ANNEX 7

Special Purpose Entities

1. Introduction

552. The purpose of this Annex is to assist compilers to identify Special Purpose Entities (SPE). The core business of SPEs is to channel funds between entities outside the country where they are established. The identification of SPEs allows foreign direct investment (FDI) compilers to segregate transactions and positions that hardly affect domestic economic activity and do not reflect genuine investment activities in or of the reporting country itself. The role of these SPEs is merely to serve as a financial turn table for enterprises in other countries.

553. Referring to Figure A.7.1 this *Benchmark Definition* addresses problems with the interpretation of FDI figures caused by SPEs as follows:

i) for the standard presentation country B should report separately on transactions and positions of its resident SPEs and non-SPEs;

ii) for supplemental presentations ("looking through non-resident SPEs"),

- ❖ country A is recommended to reallocate its outward investment position in the SPE in country B to C and D by looking through the non-resident SPE in B;
- ❖ country B is recommended to only report for its non-SPE;
- ❖ countries C and D are recommended to reallocate their inward investment positions to country A;

iii) it is suggested that country B produces a matrix linking foreign assets and liabilities of its SPEs in different countries.

554. FDI statistics under points *i)* and *ii)* above are based on the directional principle and should be geographically broken down by country and industry to facilitate the economic analysis of foreign direct investment. National compilers in economies hosting SPEs may wish to provide origin and destination matrices as supplemental information, as they may help to look through SPEs and to track international capital flows.

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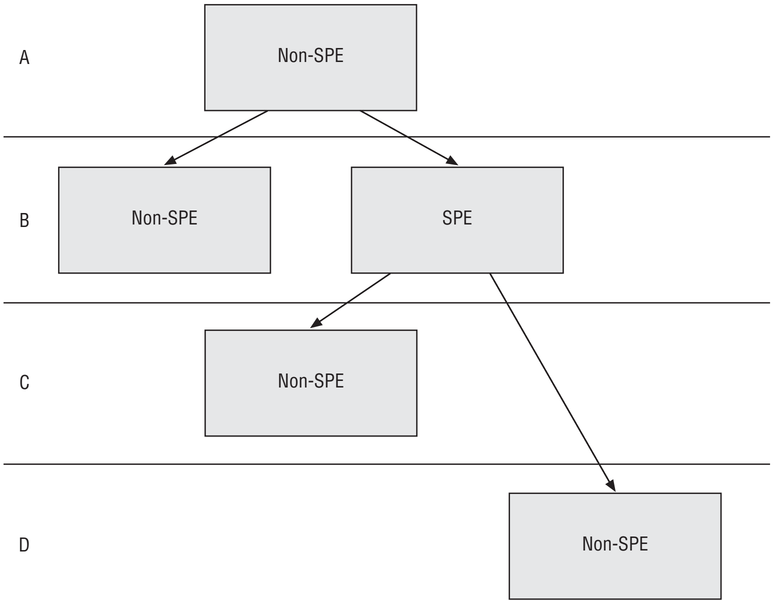
Figure A.7.1. **Direct investment positions held via an SPE**



555. The following sections provide further compilation guidance.

2. Treatment of SPEs

2.1. General principles

556. For standard FDI statistics, broken down by country and industry, it is recommended to provide data on SPEs and non-SPEs separately as described in Annex 2. Compilers are also recommended to look through, on a supplemental basis, *non-resident* SPEs by reallocating reported non-SPE data *vis-à-vis* direct counterparts to the country and industry of the first non-SPE encountered (Chapters 4 and 7).[78] Positions and transactions of resident SPEs are excluded from the supplemental presentation.

2.2. Most common types of SPE relationships

2.2.1. SPEs in direct relationships with non-resident entities

557. Many pass-through entities only have assets and liabilities *vis-à-vis* non-residents. In this case, the classification as an SPE is straightforward. In Figure A.7.2(a), for instance, on the basis of the criteria (*ii* and *iv*) listed in Box A.7.1, enterprise M would be an SPE, as it is an entity that is directly controlled by a non-resident and owns only assets in non-resident enterprises.

