

Chapter 6

Special Entities

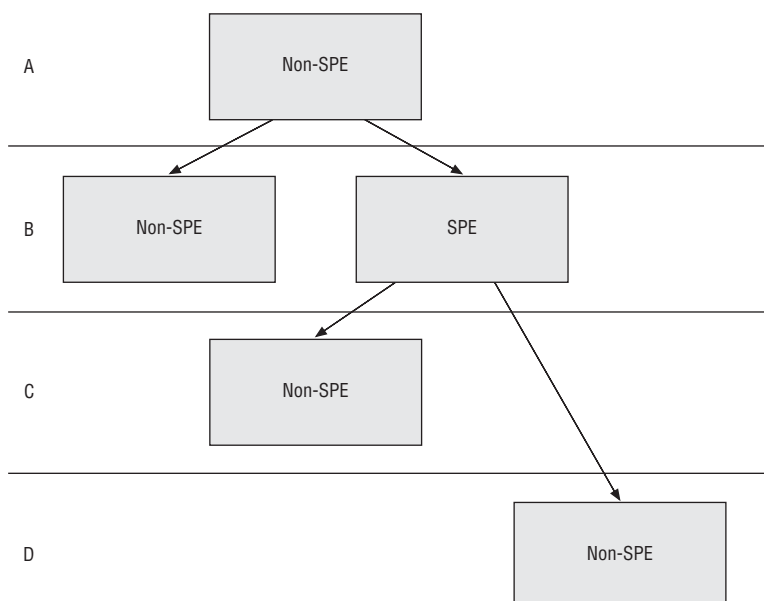
6.1. Summary

312. There are a number of special cases where it may be unclear whether or why a particular type of enterprise or activity qualifies for treatment as a direct investment enterprise or direct investment. Several of these cases are discussed below. These are Special Purpose Entities (SPEs); collective investment institutions (CIIs); land, structures and other immovable objects; construction enterprises; mobile equipment; and insurance companies.

6.2. Special purpose entities

313. Multinational enterprises (MNEs) often diversify their investments geographically, through organisational structures. These may include certain types of SPEs. Examples are *financing subsidiaries*, *conduits*, *holding companies*, *shell companies*, *shelf companies* and *brass-plate companies* (Box 6.1). Although there is no universal definition of SPEs, they do share a number of features. They are all legal entities that have little or no employment, or operations, or physical presence in the jurisdiction in which they are created by their parent enterprises which are typically located in other jurisdictions (economies). They are often used as devices to raise capital or to hold assets and liabilities and usually do not undertake significant production. In Figure 6.1, for instance, the SPE in country B is used by its parent in country A to indirectly hold enterprises in country C and country D. As explained in Chapter 4, country B should distinguish FDI positions and transactions of SPEs and non-SPEs.

Figure 6.1. Positions held via an SPE



314. As legal devices SPEs may be relatively cheap to create and to maintain. They may offer taxation, regulatory, and confidentiality benefits. Incorporation of SPEs is often associated with off-shore financial centres³⁹ but they may also be found in other jurisdictions.

Box 6.1. Some examples of SPEs: Shell companies, conduits and holding companies

The term *shell* is used to refer to a company that is formally registered, incorporated, or otherwise legally organised in an economy but which does not conduct any operations in that economy other than in a pass-through capacity. Shells tend to be conduits or holding companies and are generally included in description of SPEs.

A *conduit* is a company that obtains or borrows funds, often from unaffiliated enterprises, and remits those funds to its direct investor or another affiliated enterprise. A *holding company* is established to hold participation interests in other enterprises on behalf of its owner. Some conduits and holding companies may have a substantial physical presence as evidenced by, for example office buildings, equipment, and employees. Others may have little or no physical presence and may exist only as shell companies. If a direct investor incorporates a shell company or conduit in a non-resident economy and manages or operates it entirely from its own home economy, it is treated as an incorporated direct investment enterprise in its country of incorporation. If a shell company is incorporated abroad but all of its physical assets, operations, or management activities are in a second foreign country, then it is classified as a direct investment holding company in its country of incorporation, and its activities in the second foreign country would be evaluated to determine whether a separate institutional unit exists and thus be treated as a direct investment enterprise. Similarly, if a shell company is incorporated abroad and has some physical assets or operations in two or more other foreign countries, the resident unit in the country of incorporation is classified as a holding company, and the activities in the other foreign country are evaluated individually to determine whether they meet the criteria for treatment as a direct investment enterprise.

