9th Meeting of the Advisory Expert Group on National Accounts,
8-10 September 2014, Washington DC

Agenda item: 3.1

Global Production - Economic ownership of Intellectual Property Products (IPPs) by SPEs

Introduction

In 2013 the AEG reviewed the report of the Task Force on head offices (HOs), holding companies (HCs) and Special Purpose Entities (SPEs). It agreed that "further clarification is needed on the (economic) ownership and the subsequent recording of certain assets of SPEs. In this respect, the AEG requested the Task Force on Global Production (TFGP) to put forward more concrete proposals."

The TFGP did not examine the different types of SPEs and the recording of their transactions in depth. It did, however, discuss how the challenges associated with defining economic ownership (as opposed to legal ownership) of SPEs that hold IPP assets within large Multinational Groups could be addressed. In this context the TF developed a decision tree for assigning more broadly economic ownership of IPPs to entities (including SPEs) participating in global production arrangements, or, belonging to multinational enterprise groups.

This paper summarises the recommendations of the TFGP presented in the Guide to Measuring Global Production. Compilers are advised to stay close to statistical observation i.e. the SPE resident in a country different from the parent, is recognized as an institutional unit and de facto the economic owner of the IPP. This approach is recommended even in cases where the parent clearly acts as the economic owner of the IPP, and legal ownership is assigned to the SPE for tax reasons only.

Guidance on documentation provided

• The document "Economic ownership over Intellectual Property Products (IPPs) within global production arrangements"

Main issues to be discussed

• The AEG is requested to review the decision tree and the discussion points in section 3 of the issue paper

• The AEG is requested to express their views on the recommendations by the TFGP as formulated in section 4.

Economic ownership over Intellectual Property Products (IPPs) within global production arrangements

Task Force on Global Production

1. Introduction

1. In 2013 the AEG reviewed the report of the Task Force on head offices (HOs), holding companies (HCs) and Special Purpose Entities (SPEs). It agreed that "further clarification is needed on the (economic) ownership and the subsequent recording of certain assets of SPEs. In this respect, the AEG requested the Task Force on Global Production (TFGP) to put forward more concrete proposals."

2. In response the TFGP prepared this short issue paper that summarises how ownership issues in relation to intellectual property products (IPPs) as observed on the balance sheets of SPEs are clarified in the Guide to Measuring Global Production.

3. It should be stated that identifying economic ownership of IPPs inside the multinational enterprise (MNE) group is an issue with more complexities than just SPEs holding IPP. This is why the TFGP developed a decision tree for assigning economic ownership of IPPs to entities (including SPEs) belonging to MNE groups or participating in global production arrangements. This decision tree addressing ownership issues inside the MNE is presented in the annex of this paper.

2. Royalty and licencing companies

4. The report of the Task Force on HOs, HCs and SPEs provides a typology of SPEs. In this typology royalty and licensing companies are explained as those SPEs concentrating on group receipts of royalties and similar flows received from intellectual property rights and trademarks. Criteria put forward to identify such SPEs are:

a. Holding intellectual property rights or trademarks;

b. Receiving on behalf of a group of enterprises royalties or similar flows.

5. Issue 4 in the report of the Task Force on HOs, HCs and SPEs raises the question whether or not these royalty companies are the actual economic owners of the relevant IPP assets, and whether or not the assets should be rerouted to their "original" owner that ultimately obtains the rewards and bears the related risks. The TFGP recommends as a general rule not to reroute the ownership of assets of SPEs.

6. Some of the main characteristics of royalty companies should be considered upfront.

7. Firstly, assigning ownership of (existing) IPPs to royalty companies will lead to additional gross fixed capital formation in the country in which this company (SPE) is established in line with the recommendations of SNA 2008. However, in addition some royalty companies may also legally own trademarks, brand names or other kinds of non-produced intangible assets. These other non-produced assets are not treated as capital formation in SNA 2008 unlike IPPs. Nevertheless similar ownership considerations apply to these non-produced intangible assets in terms of who actually owns them. However; these ownership considerations do not have implications for the recording of output and gross fixed capital formation for the SPE.

