Does pass-thru funds require their own functional category?

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Abstract

The paper is focused on whether a new functional category in the balance of payments and international investment position statistics is needed. As stated in the BPM6, the functional categories are designed to facilitate analysis by distinguishing categories that exhibit different economic motivations and patterns of behaviour. It is our opinion that a significant portion of cross-border economic flows is motivated by tax purposes. The new category will cover flows (and related stock of financial assets and liabilities) connected with tax optimisation. Recent works by G20 and OECD related with Base Erosion and Profit Shifting as well as latest publications in various media prove the user-driven need for such information.
Definition we propose in the paper allows to distinguish some tax optimisation flows from other types of bop data. On this basis we use data for Poland as an example of such presentation. Pros and cons of introduction new functional category are also presented. The paper ends with some issues to be solved before implementation.

Keywords: balance of payments; tax avoidance; BEPS.

1. Introduction

In analysis of balance of payments (b.o.p.) and international investment position (i.i.p.) data users often have to be supported with additional information concerning b.o.p. data, due to the fact, that in some cases financial flows do not behave according to expectations. The most common example relates to foreign direct investment (FDI), but we have also experienced such issues with other functional categories.

Foreign direct investment (FDI)—whether mergers and acquisitions or "greenfield" ventures built from the ground up—is generally thought of as reflecting brick and mortar decisions, i.e., decisions based on long-run factors. Conventional wisdom on capital flows holds that FDI inflows are "good flows," while assessments of portfolio and other flows are more ambiguous. When considering restrictions on capital flows, the first reaction of researchers and policymakers is to want to exclude FDI inflows.

In looking, however, at measured FDI flows to emerging markets (in the course of a larger project on capital flows), we have found three facts that suggest that measured FDI is actually quite different from the depiction of FDI above. (Blanchard 2016, p. 1).

A lot of measured FDI reflects flows through rather than to the country and the suggested corrections—from separate treatment of SPEs, to measures of capital in transit, to the use of directional flows measures—reduce but do not eliminate the problem. (Blanchard 2016, p. 2).

Introduction of new manuals resulted in two separate presentations of foreign direct investment. Difference between presentation of assets/liabilities in the b.o.p./i.i.p. and directional principle in FDI statistics caused difficulties in understanding the figures.

2. Functional categories in the balance of payments

Five functional categories of investment are designed to facilitate analysis by distinguishing categories that exhibit different economic motivations and patterns of behavior. Balance of Payments and International Investment Position Manual 6th ed. (IMF, 2009 – BPM6) reads: *Direct investment is*

related to control or a significant degree of influence, and tends to be associated with a lasting relationship. As well as funds, direct investors may supply additional contributions such as know-how, technology, management, and marketing. […] *In contrast to direct investors, portfolio investors typically have less of a role in the decision making of the enterprise with potentially important implications for future flows and for the volatility of the price and volume of positions. Portfolio investment differs from other investment in that it provides a direct way to access financial markets, and thus it can provide liquidity and flexibility.* […] *Reserve assets are shown separately because they serve a different function and thus are managed in different ways from other assets. Reserve assets include a range of instruments that are shown under other categories when not owned by monetary authorities.* Tax optimalisation flows do not feed into any of these functional categories.
The characteristics of pass-through flows are different from other types of flows. They are concentrated on (i) use of different legal frameworks to achieve maximum profit from transaction or group structure. Moreover those flows often react very quickly to the change of the legal environment. An example of such situation has been observed in Poland at the end of 2016. In late November new draft law concerning taxation of investment funds had been proposed in Parliament. After one month the bill has been approved by required legal authorities and it came into force with the beginning of the new year. The reaction of the businesses was immediate. Throughout December 2016 PLN 23bn (approx. EUR 6 bn) has been moved from investment funds. It shows that behavior and motivation of such entities is completely different from motivation of either FDI (long term relation, new jobs and technology, access to new markets), or portfolio investment (interest rate, view on economy) flows.
Currently, as stated in BPM6, *Compilers in economies that have large values of pass-through funds should consider the compilation of supplementary data on funds in transit, based on national definitions.* This approach can be applied in the case of pass-through flows in the FDI. Due to the fact that pass-through funds can also be observed in other types of flows the proposal to create a new functional category has been formulated. Additional motivation is related to the will to show explicitly the size of funds moved from one economy to another due to tax purposes, as well as the stock of this type of investment.
Among statisticians all over the world there is a long lasting discussion about SPE and its' identification. This discussion is aimed at "cleaning" FDI data in order to provide the user with more meaningful information about FDI as currently presented data are inflated by "artificial" transitions. We propose not only cleaning FDI figures but also providing separate information about such flows.

