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Recording of Direct Investment Income, Reinvested Earnings, and Dividends: The Case of Superdividends

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1. INTRODUCTION

1. The 1993 System of National Accounts (SNA 1993), 5th edition of the IMF's Balance of Payments Manual (BPM5), and the 3rd edition of the OECD's Benchmark Definition of Foreign Direct Investment (BD3) were aligned in their recommendations for the recording of FDI income. The 2008 System of National Accounts (SNA2008) and the 6th edition of the Balance of Payments and International Investment Position Manual (BPM6) both introduced the concept of superdividends. However, the 4th edition of the Benchmark Definition of FDI (BD4) did not. In addition, BD4 maintained the explicit recommendation to use the Current Operating Performance Concept (COPC) to record FDI income, while BPM6 dropped an explicit reference to the COPC but continued to recommend the elements of the COPC in the recording of the different FDI income components. The differences between the manuals introduced in 2008 have led to differences among FDI compilers in the recording of FDI income.

2. This paper begins by examining the guidance in the international manuals and the conceptual foundations for the recording of FDI income. It contrasts the recommendations of the SNA2008 and the BPM6 to identify superdividends with the recommendation in BD4 to use the COPC. It shows that the use of superdividends versus the COPC has no impact on the aggregate statistics, but it does affect the components of both FDI financial transactions and income flows. Then, it argues that the COPC better reflects the economic substance of the decisions of direct investors.

3. The third section discusses some of the practical difficulties in implementing the guidance for recording FDI income, including possible difficulties in identifying the source of dividends, and business cases that could be considered for treatment as withdrawals of equity. Then, it examines evidence on the actual patterns of intrafirm dividends observed by countries and the existing guidance for identifying when a dividend is unusually large. The fifth section offers suggestions for the way forward with steps that the WGIIS could take to further improve the recording of FDI income. The last section poses questions to the Committee.

2. CONCEPTUAL FOUNDATIONS FOR THE RECORDING OF FDI INCOME, REINVESTED EARNINGS, AND DIVIDENDS

2.1. Current operating performance concept (COPC) and superdividends

4. All of the manuals (SNA 2008, BPM6, and BD4) are aligned in their recommendation that all of the earnings of the direct investment enterprise that the direct investor has a claim on should be treated as if they are distributed to the direct investor who then makes the decision about the amount to reinvest in the direct investment enterprise. The rationale behind this treatment is that, since a direct foreign investment enterprise is, by definition, subject to control or influence, by a foreign direct investor or investors, the decision to retain some of its earnings within the enterprise must represent a conscious deliberate investment decision on the part of the

foreign direct investor(s). In practice, the great majority of direct investment enterprises are subsidiaries of foreign corporations or the unincorporated branches of foreign enterprises (i.e., quasi-corporations), which are completely controlled by their parent corporations or owners.

5. The manuals diverge in their recommendation to apply superdividends to FDI. Both the SNA2008 and BPM6 introduced superdividends and recommended their use in FDI, but BD4 did not.[1] This has led to divergence among compilers in the recording of reinvested earnings and withdrawals of equity capital. This section begins with a discussion of the guidance on superdividends and explores both the reasons for its use and the circumstances in which superdividends may occur. It then explains the guidance in BD4 for recording FDI income. Next, it focuses on the needs of analysts for statistics that reflect the economic substance of the decisions being made by direct investors and argues that the statistics under the COPC do this better than the use of superdividends.

2.1.1. Guidance on FDI income and on superdividends

6. One of the changes in BPM6 was to ensure consistency between the international and national accounts in the primary income account (BPM6, appendix 8). BPM6 and SNA 2008 both introduced the concept of superdividends. SNA 2008 discussed the time of recording of dividends and defined superdividends in paragraphs 7.130 and 7.131:

> *Although dividends represent a part of income that has been generated over a substantial period, often six or twelve months, dividends are not recorded in the SNA on a strict accrual basis. …. Although dividends are notionally paid out of the current period's operating surplus, corporations often smooth the payments of dividends, often paying out rather less than operating surplus but sometimes paying out a little more, especially when the operating surplus itself is very low. For practical reasons, no attempt is made in the SNA to align dividends payments with earnings except in one circumstance. The exception occurs when the dividends are disproportionately large relative to the recent level of dividends and earnings. In order to determine whether the dividends are disproportionately large, …. it is possible to look at the ratio of dividends to distributable income over the recent past and assess the plausibility that the current level of dividends declared is in line with past practice, accepting some degree of smoothing from year to year. If the level of dividends declared is greatly in excess of this, the excess should be treated as a financial transaction, specifically the withdrawal of owners' equity from the corporation.*

7. Therefore, superdividends were introduced to ensure that dividends, a component of primary income, in any given period would not greatly exceed the earnings in that period unless that level of dividends was in keeping with longstanding practice. SNA 2008 goes on to say in paragraph 7.132 that "this treatment applies to

[1] The Income Project Group, which was responsible for recommendations in BD4 on the recording of FDI income, did discuss the paying of large dividends out of accumulated profits but mostly in the context of the difficulties it posed for forecasting income (OECD, 2007).

all corporations, whether incorporated or quasi-corporations and whether subject to public, foreign or domestic private control." Thus, it is clear in the SNA that superdividends were to be applied to FDI.