8. Secondly, the main reason for the existence of royalty companies is to reduce a MNE's tax costs by rerouting royalty and license fee payments and hence profits away from the trading entities of an MNE group to an SPE located in a low tax jurisdiction. This rerouting is facilitated by the existence of bilateral (double) tax agreements between these countries. These agreements will usually ensure that

corporate, or other kinds of, taxes will be levied only once on a stream of income rather than in both of the countries involved. Some SPEs seem to have been established, say in country B, to reallocate earnings away from a trading entity in country A,. The profits earned by the SPE and taxed in country B are then ultimately attributed to the parent or another affiliate that directly owns the SPE in country C, thus the group benefits from country B's double tax agreements with country C. This flow of income from B to C is in line with the required accounting for Direct Investment income – in this case income earned in a wholly owned subsidiary (company B) is all attributed to the owner (company C).

9. It can also occur that the royalties pass through the SPE and are recorded as imports of royalties by country B from country C followed by exports of these same royalties to country A[1]. A small margin may be earned in this scenario where the SPE in country B holds a sub licence to sell the royalties. This sub license is obtained from country C and would have little value in the balance sheet of the SPE in country B. It is important to note that the TFGP did not consider the issue of sub licences in its deliberations. Licences were generally considered in the context of actual IPP related assets.

10. Although SPEs can hold sub licences that generate streams of income, as discussed in the previous paragraph, in general IPP licences should be seen as assets. They are purchased from the parent for a consideration, often quite substantial, and they generate a stream of income from the sales by the SPE of the licensed product. This aligns with the business accounting standards and tax accounting and should be followed to avoid causing international statistical asymmetries.

11. It should be noted that the TFGP did not examine royalty companies in depth and the considerations above were not part of this TF's research agenda. One of the key focal points in chapter 4 of the Global Production Guide is providing guidance on economic ownership of IPPs within the scope of the MNE Group. This guidance is summarized in the next section.

3. Economic ownership of an IPP as observed inside the MNE Group

12. Inside the MNE Group, IPP creation, use and ownership may involve various entities which are not necessarily resident in one country. This requires that the general 2008 SNA principles of economic ownership, claiming benefits and accepting the associated risks, must be translated to the specific conditions of the MNE Group under examination, in other words to decide which entity in which country is the actual economic owner of the IPP in question.

13. Regarding the claim of benefits, rewards from IPPs can be diverse. Head offices may grant affiliated companies access to IPPs for use in production, and the returns may either take the form of turnover on sales of IPP services or as property income.

14. Acceptance of risks involves the owner's responsibility for repairs and maintenance of the asset, as well as its ultimate loss. In the case of IPPs, maintenance can be taken to mean the responsibility of paying for fees to maintain patents, copyrights or other registrations of the IPP in question. Ultimately losses are perhaps not so relevant in the case of IPPs, although the sudden termination of protection or secrecy will inevitably lead to less monopolistic power and declining competitiveness as competitors can also obtain access to the IPP in question.

15. When transactions are not observed directly, ownership and the recording of intragroup IPP transfers become uncertain and can only be based on certain conventions. The supply and use of IPPs in global production are usually observed via enterprise statistics such as business surveys, R&D surveys or related administrative sources. Additional sources, such as international trade in services statistics may also be consulted for the recording of international transactions. Some countries have established special Large Cases Units (LCU) to analyse all available source data for the MNEs and other complex enterprises. LCUs may provide important information also on IPP transactions.

