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Special purpose entities: a visit outside of the common set of residency and economic ownership[1]

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Special Purpose Entities: A Visit Outside of the Common Set of Residency and Economic Ownership

Péter Bánhegyi

Abstract

Recent international standards for macroeconomic statistics (BPM6, SNA 2008) are heavily based on both the concept of residency and the concept of economic ownership. The concept of residency requires that the focus of the economic interest of a given player should be the base of the recording of its transactions in macroeconomic statistics of a given country while the concept of economic ownership requires that the value added of an economic activity should be attributed to the economy where the economic owner of (non-financial) assets involved in this activity is resident. Usually an economic player lies in the common set of these concepts but there are some border cases. One of them is the set of foreign-owned special purpose entities (SPE) where these entities are involved in real economic activities. Foreign-owned SPEs operating in the compiling economy are resident there but are usually considered that they neither have direct relationship with the domestic economy nor have effect on domestic GDP. National concept of compiling macroeconomic statistics therefore suggests that, if necessary, their reported data should be reclassified by national compilers according to the definition of economic ownership. On the other hand, the international comparability requires that all transactions of resident players should be recorded in the same way (i.e. irrespective of their SPE status) to reduce bilateral asymmetries and reconcile national statistics for analytical purposes. This tension may lead to different concepts of compiling and releasing macroeconomic statistics regarding SPEs, similarly to national versus community concept of foreign trade statistics inside the European Union, even if there is a common definition of SPEs which can be found in the Final Report of the Task Force on Special Purpose Entities compiled in 2018 (this task force was led by the IMF). This report addressed this point, but it seems that concepts and guidelines should be more straightforward here by distinguishing the issue of data collection from the one of data compilation and release.

Keywords: macroeconomic statistics, value added, production, special purpose entities

Content

Introduction

The basic role of statistics is to provide an adequate picture of a phenomenon or a process in a specified field like economy, society or meteorology. This task requires both a comprehensive framework and relevant data of good quality. The former includes categories for which data should be released for users and definitions which serve as the base for these categories while the latter means data which should be available for compilers in order to produce good statistics. These requirements should, however, be fulfilled at different levels of aggregation since these phenomena and processes can be analysed at different levels of aggregation in a given economy or society. It is a possible issue that the required methodology and data at a given level of aggregation cannot be used automatically in the case of other levels. Therefore, it is an important goal to find the right connection between these different levels as regards methodology and data.

In macroeconomic statistics there are open methodological issues where the choice between possible alternatives may have an effect on bilateral asymmetries between data released by different countries and, as a result, the aggregation of their data at upper level. Data needs for further analysis also should be taken in account. It is important to handle well this aggregation and analysis problem through well-designed data collection and exchange systems, but it would not happen at the expense of the methodology and economic interpretability. It should be clear which problems are what we want to solve.

In the following short paper, this point will be presented through a widely discussed issue of special purpose entities (SPEs) where usually there is a conflict between two key points of methodology, namely residency and economic ownership. The first section is about the methodology itself. Although there is a definition of residency and economic ownership in recent manuals (BPM6, SNA 2008. ESA 2010), the long discussion on SPEs in different guides and reports shows that the application of these manuals to this case is not obvious and the latest step (the newly proposed definition of SPEs) has not even made the picture clear. The second section will discuss that the difference should be made more straightforward between data released at a given aggregation level and data sent to an upper level for further aggregation and analysis. At the end there will be some concluding remarks.

Concepts and definitions

Globalisation processes make production and financing transactions more and more complex. This is reflected in the fact that many of international manuals and reports deal with the location (the host country) of (elements of) these transactions since in many cases it does not seem to be ambiguous. There are two important characteristics which are intended for the right recording of economic transactions: residence and economic ownership.