3. How to pass funds via economy

From the historical perspective the flows between countries were usually bilateral. When one country invested in another it was because they wanted to gain access to that specific market and not to invest elsewhere. The balance of payments statistics replicated this type of thinking by designing functional categories described in the previous section. As described in (BEPS) documents (OECD, 2017) the tax avoidance strategies exploit gaps and mismatches in tax rules between countries and artificially shift profits to low or no-tax locations. That means that some funds have to be transferred between countries.
There are plenty of different structures in use. Sometimes tailored directly to the specific jurisdictions. Here we would like to name a few types that we observe in our data collection and compilation process. First, starting with entities designed specifically for the purpose, we have special purpose entities (SPE) which could pass funds in form of equity, debt or intellectual property or mixture of them. Second is a single element group consisting of regulated investment funds. The third group, usually most difficult to distinguish from regular flows consists of operating multinational companies, which could either engage in some of the activities typical to SPE or are transferring funds in regular operational activities.
The holding companies owned by non-residents and investing in another companies abroad, named as special purpose entities (SPE), are one of the first exercises to distinguish regular financial flows from tax optimisation. There is no unified definition of SPEs (ECB-Eurostat-OECD, 2013), but there are

some features that distinguish this type of company from others foreign assets and liabilities and limited number or lack of employees being among the most important (OECD, 2008 - BMD4). In some countries there are separate registers for this type companies e.g. the Netherlands. These companies are the backbone of the tax optimisation schemas. They usually make use of the double taxation treaties between the countries. There are direct investment positions on the side of asset as well as liabilities.

Another type of entity specialised in channelling of capital is a company that has a small equity investment from abroad, with the remainder of the balance sheet filled with liabilities to holders of debt instruments issued by the company, and the assets in form of a loan given to the owner. This type of company is used to gain access to capital markets and make use of differences in the taxation of capital gains. These type of companies have direct investment on the assets side and substantial portfolio investment and small direct investment equity stake on the liabilities side.

Intellectual property is another form of capital transfer between companies. These companies are usually registered in countries where the income on royalties and licenses for usage of intellectual property is exempt from taxation. Such companies have the intellectual property on the assets side and the equity on the opposite side. In international investment position only the equity direct investment is visible, while in balance of payments the flows in services for usage of the intellectual property are supplemented with income flows to the direct investor.

Investment funds are usually used as collective investment vehicles. In some jurisdictions the same infrastructure could be used to benefit a small or even single investor. The role assumed by an investment fund is actually the same as the role of SPE. In statistical manuals (BPM6, BMD4) there is a recommendation that any investment exceeding 10% of the voting rights in collective investment vehicle should be treated as direct investment. There are also some operational considerations, which resulted in the scope of EU that these investments are treated as portfolio investment. Exact functional category classification notwithstanding there are some investment funds, which only have foreign assets and liabilities.

International consultations on the treatment and taxation of the companies which optimise passive income, i.e. special purpose entities with income from equity, debt instruments and intellectual property, resulted in the regulation of controlled foreign corporations based on the recommendations of OECD (2015). Large multinationals with extensive network of foreign operational subsidiaries could replicate some of the tax optimisation structures with regular companies which could supplement their normal activity with channelling funds on behalf of the owners. The balance sheet of these companies is therefore a straightforward combination of balance sheet of an existing operational company and a SPE.

