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Criteria for Identification of Branches

An Issue Paper Prepared for the December 2004
Meeting of the Advisory Expert Group on National Accounts

The Statistics Department
International Monetary Fund

(1) Recommendations by BOPTEG and DITEG:

(i) The groups agreed that physical presence criteria would apply only to those industries that require physical presence. For activities (such as financial intermediation and operational leasing) that can be undertaken without physical presence, such criteria is not required for determining the existence of an institutional unit.

(ii) The groups agreed that being subject to income tax laws, rather than paying income taxes as in *BPM5*, should be taken as an indicator.

(iii) The groups considered that some flexibility is needed, so that the criteria would be used as indicators with some compiler discretion. The group agreed that not all of the criteria needed to be met. A sufficient condition was that most of the criteria would be met. However, the criteria of having separate income statements and balance sheets was considered to be the strongest factor, and would usually be decisive. The importance of such records was explained on both conceptual and practical grounds. The group noted the importance of where decisions are made, of which separate accounting could be a reflection.

(2) Alternatives rejected by BOPTEG and DITEG:

A fixed set of requirements was rejected, so as to give compilers flexibility.

(3) Committee's decision

The Committee agreed with all the recommendations.

(4) Implications for the SNA

Clarification

(5) Questions for the AEG:

(i) Does the AEG agree with the recommendation that physical presence only be required for activities other than financial intermediation? See 1(i) above.

(ii) Does the AEG agree that being subject to income tax laws should be taken as an indicator of a branch rather than a requirement? See 1(ii) above.

(iii) Does the AEG agree that all the criteria should be taken as indicators of a separate branch, while noting that availability of separate accounts be given a very strong weight? See 1(iii) above.

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

ISSUES PAPER (BOPTEG) # 5

CRITERIA FOR IDENTIFICATION OF BRANCHES

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BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP

ISSUES PAPER (BOPTEG) # 5:

CRITERIA FOR IDENTIFICATION OF BRANCHES

I. Current international standards for the statistical treatment of the issue

In many cases, a business will set up a separate legal entity in order to undertake operations in an economy outside its home economy. However, where a separate entity is not created in the outside economy, but the operations are substantial, a notional institutional unit resident in that economy may be identified for statistical purposes. In this paper, such a unit is called a "branch."[1] Although a branch is not a legal entity, it behaves in many ways as if it were, and treating it as a unit can allow statistics to give a better portrayal of the economic reality, see *1993 SNA* paras. 4.49-52. (An issues paper for DITEG deals with the valuation of branches, so this paper is only concerned with the units and residence issues.)

The *BPM5* criteria for identifying the operations of an unincorporated branch as a separate institutional unit are that the branch:

- engage in significant production of goods and services;
- plan to operate the business indefinitely or a long period of time;
- have a substantial physical presence;
- maintain a complete and separate set of accounts of local activities (i.e., income statement, balance sheet, transactions with the parent enterprise);
- pay income taxes to the host country;
- receive "funds for enterprise work for the enterprise account" (presumably this means not as an agent, a situation discussed in para. 83);

(*BPM5* paras. 73 and 78. The *1993 SNA* uses similar terms in paras. 4.49-52, although it does not mention the last two factors.)

BPM5 goes on to discuss the application of these principles to the cases of construction (para. 78) and mobile equipment (paras. 80, 82). It distinguishes between operations that are separate and substantial enough to constitute a branch (which are attributed to a separate unit) and those that do not (which are attributed back to the base of operations). The *Balance of*

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[1] Branch is used here in the sense of "a division of an organization" or "separate but dependent part of a central organization." In *1993 SNA* terminology, a branch is one type of "quasicorporation." In the *OECD Benchmark Definition of Foreign Direct Investment, third edition* para. 14, quasicorporations for land ownership and unincorporated joint ventures are also described as branches. However, the requirements for the creation of notional units for land ownership are much less restrictive than those discussed here, in that the unit is identified in all cases (*BPM5* para. 64).

Payments Textbook (BPT) paras. 98-99 mentions branches being treated as separate units simply on the basis of physical operations, without other requirements, but is presumably not intended to adopt different criteria for branch recognition from *BPM5*.

Establishing criteria such as these involves making a trade-off between the desirability of taking into account all operations connected with an economy, while avoiding the identification of artificial units for statistical purposes that do not have their own accounts or decision-making. The *BPM5* criteria take a fairly restrictive approach, in particular, requiring complete accounting data. If a branch is not recognized as a separate unit, the sales to residents in the same location will be treated as international trade in goods and/or services.

Branches in the sense used in this paper are always 100 percent-owned direct investment enterprises. However, other quasicorporations such as unincorporated partnerships, joint ventures, and land ownership could sometimes have less than 100 percent ownership, including portfolio investment and domestic investors.

II. Concerns/shortcomings of the current treatment

There seems to be less focus on the *BPM5* criteria for recognizing a branch in *BD3* and *BPT*.

The requirement for physical presence may not be appropriate for financial services that do not always have physical presence, including banking, insurance, and mutual funds. If some activities in an economy meet all the other criteria, that may constitute a sufficiently strong connection to the economy to justifying being considered a resident unit.

The requirement for paying income taxes needs to be reconsidered. Some operations otherwise strongly connected to the economy do not pay taxes because of their income situation, tax exemptions, or because there is no income tax.

The term branch is used in a somewhat wider sense in *BD3* by including land ownership and joint ventures and partnerships.

III. Possible alternative treatments

The *AO* proposes that the physical presence requirement for recognizing a branch only apply to activities that require physical presence. It also proposes that the unit's "being subject to tax laws" be taken as evidence of the existence of a branch, but not a requirement. (para. 4.15).

IV. Points for Discussion

> *(1) Should the physical presence requirement for recognition of a branch be limited to activities that require physical presence?*

(2) Should the requirement to pay income taxes to the host country be dropped? Should it be replaced by being subject to any applicable income tax laws? Or should being subject to any income tax laws be treated as indicative rather than essential?

(3) Do members' experiences in the recognition of branches in practice give rise to any other concerns about the treatment of branches? Should any of the other BPM5 criteria for the recognition of branches be amended or deleted? Should any other requirements for the recognition of branches be added?

References

BPM5, Chapter IV

Balance of Payments Textbook, Chapter II

Annotated Outline, paras. 4.14-19

OECD Benchmark Definition of Foreign Direct Investment