12th Meeting of the Advisory Expert Group on National Accounts,
27-29 November 2018, Luxembourg

Agenda item: 2.a.3

R&D Capitalisation: where did we go wrong?

Documentation

Paper by Mark de Haan and Joseph Haynes - R&D Capitalisation: where did we go wrong?

Main issues to be discussed

1. Should capitalization of freely available/accessible R&D be put back on the research agenda?
2. Is more guidance on residency of entities such as the Nike and Google IP holders needed?
3. What can be done to refine the SNA principles of economic IP ownership, particularly within the MNE framework?

1 R&D capitalisation: where did we go wrong?

MARK DE HAAN, JOSEPH HAYNES [1]

Abstract: this paper is an attempt to contribute to the discussion of research and development (R&D) capitalisation in the system of national accounts. The paper first spells out under which conditions knowledge creation truly leads to fixed assets in the national accounts sense.

As a next step, R&D capitalisation is examined in the context of globalisation. One of the serious problems that multinational enterprise (MNE) groups present for macro-economic measurement is the issue of assigning economic ownership of R&D, and intellectual property (IP) more generally, to the various fractions of a global value chain and therefore to domestic economies. This is an issue for which international guidance is currently incomplete and still under research by national accountants. In this paper the discussion of IP focuses largely on R&D.

By analysing real world companies and their production processes this paper aims to highlight some of the issues with the current recording treatment around IP. This translation of information on the MNE group's business structure to the national accounts framework will give an indication of real world distortions that national accountants may encounter when measuring the activities of MNE groups on a domestic economy basis.

All the information contained within this paper relating to these MNE groups is taken from previously published publically available sources. There may be deficiencies in the way the characteristics of these MNE group structures are being revealed by these sources. We nevertheless take these available sources as the starting point of this paper with the main purpose of highlighting the complexities of recording these structures in the national accounts.

This paper offers a number of proposals for improvements though definite solutions to the issues are not possible in one paper alone. Perhaps the greatest contribution of this paper is in highlighting clearly the need for openness and data sharing between national statistics institutes (NSIs). Accurate recording of the activities of MNE groups requires cooperation and data sharing at a far greater level than NSIs have previously been willing to do.

JEL codes: E01, F62

Keywords: national accounts, intellectual property, globalisation

[1] National accounts department, Statistics Netherlands.

1. Introduction

A significant innovation in the latest System of National Accounts (SNA) update (2008 SNA) was the capitalisation of expenditure on research and development (R&D). In the process of the SNA update, Statistics Netherlands produced several papers on this issue (de Haan and van Rooijen-Horsten (2004) and van Rooijen-Horsten et al. (2007)). These papers highlighted several data issues such as: the translation of Frascati Manual (OECD (2015)) based R&D statistics to national accounts data; assessing service lives of R&D assets; and dealing with possible overlaps between R&D and computer software. This kind of guidance was later formalised in the OECD's Handbook on Deriving Capital Measures of Intellectual Property Products (2009). While the 1993 SNA implementation included the introduction of computer software capitalisation for which the first country results showed a disparity of applied methods and results, the introduction of R&D capitalisation was 'managed' in a more careful way. Unfortunately, we cannot conclude that R&D capitalisation in the national accounts has been totally successful.

In the papers produced by Statistics Netherlands, two conceptual concerns were brought to attention:

- R&D in the public domain does not necessarily comply with the general definition of an asset in the SNA sense. Economic ownership of public knowledge cannot be claimed by one particular economic agent;
- Guidance on how to account for R&D flows and stocks inside multinational enterprises (MNEs) is totally lacking.

Supporters of the first proposition (for example, representatives from Statistics Denmark, Statistics Netherlands and the United Kingdom's Office for National Statistics) 'lost the battle'. Ultimately, it was decided that R&D expenditure, both public and private, should be treated equally as fixed assets in the 2008 SNA. The arguments supporting this choice were pragmatic rather than conceptual. Our impression is still that publicly available knowledge contrasts with the general SNA definition of an economic asset ([2]). This broad demarcation of R&D assets is also ambiguous and creates implausible outcomes. Therefore, we revisit this issue in the subsequent section of this paper before moving on to the issue of globalisation.

In recent years, a second issue on R&D within MNE groups and globalisation has received increasing attention. For national accountants, one of the key challenges of economic globalisation is explaining how capital services of intellectual property (IP) enter globally organised production chains. Several developments are complicating this globalisation puzzle. Firstly, the international fragmentation of production chains, inside or outside MNE structures, may imply that business functions such as R&D and software development (in other words, product development and design, development of software inputs) are being separated and (spatially) disconnected from the process of physical transformation (the actual manufacturing of the good embedding the IP). Secondly, production chain fragmentation may also enter the stages of physical transformation. Examples of highly fractured and specialised manufacturing webs are those found in the automobile or aircraft industries.

([2]) The misplaced *conceptual* argument in which public R&D is compared with public infrastructure is discussed later on in this paper.

Nowadays, some manufacturers entirely offshore the physical transformation stages of production; such 'production arrangers' are also called factoryless goods producers (FGPs). The issue of FGPs was intensively discussed in the UNECE task force on global production (2015). Questions about their economic classification and the kinds of transaction these companies are generally engaged in were, unfortunately, not brought to a final conclusion. Both issues are closely linked to recording R&D or, more generally, IP flows and stocks.

R&D capitalisation suggests that IP products can be accounted for like any other fixed asset in the national accounts. Our view on globalisation is that this is not the case. This point is picked up in Section 3 of this paper.

An additional complicating factor is that IP, or intangible assets more broadly, may become a vehicle for tax planning. MNE groups may locate their IP and report related IP revenues (in other words, royalties) in low tax jurisdictions and subsequently charge affiliated companies, which report substantive shares of the group's turnover, for the use of the IP. Such tax planning arrangements may involve a range of special purpose entities (SPEs) located in a variety of countries. A national accountant is usually able to observe only fragments of the tax planning arrangement and is easily misled by the information being obtained at the level of individual SPEs, or other entities in a tax planning arrangement. Judgements on substance or divergences in legal vis-à-vis economic ownership are extremely difficult. This is the main issue covered in Section 4.

Section 5 winds up with (tentative) conclusions and suggestions for future work.

2. The wheel of knowledge and IP creation

Knowledge cannot be valued in money terms. Any attempt to do so is doomed to fail as the importance of knowledge to society cannot be comprehensively evaluated in terms of all 'capital services' obtained by society from our common knowledge base. One crucial characteristic of knowledge is its use for purely scientific reasons, in other words, building up new knowledge. Knowledge creation inherently depends on existing knowledge. We call this the 'wheel of knowledge' (which also happens to be a videogame).

Another important problem to confront is that knowledge itself does not depreciate. Codified knowledge may get lost in the course of catastrophic losses (for example, a fire in a library or a computer crash), which is according to the SNA not the same as depreciation. Crucial too in the process of knowledge creation is that the complementary tacit knowledge, or human capital, is being maintained, or even expanded, by our educational systems.

In the process of developing an electric automobile for the 21st century one cannot say that the required knowledge obtained in ancient times, say the invention of a wheel millennia ago, is less significant to the car than more recent inventions, for example, the development of powerful batteries. As such, we cannot argue that the invention of a wheel is at this point of time (partly or fully) depreciated. We are still enjoying, as ever, the fine properties of a wheel.

Equally, we cannot say that contributions from ancient philosophers like Pythagoras or Socrates to contemporary thinking have become less relevant and should therefore be depreciated. But, if knowledge does not depreciate then the 'wheel of knowledge' becomes larger and larger, year after year.

How does this thinking contribute to national accounting? The last two versions (1993, 2008) of the SNA underscored rightfully the increasing significance of knowledge as a production factor. Business value and profits increasingly rely on tacit knowledge (human capital) and codified knowledge (IP products). This is why computer software, artistic originals, mineral exploration and R&D were included in the SNA list of fixed assets (not human capital which is another story).

This issue of whether IP products have equal properties as other (tangible) fixed assets is picked up in the subsequent sections of this paper. The minimum requirement is that IP products should comply with the general definition of an asset: they are subject to economic ownership and provide future benefits to their owner. In addition, a fixed asset must be the outcome of production.

With respect to intangible assets these conditions should be given careful consideration. In relation to R&D performed by businesses we can safely assume that companies are able to claim the benefits from the R&D they fund or carry out themselves. As high-tech companies may spend up to 10 % of their turnover on R&D, it is quite likely that these companies will be receiving a reasonable return to R&D capital and are capable of claiming R&D ownership by patenting or other ways of limiting access.

In the context of globalisation, this paper explains that at the level of a multinational enterprise the concepts of ownership and obtaining related benefits are conceptually sound and applicable. When stepping down to the level of affiliated companies, or when assessing ownership and R&D returns at the level of the country where these affiliates are resident, both concepts become fuzzy and less easily applicable.