Central, state, or local governments are direct investors if they hold a 10% or more ownership interest in a non-resident enterprise. In this context, there is also analytical interest in enterprises established abroad by a central government for the purpose of securitisation of assets, defeasance, and similar functions.

315. SPEs are residents of the economies in which they are incorporated and, therefore, they may be direct investors or direct investment enterprises, even if they are shell companies or pass-through entities without any other productive economic activity of their own. They qualify as part of a direct investment relationship (and are included with the Framework for Direct Investment Relationships – FDIR) by virtue of being resident in one economy and being owned by, or owning, an enterprise in a different economy in compliance with the 10% voting power criterion. Consequently, in Figure 6.1, country B

39. The definition and the geographical coverage of off-shore centres may differ depending on the purpose of the analysis. This *Benchmark Definition* does not apply any specific description of off-shore centres. The focus is rather the entity that qualifies as direct investor or direct investment enterprise and not the geographical location.

should include in its FDI assets and liabilities presentation all the FDI investments held by or in resident SPEs as well as the FDI investments held by or in resident non-SPEs.

316. In recent years, direct investors have made an extensive use of SPEs for the purpose of channelling funds to, and for borrowing funds from, third countries, and for the purpose of holding ownership interests in direct investment enterprises. As a result, when a country hosts SPEs and includes them in its FDI statistics, an increasing part of transactions and positions merely reflects the channelling of funds via this country. This can lead to a more and more significant overstatement of FDI activity. FDI transactions passing through a SPE generally do not have the expected immediate impact of direct investment concerning matters such as technology transfers, access to competitive markets, and poverty reduction in the SPE host countries. As a consequence, users are more and more interested in series segregating transactions and positions of SPEs, which are purely pass-through capital, and which render the data difficult to interpret for policy or other decision making processes. Therefore, in standard presentations of FDI according to this *Benchmark Definition*, countries should explicitly separate FDI statistics on SPEs and non-SPEs for reporting according to the directional principle.

317. Since there is no internationally agreed definition of SPEs, this *Benchmark Definition* provides some criteria to assist compilers to identify resident SPEs, in case they do not yet distinguish them on the basis of a national legal or statistical definition of SPEs. Many varieties of SPEs exist, but the general criteria listed below (Box 6.2) could nonetheless be used to identify them and be further refined by individual countries, depending on specific, national features of resident SPEs.

Box 6.2. **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 plays only a minor role.

318. If a special entity has only assets and liabilities vis-à-vis affiliated non-residents, its classification as an SPE is straightforward. In some instances, however, MNEs may use existing operational companies to perform functions usually associated with SPEs. SPEs may also be members of more complicated resident groups consisting of both SPEs and non-SPEs. Countries are recommended to deal with these cases in line with the above

recommendations, the aim of which is to separately identify all FDI transactions and positions not having the economic impact usually to be expected of them in the reporting economy where these companies are established. A way to treat local mixed groups of SPEs and non-SPEs is suggested in Annex 7.

319. Not only may the amounts of FDI shown in statistical presentations be inflated (by the inclusion of *resident* SPEs), the geographical and industry *breakdowns* of FDI statistics may also be distorted (by the inclusion of *non-resident* SPEs). In the latter context, if the non-resident counterpart is an SPE, the economic impact of investments is generally expected to occur in a country other than the country of that SPE (the immediate counterpart country). In Figure 6.1, for instance, the ultimate direct investment enterprises of A are actually located in countries C and D.⁴⁰ This *Benchmark Definition* therefore recommends this distortion be addressed as well, and to differentiate between non-resident SPEs and non-resident non-SPEs. If the non-resident counterpart is an SPE, countries are encouraged to *look through* the country where it is located, and to reallocate on a supplemental basis the reported amounts to the country of the direct investor or direct investment enterprise corresponding to the first non-resident non-SPE encountered. When the reporting SPE is part of a chain of entities, the reallocation should aim at the first non-SPE encountered. Countries are encouraged to provide supplemental breakdowns of positions and transactions on the basis of “*first non-SPE*” counterparts.