Upon international manuals, the *"residence of each institutional unit is the economic territory with which it has the strongest connection, in other words, its centre of predominant economic interest."* (SNA 2008 4.113, BPM6 4.10, cf. ESA 2010 2.04) As regards the other one, the *"economic owner of entities such as goods and services, natural resources, financial assets and liabilities is the institutional unit entitled to claim the benefits associated with the use of the entity in question in the course of an economic activity by virtue of accepting the associated risks."* (SNA 2008 3.26, cf. BPM6 5.3 and ESA 2010 1.90)

In short, residency is rather related to economic players while economic ownership is rather related to economic assets. It would be a convenient state if all resident players owned those and only those assets which are at the same time legally owned by them. Notwithstanding in the case of **financial assets**, it is practically possible. As SNA 2008 3.29 states:

"The benefits inherent in financial assets and liabilities are seldom transferred from a legal owner to an economic owner in exactly the same state. They are usually transformed to new forms of financial assets and liabilities by the intermediation of a financial institution that assumes some of the risk and benefits while passing the balance on to other units."

It means that the holding of financial assets and the activity of financial intermediary usually include characteristics of economic ownership. If the "real" economic owner of a financial asset passed this asset legally to another unit for holding it (and there is no sale or transfer) then the original owner would get in turn another financial asset since acquiring the original financial asset should be financed by a financial liability. As a result, some risks and benefits and so the economic ownership of this financial asset can be also attributable to the country of the residence of this another unit (which may be a financial intermediary).

The case of **non-financial assets** is, however, a bit different. A SNA 2008 3.39 states:

"The only non-financial assets included in the asset boundary of an economy are those whose economic owners are resident in the economy. However, in the case of most natural resources and immobile fixed capital, which physically cannot leave the economy, a notional resident unit is established if the economic owner is technically a non-resident unit. In this way the assets in question do become those with resident economic owners and so are included within the asset boundary and are included on the balance sheet."

It means that the economic ownership of non-financial assets results in production in the resident economy since the "asset boundary for fixed assets consists of goods and services that are used in production for more than one year" (SNA 2008 10.33), where fixed assets may be both physical and non-physical assets (see SNA 2008 Table 10.2). While in the case of financial assets economic ownership is not by all means accompanied by production in the resident economy, in the case of non-financial assets it should happen. In a simple wording:

"In other words, it is the economic owner that uses the asset in its production process." (UNECE 2015 3.21)

Autonomy of the economic owner seems to be not a necessary criterion. Although autonomy is one of criteria for institutional units in recent manuals, exceptional cases are also discussed (see SNA 2008 4.42, cf. BPM6 4.15, ESA 2010 2.30). There are some examples where an institutional unit engaged in production in the resident economy and so the economic owner is practically not an independent unit, moreover not an existing unit at all. A good example is the branch:

"When a non-resident unit has substantial operations over a significant period in an economic territory, but no separate legal entity, a branch may be identified as an institutional unit. This unit is identified for statistical purposes because the operations have a strong connection to the location of operations in all ways other than incorporation. An unincorporated enterprise abroad should be treated as a quasi-corporation when indications of substantial operations can be identified separately from the rest of the entity." (SNA 2008 4.47, cf. BPM6 4.27-4.28 and ESA 2010 18.12)

This example raises the question whether in practice the measured production or, in general, "substantial operation" may be considered as rather real or rather artificial. It will be also the key issue in the case of SPEs.

The recent definition of SPE was worked out by the IMF-led Task Force on Special Purpose Entities after long preliminaries. This task force has dealt with only SPEs owned and controlled ultimately by non-residents. Key elements of this definition are well-known for many years but as a formal definition this is the first one at international level:

"An SPE resident in an economy, is a formally registered and/or incorporated legal entity recognized as an institutional unit, with no or little employment up to maximum of five employees, no or little physical presence, and no or little physical production in the host economy.

SPEs are directly or indirectly controlled by nonresidents.

SPEs are established to obtain specific advantages provided by the host jurisdiction with an objective to (i) grant its owner(s) access to capital markets or sophisticated financial services; and/or (ii) isolate owner(s) from financial risks; and/or (iii) reduce regulatory and tax burden; and/or (iv) safeguard confidentiality of their transactions and owner(s).

SPEs transact almost entirely with nonresidents and a large part of their financial balance sheet typically consists of cross-border claims and liabilities." (IMF 2018, 39.)

As it could be seen before, the economic ownership is not by all means related to the autonomy of the owner which at the first sight supports the above definition of SPE having "no or little physical production in the host economy" and, as a result, being economic owners of (both financial and non-financial) non-physical assets in their resident country.