We think this is a serious issue. If national accountants are not able to explain how R&D is linked to production and output, they are not capable of accounting properly for R&D flows and stocks. These concerns are picked up in the subsequent sections of this paper.

De Haan et al. (2004) raised the question of what are the conditions under which R&D complies with the general SNA asset definition (at least at the level of a multinational enterprise). They concluded that due to the exclusive access to knowledge acquired from R&D, the owner may exert a certain level of market power which has a clear and distinct market value. This knowledge may be translated into products with, in the eyes of the consumer, unique and much appreciated properties, not found in the products offered by rival suppliers. The service obtained from knowledge assets will deteriorate in line with the loss in monopolistic power that the owner will inevitably experience over time. Competitors will eventually be able to copy the invention or may develop variants themselves, by way of new R&D projects, with product properties which outperform previous product innovations.

This loss in market power causes the knowledge asset to depreciate over time. This depreciation is by definition the outcome of obsolescence as R&D or IP generally will not be subject to wear and tear. The knowledge itself will not disappear, it may generate a positive

contribution to society for many years, yet its commercial value will inevitably decline. This distinction between knowledge and its possible commercial value is of crucial importance. The knowledge as obtained from R&D will not depreciate. However, access exclusiveness and its potential commercial value will depreciate. Depreciation refers to the fact that a patent (or exclusive user rights more generally) is time limited and the progression of technology inevitably implies advancing obsolescence.

As a thought experiment it may be worth considering the (part fictional) story of the discovery of penicillin by Alexander Fleming and his refusal to take out a patent, believing that the discovery was too important to limit its use. As national accountants, the question we should be asking is whether the discovery of penicillin therefore led to a fixed asset? If neither Fleming nor anyone else could claim economic ownership and accrue future benefits due to the knowledge being freely available and usable then there is no fixed asset. Instead, there is only knowledge. However, had Fleming opted to obtain a patent then there would have been an economic owner and a fixed asset. This example shows that it is the patent, or more generally obtaining exclusive ownership, that gives rise to the fixed asset and not the knowledge or discovery itself. Where knowledge is not protected by any means, a patent or secrecy, a fixed asset cannot be recognised.

Sharing profitable knowledge incurs a cost as it may delimit the monopolistic power of the initial owner. One should be aware that commercial success is often the combination of codified knowledge (the R&D asset) and tacit knowledge (the complementary human capital required to translate knowledge into successful product blueprints). Copying tacit knowledge may be harder than copying R&D assets. This means that exclusive ownership of scientific knowledge is not necessarily safeguarded by patenting but can equally be obtained by way of secrecy or by exclusive access to the complementary tacit knowledge.

The service lives of patents in the various scientific areas (for example, pharmaceuticals, electronic appliances, information technology (IT)) may be a reasonable proxy for assessing service lives of patented and non-patented R&D projects. This is how many national statistical institutes (NSIs) go about assessing service lives of R&D assets. As unsuccessful projects are unavoidable in the process of seeking commercial success, capitalising expenditure on both successful and unsuccessful projects is defendable in the attempt to approximate the overall market value of business R&D capital.

We have seen that the 2008 SNA recommends all R&D to be capitalised, including business research and non-commercial research (for example, university research). The argument used in the 2008 SNA for also capitalising the latter type of research is that university R&D is a public good which is beneficial to society for a longer time period, similar to public roads or bridges. The arguments below speak against this analogy. The 2008 SNA (paragraph 10.98) explains that 'the knowledge remains an asset as long as its use can create some form of monopoly profit for its owners. When it is no longer protected [. . .] it ceases to be an asset'. Yet, this wording could be read such that the 2008 SNA itself already rejects the idea of publically shared knowledge as an asset in the SNA sense.

First, looking at the resemblance of public research and public bridges or roads there is generally no confusion about economic ownership of the latter (we leave aside the complexity of public-private operations which is not relevant to this discussion). The

government is responsible for maintaining the road and may even be liable for damages to users caused by deficiencies. The government has decision-making power: it may, for example, decide to sell the road to a private operator or put the underlying land to another (public) use. In this sense public infrastructure meets the definition of a fixed asset. This may not always be the case for R&D in the public domain. Once in the public domain the R&D asset has become a pure public good. To consider this more fully we first break down, non-exhaustively, the kinds of research projects that are carried out in the public domain.

Government bodies may conduct scientific research for various reasons. Some of this research may be linked to commercial purposes and may even be patented (for example, supporting agriculture or enhancing the circular economy or, more generally, improving the environmental performance of businesses). This type of research is quite comparable to business R&D. When businesses are able to claim the (commercial) revenues of this public research, one may argue that this R&D has been transferred to them. This exclusivity gives rise to economic ownership and therefore is an indicator that such public R&D should be recorded as a fixed asset. Given its purpose this dedicated R&D is likely to be subject to obsolescence as newer techniques may replace older ones. So, this R&D depreciates in an economically meaningful way. Crucial in this context is whether or not the government unconditionally grants all parties access to this knowledge. If so, the knowledge is in fact a public good and cannot be an economic asset in the SNA sense.

Another example is defence-related research. This research may be performed either by commercial or government bodies. One may expect that this research is conducted under strict secrecy since its key purpose is obtaining a military advantage over (potential) enemies. In relation to dedicated military research there will generally be no misunderstanding about ownership and the beneficiaries of this research. By not publicising such research the government maintains a quasi-monopoly position and is the economic owner of a fixed asset. In the arms race, equal steps taken by potential enemies will inevitably lead to diminishing the defensive advantages of research projects over time, again implying this research can be depreciated in a meaningful way, even though the purpose of this R&D may be (partly) non-commercial.

Another part of R&D performed in the public domain is purely non-commercial, scientific, university-based research. Obviously the origin of scientific research is being claimed by their authors in scientific journals. This is not the same as claiming economic ownership. The main purpose of this research is extending science which requires, among other things, allowing full access to scientific results, for verification purposes or to allow other scholars to build on published findings. The main purpose of university research is feeding scientific debate. In the strict context of university research, notions such as economic ownership and economic revenue become meaningless. Scientific results are shared and applied by others for the sake of conducting new research. Once academic research has been published the revealed knowledge immediately becomes not only a pure public but also a free good ([3]). A pure public good cannot be a fixed asset as no single owner exists who can claim economic ownership and earn any future benefits. Therefore, this element of public R&D does not meet the definition of a fixed asset as it is not subject to economic ownership.

([3]) A public good is one where individuals cannot be effectively excluded from its use, while its use by one individual does not reduce availability to others. Public R&D is also a *free* good as its use is principally unlimited and not subject to depreciation.

This paper has already argued that the depreciation of business R&D is the outcome of two factors. First, competitors in the market may catch up (dispersion or sharing of knowledge). Second, new research and innovations may outperform previous innovations which will inevitably lead to its obsolescence. Following this line of thinking one may argue that the R&D assets as owned by companies will eventually be transformed into R&D in the public domain. At that moment the R&D ceases to be an asset in the SNA sense as it has become public knowledge.

This leads to the following conclusions. The main purpose of most academic research is generating public knowledge over which ownership cannot be claimed by one economic agent, not even a government. The outcome (we hesitate to call this revenue) of research is commonly shared by academia. Therefore, academic research, once published, does not meet the definition of an asset. Furthermore, academic research and knowledge in general is not subject to economic depreciation as service lives are, in principle, indefinite. Depreciation functions applied to academic research lack any conceptual underpinning.

The intrinsic inconsistency of such calculations can be underscored by the following representation of a production function of academic research (in ISIC Rev.4 Division 85). In case of public education and research, the SNA convention is to value output (X) as the sum of costs. Let us assume a purely scientific research institute (perhaps allied to a university). Its main current costs are the salaries of researchers (L). According to the 2008 SNA the output of this research institute is R&D which is recorded as gross fixed capital formation. Its depreciation feeds back into the production account of the research institute. We assume that the salaries and labour input are constant over time. We also assume geometric depreciation (d). The production function is represented by equation (1). The capital accumulation function is represented by equation (2).

(1) $X_t = L + d \times R\&D_t$

(2) $R\&D_t = (1-d) \times R\&D_{t-1} + X_{t-1}$

(3) $X_t - X_{t-1} = d \times L$

So the remarkable outcome of the SNA convention is that while labour input (L) remains constant over time, each year the R&D output of this research institute will increase linearly by $d \times L$ while the R&D capital stock will expand on an annual basis by L.

What is modelled by equations (1) and (2) is the 'expanding wheel of knowledge' which has nothing to do with economic accounting. According to equations (1) and (2), government consumption would increase annually by $d \times L$ according to the SNA convention of non-market output valued at sum of costs and ignoring labour productivity changes, while intuitively one would agree that given constant labour input the research institute would generate constant output.