320. The reallocation of transactions/positions to the first non-SPE countries contributes to economically more meaningful FDI data. Due to practical difficulties it may not always be easy or possible for data reporters or compilers to look through non-resident SPEs. It would therefore be desirable if one could then also rely on information provided by the “SPE countries” themselves. This *Benchmark Definition* therefore also suggests each country hosting a significant number of SPEs to provide on voluntary basis information on the specific routes followed by capital flowing into and out of its SPEs.⁴¹

6.3. Collective investment institutions

321. The *Benchmark Definition* recommends that, when an investor in one economy acquires at least 10% of the voting power in a collective investment institution (CII) in another economy, this investment should be regarded as direct investment. Similarly, when a CII owns at least 10% of the voting power in a non-resident entity, whether it is a CII or not, this should also be considered as direct investment. More precisely, investment in and investment by CIIs, such as mutual funds, feeder/master funds, hedge funds and distressed funds, should be included in FDI data if the standard 10% voting power threshold is met (see Annex 8 for examples of CIIs).

6.4. Land, structures and other immovable objects

322. Ownership of land and structures, including natural resources, in the compiling economy by an entity resident in another economy establishes a direct investment

40. It should be noted that the amount of FDI leaving country A need not be equal to the amount arriving in country C. This simply reflects the intermediary role of the SPE between entities in a multinational enterprise (the SPE may raise additional funds outside the group, transform equity received from its parent into loans provided to a subsidiary, etc.; see Annex 7).

41. Annex 7 explains the concept of so-called origin and destination matrix for SPEs, which gives an indication of the way funds coming from one country have been passed through to other countries.

relationship. The one-year rule that is usually used to define centre of economic interest (see Chapter 3, Section 3.2) does not apply to land and buildings. Land is always considered to be the property of the residents of the economy in which it is located. The only exception to this general concept is the ownership of land and buildings by foreign governments in the form of embassies, consulates, military bases, scientific stations, information or immigration offices, aid agencies, etc.⁴²

323. An entity resident in one economy may acquire direct ownership (that is, without the creation of a separate legal entity) of land or buildings in another economy. The relevant transactions, positions and associated income flows should be recorded in the direct investment statistics of both economies. However, given the specific nature of the assets acquired, a notional direct investment enterprise is created by the relevant compilers as the immediate owner of the assets in question. This notional enterprise is deemed to be resident in the economy where these assets are located. The actual owner of the assets, i.e. the direct investor resident in another economy is deemed to own the notional enterprise. In other words, land, structures, and other immovable equipment in the host economy that are indirectly owned by a non-resident entity should be regarded as direct investment enterprises, even if the period of ownership is less than one year. Acquisitions of land, mineral rights, and associated assets, and preparatory expenses for future direct investment units should be regarded as direct investment transactions.

324. Within the context of the previous paragraph, land and buildings owned for personal use but not for production or other business purposes are also considered as direct investment enterprises. Holiday and second homes owned by non-residents should therefore be treated in the same way as described above. Similarly where an investor resident in one economy acquires at least 10% of the ownership of property in another economy for commercial purposes (e.g. rental residential or office accommodation) this investment constitutes FDI.

325. In accordance with the System of National Accounts (SNA), in contrast to an operational lease, the existence of a financial lease on land and buildings gives rise to the creation of a notional direct investment enterprise with the understanding that it should be for a very long period rather than for a few years.

Box 6.3. Definition of land

Land is the ground, including the soil covering and any associated surface waters, over which ownership rights are enforced; included are major improvements that cannot be physically separated from the land itself but it excludes any buildings or other structures situated on it or running through it; cultivated crops, trees and animals; subsoil assets; non-cultivated biological resources and water resources below the ground (SNA, 2008, § 10.175).

326. Where a direct investment enterprise is established for the purposes of *natural resource exploration*, its exploration expenditures should be capitalised (even if the exploration does not prove sufficient economic resources to be viable) as part of the equity investment in the direct investment enterprise and written off (or written-down) as

42. The creation or relinquishment of territorial enclaves in the rest of the world should not be included in direct investment.

appropriate. This promotes consistency with the SNA, which treats these expenditures as fixed capital formation.

