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Exploring the Borderline Between Direct Investment and Other Types of Investment: The U.S. Treatment

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I. Introduction

1. In the fifth edition of the Balance of Payments Manual (BPM5), one of the key steps forward was in the provision of uniform guidelines for identifying direct investment and distinguishing it from other types of investment. BPM4 had defined direct investment only in terms of general conceptual criteria, whose implementation was likely to vary from country to country, resulting in bilateral asymmetries in the classification of investments. Thanks to the more specific guidance in BPM5, gross inconsistencies are now less of a problem. However, borderline cases, not specifically treated in BPM5 (or in its companion volumes or the OECD Benchmark Definition) still exist. These may have become more numerous and more significant over time, as multinational firms have grown in size and in organizational complexity.

2. For some time, the Committee has recognized the existence of borderline cases and the need for guidance covering them. Its interests and concerns are evidenced by a number of papers dealing with particular situations that have been presented and discussed at previous Committee meetings. At the 2001 meeting, the United States, among others, agreed to prepare a paper for the 2002 meeting, discussing its treatment of selected borderline cases of direct investment. This is that paper.

3. The United States experience may be particularly relevant to these issues, since it is both the world's largest direct investor and the host of the world's largest stock of inward direct investments. With direct investment valued using estimates of the current cost of tangible assets (plant and equipment, land, and inventories), the value of the U.S. direct investment position abroad was $1.6 trillion at yearend 2001, and the value of the foreign direct investment position in the United States was $1.5 trillion. (With direct investment valued using current indexes of stock market prices, the value of the U.S. direct investment position abroad was $2.3 trillion at yearend 2001, and the value of the foreign direct investment position in the United States was $2.5 trillion.) Included among these investments are company organizations of almost every shape and form imaginable. In attempting to classify and record their transactions and positions, the United States has confronted numerous situations that are not specifically treated by existing guidelines. In the absence of internationally accepted standards, it has established rules of its own for handling many of them.[1]

4. A primary purpose of this paper is to promote international consistency of treatment, by informing the members of the Committee of the treatments followed by the United States, and of the justifications for those treatments where they may be unclear. The cases it discusses are ones that are relatively common, complex, and/or controversial.

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[1] The United States has also established methodologies for revaluing company financial statements that are in prices of prior periods to prices of the current period. These methodologies are described in a separate paper for presentation at the October 2002 meeting of the IMF Committee on Balance of Payments Statistics, Valuing the Direct Investment Position in U.S. Economic Accounts.

5. There are no doubt numerous other cases where the borderline is unclear or the treatment is controversial. Other Committee members may wish to identify these cases, and to provide justifications or proposals for their preferred treatments. International consistency of treatment would of course be greatly improved if these borderline cases are identified, and their treatment is debated and resolved, in sufficient time for guidance on them to be included in BPM6 (targeted for release in 2007) and its accompanying textbooks and guides.

II. Summary

6. This paper identifies cases where the borderline between direct investment and portfolio and other types of investment may be unclear, and describes the handling of these cases in published U.S. statistics. In the case of permanent debt positions between affiliated banks, and the case of "positions between financial intermediaries and affiliated enterprises not principally engaged in financial intermediation," it also provides a justification for considering a change to the international standards.

7. In addition, in a separate section, selected *goods and services transactions* are briefly discussed. In the U.S. accounts, services transactions between related parties are published separately from those that are between unrelated parties. Data on related-party trade in goods are not published in the featured accounts, but are shown, after a lag, in a supplemental set of accounts that is disaggregated along ownership lines. Although BPM5 does not recommend that the accounts disaggregate goods or services transactions between related and unrelated parties, the Manual on Statistics of International Trade in Services does contain a recommendation that "total services" be broken down in this fashion. Consideration should be given to including recommendations in BPM6 to show separately related party trade in goods and/or services.

8. In the following, when the borderline between direct investment and other types of investment *positions* is being discussed, the borderline between direct investment and other investment flows is implicitly also being discussed. However, no direct mention is generally made of financial flows, except where it is essential to the discussion.

9. The following categories of investment positions are discussed:

Mutual funds
Trusts
Permanently invested debt capital of banks and other financial intermediaries
Positions between financial intermediaries and affiliated enterprises not principally engaged in financial intermediation
Shell companies
Offices that provide trade promotion or public-relations-type services; manufacturers' sales offices; State tourism and business promotion offices; news bureaus; and stations, ticket offices, and terminal or port facilities of an airline or ship operator
Corporate inversions
Derivatives

10. In addition, the desirability of distinguishing related-party trade in goods and services from such trade between unrelated parties is considered. Two services for which the distinction between these two types of trade may not always be clear – message telephone services and reinsurance – are singled out for individual discussion.

