of an existing one. Occasionally too, if the business is not too preoccupied with other start up issues, tax planning will happen at the time of the initial structuring of the enterprise and related entities. Such situations are considered further below.

**Examples of intangibles’ importance in sales and acquisitions; structures and restructures**

There are many examples of instances when tax planning may be beneficial at the time of a restructure. Arias\textsuperscript{27}, writing in *International Tax Review*, and others have identified several issues that come to light when a taxpayer is transferring goodwill and related intangibles under a merger, acquisition, or restructuring exercise. Henshall refers to the “massive opportunities” in changes to the structure of the finance industry in the UK, and advocates the reallocation of rights to goodwill within the corporate group in order to

\textsuperscript{25} Id para 6.4.
\textsuperscript{26} Id para 6.5.
take advantage of these. Restructuring and the migration of intangibles may well be undertaken for reasons other than tax, but when they take place it seems that tax complications will usually arise. Often intangibles are an integral part of a merger and acquisition. Forbes writes; “[b]rands often come up as a key element in the negotiation and valuation of a ... [merger and acquisition] deal.”

He stresses the needs to properly value, and establish the extent of coverage of a brand. He explains that frequently the intangible value of a corporation is latent and there may be a need to expose that value in the course of the sale negotiations. He gives as an example AMR’s (i.e. the holding company for American Airlines) separate identification and establishment within its own brand structure of its “Sabre” reservation system.

Forbes provides other examples of the desirability of recognising brand value. He also explains that problems arise when one attempts to realise these values and accounting standards make this impossible:

The US GAAP [generally accepted accounting practice] ...does not permit the capitalization of brands at all. Current financial reporting rules therefore woefully fail to communicate …powerful intellectual property and US companies have more value than their traditional accounting methods gives [sic] them credit for.

This lack of alignment between the accounting rules and the tax system is not unique to the US – hence the UK’s attempt to align the two more closely, specifically in the case of intangibles. Aside from misalignment with accounting, other problems arise because of the tax system itself, and the way that it impacts on intangibles.

In some jurisdictions the tax treatment of the capital value of intellectual property will vary according to the nature of the asset. In the US, for example, operating intangible assets (including brands) can be taxed differently from goodwill. Therefore allocating the purchase price of a business between other operating intangibles and goodwill will affect tax payable...

With a more European focus than that of Forbes, Arias raises other issues. He highlights the need to identify the intangibles implicated in the merger or restructure.

31 "Sabre’s current market capitalization is approximately $3.2 billion with total assets of less than $2.5 billion while AMR’s market capitalization is $4.9 billion with total assets of over $24 billion. The intangible value of Sabre is therefore now recognized whereas it would not be if it continued to be part of AMR Corporation.” Ibid.
32 Id, 47.
33 Whether the solution to this is to align accounting and tax rules is an important question and in Chapter 3 the submission is made that such a solution, if reached merely for the sake of consistency with accounting principles, may be harmful to the tax system.
34 Forbes, Thayne, (above) 48.
To establish whether an asset is identifiable and separate from goodwill, the particular circumstances must be analyzed (such as the plausibility to determine the expenses and economic benefits attributed to it, and the possibility to be used independently and transferred to a hypothetical or actual third party).\textsuperscript{35}

The consequences are important because, as he explains, tax liability on transfer of some assets such as goodwill can be offset against carried forward losses; and gains on assets such as goodwill may qualify for local roll-over relief from tax.\textsuperscript{36} The importance of this is driven home by the fact that European revenue authorities are becoming increasingly interested in restructuring transactions and often:

...claim that the relocation of function, risk and assets imply a redistribution of associated income that will harm the transferring entity entitling it to compensation. The taxable event being the transfer of earning capacity mainly in the form of goodwill, business opportunities or individual intangibles. The German Ministry of Finance is already working on administrative principles dealing with this issue.\textsuperscript{37}

He goes on to explain that the tax implications may be quite varied and widespread including: “...capital gain on the transfer of an intangible subject [to] capital gain taxation and value-added tax. Other charges would also apply (such as French transfer tax, UK stamp duty, Swedish withdrawal tax, Polish civil transaction tax, and so on).”\textsuperscript{38} In Europe it seems, the transfer of goodwill and other intangibles under a restructure can have many and complex tax implications.

Arias identifies many of the pitfalls associated with the transfer, in the course of a corporate restructure, of intangibles such as goodwill, customer base, customer lists and trade marks. He considers what of these may be transferred for tax purposes and what may not. Arias warns that “If a customer base is transferred it may be difficult to argue that a business or business segment ... and consequently goodwill has [sic] not been transferred.”\textsuperscript{39}

...goodwill is bound to a business and cannot be realised separately; the intangible elements, which contribute to goodwill, cannot be valued separately; and its value can fluctuate sharply in short periods and there is [a] high degree of subjectivity in its valuation.\textsuperscript{40}

The matter becomes even more complex when the different approaches of various European jurisdictions come into play. Often these policies and interpretations are similar, but not identical. Arias mentions a number of jurisdictions in which there is a rule regarding whether goodwill has passed or not.

\textsuperscript{35} Arias, Ignacio, (above) 48.  
\textsuperscript{36} Ibid.  
\textsuperscript{37} Ibid.  
\textsuperscript{38} Ibid.  
\textsuperscript{39} Id, 49.  
\textsuperscript{40} Id, 50.
For Italian tax purposes, goodwill can only be transferred together with the transfer of a going concern, defined in the civil code but also by the doctrine and jurisprudence in a similar way as a business. In France, the concept of an autonomous operating business or fond de commerce is extensively elaborated. In Denmark goodwill does not constitute an asset, which can be transferred separately from a business.\(^{41}\)

The UK approach is similar to that of Denmark; goodwill is not separable from the underlying business. In Germany, however, the tax risks arise not only where goodwill has been transferred but also where there is a transfer of “…a concrete business opportunity, understood as an unexploited business potentially profitable…”\(^{42}\) Each of these approaches involves a risk for taxpayers which Arias explains must be managed appropriately as regards what assets are transferred; how; to whom; and at what value. Arias’s explanation of the situation in Europe highlights the importance of intangible property in tax planning for business restructures in Europe.

