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**Note on the Application of the Residence Concept
to Small Economies with International Financial Centers**

**Prepared by the Statistics Department
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NOTE ON THE APPLICATION OF THE RESIDENCE CONCEPT TO SMALL ECONOMIES WITH INTERNATIONAL FINANCIAL CENTERS

Background

1. This note deals with issues that have arisen surrounding the identification of the residence of entities incorporated in small economies with international financial centers (SEIFiCs). Two arrangements that give rise to special statistical issues are:

- Special licenses for “offshore” banks, insurance companies, pension funds, and mutual funds. These financial corporations may or may not have any physical presence in the country, and even those with a physical presence may have the bulk of the administrative processes carried out in another jurisdiction. Such licenses are typically subject to light regulation, but the licensee is sometimes not permitted to deal with residents or in the local currency. In these cases, the substantial connection of the operations with the jurisdiction that issued the license may be quite weak. In balance of payments statistics in some of these jurisdictions, the offshore enterprises are treated as nonresidents that purchase support service exports from the domestic economy.
- IBCs (international business companies, “brass plate companies,” “shell companies,” special purpose entities, etc.). These companies are incorporated in small economies with international financial centers, have no physical presence in that jurisdiction, have all their assets, liabilities, and operations elsewhere, and are usually owned by nonresidents of the jurisdiction of incorporation. Typically, the requirements of the country of incorporation are minimal beyond payment of registration fees. The registration is usually undertaken by a local service provider who is the only contact and who has little or no idea of the activities of the companies. While service providers are required to know the name of the owner(s) in most jurisdictions, that information is not public and accounts do not need to be maintained or lodged. IBCs can be used for a range of functions such as being holding companies, being a finance conduit, holding financial and nonfinancial assets, and undertaking merchanting (or perhaps purporting to do so in order to carry out transfer pricing). To illustrate the potential significance of IBCs, Panama was recently reported to have 372,670 IBCs and the British Virgin Islands 360,000.¹

BPM5 Text

2. The fifth edition of the *Balance of Payments Manual (BPM5)* has passages that seem vague or ambiguous in dealing with the residence of the units in these cases.

¹ Source: *Washington Post* June 23, 2001.

Text (with paragraph number)	Comments
<p><i>Concept and definition of residence</i> 58. An institutional unit is a resident unit when it has a center of economic interest in the economic territory of a country.</p>	
<p><i>Economic territory of a country</i> 59 The economic territory of a country consists of the geographic territory administered by a government; within this territory, persons goods, and capital circulate freely. (Para. 21 is similar)</p>	<p>For countries where the rest of the economy is not permitted to have financial transactions with the offshore entities, the first part of the definition contradicts the second. In those cases, the offshore center is under the jurisdiction of the government, but capital does not circulate at all.</p>
<p><i>Center of economic interest</i> 62. An institutional unit has a center of economic interest within a country when there exists, within the economic territory of a country, some location, dwelling, place of production, or other premises on which or from which the unit engages and intends to continue engaging ... in economic activities and transactions on a significant scale. 63. In most cases, it is reasonable to assume that an institutional unit has a center of economic interest in a country if the unit has already engaged in economic activities and transactions on a significant scale in the country for one year or more ...</p>	<p>— The focus of the <i>BPM5</i> definition of center of economic interest is on production. —In contrast to the <i>System of National Accounts 1993 (1993 SNA)</i> para 4.16(c), the third edition of the <i>OECD Benchmark Definition of Foreign Direct Investment</i> para. 69, the draft <i>External Debt Statistics: Guide for Compilers and Users</i>, and the draft second edition of the <i>Coordinated Portfolio Investment Survey Guide (CPISG2)</i>, there is no mention in <i>BPM5</i> of country of incorporation or registration as a factor in identifying the center of economic interest. —IBCs typically have no premises in their country of incorporation and have all of their transactions and assets outside their country of incorporation.</p>
<p><i>Residence of enterprises</i> 73. An enterprise is said to have a center of economic interest and to be a resident of a country (economic territory) when the enterprise is engaged in a significant amount of production of goods and/or services there or when the enterprise owns land or buildings located there. The enterprise must maintain at least one production establishment in the country ...</p>	<p>—This definition may suggest that enterprises need to have a physical presence to be resident. For banking, insurance, aircraft leasing, which are productive activities that require little or no physical presence, this definition could result in such activities not being treated as being resident of any economy.</p>

