XIV. Income

Coverage

267. ***Income*** covers two types of transactions between residents and nonresidents: (i) those involving *compensation of employees*, which is paid to nonresident workers (e.g., border, seasonal, and other short-term workers), and (ii) those involving *investment income* receipts and payments on external financial assets and liabilities. Included in the latter are receipts and payments on *direct investment*, *portfolio investment*, *other investment*, and receipts on reserve assets. Income derived from the use of tangible assets is excluded from ***income*** and classified, as appropriate, under leasing or rentals, under *other business services*, or under *transportation*. Financial leasing arrangements are considered evidence that a change of ownership is intended (see paragraph 206), and part of the lease payments is construed as income on a financial asset.

268. Holding (capital) gains and losses are not classified as income on investments but as part of the value of the investments. All realized holding gains and losses arising from transactions are included in the ***financial account***; unrealized valuation changes are not included. However, some debt securities (such as bonds, notes, and bills) are originally issued at values that differ from the stated fixed sums that holders have the unconditional right to receive when the obligations mature. These premiums or discounts should be regarded as negative interest or interest, respectively, rather than as holding losses or gains. The values of securities entered in the ***financial account*** are the amounts for which the securities were actually issued. The fixed sums paid at maturity comprise both repayments of original principal amounts and (negative or positive) interest; the interest should be shown as *investment income*.

Definition and Classification

269. *Compensation of employees* comprises wages, salaries, and other benefits (in cash or in kind) earned by individuals—in economies other than those in which they are residents—for work performed for and paid for by residents of those economies. Included are contributions paid by employers, on behalf of employees, to social security schemes or to private insurance or pension funds (whether funded or unfunded) to secure benefits for employees. Employees, in this context, include seasonal or other short-term workers (less than one year) and border workers who have centers of economic interest in their own economies. Because embassies and consulates are considered extraterritorial to the economies in which they are located, the compensation received by local (host country) staff of these institutional entities is classified as that paid to resident entities by nonresident entities.

270. Compensation paid to employees by international organizations, which are treated as extraterritorial entities, represents payments to residents from nonresident entities if the employees are residents of the economies of location. Also, if the employees are from other economies but are employed for one year or more, they are treated as residents of the economies of location, and their compensation is classified in the same manner. Thus, in the case of employees from other economies who are employed for less than one year, no payments to residents are involved. (For treatment of technical assistance personnel working abroad on assignments of one year or more, see paragraph 69.)

271. Personal expenditures made by nonresident seasonal and border workers in the economies in which they are employed and personal expenditures made by those working on installation projects are recorded under *travel*. Taxes paid, contributions made to pension funds, etc. in those economies are recorded as current transfer payments. Gross recording of compensation and expenditures is recommended in this *Manual*, although recording may, on practical grounds, be limited to estimates of net income in some instances.

272. In practice, it is often difficult to make the distinction between persons whose earnings are classified as *compensation of employees*, even though they are not residents of the economies in which they work, and migrants who have become residents of

economies by virtue of being expected to live there for a year or more. (See paragraphs 352 through 355.) The activities of an individual—whether he or she is regarded as a resident or a migrant—do not affect the aggregate transactions of the compiling economy with the rest of the world. Therefore, difficulties on this score will not, in principle, be a source of net errors and omissions in the balance of payments. Even so, efforts should be made to observe the distinction between nonresident workers and migrants. Otherwise, the comparability of balance of payments statements for the two compiling economies will suffer from dissimilar statistical treatment of the same individuals.

273. Nonresidents of an economy may engage in transactions associated with the use of land for noncommercial purposes. Such transactions are usually included indistinguishably under components other than ***income*** (for example, *travel* or *government services n.i.e.*).

274. *Investment income* (property income in the *SNA*) covers income derived from a resident entity's ownership of foreign financial assets. The most common types of *investment income* are income on equity (dividends) and income on debt (interest). Dividends, including stock dividends, are the distributed earnings allocated to shares and other forms of participation in the equity of incorporated private enterprises, cooperatives, and public corporations. Dividends represent income that is payable without a binding agreement between the creditor and the debtor. Among other types of income on equity are (i) earnings of branches and other unincorporated direct investment enterprises and (ii) direct investors' shares of earnings of incorporated direct investment enterprises. (The latter type of earnings, which are not formally distributed, are earnings other than dividends.) Shares of reinvested earnings attributed to direct investors are proportionate to the participation of the direct investors in the equity of the enterprise. Also, in principle, income is imputed to households from net equity in life insurance reserves and pension funds and included indistinguishably under other investment. Interest, including discounts in lieu of interest, comprises income on loans and debt securities (i.e., bank deposits, bills, bonds, notes, and trade advances). Net interest flows arising from interest rate swaps also are included. (See paragraph 406.) Interest is payable in accordance with a binding agreement between the creditor and the debtor.