Arias’s observations are reinforced and supplemented by Walsh\(^{43}\) who advises multinational corporations on how to get the best out of their intangibles in the global marketplace. Her work is further evidence of the uniquely important role that intellectual property (“IP”) seems to have. She writes that:

> Tax planning with intellectual property offers the possibility to effect a substantial change in the worldwide tax rate, not necessarily requiring major displacement of the operating business.\(^{44}\)

The critical thing to bear in mind when effecting such a change, however, is the local tax regime’s impact on the transactions involved.

> Tax planning for intellectual property differs from tax planning using finance structures. Unlike cash and cash equivalents, the intellectual property is itself an asset of significant value variability. This means that, in selecting the location in which the intellectual property is to be situated, the capital gains tax regime and the facility for tax-free asset or corporate migration will be crucial.\(^{45}\)

The kinds of taxes that she explains must be taken into account are VAT and stamp duty which “…will be of more significance for intellectual property than for financing transactions and this will further influence the choice of location to own the intellectual property.”\(^{46}\) She stresses that the movement of intangibles in the corporation will be particularly important:

> …when new businesses are being acquired, there is a one-time opportunity to locate the intellectual property in a tax favoured location;

\(^{41}\) Ibid.
\(^{42}\) Ibid.
\(^{44}\) Id, 24.
\(^{45}\) Ibid.
\(^{46}\) Ibid.
• ...when businesses are being reorganized and transformed, it is opportune to consider the tax structure of the transformation in addition to its commercial structure; and

• ...early stage businesses with intellectual property in the course of formation must plan carefully where the economic risk of the intellectual property is to be located.47

Also identifying the variety of tax impacts that might arise when moving intangible property between jurisdictions, Verlinden et al describe a number of what they term “IP Horror Stories” in which “…tax planning was done with respect to intangibles without taking account of the [necessary tax and legal] requirements…As a result, the tax authorities were able successfully to call the taxpayer to order.”48 The result in one of the two “horror stories” described by the authors was that the large United States (“US”) paint product group, Sherwin Williams, was (initially) successfully challenged by the US Internal Revenue Service (“IRS”) in its attempt to transfer “hundreds of valuable brands and trading names” to two minor subsidiaries which then licensed them back to the parent company for royalties which would be deductible in the hands of the parent company. The IRS was initially successful in its argument, inter alia, “…that the licence agreements between the subsidiaries and Sherwin Williams were lacking in any economic and substantive basis and were intended solely to create deductible items in the hands of Sherwin Williams.”49 The case warrants further consideration.

In Sherwin-Williams Co v Commissioner of Revenue (Massachusetts)50 the Supreme Judicial Court of Massachusetts considered the Commissioner's disallowance of approximately $47 million that the taxpayer had deducted from its taxable income for royalty payments. The payments had been made to two wholly owned subsidiaries, for the use of certain intangible assets, principally trade names, and trademarks that the taxpayer had transferred to the subsidiaries and which the subsidiaries had then licensed back as part of a corporate reorganization. The subsidiaries were based in Delaware, which exempted from state taxation royalties and other income earned by companies such as the subsidiaries. According to the court, “These advantages were known and considered by McDonald and Sherwin-Williams in evaluating the trademark subsidiary plan.”51 The taxpayer’s board of directors documented 10 non tax based reasons for the restructuring at the time that it resolved to enter into the restructure.52 Reasons that were given for centralising the intangibles in the two subsidiaries included reasons such as better ability to resist a hostile take over; better ability to allow licences to other customers by centralisation of the trade marks; better understanding of profitability; and better ability to manage and control the taxpayer’s trademarks if held centrally. These reasons and the factual circumstances held considerable sway with the Court which set

47 Ibid.
48 Verlinden, I., Smits, A., Lieben, B., (above) para 488.
49 Id para 492.
50 Sherwin-Williams Co. vs. Commissioner of Revenue (Massachusetts) 778 N.E.2d 504; 2002 Mass. LEXIS 793.
51 Sherwin-Williams Co. vs. Commissioner of Revenue (Massachusetts) 778 N.E.2d 504 at 509.
52 Id at 510.
aside the Commissioner’s objections that the transaction variously: lacked economic substance; was a sham; and did not take place at arm’s length prices. Although the Massachusetts Supreme Court dismissed the Commissioner’s objections and the taxpayer eventually won its case, the Court accepted that there were tax advantages available to the taxpayer and that the taxpayer was aware of them when entering into the transaction. The taxpayer itself had recorded its awareness of the tax advantages in the minutes of its Board Meeting.

For the purposes of this discussion, the Sherwin Williams case makes it clear that a taxpayer will be prepared to engage in a large reorganisation of its intangible assets for reasons that are at least partly tax motivated, and the existence of tax concessions such as those to be found in Delaware, provide the opportunity and motivation to do so. Presumably a taxpayer would be even more ready to engage in such restructuring if the sundry commercial benefits identified by the taxpayer could also be realised.

