

**IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD
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DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER (DITEG) # 12 / 2

**COUNTRY IDENTIFICATION:
THREE METHODS TO DETERMINE ULTIMATE BENEFICIARY OWNER AND
ULTIMATE BENEFICIARY AFFILIATE**

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I. Coverage of this Issue paper and concepts used

1. During the DITEG meeting of December 2004, Eurostat presented a possible method to determine the Ultimate Beneficiary Owner for inward FDI relationships¹. Also for this meeting the US prepared a document describing its method to classify inward direct investment by Ultimate Owner². DITEG concluded that the geographic allocation on the basis of the Ultimate Beneficiary Owner for inward FDI will provide useful supplementary information, especially for FDI stocks and income as well as for FATS. It was agreed that more work should be done for allocating outward FDI to the Ultimate Host Country.

2. Eurostat agreed to prepare a new Issue paper for the DITEG meeting of March 2005 in which the US-method and the method originally proposed by Eurostat for assigning inward investment to the UBO (for short: US- / EU-method) are compared. It should be mentioned that Eurostat prepared its original proposal for DITEG mainly to facilitate the discussion. At this stage Eurostat does not have an outspoken preference for any method.

3. This paper is based on a set of hypothetical FDI relationships within a group of related enterprises. The example is confined to stocks of equity capital, but it seems that the results would be the same if reinvested income flows were considered. The inclusion of other capital in the example could, on the other hand, affect the preferences regarding the methodology. This will be mentioned below when applicable.

4. This paper uses the following concepts. Ultimate Beneficiary Owner (UBO), Ultimate Beneficiary Affiliate (UBA), Intermediary Affiliate (IMA) and direct investment enterprise (DIE).

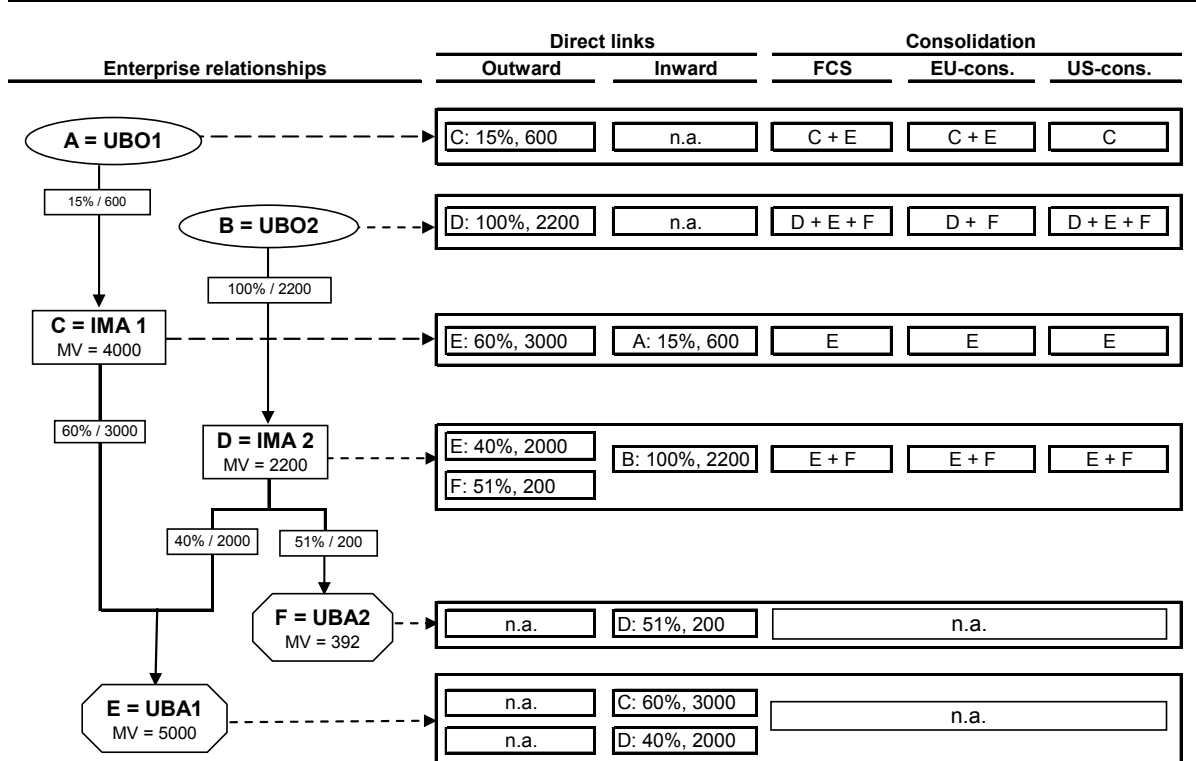
¹ DITEG Issue paper 12: *Country Identification (Ultimate Beneficiary Owner/Ultimate Destination and Immediate Host/Investing Country)*, Paolo Passerini, Eurostat, November 2004.