275. The components of *investment income* are classified as direct investment, portfolio investment, and other investment income.

Direct investment income

276. The two categories under this heading—income on equity and income on debt—cover income accruing to a direct investor resident in one economy from the ownership of direct investment capital in an enterprise in another economy. (See paragraphs 330 and 368 for the definition of direct investment capital.) Income on direct investment is presented on a net basis for direct investment made abroad and in the reporting economy (i.e., receipts of income on equity and income on debt less payments on income on equity and income on debt for each).

277. Income on equity is subdivided into (i) distributed income (dividends and distributed branch profits) and (ii) reinvested earnings and undistributed branch profits. Distributed income may consist of dividends on common or preferred shares owned by direct investors in associated enterprises abroad, or vice versa.

278. Reinvested earnings comprise direct investors' shares—in proportion to equity held—of (i) earnings that foreign subsidiaries and associated enterprises do not distribute as dividends and (ii) earnings that branches and other unincorporated enterprises do not remit to direct investors. (If that part of earnings is not identified, all branch earnings are considered, by convention, to be distributed.) Thus, reinvested earnings may be calculated as the entrepreneurial income (net operating surplus) of the direct investment enterprise, plus any income or current transfers receivable, minus any income or current transfers payable. The latter include any current taxes payable on income, wealth, etc.

279. Income on debt consists of interest payable—on intercompany debt—to or from direct investors from or to associated enterprises abroad. Income on nonparticipating preference shares is treated as interest income, rather than dividend income, and is recorded in income on debt.

Portfolio investment income

280. Portfolio investment income comprises income transactions between residents and nonresidents and is derived from holdings of shares, bonds, notes, and money market instruments and associated with financial derivatives. This category is subdivided into income on

equity (dividends) and income on debt (interest). See Chapter 19 for details on new financial instruments and treatment of financial derivatives, such as options. The financial instrument classification scheme for portfolio investment income is consistent with that in the ***financial account*** and with that in the international investment position. Subsectoring into domestic institutional sectors (monetary authorities, general government, banks, and other) is shown under **Selected Supplementary Information**. (See the table at the end of Chapter 8.) A variety of other supplementary disaggregations by foreign sector, etc. may be desirable for specific analytical purposes.

Other investment income

281. Other investment income covers interest receipts and payments on all other resident claims (assets) on and liabilities to nonresidents, respectively. This category also includes, in principle, imputed income to households from net equity in life insurance reserves and in pension funds. Other investment income is classified by the domestic sectors previously noted. Interest on assets comprises interest on long- and short-term loans, on deposits, on other commercial and financial claims, and on an economy's creditor position in the Fund, SDR holdings, and loans to the Fund. Interest on liabilities covers interest on loans, on deposits, and on other claims and interest related to the use of Fund credit and loans from the Fund. Also included is interest paid to the IMF on the Fund's SDR holdings in the General Resources Account. Borderline distinctions may arise between interest income and certain commissions and fees, such as commitment charges on undrawn funds. These are included in *financial services*. (See Chapter 13.)

Time of Recording of Investment Income

282. Dividends are recorded as of the date payable. Interest income is recorded on an accrual basis. If the interest is not actually paid, an income entry is recorded under the appropriate instrument and a counterpart entry is made in the ***financial account*** to reflect an increase in the claim associated with nonpayment. (See paragraph 121.)

283. For zero coupon and other deep discounted bonds, the substantial difference between the discounted issue price and the value at maturity is treated as interest. That difference is recorded as accruing over the life of the bond as a series of interest payments rather than being recorded when the interest is due for payment. If these securities are traded—prior to maturity—in the secondary market, prevailing rates that reflect the difference between the new owner's cost and the value at maturity should be used for the subsequent recording of interest on these securities. Implementation of this treatment may be difficult. (See paragraph 396.) Reinvested earnings of direct investment enterprises are recorded in the balance of payments in the periods in which the income is earned. Distributed (remitted) earnings of branches and other unincorporated enterprises are recorded as of the times the earnings are transferred.

284. This difference in times of recording for earnings that are formally distributed and for other earnings is attributable to the fact that reinvested earnings represent the net income accruing during a specific period. In contrast, dividends and remitted earnings of branches are discretionary distributions that can be made at any time—even in a period when a net loss is sustained. Therefore, these dividends and remitted earnings are not attributable to the earnings of a particular period. To determine the period in which those reinvested earnings are earned or other investment income becomes payable, it may be helpful to refer to balance sheets, annual reports, and similar documents of the direct investor or the enterprise.

