OECD BENCHMARK DEFINITION OF FOREIGN DIRECT INVESTMENT

Third Edition

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

Recording comprehensive, comparable and up-to-date statistics on Foreign Direct Investment (FDI) is a prerequisite for economic analysis and policy making. The objective of this Benchmark Definition of Foreign Direct Investment is to provide detailed operational guidance on how FDI data should be compiled to meet internationally agreed standards. It reviews the main statistical concepts and definitions of FDI, the valuation of FDI flows and stocks and issues related to specific transactions and entities. Practical solutions are proposed and concrete examples are used wherever possible.

The Third Edition of the OECD Benchmark Definition is fully consistent with the IMF *Balance of Payments Manual*, Fifth Edition. It was prepared under the auspices of the Group of Financial Statisticians and approved by the Committee on International Investment and Multinational Enterprises. The OECD Council, in July 1995, adopted the Recommendation attached to the Report and agreed to derestriction of the Report and the Recommendation.

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I. Introduction

1. Recording statistical data on Foreign Direct Investment (FDI) is a prerequisite for economic analysis and policy making. The need for comprehensive, comparable and up-to-date data is increasing as FDI has assumed a crucial role in the internationalisation of economic activities. The OECD Benchmark Definition provides operational guidance on how FDI data should be compiled to meet internationally agreed standards. The Benchmark Definition was first published in 1983 based on a report by the OECD Group of Financial Statisticians. Subsequent revisions were undertaken in 1990 and 1992. The current revision of the Benchmark Definition has been prompted by the recently issued IMF *Balance of Payments Manual,* Fifth Edition, 1993 with which it is fully consistent.

2. Setting a standard for FDI statistics, the OECD Benchmark Definition serves three objectives:

- It provides clear orientation for individual countries as they develop or change their statistical system for recording FDI.
- It improves the basis for economic analysis of FDI, especially in international comparisons, to the extent that progress is made in reducing national deviations from the standard.
- It offers an objective standard for measuring remaining methodological differences between national FDI data that need to be taken into account for cross-country analysis of FDI.

3. In providing operational guidance to statisticians, the OECD Benchmark Definition identifies different approaches and definitions adopted in Member countries to measure FDI and proposes practical solutions in each case; concrete examples are used wherever possible. In this approach, the Benchmark covers the main statistical concepts and definitions of FDI, aspects of valuation of FDI flows and stocks and a broad range of issues related to specific transactions and entities. A section is devoted to reporting methods.

4. Since publication of the first edition of the Benchmark Definition, substantial progress has been made in the compliance of Member countries with its recommendations. It has considerably facilitated the design and implementation of joint efforts by OECD and EUROSTAT to collect FDI data on a comparable basis for OECD countries. The OECD Yearbook on FDI statistics was published for the first time in 1993.

II. Main concepts and definitions

1. Foreign direct investment

5. Foreign direct investment reflects the objective of obtaining a lasting interest by a resident entity in one economy (''direct investor'') in an entity resident in an economy other than that of the investor (''direct investment enterprise''). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management

of the enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated.

2. Foreign direct investor

6. A foreign direct investor is an individual, an incorporated or unincorporated public or private enterprise, a government, a group of related individuals, or a group of related incorporated and/or unincorporated enterprises which has a direct investment enterprise – that is, a subsidiary, associate or branch – operating in a country other than the country or countries of residence of the foreign direct investor or investors.

3. Direct investment enterprise

7. OECD recommends that a direct investment enterprise be defined as an incorporated or unincorporated enterprise in which a foreign investor owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise.

8. The numerical guideline of ownership of 10 per cent of ordinary shares or voting stock determines the existence of a direct investment relationship. An effective voice in the management, as evidenced by an ownership of at least 10 per cent, implies that the direct investor is able to influence or participate in the management of an enterprise; it does not require absolute control by the foreign investor.

9. Although not recommended by the OECD, some countries may still feel it necessary to treat the 10 per cent cut-off point in a flexible manner to fit the circumstances. In some cases, the ownership of 10 per cent of the ordinary shares or voting power may not lead to the exercise of any significant influence while, on the other hand, a direct investor may own less than 10 per cent but have an effective voice in the management. OECD does not recommend any qualifications to the 10 per cent rule. Consequently, countries that choose not to follow the 10 per cent rule in all cases should identify, where possible, the aggregate value of transactions not falling under the 10 per cent cut-off rule, so as to facilitate international comparability.

10. Some countries may consider that the existence of elements of a direct investment relationship may be indicated by a combination of factors such as:

- *a)* representation on the board of directors;
- *b)* participation in policy-making processes;
- *c)* material inter-company transactions;
- *d)* interchange of managerial personnel;
- *e)* provision of technical information;
- *f)* provision of long-term loans at lower than existing market rates.

Other relationships may exist between enterprises in different economies which exhibit the characteristics set out above, although there is no formal link with regard to shareholding. For example, two enterprises, each operating in different economies, may have a common board and common policy making and may share resources including funds but with neither having a shareholding in the other of 10 per cent or more. In such cases where neither is a direct investment enterprise of the other, the transactions could be treated as between related subsidiaries (see also para. 40 and Annex 4). These are not regarded as direct investment.

11. In the process of globalisation of economic activities, cross border transactions are carried out that at first glance may be regarded as foreign direct investment when in fact they do not meet the criteria. For example:

a) An enterprise undertakes to build for a foreign client, usually a Government, a complete manufacturing plant, to provide technical know-how, and to manage and operate a plant for a number of years, without an ongoing on-site managerial presence and without other criteria for existence of a direct investment enterprise being met. It has complete control over day-to-day operations and receives a management fee, paid either in cash or in goods produced by the plant. However, the enterprise has no equity stake in the plant and is performing a cross-border service.

b) An enterprise has a long-term contract with a foreign company, provides it with technical know-how, and has considerable influence over the quality and quantity of output. The enterprise may provide a loan to the foreign company and sometimes will have a member on the company's board. However, there is no equity stake. It is once again a cross-border service.

c) Some host countries have made agreements with a number of foreign enterprises where the host country supplies factory accommodation, electricity, staff accommodation, administration and labour. The foreign enterprise supplies all production machinery, fixtures and fittings for the building and production materials, and is responsible for the initial training of the labour force. The foreign enterprise then pays an agreed piecework rate for each item produced. Where the production machinery and fixtures and fittings remain the property of the foreign enterprise, there is technically a direct investment branch, though the branch's profits will be zero. There is no direct investment interest if the machinery becomes the property of the host country.

d) Some professional firms operate much like a multinational firm, but do not hold equity in one another. For example, unaffiliated (in an equity sense) accounting or management consulting firms may operate globally under a single name, refer business to one another and receive fees in return, share costs (or facilities) for such items as training or advertising, and may have a board of directors to plan business strategy for the group. This is not direct investment, and would be difficult or impossible to account for as such, but it does have much in common with direct investment.

e) Other cases might include foreign sales and representative offices, as well as foreign stations, ticket offices, and terminal or port facilities of domestic airlines or ship operators. Such offices or activities can be treated as direct investment only if they meet the requirements of residence and the attribution of production in an economy as defined in the IMF *Balance of Payments Manual,* Fifth Edition.

4. Subsidiaries, associates and branches

12. A direct investment enterprise may be an incorporated enterprise – a subsidiary or associate company – or an unincorporated enterprise (branch). Direct investors may have direct investment enterprises which have subsidiaries, associates and branches in one country or in several countries.

13. The legal structures of groups of related enterprises are very complex and may bear no relationship to the management responsibilities. It can be argued that where enterprise A has a partly owned subsidiary B, which itself has a subsidiary C whose existence depends on B, not A, that C should not

be included as part of A's foreign direct investment. However, in practice it is difficult to make this type of distinction as A may have complete control of its partly owned subsidiaries and may have decided to invest in C through B rather than through some other channel.

14. For this reason OECD considers that inward and outward direct investment statistics should, as a matter of principle, cover all directly and indirectly owned subsidiaries, associates, and branches.[1] OECD recommends the following definition of these enterprises:

a) Subsidiary companies

Company X is a subsidiary of enterprise N if, and only if

i) enterprise N either

1. is a shareholder in or member of X and has the right to appoint or remove a majority of the members of X's administrative, management or supervisory body; or
2. owns more than half of the shareholders' or members' voting power in X; or

ii) company X is a subsidiary of any other company Y which is a subsidiary of N.

b) Associate companies

Company R is an associate of enterprise N if N, its subsidiaries and its other associated enterprises own not more than 50 per cent of the shareholders' or members' voting power in R and if N and its subsidiaries have a direct investment interest in R. Thus company R is an associate of N if N and its subsidiaries own between 10 and 50 per cent of the shareholders' voting power in R.[2]

c) Branches

A direct investment branch is an unincorporated enterprise in the host country that:

i) is a permanent establishment or office of a foreign direct investor (see also para. 11); or

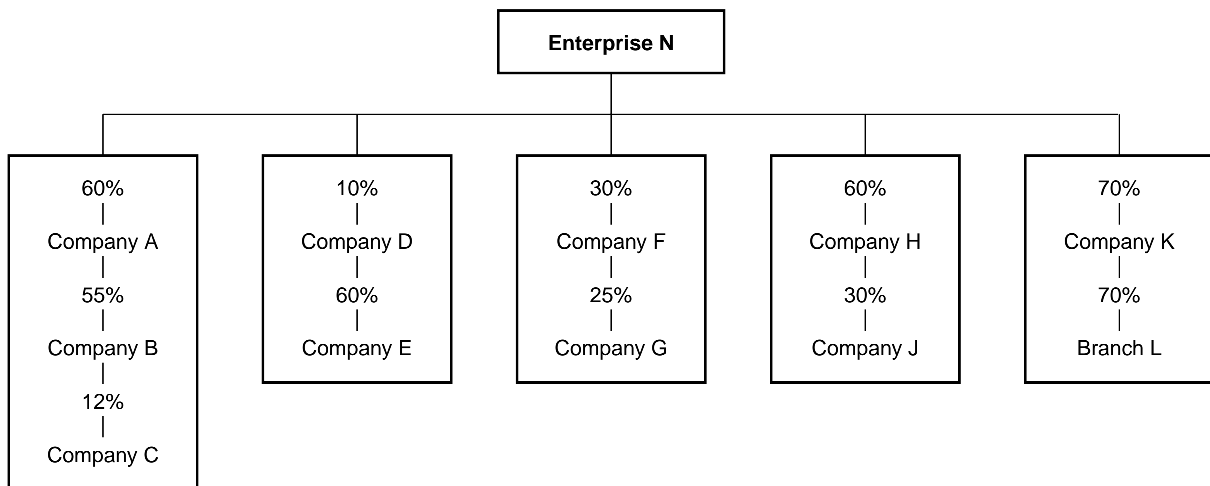
ii) is an unincorporated partnership or joint venture between a foreign direct investor and third parties; or

iii) is land, structures (except those structures owned by foreign government entities), and immovable equipment and objects, in the host country, that are directly owned by a foreign resident. Holiday and second homes owned by non-residents are therefore regarded as part of direct investment, though few, if any, countries actually include such investment in their direct investment statistics; or

iv) is mobile equipment (such as ships, aircraft, gas and oil drilling rigs) that operates within an economy for at least one year if accounted for separately by the operator and is so recognised by the tax authorities. This is considered to be direct investment in a notional enterprise in the host country.

15. Statistics based on those definitions should, as a matter of principle, cover all enterprises in which the direct investor has directly or indirectly a direct investment interest. For convenience, this approach is referred to below as the Fully Consolidated System. To illustrate the above definitions, assume enterprise N has the following investments:

Figure 1



16. Under the Fully Consolidated System, Company A is a subsidiary of N. Company B is a subsidiary of A and thus a subsidiary of N even though only 33 per cent of B is indirectly attributable to N. Company C is an associate of B and, through the chain of subsidiaries A and B, of N as well, even though only 4 per cent of C is indirectly attributable to N. Company D is an associate of N, Company E is a subsidiary of D and thus an associate of N even though only 6 per cent of E is indirectly attributable to N. Company F is an associate of N and G is an associate of F, but G is not an associate of N. Company H is a subsidiary of N and Company J is an associate of H and thus an associate of N. Company K is a subsidiary of N and L is a branch of K and thus of N. Thus direct investment statistics based on the Fully Consolidated System would cover A, B, C, D, E, F, H, J, K and L.

17. If the indirect ownership in subsidiaries, associates and branches is not included, the main effect, as shown in Annex 1, is that total and reinvested earnings can be greatly understated. Some financial account transactions between the direct investor and its indirectly owned concerns may also be excluded from the direct investment statistics, but on the whole these are small as most capital transactions are between the investor and its directly owned concerns.[3]

18. Countries which do not require their companies to produce world-wide consolidated company accounts may have difficulties in obtaining information on all indirectly owned subsidiaries and associates in order to produce direct investment statistics on a Fully Consolidated System. In these circumstances OECD suggests that these countries move in the direction of requiring consolidated accounts. To the extent that they have adopted a different system – *e.g.* by covering all enterprises in which a direct investor holds directly or indirectly 10 per cent or more of the voting stock –, such differences in methodology should be indicated by the compiler.