8. BPM6 introduced superdividends in paragraph 11.27: "Exceptional payments by corporations (including quasicorporations such as branches) to their shareholders that are made out of accumulated reserves or sales of assets should not be treated as dividends. Such exceptional payments, sometimes called superdividends, are treated as withdrawals of equity." Thus, there are two situations in which a dividend could be identified as a superdividend: 1) when it represents the holding gains from the sale of an asset or 2) when it represents the payment out of accumulated reserves.

9. However, paragraph 11.46 notes that reinvested earnings can be negative when either the dividends paid in a period are in excess of the net income in that period or if the direct investment enterprise has a loss on its operations. This is somewhat of a contradiction of paragraph 11.27 and seems to indicate that not every dividend paid out of accumulated reserves should automatically be treated as a superdividend, but only those that are sufficiently large. In addition, the use of "accumulated reserves" rather than "retained earnings" may also indicate that not all payments out of accumulated past profits are to be treated automatically as superdividends. Reserves are a portion of retained earnings that are set aside for specific purposes, which can include the payment of dividends when there are not sufficient profits to cover them. SNA paragraphs 13.90 and 13.91 state: "Retained earnings are the amount of a corporation's income available for distribution in the form of dividends. This amount may be negative on occasion, representing a withdrawal from own funds. … From time to time, some of own funds may be assigned to (or withdrawn from) either general or special reserves." Again, this raises some question about when superdividends should be identified: Should only payments out of reserves be deemed superdividends or could payments out of retained earnings also be deemed superdividends?

2.1.2. COPC in BD4

10. BD4 presents a coherent and holistic approach to measuring FDI earnings that is based in the use of the Current Operating Performance Concept (COPC) and reflects the way that the data are generally collected and compiled. The COPC measures earnings from normal enterprise operations before any non-recurring items, such as write-offs, and before capital gains and losses.[2] The alternative to the COPC is the all-inclusive concept, which measures earnings after all items causing any increase or decrease in the shareholders' or investors' interest in the enterprise, including write-offs and capital gains and losses, are included but excluding dividends and any other transactions between the enterprise and its shareholders or investors.[3] BPM5

[2] The COPC as recommended in BD4 also calls for depreciation recorded on a book value or historical cost basis to be adjusted to a current replacement cost basis. Since depreciation is not relevant to the identification of superdividends, the discussion in the paper will focus only on the treatment of holding gains and losses and extraordinary items.

[3] The International Accounting Standard "Unusual and Prior Period Items and Changes in Accounting Policy" explains the two concepts.

discussed the use of the COPC in paragraph 285, but BPM6 no longer mentions the COPC because it does not discuss FDI earnings as a whole. Instead, in aligning with the SNA, it discusses seven different types of primary income, including dividends and reinvested earnings. However, the discussion of dividends and reinvested earnings captures the elements of the COPC. Paragraphs 11.44 notes the need to exclude any realised or unrealised capital gains or losses from reinvested earnings, and paragraph 11.45 states that retained earnings should be measured after any provision for the consumption of fixed capital. Paragraph 11.27 states that dividends paid out of sales of assets should be treated as withdrawals of equity.

11. BD4 paragraph 209 recommends that direct investment earnings be measured on the COPC basis so that it conforms to the concept of income in the national accounts. Under the COPC concept, holding gains and losses are not considered as operational earnings (BD4, para. 208); they are recorded as valuation changes and, then, as withdrawals of equity when distributed. Although it should be noted that BD4 is not very clear on the treatment of holding gains and losses after their exclusion from earnings.

12. Once the earnings have been measured on a COPC basis, then they are allocated between distributed earnings and reinvested earnings. In paragraph 219, BD4 makes the point that distributed earnings can be paid out of current or past earnings and may result in negative reinvested earnings if the distribution of dividends exceeds total earnings in a particular reference period. However, all of these earnings are measured on a COPC basis, so the distributions are all of past operational earnings.

13. The recommendation in BD4 to record FDI earnings according to the COPC creates a consistent, historical time series of the decisions by direct investors to reinvest earnings in their affiliates or to withdraw equity; as discussed below, these decisions are substantively different. When summed over time, the distributed earnings will actually reflect the timing of the distributions of income. Finally, it reflects the way that reinvested earnings are compiled; because reinvested earnings do not result in actual transactions, they must be imputed from data collected on surveys about total earnings and distributions. As such, it provides a complete, analytically useful, and practical framework for the recording of FDI income.

2.1.3. FDI income always reflects the operating earnings in that period

14. The reason for introducing superdividends is to more closely align dividends in a given period with the earnings in the period, unless that level of dividends is consistent with a longstanding pattern. However, FDI income always reflects the direct investor's share of the earnings of the direct investment enterprise in that period. This is because FDI income includes not just distributed earnings but also reinvested earnings.[4] When measured on a COPC basis, FDI income always reflects the operating income in the current period. This means that the most important element

[4] Some countries derive reinvested earnings in period t not as the difference between the earnings in t and the distributed earnings in t, but rather as the difference between the earnings in t-1 and the distributed earnings in t to reflect that dividends are paid out of prior earnings. In this case, FDI income will not strictly reflect the current period’s earnings, but, over time, they will be close.

for FDI in correctly measuring Gross National Income (GNI) is to measure earnings on a current operating basis—how dividends are measured has no impact.