The last form of capital transfers, we would like to mention here, is the regular operations of the MNEs. Large MNEs with many production facilities and sales representatives are usually holding substantial intra-group assets and liabilities in different forms. They usually comprise of some sort of cash-pooling instruments, unsettled trade credits and other debt instruments resulting from usage of financing with conduits.

In the past, there have been attempts to identify different flows mentioned above. The SPEs are currently identified separately in the direct investment flows in the rising number of countries. On the other hand there are also certain attempts to assess the scope of pass-thru funds on the general basis.

4. Pass-thru funds in Poland

From the perspective of a single country the abovementioned types of capital transfers may be present both inside the country in case when the country is used for channelling funds or outside the country, when entities in other jurisdictions are used to pass funds into the country. In practice, there is a mixture of both. As the tax law is evolving around the globe, also the structures in use are changing.

Since Poland joined OECD and European Union and liberalised the flows of capital, entities established in Poland are used in international tax optimisation. In our data we observed activities of SPEs, investment funds, and capital in transit via regular operational companies. Companies established in Poland make use of foreign companies holding intellectual property or raising debt on foreign capital markets, but these two types of channelling companies are not usually present in Poland.

The SPEs have been separately identified in direct investment since 2004. The highest flows and positions where reported just before and after the financial crisis that broke out in 2008-2009. In 2007 more than 30% of the direct investment abroad was made by SPEs. Currently, after changes in the tax law abroad the number of SPEs decreased substantially, with only a few active in recent years. Flows of pass-thru funds that could be attributed to SPEs are simply the transactions in foreign assets and liabilities of these companies.

The use of investment funds for pass-thru funds is not very popular. Although of significant value there were only a few transactions in recent years.. The changes in tax treatment of closed-end investment funds may additionally limit their use.

Capital in transit via the operational companies is not very common as well but due to values it could be recorded separately in the data.

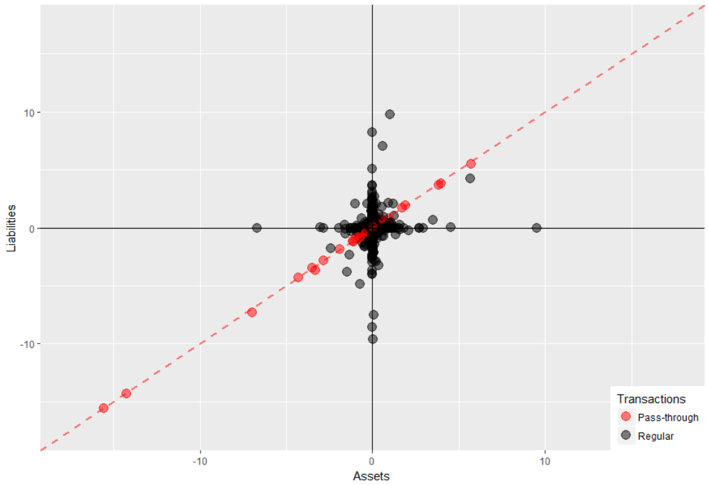
Remaining group of transactions to be included in the pass-through funds are the intra-group transactions. Here, we apply the simplified approach where - on the firm level direct investment data - we match transactions in assets and liabilities on the gross basis. Having A^{+} and A^{-} as increase and decrease in assets and L^{+} and L^{-} for liabilities respectively, the pass-thru is defined as $min\{A^{+}, L^{+}\} - min\{A^{-}, L^{-}\}$.