19. The system for outward investment should be fully compatible and symmetrical with that for inward direct investment. This means that when a host country has a direct investment enterprise which itself has direct investment enterprises in a third country, the host country should include in the balance of payments statistics of outward and inward earnings from direct investment the foreign direct

investor's share of the earnings reinvested in the third country. Similarly, the stock of direct investment of the host country should include the value of assets held in the third country which are indirectly attributable to the foreign direct investor. Otherwise, the net balance of earnings or assets of inward and outward direct investment is misleading.

III. Valuation of stocks and flows (see also paras. 72, 73, 74)

20. The OECD Benchmark Definition recommends market value as the conceptual basis for valuation.[4] Market valuation places all assets at current prices rather than when purchased or last revalued, and allows comparability of assets of different vintages. It allows for consistency between flows and stocks of assets of different enterprises, industries, and countries, as well as over time.

21. Although OECD affirms the principle of market value as the basis for valuation, it recognises that in practice book values from the balance sheets of direct investment enterprises (or investors) generally are utilised to determine the value of the stocks of direct investment. This approach reflects the fact that enterprise balance sheet values – whether they are regularly revalued on a current market value basis, reported on a historical cost basis, or are based on some interim but not current revaluation – represent the only source of valuation of assets and liabilities readily available in most countries. (In the first case, the balance sheet value is, in fact, the market value). The collection of data from enterprises on a current market value basis is to be encouraged, to narrow the gap between principle and practice. If feasible, countries that produce data on market values derived indirectly should also produce data on a book value basis, if the two differ.

1. Stock components

22. OECD recommends that the stock of direct investment be measured as:

a) for subsidiary and associate companies:

- *i)* the market value (or where market value is not available for statistical purposes, the book value – derived from the balance sheets – which is likely to be used by a number of countries for practical purposes) of their share capital and reserves attributable to the direct investor. (Reserves include retained profits. Share capital and reserves should be measured as the market value or written-down book value of the company's fixed assets and the market value or book value of its security holdings and other assets, less its liabilities and provisions);
- *ii)* plus loans, trade credit and debt securities (bonds, notes, money markets instruments, financial derivatives,[5] etc.) due from the subsidiaries and associates to the direct investor, including dividends declared but not yet paid to the direct investor;
- *iii)* less loans, trade credit and other liabilities (including equity and debt securities) due to subsidiaries and associates from the direct investor.

b) for branches, the net worth of these concerns to the direct investor measured as:

- *i)* the market value (or, where market value is not available, written-down book value – derived from balance sheets) of the concern's fixed assets, and the market value (or, where market value is not available, the book value) of its investments and current assets, excluding amounts due from the direct investor;
- *ii)* less the concern's liabilities to third parties.

23. OECD recommends that short-term loans and trade credit be included as there is often no clear distinction between short-term finance such as a loan repayable on demand but never repaid and long-term finance. Inclusion of inter-company debt and of loans from subsidiaries to parent companies may result in some cases in negative values of direct investment stocks. As a matter of practice, some countries may not include (or may net out) inter-company debt and loans provided by subsidiaries to their parents. However, OECD recommends that countries provide information on gross amounts outstanding – *i.e.* claims on direct investor and liabilities to affiliated enterprises – to facilitate international comparability of direct investment stock data.

24. According to the IMF *Balance of Payments Manual,* Fifth Edition, cross-equity holdings of at least 10 per cent in **both** directions give rise to two direct investment relationships and should be recorded as direct investment claims and liabilities for both the economy of the direct investment enterprise and the economy of the direct investor.

25. OECD recommends that the stock of outward investment be converted from foreign currency to the investor's national currency using the closing mid-market spot exchange rate (*i.e.*, average of the closing buying and selling rates) on the day to which the stock figures relate, *e.g.* if stocks are evaluated at 31st December, the closing mid-market spot rate at 31st December of that same year applies. OECD does not recommend using the historical exchange rate when the assets and liabilities were acquired.

26. Where subsidiaries, associates and branches resident in one country have assets and liabilities denominated and payable in other currencies, OECD recommends that these be valued at the closing mid-market spot exchange rate on the day to which the stock figures relate.

2. Assets

27. In addition to the value of direct investments, statistical information may be required as regards the total value of assets in which the direct investor has an interest, *i.e.*, the value of the total assets of the subsidiary, associate and branch enterprises, and not just the parental share. Some of the assets are often financed by local borrowing and local shareholders. As information on the stock of direct investment can often be obtained only by direct inquiries to direct investment enterprises, OECD suggests that a complete balance sheet be collected. However, recognising that the collection of such data may imply an additional reporting burden, it is suggested that separate information be obtained on fixed assets, investments, current assets, bank borrowing, other current liabilities, loans, and other liabilities and provisions. For subsidiaries and associates, the information should also include data on their share capital and reserves and minority shareholders' interests in consolidated subsidiaries. In the case of branches, the net worth of the enterprise due to the direct investor and to third parties should be included as well. The complete balance sheet will provide estimates of the total stock of assets under the influence of the direct investor. It will also provide a useful check to the statistician on the accuracy of the figures given for the direct investor's interest.

3. Income

28. OECD recommends that direct investment income for a given period consist of:

a) For subsidiary and associate companies:

i) dividends due for payment in the period to the direct investor gross of any withholding taxes (for example if a dividend is declared in year 1 for payment in year 2, it is only included in the statistics of direct investment dividends in year 2);

ii) less dividends due for payment in the period by the direct investor to the company gross of any withholding taxes (see also para. 24);

iii) plus the direct investor's share of the company's reinvested earnings – these earnings being defined as the direct investor's share of the total consolidated profits earned by the company and its subsidiaries and associates in the period covered, after allowing for tax, interest and depreciation, less dividends due for payment to the direct investor in the period even if these dividends relate to profits earned in earlier periods.

b) Plus for branches:

i) earnings remitted by the branch to the direct investor gross of any withholding taxes;

ii) plus the direct investor's share of the branch's reinvested earnings, these being defined as the total profits earned by the branch in the period covered, after allowing for tax, interest and depreciation, less earnings remitted in the period even if these relate to profits earned in earlier periods.

c) For all direct investment enterprises:

i) plus interest accrued during the period by the enterprise to the direct investor gross of any withholding taxes;

ii) less interest accrued during the period by the direct investor to the enterprise gross of any withholding taxes.

29. OECD suggests that countries, in their published direct investment statistics, provide separate figures for each item listed above. If figures are given of reinvested earnings, comparability between the statistics of countries which do and those which do not collect this information will be improved. In view of the fact that it can be important for economic analysis to know whether or not the net earnings cover large losses, it is also suggested that consideration be given to split the earnings of branches [see para. 28*b*] and the reinvested earnings of subsidiaries and associates [see para. 28*a ii*)] between enterprises making a profit and those making losses. In addition OECD recommends that inward direct investment earnings be shown separately from outward earnings.

30. To convert outward earnings from foreign currency to the investing country's national currency OECD recommends that:

a) dividends and profits remitted when denominated in foreign currency by the investing company, be converted at the closing mid-market spot exchange rate on the day received.[6] If they are converted immediately when received, the amount of national currency received on conversion should be used. *Interest* denominated in foreign currency by the investing company should be converted at mid-market spot exchange rate for the period when interest accrues;

b) earnings retained abroad be converted at the average mid-market spot exchange rate in the period in which the profits were earned.

31. There are two main ways of measuring earnings as explained in International Accounting Standard No. 8, ''Unusual and Prior Period Items and Changes in Accounting Policy''. One is the ''current operating performance concept'' where earnings of an enterprise are its income from normal operations and before allowing for non-recurring items and capital gains and losses. The other is the ''all-inclusive concept'' where income is after allowing for all items (including capital gains and losses) causing any increase or decrease in the shareholders' or investors' interests during the period, other than dividends and any other transactions between the enterprise and its shareholders or investors. The International Accounting Standard No. 8 recommends a definition of net income between

these two with separate disclosure of operating profits. The IMF *Balance of Payments Manual,* Fifth Edition and the *System of National Accounts,* 1993 recommend a definition of profits in accordance with the ''current operating performance concept''.

32. OECD recommends that direct investment earnings be calculated on a ''current operating performance concept''. Operational earnings of the direct investment enterprise should be reported after deducting provisions for depreciation and for income and corporation tax charged on these earnings. Depreciation should, in principle, be measured at current replacement cost, particularly if market values are available for stock figures. If the latter and depreciation data are available only on a book value or historical cost basis, those values should be used. Direct investment earnings should not include any realised or unrealised capital gains or losses made by either the direct investment enterprise or the direct investor. However, for many countries data are available only on an all-inclusive basis. Therefore, so as to promote comparability of data across countries, those countries that report earnings on either an operating basis or all-inclusive basis should collect and publish supplementary information on capital gains and losses. This data will also allow reconciliation of movements in the net asset value of the stock of direct investment between the beginning and end of the period.

33. The earnings of the direct investment enterprise which are reported using the ''current operating performance concept'', should not include any realised or unrealised capital gains or losses made by the enterprise or include any gains or losses arising from valuation changes such as inventory write-offs; gains or losses on plant and equipment from the closure of part or all of a business; writing-off intangibles, including goodwill, because of unusual events or developments during the period; writing-off research and development expenditure; abnormal charges for bad debts; abnormal provisions for losses on long-term contracts; and exchange rate gains and losses incurred by the direct investment enterprise both from its trading activities and from its holdings of foreign currency assets and liabilities. Unrealised gains or losses from the revaluation of fixed assets, investments and liabilities, as well as any realised gains or losses made by the enterprise from the disposal of assets or liabilities should be excluded from direct investment earnings, *i.e.*, gains should not be added in and losses should not be deducted. This exclusion of all classes of realised and unrealised gains and losses is applicable to all direct investment enterprises, including those such as banks and securities dealers for whom the making of such gains is an important or even the main part of their business.

34. The direct investor also incurs gains and losses arising from the sale of the direct investment enterprises; revaluations of the market value of the enterprise due to unforeseen obsolescence, falls or rises in stock markets, etc., amounts written off for bad debts owed to the direct investor; expropriation of assets without compensation; war damage; etc. These should not be taken into account in direct investment earnings. For example, if a direct investor in country X buys an overseas subsidiary in period 1 for 100, then country X should show in its balance of payments an outflow of capital of 100 under outward direct investment in the financial account. The subsidiary makes zero profit in period 1 and earns 120 in period 2, all of which is remitted. However, the subsidiary's market collapses and its stock market value falls to 20 during period 2, giving the direct investor an unrealised capital loss of 80, *i.e.*, 100 minus 20. Country X should show in its statistics for period 2 a credit of 120 for direct investment earnings and the unrealised loss should not be entered anywhere in its balance of payments. In period 3 the direct investor sells the subsidiary for 20 and X's balance of payments should show an inflow of capital of 20 under outward direct investment in the financial account. There should be no loss of 80 entered under direct investment earnings as the fall in the value is not directly associated with the subsidiary's operational earnings. For periods 1 and 3 together, the realisation of the capital loss shows up in the financial account of X's balance of payments because the sum of the

outflow of 100 in period 1 and the inflow of 20 in period 3 would equal the capital loss incurred and realised.

4. Capital flows

35. OECD recommends that direct investment flows be defined as:

a) *For subsidiary and associated companies*

i) the direct investor's share of the company's reinvested earnings;

ii) plus the direct investor's purchases less sales of the company's shares, debt securities (bonds, notes, money market and financial derivative instruments) and loans (including non-cash acquisitions made against equipment, manufacturing rights, etc.);

iii) less the company's purchases less sales of the direct investors' shares, debt securities (bonds, notes, money market and financial derivative instruments) and loans;

iv) plus the increase, net of decreases, in trade and other credit (including debt securities) given by the direct investor to the company – usually measured as the net balance of trade and other credit outstanding at the end of the period owing to the direct investor, less the balance outstanding at the beginning of the period, and less the net increase between the opening and closing balances which is due to revaluations and exchange rate movements.

b) *For branches,* the increase in unremitted profits plus the net increase in funds received from the direct investor – measured as the increase in the net worth of the enterprise to the investor less increases (net of decreases) due to revaluations and exchange rate movements.

36. In instances of *reverse investment*, in which the enterprises noted in para. 35 *a*) and *b*) have an interest in the direct investor, ''that interest is regarded as an offset to capital invested by the direct investor (*i.e.*, as disinvestment)'', as indicated by the IMF *Balance of Payments Manual,* Fifth Edition. [''In cases in which the equity participation is at least 10 per cent in both directions, (...) such transactions are recorded as direct investment claims and liabilities in both directions (...)'' (para. 371).]

37. OECD recommends that separate figures be collected and published for transactions in shares and in loans and other indebtedness, and that outward investment should be shown separately from inward investment. It is possible for these items to be recorded gross showing investment separate from disinvestment, or recorded net of disinvestments, or recorded net for each enterprise. Analytical usefulness would be improved if the flows were reported at least partly on a gross basis. OECD recommends that separate figures should be collected for each enterprise of its net flows of investment, *i.e.*, net of disinvestment, in each country; that the net investment for each enterprise should be split between reinvested earnings, shares, loans plus other indebtedness; and that countries in their published figures should give separate totals for the sum of net investments and for the sum of net disinvestments for each item. For example, if Country X's flows of outward direct investment in the share capital of concerns in country Y consisted of gross purchase of 140, 170, 25 and 10 by investors A, B, C and D respectively and of gross disposals of 40, 20, 75 and 90 by A, B, C and D respectively then A and B would have a net investment of 100 and 150 respectively and C and D a net disinvestment of 50 and 80. Country X in its published statistics should show three figures: overall net investment of 120 split between investors with net investment of 250 (sum of A + B) and investors with net disinvestment of 130 (sum of C + D).