15. One implication of this is that the use or not of superdividends will have no impact on the aggregate statistics in the primary income account, in the financial account, or in the positions. However, it will have an impact on the components. To illustrate, take the case when a firm pays dividends out of accumulated operating profits. Assume that we have a direct investment enterprise with operating earnings of 1,000 and that paid dividends of 1,200. Figure 1 shows the recording of this example with and without the recognition of superdividends; there is no impact on either the current nor the financial accounts. Following the guidance in BD4, earnings and dividends are as reported and reinvested earnings are allowed to be negative. Recognising superdividends, the dividends are limited to the earnings in the period, and there is a withdrawal of equity but no reinvested earnings. As a result, recognising superdividends lowers dividends and raises reinvested earnings in the primary income account, and, lowers equity other than reinvestment of earnings and raises the reinvestment of earnings in the financial account compared to the treatment in BD4. Therefore, the issue that superdividends was meant to address—a divergence between when the property income was recorded and when the earnings were generated—does not exist in the case of FDI.

Figure 1: Dividends paid out of accumulated reserves

Example 1: No recognition of super dividends			
Current account			
Credit		Debit	
		Dividends	1200
		Reinvested Earnings	-200
		Total earnings	1000
Current account, net			-1000
Financial account			
Net acquisition of financial assets		Net incurrence of financial liabilities	
Reduction of assets, e.g. cash	-1200	Reduction of liabilities, **reinvestment of earnings**	-200
Net acquisition of financial assets	-1200	Net incurrence of financial liabilities	-200
Financial account, net	-1000		
Example 2: Recognition of super dividends			
Current account			
Credit		Debit	
		Dividends	1000
		Reinvested Earnings	0
		Total earnings	1000
Current account, net			-1000
Financial account			
Net acquisition of financial assets		Net incurrence of financial liabilities	
Reduction of assets, e.g. cash	-1200	Reduction of liabilities, **equity**	-200
Net acquisition of financial assets	-1200	Net incurrence of financial liabilities	-200
Financial account, net	-1000		

16. The Magyar Nemzeti Bank (MNB) publishes data on superdividends that can be used to illustrate their impact on FDI income and financial flows. The MNB interprets any dividends paid out of accumulated profit reserves as superdividends (and treats them as withdrawals of equity) while any dividends paid out of current year's profits are recorded as dividends. MNB also treats any dividends paid out of extraordinary profit elements, such as the sale of assets, as superdividends. MNB modified their FDI surveys to collect information on the portion of dividends paid out of accumulated profit. As illustrated in Table 1, there is no impact on the total income or financial flows from the identification of superdividends. However, dividends are lower and reinvested earnings are higher in the income account, and equity is lower and the reinvestment of earnings is higher in the financial account when superdividends are recognised. It should be noted that while reinvestment of earnings is included in the financial account as a form of equity investment in direct investment, the guidance in the manuals that superdividends be treated as withdrawals of equity is interpreted to mean that superdividends should be included in the equity capital item rather than left as negative reinvested earnings.

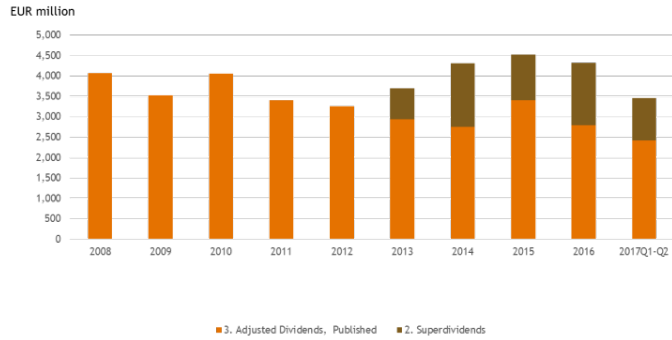
Table 1: Impact of superdividends on Hungarian FDI income and investment data

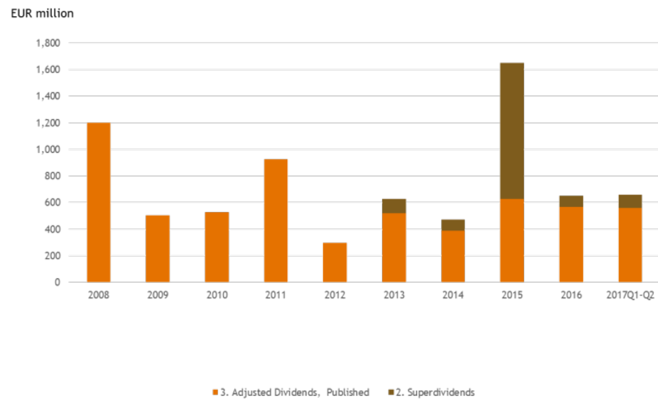
EUR million	2013	2014	2015	2016	2017 H1
Income on equity in Hungary	0	0	0	0	0
Dividends	-757	-1550	-1120	-1523	-1003
Reinvested earnings	757	1550	1120	1523	1003
Income on equity abroad	0	0	0	0	0
Dividends	-107	-83	-1024	-83	-101
Reinvested earnings	107	83	1024	83	101
FDI in Hungary	0	0	0	0	0
Equity	0	0	0	0	0
Equity other than RE	-757	-1550	-1120	-1523	-1003
Reinvestmet of earnings	757	1550	1120	1523	1003
FDI abroad	0	0	0	0	0
Equity	0	0	0	0	0
Equity other than RE	-107	-83	-1024	-83	-101
Reinvestmet of earnings	107	83	1024	83	101

Source: Presentation by Magyar Nemzeti Bank to the October 2017 meeting of the WGIIS

17. The amounts identified as superdividends in any given year can be quite significant. Figure 2 shows the amount of dividends and superdividends in Hungarian inward (top panel) and outward (bottom panel) FDI from 2008 to the first half of 2017; superdividends were only identified from 2013 on.