² DITEG Issue paper 12i: *Country identification – Use of Ultimate Owner Classification in United States Inward Direct Investment Statistics*, Ned G. Howenstine, U.S. Bureau of Economic Analysis, November 2004.

II. Basic example

5. The left side of Scheme 1 shows the enterprise relationships between two UBO's (A and B), two IMA's (C and D) and two UBA's (E and F). Each enterprise is considered to be resident of a separate country. Given the percentages of ownership shown on the left side, the data on the right present the resulting direct FDI-links and the consolidation according to the Fully Consolidated System (FCS), the EU- and the US-methods³. Given this example, in the US-system A would not consolidate E because A's multiplicative ownership of E does not exceed 10%; in the EU-system B would not consolidate E because the consolidation criterion for indirect links is an ownership of more than 50%).

Scheme 1 Enterprise structure and resulting direct and indirect (consolidation) relationships
All amounts pertain to equity capital



Explanatory note. MV = market value. N.a. means not applicable. The figures in the small rectangular boxes (e.g. 15% / 600) indicate the share in the first 'shot' DIE and its market value.

6. As the scheme shows, the direct FDI-links are typically symmetrical (mirrored) throughout the related enterprises. This characteristic does not (necessarily) apply to the concepts of UBO and UBA as will be seen below. In the example D can be considered an

³ See for instance DITEG Outcome paper 3, *Indirect FDI relationships and alternatives for the Fully Consolidated System*, for a description of these methods.

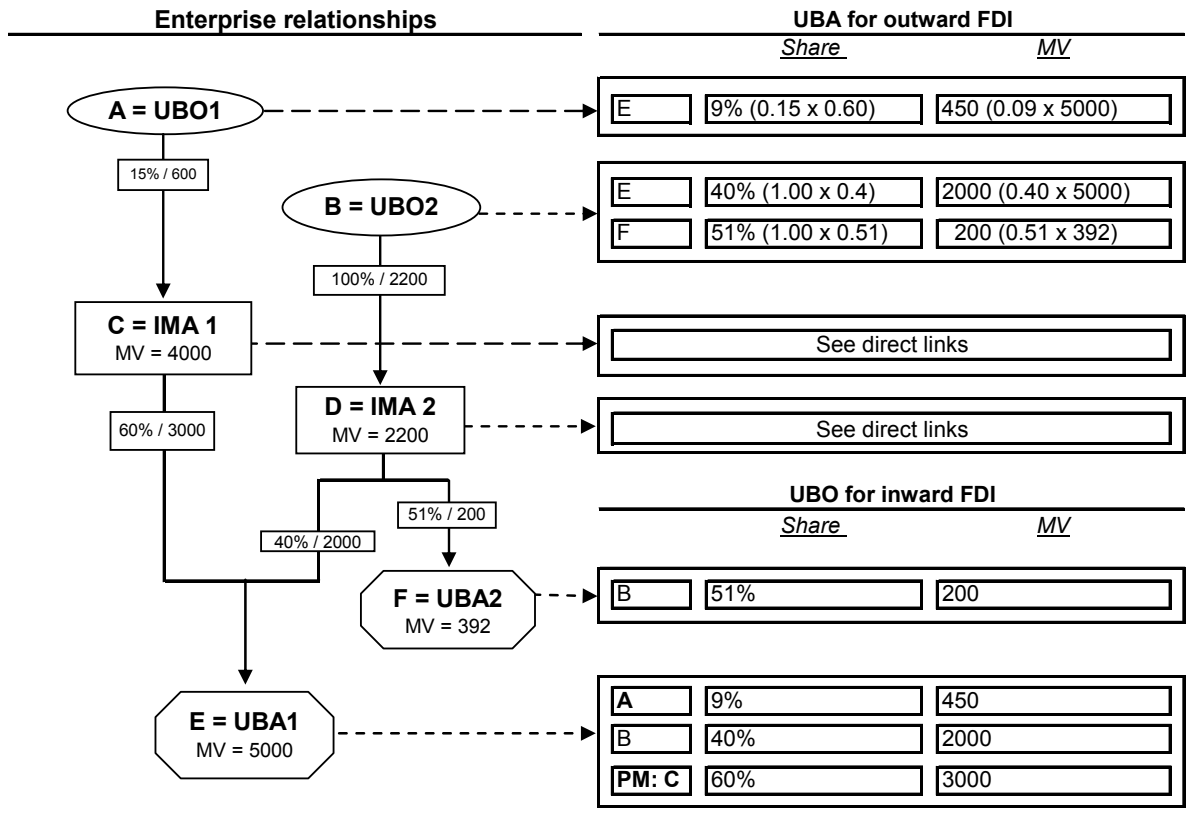
SPE / holding company. All the equity capital obtained from its parent is passed on to D's affiliates.