In other words, the R&D output of this research institute should be recorded directly as government consumption and not as gross fixed capital formation. It should be emphasised that either the consumption or investment option will have a similar impact on GDP. Though the investment option leads to the undesirable disturbance of recursive GDP additions as the

consumption of fixed capital will additionally add to the output of the government sector, measured as the sum of costs.

3. Corporate R&D property and global R&D networks

A. Introduction

At least two complicating factors limit our understanding of how the services of R&D capital enter the global production chain. The first one is the global fragmentation of production and, within the so-called global value chain, the disconnected supply of physical and intangible inputs. The second is that R&D creation itself can be subject to interlinked global research networks. Both issues are considered in this section.

B. Globally fragmented value chains

Global production contrasts with the idea of 'national' accounting and this is why so much effort has recently been put into developing guidance supplementing the 2008 SNA (UNECE (2011) and UNECE (2015), Eurostat (2014)). As explained by the OECD, international production, trade and investments are increasingly organised within global value chains, where the different stages of the entire production process, from product design all the way to product distribution and after sales services, are located across different countries ([4]).

IP and IT play a fundamental, enabling, role in the global value chain. For example, communication networks enable product development and design to be geographically disconnected from goods fabrication.

The well-known value added breakdown of an iPhone indicates that the physical parts and assembling costs represent roughly half the iPhone's retail price ([5]). All of the remaining value added generated by the iPhone's production is connected to intangible inputs such as R&D, design, marketing and presumably activities such as supply-chain management. The income is generated in different regions of the world.

Graphic presentations of global supply chains show well the geographic distribution and clustering of manufactured parts and assembling making up the iPhone, a motor car or an airplane ([6]). How R&D feeds in to these global value chains is harder to explain. This issue is often ignored as analysis of global production networks often limit themselves to the physical transformation segments of global production.

However, if according to the 2008 SNA R&D is a fixed asset, like any other (tangible) fixed asset, the national accounts should be able to explain which entities inside the MNE structure are actually investing in R&D and consuming the concomitant R&D services. In other words, we

([4]) http://www.oecd.org/sti/ind/global-value-chains.htm.
([5]) https://www.digitaltrends.com/mobile/IPhone-cost-what-apple-is-paying/.
([6]) http://www.aeronewstv.com/en/industry/commercial-aviation/3707-boeing-787-dreamliner-structure-parts-from-around-the-globe.html.

should be able to explain which (affiliated) entity (in which country) owns the R&D asset and is accountable for its depreciation or more generally the costs of using the R&D asset. Similarly, the accounts should be able to explain how R&D and IP contribute to output and multifactor productivity on a country-by-country basis.

There are several reasons why these questions are difficult to answer:

1. Basic and applied research provide capacity-enhancing technologies which facilitate product innovation but will not directly result in blueprints of new products ([7]). In other words, in contrast to product development, basic research misses a direct link to the goods and services outputs. This being the case, the head office of an MNE seems to be the most obvious candidate for economic owner of this truly corporate R&D property. It is quite likely that head offices take the (funding) decisions on basic research investments in line with the overall corporate innovation strategy. The latest Frascati Manual (OECD (2015), par. 3.11) confirms this view: 'In large and complex organisations, decisions concerning the strategic direction and financing of R&D activities units tend to occur at a higher organisational level than does the day-to-day management of R&D operations. (...) These decisions can cut across national borders, thus raising a challenge for the statistical authorities and agencies, whose responsibility is often limited to gathering information from resident units'. In other words, allocation of basic and applied research or allocating its capital services, to the goods manufacturers inside the MNE is inherently without economic meaning.

2. R&D is different from most activities performed by a corporation in the process of its operation. Research is typically not performed with the expectation of immediate profit. Instead, it is focused on the long-term profitability of a company. As such, the way in which R&D feeds into the production function is unlike other fixed asset categories. Even for computer software, its presence in a local computer or in the cloud is needed in the course of the transformation process in order to deliver its capital services. Obviously, a similar presence is also required for tangible capital items. In contrast, once a potentially successful recipe for a new medical drug, or the technical design of a new motor car, has been developed, the production process will be set up according to this new blueprint, after which the R&D capital has delivered its contribution to output. This does not imply there is no return to R&D capital involved in the course of producing the medical drug or motor car. However, this different mechanism by which R&D contributes to output implies that the R&D asset is not necessarily found in the balance sheet of the entity engaged in the transformation, in other words, the actual fabrication of the drug or motor car. Instead, the R&D asset may be on the balance sheet of an affiliated company (in a low tax jurisdiction) or may not feature on a balance sheet at all, as corporate accounting rules are generally quite restrictive in capitalising R&D.

3. Inside or outside the MNE group's scope, a production network is not just the sum of its component parts. Product development and design are activities typically carried out by the arrangers or principal entities inside global production networks. So these entities are often the main R&D investors inside the global value chain. This is also according to the explanation of factoryless goods producers (FGPs) in the Guide to Measuring Global Production (UNECE (2015)). In this regard FGPs and head offices of MNE groups carry out

([7]) Basic and applied research represents 20 % of total business R&D in the United States: https://www.nsf.gov/statistics/2017/nsf17320/.

similar tasks: they both manage global supply chains with the aim of optimising network synergy. They are both expected to bring together the intangible and physical stages of global production. The main difference is that FGPs have outsourced the physical transformation activities while inside the MNE these activities are (partly) carried out by affiliated companies. Also different from an FGP, a head office will not necessarily report turnover from sales of goods. Alternatively, this turnover is expected to be reported by one or several of the MNE group's affiliated goods producers. As product and process innovations obtained from R&D may affect several stages in the production network, from a holistic point of view it seems defendable that the FGP or head office is the typical stage where R&D enters the global production chain. It does not seem feasible to assign R&D inputs to the separate transformation stages in the production chain. One R&D asset, or one piece of knowledge, may lead to multiple product innovations and the enhancing of profits of several business units inside a single MNE group.

4. In the context of an FGP arrangement, R&D may lead to innovations of products assembled and supplied by non-affiliated contract producers in various parts of the world. The value added and profits generated by these contract producers will typically omit the return to R&D assets as their production costs, and thus their output prices, will not include R&D costs. The R&D returns are directly captured by the principal of the global production arrangement. Discussions in the global production taskforce (UNECE (2015)) showed that, in the case of an FGP, national accountants have great difficulties in explaining the nature of the transaction between the contract manufacturer and the principal: the purchase of a good or the purchase of a (manufacturing) service. Our conclusion is that in economic terms the good purchased from the contractor differs fundamentally from the good sold to consumers, even though in physical terms no distinction can be made. This may have implications for the commodity classification in the national accounts and the balance of payments. In the classifications of goods not only are the physical characteristics of the product relevant, but also the conditions under which the product is transferred from one economic owner to another.

5. In the context of an MNE, the output price of the affiliated contract producer may indeed include the return to R&D capital as its output may be directly distributed to end consumers. However, the required R&D assets may, or may not, be found on the balance sheet of the affiliated manufacturer. It is still possible that headquarters, in their role as global production arrangers, provide the R&D inputs, possibly without any intra-company flows of R&D services being observed. In such a situation the R&D profits will be repatriated to the headquarters via property income (dividends or retained earnings).

6. The latter point shows that corporate funding of R&D is not necessarily linked to how and where the R&D is translated into commercial success. Ignoring tax planning for a moment, from the MNE group's perspective a spatial allocation of generated R&D income is irrelevant as this income will eventually reach the MNE's shareholders wherever generated. Discussions with a number of R&D managers of Dutch multinational companies led to the conclusion that cost redistribution is not common practice (de Haan & van Rooijen-Horsten (2004)).

7. Ironically, R&D cost accounting (IP-related royalty payments) within the MNE is particularly observed in the context of tax planning arrangements. Fair competition authorities, tax authorities and statisticians alike have to evaluate to what extent IP cost accounting arrangements have economic substance. Looking at recent events one must conclude that tax planning arrangements of MNE groups may place national accountants in a very difficult position. This issue is further discussed in Section 4 of this paper.

To conclude, (national) IP economic ownership in the context of global production is still not a well understood concept. The arguments above indicate that IP economic ownership seems to usually coincide with the decision-making entities in the global value chain. These are the entities that are expected to manage overall the intangible and tangible inputs of production. However, such a view has several implications that require further examination:

- Assigning economic R&D ownership to headquarters on behalf of the MNE requires, amongst other things, a careful examination of cross-border R&D flows as they are reported in international trade in services statistics. R&D conducted by foreign affiliates may, or may not, be (partly) funded by headquarters (or by sister companies) or may even have been purchased. This means that the practicalities of such an approach need to be carefully thought through. Some guidance is already provided by the Frascati Manual in showing a data collection scheme for R&D expenditure at the MNE level (Figure 11.2 in OECD (2015)).
- The central product classification (CPC) should be further examined to address the economic characteristics and output of contract producers in FGP type arrangements. For example, the CPC should underscore that the iPhone delivered by a contract producer is a totally different product from the iPhone purchased by a consumer.