Figure 2: Dividends and superdividends in Hungarian FDI statistics





Source: Presentation by Magyar Nemzeti Bank to the October 2017 meeting of the WGIIS

18. As a result of the identification of superdividends in Hungarian FDI statistics, the reinvestment ratio (the share of earnings that are reinvested) is higher than it would have been without the identification of superdividends while equity capital is lower. This raises issues for the interpretation of FDI statistics by users, which will be addresses in section 2.1.5 below.

2.1.4. Cases: payments from the sales of assets and from accumulated reserves

19. As mentioned above, there are two cases where superdividends can occur: holding gains from the sales of assets or from accumulated reserves. The recommendation in BD4 to record FDI earnings according to the COPC provides consistency with the SNA and BPM6 in the treatment of holding gains and losses. As discussed above, the treatment under the COPC of holding gains and losses is equivalent to the recommended treatment according to superdividends: holding gains and losses are not considered as operational earnings, and, so, are recorded as valuation changes and then as withdrawals of equity when distributed. In addition, Annex A illustrates that the use of superdividends does not fully address the issue of holdings gains and losses when earnings are measured under the all-inclusive concept rather than the COPC.

20. There is a divergence in the recording, however, in the case of payments from accumulated reserves. As shown above, the aggregates are the same and both cases result in a reduction in equity. However, the components are different: following BD4 and the COPC, the pay out from accumulated operating profits is recorded as negative reinvested earnings while, under superdividends and BPM6, it would be treated as a withdrawal of equity capital. As discussed above, following the recommendations in BD4 leads to consistent historical time series that differentiates between a pay out of historical earnings versus a withdrawal of the historical equity capital invested in the firm. A few countries at the WGIIS expressed that in their contexts, reinvested earnings are usually invested in real assets, so any pay out from accumulated reinvested earnings would likely reflect the sale of real assets, which would be better reflected as withdrawals of equity capital. The next section examines the economic substance behind decisions to reinvest earnings and to pay dividends to shed light on which presentation provides more useful and relevant information to users.

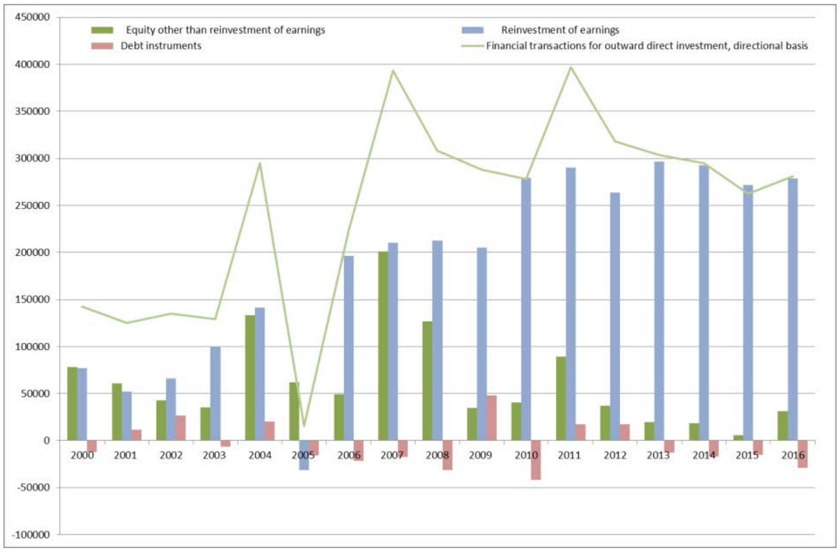
2.1.5. Economic substance of reinvested earnings

21. Given that the use of superdividends versus the COPC has no impact on the aggregate statistics but does affect the components, the decision about which to use should depend on which produces statistics that better reflect the economic substance of the transactions involved. Reinvested earnings are a form of equity investment but are recorded separately from equity capital in the financial account. This reflects the major difference between reinvested earnings and other financial account transactions: reinvested earnings originate in the host country rather than being transferred from the home country (Lundan, 2006). As a result, users of FDI statistics often distinguish between “fresh” capital as in equity capital and intercompany debt, and reinvested earnings (see, for example, Oblath, 2017). Reinvested earnings are taken as a sign of the attractiveness of the economy for expansion by existing investors while equity capital is seen as a sign of the attractiveness of the economy to new investments. If instead any dividend in excess of earnings is treated as a withdrawal of equity, reinvested earnings will appear higher over time, and equity capital will appear lower due to higher equity capital decreases. Together, this could be interpreted as a sign of increased expansion by existing investors while at the same as an indication of fewer new investments (or even greater divestments).