Although the taxpayer in the Sherwin Williams case was eventually successful – the warning by Verlinden et al is salutary. Dealings with intangibles that have tax implications should be undertaken with care. The authors warn clients about another case involving an attempt by a US company, in the course of acquiring a UK subsidiary, to structure the transaction in such a way as to first transfer the UK company’s brand name and copyright in certain software to a Dutch subsidiary established for that purpose and then to licence the use of the brand and copyright back to the UK subsidiary.\textsuperscript{53} The intention of the structure was that “…the acquisition cost would be converted into a tax-deductible royalty cost in the United Kingdom (“UK”), which, via a limited tax charge in the Netherlands, should allow low-taxed income to flow upstream to the United States.”\textsuperscript{54}

The scheme failed, from a tax point of view, in that the UK revenue authorities did not accept the price paid for the intangibles as being at arm’s length and therefore it was inadequate for calculating a royalty, whilst the low actual value of the intangibles involved gave an inadequate depreciation base for the purpose of offsetting the royalty income in the Netherlands. Furthermore “…the necessary tax credits were obtained in neither the Netherlands nor the United States.” The upshot of what the authors attribute to poor planning and structuring was that although some avoidance of double taxation was achieved in the example cited, “…there nonetheless remained very little over from the tax savings that had initially been postulated.”\textsuperscript{55} The authors conclude that; “[t]he message here as well is thus: good tax planning can lead to a great deal of savings, but if and only if it is preceded by a thorough study and proper underpinning.”\textsuperscript{56}

\textsuperscript{53} Verlinden et al (above) para 497. The authors base this example on Henshall, J., “Failure to Examine Intellectual Property can lead to ‘Horror Stories’”, January 24, (2001), \textit{Tax Management Transfer Pricing Report} 639-640.

\textsuperscript{54} Verlinden et al, para 499.

\textsuperscript{55} Id para 503.

\textsuperscript{56} Ibid.
There are some important features that are discernible in the transactions that have been described in these examples. These include:

- Employing licence arrangements to allow the use of a valuable intangible by some other entity;
- The licence arrangements were intended to allow a tax deduction for the licence fees paid for the use of the asset in question;
- The transactions usually involve a “migration” of intangibles to a holding vehicle, which enters into the licence arrangements mentioned in (a);
- The entity using the intangible is frequently the entity that originally owned and established the intangible;
- In some examples tax benefits were intended to help finance the acquisition being made.

All of the listed features highlight the opportunities that can be found for tax effective structuring of commercial relationships where moveable intangibles are involved.

**Tax effective structuring using goodwill and other intangibles - the international dimension**

It has been demonstrated that intangibles are extremely important in tax planning and other business decisions of relevant (often large) taxpayers. The structures used frequently appear to involve international transactions with international tax implications. Accordingly, consideration should be given to where intangibles fit into such international structures.

Tax motivated dealings in intangibles within a group of related entities are increasingly common, and have become a cause for concern within the OECD, which has a particular focus on international transfer pricing, and naturally, the role of intangibles in transfer pricing.  

Although it is difficult to find direct evidence of the scale and nature of transfer pricing (and income shifting) activities, Grubert writes that “Several studies have found evidence indicating that multinational corporations …shift income from high-tax to low-tax locations.”  

Grubert asks whether incentives to income shift distort “real” decisions, “[f]or example, are companies induced to engage in more intercompany transactions, at the expense of arm’s length transactions, because of the income shifting opportunities

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they offer?“60 We might, in light of the previous discussion, frame the question, would the tax incentive that companies such as Sherwin Williams have to shift royalty income to Delaware, override other (more) commercial considerations?61

Although Grubert does not address this question directly, he asks whether a multinational company’s choice of location is materially influenced by the opportunity to shift income from a high-tax to a low-tax location. His economic model demonstrates

…how opportunities for income shifting can stimulate a greater volume of intercompany transactions and investments in both high and low tax countries. … The model shows that there are two channels through which intangible assets can promote income shifting. One is by increasing the volume of intercompany transactions and thereby expanding opportunities for income shifting. The other is by increasing the range of uncertainty in what constitutes an “arm’s length” price for intercompany sales and thus reducing the cost of an aggressive pricing policy.62

According to Grubert’s model multinational corporations are more likely to indulge in income shifting where they have invested in either high or low tax jurisdictions.

The type of income and expenditure that is shifted

Grubert goes on to ask “Which type of income or expense is shifted?” He accepts previous studies that have presented evidence supporting the theory that income shifting takes place from high-tax to low-tax countries. He seeks to establish whether the presence of assets such as intangibles contributes to income shifting. He remarks that “About half of the observed difference in profitability between high and low tax countries seems to be accounted for by the shifting of income derived from industrial intangibles.”63 Grubert also makes the significant observation that, according to the model, “[I]ncome associated with industrial intangibles such as patents and know-how is shifted from high-tax countries to low-tax countries, but income from marketing intangibles apparently is not.”64

Grubert expands on this, commenting on the difference between what he terms “R&D” (i.e. “Research and Development”) intensive multinational companies (i.e. those with significantly large assets in the form of industrial intangibles such as patents and know-how), and companies that rely rather on advertising and marketing intangibles. He states that “R&D is associated with a much higher level of transactions, particularly purchases, while [multinational corporations] with marketing intangibles have a much lower level of transactions between foreign subsidiaries and their U.S. parents.”65

60 Grubert, Harry, (above), s 221 - 222.
61 Tsiopoulos et al, (above), suggest that it does, and usually the only reason to transfer price across international boundaries is the tax outcomes.
62 Grubert, Harry, (above), 226.
63 Id, 229.
64 Ibid.
65 Id, 233.
Certainly the remarks of Walsh (below) suggest that in some jurisdictions there is scope for profit shifting using marketing intangibles (amongst other things) under licensing arrangements where the intangibles are held in a low tax jurisdiction and royalties are paid to the entity holding the intangibles in a low tax jurisdiction by entities in a high tax jurisdiction.