This approach, however, also includes ambiguity. It is well-known for many years that SPEs may legally own non-financial assets in their resident economy while their economic ownership is at least questionable:

"The Task Force concluded that the SPEs generally acquire the legal ownership of the non-financial assets, but the foreign owner of the SPE should be considered as the economic owner when it is the sole client of the SPE, possibly together with other affiliates of the group." (Eurostat 2009, p. 14)

Therefore, it is not clear whether this new definition (together with the proposed template) just reflects data needs upon legal status and book-keeping for further analysis or, at the same time, it is also the suggested application of methodology and release template for national compilers. The first case is rather related to data collection while the second one is also the issue of data release to the public. This point will be tackled in the next section.

Questions and datasets

The IMF-led Task Force Final Report proposed the template for national compilers in Annex VII to collect data on SPEs, at least for the selected BOP and IIP items. Upon the discussion and the definition of SPEs in this report, goods and some services category were also selected where formally SPEs may be concerned. It is well understandable and acceptable if the goal is to collect data on this phenomenon upon legal status for further analysis. In addition, SPEs may inflate transactions under various instruments and if their transactions and positions are well detected then they can be separated from standard BOP and IIP data at national level (see Montvai 2015). In principle this kind of process does not harm the requirements of bilateral symmetry. The question is whether this is all which should be served by this dataset.

It is well-known that there is here also a debate on methodology, namely which recording is required by the economically reasonable recording of SPEs in macroeconomic statistics. Differently from this definition, BD4 Box 6.2 stated that one characteristic of an SPE is that it *"has no or few employees, little or no production in the host economy and little or no physical presence"*. This wording would exclude SPEs from almost all production processes (and so from economic ownership of non-financial assets) in their resident economy (more exactly in this case their production should be valued at costs) and it can be argued that this approach would be more in line with the experience that these units have relationships and transactions mainly with non-residents and have *"little or no physical presence"* in the resident economy.

This was also reflected in different papers in last years:

"Probably, it would be preferable though to limit the relevant criterion to 'having no or few employees', as the second part of the criterion 'having little or no production' is slightly ambiguous, when one interprets it as having little or no output and value added. In the case of some SPEs, e.g. royalty and licensing companies, output and value added can be quite substantial. … Although there seems to be an economic rationale for imputing transactions and positions to (better) reflect the economic ownership of the assets, it would without any doubt lead to a considerable number of imputations. The Task Force and the AEG suggest as a general rule not to reroute the ownership of assets of SPEs. … It should also be noted that the classification of these assets may have a direct impact on the recording of output and value added which is dealt with below." (ECB-Eurostat-OECD 2013, p. 11-14)

"The income generated by an SPE is subject to the tax code of its country of residence and this fact cannot be ignored. If (economic) ownership of the IPP was not assigned to the SPE in question a considerable amount of rerouting of transactions and related financial flows would be necessary. In general, the 2008 SNA does not encourage such imputations, probably because of the risk of asymmetries, as approaches may diverge between countries." (UNECE 2015 3.58)

After these preliminaries it seems as if points of views of aggregation, analysis and methodology would be confused or rather this latter would be thrown into the shade by this new proposed definition and template. These papers argue that compiling of economically more reasonable data on SPEs would be accompanied by number of imputations and so practically difficult and harmful for bilateral symmetries so data on SPEs should be compiled upon their legal status (more exactly similarly to data on non-SPEs).

This point will be tackled below but before this another issue should be discussed: these papers, as it seems, also accept that the handle of SPEs upon their legal status in national data may have an effect on resident GDP, but they find that it can also accepted methodologically:

"Concerning production by SPEs, the text of the SNA of 2008 4.57 quoted before is not particularly clear and it is not sufficient to describe all the cases of SPEs that can be found in the case studies produced by the Task Force. Indeed, the SNA of 2008 (4.47a and 26.30b) gives also a list of examples of production activities that do not involve physical presence and that therefore should be considered in connection with SPEs." (Eurostat 2009, p. 10)

Under 4.47 and 26.30 SNA 2008 discusses the case of branches whose physical present in principle also may be low-level in the resident economy. SNA 2008 (and BPM6) does not make a difference as regards recording of production in the resident economy whether a branch has significant physical presence there or not. Since from the point of view of taxation setting up an SPE seems to be more advantageous than setting up a branch, it is not clear why a branch was set up for activities without significant physical presence (e.g. merchanting or collecting licence fees from customers and converting these receipts to incomes for their non-resident parents) instead of an SPE. If a branch is considered in every case to have production and economic ownership in the resident economy than it can be argued for the economic ownership of SPEs in the resident economy.