22. While most analysis has focused on FDI flows as a whole, there has also been analysis of the components separately. In particular, intrafirm dividends have long been studied in the context of tax policy. This research has focused on US multinational enterprises and the impact of the US tax regime on their incentives to pay intrafirm dividends due, in part, to the availability of US FDI data to outside researchers for many years (see papers by Desai, Foley, and Hines for examples). A good example of the value of recording distributions of accumulated profits as dividends rather than as withdrawals of equity was provided in 2004 when the United States passed the American Jobs Creation Act; one of the provisions was a temporary tax holiday on repatriated earnings from foreign affiliates. Figure 3 illustrates the impact on FDI financial flows during the time that the law was in effect. The US Bureau of Economic Analysis applied the COPC in measuring direct investment earnings, and, so ensured that the accumulated operating profits of the affiliates were sufficient to support the amount of dividends being paid out of the affiliates and also determined that the dividends did not include any extraordinary items. The impact of the temporary tax holiday is clear: reinvested earnings became negative as US MNEs

pulled accumulated profits out of their foreign affiliates and repatriated them to the United States. If these withdrawals of accumulated profits had been treated as superdividends instead, there would have been only a small change (or none at all) in the reinvestment behavior of US MNEs, contrary to the expectations of data users. In addition, there would have been equity capital withdrawals, which analysts may have interpreted as sell-offs rather than as companies repatriating accumulated profits. As figure 4 shows, this interpretation would have been incorrect as the distributions did not have any discernible impacts on the US MNEs' foreign operations, suggesting that the repatriated funds were held in financial rather than real assets.

Figure 3: US outward FDI financial flows by component, 2000 to 2016



Source: U.S. Bureau of Economic Analysis

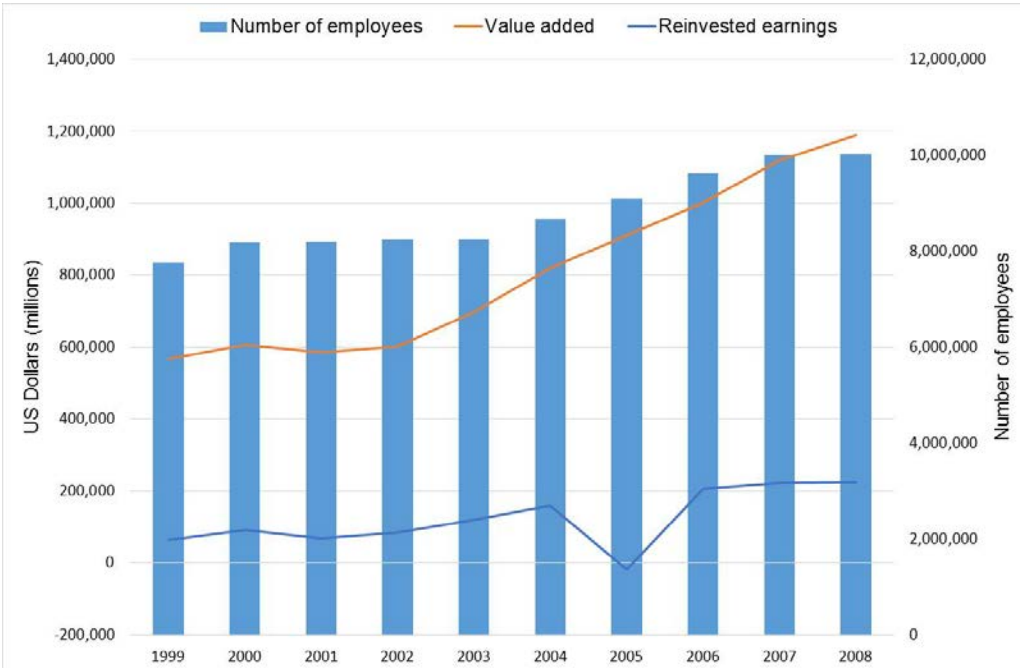
23. The US tax reform passed in 2017 led to large repatriations of earnings starting in the first quarter of 2018 which the US BEA again treated as dividends, enabling users to identify the impact of the change in tax policy on FDI.[5] The implications of the US tax reform on US MNEs investments abroad and their decisions to repatriate earnings are currently being analysed; see, for example, Chalk, Keen and Parry (2018).

24. While there is a vast literature on factors that attract FDI, recently, more attention has been paid to the determinants of the separate components of FDI flows. Research on the determinants of reinvested earnings has looked at the factors that determine the decision of the MNE to reinvest earnings in its affiliates (Polat, 2017). While many of the determinants are similar to the decision to invest in the first place, some factors are different, such as agency considerations. As Lundan (2006) explained, high dividends may be a way for the direct investor to control the affiliate. Parents would choose to repatriate more earnings (and, thus, reinvest less) in affiliates that presented a greater agency risk to the parent. Other factors, such as exchange

[5] See http://www.oecd.org/investment/investment-policy/FDI-in-Figures-July-2018.pdf for details.

rates, impact reinvestment of earnings differently than the decision to invest. As Polat notes, the literature on FDI yields mixed evidence on the impact of exchange rate movements on FDI inflows. However, one can assert a negative relationship between exchange rate appreciation and reinvested earnings given that the latter represents an opportunity cost of keeping funds in a host country.

Figure 4: Activities of US MNEs abroad and FDI reinvested earnings, 1999-2008



Source: OECD AMNE Statistics database Outward Activity of multinationals in *ISIC3* for 1999-2007 and in *ISIC4* for 2008) and US Bureau of Economic Analysis

25. Another area of interest is the divestment decisions by MNEs, especially as there is more focus by policymakers on not just attracting new investments but on retaining existing investments; these would be recorded as equity capital decreases. UNCTAD (2013) discussed strategic divestments by MNEs and the impact they can have on FDI and called for more research on the topic. In a forthcoming report, the OECD found that the policy drivers of divestment can differ from those driving the original investment decision. For example, tax policy has been found to be significant in the location choices of MNEs, but was not found to be a significant driver of divestment decisions.

