

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

ISSUES PAPER #21C

**VARIOUS SPECIAL CASES, INCLUDING NATURAL RECOURSE
EXPLORATION AND CONSTRUCTION**

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Various Special Cases, including Natural Recourse Exploration and Construction

Current international standards for treatment of special cases

- Determination of the borderline between FDI and services regarding construction and natural resource exploration carried out abroad by unincorporated site offices of resident enterprises is similar in BOP manuals and OECD Benchmark Definition of FDI (BD3), (see BPM5, paras.73, 78, 383; BPT, paras. 120-123, 545-549; BPCG, paras. 452-454, 712-717); BD3, paras. 58-60).

- The manuals agree that the key problem lies in determination of residence of these units and that a guideline of one year should be applied flexibly. The manuals cite the criteria for identification of branches and give examples of site offices and other special cases.

- The BOPTEG Outcome Paper5# and the DITEG Outcome Paper10# on the criteria for identifying branches consider these criteria as indicative and therefore the decision is left at compilers' discretion. Not all the criteria should be met. However, the criterion of having a separate income statement and balance sheet is considered to be the strongest factor, and would usually be decisive. An alternative of development of a fixed set of requirements was rejected.

- The issue under review is avoided by other internationally recognized systems. Thus, GATS approach to services classification described in Manual on Statistics of International Trade in Services (MSITS, paras. 2.86-2.88, 3.5 -3.7, chapter 4) distinguishes four modes of supply of services transactions between residents and non-residents depending on territorial presence of transactors (consumer and supplier) at the time the service is supplied. Mode 3 is applicable when the supplier (an enterprise) moves to the territory of the consumer and the so-called "commercial presence" is set up. Under GATS, a commercial presence may represent any type of establishment owned or controlled by foreign entities, including those created for a short period as well as foreign affiliates. Consequently, for commercial presence GATS makes no distinction between resident-nonresident transactions in services and domestic sales of services by foreign affiliates (i.e., transactions between residents), and all transactions are attributed to services. The GATS approach indirectly indicates practical limitation of different classification in special cases.

Concerns/shortcomings of the current treatment

- Theoretically the border between services and FDI is blurred, but in practice a problem of proper classification still arises. The uncertainty in the field troubles compilers in many countries (Banco de Espana. The Spanish Balance of Payments for 2000, p.23). Evidently, the solution in each country is conventional.

- Compilers in different countries in their practical work can give preference to different criteria thereby exaggerating one of the items (services or FDI) at the cost of reducing the other. It looks like this is the case at present. Data collection system

applied by a country also has an impact on the proportion between services and FDI: under ITRS, services (both entries – credits and debits) are probably more significant than they should be. To a great extent the solution depends upon information available. But, according to domestic law, these entities at their legal status may be non-residents, which have no obligation to provide statistical data on their activities and opportunities for surveying them directly, are limited. At the same time, in ITRS the site offices are mostly treated as non-residents and thorough unit-by-unit reclassification should be made manually to avoid overestimation of services.

- As long as strict distinction is not made the symmetrical recording can be hardly reached. This can lead at least within the countries' unions to establishment of more strict differentiation principles.

- The description of BOP entries concerning both types of construction activities in the above-mentioned manuals seems sufficient. Though in practice some uncovered important cases may arise.

- The case of Natural resource exploration is explained very shortly: only the first and the last stages – fixed capital formation and enterprise shutdown - are mentioned, the rest are similar to construction site offices. On the other hand, the recording of expenditures on establishment and shutdown of a mining enterprise (BPM5, para.383) refers to construction projects as well. Specific features of contracts between the investors and the government (e.g. concessions, production sharing agreements) are worth describing.

- Annotated Outline, para.4.23 is going to add very useful comments on recording of initial expenses (mining licenses and legal fees). Bonuses paid by production sharing agreements could be added.

Possible alternative treatment

- Following the Outcome Papers' recommendations, in determining FDI relationship in special cases the reference to the one year rule can be changed for maintaining of a separate income statement and balance sheet.