16. Whether intragroup IPP flows are captured in international trade in services statistics largely depends on the type of cost recovery methods and transfer prices used by the MNE. Transactions

[1] This type of arrangement exists to avoid withholding tax in the country of the trading entities of the MNE group i.e. in country A. Examples of this arrangement are termed the Dutch sandwich or Double Irish.

between units inside the MNE should be observed carefully as the legal transfer of goods and assets inside the MNE may not necessarily reflect actual economic operation of the MNE's global production. This requires a case-by-case analysis as these arrangements can have unique features.

17. The decision tree in the annex assists in determining the economic ownership of IPPs, and the recording of IPP related transactions (particularly import and export of IPP related services). The tree represents a sequence of steps, from the left to the right, guiding the statistics compiler to a decision. The starting point of the tree is the observation of IPP output or IPP ownership at the level of a certain unit. The obtained information is examined in 4 different steps:

a. Control/ownership of the unit, is the unit member of a MNE (yes/no)?

b. Is the unit producer of the IPP (yes/no)?

c. What is the main kind of activity (in terms of ISIC) of the unit, or, is the unit expected to use the IPP in its production process (yes/no)?

d. Does the unit receive income related to IPPs, or, does the unit pay for the use of IPPs (royalties and licences) (yes/no)?

18. Together these steps should lead to a coherent decision on ownership, the recording of capital formation and the recording of IPP related services (imports/exports). However, it should be acknowledged that the available information needed to go through each of these steps may be insufficient. Particularly inside MNE groups it may be quite challenging to classify IPP related transactions properly, identifying separately IPP funding, IPP purchases and sales and also payments for IPP use. This means that each situation identified in the decision tree will be provided with a default solution in case information is insufficient to run properly through each of the decisive steps.

19. The recommendations of the TFGP are quite prudent. For example, specialized IPP producers (Annex 1 - decision tree 1.1.2.2) are considered the economic owners of the produced IPP unless there is clear evidence the unit does not generate any IPP related turnover (e.g. sales of copies, licences to use), or, there is evidence of sales of the original to the parent or to other customers (1.1.2.1). No observed IPP related turnover implies the unit is indirectly funded by the parent. Such funding should be observed. Without conclusive evidence the default solution is to assign economic ownership to the producing unit (1.1.2.2).

20. Case 1.2.2 2 of the decision tree reflects the royalty companies created by MNEs with the purpose of taking advantage of low tax jurisdictions. Although the decision tree leads to an identification of such royalty companies, rerouting of ownership and corresponding transactions between the legal and the economic owner is not recommended. The default solution is assigning economic ownership of the IPP to these units, in correspondence with legal ownership.

21. Effectively these recommendations in Sections 1.2.1 and 1.2.2. of the decision tree are in line with the recommendations of 2008 SNA (par 26.28)2 where it states that "….a legal entity that is resident in one jurisdiction is never combined with a legal entity resident in another. As a result, SPEs and other similar corporate structures owned by non-residents are considered to be resident of their territory of incorporation, even though most or all of their owners and most or all of their assets are in another economy." in other words a separate institutional unit is recognised and consequently considered, as shown in the decision tree, to be the economic owner of the IPP assets and related liabilities. This designation of economic owner however does need to be verified by establishing whether the IPP assets are in fact included on the balance sheet of the SPE and also that the taxable income of the SPE includes the royalty or similar receipts.

22. Furthermore, the TFGP also considered that looking beyond the legal framework is difficult and not really practical. This TFGP view was based on the difficulties associated with attributing transactions, assets and liabilities to a country where the parent of the SPE is resident and the potential for the creation of asymmetries in international economic statistics if such an approach is not mirrored by statistical compilers in other countries.

[2] See also 2008 SNA par 4.55 – 4.71

23. However, it is recommended to classify transactions (the fixed capital formation, income and expenditure) by these units under a separate heading – for example income from sales as “IPP related services provided by SPEs”, since the provision of these services through such “brass-plate” companies have very little economic significance for the economy where they are placed. A separate reporting of these artificial IPP services will provide a clearer view on national accounts and balance of payment statistics.