The relationship, however, may be also the reverse: since for SPEs the form of institutional unit is not defined, branches without (significant) physical presence and engaged in activities similar to invoicing companies also can be considered as SPEs (since probably they have also no significant connection with the resident economy). As a result, the issue of little or no physical presence of branches rather strengthens the approach of BD4 as regards the SPE with *"little or no production in the host economy"* which would result that an SPE may not be an economic owner of non-financial assets in the resident economy due to the lack of significant production. This point should be also cleared well in international manuals.

Returning to the question of how this template or, in general, the separated data on SPEs would be handled in national publications, one trivial goal is to prevent inflation of transactions and positions in FDI figures deducting data on SPEs from them. Transactions under goods and services data of resident SPEs, however, seem to be more complicated to explain. If they belong to resident production and GDP, then it is not necessary to separate them from standard BOP and SNA figures. If, however, there were an economic interpretation of their separation from standard figures at national level, then it should question whether these SPEs represent an integral part of resident production and GDP.

Traditional economic theory says that there is no production without production factors. Although in our digitalised world the location of these factors may become less obvious, the measured factor productivity figures can show if artificial production is present:

"A large part of service production, exports, and imports, and some part of goods production can begin to consist of phantom production and trade that makes no use of factors of production actually resident in the countries to which they are attributed. If that takes place to an important degree, the measures of the current balance and national output begin to lose their meaning." (Lipsey 2009, p. 61)

These considerations also support the concept of SPEs not holding economical ownership of non-financial assets in the resident economy. If this concept were accepted, the newly proposed dataset on SPEs should serve other goals than the separation of data on SPEs from resident figures and analysis of them. In the first step, however, the question of this separation (together with the issue of bilateral asymmetries) and the one of compilation of economically more interpretable data should be detached from each other. The former can be approached rather through templates like the one proposed by the IMF-led task force (with detailed country breakdown) while the latter rather by compilation of full set of BOP and IIP data for the resident economy without resident SPEs where these units cannot be economic owners of non-financial assets. These data should be not in contradiction with each other since they answer to different questions. Of course, at the same time these datasets should not also be independent from each other since both are resulted from the same national data collection and compilation system. In sum, the separation of datasets and questions cannot be confused with their independence.

At national level imputation and rerouting transactions of SPEs seem to be less problematic in the case of resident SPEs since the main task is to record their transactions under FDI income instead of goods and services if necessary. At the first sight it is not a question here whether to which country these latter should be attributed or how this rerouting affects bilateral asymmetries since theoretically it is not a primary goal of national publications (which cannot be again confused with national data collecting and compilating system which should face the issue of bilateral asymmetries). On the other side, however, under the concept of resident SPEs holding no non-financial asset in the resident economy the issue is not just adjusting for resident SPEs in resident statistics but also for non-resident SPEs where production and economic ownership should be attributed to resident players from non-resident SPEs and there is a need for data on them available somewhere in other countries. Maybe somewhere here is the point where the issue of rerouting is not supported by international manuals and reports, but it in itself cannot make national data economically more reliable. It is possible that, in the case of (supposed) significant turnovers, national compilers, together with tax authorities which may be also very interested in this topic, apply for other methods to make this attribution like formulary apportionment which in the case of *"little chance for bilateral or multilateral agreements"* regarding this regime, *"likely would be the only practical approach"* (Fleming-Peroni-Shay 2014, p. 9).

The other dataset including separated data on SPEs upon legal status would help this issue, too, if there were a will to address these user needs, e.g. with a well-defined concept of rerouting (i.e. who is the real economic owner), detailed country breakdown and data exchange system. If the concept of ultimate investor is important for FDI statistics, the concept of ultimate owner of non-financial assets also can be important for compiling resident GDP. This work should concern not only countries with hosting residents SPEs but also the ones owning them abroad – these two sets of countries are not necessarily reconciled with each other.