C. Global R&D networks

R&D statistics based on the Frascati Manual (OECD (2015)) provide information on R&D expenditure. This is without any doubt crucial information for the purpose of measuring R&D investment. The assumption that R&D expenditure is overall a reasonable approximation of its commercial benefits is not likely to be replaced by an alternative measurement method. The costs of carrying out R&D and maintaining global R&D networks can be statistically observed in a meaningful way on a country-by-country basis. The allocation of (economic ownership of) investments of R&D networks on a country-by-country basis is a less clear concept. Of course we can assume that the allocation of costs is representative for the allocation of investments but this seems to be a rather shaky assumption.

Global R&D networks within MNE groups are best illustrated with the help of a few real life examples. The technology firm Samsung has over 50 000 employees working in collaboration on R&D spread across multiple R&D centres in South Korea as well as others in Russia, India, China, Israel, Japan, Poland, the United States and the United Kingdom ([8]). Table 1.1 details some of the R&D activities undertaken by Samsung outside of South Korea.

Table 1.1: The Samsung R&D network

	Research institute	Country	Type of R&D activities
1	Beijing Samsung Telecommunication	China	Mobile telecommunications standardisation and commercialisation for China
2	Samsung Semiconductor China R&D	China	Semiconductor packages and solutions
3	Samsung R&D Institute India	India	System software for digital products, protocols for wired/wireless networks, application and graphic design
4	Samsung Telecom Research Israel	Israel	Hebrew software for mobile phones
5	Samsung R&D Institute Japan-Yokohama	Japan	Core next-generation parts and components, digital technologies
6	Samsung R&D Institute Poland	Poland	STB software platform development, EU STB/DTV commercialisation
7	Moscow Samsung Research Centre	Russia	Optics, software algorithms and other new technologies
8	Samsung R&D Institute United Kingdom	United Kingdom	Mobile phones and digital TV software
9	Dallas Telecom Laboratory	United States	Technologies and products for next-generation telecommunication systems
10	Samsung Information Systems America	United States	Strategic parts and components, core technologies

Another example is Philips, a leading technology company operating in the healthcare and consumer electronics sector and one of the largest Dutch MNE groups, with its headquarters located in the Netherlands. However, Philips also conducts R&D activities across the world as shown in Table 1.2 ([9]).

Table 1.2: The Philips R&D network

	Research institute	Country	Type of R&D activities
1	Philips Research Shanghai	China	Imaging systems
2	Philips Research Suresnes	France	Healthcare
3	Philips Research Aachen	Germany	Healthcare
4	Philips Research Hamburg	Germany	Imaging systems, biological modelling, computer assisted detection
5	Philips Research Asia	India	Healthcare
6	Philips Research Africa	Kenya	Healthcare, design, user interface
7	Philips Research Eindhoven	Netherlands	Healthcare and global headquarters for all R&D
8	Philips Research Cambridge	United Kingdom	Healthcare
9	Philips Research North America	United States	Healthcare, artificial intelligence

([8]) http://www.samsung.com/semiconductor/about-us/research-development/.
([9]) https://www.philips.com/a-w/research/locations.html.

Although we did not undertake a full investigation, the literature on R&D management seems to confirm that regional R&D facilities may support local product development as well as the overall MNE's longer-term research strategy. For example, Papanastassiou and Pearce (2005) find that local R&D laboratories in the United Kingdom are mostly funded by the parent company of the MNE group. This is considered as being powerfully indicative of the manner in which such decentralised operations are now integral to the ways in which these companies seek to apply existing core technologies and to regenerate and broaden the scope of these crucial knowledge competences. It depicts a process of refocusing decentralised R&D away from the short-term objective of assisting particular subsidiaries to apply existing technologies to their specific competitive situation, towards positions integral to the more sustained technological and competitive development of the MNE group. In contrast to independently operating R&D facilities, close cooperation between the regional R&D units within an MNE is expected to provide substantial externalities, in the form of systematic group-level spillover benefits. Central financial participation in the funding of laboratories can be seen as crucial in developing the necessary interdependencies between decentralised R&D units, and in securing the cohesive growth of intra-group knowledge flows.

Some MNE groups like Apple follow quite aggressive strategies in obtaining the knowledge required for strengthening global competitiveness. Recently Apple opened R&D units in Berlin, the French Alps and New Zealand, all in the close neighbourhood of companies with a strong record in certain scientific areas (for example, mapping or augmented reality). In several cases these companies lost employees to Apple soon after Apple opened its new R&D unit ([10]). This shows that the choice of location of newly-established R&D units is on occasion solely driven by knowledge acquisition, the availability of human capital/tacit knowledge and not by locating the R&D unit close to those MNE affiliates that are supposed to transform the R&D into a product innovation, output and commercial success.

The existence of R&D networks within the MNE structure appears to have similar implications for the national accounts as the existence of fragmented production chains. While the geographical distribution of R&D costs within the MNE structure as reflected by Frascati Manual (OECD (2015)) based statistics is likely to be reasonably well measured, the distribution of (the economic ownership of) the created R&D assets inside the MNE is not well understood. For smaller national firms, there will likely be a strong geographical correlation between R&D activities and the obtained commercial gains. In those cases it is reasonable to assume that the location of R&D activity coincides with R&D asset ownership. However, within the MNE framework this assumption cannot generally be made on solid grounds. As R&D strategies and R&D funding are expected to result from the overall corporate strategy, the choice of considering R&D as genuine corporate property appears attractive. However, as mentioned the practicalities of such a choice should be carefully considered.

When assigning R&D ownership to the head offices one should ensure that the production accounts for each of the MNE group's entities meaningfully represent the various fragments of production encountered inside the MNE group. For example, each of the accounts should sufficiently support productivity measurement (Schreyer (2018)). This implies that together with R&D ownership, the R&D revenues need to be recorded in the accounts of the head office. Equally, the R&D costs need to be assigned to the MNE groups' affiliates. This is not a

([10]) https://www.bloomberg.com/news/articles/2017-09-21/apple-s-global-web-of-r-d-labs-doubles-as-poaching-operation.

new phenomenon as head offices will more broadly provide all sorts of intra-group services to its affiliates, for example, supply-chain management services, financial services and marketing activities.

One way to allocate all of these costs is by using allocation mechanisms such as the formulary apportionment techniques used by Guvenen et al. (2017). The main goal of Guvenen et al. is to allocate the generated income over those entities in the MNE which are carrying out the actual production activities. This is an attempt to overcome the disturbances caused by tax planning arrangements. In this paper we suggest allocating the sum of 'overhead costs', or in other words all intra-group services provided by head offices, to those affiliated companies which carry out part of the genuine economic activities. Obviously such allocation requires a concerted action from all the NSIs involved. The outcome of this exercise should be an economically sound allocation of the MNE group's value added and gross operating surplus leading to meaningful productivity statistics at the level of individual enterprises or establishments inside the MNE group. This goal corresponds closely to formulary apportionment allocation of profits as carried out by Guvenen et al. Please be aware that the proposed exercise may also help to overcome some of the substantive bilateral asymmetries witnessed for trade in services statistics today. Perhaps a concerted cost allocation of head offices could also overcome some of the disturbances of transfer pricing.

The example presented in the annex to this paper is quite simple as all R&D costs are assigned to one single affiliated company. But in essence it illustrates the cost reallocation proposed in this paper.

4. Intellectual property and tax planning

One may argue that R&D capitalisation in the 2008 SNA revealed (but did not necessarily cause!) the national accounts' vulnerability to problems arising from globalisation, as MNE groups may use IP assets as vehicles for tax planning. The goal of such tax planning is to shift revenue to units within the MNE structure that are tax resident in low tax jurisdictions, a consequence of which is that MNE groups can minimise their global tax liability. This is often achieved through the use of royalty and licence agreements linked to IP assets. Units of an MNE will typically be required to pay a royalty charge to another unit within the MNE for the right to use assets intrinsic to the production process. In doing so, profit from sales in higher tax jurisdictions can be transferred to units in lower tax jurisdictions, minimising the global tax liability for an MNE. Such constructions are often used by MNE groups in high technology-based industries where R&D and other forms of IP play a crucial role. The lack of a physical presence of IP assets lends themselves to such constructions as they can be easily located and relocated around the world at little cost. Under such conditions, the observable global value chain of MNE groups reflects an artificial, tax-driven, reality rather than what could be considered the true production process reflecting economic substance. We should also note that movable tangible assets such as transportation equipment may also be subject to tax planning arrangements as their (legal) ownership can be assigned to a leasing company resident in a low tax jurisdiction.

The two real life examples of Google and Nike explored in this section highlight the expected consequences of following, as a national accountant, the legal reality as revealed in source statistics, rather than looking around the legal reality and depicting the MNE group's real economic substance, which can only be seen once the entire 'elephant' has been observed.

It should be emphasised that all information on both cases has been obtained from public sources that have previously been published such as news articles and business reports and does not use information obtained for the purpose of official statistics.