327. For example, assume an oil company incorporates a direct investment enterprise that drills an oil well. Assume also that the direct investor makes an equity investment in its direct investment enterprise of 100 in period 1 (including expenditure on bonus preliminary fee payments made by the direct investor to a resident of the host country, usually the government for the right to undertake exploration for natural resources), 30 in period 2, and then closes down the operation at the end of period 2 when the well proves to be dry. There is a financial flow from the direct investor to the direct investment enterprise of 100 in period 1 and 30 in period 2 in direct investment accounts of both economies. No further entries for cross-border transactions are recorded after the shutdown of the operation in period 2. Instead, a negative stock adjustment of 130 is made in the direct investment asset position of the economy where the oil company parent is located, and an equal reduction is made in the direct investment liability position of the economy where the affiliate was located.⁴³

328. Assume in contrast that the direct investor makes an equity investment in its direct investment enterprise of 100 in period 1 (including expenditure on bonus preliminary fee payments made by the direct investor to a resident of the host country, usually the government, for the right to undertake exploration for natural resources), 30 in period 2, and receives natural resources (payments in-kind) as 40 of dividend in periods 3-5 and 10 of disinvestment in the last period. In this scenario, there are receipts of direct investment income and a withdrawal of direct investment (equity capital) by the direct investor; a decrease in the direct investment asset position is recorded accordingly.

6.5. Construction enterprises

329. A *construction enterprise* in one economy may undertake the construction of plant, buildings, etc., in another economy through subsidiary or associate companies in that economy, through a foreign branch in that economy, or by directly undertaking the work itself. The construction work abroad is to be regarded as a direct investment activity in the economy in which it is being carried out in the first two circumstances. If the construction enterprise undertakes the work itself (such as through an unincorporated site office), its activities may be regarded either as a direct investment activity or as an export of services by that enterprise, depending on circumstances. If certain criteria are met, such as the project extending over a period of at least one year, the maintenance of a complete and separate set of accounts for the activity (i.e. income statement, balance sheet, transactions with the parent company, etc.), the activity being subject to tax and other legislation in the host country, the existence of a substantial physical presence, the receipt of funds for its work for its own account, etc. the work undertaken is to be treated as having involved the creation of a separate institutional unit – a branch – resident in the economy where the activity is being carried out and therefore a direct investment enterprise. If the criteria are not met, the activity is to be treated as an export of services by the construction enterprise. Constructions involved with major projects (bridges, dams, power stations, etc.) that are carried out through unincorporated site offices, in most cases, meet the criteria that requires treatment as the production of a resident unit, i.e. a direct investment enterprise

43. Both adjustments should be recorded under “volume changes” in the international investment position.

and thus as part of the production of the host economy, not as an export of services to that economy.

330. Where an enterprise resident in one economy installs machinery and equipment in another economy, the *Benchmark Definition* recommends that the work be regarded as services provided to another economy if the installation is carried out entirely, or primarily, by employees of the enterprise who travel abroad to do the work and they complete the installation in less than one year (that rule to be applied flexibly).

6.6. Mobile equipment

331. The operator of mobile equipment (such as ships, aircraft, gas and oil drilling rigs) that operate within a single economy for at least one year and that fulfil the criteria for treatment as an unincorporated direct investment enterprise should be treated as direct investment branches (see also Chapter 3).

332. Various entities may be involved in the provision of shipping and other transportation services. For shipping, the following entities may be involved:

- *Owner* – holds an asset (the ship) and may be engaged solely in a leasing activity, i.e., the leasing of the ship to an operator.
- *Operator* – is involved in shipping activities such as fishing, drilling or transporting freight and passengers.
- *Ticket sales or business promotion offices* – established either by the owner of the ship (who is seeking operators) or by the operator of the ship (who is seeking passengers, freight, or other business).

333. The flag of a ship determines the authority that is responsible for overseeing the operations of the ship and may help determine the jurisdiction where business disagreements are litigated. The flag is often a “flag of convenience” – that is, neither the ship owner nor its operator may have any business operation in the country whose flag is flown. Therefore the country of registration of the mobile equipment (*e.g.* of the ship) is not considered in determining the residency of any of the units involved in the shipping activity (that is, the owner or operator of the ship, and the ticket sales and business promotion offices), and so it is not relevant to the discussion of whether there may be a direct investment relationship.

334. If the owner and the operator are the same entity (such as when the owner operates the ship in its own economy of residence), then there is no direct investment. If the owner and the operator are not the same entity (or are not related), then they are separate institutional units. The owner will typically receive a fee from the operator, reflecting the payment (rental services) for the use of the vessel. In this case, the owner is a lessor, and is not a provider of transportation services. The operator of the vessel provides transportation services; it receives revenues for transporting passengers and/or freight, pays wages to crew members (who may be residents of a different economy than the operator), and incurs other transportation-related expenses including port expenditures. The relationship between the owner and the operator of the ship is essentially that of a lessor and its lessee, not that of direct investor and a direct investment enterprise, though it is possible that they could be in a direct investment relationship if the lessor owns at least 10% of the voting power in the lessee.