38. Some components of the flows will be in foreign currency. OECD recommends that these be converted into national currency for:

- *a)* *outward retained profits* at the average mid-market spot exchange rate in the period in which the profits were earned.
- *b)* *shares and loans*
  - *i)* at the closing mid-market spot exchange rate for amounts received and at the closing mid-market spot exchange rate for amounts paid on the day received or paid;
  - *ii)* or if converted immediately prior to purchasing the shares and loans, or sold immediately after receipt, the amount of national currency paid or received.
- *c)* *net balances of subsidiaries and associates and net worth of branches due to the direct investor,* at the closing mid-market spot exchange rate at the date to which the balances relate.

5. Inter-company flows

39. OECD recommends that inter-company flows – with the exception of certain flows between affiliated banks, affiliated financial intermediaries (*e.g.* security dealers), and Special Purpose Entities (SPEs) with the sole purpose of serving as financial intermediaries – be encompassed within the scope of foreign direct investment transactions. Such flows include those flows routed through SPEs however they may be structured (subsidiary, associate, or branch) or whatever functions (with the exception noted above) they may serve: financing subsidiary, various types of holding companies, operating subsidiaries which also transfer funds among the entities of multinational enterprises, etc. (See Annex 3.) OECD also recommends that loans provided by all subsidiaries to parent companies be included in foreign direct investment transactions, with the exception of financial loans provided by banks and other financial intermediaries to the parent bank [see also para. 40 *c*]. Recognising that some countries may not include (or may net out) transactions through SPEs, and/or inter-company debt flows, and loans provided by subsidiaries to parents within direct investment transactions, OECD recommends that countries provide information on gross flows to facilitate international comparability of direct investment data.

40. Particular examples which merit further discussion include:

- *a)* *Amounts outstanding with fellow subsidiaries*

  Inward and outward direct investment enterprises may have loans or balances due to or from fellow subsidiaries and branches – that is, companies and their branches which have the same ultimate parent as the direct investment enterprise – or due to or from indirectly controlled direct investment enterprises. The IMF *Balance of Payments Manual,* Fifth Edition (para. 368) says ''Direct investment capital is *i*) capital provided (either directly or through other related enterprises) by a direct investor to a direct investment enterprise; or *ii*) capital received from a direct investment enterprise by a direct investor.'' OECD recommends that these amounts be included in direct investment and allocated to the country of the fellow subsidiary or branch, or of the indirectly controlled direct investment enterprise, as appropriate (see also Annex 4).
- *b)* *Loans by subsidiaries to their direct investors*

  Some subsidiaries raise loans which they on-lend to their direct investor and others make loans to their direct investor from their own resources [see also para. 40 *c*]. OECD recommends that these be treated as disinvestment flows and be included in the direct investment

statistics as they reduce the net value, and in some cases may result in a negative value, of the direct investor's stake in the subsidiary (see also paras. 36 and 70).

c) Banks and certain other financial institutions

Deposits placed by a parent bank with its branch or subsidiary abroad and deposits taken from such offices should be classified as ''other investment'' rather than direct investment. OECD recommends that in the case of banks all inter-company flows – with the exception of those considered to represent permanent debt or equities – with related affiliates should not be counted as part of direct investment. Similar considerations apply to financial intermediaries, *e.g.* dealers in securities and certain other financial instruments, and to SPEs whose sole purpose is to serve as financial intermediaries. OECD recommends that inter-company flows between affiliated entities involved in these activities be excluded from direct investments (see also paras. 61 and 62). However, when possible, Member countries should identify separately these inter-company flows, as an aid to resolving differences between the figures they report.

IV. Country and sectoral analysis

1. Identifying host and home countries

41. Any country analysis is complicated by holding companies where the ultimate parent enterprise's investment in Country C is held through another subsidiary in Country B. Information is often required on two bases:

a) by ultimate host country/ultimate investing country;
b) by immediate host country/immediate investing country.

The immediate host/investing country system looks, for outward FDI, only to the country of the directly owned subsidiaries, associates and branches. For inward FDI, it is the country directly owning the domestic enterprises that is of interest. In this approach, the consolidated earnings and consolidated net assets cover the directly owned enterprise and all its subsidiaries and associates in its country and any other country, all of them being allocated for outward FDI to the country of the directly owned enterprise, and in the case of inward FDI to the country directly owning the enterprise.

42. For outward direct investment although it may be possible in some instances to compile earnings and the stock of net assets on either basis, it is often very difficult to obtain data on outward direct investment flows by the ultimate host country; funds received by the ultimate host country may bear no relationship to the outward direct investment flows by the ultimate parent company. For example ultimate parent A invests in its directly owned company X in Country B which invests in its subsidiary Y in country C. Company X could finance its investment by local borrowing; or X could borrow locally and repay a loan to A while using its own resources to invest in Y; and so on. The position becomes even more complex if the companies are not 100 per cent owned. Statistical systems could be devised to estimate flows by the ultimate host country, but they would be artificial and would need a change in the IMF definition of direct investment to handle local borrowing. It has been argued that where there is a 100 per cent owned holding company which does not trade itself, one should for direct investment flows ignore it and look through to its subsidiaries. This is only possible if the holding company does not borrow or pay income taxes locally, and there are no indications that it will do so in the future.

43. For inward direct investment it is possible to estimate earnings and the stock of net assets due to the immediate investing country and to reanalyse this by country of ultimate control. The share of the earnings and net assets attributable to the ultimate parent company will not normally be known. This is because the host country does not know the percentage shareholdings in the various intermediary companies between it and the ultimate parent; for instance in the example in the previous paragraph, A may own only 70 per cent of X, but Country C may not know this. For direct investment flows the available information will only enable inward flows to be compiled by immediate investing country.

44. Information by the immediate host or investing country is needed for balance of payments statistics, and in particular for bilateral estimates. Governments and international bodies are also interested in data on ultimate host or investing country.

45. OECD suggests that the stock of direct investment net assets be compiled in respect of the immediate host or investing country and in respect of the ultimate host or controlling country.

46. OECD recommends that total direct investment flows be compiled only in respect of the immediate host or investing country.[7] Any figures in respect of the ultimate host or controlling country would be artificial. Changes in the stock of outward direct investment will, however, give some indication of investment flows to the ultimate host countries.

47. OECD suggests that inward and outward direct investment earnings be compiled in respect of the immediate host or investing country. Ideally, outward FDI earnings should also be recorded with respect to the ultimate host country. This would enable investing countries to see where their overseas earnings originate. However, in practice, recording earnings on the basis of the ultimate host country would appear more appropriate in the case of operating data of affiliates, for those countries that collect such data.

2. *Industry sector classification*

48. There is interest in the industrial activity of both direct investment enterprises and their direct investors. Most countries publish an industrial breakdown of direct investment, but the industrial classifications vary to some extent between countries. Any sectoral analysis of direct investment will remain fairly broad as most direct investors and most direct investment enterprises are incorporated companies, not single establishments, and thus may be involved in a wide range of activities.

49. OECD recommends, in both inward and outward direct investment statistics, that, where feasible, the direct investment enterprise be analysed both by its industrial activity in the host country and by the industrial activity of its direct investor. OECD recommends that countries should as a minimum provide an industrial analysis which corresponds to the nine major divisions in the ''United Nations International Standard Industrial Classification of All Economic Activity'', plus, as recommended in para. 67, shipping. The nine divisions are: 1. agriculture, hunting, forestry and fishing; 2. mining and quarrying; 3. manufacturing; 4. electricity, gas and water; 5. construction; 6. wholesale and retail trade and restaurants and hotels; 7. transport, storage and communications; 8. financing, insurance, real estate and business services; and 9. community, social and personal services. Each country will probably wish to provide a more detailed analysis than this based on its own national industrial classification, but if this can be aggregated to correspond with the nine United Nations major divisions, international comparability will be greatly improved.

50. A direct investor involved in a wide range of activities may make its overseas investment in each activity through its domestic subsidiary specialising in that activity or it may make all its overseas investment through a single domestic subsidiary set-up to handle overseas investment. OECD recommends that the economic activity should be the main activity of the direct investor and all its

subsidiaries and related companies in its country of residence. This avoids distortions due to different organisational arrangements.

51. The economic activity of a direct investment enterprise which has subsidiaries, etc., of its own can be measured as that of the enterprise or as that of the enterprise and all its subsidiaries, etc. The two will not necessarily be the same, and where some of the subsidiaries are in a third country, the main activity in the host country may be different from that in the third country. OECD recommends that the economic activity of the direct investment enterprise should be, where consolidated figures are given, the main activity of the enterprise and all its consolidated subsidiaries and associates. Where unconsolidated figures are given for each directly and indirectly owned direct investment enterprise, it should be the main activity of each enterprise. However, where separate figures are given only for some of the unconsolidated direct investment enterprises, it should be the main activity of the enterprise and all its subsidiaries and associates for which separate figures are not collected, as the earnings of the enterprise will include dividends and interest received from these subsidiaries and associates.

V. Special transactions

1. Acquisitions

52. Direct investment flows should include shares and loans acquired from or sold to a third party by the direct investor as well as new issues and redemptions.

53. If an inward direct investment enterprise owned by Country A is taken over by a concern in Country C, OECD recommends that the host country should record this as a disinvestment by A and a direct investment by C. However, some countries will not always have sufficient data available to follow this recommendation.

54. Where an investor holds a portfolio investment in an enterprise and then acquires further shares, etc., giving it a direct investment interest, only this additional purchase of shares, etc. should be treated as a direct investment flow. When this additional purchase is made, the previous holding should be adjusted out of portfolio investment and into direct investment under ''other adjustments'' in the international investment position statement. It should not be shown in the balance of payments as a portfolio disinvestment and as a direct investment acquisition because when originally made it was portfolio investment. In the stock figures the total will of course be treated as the direct investment interest as these figures relate to the total stake at a given point of time.

2. Loan guarantees

55. Subsidiaries may borrow funds which are guaranteed by the direct investor. These loans are not part of direct investment as there is no flow of funds, nor is any actual liability incurred. In other cases the direct investor borrows the funds from the subsidiary's bank and on-lends them to the subsidiary. This is direct investment. OECD suggests that supplementary information be requested on loans guaranteed by the direct investor when the stock of direct investment is collected. This plus the other components will give the total amount the direct investor has directly and indirectly committed to the direct investment enterprise.

56. When a guarantee is invoked following default by a subsidiary, there is a flow of funds from the direct investor to the lender. If the subsidiary continues to trade, OECD recommends that this be regarded as direct investment in the subsidiary. This situation is only marginally different from one

with no guarantee where the direct investor, in order to prevent the subsidiary going into liquidation, had given the subsidiary these funds so it could repay the lender. This is direct investment. When the subsidiary goes into liquidation, OECD recommends that the loan repayment also be treated as direct investment but not as a capital transfer. It is only marginally different from the situation where a direct investor pays off the debts of a bankrupt subsidiary when under no legal obligation to do so. This would be direct investment as technically the payment is to the subsidiary which then repays its creditors.

3. Leasing

57. Wherever an operator (the lessee) employs assets which are held under financial lease (as distinct from operating lease) rather than being owned outright, the legal owner of the assets (the lessor) should be regarded as making a loan to the lessee, which the lessee uses to buy the assets. If this arrangement is between a direct investor and its branch, subsidiary or associate, the loan should be regarded as direct investment, and be treated according to the provisions of this benchmark definition, in the same way as a conventional loan would be regarded and treated. In the IMF *Balance of Payments Manual,* Fifth Edition (para. 206), it is stated that financial leases are lease arrangements ''for a capital good for most or all of its expected economic life'', during which time ''the lessor expects to recover most or all of the cost of the goods and the carrying charges''. Therefore, a financial lease arrangement is to be taken as presumptive evidence that a change of ownership is intended. A change of ownership is imputed because the lessee assumes all rights, risks, rewards, and responsibilities of ownership in practice, and from an economic point of view, can be regarded as the de facto owner. The financial lease essentially is a method of financing the purchase of the good by the lessee (as opposed to taking out a loan for the purchase). The OECD defines a financial lease as ''a contract involving payments over a basic period (during which the agreement cannot be terminated) sufficient in total to cover in full the capital outlay of the lessor together with all subsidiary or financing cost and to give some profit to him. This obligatory period does not exceed the estimated useful life of the asset. The asset is selected by the lessee (...) The cost of maintenance and repair, on the subject of the lease, and all risks connected therewith, are borne by the lessee. At the end of the primary lease, the contract may be extended for a further (secondary) period at a much reduced and perhaps purely nominal rental, or the asset may be sold to the lessee at a very low and perhaps purely nominal price, or the asset may be sold to a third party with some, or perhaps most, of the proceeds from the sale being passed on to the lessee as a 'rebate of rental'.'' It is hoped that in due course a common definition of financial leasing will be established.