A. The double Irish with a Dutch sandwich ([11])

EXPLAINING THE CASE

The 'double Irish with a Dutch sandwich' is a name given to a legal business arrangement which is designed to minimise the MNE's global tax liability. This technique has most prominently been used by technology companies, because these firms can easily shift large portions of profits to other countries by assigning IP rights to subsidiaries abroad. From 2015 onwards, Irish tax legislation no longer allows companies to use the double Irish Dutch sandwich for new tax plans; existing plans can be continued until 2020. The latter may have severe repercussions for national statistics as in response MNE groups may restructure their business and set-up alternative tax planning schemes. Business restructurings may also be a response to recent United States tax reforms.

One of the MNE groups using the double Irish Dutch sandwich construction is Google ([12]). The main ingredients, which are typical for the double Irish Dutch sandwich recipe, are as follows. The parent company at the top of the corporate hierarchy is Alphabet Inc. This company is based in Mountain View, California (United States). Although most of the ultimate parents of MNE groups using the double Irish Dutch sandwich structure are resident in the United States, this is not necessarily the case. Google Inc. sits below Alphabet Inc. in the hierarchy and is the top of the structure for what can best be described as the everyday Google internet functions such as its search engine, maps, e-mail. A large number of companies operating across the world sit below Google Inc. in the hierarchy.

One of these is Google Ireland Holdings Unlimited, which is an Irish incorporated entity managed and controlled from Bermuda — a common choice. This is a special purpose entity (SPE) registered in Ireland but not liable for tax in Ireland. Rather, it is liable for tax in Bermuda from where it is officially managed and controlled ([13]). This type of holding company with only holding activities has no physical presence and zero employees, or only sufficient employment to fulfil a strict legal requirement, in other words, the only employees are directors or shareholders who are normally non-Irish residents.

([11]) A detailed legal explanation of the double Irish with a Dutch sandwich is given in Brothers, J (2014), 'From the Double Irish to the Bermuda Triangle', Tax Analysis.
([12]) https://fd.nl/ondernemen/1180304/google-sluisde-vorig-jaar-15-mrd-royalties-door-nederland.
([13]) Idem, see footnote (12).

Google Netherlands Holding B.V. is a Dutch resident company. It is an SPE type unit with no employees and no activities other than financing and participating in affiliated companies ([14]). This Dutch SPE receives royalty payments from Google units in Ireland and Singapore which are directly transferred to Google Ireland Holdings Unlimited, minus a small amount for administrative costs.

Google Ireland Limited is an Irish registered company that undertakes real economic activities in Ireland. It also has a wider role outside Ireland of being the company that closes all deals for Google AdWords across Europe. AdWords represents a large portion of Google's revenue. It has been estimated that as much as 88 % of Google's non-U.S. revenue is recorded by Google Ireland Limited ([15]). Together these Google affiliates, representing the double Irish Dutch sandwich, operate as follows.

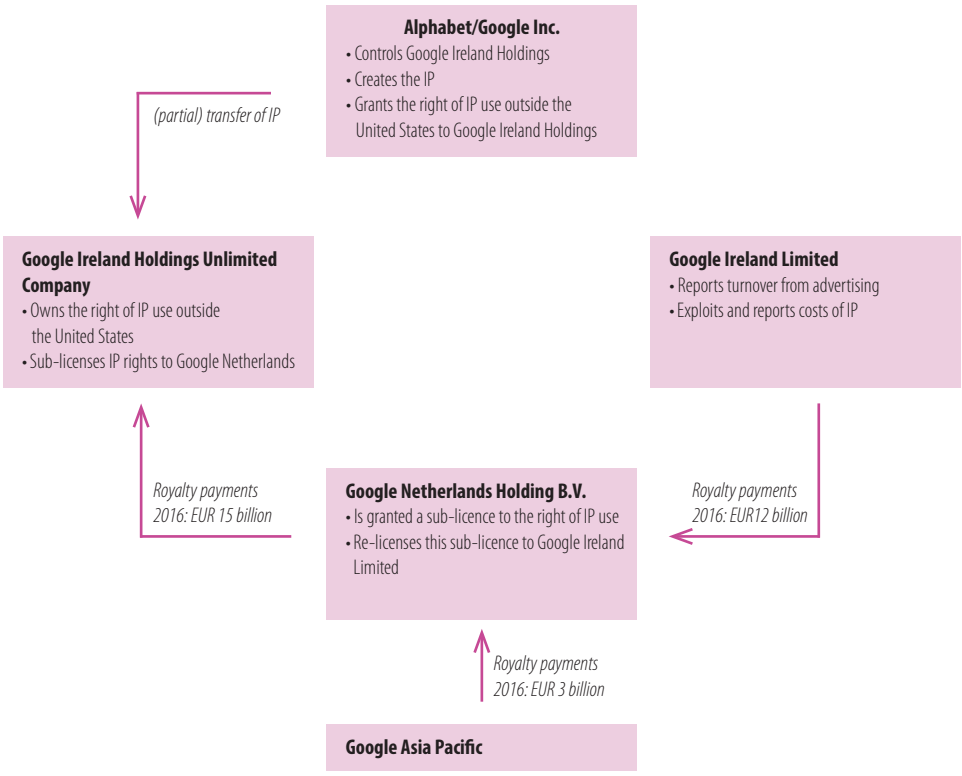
Google Ireland Holdings Unlimited owns various IP rights which it licences to Google Netherlands Holding B.V. who in turn then sublicenses these rights to Google Ireland Limited. Google Ireland Limited uses the sublicenses in its production process and generates revenue. In doing so it is liable to pay royalty fees to Google Netherlands Holding B.V. as a result of using the IP.

Google Netherlands Holdings B.V. is also liable to pay royalty fees to Google Ireland Holdings Unlimited on account of the licencing agreement between the two. As such, the royalty payments make their way from Ireland via the Netherlands back to an Irish registered company which is however controlled, managed and liable to pay corporation tax in Bermuda. Google Netherlands Holdings B.V. acts only to channel financial flows between units. In comparison with the value of the royalty flows, little profit remains in the Netherlands.

The Dutch SPE is not an essential hub in the tax planning arrangement. Rather, it is an additional insurance layer against potential withholding tax liabilities arising on direct royalty payments. The zero rate of withholding taxes on incoming and outgoing royalty payments between Ireland and the Netherlands allows this royalty flow to be seen as being taxed already (though at a zero rate) meaning the potential tax liability is therefore removed. Typically, the Dutch SPE will pay virtually identical royalty payments to the Irish holding unit as it receives. In 2015, over 99.9 % of the royalties received by Google Netherlands Holdings B.V. were repaid to Google Ireland Holdings ([16]). An overview of the Google structure is presented in Figure 1.1.

([14]) Google Netherlands Holdings B.V., Annual report 2016.
([15]) van Geest, van Kleer and Smits (2015), pp. 64.
([16]) As calculated based on data from Google Netherlands Holding B.V., Annual report 2015, publically available at www.kvk.nl. Royalties received EUR 14 963 billion, royalties repaid EUR 14 951 billion.

Figure 1.1: A double Irish Dutch sandwich: the Google case



NATIONAL ACCOUNTS IMPLICATIONS

There are several concerns when translating the information obtained from each of these entities to national accounts statistics.

The arrangement requires that IP ownership is transferred from the ultimate parent (in the United States) to the royalty and licence company in a low tax jurisdiction (Bermuda); in the Google case this is Google Ireland Holdings. This apparent IP transfer raises several questions: for example, would this be an IP purchase/sale, and if so, what would be a representative market value of such an intra-MNE group transaction? But perhaps an even more fundamental issue is whether or not this transaction has economic substance at all. Is Google Ireland Holdings, besides the legal owner, also the economic owner of this IP? One may expect that, despite this arrangement, strategic decisions about IP creation and allocation continue to be made in the United States, even in cases where part of its IP ownership is transferred to an affiliated company abroad. A practical question is whether such international intra-group IP transactions will be recorded in all the countries involved in a symmetrical way. In other words, will the value representing the export of the IP from the United States equal the import value as reported in Bermuda/Ireland?

Another question is the country of residence of Google Ireland Holdings Unlimited, as this company is registered in Ireland but managed and controlled in Bermuda and is also liable

for tax in Bermuda. Which country should conceptually be recording this unit in their national accounts and which country is actually doing this?

Google Netherlands Holding B.V. is registered in the Netherlands, files annual returns to the Dutch Chamber of Commerce and is liable for tax in the Netherlands. As Google Netherlands Holding B.V. lacks a domestic parent it must be considered an independent resident institutional unit in the Netherlands. Google Netherlands Holding B.V. is granted a sub-licence for the IP assets but no information of its value is shown in business reports. Google Netherlands Holding B.V. does not carry out significant economic activity from a national accounts perspective, has no employment and appears to do no more than channelling financial flows from one country to another. In doing so it fully acts on behalf of its foreign parent. The inflows of funds equal outflows with a small margin covering local costs. From the point of view of the Netherlands, it is defendable that these inflows and outflows are recorded as financial transactions and not as IP related services imports and exports. But from the point of view of Ireland such a recording would create an asymmetry as Google Ireland Limited is expected to report an import of IP services from the Netherlands. Or perhaps directly from Bermuda?