III. General Description of What Constitutes a Foreign Affiliate

11. Before discussing borderline cases in detail, it may be useful to provide a general description of what is considered to constitute a direct investment enterprise, or affiliate, in the U.S. statistics. For convenience, the description relates only to foreign affiliates of U.S. companies, but the criteria for U.S. affiliates of foreign companies could be described in a parallel fashion.

12. A business enterprise may be either incorporated or unincorporated.[2] A business that is incorporated abroad is a foreign affiliate if it is directly or indirectly owned or controlled by one U.S. person to the extent of 10 percent or more of its voting securities. (An associated group of investors acting in concert is regarded as a single person.) If a company is incorporated in the United States but carries out substantially all of its operations abroad, its foreign operations are treated by BEA as a branch (and, therefore, as a foreign affiliate), even though the U.S. company itself may consider the operations to be an integral part of, and would normally consolidate them with, its own operations and accounts.

13. In general, the foreign operations or activities of a U.S. person are considered to be a foreign affiliate if they are legally or functionally separable from the domestic operations or activities of the U.S. person. In most cases, it is clear whether the foreign operations or activities constitute a foreign affiliate. As mentioned, if an operation or activity is incorporated abroad - as most are - it is *always* considered as a foreign affiliate. The situation is not always so clear with unincorporated foreign operations or activities. Most are legally or functionally separable from those of the U.S. person, but some are not clearly separable, and the determination of whether they constitute a foreign affiliate may be made on a case-by-case basis, depending on the weight of the evidence.

14. The following characteristics would indicate that the unincorporated operation or activity probably *is* a foreign affiliate:

- It pays foreign income taxes.
- It has a substantial presence abroad, as evidenced by plant and equipment or by employees that are permanently located abroad.
- It has separate financial records that would allow the preparation of financial statements, including a balance sheet and income statement. (A mere record of disbursements to, or receipts from, the foreign operation would not constitute a "financial statement" for this purpose).*

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[2] Unincorporated business enterprises primarily take the form of branches and partnerships.

- o It takes title to the goods it sells and receives revenues from their sale, or it receives funds from customers for its own account for services it performs.

15. The following characteristics would indicate that the unincorporated operation or activity probably is *not* a foreign affiliate:

- o It engages only in sales promotion or public relations activities on behalf of the U.S. person.
- o It conducts business abroad only for the U.S. person's account, not for its own account.
- o It has no separate financial records that allow the preparation of financial statements.*
- o Its expenses are paid by the U.S. parent.
- o It pays no foreign income taxes.
- o It has limited physical assets or few employees permanently located abroad.

* The existence of financial records that would allow the preparation of financial statements is a criterion for determining whether an unincorporated operation is an affiliate, because the existence of such records (including an income statement and balance sheet) greatly facilitates the treatment of the operation as a affiliate, and the absence of such records will often make it impractical or much more difficult to account for the operation as a separate business.

IV. Borderline Cases

Mutual Funds

16. In the United States statistics on direct investment, mutual funds (including those that are "funds of funds") are uniformly excluded: They are not recorded as either direct investors or direct investment enterprises. The rationale for these exclusions is partly practical and partly conceptual.

17. Discussing first the case of cross border investment *in* a mutual fund, mutual funds generally are considered temporary investment vehicles. Although it is unusual for investment in a mutual fund by a single investor to reach the level of 10 percent or more, it can occur. However, unlike other ownership interests of 10 percent or more, investments of that size in a mutual fund are usually readily marketable at published prices. ("Open end" mutual funds stand ready to redeem outstanding shares at the per share net asset value.) Also, investors in mutual funds generally have not invested for the purpose of managing or controlling the mutual fund - instead, they typically do so for precisely the opposite purpose, which is in order to be relieved of responsibility for managing the company in which they have invested. A mutual fund's operations are controlled by a mutual fund manager - who is usually affiliated with the sponsor or creator of the fund - who makes all investment decisions on the fund's behalf. Because investments in the mutual fund are usually temporary, and no managerial control is exercised by the investors in those funds, these investments do not appear to meet the conceptual criteria for classification in direct investment, as set forth in BPM5 and the OECD Benchmark Definition of Direct Investment.

18. Discussing next the case of cross-border investment *by* a mutual fund, some similarities with the above discussion of investments in a mutual fund may be drawn. A mutual fund that invests in the equity of a foreign company usually does not do so for the purpose of controlling the company. Instead, it usually does so solely to obtain passive investment returns in the form of dividends and capital gains. Because the cross border investment is usually temporary and managerial control is usually absent, such investments do not appear to meet the conceptual criteria for direct investment.