Table 1. Pass-thru funds by different channels in PLN Billion

Channel	2011	2012	2013	2014	2015
Special Purpose Entities	6,9	-20,9	-22,9	-0,3	-4,7
Capital in transit	0,0	0,0	0,0	0,0	3,9
Investment Funds	0,0	2,1	0,0	0,0	23,4
Operations of MNEs (Intragroup)	-13,6	4,0	-2,7	1,3	-8,7
Total	**-6,7**	**-14,8**	**-25,6**	**1,0**	**13,9**

As we can see from Table 1. the pass-thru funds where channelled via different entities. It is typical for these flows that their organisation is easily changeable. The flows are volatile, even more if we look at the specific channel. The outflows reported for the SPEs where the consequence of the inflow few years earlier. As the governments across the world are closing loopholes used in the tax optimisation, the companies are accommodating. After SPEs had been liquidated, investment funds became the next channel used. The volatility of pass-thru funds' composition may hinder coverage of this type of transactions.

Figure 1. Intragroup transactions of MNEs (including special purpose entities and capital in transit) in the years 2011 to 2015 in PLN Billion.



If we map transactions in foreign assets and liabilities we could relatively easily spot transactions that are just inflating the balance sheets of resident companies were there is no actual investment in the host economy. Also the liquidations of these positions are visible. These are the transactions shown in red along the dashed line in Figure 1. Please be aware that not always changes in both assets and liabilities occur simultaneously. Here we mapped a sum of transactions that occurred within a calendar year.

The pass-thru funds we described are unstable both in value and direction. Changes in the channels within the country and also between different countries often happen at a very short notice. As driven not by the intention of having long lasting interest as in direct investment. While sometimes (as in portfolio investment) involving debt or equity securities, other than those included in direct investment or reserve assets but held for optimisation purposes, we recognize the need for the separate category of flows in the balance of payments to deal with pass-through funds. The BPM6 (in para. 6.34) argues that this type of funds should be separated as a part of direct investment. Our analysis points at the necessity of including portfolio investment. We discovered that having these funds one category is better for data presentation. Also if we present pass-through funds separately it could be easily spotted that the net effect of those funds on the reporting economy is zero. Below (Table 2.) we have a balance of payments for Poland with separate identification of pass-through funds. One can easily verify that separation of pass-through funds substantially changes the picture of flows. While there are arguments that direct investment is understated in this presentation, in our opinion this presentation helps to differentiate stable financing (direct investment) from the positions that investors could wind up quickly. This is especially valuable since assets and liabilities are often analysed separately. In the traditional presentation offsetting positions of the pass-through funds are not visible clearly.

Table 2. Balance of payments for Poland with “pass-thru” functional category in PLN Billion. For comparison values in parentheses are respective direct and portfolio investment flows as required by the BPM6 Manual