THE BERMUDA TRIANGLE

Given the residency issue of Google Ireland Holdings Unlimited, there is a relatively high chance that this entity will show up neither in Irish nor in Bermudan statistics. In other words, in the world of statistics the Bermuda triangle appears a real threat. This view is strengthened by simply comparing the value of the royalty transactions involved to the annual GDP figure for Bermuda. In 2015, Bermudan GDP was valued at USD 5.9 billion ([17]). This amount is far less than the EUR 14.9 billion that Google's Dutch subsidiary paid in 2016 to its Bermudan subsidiary. The tentative conclusion is that earnings of Google Ireland Holdings Unlimited are not included in Bermudan measures of GDP. The compilers of Bermudan GDP may not view this unit as being resident in Bermuda, or otherwise may not conceive Google Ireland Holdings Unlimited as the producer of IP services with a turnover of EUR 14.9 billion.

The double Irish with a Dutch sandwich strategy is known to be used, or has been used in the past by large companies other than Google. Attempting to extrapolate out from this one case study to quantify with any degree of accuracy what might be the total value of unrecorded GDP is nearly impossible without vast amounts of time and resources. Even then, a wall of corporate secrecy would act as a serious impediment to obtaining good estimates of globally unrecorded output.

Research undertaken in other areas does allow some attempt to be made to come to a ball-park estimate for this global issue. For instance, Garcia-Bernardo et al (2017) analyse global corporate ownership structures from a network analysis approach and in doing so designate certain countries as either sink or conduit financial centres. The authors identify Bermuda as one of the largest sink offshore financial centres in that it is the net recipient of far more foreign capital than would be expected given Bermuda's level of GDP. The question remains whether this lost income should be recorded in Bermuda's GDP at all.

([17]) Official estimate of Bermudan government, available at: https://www.gov.bm/bermuda-economic-statistics.

Guvenen et al (2017) attempt to reattribute foreign earnings of United States led MNE groups to study what impact this has on measures of United States output and industry productivity. In doing so, they reattribute earnings from Bermuda to the United States of USD 35 billion which represents the equivalent of almost six times Bermudan GDP. The authors conclude that current United States measures of output suffer from measurement errors as a result of earnings by United States corporations being shifted to countries with relatively low tax rates. The authors also indicate that repatriated earnings from United Kingdom territories in the Caribbean including the British Virgin Islands, Cayman Islands and Turks and Caicos Islands are equal to 4.8 times the GDP of these lands. The largest repatriation, 28 % of the total, is actually from the Netherlands. This shows that the issue of profit shifting does not necessarily have to involve what could be termed the traditional tax paradises.

This paper makes no attempt to put a value on the total of global unreported value added. Rather, it concludes that this total is expected to be substantial. If the coverage of just one MNE in the national accounts alone is responsible for USD 15 billion of missed output then the total of all MNE groups could easily exceed USD 100 billion. Zucman (2015) indicates that profit shifting to low tax jurisdictions outside the United States represents an amount of USD 130 billion. One may expect that most of this capital income will not be reported in any country's GDP. Compared with global GDP of around USD 75 trillion this unobserved income may still seem small. But as indicated by Guvenen et al. tax planning arrangements may have significant and undesirable effects on macro-economic indicators at a national level.

B. The case of Nike

A so-called 'closed' Dutch limited partnership, in Dutch a 'commanditaire vennootschap' or C.V., is used by several American MNE groups such as Nike, General Electric, Heinz, Caterpillar, Time Warner and Foot Locker ([18]). The C.V. tax planning route has led to accusations against the Netherlands of being a tax haven for American companies in a similar manner to places such as the Caymans Islands, Switzerland and Bermuda. How the C.V. construction works is explained with the help of another case study, based on Nike.

Once again, IP assets are a key element of this tax planning arrangement. As explained in the UNECE Global Production Guide (2015, paragraph 2.17) the value of sports brands such as Nike may partly originate from R&D, for example, the development of 'a midsole, the most important part of an athletic shoe, that cushions and protects the foot'. However, it is quite clear that sports brands such as Nike are also the outcome of intensive marketing operations which are — in the strict sense of the 2008 SNA — a non-produced asset. When observing the profit and loss accounts and balance sheets of companies characterised by royalty and licence payments, the distinction between produced and non-produced intangible assets, also in terms of related capital services or royalty receipts, is not easily made. This point is addressed later on in this section.

From a national accounts perspective the case of Nike looks similar to that of Google in that specific units within the MNE own IP assets intrinsic to the production process for which they are reimbursed by other units within the MNE group's global value chain for the use of

([18]) https://thecorrespondent.com/6942/bermuda-guess-again-turns-out-holland-is-the-tax-haven-of-choice-for-us-companies/417639737658-b85252de.

those IP assets. However, Nike does not use Irish registered units but rather a specific type of Dutch legal construction. Nike Innovate C.V. is a subsidiary of the Nike Group and is registered with the Dutch Chamber of Commerce, although its official address is recorded as being in Oregon (United States). The activities of the business are recorded by the Dutch Chamber of Commerce as 'holding IPP rights, financing R&D and buying-out third party licences'. As reported in the international media, Nike Innovate C.V. is the legal owner of IP assets including trademarks and designs belonging to the Nike Group ([19]). It is useful to emphasise that purchased marketing assets and goodwill are also assets in the 2008 SNA sense, however they are classified as non-produced and therefore not considered as IP products.

According to Dutch tax law, C.V.'s are not themselves liable to pay Dutch corporate income tax. It is assumed that the sponsor or owner of the C.V. is liable to pay corporate income tax. However, under United States tax law the C.V. is seen as liable for tax in the Netherlands. This misclassification can result in certain C.V.'s being liable for corporate income tax in neither the Netherlands nor the United States. In effect such C.V.'s become stateless ([20]).

If Nike Innovate C.V. is not liable to pay corporation tax in the Netherlands, it will also not appear in tax data used by Statistics Netherlands for compiling economic statistics. Also, as Nike Innovate C.V. is not registered with an address in the Netherlands, this entity is not surveyed for official statistics. As a result, Nike Innovate C.V. remains uncovered by official statistics for the Netherlands; nor should it be expected that this entity will show up in the statistics of any other country.

The Netherlands also hosts Nike Europe Holding B.V., which is a holding company for other Nike units within Europe including Nike Europe Operations Netherlands B.V. This unit is the European headquarters of Nike with around 2 000 employees in the Netherlands. Nike Europe Holding B.V. has a branch located in Belgium, where the Nike Customer Service Center is located. The customer service centre provides central warehousing activities to its subsidiary Nike Europe Operations Netherlands B.V. which is the owner of the inventory held at the warehouse and which is the main commercial entity of the Nike group in Europe and the Middle East. As explained in the financial report ([21]), the warehousing activities involve all supply-chain related activities, including receipt, storage, order handling and shipment of Nike products.

The principal business activity of Nike Europe Operations Netherlands B.V. is given as the marketing and selling of athletic footwear, apparel, equipment, accessories and services ([22]). For the year June 2015 to June 2016 the unit recorded revenues of EUR 8.4 billion, the majority of which were generated outside the Netherlands by its subsidiaries. Nike Europe Operations Netherlands B.V. and its subsidiaries generate revenue by selling goods across Europe and beyond, either directly to consumers, or via independent distributors and licensees.