2.2.2. Resident chains of pass-through entities

558. The part of a chain of FDI passing through a country may also consist of two or more entities, as is illustrated in Figure A.7.2(b). The resident entity reporting outward investments (enterprise M), owns foreign assets only. At the same time, it is indirectly controlled (via L) by a non-resident parent. Hence, it can be considered as an SPE. However, the entity reporting incoming funds (enterprise L) has no non-resident assets. It has

78. In Figure A.7.1, an enterprise in country A holds an equity position in its SPE in B, a (pure) holding company without any employment. This SPE has invested the total amount of the funds received from A in its affiliates in C and D. The enterprise in A also holds an equity position in a non-SPE in B.

Box A.7.1. **General criteria to assist compilers to identify SPEs**

An enterprise is usually considered as an SPE if it meets the following criteria:

i) The enterprise is a legal entity,

a) Formally registered with a national authority; and

b) subject to fiscal and other legal obligations of the economy in which it is resident.

ii) The enterprise is ultimately controlled by a non-resident parent, directly or indirectly.

iii) The enterprise has no or few employees, little or no production in the host economy and little or no physical presence.

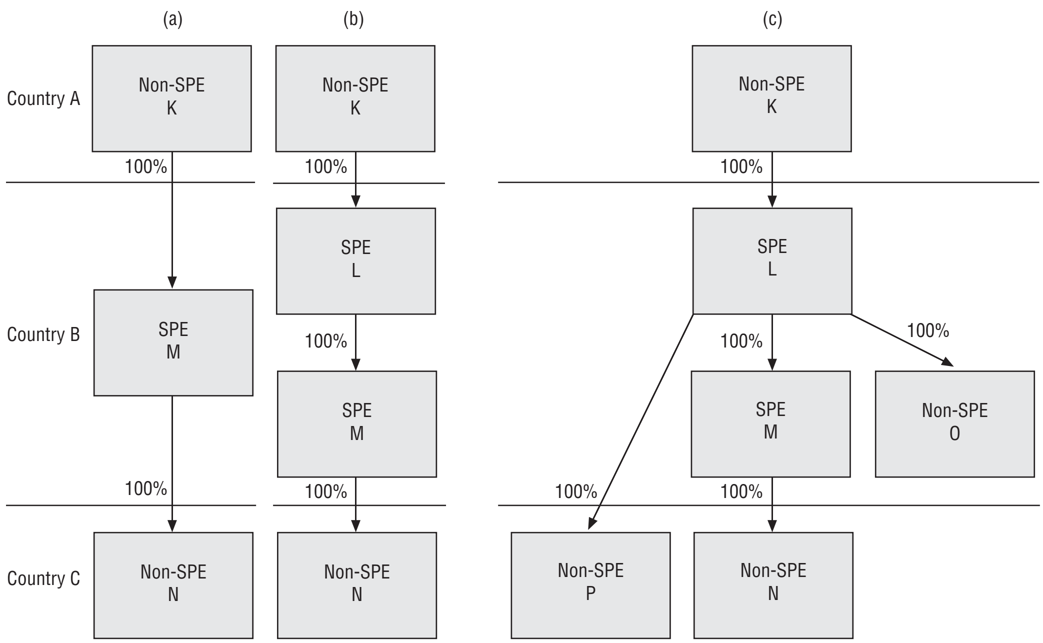
iv) Almost all the assets and liabilities of the enterprise represent investments in or from other countries.

v) The core business of the enterprise consist of group financing or holding activities, that is – viewed from the perspective of the compiler in a given country – the channelling of funds from non-residents to other non-residents. However, in its daily activities, managing and directing local operations plays only a minor role.

invested in the next entity down the chain (enterprise M, which is another resident entity in the same economy B). Hence, enterprise L does not meet criterion *iv*), according to which almost all assets should be non-resident assets. Therefore, on the basis of a strict interpretation of the above criteria, enterprise L could not be considered as an SPE. At the same time, however, it is clear that the domestic assets of L in M are assets in an entity that has no economic links with the domestic economy. In consequence, compilers are recommended to consider enterprise L as an SPE and to look through it, given that its assets are indirectly owned *non-resident* assets.