4. Conclusions

24. The recommendations of the TFGP on royalty companies are essentially practical and pragmatic. Compilers are advised to stay close to statistical observation i.e. the SPE is recognized as an institutional unit and de facto the economic owner of the IPP. This approach is recommended even in cases where the parent clearly acts as the economic owner of the IPP, and legal ownership is assigned to the SPE for tax reasons only. It is also recommended to classify the transactions related to these IPP holding SPEs separately to allow analysis excluding "brass plate" units, also because the transactions carried out by these units are not necessarily at arm’s length.

25. The AEG is asked to discuss the decision tree developed by the TFGP and confirm the TFGP’s position.

Annex - Decision tree for determining economic ownership of an IPP as observed inside the MNE Group

Control/ownership of unit	Production of the IPP	Type of producer	Income and expenditure related to the IPP	Decision about economic ownership of the IPP	Related decisions
		1.1.1. The unit is a main producer of other (non IPP) goods and services and is expected to use the IPP in its production process	1.1.1 The unit may, or may not, receive funding from the parent as compensation for IPP development costs but this aspect is not decisive.	Attribute by default economic ownership of the IPP to this unit	The IPP is by convention recorded on the balance sheet of this unit, even when other member units of the MNE may benefit from the IPP.
	1.1 The unit produced the IPP				
			1.1.2.1The unit does not receive income from royalties or licences to use, but either receives compensation for IPP development from the parent or sells the IPP originals to the parent.	This unit serves as a dedicated IPP producer for the benefit of the MNE as a whole.	Do not record the IPP as fixed capital formation of the unit. Instead record the developed IPP as export to the (foreign) MNE parent. Reported sales of IPP originals may show up in international trade in services statistics.
		1.1.2. The unit is a main IPP producer.			
			1.1.2.2. The unit receives income from royalties or licences to use, or does not receive any compensation for IPP development from the parent, so it can be assumed that it is expected to obtain income from royalties and licences to use in the near future.	Attribute economic ownership to the unit. The unit functions as a dedicated IPP producer with income from units outside the MNE from the IPPs produced.	The IPP is recorded as fixed capital formation of the unit.
1. The unit is part of a multinational enterprise (MNE)					
			1.2.1.1. The unit pays royalties or licences to use.	The unit does not own the IPP	Do not record the IPP as fixed capital formation of the unit. IPP service payments to foreign suppliers are recorded as import of IPP services (or royalties).
		1.2.1. The unit is a main producer of other (non IPP) goods and services and may use the IPP in production			
			1.2.1.2 The unit purchased the IPP original for use in production	Attribute economic ownership of the IPP to the unit	The IPP is fixed capital formation of the unit. If purchased from abroad register an import of the IPP (original)
			1.2.1.3. No IPP related payments are being observed. IPP use may be indirectly observed based on the nature of the production process (with usually high IPP requirements) and above average returns to capital.	The MNE parent is expected to be the economic owner and supplier of the IPPs used in production.	Conceptually, an imported IPP service flow should be recorded. But this is not an easy task (and not without risks) as the nature and size of these flows are principally unknown. Such imputations of imports/exports should preferably be the outcome of a concerted action in which all NSIs involved join efforts in filling in the IPP flows between the member units of an MNE.
	1.2. The unit did not produce the IPP				
		1.2.2. The unit is not a producer of other (non IPP) goods and services. Its main output is IPP related.	1.2.2. Purchase of the IPP from the parent and income from royalties and licences to use may, or may not, be observed.	The unit is assumed to have purchased the IPP (original) from the parent and to receive (on behalf of the parent) income from royalties or licences to use the IPP. Attribute economic ownership of the IPP to the unit. The unit is considered an IPP holding SPE providing its services to the MNE parent.	It is recommended to classify the fixed capital formation, income and expenditure related to these IPP holding SPEs separately to allow analysis excluding "brass plate" units, also because the transactions carried out by these units are not necessarily at arm's length.