19. Nonetheless, if one were to consider mutual fund investments on a case-by-case basis, there may be some instances where inclusion in direct investment could seem appropriate, particularly in the case of investments *by* a mutual fund. Subjective assessments of the existence of direct investment are not recommended in BPM5 (see paragraph 363), are resource-intensive, and would result in bilateral asymmetries where counterparty countries reach different conclusions on questions such as the degree of managerial control that is exercised by a mutual fund. In addition, cross-border securities transactions by mutual funds may be effected by intermediaries (e.g., brokers and dealers), who may have the primary responsibility for filing statistical reports on their investment activities. Because the intermediary may lack knowledge of the cumulative position of the fund, there could be practical difficulties in excluding mutual fund holdings from portfolio and other investment. For these reasons, the United States has developed a general rule that a mutual fund should not be considered to be a direct investor, nor may there be direct investment in it. However, we nonetheless have left the door a slight bit open, and would consider exceptions to this rule on a case-by-case basis, should holdings be identified that are so large as to warrant close examination.

Trusts

20. The treatment of trusts in the U.S. international economic accounts varies, depending upon the type and characteristics of the trust. In particular, depending upon the precise circumstances, a trust that is a U.S. parent or a U.S. affiliate is often combined with its creator, or with its beneficiaries, for direct investment reporting purposes, when the trust, and the other relevant person or group, are both located in the United States. In no cases are the trustees of the trust considered to be direct investors in the U.S. economic statistics. In essence, the trustees are considered independent managers of the trust assets and operations, and not as owners of the trust assets.

21. Taking first the case of a U.S. direct investor that is a trust: The trust and its creator would jointly be considered the U.S. parent company in reports to BEA if the creator has a reversionary interest in the trust - that is, if the trust assets may be returned to the creator under some set of circumstances. Also, the trust and its creator are jointly considered to be the parent in reports to BEA if the creator is an organization that designates its own shareholders or members as beneficiaries of the trust. This is because, when these conditions exist, the trust is not considered to be independent from the creator. In cases where these conditions do not exist, the U.S. beneficiary(ies) of the trust and the trust itself would jointly be considered to be the parent.

22. Some U.S. corporations have created trusts for the purpose of converting illiquid or nonmarketable assets into marketable securities. Nonmarketable assets such as real estate mortgages and credit card receivables have been contributed to these trusts, and the trusts, in turn, have sold debt securities to U.S. and foreign investors, the proceeds of which are used to compensate the creator of the trust for the assets that it contributed. The creator has thereby removed otherwise nonliquid or nonmarketable assets from its balance sheet via these sales to the trusts, and the holders of the securities that were issued by the trusts receive the income and other receipts of the trusts (interest, dividends, principal payments on mortgages, credit card payments, etc.). The size of the U.S. market in the debt of trusts that hold real estate mortgages is large, and foreign investors are significant investors in the securities issued by these trusts. Foreign holdings in the securities of these trusts are classified in foreign portfolio debt investment in the United States.

23. Turning to the case of a foreign trust, if a U.S. direct investment interest in a foreign affiliate is sold to a foreign trust that was created by the U.S. direct investor, this is *not* considered to be a bona fide disposition of a direct investment interest if the U.S. direct investor has a reversionary interest in the trust. The rationale for this treatment is the same as discussed in regard to U.S. trusts; that is, when a reversionary interest exists, the assets of the trust are not considered to be held by a person independent of the creator. However, if the U.S. direct investor does not have a reversionary interest, then the trust is considered to be an independent party, and the sale of a foreign affiliate to the trust would be considered a bona fide disposition of a direct investment interest.

24. Foreign trusts may have direct investment in the United States. When that occurs, the trust is considered to be the foreign parent of the U.S. affiliate. There are several examples of foreign pension funds and foreign Real Estate Investment Trusts that are parents in the foreign direct investment in the United States statistics.

25. Although it is beyond the focus of this paper, members of the Committee may find it informative to learn how trusts are recorded in the U.S. national economic account statistics. Many different types of trusts exist in the United States, and, as with the treatment of trusts in the international economic accounts, their treatment varies, depending upon the type and characteristics of the trusts. More specifically, unit trusts are treated as mutual funds. (Mutual funds are treated as pass-through entities - that is, their interest, dividends, and capital gains are attributed to their shareholders.) Funded pension plans (which are usually organized as trusts) are also treated as pass-through entities, and their income is attributed to the beneficiaries (annuitants) rather than to the funds themselves or to the companies that funded them. Transactions of nonprofit institutions serving businesses (including trusts), and personal injury settlement trusts, are consolidated in the corporate sector, and nonprofit institutions (including charitable trusts) serving individuals are consolidated with those of individuals, to form the personal income and outlay accounts in the national economic accounts.