III. Measuring the actual indirect ownership links

7. On the right side of Scheme 2 the indirect ownership links between A and B on the one hand and E and F on the other are shown. These links have been calculated by multiplying the respective ownership shares in the chains, without using any cut-off criterion, e.g. regarding influence. As a result, the indirect links between the included enterprises are completely symmetrical (for instance both B and E compute the same market value for B's share in E).

Scheme 2 Assessing the indirect ownership links with the enterprises at the extremes of the chain

All amounts pertain to equity capital



8. It should be noted that the terms UBO and UBA (as assigned to A, B, E, F) have so far been used without the underlying concepts having been defined. Strictly speaking A, B, E and F only represent the extremes of the chains in the example. From A's point of view, E may very well be considered its UBA. After all, A holds 600 FDI equity of which 450 can be

assigned to E. E on the other hand has a direct equity liability to C of 3000, much more than its indirect liability to A. As regards E, enterprise C would therefore be the more likely candidate to be considered its UBO.

9. The (purely mathematical and symmetrical) indirect links shown in Scheme 2 are used as reference for the results obtained when applying the EU- and US-method to determine the UBO's and UBA's in Section V.

IV. SPE's and data on UBO's / UBA's

10. In the simplified example of Scheme 2 with only one layer of Intermediary affiliates, notably C and D, the direct and indirect links of the IMA's are identical, because in this case both data sets refer to the extremes of the chains (A, B, E, F). It should be observed that, also if there are more layers of IMA's, their indirect links with the extremes of the chains will not be mirrored by the indirect links compiled by the extremes which look through the IMA's. This raises the question how the indirect links of e.g. enterprise D, which could be an SPE / holding company, should be interpreted.

11. DITEG previously has recommended that the transactions and positions of SPE's with related non-resident enterprises should remain in the functional category of FDI. An important reason for that recommendation was to retain the symmetry of FDI data relating to direct / first shot links (Scheme 1). At the same time it was recommended that further work be done to improve the analytical value of FDI data for countries with large numbers of SPE's. Supplementary UBO / UBA data could be useful in that respect. The positions of D in Scheme 2 vis-à-vis its UBO and UBA's represent the FDI equity that has passed through D's economy, without having much impact there. In D's statistics, these positions could be identified under a separate FDI category, e.g. as 'FDI equity capital in transit' between the countries of B, E and F. Additionally, it could be considered to include this item also in the b.o.p. flows. But it would probably be more difficult to collect these data for flows, for instance because there may be a time gap between the inward and outward flows.

V. Measuring the indirect ownership links using the EU- and US-method

12. Scheme 3 shows the results when Eurostat's original proposal and the US-method for compiling UBO data are applied to the basic example of Scheme 1. Both methods have been extended to also cover UBA data, because the collection of supplementary UBA data may be considered useful, for instance to determine the ultimate origin and destination of equity capital transferred through SPE's.