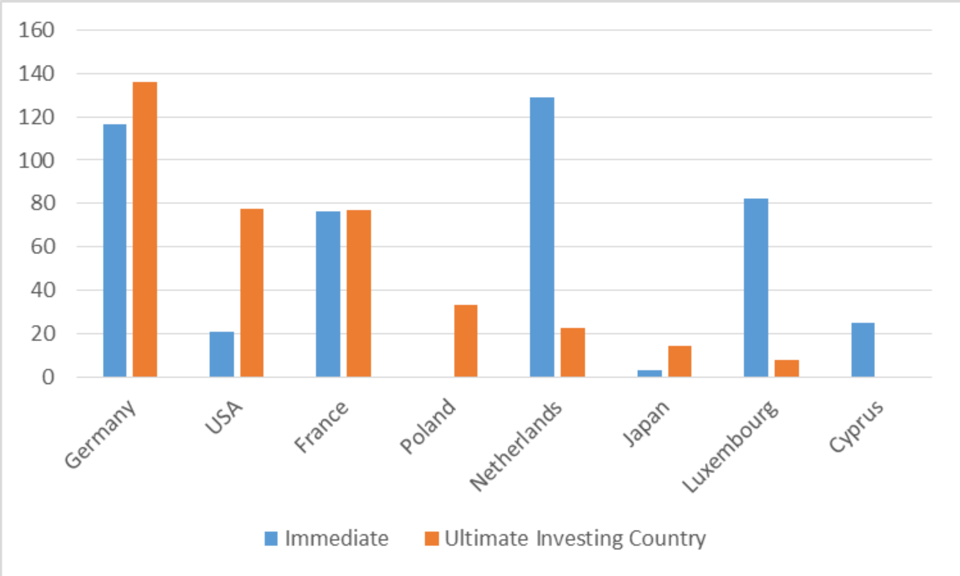
	2011	2012	2013	2014	2015
Current Account	-81,5	-60,5	-21,0	-35,7	-11,2
Capital Account	30,6	35,7	37,9	42,0	42,5
Financial account	-80,2	-37,3	-18,7	-19,6	5,3
Direct investment - assets	19,6 (12,9)	21,1 (4,2)	15,1 (-10,5)	20,3 (21,3)	25,2 (15,7)
Direct investment - liabilities	60,3 (53,6)	40,8 (23,9)	28,4 (2,8)	61,0 (62,0)	62,5 (53,0)
Portfolio investment - assets	-2,8 (-2,8)	-0,7 (1,4)	6,9 (6,9)	17,6 (17,6)	18,4 (41,8)
Portfolio investment - liabilities	47,4 (47,4)	63,4 (65,5)	7,3 (7,3)	10,0 (10,0)	6,1 (29,5)
Pass-thru - assets	***-6,7***	***-14,8***	***-25,6***	***1,0***	***13,9***
Pass-thru - liabilities	***-6,7***	***-14,8***	***-25,6***	***1,0***	***13,9***
Other investment - assets	11,1	7,2	5,3	12,8	20,1
Other investment - liabilities	18,9	-11,7	11,1	1,1	-10,6
Financial derivatives	0,5	-8,9	-2,2	-0,1	-3,6
Official reserve assets	18,0	36,6	3,0	1,9	3,1
Net Errors and Omissions	-29,4	-12,5	-35,5	-25,9	-25,9

Source: Narodowy Bank Polski and own calucalations

The analysis of pass-thru funds is important also from the point of view of country where the investment is hosted. The tax optimisation clouds the immediate counterpart presentation. Since the end of 2016 twelve OECD countries have been publishing FDI positions according to ultimate investing country[1]. In all of the countries we could observe that one of the most important "foreign" investors is the reporting country. That is a tax optimisation activity concerning e.g. Polish entities with the use of other, than Polish, jurisdiction. This phenomenon is known as round-tripping. The scope of round-tripping varies across countries but it has impact on both policy makers and statisticians.

This presentation is another attempt at identification of pass-through funds. With geographical breakdown based on direct investor and Ultimate Investing Country we could not only spot the value of round-tripping but also other jurisdictions used for passing funds through. In the case of Poland the countries that have assumed this role are the Netherlands, Luxembourg and Cyprus. Pass-thru countries for investment vary across countries as the result of different double taxation treaties entered into by these countries.

Figure 3. Comparison of FDI positions at the end of 2015 of the selected countries according to immediate and ultimate counterpart



Source: Adapted from Narodowy Bank Polski (2017)

5. Conclusions

The presented approach:

(i) is simple – requires only identification of flows that have the same value for both assets and liabilities;

(ii) allows to clean FDI data, which is the most common user requirement;

(iii) is able to identify the size of flows and stocks of funds located in particular country for tax purposes only.

Taking into account current discussions on political level this last point is essential to conducting evidence-based policy making.

There are also several issues that need addressing before the proposed solution is implemented. The first one relates to consistency among countries. If country A invests in county C through tax optymalisation vehicle in country B, from the point of view of country A we have a transaction on FDI while from the perspective of country B a pass-through transaction from country A. Presently,

[1] See Borga (2017) for the discussion of current state of reporting on ultimate investing country and the discussion of issues related to this presentation.

however, despite implementation of extended directional principle in FDI the consistency between countries is not achieved either. Second issue to be considered refers to pass-through entities located in the country of investment. The decision how to treat this kind of outward investment needs to be taken.

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