Positions between affiliated banks and between affiliated financial intermediaries

26. Under guidelines in BPM5, certain debt positions between affiliated banks and affiliated financial intermediaries are to be excluded from direct investment. Paragraph 372 of BPM5 says:

> Intercompany transactions between affiliated banks (depository institutions) and affiliated financial intermediaries (e.g., security dealers) -- including SPE's with the sole purpose of serving as financial intermediaries -- recorded under direct investment capital transactions are limited to those transactions associated with permanent debt (loan capital representing a permanent interest) and equity (share capital) investment or, in the case of branches, fixed assets. Deposits and other claims and liabilities related to usual banking transactions of depository institutions and claims and liabilities of other financial intermediaries are classified, as appropriate, under *portfolio investment* or *other investment*. The stock of foreign assets and liabilities of banks and other financial intermediaries (international investment position) should be treated in a parallel manner.

27. We have found the above guidance to be difficult to apply in practice. (The recent efforts to clarify this standard - and to have it also apply to SPE's with a *primary* purpose of serving as financial intermediaries - have not made implementation any easier.) The United States has strived for many years to follow this guidance in the case of affiliated depository institutions.[3] However, the practical problems associated with identifying permanently invested debt capital are so significant that we recommend that strong consideration be given to excluding all debt between affiliated banks and other affiliated financial intermediaries from direct investment. The following discussion concentrates on permanent debt investment in the case of affiliated banks, but it may be extended to all other types of affiliated financial intermediaries.

28. From the viewpoint of a bank affiliate, virtually all of the funds that it receives (whether from debt or equity that it has issued, reinvested earnings, or other sources) is used in conducting its business - no funds sit idle. Also, reflecting the fact that money is fungible, it usually is impossible for a bank to directly link the source of funds to its use of those funds, but this is what the current international standards would appear to require. For example, BPM5 paragraph 372 relates debt funding provided *to* a bank branch with a use of those funds (i.e., acquisition of fixed assets), in determining whether the debt should be classified in direct investment. The principles pertaining to transfers of funds to incorporated bank affiliates are similar - the uses of those funds would need to be known, and, if the funds are either not permanent or used for usual banking activities such as lending, then those funds are to be classified outside of direct investment, but if they are both permanent and not used for

[3] The United States records all debt between affiliated securities dealers and other types of affiliated financial intermediaries, except banks, in portfolio or other investment, and not in direct investment. Because virtually none of the affiliated debt can be linked to a particular use, the debt cannot be judged to be Apermanent.

usual banking activities (such activities are undefined), then they are to be classified in direct investment. As mentioned, this linking of sources and uses of money in the U.S. statistics is usually impossible to achieve in practice.

29. In addition, it should be recognized that, when businesses are in a direct investment relationship, what is considered to be permanent and what is not considered to be permanent can quickly change, almost based on the whim of the direct investor (or the person who completes the BEA survey form).

30. Furthermore, most major users of the U.S. statistics have indicated a desire to see all of the debt positions of banks in a particular type of instrument classified together. For example, U.S. Government agencies that supervise and regulate banks are interested in monitoring the worldwide transactions and positions in loans and securities by U.S. banks, regardless of whether certain debt is deemed by BEA to be "permanent" investment.

31. Also, our experience has been that, if the amount of permanently invested debt reported to BEA by a bank is large, it is almost assured that the debt has been misclassified, and that it should not be regarded as permanent investment. That is because it is exceedingly rare for a large intercompany debt position with a bank affiliate to reflect funds that are NOT used for the usual banking transactions of the affiliate.

32. Finally, under the current recording rules, different countries are likely to identify or define permanent debt inconsistently. For all these reasons, we believe consideration should be given to excluding *all* debt between affiliated banks and between affiliated financial intermediaries from direct investment.

Positions between financial intermediaries and affiliated enterprises not principally engaged in financial intermediation

33. At its 2001 meeting, the Committee affirmed the guidance contained in BPM5, which is to record under direct investment all positions and financial transactions between a unit that is not a financial intermediary and an affiliated financial intermediary, and it recommended that this decision be reviewed in connection with the updating of BPM5.

34. In most cases, the U.S. treatment of positions (and transactions) between a parent company that is not a financial intermediary and its affiliate that is a financial intermediary is consistent with the treatment outlined in *BPM5*. That is, they are included in direct investment. There is, however, an exception to this statement.

35. In the U.S. statistics, debt positions of U.S. parent companies with their Netherlands Antilles finance affiliates are excluded from direct investment and are instead grouped with liabilities to unaffiliated foreigners reported by U.S. nonbanking concerns. The use of Netherlands Antilles finance affiliates has significantly diminished in recent years due to changes in regulations and tax treaties, but the primary or a sole purpose of these affiliates had been to serve as conduits between U.S. corporations and unaffiliated foreign lenders. More specifically, U.S. parent companies used these affiliates for issuing bonds in foreign

capital markets, and then the affiliates re-lent the proceeds to their U.S. parent companies. The U.S. parent companies paid interest on their borrowings to their Netherlands Antilles affiliates, who, in turn, used the funds to pay interest to the foreign bondholders. The Netherlands Antilles affiliates generally had few if any operations other than those arising from issuance and servicing of the bonds, and they generally had no physical presence in the Netherlands Antilles. These affiliates were able to find buyers for the bonds because their U.S. parent companies guaranteed the timely payment of principal and interest to the bond holders.