4. Construction

58. Construction enterprises in one economy can undertake the construction of plant, buildings, etc. in another economy through subsidiary and associate companies in that economy, a foreign branch set up for the project, or directly undertake the work themselves. The construction work abroad is to be regarded as a direct investment activity (resident) in the economy in which it is being carried out in the first two instances. If the construction enterprise directly undertakes the work itself (*i.e.*, through an unincorporated site office) it may be treated either as a direct investment activity or as an export of services by that enterprise. If certain criteria are met, such as the maintenance of a complete and separate set of accounts of the activity (*i.e.*, income statement, balance sheet, transactions with the parent company, etc.) and the payment of income taxes to the host country, a substantial physical

presence, the receiving of funds for its work for its own account, etc. the work undertaken is to be treated as a direct investment activity (the one year or more guideline, to be applied flexibly, is also a consideration). If such criteria are not met, the activity is to be treated as an export of services. Construction involved with major projects (bridges, dams, power stations, etc.) carried out through unincorporated site offices, in most cases, meets the criteria that requires treatment as the production of a resident unit and thus as part of the production of the host economy, not as an export of services to that economy.

59. Where an enterprise in one country is installing machinery and equipment in another country, OECD recommends that the work should be regarded as services provided to the foreign country if the installation is carried out entirely, or primarily, by employees of the enterprise who go abroad to do the work and they complete the installation in less than one year (that rule to be applied flexibly).

5. Exploration of natural resources

60. Where a direct investment enterprise is set up to explore for natural resources, related exploration expenditures are treated as capital expenditures (fixed capital formation) in the SNA. For example, assume an oil company in country A sets up an operation in another country X to drill an oil well, spends 100 in period 1, 30 in period 2, and then closes down the operation in period 2 when the well proves to be dry. There is an inward direct investment capital flow of 100 in period 1 and 30 in period 2 in the balance of payments accounts of country X, and outward flows of equal amounts in the accounts of country A. No further balance of payments entries are recorded after the shutdown of the operation in period 2. Rather, a negative stock adjustment of 130 is made in the direct investment position of A in X, and an equal reduction is made in the liability position of X in regard to A. (Both adjustments should be recorded under ''other adjustments'' in the international investment position.)

VI. Special entities

1. Financial intermediaries

61. OECD recommends that direct investment for banks be restricted to transactions in share capital of its subsidiaries and in permanent debt (defined as representing a permanent interest in the subsidiaries), or in the case of branches, invested in fixed assets.[8] The treatment of inter-company flows between banks and their foreign affiliates was discussed in para. 40. Participations in international organisations of monetary and non-monetary nature should not be included in direct investment statistics.

62. Similar considerations apply to other financial intermediaries and SPEs whose sole function is to serve in that capacity. OECD recommends that only investment in shares and loan capital and in fixed assets be included in direct investment for these entities.

2. Insurance companies

63. Transactions by insurance companies are complex, particularly for overseas branches of reinsurers and life insurers. It may not be possible to obtain direct investment figures for these branches. However, OECD recommends that, as far as possible, direct investment for insurance companies be defined in exactly the same way as for industrial and commercial companies, with the exception of

their technical reserves (actuarial reserves against outstanding risks, prepayment of premiums, reserve for with-profits insurance, reserve against unsettled claims) which should be excluded from direct investment stocks. Special inquiry forms, however, will be needed for this complex industry.

3. Shipping companies

64. Ships involved in international trade may be:

a) owned and operated from the same country;

b) owned in one country and operated by the owner for as much as one year primarily on the territory of another country;

c) owned in one country and chartered or hired to a related or unrelated enterprise in another country;

d) owned in one country and leased under a financial lease to a related or unrelated enterprise in another country.

In addition the ship may be registered under the flag of the country of the owner, or of the operator, or of another country.

65. In the particular case of ships flying flags of convenience, it often is difficult to determine the residence of the operating enterprise, because of complex arrangements involving the ownership, mode of operation and chartering of such ships, and the fact that the country of registry in most instances is different than the country of residence of the operator (or owner). Nonetheless, in principle, the shipping activity is to be attributed to the country of residence of the operating enterprise. If that enterprise establishes a branch (direct investment) in another country to manage the operation, for tax or other considerations, the operation is to be attributed to the resident (branch) of that country. In practice, because of limitations in obtaining adequate or appropriate data, partly due to the complicated arrangements referred to above, the attribution of residence may not be satisfactorily determined.

66. Where a ship is leased under a financial lease as set out in para. 57 above, OECD recommends that this should be taken as presumptive evidence that a change of ownership is intended, and be regarded as being owned by the lessee (the one to whom the lease is granted) with the lessor being regarded as giving a financial loan to the lessee. The loan is not to be included in direct investment unless the lessee and the lessor are related concerns. If the lease is not a financial lease, it should be treated in the same way as a hired ship.

67. Many countries try to allocate ships involved in international trade to the country of residency of the owner regardless of the country under whose flag the ship is registered. Other countries allocate the ship to the country of the ship's operator if different from that of the owner.

4. Offshore companies

68. There are a number of companies incorporated in one country with their management office in another country which do not trade in their country of incorporation. The management office holds all the assets of the company and the only transaction with the country of incorporation is that the management office pays dividends on behalf of the company to any resident shareholder of the company in the country of incorporation. These companies may also have direct investment in third countries, the dividend and capital flows then being between the third countries and the country of the management office. The third country will probably assume in its statistics that these transactions are with the country of incorporation, while the management office's country will probably show the

transactions as being between it and the third countries. An added complication is that the company owning the management office may itself be a subsidiary of an enterprise in another country.

69. OECD recommends that where a company Z incorporated in Country A has its management office in another Country B, Country A in its outward direct investment statistics regard the foreign management office as direct investment by Country A in a branch in Country B. If company Z has any subsidiary and associate companies, these should be regarded as being directly owned by the foreign branch in Country B and thus only indirectly owned by company Z. The host countries of the subsidiary and associate companies should in their inward direct investment statistics regard the immediate investing country as being that of the management office, that is Country B, and regard the ultimate investing country either as Country A, the country of incorporation of company Z, or as Country C if company Z is itself a subsidiary with its ultimate parent in another Country C. Country B, the country of residency of the management office, should in its inward direct investment statistics regard the management office as an inward branch owned by Country A, with the ultimate investing country being Country C if company Z is a subsidiary with its ultimate parent in Country C. Country B in its outward direct investment statistics should regard the subsidiaries and associates of company Z that are not resident in Country B as part of Country B's outward direct investment.

5. Special purpose entities

70. As multinational enterprises mature, they diversify their investments geographically, through adequate organisational structures. These include certain Special Purpose Entities (SPEs) which facilitate financing of investments for the group from sources both internal and external to the multinational enterprises. Additionally, such SPEs also serve other functions such as sale and regional administration including management of foreign exchange risks and other activities aimed at profit maximisation. Special Purpose Entity is a generic label applicable to such organisational structures which are also variously referred to as financing subsidiaries, conduits, holding companies, base companies and regional headquarters. In some instances, multinational enterprises use existing operational companies to perform functions usually associated with SPEs. Since these SPEs are an integral part of the organisational structure of a multinational enterprise, their transactions that arise from direct investment relationships [except as noted in paras. 39 and 40*c*)] should be reflected in the statistics and, if possible, shown as a sub-component. In some instances, these transactions may give rise to negative direct investment positions. For a more detailed description of the SPEs or of transactions that exhibit the characteristics of functions carried out through these entities, refer to Annex 3.

6. Nominees

71. Some direct investment interests are held through nominees. For international comparisons, countries need to identify these nominee holdings. OECD recommends that countries attempt to look through nominee holdings wherever possible to the ultimate beneficial owner.

VII. Accounting practices

72. The value of direct investment can be recorded as that in the books of the investor or that in the books of the investee. Accounting methods vary between countries, and international comparability of earnings and reinvested earnings is only possible if both the investing and host countries use for their

statistics data taken either from the books prepared for the host country or from those prepared for the investing country. Investing countries which do not produce consolidated accounts will only have data taken from the books prepared for the host country, but investing countries which produce consolidated accounts will often use their own accounting methods to value the profits and balance sheets of their direct investment enterprises. This is necessary to produce consolidated accounts on a consistent basis. In the future more countries are likely to adopt consolidated accounts.

73. No recommendation is suggested for accounting practices, except that countries should state what method is used when publishing their figures.

74. The main difference in accounting methods is in the valuation of inventories and fixed assets. Following the IMF *Balance of Payments Manual,* Fifth Edition (para. 286), OECD recommends that depreciation should be ''measured by the value, at current replacement cost, of reproducible fixed assets used up (...) during an accounting period''. If this is not feasible, because of accounting practices, existing balance sheet values may be used but, in such cases, efforts should be made to develop replacement cost estimates. To the extent that countries apply in practice other depreciation methods, a reference to this effect should be included in published data. OECD suggests that the value of accumulated depreciation to date be collected as a supplementary item in the stock figures, and that the depreciation charge for the year be given as a supplementary item with the earnings and direct investment flows. It should be noted that depreciation would have to be available on a direct-investor's-share basis, in order to be consistent with the earnings figures used in the balance of payments.

VIII. Reporting methods

1. Reporting requirements

75. In some countries reporting requirements are voluntary, whereas in others they are compulsory and punishable under law for non-compliance. Though the law is seldom evoked in the countries where reporting is compulsory, the response is better in countries that have compulsory reporting requirements. OECD recommends that the published results should include some allowance for non-responders.

2. Reporting year

76. Some countries require reporting on a calendar-year basis, and others allow enterprises to report for their accounting year. In yet others there may be a mixture of both. Ideally, attempts should be made to adjust accounting year figures to calendar years.

3. Surveys

77. Some countries have fairly well established annual surveys for both flows and stocks of direct investment supplemented by more concise quarterly surveys. Others have very comprehensive census-type questionnaires for infrequent surveys supplemented by abbreviated questionnaires on a quarterly basis for a more limited population. Differences in periods covered, survey frequency, sampling methods, response as well as differences in the statistical techniques used to handle non-response and to estimate flows and levels for the total population, will have some effect on international comparability.

4. Small and medium-sized enterprises

78. Some countries attempt to cover all direct investment enterprises, whereas others exclude small and medium-sized enterprises. OECD recommends that data collection procedures should cover all enterprises as a matter of principle. Whenever practical difficulties exist in this regard, published results should include some allowance for enterprises not directly covered in the data collection process.

Annex 1

Alternative Methods of Recording Foreign Direct Investment

79. This annex compares balance-of-payments estimates of direct investment earnings and investment using three different systems.

a) *Fully consolidated accounting system*
(system recommended by OECD and described under ''Subsidiaries, Associates and Branches'').

b) *United States system*
(covers every enterprise in which 10 per cent or more of voting stock is directly or indirectly attributable to the direct investor).

c) *Unconsolidated system*
(for earnings, covers only earnings of and dividends received by directly owned enterprises, and ignores the earnings of any indirectly owned subsidiaries and associates; for investment, covers only investment in directly owned enterprises).

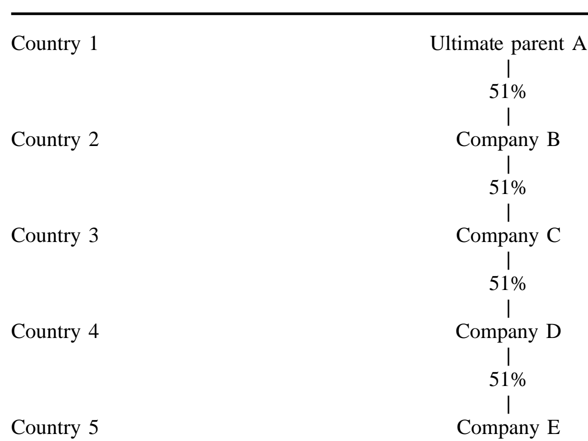
80. Two different company group structures are examined. Example 1 is of a group with partially owned subsidiaries, where the ultimate parent A has a string of 51 per cent owned subsidiaries. Table 1 shows the group structure and Table 2 shows the proportion of each company's share capital directly and indirectly attributable to each company. Table 3 shows the annual flow of direct investment, excluding reinvested earnings, between members of the group, and Table 4 sets out the earnings, dividends and reinvested earnings of each company in the group and shows how reinvested earnings for the balance of payments are calculated under each system. Table 5 combines Tables 3 and 4 and shows the balance of payments entries each country would make under the different systems.

81. In Table 5 the fully consolidated system covers all companies in the group. The United States system covers all except, for country 1, Company A's investment in and earnings from E, and for country 5, the direct investment by A in E. This investment and earnings are excluded, as less than 10 per cent of E is attributable to A. The unconsolidated system covers only directly owned companies and excludes all indirectly owned companies. The Fully Consolidated System and the Unconsolidated System represent the two extremes.

82. The second example is of a wholly owned group of companies as shown in Table 6. Here the ultimate parent F could, if it wished, own each subsidiary directly and could have grouped the operations in country 4 into one company. Table 7 gives the flows of direct investment excluding reinvested earnings. Table 8 gives the earnings, dividends and reinvested earnings of each company in the group, and shows how reinvested earnings for the balance of payments are calculated under each system. Table 9 combines Tables 7 and 8 to show the balance of payments entries each country would make under the different systems. Where all the companies are 100 per cent owned there is no difference between the fully consolidated system and the United States method as is shown by Table 9.