It means that in the second step both datasets can serve both the reconciliation of bilateral asymmetries and the issue of compilation of economically more interpretable data at both national and international level. The less is the ambition, the less will be the result.

Concluding remarks

The phenomenon of SPEs requires special attention. There are many questions to be answered which they raise, and these may require different data. At national level the main issue is the level of production or inward and outward FDI without capital in transit and asset-portfolio restructuring. At international level important question is the bilateral asymmetry or the distribution of production and wealth across countries. These can be answered by the help of different datasets which should be compiled. Possibly it requires more effort both by national compilers and users of their data including international organisations. There is, however, a precedence for these different datasets since this issue resembles national and community concept of international trade in the European Union.

At last but not at least it may be also raised that if we intend to compile economically more interpretable national statistics, then data should be adjusted not for data on SPEs since transfer pricing and capital is transit are present more generally in national data. It is well-known that there are resident players who can be considered as SPE-type or near SPE where some but not all of their transactions have similar characteristics to ones of SPEs. If they are engaged in production, i.e. they are economic owners in the resident economy, then their goods and services data cannot be separated from other transactions since they form a part of the resident GDP. The only possibility is to make other adjustments based on other available information (like in the case of VAT registrations) similarly to adjustment for capital in transit in the case of non-SPEs. These steps, however, are otherwise done regularly by national compilers affecting also bilateral asymmetries. From this point of view the importance of SPEs can be found in the fact that they can be a well-defined, compact subset of these adjustments.

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SPECIAL PURPOSE ENTITIES: A VISIT OUTSIDE THE COMMON SET OF RESIDENCY AND ECONOMIC OWNERSHIP

OVERVIEW

- *Starting points*
- *Residency and economic ownership*
- *Approaches to SPEs*
- *Conclusions*

STARTING POINTS

- Economic growth and global production are current issues in recent analyses both at national and international level.
- Data for global and regional analysis should fulfil the following criteria:

  - bilateral asymmetry;
  - economically adequate distribution of production and trade across countries.

- Production and trade are linked to non-financial assets.
- Country data are compiled upon international methodological standards including residency and economic ownership.

RESIDENCY AND ECONOMIC OWNERSHIP 1.

- As regards residency: the *"residence of each institutional unit is the economic territory with which it has the strongest connection, in other words, its centre of predominant economic interest."* (SNA 2008 4.113)
- Residency is related to legal ownership.
- As regards economic ownership: the *"economic owner of entities such as goods and services, natural resources, financial assets and liabilities is the institutional unit entitled to claim the benefits associated with the use of the entity in question in the course of an economic activity by virtue of accepting the associated risks."* (SNA 2008 3.26)
- It is a bit different issue in the cases of financial and non-financial assets.

RESIDENCY AND ECONOMIC OWNERSHIP 2.

- In the case of financial assets it is possible to transform an asset into the other one (through intermediation) which includes some of risks and benefits – legal ownership can be considered as economic ownership here in statistics.
- In the case of non-financial assets this intermediation is not possible – non-financial liabilities do not exist!
- As we can read: *"The only non-financial assets included in the asset boundary of an economy are those whose economic owners are resident in the economy."* (SNA 2008 3.39) *"In other words, it is the economic owner that uses the asset in its production process."* (UNECE 2015 3.21)
- As a result, economic ownership of non-financial assets is linked to production.
- Autonomy is not a necessary criterion to be an economic owner!

RESIDENCY AND ECONOMIC OWNERSHIP 3.

It would be a wonderful world if residency and economic ownership coincided with each other…

…but the reality is a bit different.

One element of this difference is the presence of special purpose entities (SPEs).

APPROACHES TO SPEs 1.