335. An owner may establish an incorporated or unincorporated enterprise that operates the ship. The country of the (affiliated) operator may differ from that of the owner, in which case a direct investment relationship exists. When the ship operations occur in international waters, the activities should be attributed to the economy in which the operator maintains residence.

336. The classification of management offices and business promotion and ticket sales offices also depends upon the criteria listed for the determination of, firstly, the existence of an institutional unit and then for a direct investment enterprise. In some circumstances, they will qualify for classification as direct investment and, in other circumstances, they will not. Under the criteria used to determine the existence of direct investment (see Chapter 3), a distinction should be made between those enterprises that engage in real economic activities and have income statements, etc., and units that are set up to increase sales of the institutional units that established them but that have no sales of their own, such as ticket sales offices and business promotion offices.

337. Determining the residence of shipping companies is often a difficult issue. The residence of the owner and of the operator are determined independently from the country where the ship is registered (and whose flag the ship flies), and different types of leasing arrangements may exist that can make it difficult to determine whether the ship is being used under an operational lease or whether it has been effectively sold to the enterprise that operates it (that is, under a financial lease). Also, a ship may operate entirely in an economy outside the one in which its operator is incorporated. In this circumstance, the activity in the economy where the ship operates is a direct investment enterprise (if it meets criteria of a branch) that is owned by a direct investor located in the economy where the operator is incorporated.

338. Issues related to owners and operators of ships and complex leasing arrangements and their solutions are applicable to other types of mobile equipment, such as aircraft.

6.7. Insurance

339. The treatment of insurance raises many complex methodological questions. Most of these questions have applicability beyond direct investment, such as to portfolio investment, other investment, other investment income, and services (see BPM6). The *Benchmark Definition* is intended to be fully consistent with the other major international standards where cross-cutting questions concerning the handling of insurance and insurance enterprises are more thoroughly discussed.

340. In general, the *Benchmark Definition* recommends that direct investment statistics for insurance companies be defined in the same way as those for industrial and commercial companies. However, compilers should take special steps for their appropriate treatment as positions and transactions involving insurance companies may be quite significant and the accounting principles they follow may not always be fully consistent with preferred direct investment concepts.

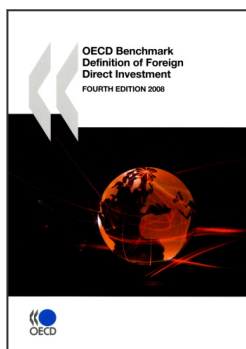
341. One complex area involves the treatment of non-life insurance company technical reserves (actuarial reserves against outstanding risks, prepayments of premiums, reserves for with-profits insurance, and reserves against unsettled claims). Normally, these reserves should not be included in the direct investment equity position, because these are amounts that are considered to be set aside for eventual payment of claims to policyholders. In the special case of a captive insurance affiliate, however, the policyholder

may be affiliated with the insurance enterprise. Businesses may establish or acquire a “captive” insurance company, in order to obtain insurance coverage for unusual types of risk, or for lower premiums than may be available commercially. In this case, a 10% or more ownership level often is reached, and the captive insurance company then meets the criteria for treatment as a direct investment enterprise.

342. In this circumstance, the technical reserves should be included in the direct investment debt component of the position.

343. For clarification, non-life insurance companies tend to classify insured losses according to general types. The first type includes losses that arise from events that are expected (from an actuarial perspective) to occur sometime in the future. Insurance companies establish and maintain sizable technical reserves largely for the purpose of satisfying future losses from these future events. The second type includes losses that are “incurred but not reported”. These are losses from insured events (such as natural disasters) that have already occurred, but the insurance company does not know the size of the losses because claims have not yet been filed (that is, these losses were incurred but were not reported to the insurer). The third are known losses (incurred and reported to the insurer). To be consistent with the treatment of technical reserves (these belong to policyholders and not to stockholders or owners), liabilities arising from all three types of losses should be regarded as debt obligations of the insurance company to its policyholders and not as equity. As noted, in the case of a captive insurance affiliate, the policyholder is the direct investor, and so the debt should be recorded in the direct investment.

344. *Mutual insurance companies* are owned by their policyholders who tend to be unrelated to one another. Typically, no one resident owns at least 10% of the voting power (or the equivalent, for an unincorporated business enterprise) of a mutual insurance company and so these companies do not usually meet the criteria for treatment as direct investment enterprises.



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