The explanation given by Grubert himself is that under the US controlled foreign companies (“CFC”) tax rules, marketing intangibles are extremely hard to use for profit shifting. Grubert explains that

…in contrast to the case of Puerto Rico [which was the subject of some of Grubert’s earlier work], the tax rules make it very difficult to shift income from domestic U.S. sales out to a foreign subsidiary if the U.S. income is attributable to a marketing intangible such as a trademark. However, a parent could transfer a domestically-developed patent to a low tax country and attempt to exploit the range of uncertainty in the application of the transfer pricing rules by either paying too high prices for the goods brought back or receiving inadequate royalties for the use of the patent.66

Thus, the Grubert model appears to demonstrate the efficacy of the US CFC rules in discouraging profit shifting via marketing intangibles. This is useful intelligence for revenue authorities with less effective (or no) CFC rules. There is also a warning in these data for the US Treasury and IRS in cases where the CFC rules are modified in their application to certain countries with some or other favoured tax status.

Although the Grubert model may suggest that the role of marketing intangibles, such as goodwill and brands, in profit shifting is more limited than the role of industrial intangibles, it may be that the phenomenon identified by Grubert is specific to the US as there is other evidence that marketing intangibles are nevertheless used in such activities. For example, marketing intangibles are as significant a focus as industrial intangibles in the advice given by Hardgrove and Voloshko, who, although they warn against using such items in tax planning at lower than arm’s length prices, attempt to demonstrate the myriad strategic advantages of a well developed and integrated, but flexible, policy for the holding of intellectual property by multinational companies.67

An aspect that possibly gives some support to the Grubert view is that issues related to dealings with goodwill and related assets appear to arise more often in the context of one off transactions such as sales, mergers and acquisitions and restructuring exercises than in the context of periodic and more routine arrangements involving payments of royalties and similar amounts. An explicit example of this may be found in the work of Arias,68 referred to above in the context of the tax risks associated with corporate restructuring involving intangibles.

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66 Grubert, Harry, (above) 239.
67 See Hardgrove, Michael, W., and Voloshko, Alex, in “Maximize your global IP”, [April, 2003], Journal of Accountancy 43 – 47, 47.
68 Arias, Ignacio, (above).
Arias’s work also identifies another important aspect of mergers and acquisitions and restructuring exercises in Europe, that highlights the role of goodwill and related intangibles in international tax. He mentions transactional analysis and the role of intangibles where a restructure has taken place in such a way as to affect a taxpayer’s customer base. The issue he explains is that

Customer base as such, is a reliable flow of customers of a business in a specific market considering their migration rate. These customers must be acquired by the transferring entity’s own efforts. Different elements could determine the customers’ loyalty (the quality or uniqueness of the product/service, location, advertisement, price, customer service and so on). The customer base cannot be transferred unless these elements are transferable. To own a customer base it must be established who has contributed to the creation of this loyalty and who has originally acquired or enhanced businesses with these customers.69

The question which arises where there is an attempt to restructure or transfer a customer base is whether this is possible because in order to transfer a customer base it is necessary to transfer other intangibles, such as those suggested above. There is disagreement on whether this is possible and particularly what the effects are where the resultant arrangement is a “commissionaire arrangement”70. Arias explains further:

Some authors state that there is no transfer when a buy-seller is replaced by a commissionaire/agent because there is no change in the use of the clientele. Others add that there is no change in the use only if the principal does not intend to make direct use of the pre-existing clientele and it remains with the commissionaire despite the access of the principal who should not compete in the same market….If a customer base is transferred it may be difficult to argue that a business or business segment … and consequently goodwill has not been transferred.71

Although a commissionaire style of arrangement can no doubt be established within a domestic context, it is within the international tax context that commissionaire arrangements are most popular and currently most concerning to tax authorities.72 Under such arrangements the separate processes of marketing, manufacturing, sales and distribution are all undertaken under contract on behalf of a principal usually, with the exception of sales, outside the country. The result is that, using a manufacturing and retail sales arrangement as an example; a principal company can undertake an extensive merchandising operation, without it establishing a permanent establishment or similar link with the country in which the sales take place, which might trigger a liability to taxation in that country. Thus the real profit on the transactions involved may be enjoyed

69 Id, 50.
70 A commissionaire arrangement is one in which the sale of goods or provision of services within a jurisdiction is achieved by a foreign entity through contracts and agency arrangements with suppliers in such a way that the foreign entity does not establish a permanent establishment in the country in which the supply or sale is made.
71 Arias, Ignacio, (above) 50.
outside of the jurisdiction in which the valuable transactions (with the customers) take place. Commissionaire arrangements are one of the matters of most concern to OECD members. In 2002 Silbertzein wrote \(^{73}\) that Working Party No 6 of the OECD Committee on Fiscal Affairs, which is responsible for work on the OECD’s Transfer Pricing Guidelines, was concentrating principally on transfer pricing matters. Amongst its activities is the identification and discussion of “Hot Issues”. This is done, inter alia, by development of “Examples and Difficult Case Paradigms”. These are either based on the experience of different countries or are matters that have been submitted to the Business Industry Advisory Committee. Among the current issues are:

- how to determine an appropriate reward for an enterprise undertaking marketing activities in relation to a marketing intangible it does not own;
- the issue of economic substance in shifting of risk; and
- a number of cases illustrating difficulties encountered in the use of profit methods.\(^{74}\)

The items listed relate principally to the problems raised by the use of commissionaire and agency style arrangements under which the parties to the arrangement bear no risk and make limited profit so that it is difficult to attribute an appropriate arm’s length price for the contribution they make to the enterprise undertaken.

Even in the absence of a commissionaire arrangement, there can be opportunities for one group member to charge a foreign member of the group for the use of the first group member’s name, mark, and goodwill. For an example of this, see the work of Henshall, described below. Thus it seems there is a link between structuring arrangements and international tax issues. Even considerations related ostensibly to domestic tax issues can have relevance in the context of the international tax problem of commissionaire and agency arrangements.