- It could be noted that the problem arises, when branches have a legal status of non-residents or are not registered as legal persons in the host economy. Other branches having a resident status and enterprises with less than 100 percent ownership are considered DI enterprises. When a construction firm or mining enterprise carries out a project abroad on its own it is also treated as a DI enterprise.

- Starting a local construction or mining project normally requires allocation of large volumes of funds, many contracts with subcontractors should be drawn up, large number of workers should be hired, etc. Consequently, short-term presence in these industries is likely to be unremunerative, and though a site office takes different forms, it usually meets most of the indicative criteria of branches. Taking into account the specific features of construction and mining industries, a recommendation could be worked out that in cases of doubt these site offices should be attributed to DI enterprises.

- Last but not least. The appropriate information on the scope of services and FDI in the country should be included in metadata.

Questions/points for discussion

- 1. Do the DITEG members admit that under the circumstances when the definitions are flexible the classification between services and FDI applied in practice is conventional in each case?*
- 2. Do the DITEG members find it useful to provide an unambiguous recommendation for classification of all borderline cases?*
- 3. If yes, should preference be given to FDI rather than to services supply?*

Supplementary information: examples

- **Major projects.** Russia's experience shows that there can be a different treatment even in the case of long-term major projects. A site office of an enterprise involved in long-term pipeline construction abroad does not receive project financing on its account directly, it gets it through its parent, that redistributes the centralized resources. Therefore, the parent compensates the construction costs to the office from the revenue, and the other part of the revenue equal to profit is retained by the parent. The site office maintains its balance sheet and does not have any income statement. It does not pay income taxes in the host country as well (probably, only because of double taxation avoidance). In this case, the parent inspects the local office and it depends on the parent strongly.

- **«Regenerative» enterprises.** The schemes of a longstanding use of advantages of double taxation avoidance, which are common practice, are related to the issue under consideration. A foreign construction/mining firm creates a local office (which can be very large), that undertakes a short-term project (say, 11 months) and maintains a full set of accounts. In 11 months this office is closed, the parent signs a new contract, and a new office is registered (in the same premises), and it continues operations for another 11 months. In this case the data collection system (the same as tax authorities) can't identify the new office with the old one, as their registration numbers are different. Under the circumstances to give a proper judgement seems problematic.

- **Production sharing agreements (PSAs).** PSAs are arrangements between governments (acting on behalf of the state as the owner of the mineral resources) and investors which govern exploration and production rights. These contracts are intended to provide a predictable legal and tax regime and are internationally recognized in law. The most recent PSA model applied worldwide is the so-called "Russian" model. It is characterized by four "levels": (i) the investor pays royalties to the state; (ii) the investor receives "cost production" to cover expenses; (iii) after that "profit production" starts, that is split between the state and the investor on the basis of a negotiated formula which takes into account the characteristics of the project (usually a sliding scale is included to deal with the impact of changes in the world price of the commodity); (iv) the investor pays a profit tax on his portion of profit production.

According to the law, PSAs are not registered as legal entities in the host country, use special accounting principals, and have limited reporting obligations. As PSAs meet all statistical criteria for branches, they are treated unambiguously as residents for BOP purposes. The problems arise in (i) data collection as the reporting entities treat them as non-residents; (ii) determining the BOP item for attribution of their transactions; (iii) determining the magnitude of each transaction in accordance with BOP methodology as PSAs apply special principals of accounting.

	Accounting rules	Recording in the BOP
Payment of royalties, rentals, bonuses	Investment in equity capital	Investment in equity capital
Other expenses	Investment in equity capital	Investment in equity capital
Revenue from commodity exports not exceeding investment in equity capital	Disinvestment of equity capital	Disinvestment of equity capital + Distributed branch profit on gross basis (current transfers in the form of accrued but delayed profit tax balanced by increase of other assets/liabilities to receive/repay this tax are recorded at the same reporting period)*
Investor's share in revenue from commodity exports exceeding investment in equity capital	Profit + profit tax	Disinvestment of equity capital + Distributed branch profit (current transfers in the form of accrued profit tax + decrease of other assets/liabilities to receive/repay tax accrued in earlier periods are recorded at the same reporting period)*

*- the split is made via a model

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