Figure A.7.2. **Examples of chains of SPEs**

(enterprises L and M do not have any assets in addition to those indicated)



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2.2.3. Mixed groups of SPEs and non-SPEs

559. A resident enterprise, directly owned by a non-resident enterprise, may also hold, in the same (domestic) economy, both SPEs and operating subsidiaries [see Figure A.7.2(c)].Whether the resident enterprise (L), should be considered as an SPE depends on the composition of its balance sheet. Although it is directly controlled by a non-resident enterprise, its assets are partially non-resident and partially resident. The assets include investments in a resident enterprise (non-SPE) as well as non-resident assets, which it holds directly in non-resident enterprise (P) and indirectly in non-resident enterprise (N). The relative weight of foreign and domestic assets determines whether L should be classified as a SPE or as a non-SPE.[79]

560. From the above examples it may be concluded that for an appropriate treatment of enterprises owned by non-residents, and related with each other in chains or groups, compilers may want to use additional criteria depending on national circumstances. In the case of resident chains of entities, compilers should take into account whether assets in resident entities, such as those of L in M, are really relevant to the domestic economy. If not, these enterprises would be considered as potential SPEs.

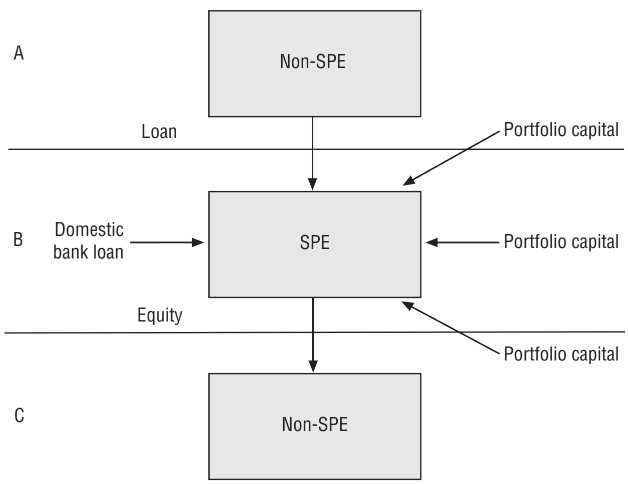
3. Analytical consistency

561. New recommendations included in this *Benchmark Definition* improve the quality and comprehensiveness of geographical and industry breakdowns. More specifically, it is recommended that a compiler looks through non-residents SPEs and reallocates positions and transactions with non-residents SPEs to the countries and industries of the first non-SPEs further up or down the FDI ownership chain. This recommendation is consistent with and complementary to the recommendation to segregate FDI figures reported by resident SPEs and to present them in separate breakdowns by country and industry.

562. In Figure A.7.3, for instance, the compiler in country A should reallocate to country C the outward inter-company loan provided to the SPE, the immediate counterparty, in

Figure A.7.3. **The transformation of capital by SPEs**

(the links in the chain of FDI shown below represent 100% ownerships)



79. In the Netherlands, for instance, the Dutch National Bank for its FDI statistics would classify L as an SPE if the domestic assets of L (in O) were less than 10 per cent of total assets.

country B. In practice, country A is not effectively investing in country B but in country C. Likewise, the compiler in country C should reallocate to A the extension of equity capital, *i.e.* inward FDI capital flows from B. Otherwise the geographical breakdown would erroneously suggest that country B is investing in country C, whereas it is actually country A where a non-SPE recorded a genuine outward direct investment.

563. It should be noted that as country A and C both look through country B, the amount of FDI transacted from country A no longer needs to be equal to the amount arriving in country C. This difference should not be interpreted as an inconsistency between outflows of A and inflows of C. It simply reflects the intermediary role of the SPE between entities in a multinational enterprise. For instance, SPEs may take up additional bank loans or raise capital in financial markets as additional financing for outward investments which may exceed inward investments, as is illustrated in Figure A.7.3. The inward and outward direct investments reported by the SPE in country B are not necessarily of equal amounts; hence, the same argument is true for the corresponding outward and inward direct investments reported by A and C.