	<p>—As noted below (in the comments on <i>1993 SNA</i> para. 5.1) <i>BPM5</i> does not contain a definition of “enterprise” although it needs to be understood that these <i>BPM5</i> guidelines refer only to entities undertaking productive activity.</p>
<p><i>Branches (Heading is “Attribution of production” in BPM5)</i> 78. Production undertaken outside the economic territory ... is treated as part of host country production (branch or subsidiary) of the country if the enterprise meets the conditions noted in paragraph 73. In addition, the enterprise must, among other considerations, maintain a complete and separate set of accounts of local activities (i.e., income statement, balance sheet, transactions with parent enterprise), pay income taxes to the host country, have a substantial physical presence, receive funds for work for the enterprise account, etc.</p>	<p>—Some IBCs may have all their activity outside their country of incorporation, so that the branch constitutes all of its activities and the parent none. (This is adverted to in the third edition of the <i>OECD Benchmark Definition of Foreign Direct Investment</i> para. 69.) —In many small economies with international financial centers, not only are IBCs or other “offshore” entities not required to have accounts or pay taxes, so the parents would not satisfy the requirements of the branch.</p>
<p><i>Residence of corporations that simply hold assets and liabilities (without financial intermediation or productive activities)</i></p>	<p>Such corporations are not within the <i>1993 SNA</i> definition of enterprises (see discussion of <i>1993 SNA</i> para. 5.1 below), as they do not undertake production. Their sectorization and status as units are not discussed in <i>BPM5</i> or other statistical manuals, except to the extent that they are ancillary corporations or special purpose entities.</p>
<p><i>Offshore enterprises</i> 79. Offshore enterprises engaged in manufacturing processes ... are residents of the economy in which the offshore enterprises are located. ... The statement also applies to nonmanufacturing operations (i.e., trading and financial enterprises), including so-called special purpose enterprises. 381. The residency of offshore enterprises—including those engaged in the assembly of components manufactured elsewhere, those engaged in trade and financial operations, and those in special zones—is attributed to the economies in which the enterprises are located.</p>	<p>—The meaning of “located” is unclear for financial operations because financing may lack a physical dimension. —Many offshore financial intermediaries have no physical presence in their country of incorporation or registration or anywhere else as all their administrative support is contracted out to other organizations.</p>

Special purpose entities

See para. 79 above. In addition:

365. In this *Manual*, it is recommended that so-called special purpose entities be included as direct investment enterprises if they meet the criteria in the previous paragraphs [presumably, the 10 percent criterion given in paragraphs 362-4] ...

—Special purpose entities are not defined in *BPM5*, so it is not clear whether the intention is to cover only financial conduits (as mentioned in *Monetary and Financial Statistics Manual (MFSM)* para.72) or IBCs generally (as seems to be the case in and *Balance of Payments Textbook* para. 542 and Annex 3 of the third edition of the *OECD Benchmark Definition of Foreign Direct Investment*).

—Although the topic of the chapter in which para. 365 appears is direct investment, there could be an inference that the residence is the country of incorporation.

—The *Balance of Payments Textbook* paras. 542-4 illustrate the treatment of special purpose entities as direct investment enterprises resident in their country of incorporation.

—These references seem to suggest that entities can be “direct investment enterprises” even though they undertake no productive activities. This would contradict the *1993 SNA* definition of “enterprises.”

—*MFSM* treats special purpose vehicles as part of the parent corporation if they are resident in the same country, but as a separate unit if they are in a different country to the parent (paras. 71-72).

1993 SNA Text

3. Some relevant issues discussed in the *1993 SNA* are not mentioned in *BPM5*.

Text (with paragraph number)	Comment
<p><i>Corporations</i> 4.16 (c) Corporations and [nonprofit institutions] may normally be expected to have a center of economic interest in the country in which they are legally constituted and regulated.</p>	<p>—The only exception to “normally” that is mentioned is for branches (discussed in the remainder of para. 4.16(c)), i.e., where there is “a significant amount of production over a long period of time but without creating a subsidiary corporation, the branch, office or site is considered to be a quasi-corporation (i.e. separate institutional unit) resident in the country in which it is located.” —This treatment is not repeated in <i>BPM5</i>, although residence is a central issue for balance of payments. However, <i>BPM5</i> para. 21 states that the concepts of economic territory, residence, and center of economic interest are [intended to be] identical to those of the <i>1993 SNA</i>.</p>
<p><i>Holding corporations</i> 4.37 On the other hand, the principal function of a corporation may be to control and direct a group of subsidiaries, without having any other significant production of its own. Such a corporation is described as a "holding corporation" or "holding company". 4.38 For certain purposes, it may be desirable to have information relating to a group of corporations as a whole. However, with the exception of ancillary corporations described in the next section, each individual corporation should be treated as a separate institutional unit, whether or not it forms part of a group. Even subsidiaries which are wholly owned by other corporations are separate legal entities that are required by law and the tax authorities to produce complete sets of accounts, including balance sheets. Although the management of a subsidiary corporation may be subject to the control of another corporation, it remains responsible and accountable for the</p>	<p>—Paragraph 4.100 is under the heading of financial enterprises, but presumably the principle of sectorization on the basis of preponderance would also apply to other cases (and presumably also to industrial classification). —This issue is not discussed in <i>BPM5</i>, although the issue is particularly difficult in a balance of payments context because it is unclear how preponderance might be applied to a multi-country situation (e.g., where the holding company is in a different country from its subsidiaries, or where subsidiaries in different countries have preponderances in different sectors)</p>