Further evidence of the role of marketing intangibles in international transfer pricing is to be found in the work of Forbes who explains:

> Another key tax area is the impact of transfer pricing, either on a brand’s capital value or on royalties charged within a group for use of a brand. In 1999, after the acquisition of Carnation, Nestle transferred its brands to Switzerland. The transfer values were hotly contested by the US Internal Revenue Service (IRS). Lengthy court battles ensued with hundreds of millions of dollars at stake. This issue is worth knowing about as part of post acquisition planning or due diligence enquiries.\(^{75}\)

It seems then that although the use of marketing intangibles for transfer pricing was not statistically significant in Grubert’s model, there are nevertheless important and valuable issues in this area. It may indeed be that the Grubert model, based as it was on the

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\(^{74}\) Id, 5.

\(^{75}\) Forbes, Thayne, “To have and to hold”, (above), 47.
analysis of a short period of returns\textsuperscript{76}, could not pick up the important “one-off” issues that apply where restructuring and similar transfers take place.

It is submitted that if sufficient incentive is afforded a taxpayer to relocate intangibles, all intangibles are prone to such relocation because they are portable and valuable. Even if the specific incentives in international tax are not readily available or apparent for a multinational corporation operating within and beyond the USA, the nature of tax competition is such that they might be one day be put in place as global tax competition rises. Owens has commented on greater international competition between countries to attract international corporations and sees an increasing trend in this:

The base for taxes on income and wealth will become more geographically mobile and therefore more sensitive to tax differentials. This, in turn, will lead to a greater danger of tax competition between countries, with each country trying to attract a larger share of the global tax base…. It will become more difficult to determine and to collect taxes on activities which take place outside a country’s tax jurisdiction. This is not just a question of the volume of cross-border transactions increasing, but of their changing nature.\textsuperscript{77}

Even if the use, in the US, of marketing intangibles for income shifting is outstripped by the use of industrial intangibles, other countries with less rigorous, or less rigorously enforced, regimes applicable to subsidiaries than the USA’s CFC regime, may well find that the marketing type of intangible is as attractive as industrial intangibles for profit shifting. Indeed, Walsh suggests this very application in her advice to taxpayers and their advisers. In order to properly structure an acquisition to best tax advantage, Walsh suggests using the very arrangement that Grubert’s model indicates is rare in US multinational corporations operating out of the US. She advocates the location of marketing intangibles within a low tax jurisdiction if a licence fee arrangement can be entered into. In her “licensing model”, which is common in retail and services businesses, she illustrates the location of both marketing and trade intangibles, together with other intangibles and services, within a low tax jurisdiction.\textsuperscript{78}

Others make similar suggestions and another example of such advice is found in the work of Stirling\textsuperscript{79}, who warns that revenue authorities will be quick to ensure that marketing intangibles shared within a group are charged for. He counsels that the need to charge arm’s length market prices may be obviated by entry into cost sharing arrangements, except where profit shifting opportunities arise. In such cases he advocates the

\textsuperscript{76} The 1996 Treasury files of US based multinational enterprises.


exploitation of the opportunity, where it presents itself, to shift profit from a high tax jurisdiction to a low tax jurisdiction.\textsuperscript{80}

A further explicit example of the use of the goodwill associated with a name and trademark to shift income internationally is given by Henshall, who suggests that when the UK finance industry was due to undergo changes as result of the Sandler Review of Pensions and Savings the changes in the industry would provide “…opportunities for transfer pricing planning for intangibles.”\textsuperscript{81} The particular strategy suggested is that a new foreign subsidiary should be created to distribute new financial products and, essentially, develop its own goodwill for which it will charge the UK company an increasing royalty. In the meantime, it should have use of the existing goodwill of the UK company and pay a declining royalty for its use. He suggests that “… [a related] offshore company take ownership of the new ‘local goodwill’…achieved simply by including the necessary conditions in the contract.

If there is no transfer of existing local goodwill …and the distributor is rewarded adequately in recognition of their use of local customer lists, it is possible to implement this structure without generating any disposal of existing goodwill. Over time the value of the ‘old’ local goodwill owned by the distribution company will reduce….As the ‘old’ local goodwill is dying the value of the ‘new’ local goodwill owned by the offshore company will grow, as will the arm’s length charge to the UK company for having access to it.”\textsuperscript{82}

The result is a shift of profits, achieved via payment of rights to goodwill from the relatively high UK tax jurisdiction to (presumably) a lower taxed jurisdiction. The device suggested by Henshall also avoids the incidence of any capital taxes on transfer of goodwill because a right to use goodwill is established, rather than an outright transfer of goodwill.

It can be concluded from this that there are clearly tax planning issues surrounding the involvement of all intangibles, in transactions involving the acquisition and disposal of such assets, either under a corporate restructure or otherwise. It is also clear that there is a link between structuring arrangements and international tax issues. As this is the case the type of changes that were introduced by the \textit{Finance Act 2002} should lead us to the identification of an increase in the movement to, and retention in, the UK of wealth in the form of intangible property. The question of identifying such growth and retention is addressed in the following section of this paper.

\textsuperscript{82} Id, 13.
**Have the UK’s changes to taxation of intangibles led to growth in the UK’s knowledge economy?**

If the tendency of corporations is to take advantage of tax incentives in choosing a location for themselves and/or their intangible assets the changes to the UK’s tax rules should evidence an increase in the value of intangible property held by taxpayers in the jurisdiction as a result of the changes.

Such an increase in value of intangible property located in the jurisdiction might be evidenced by a number of measures such as:

- Numbers of registrations of patents and trade marks;
- Values of intangible property in company balance sheets;
- Statements to shareholders on changes relating to migration or location of intangible property to the UK;
- National levels of investment in Research and Development activities.

This is not a closed list, there may be others.

What evidence is there of such changes?

**Patent and trade marks registrations**

A review of the official information relating to registrations of Intellectual Property in the UK reveals interesting trends, but the trends are not really conclusive for our purposes.

The following charts demonstrate the trends apparent over the very short time scale involved.