Measurement and Recording of Direct Investment Earnings

285. Direct investment earnings are measured on the basis of current operating performance. Operational earnings represent income from normal operations of the enterprise and do not include any realized or unrealized holding (capital) gains or losses arising from valuation changes, such as inventory write-offs; gains or losses on plant and equipment from the closure of part or all of a business; write-offs of intangibles, including goodwill, because of unusual events or developments during the period; write-offs of research and development expenditures; losses on the write-offs of bad debts or on expropriation without compensation; abnormal provisions for losses on long-term contracts; and exchange-rate-related gains and losses. Unrealized gains or losses resulting from the revaluation of fixed assets, investments, and liabilities and any realized gains or losses resulting from the disposal of assets or liabilities should be excluded from direct investment earnings; that is, gains should not be added in and losses should not be deducted. In addition, valuation changes resulting from unforeseen obsolescence, catastrophes, and depletion of natural resources are

treated as holding losses at the times that the decreases in values actually occur. Because data for many countries are available only on an all-inclusive basis, when holding gains and losses and other extraordinary income are included in reported earnings, those countries that report earnings on either an operating basis or all-inclusive basis should collect and publish supplementary information on holding gains and losses and other extraordinary items. This practice would enhance international comparability for both flows and stock positions.

286. Earnings of a direct investment enterprise are measured net of income or corporation taxes payable without penalty during the recording period by the enterprise to the economy in which that enterprise operates. This practice is followed because such taxes are considered payable by the enterprise and not by its owners. Furthermore, earnings should be calculated net of any provision for depreciation of fixed capital. Depreciation is measured by the value, at current replacement cost, of the reproducible fixed assets used up (as a result of normal wear and tear, foreseen obsolescence, and accidental damage not made good by repair) during an accounting period. In the calculation of depreciation, the expected economic life of an individual asset should be taken into account. Although depreciation should, in principle, be calculated at current replacement cost, often the only data available may be based on historical cost.

287. Dividends payable to direct investors, remitted branch earnings, and interest payable by direct investment enterprises are recorded gross of any withholding taxes. These taxes are deemed paid by the recipient and are transferred to the country of the direct investment enterprise and recorded under transfers.

288. Reinvested (undistributed) earnings of branches and other unincorporated direct investment enterprises and direct investors' shares of earnings, which are not formally distributed, of incorporated direct investment enterprises are deemed to provide additional capital to the enterprises and to increase the value of an economy's stock of foreign assets and liabilities. When such earnings are recorded in the balance of payments, therefore, entries should be made both for direct investment income and for direct investment capital. For example, reinvested earnings attributable to a resident direct investor of a direct investment subsidiary or of a branch should be entered as a credit in the **current account** under direct investment income (income on equity) and as a debit in the ***financial account*** under *direct investment-abroad* (reinvested earnings). Portfolio investors' shares in earnings, which are not formally distributed, of incorporated direct investment enterprises should not be entered in the balance of payments.

289. Direct investors' shares in net losses, other than holding (capital) losses of enterprises, should be recorded as negative income in the direct investment income component of the balance of payments. Thus, the economy recording losses on residents' direct investments made abroad should enter the losses as negative credits, while the economy in which the direct investment is made should record the losses as negative debits. This method of recording losses is used so that the credit side of the component will reflect the compiling economy's net earnings on direct investments made abroad, while the debit side will refer to nonresident direct investors' net earnings on direct investments in the compiling economy.

Stock Dividends, Bonus Shares, and Liquidating Dividends

290. The distribution of earnings, in the form of stock dividends, to nonresident shareholders is construed as a capitalization of current earnings and an alternative to distributing cash dividends. Such earnings distributions are recorded in the balance of payments in the same manner as reinvested earnings (i.e., as investment income in the **current account** and as offsetting equity investment in the ***financial account***). General bonus shares, on the other hand, represent the substitution of one type of equity (paid-up capital or capital stock) for another (reinvested earnings) and thus should not be recorded in the balance of payments. (In some countries, accumulated reserves from reinvested earnings are credited to a reserve account that is converted to bonus shares when the account reaches a certain level.) Liquidating dividends are excluded from *investment income* because such dividends represent returns of capital contributions rather than remittance (distribution) of earnings. Therefore, liquidating dividends should be recorded in the ***financial account*** as withdrawals of capital.