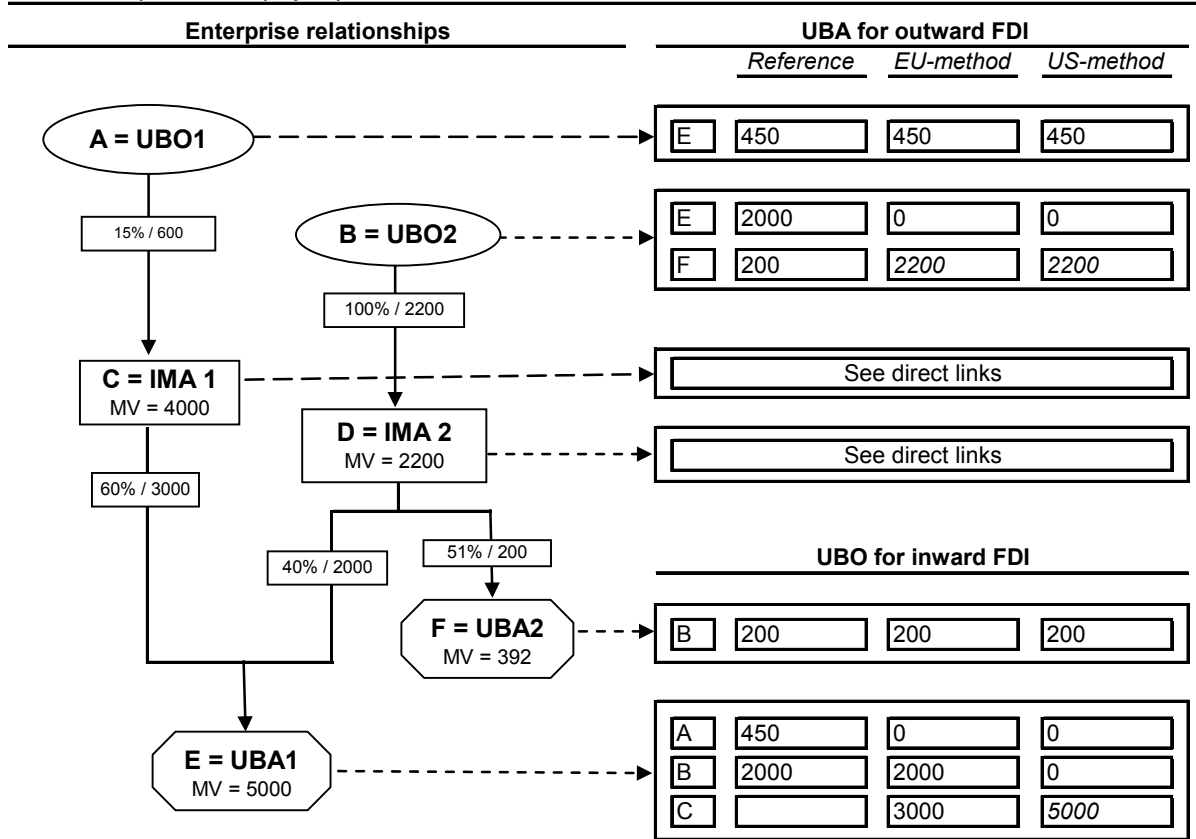
Application and extension of the US-method

13. The US-method only follows *one* ownership chain to determine the UBO of a DIE. The first / direct link is the foreign parent with a share of more than 10%. If the DIE has more than one owner, the chain will only follow the direct parent owning the highest share.

The UBO is the first enterprise moving up the chain that is not owned more than 50% by another enterprise. If the first / direct link of the DIE is not controlled itself, this immediate parent is also the UBO. In the US-method the (market) value of the equity liability of the DIE is fully assigned to the (unique) UBO.

Scheme 3 Application of the EU- and US-methods to determine both UBO's and UBA's

All amounts pertain to equity capital



Explanatory note. The amounts in italic print refer to under- or overestimations resulting from the methods used. These results are, however, to some extent related to the figures chosen in the example.

14. Applying the US- method to the example of Scheme 1 results in C being the UBO of E, because C owns a larger share of E than D. Moreover, since A does not control C, it is not the UBO of E. Consequently, the full market value of the foreign participations in E, 5000, will be assigned to its UBO C. This is shown in the last column of Scheme 3, under the heading 'UBO for inward FDI'. In the example, this implies a large overestimation since 40% (2000) of C is owned up the chain D / B. It can further be assessed that B is the UBO of F since B controls F's direct parent D. The total foreign participation in F (200) will therefore be assigned to B.

15. The US-method can be reformulated to determine the UBA going down the ownership chain. The first / direct link in that case is the foreign affiliate that is owned by more than 10% by a domestic enterprise. If more direct links fulfil this criterion, only the one owned by the largest share will be followed to determine the UBA. The chain will continue down the ownership ladder to include enterprises that are controlled by the direct link and its subsidiaries. If there is more than one subsidiary at any given level down the chain, only the link owned by the largest share will be pursued. If the first direct link does not have any subsidiaries, it is also the UBA. Since only one chain resulting in one UBA is pursued, the full FDI equity capital held by the enterprise at the top of the chain will be assigned as a liability to the (unique) UBA.

16. Applying this method, it can be seen from Scheme 3 (under the heading 'UBA for outward FDI') that E is the UBA of A. F is the UBA of B because B is the parent of D while D controls F (but not E). Consequently the full outward FDI equity capital of B (2200) will be assigned to F. In the chosen example this results in a large overestimation because the total FDI equity capital liability of F is only 200. The largest part of B's FDI equity capital (2000) is indirectly invested in E which is however not included in the relevant ownership chain.