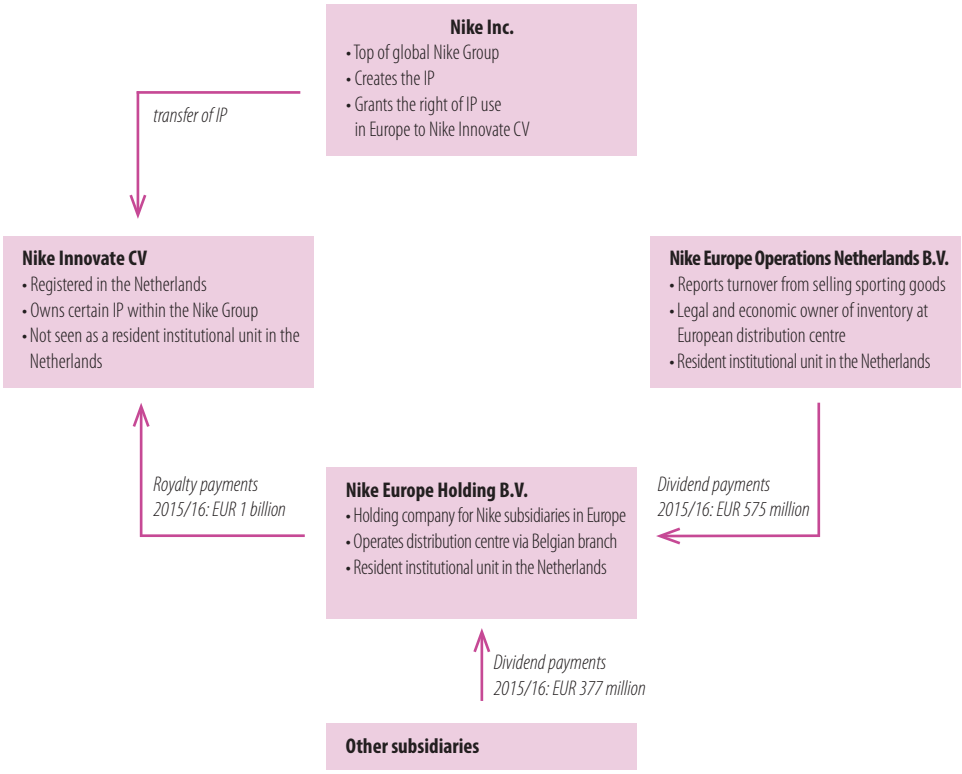
The revenue of Nike Europe Holding B.V. is solely limited to the services provided by the customer service centre to Nike Europe Operations Netherlands B.V. for which they are reimbursed on a cost plus mark-up basis. For the year from June 2015 to June 2016 this

([19]) https://www.irishtimes.com/business/how-nike-slashes-its-tax-bill-between-the-netherlands-and-bermuda-1.3281665.
([20]) http://leidenlawblog.nl/articles/what-about-cv-bv-structures-and-state-aid.
([21]) Nike Europe Holding B.V., Financial report for year ending May 2016, publically available from www.kvk.nl.
([22]) Nike European Operations Netherlands B.V., Financial report for year ending May 2016, publically available from www.kvk.nl.

revenue is recorded as EUR 262 million. However, Nike Europe Holding B.V. recorded — for the same period — general and administrative expenses of EUR 1 268 billion. Of this EUR 1 017 billion is recorded as trademark royalties, ''in connection with the distribution and commercial exploitation of Nike intangible property and Nike marks' ([23]). The result of making a royalty payment far in excess of revenue is that Nike Europe Holding B.V. records an operating loss which is then financed by dividends from its subsidiaries and principally from Nike Europe Operations Netherlands B.V. This description of Nike's operations in the Netherlands reflects the structure and practices that have been in place since November 2012 when Nike Europe Holding B.V entered into 'a certain agreement in connection with the distribution and commercial exploitation of Nike intangible property and Nike marks' ([24]).

Figure 1.2 details the transactions that take place between the units under discussion with additional details taken from the publically available annual reports filed at the Dutch Chamber of Commerce.

Figure 1.2: The Nike case



([23]) Idem, see footnote (22).
([24]) Nike Europe Holding B.V., Financial report for year ending May 2013 publically available from www.kvk.nl.

The case of a sports shoes manufacturer was also a prominently used example in the UNECE Guide to Measuring Global Production (UNECE (2015)). The example was used to discuss the production arrangements between a principal and contracted foreign suppliers including the more specific issues of merchanting and FGPs. However, the particular issue of IP assets being held in an, as far as national accounts measures are concerned, stateless entity was not discussed. Before the information revealed by the Paradise papers, such an example was simply too bizarre to imagine.

As a commanditaire vennootschap, Nike Innovate C.V. is not required to file annual accounts with the Dutch Chamber of Commerce. Obtaining details on any of this entity's transactions is therefore difficult. The accounts of Nike Europe Holding B.V. do not reveal the names of the recipients of the royalty payments within the Nike Group. Media reports have identified Nike Innovate C.V. as being the recipient of royalty payments from Nike's European headquarters in the Netherlands ([25]).

From a conceptual viewpoint, it is not clear how the income flows related to non-produced intangible assets such as brand names should be recorded in the national accounts. Marketing assets, trademarks and designs fall outside the fixed assets boundary. As explained by BMP6 (paragraph 10.140) trademark revenue, payments for use of brand names, and so forth include aspects of property income (in other words, putting a non-financial non-produced asset at the disposal of another unit) as well as aspects of services (such as the active processes of technical support, product research, marketing, and quality control). The recording of income flows obtained from non-produced intangible assets such as trademarks and brand names is not explicitly addressed in the 2008 SNA.

NATIONAL ACCOUNTS IMPLICATIONS

It is expected that the revenues of the above C.V.'s will not be accounted for in either the GDP of the United States or the Netherlands. This is due to the peculiar tax status of these C.V.'s. The repercussion for statistical measurement is that Nike Innovate C.V. has no resident status. This would imply that the more benign sounding Dutch polder is equally as dangerous to global GDP as the Bermuda triangle; both arrangements function as royalty income sinks. Looking at the substance of the arrangement one would probably argue that the actual economic ownership of the Nike brand name is still in the hands of Nike headquarters in Beaverton, Oregon (United States).

At the same time, one may expect that the service charges for using the Nike brand will be (implicitly) recorded in business surveys as production costs of Nike Europe Operations Netherlands and perhaps of other affiliated companies. Whether these cost charges are 'at arm's length' cannot be assessed.

Also, the 2008 SNA is not particularly clear on whether these expenses should be part of the current cost of production, in other words, intermediate consumption, at all. The Nike case shows that non-produced assets can be put at the disposal of other units for use in their production process. If this is done, the owner of the assets may receive royalty or licence payments in exchange. This can be the case with marketing assets such as trademarks, logos

([25]) https://www.theguardian.com/news/2017/nov/06/nike-tax-paradise-papers.

or brand names. Royalty payments in exchange for the use of marketing assets would differ from those for produced assets as marketing assets are classified in the SNA as non-produced assets. This raises the question of how royalty payments for the use of non-produced assets should be recorded.

Besides loopholes caused by differences in tax policies, the national accounts seem to suffer from a similar kind of mismatch. Entities such as Google Ireland Holdings and Nike Innovate C.V. appear to be stateless in the eyes of the national accountant. This may partly result from differences in how national accountants put in practice the SNA guidelines on, for example, the residency principle of statistical units.

5. Conclusion

Unlike Lynch & Thage (2017) we generally support the choice of capitalising R&D expenditure in the national accounts. It is beyond doubt that knowledge investments are crucial for the competitiveness of companies. As successful knowledge investments will generate returns over a range of years, it is difficult to ignore the concept of knowledge capital in the national accounts. Doing so would inevitably diminish the relevance of national accounting.

At the same time we argue that the 2008 SNA approach of R&D capitalisation has gone too far. The 2008 SNA is insufficiently clear in explaining under which conditions knowledge truly represents an economic asset in the SNA sense. As argued in this paper, knowledge becomes an economic asset under the following conditions:

- the economic owner has exclusive ownership over the knowledge;
- this exclusive ownership is expected to generate for its owner an economic (competitive) advantage and a return on investment.

Exclusive ownership enforced by a patent, secrecy or by other means (having access to the complementary tacit knowledge) is, in our opinion, a precondition for the existence of a knowledge asset. As a consequence, capitalisation of freely accessible academic research as recommended in the 2008 SNA should be reconsidered.

Also within the enterprise group the concept of knowledge (R&D) ownership is insufficiently understood. The national accounts methodology does not acknowledge that decisions on R&D programmes and funding are often made by headquarters and affect the entire MNE structure. As such, the international guidelines do not adequately explain how knowledge capital is linked to the MNE and international value chains. For example, the SNA should provide guidance on whether knowledge capital ownership should be identified at the level of the establishment, enterprise or enterprise group. Additional guidance on these general principles is greatly needed. This paper shows that R&D ownership is most easily identified at the level of the enterprise group. Assigning its ownership to lower levels in the MNE structure such as establishments, as is done for other fixed capital asset categories, is not straightforward.

In the national accounts, production is described at the level of establishments or kind-of-activity units. Their classification is according to ISIC. Similarly, a multifactor type productivity analysis usually requires that inputs and outputs of production can be statistically described at the level of establishments. Our impression is that R&D is different from other fixed assets. Particularly within the global value chain, R&D asset ownership is not easily linked to the individual fragments of the global value chain and cannot be assigned to individual ISIC classes. The Frascati Manual (OECD (2015)) recommends collecting R&D statistics at the level of the institutional unit (in other words, the enterprise) and not the kind-of-activity unit. Vancauteren et al. (2018) show that for the analysis of patent ownership the enterprise is essential in the construction of patent datasets as firms tend to register patents (and R&D) under separate enterprise names.

Additionally, the 2008 SNA should provide much more guidance on how to treat R&D (or IP) ownership in the context of tax planning. The UNECE Global Production Guide suggests following legal ownership as a second best alternative. This paper shows that this solution is unsatisfactory from an analytical point of view, as following legal ownership seems to imply that portions of IP related income are not accounted for at all, neither from a national nor global viewpoint.