36. The question that may arise is, why did these U.S. companies issue bonds indirectly, through shell corporations in the Netherlands Antilles who relent the proceeds back to them, rather than sell the bonds directly to foreign investors? The reason was that, under the provisions of a tax treaty between the United States and the Netherlands Antilles, payments of interest to the Netherlands Antilles were exempted from U.S. withholding tax, whereas direct payments of interest to most European and other foreign investors were subject to this tax.

37. The U.S. companies that established these Netherlands Antilles affiliates were, in many cases, not international companies. For example, U.S. electric utilities with no other foreign affiliates often established affiliates in the Netherlands Antilles. If the debt positions created by the U.S. parent companies' foreign borrowing through these affiliates were classified in direct investment, the U.S. direct investment debt position in the Netherlands Antilles would be a large negative amount. (In fact, this was what occurred until the United States revised the treatment for these affiliates in 1998.) For analytical and practical purposes, the U.S. direct investment statistics exclude these debt positions from direct investment and treat them instead as liabilities to unaffiliated foreigners. The essence of these positions is that U.S. parent companies are issuing bonds to unaffiliated investors in Europe. It would misstate both the U.S. direct investment position and the other types of investment positions to show them as negative direct investment in the Netherlands Antilles.[4]

Shell companies

38. In the following, the term "shell" is used to refer to a business that is formally registered, incorporated, or otherwise legally organized in a foreign country, but that does not conduct any operations in that country.

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[4] Actually, the United States changed its treatment more than once. Data on debt owed to Netherlands Antilles affiliates is classified in portfolio investment in 1968-76. For 1977-93, it is classified in direct investment. But, for 1994 forward, it is again classified in portfolio investment. The changing treatment of this debt is partly due to changes in U.S. regulations - including changes in direct investment controls and in U.S. tax law - that resulted in repeated changes in the use and primary purpose of these affiliates. To facilitate analysis, data were published separately for these affiliates.

39. If a U.S.-owned foreign shell is incorporated abroad and operates entirely from the United States (such is sometimes the case with businesses incorporated in tax haven countries in the Caribbean region), it is treated as an incorporated foreign affiliate in its country of incorporation. Turning next to the shell's operations in the United States: If the shell does not own a company that is incorporated in the United States, and the U.S. operations mainly consist of maintaining the books of the foreign shell company and effecting financial transactions on its behalf, the operations are not treated as an inward investment affiliate of the foreign company. Instead, the transactions effected on behalf of the foreign company are recorded as if they were directly effected by the shell abroad.

40. If the foreign shell is incorporated abroad but all of its physical assets or operations are in a second foreign country, then the enterprise is treated as an incorporated foreign affiliate in the country where its physical assets or operations are located. For example, a U.S.-owned retail trade company incorporated in Panama that operates entirely in Canada would be treated as an incorporated foreign affiliate in Canada. If, however, a foreign shell is incorporated abroad and has some physical assets or operations in two or more other foreign countries, the entity in the country of incorporation is classified as a holding company affiliate, and its operations in each separate additional foreign country are treated as a separate, indirectly owned foreign affiliate in each of the other countries.

41. If a foreign shell company is not incorporated abroad (usually they are incorporated abroad), however, it is treated according to the general principles outlined in Part III, pertaining to the treatment of unincorporated foreign activities. A foreign shell would typically not meet many - if any - of the criteria given (paying foreign income taxes; having a substantial physical presence, as evidenced by plant and equipment or by employees that are permanently located abroad; having separate financial records; taking title to the goods that it sells and receiving revenue for its own account from customers), and thus would not normally be expected to qualify for treatment as an affiliate.

Offices that provide trade promotion or public-relations-type services; manufacturers' sales offices; State tourism and business promotion offices; news bureaus; and stations, ticket offices, and terminal or port facilities of an airline or ship operator

42. Consistent with the guidelines given earlier concerning what constitutes a direct investment affiliate, offices that provide trade promotion or public-relations-type services; manufacturers' sales offices; State tourism and business promotion offices; and news bureaus are not treated as direct investment enterprises in the U.S. statistics. For example, the funding to maintain foreign sales promotion and representative offices is treated as a U.S. import of services. Sales promotion offices typically have few assets other than office furniture. To the extent that their employees are compensated by commissions, the commissions arise only from sales or business that the employees generate for their U.S. parents. They do not produce revenue (although they may obtain funds from their parents to cover their expenses); and they are engaged only in sales promotion, representational, public-relations-type activities, or the gathering of market information, on behalf of their parents. If an office does produce revenue for its own account from goods or services it provides to unaffiliated foreign persons, then it is considered a foreign affiliate and is subject to the

reporting requirements for BEA's direct investment surveys. Similarly, State tourism and business promotion offices, and news bureaus, located abroad exist to generate business for others, rather than for their own account, and funding to maintain them is treated as a U.S. import of services. Funding by foreign entities to maintain such offices in the United States are treated analogously, as a U.S. export of services.