Table 1. Example 1

Group structure with partially owned subsidiaries



Country 1	Ultimate parent A
	51%
Country 2	Company B
	51%
Country 3	Company C
	51%
Country 4	Company D
	51%
Country 5	Company E

Table 2. Example 1

Proportion of share capital directly and indirectly attributable to direct investor

Per cent

Direct investor in	Host country			
	2 (Company B)	3 (Company C)	4 (Company D)	5 (Company E)
Country 1 (Company A)	51	26.01	13.27	6.76
Country 2 (Company B)	–	51	26.01	13.27
Country 3 (Company C)	–	–	51	26.01
Country 4 (Company D)	–	–	–	51

Table 3. Example 1

Value of outward direct investment flows in year

(excluding reinvested earnings)

Balance of payments sign: – = investment
+ = disinvestment

(US$)

Outward direct investment by	Investment in country				**Total**
	2 (Company B)	3 (Company C)	4 (Company D)	5 (Company E)	
Country 1 (Company A)	–200	–25	–100	–100	**–425**
Country 2 (Company B)		+100			**+100**
Country 3 (Company C)			–50		**–50**
Country 4 (Company D)				–150	**–150**
Total	**–200**	**+75**	**–150**	**–250**	

Table 4. Example 1

Earnings of partilly owned subsidiaries

Line	Country of residence	Company	Percentage of equity held by immediate parent	Profits after tax			Dividends received from subsidiaries (from col. 8 of subsidiary)	Total earnings (Profits and dividends received)		Dividends paid			Reinvested earnings	
				Due to immediate parent	Due to other share holders	Total		Total	*of which:* due to immediate parent	To immediate parent	To other share-holders	Total	Total	*of which:* due to immediate parent
				(4 × 1)	(4 – 2)			(4 + 5)	(6 × 1)	(10 × 1)	(10 – 8)		(6 – 10)	(11 × 1)
			(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11	(12)
i.	5	E	51%	102	98	200	–	200	102	51	49	100	100	51
ii.	4	D	51%	178	171	349	51	400	204	102	98	200	200	102
iii.		Share D + E due to C		230			–		230	102				128
iv.	3	C	51%	356	342	698	102	800	408	255	245	500	300	153
v.		Share C + D + E due to B		473			–		473	255				218
vi.	2	B	51%	23	22	45	255	300	153	102	98	200	100	51
vii.		Share B + C + D + E due to A		264					264	102				162

Country 1						
Fully consolidated	= .51(Re E of B)	+ .51(.51)(Re E of C)	+ .51(.51)(.51)(Re E of D)	+ .51(.51)(.51)(.51)(Re E of E)	= 51 + 78 + 26 + 7	= 162
US system	= ,,	,,	,,		= 51 + 78 + 26	= 155
Unconsolidated	= ,,				= 51	= 51
Country 2						
Fully consolidated	= .51(Re E of C)	+ .51(.51)(Re E of D)	+ .51(.51)(.51)(Re E of E)		= 153 + 52 + 13	= 218
US system						
Unconsolidated	= .51(Re E of C)				= 153	= 153
Country 3						
Fully consolidated						
US system	= .51(Re E of D)	+ .51(.51)(Re E of E)			= 102 + 26	= 128
Unconsolidated	= .51(Re E of D)				= 102	= 102
Country 4						
All systems	= .51(Re E of E)				= 51	= 51

Note: Calculation of Outward Reinvested Earnings (Re E = reinvested earnings).

Table 5. Example 1

Comparison of balance of payment entries under different systems

Balance of payments sign: + = inflow of funds into country
− = outflow of funds from country

(US$)

Country	Current account – Direct investment earnings			Capital account – Direct investment						
					Other investment in					
	Dividends	Reinvested earnings	Total (1 + 2)	Reinvested earnings (Contra for 2)	Country 2	Country 3	Country 4	Country 5	Total (5 + 6 + 7 + 8)	Total **(4 + 9)**
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
FULLY CONSOLIDATED SYSTEM										
1. Outward	+102	+162	+264	–162	–200	–25	–100	–100	–425	–587
2. Inward	–102	–162	–264	+162	+200				+200	+362
Outward	+255	+218	+473	–218		+100			+100	–118
3. Inward	–255	–218	–473	+218		–75			–75	+143
Outward	+102	+128	+230	–128			–50		–50	–178
4. Inward	–102	–128	–230	+128			+150		+150	+278
Outward	+51	+51	+102	–51				–150	–150	–201
5. Inward	–51	–51	–102	+51				+250	+250	+301
Total			Zero						Zero	Zero
UNITED STATES' SYSTEM COVERING ALL AFFILIATES IN WHICH DIRECT OR INDIRECT INTEREST OF 10% OR MORE										
1. Outward	+102	+155	+257	–155	–200	–25	–100		–325	–480*
1. Inward	–102	–155	–257	+155	+200				+200	+355*
Outward	+255	+218	+473	–218		+100			+100	–118**
3. Inward	–255	–218	–473	+218		–75			–75	+143**
Outward	+102	+128	+230	–128			–50		–50	–178**
4. Inward	–102	–128	–230	+128			+150		+150	+278**
Outward	+51	+51	+102	–51				–150	–150	–201**
5. Inward	–51	–51	–102	+51				+150	+150	+201***
Total			Zero						Zero	Zero
UNCONSOLIDATED SYSTEM										
1. Outward	+102	+51	+153	–51	–200				–200	–251
2. Inward	–102	–51	–153	+51	+200				+200	+251
Outward	+255	+153	+408	–153		+100			+100	–53
3. Inward	–255	–153	–408	+153		–100			–100	+53
Outward	+102	+102	+204	–102			–50		–50	–152
4. Inward	–102	–102	–204	+102			+50		+50	+152
Outward	+51	+51	+102	–51				–150	–150	–201
5. Inward	–51	–51	–102	+51				+150	+150	+201
Total			Zero	Zero					Zero	Zero

* Excludes investment in E.
** As for fully consolidated.
*** Excludes investment from A.

Table 6. Example 2

Group structure with fully owned subsidiaries

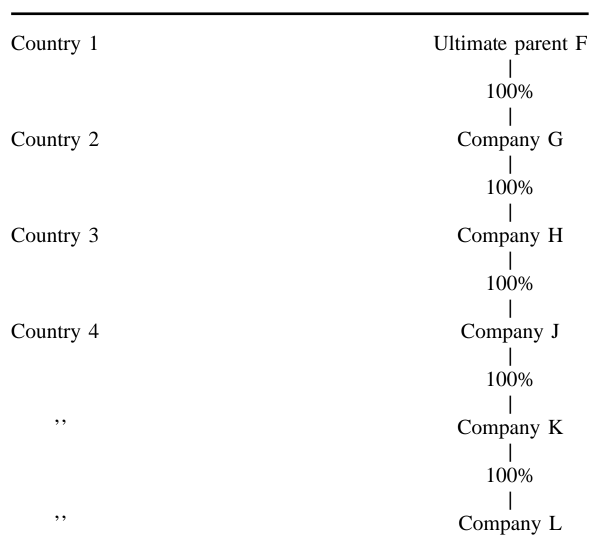


Table 7. Example 2

Value of outward direct investment flows in year

(excluding reinvested earnings)

Balance of payments sign: – = investment
+ = disinvestment

(US$)

Outward direct investment by	Investment in country					**Total**
	2 (Company G)	3 (Company H)	4 (Company J)	4 (Company K)	4 (Company L)	
Country 1 (Company F)	–200				–150	**–350**
Country 2 (Company G)		–50	+175			**+125**
Country 3 (Company H)			–100	–225		**–325**
Total	**–200**	**–50**		**–300**		

Table 8. Example 2

Earnings of fully owned subsidiaries

(US$)

Line	Country of residence	Company	Percentage of equity held by immediate parent (1)	Profit after tax (all due to immediate parent) (2)	Dividends received from subsidiaries (3)	Total earnings (profits plus dividends received) (2 + 3) (4)	Dividend paid (all to immediate parent) (5)	Reinvested earnings (4 – 5) (6)
i.	4	L	100% by K	650	–	650	100	550
ii.	4	K	100% by J	200	100	300	150	150
iii.	4	J	100% by H	500	150	650	550	100
iv.		Total J + K + L due to H		1 350	–	1 350	550	800
v.	3	H	100% by G	500	550	1 050	600	450
vi.		Total H + J + K + L due to G		1 850	–	1 850	600	1 250
vii.	2	G	100% by F	–	600	600	600	–
viii.		Total G + H + J + K + L due to F		1 850		1 850	600	1 250

Note : **Calculation of outward reinvested earnings.**

Country 1	Fully consolidated US System	}	= Reinvested earnings of G + H + J + K + L = 0 + 450 + 100 + 150 + 550 = 1 250
	Unconsolidated		= Reinvested earnings of G = 0
Country 2	Fully consolidated US System	}	= Reinvested earnings of H + J + K + L = 450 + 100 + 150 + 550 = 1 250
	Unconsolidated		= Reinvested earnings of H = 450
Country 3	Fully consolidated US System	}	= Reinvested earnings of J + K + L = 100 + 150 + 550 = 800
	Unconsolidated		= Reinvested earnings of J = 100

Inward reinvested earnings under fully consolidated, US and unconsolidated systems.
These are the same as the immediate direct investor's outward reinvested earnings under the same system.

Table 9. Example 2

Comparison of balance of payment entries under different systems

Balance of payments sign: + = inflow of funds into country
– = outflow of funds from country

(US$)

Country	**Current account** Direct investment earnings			**Capital account** Direct investment					
					Other investment in				
	Dividends	Reinvested earnings	Total (1 + 2)	Reinvested earnings (Contra for 2)	Country 2	Country 3	Country 4	Total (5 + 6 + 7)	Total (4 + 8)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
FULLY CONSOLIDATED AND UNITED STATES SYSTEM									
1. Outward	+600	+1 250	+1 850	–1 250	–200	–	–150	–350	–1 600
2. Inward	–600	–1 250	–1 850	+1 250	+200	–	–	+200	+1 450
Outward	+600	+1 250	+1 850	–1 250	–	–50	+175	+125	–1 125
3. Inward	–600	–1 250	–1 850	+1 250	–	+50	–	+50	+1 300
Outward	+550	+800	+1 350	–800	–	–	–325	–325	–1 125
4. Inward	–550	–800	–1 350	+800	–	–	+300	+300	+1 100
Total			Zero						Zero
UNCONSOLIDATED SYSTEM									
1. Outward	+600	–	+600	–	–200	–	–	–200	–200
2. Inward	–600	–	–600	–	+200	–	–	+200	+200
Outward	+600	+450	+1 050	–450	–	–50	–	–50	–500
3. Inward	–600	–450	–1 050	+450	–	+50	–	+50	+500
Outward	+550	+100	+650	–100	–	–	–100	–100	–200
4. Inward	–550	–100	–650	+100	–	–	+100	+100	+200
Outward									
Total			Zero						Zero

Annex 2

Germany's Survey of Direct Investment Assets

Outward direct investment

83. Enterprises resident in Germany required to report their outward direct investment assets are:

a) residents (including private individuals) who on the reporting date hold directly or indirectly more than 20 per cent of the shares or voting rights in a non-resident enterprise which has a balance sheet total equivalent to more than DM 1 million;

b) residents who maintain in foreign economic areas branches or permanent business establishments having gross operating assets totalling more than DM 1 million each. Two or more branches and business establishments maintained in a country by any one resident may be combined for the purpose. Permanent business establishments are considered not to include, in particular, assembly plants, building sites, etc. set up for a limited period to carry out a specific project.

84. The party required to report has to give information on the non-resident enterprises in which it has a direct or indirect interest, and on its branches and business establishments in foreign economic areas. The party required to report has an indirect interest if a non-resident enterprise in which the party has an interest of more than 50 per cent – this is then regarded as a ''controlled enterprise'' – itself has an interest of more than 20 per cent in other non-resident enterprises. If the controlled enterprise has an interest of 100 per cent in another non-resident enterprise, the other enterprise and any additional enterprise fulfilling the condition of a 100 per cent interest is also regarded as ''controlled''. Interests of these additional controlled enterprises in non-resident enterprises, if they amount to more than 20 per cent of the shares or voting rights, are likewise considered to be indirect interests of the party required to report.