Application and extension of the EU-method

17. Contrary to the US-method the original proposal by Eurostat ('EU-method') allows more than one UBO to be assigned to a direct investment enterprise. In particular, all foreign parents holding more than 10% of a DIE are at the basis of an upward chain of ownership. For each chain, the UBO is the first enterprise moving up the ownership ladder that is not owned more than 50% by another enterprise. If a first / direct link is not controlled itself, this immediate parent is also UBO. The (market) value of the share of each direct link is assigned to the UBO of that chain. The effect of this method in the example of Scheme 3 is that E will consider both B and C as its UBO's, whereas according to the US-method only C is UBO to E.

18. If the EU-criteria are 'mirrored' for the sake of determining UBA's, this means that FDI investors need to follow each chain starting with each of their first shot DIE's. Each chain will continue down the ownership ladder to include enterprises that are controlled by the direct link or its subsidiary. If there is more than one subsidiary at any given level down a chain from the first shot DIE, only the link owned by the largest share will be pursued. If a first shot DIE does not have any subsidiaries, it is also a UBA. The market value of the participation in a first shot DIE will be assigned to the UBA of that DIE chain.

19. In the example shown in Scheme 3, the adjusted EU-method to determine the UBA's for A and B gives the same results as the US-method, because both A and B are parent to only one first shot DIE. Consequently, there is only one ownership chain to be pursued. From B's first shot affiliate (D), only the chain down to D's subsidiary (F) will be followed, making F the single UBA of B. The difference between the extended US- and EU-methods

can be shown by identifying D's UBA's as they would be assessed by compilers in the *country of D*. In the adjusted US-method only the chain to the affiliate owned by the largest share would be pursued, making F the only UBA of D. In the EU-method both D's first shot DIE's would be included, making E and F UBA's to D.

Assessment of the US- and EU methods for UBO data

20. The EU-method to determine the UBO will give more accurate data than the US-method, especially when there is more than one *direct* link going up the ownership chain (like is the case for E in Scheme 3). The additional amount of data needed for this method, could on the other hand make it easier to implement the US-method. To reach a balanced judgment on the preferability of each system, it would be useful to dispose of quantitative data showing the relative occurrence of more than one foreign parent.

VI. Final remarks regarding the combined collection of UBO and UBA data

21. The reference method (using a strict multiplicative calculation) gives the most accurate UBO / UBA data because it takes into account all ownership relationships between the related enterprises, including ownership shares and their (market) values. The method leads to complete symmetry between the UBO / UBA data for the enterprises at the extremes of the ownership chains. The strict multiplicative calculation, on the other hand, is not necessarily compatible with the FDI ownership criteria and additional requirements would therefore have to be assessed. Most importantly, the method would not seem feasible in practice because the amount of data needed would be prohibitive.

22. As was shown in Scheme 3, the criteria proposed to define UBO and UBA relationships (in the EU- and US-systems) result in asymmetries between the UBO and UBA data. The UBO/UBA data are further not always compatible with the consolidation criteria⁴. If, therefore, supplementary data on both UBO's and UBA's were to be collected in the future, more work would need to be done to assess how to interpret the data, especially in international comparisons. Also, the extensions of the EU- and US-methods suggested above on behalf of the compilation of UBA data are not yet sufficiently elaborated and would also need more work⁵.

IV. Points for discussion

⁴ In all three methods shown in Scheme 3, A assigns E as its UBA. But only in the FCS and EU-consolidation (shown in Scheme 1) does A consolidate E in its FDI data. E on the other hand does not consider A as its UBO in either the EU- or the US-method.

⁵ An illustration of this problem was given in Scheme 3. In both the EU- and US-methods F is considered the UBA of B. Consequently, all FDI assets of B (2200) are assigned to F, but this amount largely exceeds the total of F's FDI equity liability (200). This implies that for UBA data a criterion based only on relative shares does not suffice to determine the downward chain. Additionally, the absolute market values of the affiliates down the chain must be taken into account.

1. *Do DITEG members agree that both UBO and UBA data may be useful to present supplementary FDI data for countries with large activities of SPE's ?*
2. *Do DITEG members have a preference for the US-method or for the method originally proposed by Eurostat. Do DITEG members need quantitative data on the occurrence of more than one direct foreign parent to come to a balanced decision.*
3. *Do DITEG members want more work to be done on the criteria to determine the UBA?*