43. The stations, ticket offices, and terminal or port facilities of an airline or ship operator that provide services only to the airline's or ship operator's own operations are not considered affiliates, because most of the revenues, such as passenger fares and freight charges, collected by these facilities are generated by the travel and transportation services rendered by the airline or ship operator of which they are a part, not by the activities of these facilities. However, if the facilities provided services to unaffiliated persons rather than, or in addition to, the airline or ship operator that owns them, then they are considered affiliates.

Corporate Inversions

44. In a number of cases, a U.S. corporation has created a new corporation in Bermuda or another low-tax country, and the resulting corporation has exchanged stock in itself for the outstanding shares of stock in the U.S. corporation that created it. After an exchange of this type is completed, there is foreign direct investment in the United States by Bermuda, and U.S. portfolio investment in Bermuda. A question that arises is whether the current treatment of these transactions in the U.S. accounts is statistically meaningful or appropriate, or whether it simply represents an artificial grossing up of the accounts that distorts the statistics on both types of investment. Some users of the statistics have complained that it makes no sense for portfolio investment outflows to be dominated by inversion transactions, and that these transactions make the picture of U.S. portfolio investment abroad seem stronger than it actually is. Similarly, it might be argued that the picture of foreign direct investment in the United States is distorted, if the foreign investing company does not influence the management of the enterprise that is located in the United States.

45. On the other hand, it is likely to promote greater uniformity of treatment, and be much less resource intensive, if general classification principles are followed and one avoids case-by-case investigations into the economic substance of portfolio investment and direct investment transactions. In addition, the offshore companies that are created are generally not completely lacking economic substance. Instead, a degree of "substance" may be necessary to achieve recognition as a bona fide foreign business enterprise for tax and other purposes. For these reasons, under the general classification principles that are now followed by the United States, inversion transactions qualify for treatment as new foreign direct investments in the United States, and as new U.S. portfolio investment abroad.

46. Nonetheless, we are mindful of the concerns expressed by our data users, and have research underway to study these transactions and to consider whether they should be recorded differently or identified separately in the accounts (assuming that confidentiality can be maintained).

Derivatives

47. This item is included here mainly for completeness and not because the classification of derivatives poses special problems for the United States. The Committee agreed at its 2001 meeting that financial derivatives should be excluded from direct investment and classified instead in the separate functional category (or as a reserve asset), even where the position in derivatives is between related parties that are not banks or other types of financial intermediaries. The United States concurs with this recommendation.

V. Goods and Services Transactions

48. In the U.S. statistics, a supplemental, ownership-based framework of the current account portion of the U.S. international transactions accounts is published periodically (table 1). This framework was developed in the early 1990s in response to interest in looking at international transactions in a way that would reflect the increasing role and importance of multinational companies (MNC's) in world economies and, in particular, the growing tendency of these companies to use locally established affiliates to deliver goods and services to international markets.

49. In the current account as conventionally constructed, the trade balance reflects only those goods and services that are delivered to international markets through cross-border exports and imports. The underlying gross flows are important indicators of U.S. performance in foreign markets and of foreign performance in the U.S. market; they reflect the value of goods and services transactions between persons resident in the United States and persons resident abroad. In the ownership-based framework, in contrast, a measure is introduced in which net receipts of income resulting from sales by affiliates are combined with cross-border exports and imports of goods and services. In addition, the framework provides information on ownership relationships by disaggregating trade in goods and in services into trade between affiliated parties (that is, trade within MNC's) and trade between unaffiliated parties.

50. Many of BEA's data users have praised the usefulness of the ownership-based framework, and have asked BEA to publish it more regularly and to begin featuring it more prominently. Several of them particularly appreciate seeing the added detailed data on affiliated versus unaffiliated trade in goods and services. Some have gone so far as to argue that it is a more useful depiction of how international business is conducted than the conventionally constructed set of accounts based on residency.

51. Thus, questions for the Committee to consider include (1) whether it would be useful to recommend creating a split between related-party and unrelated-party transactions for goods trade, and/or for services trade, as supplemental items in the balance of payments accounts, and (2) if so, where the borderline should be drawn.