26. Finally, there has also been research into the different implications of reinvested earnings versus equity capital (or “fresh” capital) on financial stability analysis. Hansen and Wagner (2015) found that reinvested earnings often behaved differently from “fresh” capital; for example, reinvested earnings rather than “fresh” capital drove the pro-cyclical behaviour of FDI as a whole. They also note that if reinvested earnings are held in liquid assets they can more easily be repatriated than equity flows or reinvested earnings in fixed assets. As such, a large amount of reinvested earnings in liquid assets could contribute to the risk of a bunching of capital outflows for the host economy.

27. This increased focus on understanding what drives the different components of FDI and their implications for financial stability as well as on understanding the divestment decisions of MNEs separate from their investment decisions underlines the need for data that tracks these decisions separately to as great an extent as possible. The recording of FDI income under the COPC arguably does this better than the use of superdividends.

3. PRACTICAL ISSUES IN IMPLEMENTATION AND ADDITIONAL BUSINESS CASES TO CONSIDER

28. While the recording of FDI income under the COPC either addresses the issues meant to be addressed by superdividends or provides more meaningful data for users of FDI statistics, there may be certain situations where an extraordinarily large dividends should be treated as a withdrawal of equity rather than as a distribution of earnings. This occurs either due to practical issues with the implementation of the COPC or to special business cases. If this is the case, it might be useful to develop guidance for countries to identify and treat very large dividends as withdrawals of equity.

3.1. Practical issues in the implementation of the guidance

29. First, it can be difficult to identify holding gains and losses. To do so requires collecting additional information from companies on realised and unrealised gains and losses and extraordinary items. The ease of identifying these items in company accounts varies depending on the accounting standards used by the company. In addition, for the finance and insurance sector, the identification of holding gains and losses can be particularly problematic because some holding gains and losses are treated as part of operating income.

30. Second, it can be difficult to identify the source of earnings that are distributed. There was disagreement among WGIIS delegates on this point; while some successfully collect data on the sources of dividends, others reported that companies could not identify the source of the earnings paid as dividends. Specifically, it may not be possible for a company to report whether an unusually large dividend is paid out of accumulated past operating profits or if it is from the proceeds of the sale of an asset. Since the application of the COPC and superdividends both require that the earnings distributed omit holding gains and losses, this is a problem for the recording of FDI income no matter which guidance is followed.

31. Third, there were also issues raised with the identification of the source of the dividends when they are passed along an ownership chain. It may be difficult for a holding company to identify the source of dividends it receives from entities down the ownership chain.

3.2. Business cases potentially to be treated as withdrawals of equity

32. WGIIS delegates identified a couple of cases where distributions of accumulated earnings should possibly be treated as withdrawals of equity. The first was what might be thought of as a partial liquidation of an affiliate. The liquidating dividends associated with the termination of a company are treated as a withdrawal of equity rather than as dividends because they are viewed as a return of equity (BD4,

para. 219). However, companies can make significant changes to the operations of an affiliate, including scaling back their operations considerably, while not completely liquidating the affiliate. A dividend paid out as part of this scaling back should perhaps also be seen as a return of equity. This treatment is in line with the interpretation of equity capital withdrawals as a reduction in the investment links between countries.

33. A second situation was the case where a parent has just acquired an affiliate and then pays out a large dividend. It could be argued that this should best be interpreted as a withdrawal of equity rather than a return of income to the new parent. A third situation was that of a greenfield investment. A newly established affiliate may not pay out dividends until it is well-established at which time it may begin to pay out dividends, which could reflect some historical earnings.

34. In conclusion, countries that can determine the source of earnings used to pay the dividends or ensure that the affiliate has adequate accumulated operating profits to support the dividends being paid can treat dividends in excess of earnings from the current period as dividends and not as withdrawals of equity. However, this may not be possible for all countries, so it might be useful for FDI compilers to treat some especially large dividends as withdrawals of equity. Guidance needs to be developed to do this.

4. Guidance on determining if dividends are unusually large

35. In cases where the compiler cannot be sure whether an unusually large dividend represents the proceeds from the sale of an asset or in the business cases discussed above, the guidance on identifying if such a dividend is unusually large will have to account for the actual patterns observed for intrafirm dividends. The section will begin by reviewing some evidence on the actual pattern of intrafirm dividends observed by countries, which has implications for the identification of unusually large dividends, and then discusses the guidance that has been developed (SNA2008, BPM6, ESA2010, and an ECB memo).

4.1. Patterns of intrafirm payments of dividends

36. To determine what guidance might help in identifying superdividends in direct investment, the WGIIS asked for more information on the actual pattern of payments of intrafirm dividends. Four countries provided this information: Brazil, Switzerland, Poland, and the United States. In all of these countries, only a small share of affiliates paid regular dividends to their parents. Brazil examined data for years 2010 to 2016 and found that 80% of Brazilian enterprises recipient of FDI never pay dividends, 6% pay regular dividends (which corresponded to 30% of total dividends), and the remaining 14% of enterprises paid dividends on an irregular basis. Switzerland looked at years 2012 to 2016 and found that roughly 10% of affiliates never paid dividends to their parents; of the 90% that do pay dividends, the vast majority (greater than 80%) do not follow any pattern in their dividends. Only 5-6% paid dividends on a quarterly basis, and only 2-3% showed a regular seasonal pattern. Poland examined data for 2011 to 2015 and found that, for assets, only 31% of direct investment enterprises paid dividends; 3% paid regularly, 9% represented a change in dividend policy, and 19% paid occasionally. For liabilities, 40% of direct investment enterprises paid dividends; 5% paid regularly, 14% represented a change in dividend policy, and 10% paid

occasionally. The United States indicated that only 3% of foreign affiliates of US parent companies paid regular, seasonal dividends; 10% paid dividends for special events and 24% paid dividends on an irregular basis while the remaining 64% never paid dividends between 2004 and 2012.