Finally, this paper shows that official statistics as collected at national level will not necessarily reveal the tax planning arrangements MNE groups are undertaking. Official statistics can only fulfil their key task of informing the public about macro-economic developments if national accountants combine their efforts in making sense of the data collected from internationally operating companies. The work on data sharing that is currently being undertaken is therefore very welcome. Also, one may hope that the OECD Base Erosion and Profit Shifting (BEPS) initiative will provide improved data sources on the activities of MNE groups.

Our recommendations to improve the recording of R&D and IP in national accounts are the following:

- The definition of (R&D) knowledge assets in the SNA requires refinement to explain that freely shared knowledge is not an asset in the SNA sense.
- The issue of R&D asset ownership inside the MNE requires continued investigation. As a starting point it is worth investigating whether R&D ownership could and should be assigned to the enterprise group or its headquarters. This is where decision-making on R&D programmes and budgets often takes place. However, from a statistical measurement point of view this proposal has undoubtedly several practical implications. For example:
  - As explained in Section 3 this would require modifications in the accounts and close cooperation between all the NSIs involved. A rerouting of a more limited scope would address the IP transactions of artificial brass plate type royalty and licences companies. A worked example is presented in the annex. The operation increases in complexity once several affiliates or business units inside the MNE group may generate profits which partly originate from the MNE group's IP. The option of applying cost retribution methods in the national accounts, not only for IP costs but generally for all sorts of intra-group services provided by head offices, should be investigated.
  - Another proposed step is assigning the R&D from regional R&D units to headquarters (see Tables 1.1 and 1.2). From the perspective of the country (A) in which this R&D facility is resident the recording of its output would be an export rather than gross fixed capital

formation. The accounts of country (B) domiciling the headquarters would show the R&D gross fixed capital formation which originates from imports. The R&D would subsequently be depreciated in country (B).

- The extent to which MNE group activities can impact macro-economic statistics may require the need for more radical solutions that go beyond rerouting within the current SNA framework. For example, Rassier (2017) has raised the question of whether MNE group activities would be better recorded in an SNA framework that offers dual presentation measures rather than single measures that conflate operating entities with special purpose entities.

Obviously, all such options require a concerted action on the part of all the countries involved/concerned. Such accounting solutions can only work when national statistical offices start working closely together. In the current information society this should work, particularly when NSIs are able to overcome legal constraints when strictly cooperating within official multinational statistical networks.

- Throughout the world, and of course on a confidential basis, national accountants must start sharing their data and knowledge on MNE groups with the main goal of improving the common understanding of MNE group structures and the recording of MNE group activities on a country by country basis. Recent experiences show that accounting for MNE groups is no longer achievable on an individual country basis. The accurate recording of IP transactions and ownership inside MNE groups requires international statistical coordination in order to avoid the existence of GDP sinks such as the Bermuda triangle and the Dutch polder. International organisations should facilitate such data sharing initiatives: some of them — Eurostat, UNECE and OECD — have already started to do so.
- Statisticians and national accounts compilers should inform the public that tax planning is not only an issue for government revenue but also for official statistics. This may sound naïve as tax base erosion is of course primarily an issue of social fairness in terms of fair tax bill sharing between citizens and companies and in terms of fair corporate competition. However, one of the undesired consequences of non-published arrangements between MNE groups and tax authorities is that statisticians are seriously hampered in their task to inform the public properly on the actual state of economic affairs and the nature of activities that companies are undertaking in their countries.
- National accountants need to be vocally supportive of country-by-country company reporting as recommended in the OECD's Base Erosion and Profit Shifting prevention initiative as a way to ensure an improved monitoring of national and global economic developments ([26]).
- Future updates of SNA should consider the recording of non-produced non-financial assets (marketing assets) and royalties earned on them particularly in the context of tax planning strategies within MNE groups. As a minimum, the 2008 SNA should elaborate on the advice of BPM6 for how to deal with income (rent) obtained from the ownership of non-produced assets (in other words, trademarks and marketing assets).

([26]) http://www.oecd.org/tax/beps/country-by-country-reporting.htm.

Acknowledgements

The authors would like to thank Dirk van den Bergen, Michael Connolly, Tihomira Dimova, Henk Nijmeijer, Paul Konijn, Rami Peltola, Peter van de Ven, Piet Verbiest and two anonymous referees for their excellent comments.

References

Brothers, J. (2014) 'From the Double Irish to the Bermuda Triangle', *Tax Analysis*.

Eurostat (2014), *Manual on goods sent abroad for processing*, Luxembourg.

Garcia-Bernardo, J., J. Fichtner, F. W. Takes and E. M. Heemskerk (2017), 'Uncovering Offshore Financial Centers: Conduits and Sinks in the Global Corporate Ownership IPP Network', *Scientific Reports*, No. 7, Article no. 6246.

van Geest, M., J. van Kleef and H. Smits (2015), Het Belastingparadijs. *Waarom niemand hier belasting betaalt - behalve u*, Business Contact.

Guvenen, F. et al. (2017), 'Offshore Profit Shifting and Domestic Productivity Measurement', National Bureau of Economic Research Working Paper, No. 23324; available at: http://www.nber.org/papers/w23324.

de Haan, M. and M. van Rooijen-Horsten (2004), 'Measuring R&D Output and Knowledge Capital Formation in Open Economies', paper prepared for the 28th General Conference of the International Association for Research in Income and Wealth, Cork.

de Haan, M., P. H. van Mulligen, P. van de Ven and K. Zeelenberg (2004), 'National accounting in the knowledge and information society', paper prepared for the 28th General Conference of the International Association for Research in Income and Wealth, Cork .

European Commission, IMF, OECD, UN and World Bank (2008), *System of National Accounts* 2008.

Lynch R. and B. Thage (2017), 'Maintaining the National Accounts as official statistics', *Review of Income and Wealth*, Vol. 63, Issue S2, pp. 411-436.

OECD (2009), *Handbook on deriving Capital Measures of Intellectual Property Products.*

OECD (2015), *Frascati Manual.*

Papanastassiou, M. and R. Pearce (2005), 'Funding sources and the strategic roles of decentralised R&D in multinationals', *R&D Management*, Vol. 35, Issue 1.

Rassier, D. (2017), 'Improving the SNA treatment of multinational enterprises', *Review of Income and Wealth*, Vol. 63, Issue S2, pp. 287-320.

van Rooijen-Horsten, M. M. Tanriseven and M. de Haan (2007), 'R&D Satellite accounts in the Netherlands: a progress report', paper prepared for the OECD working party on national accounts (session: measuring capital stock, capital services and productivity), Paris.

Schreyer, P. (2018), 'Globalisation, Intellectual Property Products and Measurement of GDP: Issues and Some Proposals', paper for the OECD's Committee on Statistics and Statistical Policy (CSSP) informal reflection group.

UNECE (2011), *The impact of globalization on the National Accounts*.

UNECE (2015), *A guide to measuring global production*.

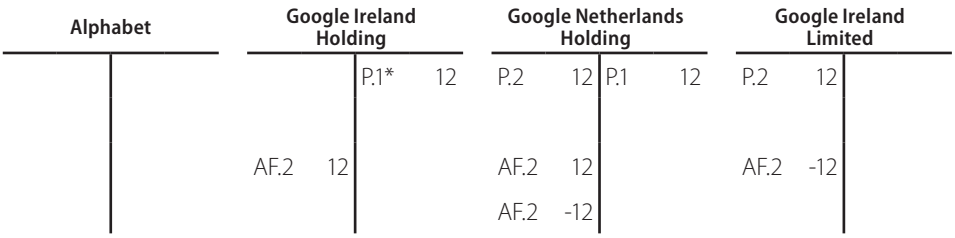
Vancauteren, M., M. Polder and M. van den Berg (2018), 'The relationship between tax payments and MNEs patenting activities and implications for real economic activity: evidence from the Netherlands', paper prepared for the Conference on Research in Income and Wealth, The Challenges of Globalization in the Measurement of National Accounts, Washington D.C.

Zucman, G. (2015), *The hidden wealth of nations*, The University of Chicago Press.

Annex 1: Google case — re-routing of IP transactions

The concerted accounting treatment of Google, as proposed in this paper, would be to identify Alphabet as the genuine producer of the IP services as consumed by Google Ireland Limited (and of course as consumed by any other non-United States Google affiliate). This coincides with the economic ownership of the IP being assigned to Alphabet in the United States (in contrast to its legal ownership). Of course this would imply that Google Ireland Holding is no longer identified as a royalty and licences firm. In fact, both Google Ireland Holding and Google Netherlands Holding would be classified as purely financial vehicles, 'Other financial intermediaries (S.127)', with no output. Their main purpose seems to be managing international cash flows on behalf of their mother company.

Legal representation



Economic interpretation