52. Two categories of services transactions where the borderline between related-party (or affiliated) transactions, and unrelated-party (or unaffiliated) transactions, may be unclear or controversial are discussed below. It should be recognized that services transactions between related and unrelated parties often differ from one another, such as in pricing (transactions between related parties and unrelated parties may be charged at different prices), and in the types of services that are provided or billed (for example, U.S. headquarter companies may assess their foreign affiliates for a portion of their general management or overhead-type expenses, whereas this particular type of charge would not have a directly comparable counterpart in transactions among unaffiliated parties). However, in the following cases, an argument could be made that the transactions should be recorded in unaffiliated services, even where they occur between related parties. The rationale is similar to that in the cases discussed above, where certain financial positions or flows between related parties are excluded from direct investment.

A. Telecommunications Services

53. In the U.S. statistics, receipts and payments between telecommunications companies for basic telecommunications services are classified as unaffiliated services, even where the transaction is between related parties. Intrafirm trade in these services may be viewed as representing the distribution of revenues collected from unaffiliated customers among the domestic and foreign telecommunications carriers who are jointly providing the service. That is, when a customer places an overseas call, telecommunications companies in 2 or more countries cooperate to provide the service - the company in the customer's country, and a company in the country in which the call is received. The customer pays the company in its own country, and that company, in turn, forwards a portion of that payment to the foreign telecommunications company that completes the call. In the U.S. statistics, this transaction would be treated as if the person who placed the call were paying both the unaffiliated U.S. and foreign companies (which results in categorizing the transaction in unaffiliated services).

Reinsurance services between affiliated insurance companies

54. In the U.S. statistics, reinsurance services transactions are classified as unaffiliated services, even where the transaction is between related parties. Insurance companies reduce their risk by reinsuring, which involves remitting a portion of the insurance premiums that they receive from an insured party to the company with whom they have ceded reinsurance; when losses are sustained, the company that assumed the reinsurance risk must reimburse the ceding company. Under BPM5, the claims and liabilities associated with premiums and claims – as well as all other transactions associated with insurance company technical reserves - are excluded from the stock of direct investment (paragraph 379). It may therefore follow that insurance services also should be categorized outside of direct investment. This is because the payment for insurance services can be viewed as being a component of total premiums (see BPM5 paragraph 257). Thus, if the premiums are to be entirely recorded outside of direct investment, and if the payment for services is a component of premiums, then it follows that the services component of premiums should also be recorded outside of direct investment.

VI. Questions for the Committee

The views of the Committee members would be appreciated on the following questions:

Does the Committee have comments or suggestions regarding the appropriateness of the treatment in the United States statistics of the various special cases identified?

Are there additional borderline cases that the Committee wishes to discuss?

Does the Committee agree that consideration should be given to excluding all debt between affiliated depository institutions and other financial intermediaries from direct investment?

Does the Committee agree that consideration should be given to excluding from direct investment certain positions between a financial intermediary and an affiliated enterprise that is not principally engaged in financial intermediation?

Does the Committee agree that investments of 10 percent or more resulting from corporate inversions should be included in direct investment, even if the owning company does not influence the management of the affiliate?

Does the Committee agree that the presentation of related-party services trade data should be considered, as a supplemental item in the balance of payments accounts?

> If so, does the Committee agree that the some services transactions that are nominally between related parties (including telecommunications services and reinsurance services), but ultimately reflect dealings between unrelated parties, should be recorded as unaffiliated services?

Finally, does the Committee agree that the presentation of related-party goods trade data should be considered, as a supplemental item in the balance of payments accounts?

Table 1. Ownership-Based Framework of the U.S. Current Account, 1998-99
(Billions of dollars)

		1998	1999
1	**Exports of goods and services and income receipts (IT table 1, line 1)**	1,191.9	1,242.7
2	**Receipts resulting from exports of goods and services or sales by foreign Affiliates**	1,036.5	1,081.1
3	**Exports of goods and services, total**	932.7	957.4
3a	Goods, balance of payments basis (IT table 1, line 3)	670.4	684.6
3b	Services (IT table 1, line 4)	262.3	272.8
4	To unaffiliated foreigners	644.3	666.9
4a	Goods	436.5	449.0
4b	Services	207.8	217.9
5	To affiliated foreigners	288.4	290.4
5a	Goods	233.9	235.6
5b	Services	54.5	54.9
6	To foreign affiliates of U.S. companies	218.8	218.6
6a	Goods	176.3	176.0
6b	Services	42.5	42.6
7	To foreign parent groups of U.S. affiliates	69.6	71.8
7a	Goods	57.6	59.5
7b	Services	12.0	12.3
8	**Net receipts by U.S. companies of direct investment income resulting from sales by their foreign affiliates (IT table 1, line 14)**	103.8	123.7
9	Nonbank affiliates	103.1	122.1
10	Sales by foreign affiliates	2,370.0	2,587.3
11	Less: Foreign affiliates' purchases of goods and services from the United States	248.9	251.5
12	Less: Costs and profits accruing to foreign persons	1,601.4	1,761.9
13	Compensation of employees of foreign affiliates	263.6	288.5
14	Other	1,337.8	1,473.5
15	Less: Sales by foreign affiliates to other foreign affiliates of the same parent	416.6	451.9
16	Bank affiliates	0.7	1.7
17	**Other income receipts**	155.4	161.6
18	Other private receipts on U.S.-owned assets abroad (IT table 1, line 15)	149.9	156.2
19	U.S. Government receipts (IT table 1, line 16)	3.6	3.2
20	Compensation of employees (IT table 1, line 17)	1.9	2.2
21	**Imports of goods and services and income payments (IT table 1, line 18)**	1,365.0	1,518.1