Inward direct investment

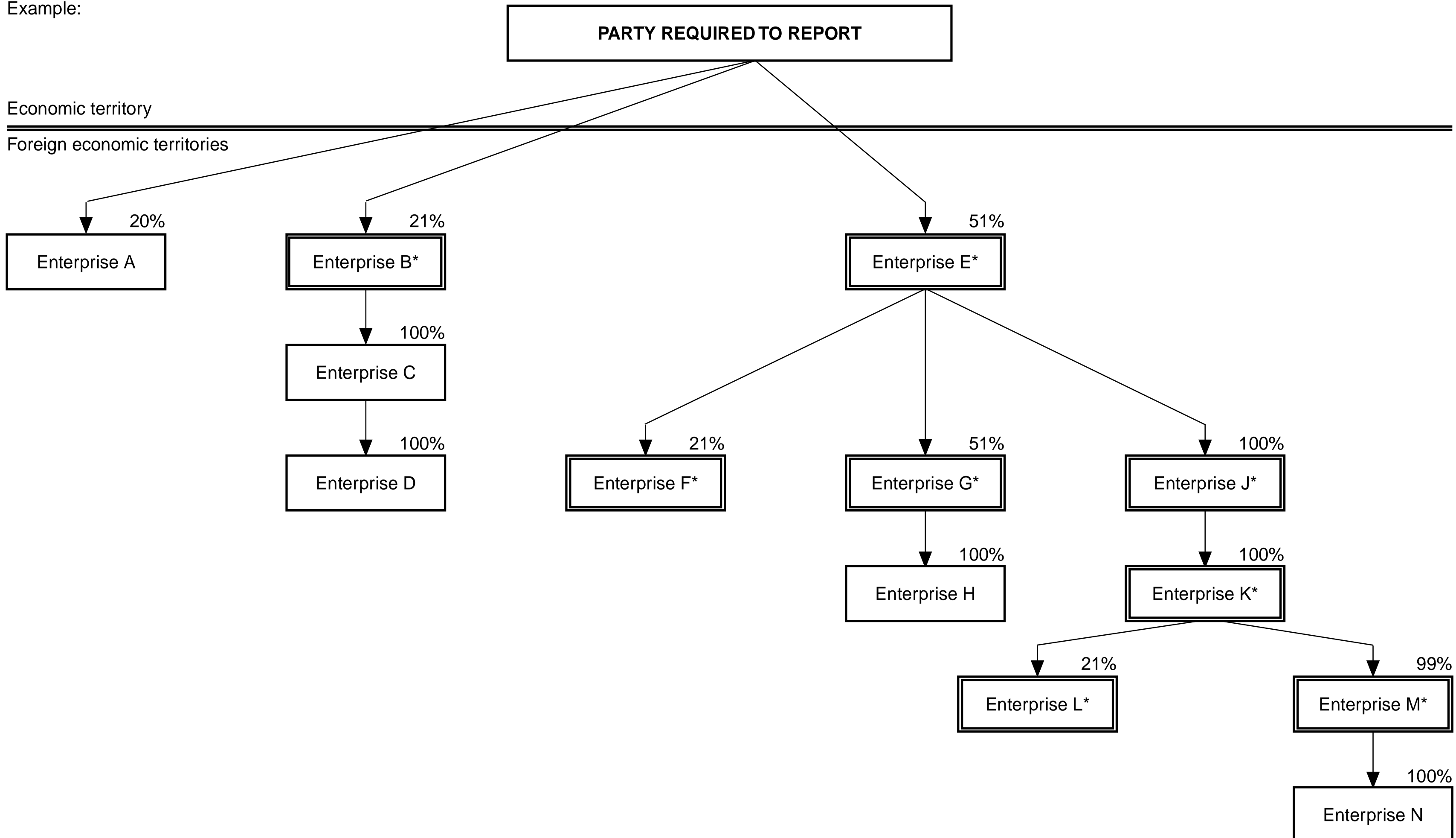
85. Reports must be made by the following enterprises resident in Germany:

a) Resident enterprises having a balance sheet total of more than DM 1 million if on the balance sheet date a non-resident or a group of economically connected non-residents holds more than 20 per cent of the shares or voting rights in the enterprise. In this context, non-residents who have come together in connection with the resident enterprise (*e.g.* to establish it), who are fairly closely related to each other (in particular, married to each other or related to each other in the direct line by blood or by marriage), or who are linked with each other within the meaning of section 15 of the Companies Act, are considered to be economically connected.

b) Resident branches and permanent business establishments of non-residents having gross operating assets totalling more than DM 1 million. Two or more resident branches and business establishments of any one non-resident are to be regarded as a unit. Permanent

business establishments are considered not to include, in particular, assembly plants, building sites, etc. set up for a limited period to carry out a specific project.

86. In addition, enterprises required to report which are more than 50 per cent owned by a non-resident or a group of economically connected non-residents and which themselves hold more than 20 per cent of the shares or voting rights in resident enterprises, have to give general information on the resident enterprises in which they have an interest if these enterprises have a balance sheet total or more than DM 1 million each (indirect interests of non-residents).


Example:
PARTY REQUIRED TO REPORT
Economic territory
Foreign economic territories
20%
Enterprise A
21%
Enterprise B*
100%
Enterprise C
100%
Enterprise D
51%
Enterprise E*
21%
Enterprise F*
51%
Enterprise G*
100%
Enterprise H
100%
Enterprise J*
100%
Enterprise K*
21%
Enterprise L*
99%
Enterprise M*
100%
Enterprise N
* Indicates direct investment enterprises for which reports are required.

Annex 3

Special Purpose Entities

87. Special Purpose Entity (SPE) is a generic label covering what, over the years, has had many different names. It includes holding companies, conduits, tax haven corporations, base companies, look-through companies, finance subsidiaries, and regional headquarters.

88. A number of aspects of SPEs are examined in this appendix:

a) international transactions routed through SPEs of multinational enterprises (MNEs), and similar types of transactions routed through normal operating companies but exhibiting all the characteristics of transactions flowed through SPEs;

b) the problems posed by such transactions for the construction of balance of payments and investment position statistics;

c) the Canadian experience in coping with these transactions, together with references to the United States and the Netherlands practices.

Structure and function of SPEs

89. SPEs may be structured in a number of ways, including separate legal entities and branches of legally constituted entities.

90. SPEs formed out of separate legal entities are in most cases wholly owned subsidiaries, and may be directly held by the ultimate parent company or by an intermediate holding company of the MNE. Some of these subsidiaries are the financing entities of the MNE. Others are holding companies maintaining investment portfolios, and may be known as regional headquarters, investment companies or management companies.

91. SPEs that are financing subsidiaries are principally engaged in raising funds or allocating funds from one unit of an MNE to another. Some of these companies may perform other functions as well. They may co-ordinate sales or perform other managerial functions, although these are not the primary purposes for which they were created.

92. As well, some operating companies act as conduits transferring funds among different entities of the MNE. Here, too, acting as a conduit is typically not a major function of the firm. Rather, such firms are primarily operating companies which also happen to be convenient vehicles for re-channelling funds. However such operations should be distinguished from normal investment activities conducted by these corporations.

Location of SPEs

93. SPEs are usually located in tax havens. They offer tax advantages for investment financing, and tax sheltering for income from the provision of services.

94. Tax havens include the Bahamas, Bermuda, Cayman Islands, Channel Islands, Hong Kong, Isle of Man, British Virgin Islands, Liechtenstein, Luxembourg, Netherlands Antilles, Panama and Switzerland. In recent years, SPEs have also been located in some other countries, such as Singapore, Vanuatu, Jamaica, and the Philippines.

95. In addition, some relatively high-tax countries, such as Canada, are locations for SPEs. These locations may be used, among other things, to hide the true source of income or to take advantage of jurisdictions that permit less-than-full disclosure of the total income of MNEs.

96. Tax haven countries usually exhibit the following characteristics:

a) relatively low rates of tax;
b) high levels of bank or commercial secrecy;
c) predominant financial sectors;
d) modern communications facilities;
e) absence of currency controls;
f) absence of requirements to file financial statements with regulatory or statistical agencies.

Perception of SPEs

97. Some would regard SPEs as tax avoidance gimmicks. However, the Business and Industry Advisory Committee (BIAC) of the OECD has given examples of the legitimate use of tax havens. According to the BIAC, ''much of the use of tax havens is not motivated by a desire to pay no, or little, tax, so much as an economic necessity to reduce costs, including taxes, to a bearable level in circumstances where the laws of countries are uncoordinated, and even the laws of individual countries are inconsistent, insofar as they relate to the treatment of international business''.[9]

98. SPEs, while minimising the overall tax cost of international business, help to achieve other corporate objectives such as hedging foreign exchange risk, minimising currency controls, avoiding unnecessary international capital transfers, or, for international banks, avoiding minimum reserve requirements that constrain total lending.[10] However, a very thin line separates legitimate tax avoidance from illegal evasion. Given the inherent difficulties of legal proceedings, governments have resorted to a number of initiatives other than active prosecution to discourage the use of SPEs for tax avoidance purposes. These include reciprocal tax treaties to avoid double taxation, or broader economic initiatives such as the United States' Caribbean Basin Plan to help countries that, out of economic necessity, act as tax havens.

Tax havens and foreign ownership and control statistics

99. Nevertheless, tax havens will continue to be a fact of life. The question for those involved in tracking foreign investment is how to ensure that the geographical and industrial allocation of such investment is not distorted. Fortunately, statisticians do not have to concern themselves with the legitimacy or otherwise of tax haven arrangements, nor, unlike tax authorities, do they face the possibility of court challenges to their actions.

100. Despite the complexity of the issues and the diversity of treatments, statisticians, have not, by and large, developed consistent ways of handling SPEs. Certainly, the problems are well-known, and countries such as the United States, Canada, Germany and the Netherlands have adopted methodologies to cope with the problems caused by SPEs. But by and large these methods are not well-documented. For Canada, which has probably had more reason than other countries to pay attention to SPEs, there is some documentation on the statistical treatment of certain types of SPEs.[11] But even here the treatment

has not been entirely comprehensive or consistent. An exception, however, is the United States treatment of Netherlands Antilles finance subsidiaries which is well-documented in the relevant issues of the Survey of Current Business.[12]

Tax authorities' perception of the SPEs

101. Tax authorities in many countries have been examining this phenomenon for many years. What the tax authorities have done is to concentrate on the substance rather than the form of transactions of SPEs. Do SPEs, for instance, engage in real economic activities in the countries of their incorporation or location? To answer this question, it is important to know the industrial activities of SPEs.

Manufacturing SPEs

102. In the case of an enterprise engaged in manufacturing activity, it is not difficult to see direct investment mostly in the form of bricks, mortar and machinery. However, tax authorities have found that some enterprises have disguised their actual activities by operating rudimentary assembly plants so as to pass for manufacturing concerns.[13] If tax authorities find it difficult to ferret out the relevant facts, how would statisticians be able to do so, particularly given the confidentiality that is so essential in enabling statisticians to work hand in hand with their corporate respondent base?

103. In fact, there are ways of determining whether a manufacturing operation in a tax haven country is a bona fide activity. Some countries, such as the United States and, recently, Canada, collect information on capital expenditures of direct investment enterprises abroad. These surveys report the costs of land and buildings, construction costs of new buildings, and purchase costs of machinery and other fixed assets. In this way, the legal existence of a direct investment relationship in a tax haven country can be backed up by relating it to real bricks and mortar and machinery.

Other types of SPEs

104. It is not usual to associate SPEs with manufacturing or other operating activities. However, some companies that appear to be merchandising, insurance, or other financial or shipping companies are really SPEs. In these cases, the statistician has to determine the centre of their economic activities. For instance, if a Canadian company incorporates a subsidiary shipping company in Singapore, flies a flag of convenience of another country, and directs the activities from Belgium, to which country should Canadian direct investment abroad be attributed?

Merchandising SPEs

105. What appear to be merchandising companies in tax haven locations are sometimes found to be the instrumentalities of transfer pricing. Prosecutions launched by taxation authorities in Canada have revealed that Canadian-based MNEs have made use of these types of SPEs to book income in tax haven countries.

Example of United States treatment

106. United States statisticians have gone to some lengths to determine the geographical location of investments of the merchandising companies. They have done this as a result of changes made to concepts and definitions for the 1977 benchmark survey of United States direct investment abroad. It was realised at that time that most United States petroleum parent companies had trading subsidiaries, mainly incorporated in the United States. They purchased foreign oil which they then resold to customers in the United States and third countries. Prior to 1977, the treatment of the nationality of these subsidiaries depended on the reporting and consolidation practices of the United States parent companies. However, in processing their benchmark survey, the Bureau of Economic Analysis (BEA) applied certain criteria to determine whether these subsidiaries were based in the United States or abroad. The criteria included such tests as to whether the subsidiaries, in their foreign locations had *a*) Employees, *b*) property, plant and equipment, *c*) trading activities based abroad, *d*) taxes paid to a foreign government or *e*) foreign incorporations. If none of the criteria were met, the subsidiaries were classified as domestic. In most cases, this exercise resulted in the reclassification of subsidiaries from foreign to domestic.[14] It is revealing that in the majority of cases, it was possible to determine, on the basis of objective criteria, that what were reported as foreign subsidiaries were in fact domestic ones.

Service industries in tax havens – Captive insurance companies and management service companies

107. It may be relatively easy to determine that manufacturing or merchandising activities of MNEs in tax haven countries are somewhat out of place. But are service industries, such as captive insurance subsidiaries providing self-insurance for MNE affiliates really out of place in tax havens? These companies spread their risks by engaging in re-insurance activities. On the one hand, it is a sound business principle for a large MNE to engage in self insurance. On the other hand, if profits are substantially reduced in high-tax countries through premiums paid to insurance affiliates in tax haven countries, then the real motives for setting up these subsidiaries become questionable. Tax authorities have certain criteria to decide which of these insurance companies are legitimate operations. To the extent that the tax authorities are efficient enough to weed out the questionable operations, statisticians are left with measuring the activities of the genuine operations. This same approach may be applied to management service companies.

Banks

108. It is well known, of course, that tax havens are popular locations among banks. There are sound business reasons for this. Some of the more obvious reasons are the strict bank secrecy requirements, the absence of reserve requirements, and the availability of modern communications. In the case of banks, only investment in shares, permanent debt loan capital and fixed assets are the operations to be included in direct investment (see also paras. 40, 61 and 62).

Offshore mutual fund companies

109. Offshore mutual funds are in a different category. The attraction of these companies lies in the fact that the clients of these companies, usually those in high tax countries, are able to convert income from high yield instruments such as bonds into capital gains, thereby attracting lower rates of tax. It is questionable whether these companies even have a physical presence in the countries of incorporation.