<p>conduct of its own production activities.</p> <p>4.100 As explained earlier in the chapter, holding corporations are corporations that control a group of subsidiary corporations and whose principal activity is owning and directing the group. Holding corporations are classified as financial if the preponderant type of activity of the group of corporations as a whole is financial. In the absence of suitable information about the relative sizes of the subsidiaries, a holding corporation may be classified as financial if a simple majority of the corporations it controls are financial. Similarly, financial holding corporations may be allocated to sub-sectors according to the type of financial activity mainly carried out by the group it controls. For example, if the group of corporations is mainly concerned with insurance, the holding corporation will itself be classified in the sub-sector, insurance corporations and pension funds. If there is no single type of financial activity which is clearly predominant within the group, the holding corporation should be classified in the sub-sector, other financial intermediaries except insurance corporations and pension funds.</p>	
<p><i>Ancillary corporations</i></p> <p>4.42 A corporation may find it advantageous for tax or other reasons to create a subsidiary corporation purely in order to perform certain ancillary activities for its own benefit. For example, it may create a subsidiary to which ownership of its land, buildings or equipment is transferred and whose sole function is to lease them back again to the parent corporation; or it may create a subsidiary to keep its accounts and records on a separate computer installation; and so on. In some cases, corporations may create "dormant" subsidiaries which are not actually engaged in any production but which may be activated at the convenience of the parent corporation.</p> <p>4.43 Ancillary corporations are not treated as separate institutional units in the System. When a parent corporation has created a single ancillary corporation, the ancillary corporation should be treated as an integral part of the parent and its accounts consolidated with those of the parent.</p>	<p>—This treatment is feasible when the ancillary corporation is in same jurisdiction.</p> <p>—There is no mention of the situation where the ancillary is incorporated in another jurisdiction or how this treatment might interact with para. 4.16 (c).</p> <p>—Ancillary corporations are discussed in the <i>Balance of Payments Compilation Guide</i> paras. 705-711 (under the heading of “Nonoperating direct investment enterprises”) and the <i>Balance of Payments Textbook</i> paras 542-544. In both cases, the country of incorporation principle is adopted, i.e., para. 4.16(c) is taken to override para. 4.42 with cross-border ancillary corporations.</p>

<p>When a parent corporation has created several ancillary corporations, they should all be combined with the parent corporation to form a single institutional unit.</p> <p>4.44 Ancillary corporations are not treated as separate institutional units because they can be regarded as artificial units created to avoid taxes, to minimize liabilities in the event of bankruptcy, or to secure other technical advantages under the tax or corporation legislation in force in a particular country.</p>	
<p>5.1 ... The present chapter defines an institutional unit engaged in production as an enterprise...</p>	<p>This definition is not mentioned in <i>BPM5</i>, but is necessary to understand when <i>BPM5</i> para. 73 “Residence of Enterprises” is applicable.</p>

CPISG2

The draft second edition of the *Coordinated Portfolio Investment Survey Guide (CPISG2)* provides the following guidance for dealing with residence issues. (The same approach is also adopted in the draft *External Debt Statistics: Guide for Compilers and Users (Guide)*. The IMF Committee on Balance of Payments Statistics endorsed the draft *CPISG2* in 2000, while the draft Guide is a product of the Interagency Task Force on Finance Statistics and its contents have been reviewed by national compilers and data users.

52. ... [T]he economic territory of a country is the basis upon which residence is determined. It includes the geographic territory administered by a government, territorial enclaves, and free zones and bonded warehouses operated by offshore enterprises under customs control. These principles have been applied to offshore financial centers, so that they are treated as resident in the economic territory of which they are a part, regardless of their treatment under local exchange control, tax, or employment regulations.¹⁶ Apart from being consistent with the concept of residence recommended in the *1993 SNA* and in *BPM5*, this treatment is critical to ensure consistency in applying a common principle of residence across territories. It is also consistent with the definition of a SEIFiC (given earlier).