Line	Item		
22	**Payments resulting from imports of goods and services or sales by U.S. affiliates**	1,137.1	1,275.9
23	**Imports of goods and services, total**	1,099.5	1,219.2
23a	Goods, balance of payments basis (IT table 1, line 20)	917.1	1,030.0
23b	Services (IT table 1, line 21)	182.4	189.2
24	From unaffiliated foreigners	710.0	797.8
24a	Goods	555.6	640.9
24b	Services	154.4	156.8
25	From affiliated foreigners	389.5	421.4
25a	Goods	361.5	389.0
25b	Services	28.0	32.4
26	From foreign affiliates of U.S. companies	168.6	177.2
26a	Goods	156.4	163.2
26b	Services	12.2	14.0
27	From foreign parent groups of U.S. affiliates	221.0	244.2
27a	Goods	205.2	225.8
27b	Services	15.8	18.3
28	**Net payments to foreign parents of direct investment income resulting from sales by their U.S. affiliates (IT table 1, line 31)**	37.6	56.7
29	Nonbank affiliates	35.0	53.7
30	Sales by U.S. affiliates	1,875.5	2,035.4
31	Less: U.S. affiliates' purchases of goods and services from abroad	307.8	325.5
32	Less: Costs and profits accruing to U.S. persons	1,532.7	1,656.2
33	Compensation of employees of U.S. affiliates	262.1	290.0
34	Other	1,270.5	1,366.3
35	Less: Sales by U.S. affiliates to other U.S. affiliates of the same parent /1/	n.a.	n.a.
36	Bank affiliates	2.6	3.0
37	**Other income payments**	227.9	242.2
38	Other private payments on foreign-owned assets in the United States (IT table 1, line 32)	129.8	139.8
39	U.S. Government payments (IT table 1, line 33)	91.1	95.1
40	Compensation of employees (IT table 1, line 34)	6.9	7.3
41	**Unilateral current transfers, net (IT table 1, line 35)**	-44.4	-48.9
	Memoranda:		
42	**Balance on goods and services (IT table 1, line 73)**	-166.8	-261.8
43	**Balance on goods, services, and net receipts from sales by affiliates (line 2 minus line 22)**	-100.6	-194.8
44	**Balance on current account (IT table 1, line 76)**	-217.5	-324.4
	Addenda:		
	Source of the content of foreign nonbank affiliates' sales: /2/		

Line	Item		
45	Output sold to nonaffiliates or added to inventory, total (line 10 minus line 15 plus the change in inventories)	1,959.2	2,168.0
46	Foreign content.	1,710.3	1,916.6
47	Value added by foreign affiliates of U.S. companies	608.5	661.4
48	Other foreign content	1,101.8	1,255.2
49	U.S. content	248.9	251.5
	Source of the content of U.S. nonbank affiliates' sales: /2/		
50	Output sold to nonaffiliates or added to inventory, total (line 30 minus line 35 plus the change in inventories)	1,887.2	2,046.3
51	U.S. content	1,579.4	1,720.9
52	Value added by U.S. affiliates of foreign companies	419.8	451.7
53	Other U.S. content	1,159.6	1,269.2
54	Foreign content	307.8	325.5

1. Conceptually, sales by U.S. affiliates to other U.S. affiliates of the same foreign parent should be subtracted, but information on these sales is unavailable. However, because U.S. affiliates are generally required to report to BEA on a fully consolidated basis, most of these sales are eliminated through consolidation, and the remaining amount is thought to be immaterial.

2. The sales exclude the affiliates' sales to other affiliates of their parent. For U.S. affiliates, data on sales to other affiliates are unavailable.

IT International transactions
n.a. Not available.
NOTE: Data in IT table 1 are from "U.S. International Transactions, First Quarter 2001" in the July 2001 Survey of Current Business.