Financing subsidiaries

110. The financing subsidiaries set up by the MNEs in various jurisdictions are of another type. The best known and best documented of these are the Netherlands Antilles finance affiliates of United States parent companies. Most of these were incorporated in the 1968-1974 period in response to the United States mandatory controls on direct investment abroad, when United States companies were constrained from raising funds for their foreign operations in United States capital markets. Borrowing through these affiliates on the Euro-market provided certain tax advantages to the parent companies. Because of treaty between the two countries, interest payments on borrowings channelled through the Netherlands Antilles were not subject to withholding taxes. Even though the United States had similar treaties with other countries, the Netherlands Antilles proved the most popular with United States based MNEs for two reasons: firstly, the Netherlands Antilles does not have a withholding tax on interest payments to third countries; and secondly, most taxes on affiliates in the Netherlands Antilles generate offsetting tax credits for the United States parents.

111. In 1984, the 30 per cent United States withholding tax on interest paid to foreigners was repealed. As a result, interest payments to foreigners in all countries, not just those in treaty countries like the Netherlands Antilles, are now exempt from United States withholding taxes. In 1984, the United States direct investment position with the Netherlands Antilles constituted a negative asset position of $25.1 billion. It was also the year in which borrowings by United States parent companies from their Netherlands Antilles finance affiliates were at their highest level, at some $42 billion. By end-1993, the net outstanding debt had been reduced to $8.7 billion and the negative direct investment position had become negligible.

Netherlands Antilles subsidiaries of the United States MNEs

112. The BEA's statistical treatment of borrowings by United States parent companies through their Netherlands Antilles subsidiaries has not been consistent over the years. As noted earlier, such subsidiaries had come into existence as a result of the United States mandatory controls on direct investment imposed in 1968. If any of these subsidiaries had existed prior to 1968, the net inter-company debt would have been treated as direct investment. From 1968 to 1979, however, such borrowings were treated as portfolio investment in the United States parent companies from Europe, the ultimate source of nearly all the borrowed funds. Reductions of these liabilities were shown as repayments of principal to unaffiliated foreigners in Europe. Interest payments by the subsidiaries were shown as interest payments by the parents to unaffiliated foreigners in Europe. Other equity or income flows were included in the direct investment accounts, but were classified not to the Netherlands Antilles but to ''international and unallocated''.

113. When the direct investment controls were dismantled by the United States in 1974, these borrowings declined at first, but they picked up again in later years. It is not clear to what extent this new wave of borrowing was associated with direct investment abroad as opposed to the parents' needs at home.

114. The results of the 1977 benchmark survey of United States direct investment abroad were incorporated in the 1980 data, published in August 1981, and estimates for earlier years were revised to 1977. The distinction between Netherlands Antilles affiliates and other finance affiliates was dropped, and since then, all transactions of finance affiliates with their parents have been recorded as direct investment. The reason given by the BEA for this change is that ''it facilitates the integration of the two major types of data – balance of payments data and financial and operating data – for such affiliates collected in BEA's benchmark surveys''.[15] However, BEA has noted that the treatment of these affiliates may now be reconsidered in the light of specific guidance provided by the IMF *Balance*

of Payments Manual, Fifth Edition and by OECD *Benchmark Definition of Foreign Direct Investment*, Third Edition.

Other financial affiliates of United States MNEs

115. In the 1970s and 1980s, United States parent companies also raised funds abroad through financial affiliates other than those in the Netherlands Antilles. For instance, for the year 1981, the BEA reported inflows from a Bermuda finance affiliate of a United States petroleum company. This flow resulted in the direct investment position of the United States petroleum industry in Bermuda declining further to a negative position of $609 million compared to the previous year's negative position of $169 million.

Conduit financing through operating subsidiaries of United States MNEs

116. The type of financing described in the previous paragraph was not confined to financial affiliates. Also in 1981, the BEA reported that United States auto companies obtained financing for operations in the United States through their European manufacturing affiliates.[16]

Holding companies

117. A major category of SPEs consists of holding companies whose function is to hold investments in other corporations. These are considered financial corporations even though the investments that they hold may be in other industries such as manufacturing, mining, or merchandising.[17] Unlike some of the other types of companies in tax havens, holding companies may often be passive entities of MNEs. Their main purpose may be to hold claims on investments in third countries. Sometimes these claims have to be traced through a labyrinth of widely dispersed holding companies in order to identify the ultimate location of the investments. These holding companies often do not have any fixed assets in their countries of incorporation. Their physical presence in their country of incorporation may amount to no more than a set of files located in the offices of lawyers, accountants or banks. These files contain information on their incorporation, ownership and financial positions. The only employment generated by these entities may be whatever is needed to keep these files up-to-date.

Holding companies – Canada

118. In the case of Canada, holding companies may be interposed between foreign investors and their direct investment enterprises in Canada as well as between Canadian investors and their direct investment enterprises abroad. It was not until the 1970s that holding companies became important for Canadian direct investors, but since then, their use has kept pace with the rapid increase in Canadian direct investment abroad. At present, in absolute terms, Canadian direct investment abroad channelled through these holding companies exceeds similarly structured foreign direct investment in Canada.

119. Until 1972, Canada was something of a tax haven. Non-residents were able to obtain some tax relief by booking their investments in third countries through companies incorporated in Canada. Such companies were known as non-resident owned investment corporations (NROICs) and foreign business corporations (FBCs). Tax reforms in 1972 phased out the tax haven aspects enjoyed by these corporations, which diminished in number. In the case of NROICs, liabilities to foreigners and assets abroad were disregarded for both balance of payments and international investment position statistics, except

to the extent that there were transactions with Canadian residents (*e.g.* payment of withholding taxes). FBCs were of two types: Canadian controlled and non-resident controlled. In the case of the former the Canadian component of the investment was regarded as Canadian direct investment abroad. In the case of the latter the Canadian component was regarded as portfolio investment abroad.

Wholly foreign-owned operating companies in Canada

120. Other adjustments were also made in the Canadian statistics for investments abroad through operating companies in Canada wholly owned abroad. These companies were usually wholly owned subsidiaries of United States MNEs. Some of them held certain investments abroad over which they did not seem to exercise any kind of influence even though, in form, they constituted direct investments. Such investments were managed by the ultimate parent companies. Financial information on these investments would normally be available only at the headquarters of the ultimate parent. For all practical purposes, the parent companies could have held these investments directly. For these reasons it seemed inappropriate to treat them as Canadian direct investment abroad. Capital flows that took place ostensibly for the purpose of direct investment abroad, were treated instead as a return of foreign direct investment in Canada. Therefore, if a wholly owned subsidiary in Canada of a United States MNE made a direct investment in Germany, it was treated as a withdrawal of United States direct investment in Canada. All transactions between the Canadian and the German affiliates were carefully tracked and appropriate adjustments made in keeping with the decision to treat the investment flow to Germany as a return of United States direct investment in Canada rather than as Canadian direct investment in Germany. For instance, if the German subsidiary made a dividend payment to the Canadian parent company, it was considered a direct investment infusion from the United States. When the Canadian subsidiary made a dividend payment to its parent company, it was treated as a return of United States direct investment in Canada to the extent of the dividends received from Germany. Once the amount of dividends received from Germany were run down to zero, the balance of dividends paid to the United States parent company was attributed to the current rather than the capital account. All this, of course, meant that very meticulous records of the transactions of these companies had to be kept.

121. The type of situation described above is that of an operating company that is also used as a conduit in some instances. There were various reasons why United States MNEs used their Canadian subsidiaries as conduits. In earlier years, much United States direct investment in Canada was for the purpose of taking advantage of British Commonwealth tariff preferences. In later years, other reasons came into play as well.

122. In the mid-eighties, the treatment described above was reviewed. It had become difficult to determine which investments were held for tax or other administrative reasons and which were directly related to operations in Canada. Starting in 1985, therefore, investment abroad in the form (although not necessarily the substance) of direct investment was classified as direct investment. Revisions were carried back to 1979. It was felt that the circumstances in earlier years that had enabled these subsidiaries to be used as conduits as well as operating companies had largely disappeared.

123. However in very recent years, it appears that large amounts of funds are being booked abroad as direct investment by wholly owned subsidiaries of foreign companies. These investments have all the characteristics of conduit transfers of capital, and are being carefully analysed to determine how they should be treated.

Holding companies of Canadian direct investors

124. Nowadays, most Canadian direct investment abroad (CDIA) is held by Canadian controlled MNEs. A substantial and growing proportion of this investment is located in the United States. Canadian investment in foreign holding companies located in tax haven countries and then re-channelled to third countries, principally the United States, has also increased, amounting to approximately $5 billion in 1980, or nearly 20 per cent of total CDIA.[18] Since 1980, both the absolute and relative amounts of such investment have increased.

Comparison of Canadian and United States statistics

125. A comparison of Canadian and United States statistics on Canadian direct investment in the United States also gives a clue as to the amount of CDIA routed through tax haven countries. For the period from 1978 to 1985, the difference between these two sets of figures varied from a low of United States $1.4 billion in 1978 to a high of United States $9.2 billion in 1983.[19] Various factors gave rise to these differences. Short-term investments were included in the United States statistics but excluded from Canada's. At the time when the above comparison was made, the Canadian statistics did not include direct investment in the United States by Canadian banks.[20] Differences also arose from coverage and consolidation. However most of the difference resulted from CDIA in the United States being routed through holding companies in tax haven countries.

Comparison of United States and Netherlands statistics

126. Yet another example of the role of holding companies is provided by the work done by Van Nieuwkerk and Sparling on the direct investment position of the Netherlands.[21] They have drawn attention to major discrepancies between Netherlands and United States statistics on the bilateral direct investment positions. For instance, for 1980, according to the Netherlands statistics, the direct investment position of the Netherlands in the United States was Fl 16.9 billion. But according to the Benchmark Survey for that year by the BEA, the amount was Fl 41.2 billion. Van Nieuwkerk and Sparling attributed most of the difference to investment directed to the United States from holding companies established in the Netherlands by third countries. ''In the United States statistics all direct investment from the Netherlands to the United States is allocated to the Netherlands, including that of foreign groups' intermediate holding companies in the Netherlands. However, in the Netherlands statistics this direct investment by such intermediate holding companies or 'Special Financial Institutions' (SFIs), as they are called in the Netherlands, is recorded separately.''[22]

Growing use of holding companies in FDIC

127. The role of holding companies has been less significant for foreign direct investment in Canada (FDIC), than for CDIA, although in recent years the use of such companies has been growing. Asian-based MNEs seem to channel a greater proportion of FDIC through holding companies than do MNEs based in other countries. In 1987, however, Asian-based MNEs accounted for less than 5 per cent of total FDIC.

Complex financing arrangements. Canadian examples

128. Another recent development is the shuffling of investment funds between holding companies and financing subsidiaries situated in Canada, the home countries of the MNEs and several tax haven countries. In such instances, the companies between which funds are being shifted may not always have direct ownership links with one another. They are related only indirectly through the parent's ownership of these affiliates. The structure of such transactions resembles FDIC in some instances and CDIA in others. However, when all the affiliates of the same enterprise are examined as one entity, the substance of the transactions appears rather different. For instance, what in form appears to be CDIA may turn out to be the return of the parent's direct investment in Canada.

129. Some of the MNEs involved export capital out of Canada at the same time as they import capital into Canada, raising questions as to whether their investments in Canada are financed from abroad or from funds raised in Canada. The MNEs concerned state that they resort to this kind of financing for very sound business reasons such as foreign exchange management and tax minimisation.

130. The Canadian practice in such cases is to ignore the structural form of such transactions in order to capture their inherent substance.

Bona fide tax haven investors in Canada

131. Some FDIC from tax havens constitutes investment by residents of those countries rather than funds re-routed from third countries. The investors are usually former residents of Canada who have chosen to live in those countries, particularly in the Caribbean, in order to enjoy the more attractive meteorological and tax environments.

Summary

132. A number of issues related to SPEs that multinational enterprises use in their international investment activities, and the classification problems that they create for the balance of payments and international investment position statistics have been discussed. Problems are particularly encountered with regard to the proper identification of the type and location of investments. These problems are compounded by the fact that not only SPEs but, on occasion, operating companies exhibit some of the characteristics associated with SPEs. Furthermore, SPEs are not the only types of companies in tax havens that invest abroad. There are many foreign-owned companies in tax havens that engage in non-tax related activities. Similarly some companies based in tax haven countries carry out real economic activities in other countries.

133. Examples drawn from Canada, the Netherlands and the United States show how similar transactions have been treated in different countries and at different times. There is some evidence that changes in statistical treatment have been consistent with related surveys in these countries.

134. In Canada, it was felt sufficient some years ago to monitor the transactions of the operating affiliates of the MNEs on the basis of their legal relationships. But in retrospect this may be an over simplified way of treating the transactions of the MNEs. In any event, there is no alternative to monitoring the substance as well as the form of transactions of MNEs.

Annex 4

Recording Specific Transactions

Amounts outstanding with fellow subsidiaries: alternate solutions

135. Both the OECD and the IMF recommend that loans or balances due between fellow subsidiaries and branches or indirectly controlled direct investment enterprises, should be included in direct investment statistics and allocated to the country of the aforesaid.