**Chart 1. UK Patent applications and grants of applications 2002 – 2004**

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The shows a slight decline in applications but a slight increase in grants of patents over the time period involved.

**Chart 2. UK Trade Mark Applications filed and registered 2001 – 2004**

This chart suggests a slight increase (albeit fluctuating) increase in Trade Mark applications over the period and a slight (again, fluctuating) decline in registrations over the period.

**Chart 3. UK Design applications and registrations 2001 - 2004**

This chart suggests a decline in both design applications and registrations over the period. There is however a noticeable increase in applications and registrations in 2002 – this might be a response to the foreshadowed changes in the tax law and could possibly be explained by the tax changes. It is submitted, however, that the increase sought in this study would be unlikely to occur in the actual year in which the changes were introduced,

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as their effect will be more apparent in subsequent years as companies respond to the new regime once it is legislated.

On the whole, the data here are not a very emphatic indication of a taxpayer response in the form of location of IP in the UK as a result of the changes to the UK’s tax laws.

**Balance sheet information**

Another avenue that was explored that might indicate that the UK has, as a result of the changes to its tax laws, assumed a more competitive position in relation to investment in IP and other intangibles might be changes in the value of intangibles held on the balance sheets of UK corporations in the period immediately after the change to the tax laws. This avenue was abandoned because the consolidated accounts of the public companies that were available, obviously, do not reveal movements in IP between jurisdictions. The IP holdings remain within the group. Other possible indicators of dealings in IP prompted by tax were also apparently masked by the simultaneous introduction of International Financial Reporting Standards (IFRS), which made comparisons of financial statements across the years likely to be affected (2001 – 2004) impossible.

**Research and Development Data**

The authors were able to source comparative data from the UK National Accounts which reported the investment in Research and Development (R&D) in a number of OECD countries including the UK.

This data provides an indication of the overall and relative levels of investment in R&D, in the time period under review, in the UK compared with other countries and is reported in the tables below.

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86 A sample of names of public companies was drawn from the UK companies listed on the London Stock Exchange. The companies list was then ranked according to market capital from highest to lowest and of the top 49, a handful considered to have high levels of IP were identified. The sectors identified were pharmaceuticals, banking, food, publishing, and entertainment. 2002 – 2005 Annual Financial Reports of 7 companies identified from this sample were perused to determine whether balance sheet activity might suggest a change in behaviour in relation to IP as a result of the changes to UK tax. No useful data could be found.

87 The very mixed results that were forthcoming from this research are shown in M. Walpole “The role of taxation in business’s choice of location of intangible property”, Proceedings of Tax Research Network Annual Conference, University of Southampton, September 2006. See [http://www.law.soton.ac.uk/trn/](http://www.law.soton.ac.uk/trn/).

Table 1. Expenditure on R&D performed in UK businesses: broad product groups, in cash & real terms 2000-2003

<table>
<thead>
<tr>
<th>Year</th>
<th>In cash terms £ billion</th>
<th>In real terms (2003=100) £ billion</th>
<th>% increase from previous year</th>
<th>% increase from previous year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>11,510</td>
<td>12,562</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>12,336</td>
<td>13,129</td>
<td>7.17%</td>
<td>4.51%</td>
</tr>
<tr>
<td>2002</td>
<td>13,110</td>
<td>13,490</td>
<td>6.27%</td>
<td>2.74%</td>
</tr>
<tr>
<td>2003</td>
<td>13,687</td>
<td>13,687</td>
<td>4.4%</td>
<td>1.46%</td>
</tr>
</tbody>
</table>

This table shows that in real terms the level of investment in R&D in the UK between 2000 and 2003 (no further data yet being available) increased every year, although at a declining rate of increase from 4.51% in 2001 to 1.46% in 2003.

The following table indicates in what broad industry groups government funded R&D expenditure was expended and how this compares with 6 other countries, during 2003.

Table 2. International comparison of Government funding of R&D in 2003 by socio-economic objective (percentage distribution)

<table>
<thead>
<tr>
<th>Per cent</th>
<th>UK</th>
<th>Germany (p)</th>
<th>France (p)</th>
<th>Italy (p)</th>
<th>Japan²</th>
<th>Canada</th>
<th>USA³</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, forestry and fishing</td>
<td>3.3</td>
<td>1.9</td>
<td>2.0</td>
<td>1.9</td>
<td>3.3</td>
<td>7.8</td>
<td>2.1</td>
</tr>
<tr>
<td>Industrial development</td>
<td>5.2</td>
<td>12.3</td>
<td>6.4</td>
<td>10.2</td>
<td>7.2</td>
<td>13.0</td>
<td>0.4</td>
</tr>
<tr>
<td>Energy</td>
<td>0.3</td>
<td>3.0</td>
<td>4.0</td>
<td>3.6</td>
<td>17.2</td>
<td>4.0</td>
<td>1.1</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>1.4</td>
<td>1.8</td>
<td>0.5</td>
<td>0.4</td>
<td>4.1</td>
<td>3.1</td>
<td>1.5</td>
</tr>
<tr>
<td>Environmental protection</td>
<td>1.8</td>
<td>3.3</td>
<td>3.0</td>
<td>2.3</td>
<td>0.9</td>
<td>4.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Health</td>
<td>13.7</td>
<td>4.2</td>
<td>5.1</td>
<td>7.0</td>
<td>4.0</td>
<td>16.4</td>
<td>22.7</td>
</tr>
<tr>
<td>Social development and services</td>
<td>3.2</td>
<td>4.9</td>
<td>0.8</td>
<td>4.4</td>
<td>0.7</td>
<td>3.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Earth and atmosphere</td>
<td>2.1</td>
<td>1.7</td>
<td>0.9</td>
<td>1.9</td>
<td>1.7</td>
<td>2.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Advancement of knowledge</td>
<td>35.2</td>
<td>54.8</td>
<td>44.7</td>
<td>57.0</td>
<td>49.7</td>
<td>34.9</td>
<td>5.8</td>
</tr>
<tr>
<td>Civil space</td>
<td>1.6</td>
<td>5.0</td>
<td>8.2</td>
<td>7.3</td>
<td>6.7</td>
<td>5.5</td>
<td>7.9</td>
</tr>
<tr>
<td>Defence</td>
<td>31.9</td>
<td>6.5</td>
<td>22.8</td>
<td>4.0</td>
<td>4.5</td>
<td>3.6</td>
<td>56.1</td>
</tr>
<tr>
<td>Not elsewhere classified</td>
<td>0.5</td>
<td>0.6</td>
<td>1.6</td>
<td>–</td>
<td>–</td>
<td>1.2</td>
<td>–</td>
</tr>
<tr>
<td><strong>Per cent</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
</tr>
<tr>
<td><strong>Total £ million</strong></td>
<td><strong>8,407</strong></td>
<td><strong>11,140</strong></td>
<td><strong>11,410</strong></td>
<td><strong>6,436</strong></td>
<td><strong>16,213</strong></td>
<td><strong>3,893</strong></td>
<td><strong>73,199</strong></td>
</tr>
</tbody>
</table>