564. The fact that country A reports outward *loans* provided to country C, whereas country C reports inward *equity* coming from country A, should not be considered as an inconsistency either. This difference too merely reflects the intermediary role of SPEs and their finance transformation activities. For instance, in Figure A.7.3 the SPE in country B has simply transformed the nature of the direct investment capital that it received from its parent, in country A, by applying the incoming *loan* for *equity* investment in country C. The possibility of this type of difference is inherent to the segregation of SPEs in order to reduce the overstatement (inflation) of FDI data and the distortions of geographical and industry allocations.

4. Origin and destination matrices

565. The reallocation to first non-SPE countries contributes to more meaningful FDI statistics. In some cases it may be difficult for reporters or compilers to look through non-resident SPEs. Therefore, this issue is referred to the research agenda (see Annex 13) for a complete set of recommendations. However, in the meantime, the practical recommendations provided could be useful to compilers.

566. It would be desirable if compilers could also rely on information provided by the SPE countries themselves. This *Benchmark Definition* therefore suggests that each country hosting a significant number of SPEs provides supplemental information on the specific linkages between the inward and outward positions of its SPEs. Normally these linkages cannot just be derived from a geographical breakdown of the data reported by resident SPEs. For instance, Figure A.7.4 does not facilitate the identification of where the capital

Figure A.7.4. **Asset and Liability Positions of country X *vis-à-vis* direct counterpart countries reported by resident SPEs of X**

Country	Assets	Liabilities
A		80
B	120	20
C	60	
D	30	
E	90	40
F		160
	300	300

provided by country B to country X has been invested by the SPEs in X. Likewise it is impossible to determine which country provided the financial means for the investments by X's SPEs in B. In both cases the difficulty relates to the fact that there are (too) many origins and destinations.

567. At the level of individual SPEs, however, the number of origins and/or destinations may be limited. For individual SPE a pro-rating approach could be applied (Figure A.7.5). If, for instance, in the Figure A.7.5, 80 per cent of the liabilities of SPE1 represent equity capital invested by country A, one could reasonably assume that 80% of the assets in country C are financed by inward capital from A (80% of 60 is 48).

Figure A.7.5. **Linking inward and outward positions of individual resident SPEs of a country X**

All SPEs

Assets		Liabilities	
	Country		Country
120	B	120	A
60	C	60	B
30	D	30	E
90	E	90	F
300		300	

SPE1

Assets		Liabilities	
	Country		Country
60	C	80	A
30	D	20	B
10	E		
100		100	

A ==> C 48	B ==> C 12
A ==> D 24	B ==> D 6
A ==> E 8	B ==> E 2

SPE2

Assets		Liabilities	
	Country		Country
120	A	40	E
80	B	160	F
200		200	

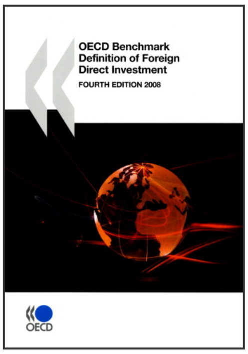
E ==> B 24	F ==> B 96
E ==> C 16	F ==> E 64

568. Similar calculations can be made for all SPEs, where after the results (the arrows in Figure A.7.5) can be summed up and presented in an origin and destination matrix (ODM as in Figure A.7.6).

Figure A.7.6. **An origin and destination matrix showing estimated international linkages via resident SPEs in country X**

SPEs		Origin countries: A	B	E	F	Total liabilities
Destination countries	B			24	96	120
	C	48	12			60
	D	24	6			30
	E	8	2	16	64	90
	Total assets	160	20	20	160	300

569. An ODM provides information on assets and liabilities of resident SPEs broken down by country. It also provides an indication of the way the funds invested in these entities by different source countries have been distributed across different destination countries. Users of FDI statistics could consult the above matrix for a better insight in the real counterparties of *e.g.* country B if the compiler of FDI for country B was not able to look through country X.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