There are two detailed description of SPEs in international methodology:

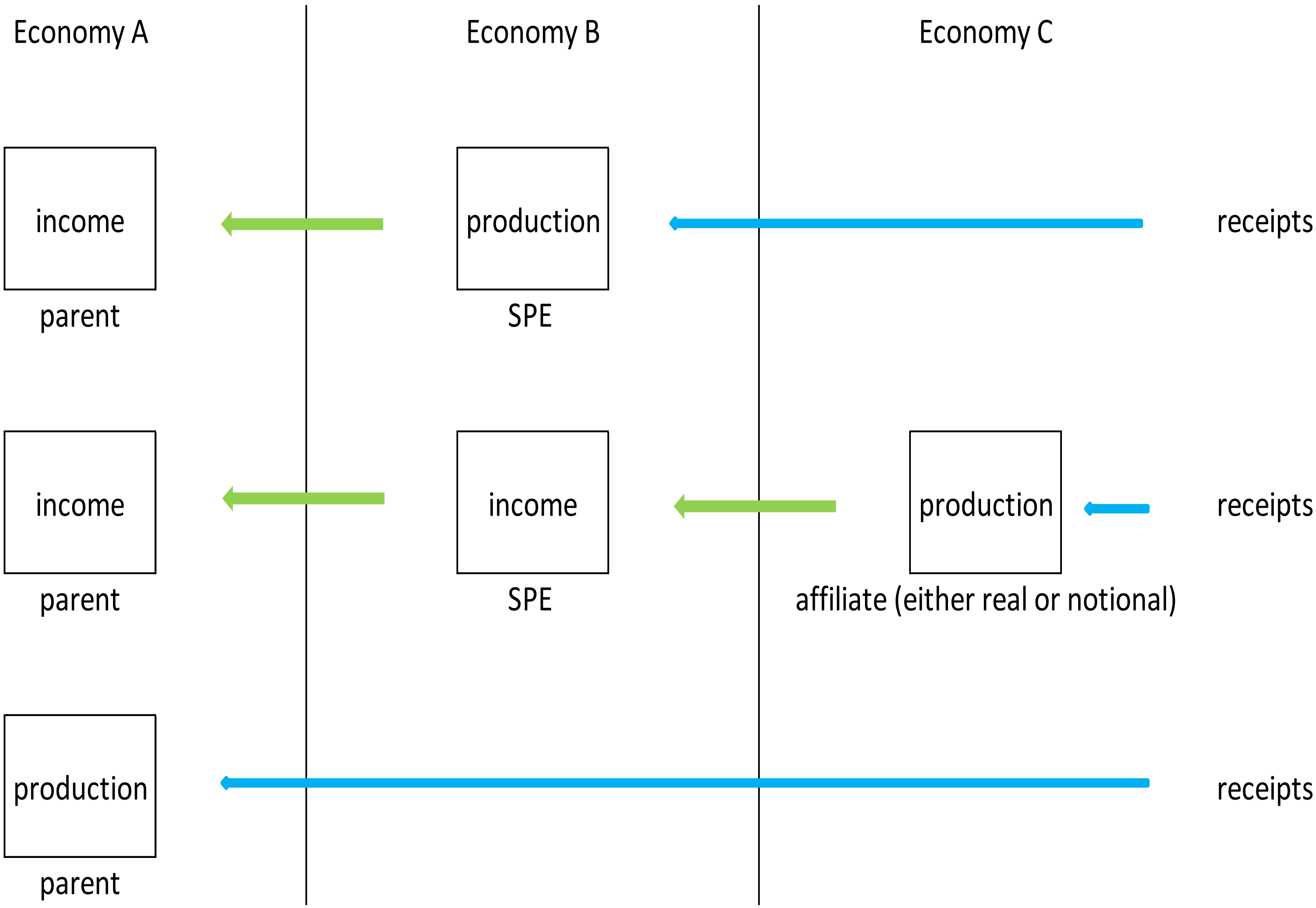
- general criteria in OECD BD4 in 2008 and
- definition of the IMF-led Task Force on Special Purpose Entities in 2018.

Criterion	IMF TF definition	OECD BD4 general criteria
Legal and formally registered unit in the resident economy	*yes*	*yes*
Directly or indirectly controlled by non-resident parent	*yes*	*yes*
Their financial balance sheet typically consists of cross-border claims and liabilities	*yes*	*yes*
Physical presence	*little or no*	*little or no*
Employment	*up to maximum five employees*	*no or few employees*
Production	*little ot no **physical** production*	*little or no production*

APPROACHES TO SPEs 2.