*Source: OECD databank (June 2005)*

*Notes:*

1 Data for Italy are for 2001.


The data indicate that in 2003 the UK had a relatively low level of investment in R&D outperforming only Canada and Italy in this respect. However on closer analysis the authors noted that relative to the others in the group of countries the UK had a relatively higher increase in R&D in the Business Enterprise sector in the period 2000 to 2003. This expenditure was, however, government funded R&D and it is submitted that this is probably not the type of expenditure that would be influenced by changes to tax laws relating to treatment of IP.

Of greater interest, it is submitted is the expenditure on R&D directly incurred by business and it is this expenditure that changes to the tax law would seek to influence. The relative expenditure of the UK compared with that of other countries in the group for which we have data - with the percentage increase in R&D expenditure - is set out in the table below.

Table 3. R&D performed in the Business Enterprise sector (BERD), 2000 to 2003

<table>
<thead>
<tr>
<th>Year</th>
<th>UK</th>
<th>Germany</th>
<th>France</th>
<th>Italy</th>
<th>Japan²</th>
<th>Canada</th>
<th>USA³</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>11.5</td>
<td>22.9</td>
<td>13.4</td>
<td>4.9</td>
<td>–</td>
<td>6.3</td>
<td>126.2</td>
</tr>
<tr>
<td>% increase(dec)</td>
<td>6.95%</td>
<td>1.3%</td>
<td>7.4%</td>
<td>4.08%</td>
<td>0%</td>
<td>13.7%</td>
<td>(0.87%)</td>
</tr>
<tr>
<td>2001</td>
<td>12.3</td>
<td>23.2</td>
<td>14.4(²)</td>
<td>5.1</td>
<td>–</td>
<td>7.1</td>
<td>125.1</td>
</tr>
<tr>
<td>% increase(dec)</td>
<td>6.5%</td>
<td>1.29%</td>
<td>2.77%</td>
<td>1.96%</td>
<td>0%</td>
<td>(14.08)%</td>
<td>(5.11)%</td>
</tr>
<tr>
<td>2002</td>
<td>13.1</td>
<td>23.5</td>
<td>14.8</td>
<td>5.2</td>
<td>–</td>
<td>6.1</td>
<td>118.7</td>
</tr>
<tr>
<td>% increase(dec)</td>
<td>4.58%</td>
<td>5.1%</td>
<td>(2.02)%</td>
<td>1.92%</td>
<td>0%</td>
<td>0%</td>
<td>2.44%</td>
</tr>
<tr>
<td>2003</td>
<td>13.7</td>
<td>24.7(²)</td>
<td>14.5(²)</td>
<td>5.3(²)</td>
<td>–</td>
<td>6.1(²)</td>
<td>121.6</td>
</tr>
</tbody>
</table>

Source: OECD databank (June 2005)

Notes:
1 Amounts are converted to £ sterling using the purchasing power parities (ppp) developed by the OECD.
2 Data for Japan are adjusted by OECD.
3 Excludes most or all capital expenditure.
(a) = break in series with previous year
(p) = provisional
(e) = estimate

With the exception of Germany, which had a large increase of R&D expenditure in 2003, the UK had the greatest and most consistent increases in this R&D expenditure in the 2000 - 2003 period. The smallest of these, however, was after the introduction of the 2002 Finance Act changes. The data therefore, again, gives a mixed message.

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**Conclusion on R&D data**

It can be concluded from the comparative data that there was no marked increase in R&D expenditure in the UK in the period under review, and that there is little indication that the change in the tax treatment of IP resulted in a marked increase in expenditure on the creation of intangible property in the UK.

This conclusion should be tempered, however, by the observation that, compared to the other countries in the group for which the authors have data, the UK’s modest increase in investment in R&D was greater than that of the other countries. This is not convincing evidence of a change in corporations’ behaviour but it is indicative of something that distinguishes the UK within this group.

**Royalty income from UK located IP**

Turning to other indicia of the effectiveness of changes in the tax law in encouraging a change in corporate behaviour in the location of IP, it is likely that internally created IP of companies will not be particularly noticeable on the balance sheets, but increased income streams from royalties might suggest an increase in the flow of income from IP such as Patents, Trade Marks etc that have been located in UK entities.

Table 4 reveals that few of the companies disclosed income from royalties in the 2002 – 2005 period.