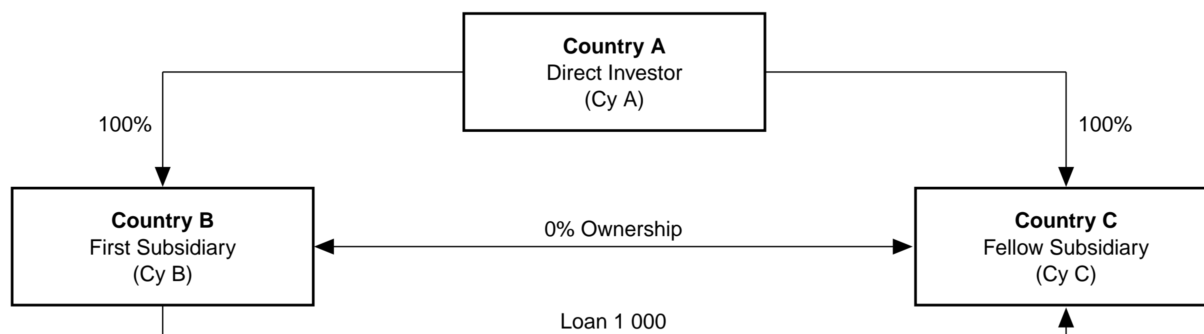
136. For some countries, where financial centres of multinational groups are established, this kind of relationship can be significant for direct investment statistics or for the corresponding component in the balance of payments.

137. This annex presents two ways of dealing with this kind of relationship. The first is that recommended by the OECD and the IMF based on the creation of a special memo item in the statistics on direct investment so as to facilitate international comparability. The second is based on a more complex construction.

Recommended method

138. If countries wish to isolate such transactions for analysis in their direct investment and balance of payments statistics, this method aims at providing separately supplementary information covering transactions between fellow subsidiaries. The character of inward or outward direct investment is still defined at the individual level of each country part to the transaction. For the international presentation, these transactions are of course recorded within the standard components under ‘‘other capital’’, sub-component of direct investment.

Examples of analytical presentation



Company B and company C are fellow subsidiaries through their respective relation with the mother company A. Company B and company C are supposed to have no cross-participation. Company B gives a loan of 1 000 units to company C.

Direct investment statistics

Country A	Nil	
Country B	Value of outward investment	
	– Fellow subsidiaries (Country C)	–1 000
Country C	Value of inward investment	
	– Fellow subsidiaries (Country B)	+1 000

Balance of payments statistics

Country A	No registration	
Country B	1. Direct investment	
	1.1 Abroad	
	1.1.3 Other capital	
	Fellow subsidiaries	–1 000
Country C	1. Direct investment	
	1.2 In reporting economy	
	1.2.3 Other capital	
	Fellow subsidiaries	+1 000

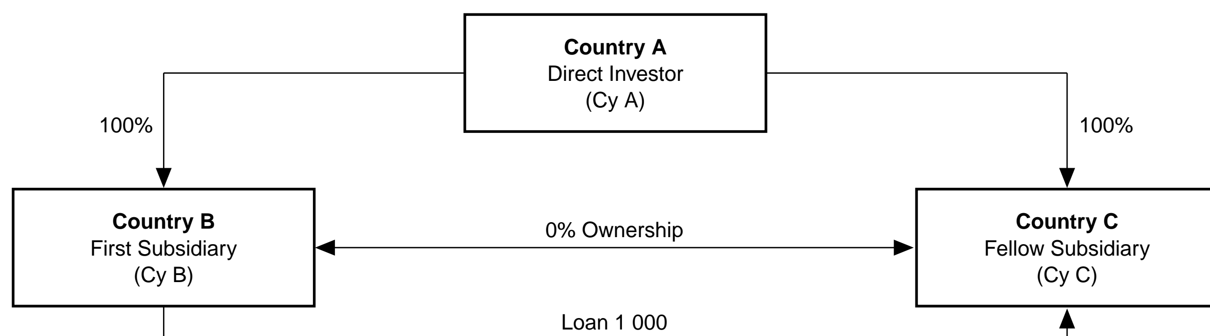
Alternative method

139. This method is based on the use of an artifice through the recording of the transactions between the fellow subsidiaries in order to maintain a complete consistency within the different components of the direct investment statistics and the balance of payments.

140. When an enterprise (Cy B), being a subsidiary, associate or branch of a direct investor (Cy A), provides loans to a fellow subsidiary (Cy C), of which it does not own directly or indirectly a part of the shares, the present method implies that these loans are not considered as an asset of the first enterprise on the second fellow subsidiary but as an asset (inward investment) *vis-à-vis* the direct investor.

141. The second fellow subsidiary has to consider in these circumstances that it has a liability (inward investment) *vis-à-vis* the direct investor. The direct investor has a liability (inward investment) *vis-à-vis* the first subsidiary and an asset (outward investment) *vis-à-vis* the second subsidiary.

Examples of analytical presentation



Direct investment statistics

Country A	Value of outward investment (loans)	
	Country B:	+1 000
	Country C:	–1 000
Country B	Value of inward investment (loans)	
	Country A:	–1 000
Country C	Value of inward investment (loans)	
	Country A:	+1 000

Balance of payments statistics

Country A	1. Direct investment	
	1.1 Abroad	
	1.1.3 Other capital	
	1.1.3.1 Claims on an affiliate	–1 000
	1.1.3.2 Liabilities on an affiliate	+1 000
Country B	1. Direct investment	
	1.2 In reporting economy	
	1.2.3 Other capital	
	1.2.3.1 Claims on direct investor	–1 000
Country C	1. Direct investment	
	1.2 In reporting economy	
	1.2.3 Other capital	
	1.2.3.1 Liabilities to direct investor	+1 000

142. This approach can be justified by the fact that the first subsidiary, considering that it has no direct or indirect relationship with the second one, is giving the loan to the latter in application of the relationship with the direct investor. This transaction can even be initiated by the direct investor. This kind of situation is certainly the case for affiliates that are financial units of a multinational group. This procedure does not address the practical question of how should the statistical compilers of country A be aware of the loan-transaction between country B and country C.

143. If countries choose to adopt this method, they should, for international comparability purposes, also compile data on the basis recommended in the IMF *Balance of Payments Manual,* Fifth Edition.

Special purpose entities

144. OECD recommends that transactions between SPEs and other members of a multinational group should be reflected in the statistics except for those involving SPEs with the sole purpose of serving as financial intermediaries.

145. This statement is difficult to bring into practice for some Special Purpose Entities such as financial headquarters or financing subsidiaries because of complicated bookkeeping procedures and problems related to distinguishing between transactions within the related group and those with outside parties. Some countries may desire to regroup all cash management transactions as a supplementary item, for analytical or other purposes. Nonetheless, in principle, such intra-group transactions should be included in direct investment statistics.

Annex 5

COUNCIL RECOMMENDATION ON REVISION OF THE OECD BENCHMARK DEFINITION OF FOREIGN DIRECT INVESTMENT

(adopted by the Council at its 856th session on 27 and 28 July 1995)

THE COUNCIL,

Having regard to Article 5 b) of the Convention on the Organisation for Economic Co-operation and Development of 14th December 1960;

Having regard to the Resolution of the Council of 13th December 1984 on the Terms of Reference of the Committee on International Investment and Multinational Enterprises [C(84)171(Final)] as extended by the Council on 27 September 1990 [C/M(90)17(Final), Item 208];

Having regard to the Recommendation of the Council of 27 February 1992 concerning the revised detailed benchmark definition of foreign direct investment [C(91)80(Final)];

Recognising the improvements that have been achieved in the comparability of data collected on foreign direct investment since the publication of the OECD Benchmark Definition of Foreign Direct Investment in 1983 and the desirability of ensuring that the methodology of the Benchmark continues to reflect the reality of foreign direct investment transactions;

Considering that divergences still exist between the methodology used by some Member countries and the methodology of the Benchmark;

On the proposal of the Committee on International Investment and Multinational Enterprises;

I. RECOMMENDS that Member countries continue to take steps to bring their statistical methodology into line with the OECD Benchmark Definition of Foreign Direct Investment as set out in the Report of the Committee on International Investment and Multinational Enterprises (Third Edition) OECD/GD(95)36, thereby providing a comparable basis for users of foreign direct investment statistics.

II. INSTRUCTS the Committee on International Investment and Multinational Enterprises, in co-operation with the Group of Financial Statisticians, to continue co-ordinating within OECD the collection of information on international direct investment and multinational enterprises, and to collect and publish at regular intervals stock and flow data on inward and outward foreign direct investment, accompanied by notes describing the areas where the methodology used by Member countries differs from the OECD Benchmark Definition.

III. DECIDES to repeal the Recommendation of the Council of 27 February 1992 referred to above.

Notes and References

1. In those cases where countries may not be in a position to distinguish between subsidiaries, associate companies and branches in respect of balance of payments flows, a qualitative indication should be provided to this effect.
2. As an exception to this general principle, for those countries which (Fifth choose to implement the qualifications to the 10 per cent rule mentioned above, N must in addition have an effective voice in the management of R. By the same token, R would be treated as an associate of N even if N and its subsidiaries own less than 10 per cent of R provided N and its subsidiaries have an effective voice in the management of R.
3. Methods of producing consolidated figures vary between countries, but all are probably sub-sets of the Fully Consolidated System recommended above. Some countries' statistics are based on the consolidated accounts produced by their companies. For instance, until recently, the United Kingdom's direct investment statistics are based upon and have the same coverage as the world-wide consolidated accounts companies are required by law to produce. Subsidiaries are as defined above and associates are defined on similar lines to that recommended above except that the minimum shareholding is 20 per cent. In terms of the example in para. 15, the United Kingdom direct investment statistics would cover directly and indirectly owned subsidiary companies A, B, H and K and directly held associate F. In addition, included in the profits of F and H would be their share of the profits of their associates G and J, and the figures for K would include indistinguishably its share of Branch L's earnings and any investment flows between N and L. The figures reported by N would include any direct investment flows between it and B, G and J. Companies C, D and E would not be covered.

   A different approach is used by the United States. Direct investment statistics cover every enterprise in which 10 per cent or more of the voting stock is directly or indirectly attributable to the direct investor. In the example above the United States statistics could cover Companies A, B, D, F, H, J, K and L, but not C, E or G.

   Germany uses another system as well (see Annex 2). Stocks of outward direct investment cover all foreign enterprises directly owned to more than 20 per cent by German residents; all foreign enterprises owned more than 20 per cent by foreign enterprises, which are more than 50 per cent directly owned by German residents; all foreign enterprises (directly or indirectly) owned 100 per cent by these 50+ per cent directly owned enterprises, plus all foreign enterprises in which these 100 per cent directly and indirectly owned enterprises have a direct interest of more than 20 per cent. In the above example the German outward figures would cover Companies A, B, F, H, J, K and L, but not C, D, E or G. The German statistics of the stock of inward direct investment cover all German domestic enterprises which are more than 50 per cent directly foreign owned; all domestic enterprises in which these 50+ per cent directly owned enterprises have a stake more than 20 per cent; plus all domestic enterprises in which foreign residents have a direct interest of more than 20 to 50 per cent. Any foreign subsidiaries of these domestic concerns are not included. In the above example, if N is the foreign direct investor and Companies A, D, F, H and K are German domestic companies, then the German statistics would cover Companies A, F, H and K, plus if they are resident in Germany, Companies B and J, and branch L, but not C, D, E or G.
4. Recommendation in line with the IMF *Balance of Payments Manual,* Fifth Edition, 1993 and the *System of National Accounts*, 1993. The IMF Manual also recommends that ''those countries that compile data on the basis of market values derived indirectly should also compile data, as provided by enterprises, on a balance sheet (book value) basis – if the two types of data differ – to facilitate international comparability (para. 467).''
5. As defined in the IMF *Balance of Payments Manual,* Fifth Edition, 1993 and the *System of National Accounts*, 1993.

6. In practice, when the exact day of remittance is not available, mid-month spot rate of the relevant period may be used.
7. Reporting basis used in the joint OECD-EUROSTAT questionnaire for collecting data on foreign direct investment.
8. BIS ''second-tier'' capital might be a useful indication for compilers regarding what represents permanent debt.
9. Organisation for Economic Co-operation and Development (1985), *Issues in International Taxation*, No 1. *International Tax Avoidance and Evasion*, Paris.
10. BREAN, Donald J.S. (1984), *International Issues in Taxation.* The Canadian Perspective, Canadian Tax Foundation, Toronto, p. 119.
11. Statistics Canada (1981), *The Canadian Balance of international payments and International Investment Position. A Description of Sources and Methods*, Ottawa.
12. United States Department of Commerce/Bureau of Economic Analysis, *Survey of Current Business,* Various issues.
13. BREAN, Donald J.S., *op. cit*.
14. *Survey of Current Business, op. cit*., August 1981.
15. *Ibid*, p. 39.
16. *Survey of Current Business, op. cit*., August 1982.
17. In some of their statistical series, Statistics Canada codes the holding companies to the industries of their investments.
18. Statistics Canada (1984), *Canada's International Investment Position, 1979* and *1980,* Ottawa, p. 20.
19. RICHARDS, C.F.J. ''International Investment Statistics: Can They Be Compared?'' *Investing in Canada*. Vol. 1, No. 4, Spring 1988, Investment Canada, Ottawa.
20. CDIA for the Canadian banks was covered comprehensively for the first time for the year 1987. Revisions were carried back to 1983. See also: *Statistics Canada,* 1990, *Canada's International Investment Position*. 1987, Ottawa.
21. VAN NIEUWKERK, Marius and SPARLING, Robert P. (1985), ''The Netherlands International Direct Investment Position''. Monetary Monographs No. 4, *De Nederlandsche Bank N.V*.
22. *Ibid*. Appendix C: *Discrepancies between Netherlands and United States statistics*. See also Appendix D. *Special Financial Institutions* (SFIs) which provides an excellent description of the functioning of the SFIs and their statistical treatment in the Netherlands statistics.

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