37. This irregular pattern of intrafirm dividend payments does not square with the logic underlying the concept of superdividends, which assumes that companies prefer to make regular, smoothed dividend payments to their shareholders, and has implications for the identification of superdividends. If these patterns hold more broadly, it suggests that comparing to the pattern of dividends is not a feasible way to identify superdividends within direct investment. Even comparing to a full year of earnings may lead to a significant share of dividends being deemed superdividends given that the majority of direct investment enterprises paying dividends appear to do so on such an irregular basis. Rather than being a relatively rare occurrence superdividends would be quite common.

4.2. Guidance on identifying superdividends

38. The SNA 2008, BPM6, and ESA2010 provide guidance on determining when dividends are superdividends. As discussed above, SNA 2008 recommends comparing the ratio of dividends to distributable income over the recent past and assess the plausibility that the current level of dividends declared is in line with past practice. If the level of dividends declared is greatly in excess of this, the excess would be identified as a superdividend.

39. BPM6 also offers guidance on the identification of superdividends in paragraph 11.27: "The exceptional nature of the payments is normally determined as being disproportionately large relative to the recent levels of dividends and earnings. If the level of dividends is greatly in excess of previous dividends and trends in earnings, the excess should be excluded from dividends and shown as withdrawal of equity."

40. Paragraph 20.206 of ESA states: "Large and irregular payments or payments that exceed the entrepreneurial income of the year are called super-dividends. They are funded from accumulated reserves or sale of assets, and are recorded as withdrawal of equity equal to the difference between the payment and the entrepreneurial income of the relevant accounting period. In the absence of a measure of entrepreneurial income, the operating profit in business accounts is used as a proxy." This guidance implies that any payment of a dividend in excess of the entrepreneurial income in a year is a superdividend, and, so, the only way that reinvested earnings in direct investment would be negative is if there were operating losses. This seems to go further than the SNA and BPM6, which did allow for negative reinvested earnings as part of the smoothing of dividends.

41. Given the actual pattern of intrafirm dividends observed by countries, it is difficult to make a meaningful comparison to recent patterns of dividends for many affiliates as called for in the methods above because they do not pay regular dividends. This could result in a significant share of dividends being labelled as superdividends, as shown for Hungarian FDI income payments in figure 3. In addition, this guidance is not useful in the case of a new affiliate, which will not have a history of dividends to compare to.

42. The ECB developed a method to help ensure consistency across countries in the identification of superdividends. The ECB guidance noted that superdividends should be regarded as extraordinary events, and so, evidence should be sought before identifying a dividend as a superdividend to avoid misinterpreting normal dividends as superdividends. A step-by-step approach in which only dividends above a certain threshold were examined to determine if they were superdividends was developed. Any potential superdividends identified are then compared to average earnings over the past 5 years to determine if they are excessive. While no specific criterion for determining if the dividend was excessive was given, an amount double of average earnings was suggested. If this test was met, then the company should be contacted to determine if the dividend payment was extraordinary. This method is being used in several countries and is in line with the conclusion above that superdividends should only be identified if a dividend is extraordinarily large and the compiler cannot determine the origin of the earnings being distributed. However, it does have a drawback: it cannot be used on new affiliates.

43. As such, the WGIIS could explore other possibilities. One possibility is to use a step-by-step approach as developed by the ECB in which only dividends above a certain threshold are considered to be potential superdividends, but, then, the dividends could be compared to the equity in the affiliate in the prior period to determine if the dividend exceeds some threshold dividend to equity ratio. This would have the advantage of being possible to do for new affiliates or those for which recent earnings information has not yet been collected. It also seems to be more closely related to determining if the dividend should actually be considered as a withdrawal of equity by considering whether the dividend represents a substantial portion of the equity in the affiliate.

44. There are two other possibilities that the WGIIS could explore. First, the methods used by Hungary (as discussed above) and Poland (Narodowy Bank Polski, 2015) to identify superdividends provide a clear-cut method to identify superdividends. Poland also asks reporters to split dividends between those from the operational earnings in the current period and both accumulated profits and exceptional income due to the sale of assets. This increases the burden on reporters and requires the compilers to verify the information provided. However, it can be used on affiliates with a short history and can identify changes to dividend policies. However, as argued above, it would substantially change the statistics on reinvested earnings and equity capital and may provide less information to users on the decisions of direct investors. A second method is for the compiler to compare large dividends to the accumulated operational earnings of the affiliate and, if they are sufficient to support the dividend, to treat it as a regular dividend; if they are not sufficient, then the company would be contacted. This would place no additional reporting burden on the companies but would require the compiler to keep track of the historical reinvested earnings of the affiliate.

5. WAY FORWARD

45. The differences in the manuals in regards to superdividends has led to differences in the compilation of FDI statistics across countries. This paper looks at the conceptual foundations for recording FDI income, dividends and reinvested earnings and argues that the COPC provides a coherent and holistic approach to recording FDI income that also reflects the economic substance of the transactions.