**Table 4. Royalty income in Balance Sheet 2002 to 2005 (where available)**

<table>
<thead>
<tr>
<th>Company name</th>
<th>Royalty income by year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>ASTRAZENECA(^{92})</td>
<td>N/A</td>
</tr>
<tr>
<td>BARCLAYS</td>
<td>Nil</td>
</tr>
<tr>
<td>BRITISH SKY</td>
<td>Nil</td>
</tr>
<tr>
<td>CADBURY SCHWEPPES</td>
<td>Nil</td>
</tr>
<tr>
<td>GLAXOSMITHKLINE(^{93})</td>
<td>£75m</td>
</tr>
<tr>
<td>HSBC</td>
<td>Nil</td>
</tr>
<tr>
<td>REED ELSEVIER</td>
<td>Not determinable</td>
</tr>
</tbody>
</table>

**Comments:**

Neither the increase in royalties by Astrazeneca, nor that of Glaxo Smith Kline are explained in the Notes to the Financial Statements.

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\(^{92}\) Astrazeneca Annual Report 2005, Note 1 to Financial Statements, 90.

None of the other companies showed royalties. The authors were surprised to encounter this in the case of publishing company Reed Elsevier, but the sources of revenue identified in the Financial Statements examined were unclear as to whether or not there was royalty income.

This aspect of the examination was at best, inconclusive. In addition:

- it is possible that consolidated accounts for the group, which many of the financial statements under review are, would not reveal the details of transactions between members of the group because segment information is not disclosed for royalties from intangible assets; and
- the 2002 Finance Act actively discourages the movement of existing IP to the UK in order to benefit from the beneficial tax regime,\(^94\) thus the more likely indicator of stimulus for growth from the changes in the 2002 Finance Act is probably the expenditure on R&D discussed above.

**Statements to shareholders**

A further possible source of information regarding the companies’ choice of location of IP for tax reasons might be statements made to shareholders and other investors in Annual Financial Reports.

The reports examined certainly did contain a number of statements and explanations concerning the particular companies’ dealings with IP. Examples include comments in the Astrazeneca 2005 Annual Report which explained:

**Goodwill and intangible assets**

Additions to goodwill and intangible assets amounted to $215 million, whilst amortisation totalled $306 million. There was a small writeoff of goodwill in connection with *Exanta* of $10 million. Additions included an intangible arising from the collaboration agreement with Cambridge Antibody Technology of $34 million and capitalisation of software. Combined with the effects of exchange, the carrying value of goodwill and intangible assets rose slightly from $3,027 million to $3,050 million.\(^95\)

The British Sky Reports comment extensively on changes in goodwill values and the values of other intangibles e.g.:

At 30 June 2005, the carrying value of goodwill amounted to £301 million (2004: £417 million) and represented 13% (2004: 18%) of the Group’s total assets. Applying …[the company’s stated amortisation policy] resulted in this year’s charge for amortisation amounting to £116 million (2004: £119 million).

… The Group completed two significant acquisitions in the year ended 30 June 2001. These were the acquisitions of the 67.5% of British Interactive Broadcasting Holdings

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\(^94\) See para 3.41 *Reform of the Taxation of Intellectual Property, Goodwill and Intangible assets: The next stage*. Technical Note by the Inland Revenue, 8 November 2000. This was followed up by the provisions in s 84 Schedule 29 *Finance Act 2002*.

\(^95\) Astrazeneca Annual Report 2005, 58.
Limited ("BiB"), not previously owned by the Group and 100% of Sports Internet Group ("SIG") (a company that the Group acquired in July 2000, which owns a bookmaker which operates telephone and interactive betting services under the brand name “SkyBet”).

In accordance with FRS 11, “Impairment of Fixed Assets and Goodwill”, impairment reviews were performed on the carrying values of BiB and SIG goodwill balances at the end of the first full financial year after acquisition, at 30 June 2002, which did not indicate impairment. …the carrying value of the goodwill is … heavily dependent on the forecast performance of, and projections for, these businesses. The Group continues to monitor the performance of these businesses and is satisfied that no impairment of goodwill has occurred.96

Other aspects of the British Sky Financial Statements provide detail about movements in IP and goodwill value within the company. One note to the 2005 Annual Report details the goodwill, totalling £820 million, derived from three business acquisitions (Sports Internet Group, British Interactive Broadcasting, and WAPTV) and explains how this is being amortised. The note continues to describe how an impairment review of another acquisition (planetfootball.com Limited) resulted in a reduction of goodwill value of £3 million.97

**Conclusions on statements to shareholders**

Despite the detailed explanations of movements in goodwill value, and despite other statements recognizing changes in regulations and explaining tax impacts on the companies, nowhere in any of the Annual Reports reviewed was there a statement concerning choices made about change of location of intangible property for any reason, let alone tax reasons.

**Overall Conclusions**

It seems that if evidence of the effect of the changes in the UK tax law as a result of the Finance Act 2002 is to be found in reported data available to the public much more research is required. None of the data ascertainable from the Patents Office or the public statements of the selected companies is indicative of a change in investment strategy of the companies when it comes to intangible property, some of the data drawn from the national statistics showing overall investment in R & D is however suggestive of an increase of expenditure on the development of IP in the relevant period. Those suggestions are however far from what one might describe as emphatic.

There are a number of possible explanations for this:

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97 Id 52.
• tax incentives for changes in use and location of intangibles are not attractive to public companies that rely on profits to maintain their share price as tax changes to the value of intangibles affect the profit and loss of companies. Private companies are less sensitive to changes in profit and loss as they do not necessarily affect investment decisions of the shareholders;
• the published accounts of large public companies are too consolidated for intra group changes in location of intangibles to be discernible;
• the published accounts of such companies have been obfuscated by the adoption of IFRS;
• the proposed ‘quarantine’ around IP preventing companies bringing existing IP to the UK to take advantage of the tax changes were successful; and
• in light of the above only new IP can benefit from the changed tax laws – and the growth of new IP is a slow process that will be difficult to discern from year to year over the few years for which we have data available.

There are no doubt other explanations for the lack of readily identifiable responses to the changes in the tax law in the UK in 2002. The research continues.