- If we take literally these approaches (and we would suppose that every word is in its place), **there is an important difference between them since OECD BD4 general criteria practically exclude while IMF TF definition practically allows the economic ownership of (basically intangible) non-financial assets for SPEs in the resident economy.**
- This issue may be practical: *„If (economic) ownership of the IPP was not assigned to the SPE in question a considerable amount of rerouting of transactions and related financial flows would be necessary. In general, the 2008 SNA does not encourage such imputations, probably because of the risk of asymmetries, as approaches may diverge between countries."* (UNECE 2015 3.58)
- From economic point of view, however, **the attribution important production to an economy upon legal base may be problematic** and demands for other possibilities (e.g. formulary apportionment). OECD BD4 general criteria seem to be more adequate here – unless we find that the set of SPEs under OECD BD4 criteria is just a subset of SPEs under the IMF TF definition (is this what we wish?)

APPROACHES TO SPEs 3.



APPROACHES TO SPEs 4.

- The first case is the application of IMF TF definition while the second and the third ones are possible reroutings of production to other countries upon economic ownership (issue of incomes may be a heavy barrier to the application of the third case!).
- Important question arises here: **what is the status of the IMF TF definition?**
  - First, it can fulfil IMF data needs for getting information on SPEs from the concerned countries.
  - Second, it may serve also as a methodological guideline for national compilers for SPEs in their national statistics.
- The first case (if every concerned country provides data upon this definition on SPEs to the IMF) can assure the global measure the activity of SPEs upon legal ownership.
- The second, in addition, may assure bilateral symmetries but may take the autonomy of member states away as regards the application of the concept of economic ownership.

APPROACHES TO SPEs 5.

These two approaches can be compared as regards statistical consequences (where the set of SPEs under these two approaches is considered as the same and these findings should be explained as if „every other issues were all right”!):

	IMF TF definition	**OECD BD4 criteria without cooperation**	**OECD BD4 criteria with cooperation**
Country GDP data aggregable at global level	*yes*	*partly*	*yes*
Country GDP data aggregable at regional level	*partly*	*partly*	*yes*
Bilateral asymmetry of trade	*no*	*partly*	*no*
Adequate distribution of production across countries	*partly*	*partly*	*yes*
Possibility of excluding economic ownership of non-financial assets	*no*	*yes*	*yes*
Possibility of "missing" or "excess" GDP at global level	*no*	*yes*	*no*
Possibility of "missing" or "excess" GDP at regional level	*yes*	*yes*	*no*

APPROACHES TO SPEs 6.

- The optimal solution would be the application of BD4 general criteria together with the cooperation of concerned countries in order to achieve bilaterally asymmetric, aggregable country GDP and trade data and economically adequate distribution of production and trade across countries.
- In the lack of this cooperation the definition and the data template for SPEs have their own legitimacy - which can be raised if these data will be also sources for international cooperation.
- **The application of the concept of economic ownership for SPEs, i.e. the rerouting production and trade to another countries may require compilation of two datasets from national compilers for SPEs** – it may be well-known from the difference between national and community concept of foreign trade inside the European Union.
- *This concept of economic ownership theoretically also would require the rerouting the production of resident-owned non-resident SPEs to the resident economy!*

CONCLUSIONS

- Different needs of compilation of national and international figures may require different datasets for SPEs in the first step in the lack of global or regional cooperation of countries.
- In the second step, however, data collected by the IMF through the proposed data template may be the source of international cooperation for data reconciliation of SPEs upon economic ownership – *towards the concept of ultimate producer and owner*.
- This application of economic ownership can operate only in the case of SPEs – near SPEs and similar enterprises have real resident production which should be recorded in resident statistics (adjustments for capital in transit should be made for them also!).
- Rerouting of production and trade affect FDI incomes also and they cannot be negligible – this is why rerouting of production and bilateral symmetry of total balance of payments (or rest-of-the-world account) never can be achieved at the same time and data excluding SPEs (in general, capital in transit) should be analysed.

THANKS FOR YOUR ATTENTION!