The paper also explored some practical issues in measuring FDI income and concluded that additional compilation guidance would be helpful. Given the greater emphasis being placed on FDI income in understanding globalisation, this exercise will provide timely help to countries and enhance cross-country comparability. To further this, the WGIIS could:

- *Gather examples from countries of their practices in compiling FDI income statistics. These could be on identifying holding gains and losses in earnings, the treatment of depreciation under the COPC, and the identification and treatment of unusually large dividends.*
- *On the basis of the different practices identified, draw a typology of methods applied and elaborate a recommendation regarding the recording of FDI income on the COPC basis to avoid inconsistencies in the interpretation and the implementation in the statistics. Another recommendation should be formulated regarding the special cases mentioned above (e.g., partial liquidations).*
- *Elaborate on how the COPC is applied to finance and insurance companies. Many of the elements that the COPC calls for excluding from earnings are a part of operating income under financial accounting standards for these companies, which can make it difficult to apply the COPC. This could include gathering examples of how countries have applied the COPC to finance and insurance companies and how they communicated on COPC earnings in these sectors to users.*
- *Elaborate on the uses of FDI income to the analysis of globalisation, such as its use in the extension Trade in Value Added (TiVA) to primary income flows, and identify any implications for the recording.*
- *While there are not asymmetries in the aggregate statistics due to differences in implementation across countries, the implications of asymmetries in the components could be explored.*

Questions for the Committee:

1. *Do Committee members agree with the conclusion in the paper that the COPC provides a coherent and holistic approach to recording FDI income that also reflects the economic substance of the transactions?*
2. *Are Committee members aware of any other cases for treating very large dividends as withdrawals of equity capital?*
3. *Do Committee members agree that the concluding step would be to publish a clarification note on identifying and recording superdividends in external sector statistics?*

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Annex A. Income, reinvested earnings, and dividends under the COPC and all-inclusive concepts

46. This annex examines the recording of FDI income, dividends, and reinvested earnings under the COPC and the all-inclusive concept. The example considers the operations of a firm for 2 years. In the first year, the firm has current operating profits of 800 and also realises a capital gain of 700; they pay out a dividends of 600, 400 of which is from the current operating profits and 200 of which is from the capital gain. In the second year, they earn a current operating profit of 250 and have no capital gain; they again pay out a dividend of 600, 250 of which is from the current operating profits, 150 of which is from operating profit reserves, and 200 of which is from the capital gains earned from the year before. There are no equity capital transactions (either capital contributions or withdrawals) in either year. Table 1 contains the particulars of the example.

Table 1: Information for the example

	Year 1	Year 2
Current profits	800	250
Realised capital gains	700	0
Total income	1500	250
Dividends	600	600
Of which:		
From current profits	400	250
From profits reserves		150
From capital gains	200	200
Reinvested earnings	900	-350
Equity capital	0	0

47. Table 2 provides the recording of these under the three assumptions on recording. In case 1, the earnings and dividends are recorded according to the all-inclusive concept. In case 2, earnings are recorded according to the COPC but dividends are on an all-inclusive basis. In case 3, both earnings and dividends are under the COPC. Superdividends are identified in cases 1 and 2 and are equal to the capital gains plus the reduction in reserves in year 2; this assumes that the dividend of 600 in year 2 was deemed unusually high compared to history for this affiliate, perhaps because of the presence of the holding gain. For case 3, no superdividends are identified, but the proceeds from the sale of the asset are treated as equity capital withdrawals.

48. The first thing to note is that even with the identification of superdividends in case 1, reinvested earnings are still overstated because some of the holding gain is reflected in the reinvestment of earnings. This underlines the importance of the guidance in BPM6 that FDI reinvested earnings should exclude holding gains and

losses so that it is important for compilers not to just identify dividends being paid from the proceeds of sales of assets but to also identify all holding gains and losses in earnings. Under the COPC, all holding gains and losses are excluded from earnings, so reinvested earnings in cases 2 and 3 do not include any holding gains. It should also be noted in this case that it is unlikely that the superdividend would be identified with earnings on an all-inclusive basis.

49. In cases 2 and 3, the recording is the same in the first year as both record the same dividend out of operating profits and both treat the dividend paid from the proceeds of the same as a withdrawal of equity. They differ in the second year as the withdrawal from accumulated profits is treated as a superdividend and recorded as a withdrawal of equity capital in case 2 but is treated as a regular dividend and recorded as negative reinvested earnings in case 3. This shows that as long as earnings are recorded according to the COPC, then it does not matter if dividends paid out of the proceeds from the sale of an asset are treated as superdividends or the COPC is applied, the resulting recording will be the same. There is a difference, however, in year 2 due to the differing treatment of dividends paid from accumulated operating profits.

Table 2: Example of recording under the COPC and all-inclusive concept and different treatments of superdividends

	Case 1: All-inclusive dividends and earnings		Case 2: All-inclusive dividends and COPC earnings		Case 3: COPC earnings and dividends	
	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2
FDI earnings	1500	250	800	250	800	250
Dividends	400	250	400	250	400	400
Reinvested earnings	1100	0	400	0	400	-150
Identification of superdividends						
Financial transactions	900	-350	200	-350	200	-350
Equity capital	-200	-350	-200	-350	-200	-200
Reinvestment of earnings	1100	0	400	0	400	-150