53. Both the *1993 SNA* and *BPM5* define the residence of units in terms of their center of interest. The application of this concept to individuals and enterprises for the purposes of the CPIS is the same as in the *SNA* and

¹⁶ Both the *1993 SNA* and *BPM5* say that liability to pay taxes is an **indicator** in helping to determine the residence of an entity. This is so regardless of the rate of tax. The important consideration is whether the entity is subject to the laws and taxes of the jurisdiction in which it is located.

BPM5.¹⁷ Both the *1993 SNA* and *BPM5* recommend that offshore enterprises (which may be engaged in manufacture, trade, and financial services) be treated as resident in the economy in which they are located.¹⁸ *BPM5* gives particular attention to the residence and classification of special purpose entities (SPEs) as direct investment enterprises.¹⁹ SPEs are commonly engaged in providing financial services.

54. For the CPIS it is necessary to provide further clarification of the treatment of so-called “brass-plate” companies, “international business companies”, “shell companies” and special purpose entities (SPEs) that may have a limited physical presence in the economy in which they are located, may be offshore in the sense just defined, and yet may be significant vehicles for cross-border portfolio investment. To ensure their inclusion in the CPIS, the legal domicile of an enterprise is a preferred indicator of residence. In a typical SEIFiC, the transactors that are likely to meet the test of legal domicile may well include: (i) companies that are incorporated in the jurisdiction (including so-called “international business companies” and “exempt” companies) even though they may be managed or administered in another jurisdiction; (ii) branches of companies incorporated abroad (including financial holding companies); and (iii) unincorporated enterprises that are deemed to be legally domiciled, can produce separate accounts, and are expected to be in business for a period of one year or more. This test of residence is consistent with that followed in the draft inter-agency *External Debt Statistics: Guide for Compilers and Users* (forthcoming), which treats debt issues on the balance sheet of entities legally incorporated or domiciled in SEIFiCs as external debt of the SEIFiC. However, although international business companies in SEIFiCs are residents of the countries in which they are incorporated, unless they undertake financial intermediation they are not usually regulated and are not usually required to have accounts, so data collection may not be feasible for the CPIS in SEIFiCs.

¹⁷ For the purposes of balance of payments statistics, enterprises comprise: “(i) incorporated enterprises (e.g., corporations, joint stock companies, limited liability partnerships, cooperatives, or other business associations recognized as independent legal entities by virtue of registration under company and similar acts, laws, or regulations; (ii) unincorporated enterprises; and (iii) nonprofit institutions.” (*BPM5*, paragraph 76).

¹⁸ Although the term “offshore” is used as an adjective in both the *1993 SNA* and in *BPM5*, no definition is given. For the CPIS, an offshore enterprise is one that is wholly or largely owned by nonresidents of the jurisdiction in which it is domiciled and is wholly or largely engaged in providing services to nonresidents.

¹⁹ That an SPE may be a direct investment enterprise does not necessarily mean that it is excluded from the CPIS as it is the nature of its assets, not its liabilities, that determines whether or not any holdings of securities are portfolio or direct investment. ...

59. Large multinational corporations (MNCs) may have more than one center of economic interest; others appear to have more than one head office. However, there are usually either separate corporations that operate within the larger entity or there may be a standard allocation principle among the countries of residence of the different owners, based on their equity shares. Moreover, some companies, listed on major stock exchanges and having all the characteristics of a resident of that economy, may be incorporated in another jurisdiction altogether. In addition, some MNCs may use a “shell company” or an SPE²⁰, domiciled and registered in another country or economic territory—typically a SEIFiC—to issue securities, usually debt instruments, even though there is “no physical presence” in the economy or territory. In that instance, the securities should be attributed to the country or territory in which the issuing entity is legally incorporated, as opposed to the country of the parent enterprise, even though the legal entity in the SEIFiC is merely a conduit for raising funds in the parent company.

60. Even where the issue is guaranteed by the parent company, either explicitly or implicitly, and the funds are for use by the parent company, the residence of the issuer should be attributed to the place of registration of the special financing vehicle. Even for countries using a security-by-security approach (see Chapter 4), the database should be checked because the country allocation of issuer, especially for such special financing vehicles, is not always attributed correctly.

Topics for Discussion

(1) What should be the treatment of companies that undertake no production (both holding companies and more generally) – Should they be treated as separate units from their owners? Should they be treated as separate units from their owners only if the company is resident of a different jurisdiction to its owners? If they are separate units, do they belong to the sector of their owner, the financial sector, or some other sector?

(2) Does the Committee agree with the CPISG2 approach to determining the residence of offshore companies?

What are the implications for data collection?

(3) Are inconsistencies in the interpretation of the residence of offshore companies a possible factor in causing global statistical imbalances?

²⁰ See paragraph 54 for discussion of “shell companies”, “brass plate companies”, “international business corporations” and SPEs.