

**DESCRIPTION OF H.R. 4986
(THE “FSC REPEAL AND EXTRATERRITORIAL
INCOME EXCLUSION ACT OF 2000”)**

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I. INTRODUCTION

In July 1998, the European Union¹ requested that a World Trade Organization (“WTO”) dispute panel determine whether the foreign sales corporation provisions of sections 921 through 927 of the Internal Revenue Code (“the Code”) comply with WTO rules, including the Agreement on Subsidies and Countervailing Measures. A WTO dispute settlement panel was established in September 1998 to address these issues. On October 8, 1999, the panel ruled that the foreign sales corporation regime was not in compliance with WTO obligations. The panel specified that “FSC subsidies must be withdrawn at the latest with effect from 1 October 2000.”² On February 24, 2000, the WTO Appellate Body affirmed the lower panel’s ruling.

This document,³ prepared by the staff of the Joint Committee on Taxation, provides an overview of present law relating to foreign sales corporations. This document also provides a description of H.R. 4986, the “FSC Repeal and Extraterritorial Income Exclusion Act of 2000,” as passed by the House of Representatives on September 13, 2000. H.R. 4986 is scheduled for markup by the Senate Committee on Finance on September 19, 2000.

¹ The European Union comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom. Canada and Japan made third-party submissions to the subsequently established dispute settlement panel in support of the European Union position.

² WTO, United States B Tax Treatment for “Foreign Sales Corporations,” *Report of the Panel*, October 8, 1999, p. 334.

³ This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 4986 (The “FSC Repeal and Extraterritorial Income Exclusion Act of 2000”)* (JCX-97-00), September 15, 2000.

II. OVERVIEW OF PRESENT-LAW FOREIGN SALES CORPORATION RULES

Summary of U.S. Income Taxation of Foreign Persons

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person.⁴ The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. An indirect foreign tax credit may reduce the U.S. tax imposed on such income.

Foreign Sales Corporations

The income of an eligible foreign sales corporation is partially subject to U.S. income tax and partially exempt from U.S. income tax. In addition, a U.S. corporation generally is not subject to U.S. tax on dividends distributed from the foreign sales corporation out of certain earnings.

A foreign sales corporation must be located and managed outside the United States, and must perform certain economic processes outside the United States. A foreign sales corporation is often owned by a U.S. corporation that produces goods in the United States. The U.S. corporation either supplies goods to the foreign sales corporation for resale abroad or pays the foreign sales corporation a commission in connection with such sales. The income of the foreign sales corporation, a portion of which is exempt from U.S. tax under the foreign sales corporation rules, equals the foreign sales corporation's gross markup or gross commission income, less the expenses incurred by the foreign sales corporation. The gross markup or the gross commission is determined according to specified pricing rules.

A foreign sales corporation generally is not subject to U.S. tax on its exempt foreign trade income. The exempt foreign trade income of a foreign sales corporation is treated as foreign-source income which is not effectively connected with the conduct of a trade or business within the United States.

⁴ A variety of anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation. The Code sets forth the following anti-deferral regimes: the controlled foreign corporation rules of subpart F (secs. 951-954), the passive foreign investment company rules (secs. 1291-1298), the foreign personal holding company rules (secs. 551-558), the personal holding company rules (secs. 541-547), the accumulated earnings tax rules (secs. 531-537), and the foreign investment company rules (sec. 1246). Detailed rules for coordination among the anti-deferral regimes are provided to prevent a U.S. person from being subject to U.S. tax on the same item of income under multiple regimes.

Foreign trade income other than exempt foreign trade income generally is treated as U.S.-source income effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States. Thus, a foreign sales corporation's income other than exempt foreign trade income generally is subject to U.S. tax currently and is treated as U.S.-source income for purposes of the foreign tax credit limitation.

Foreign trade income of a foreign sales corporation is defined as the foreign sales corporation's gross income attributable to foreign trading gross receipts. Foreign trading gross receipts generally are the gross receipts attributable to the following types of transactions: the sale of export property; the lease or rental of export property; services related and subsidiary to such a sale or lease of export property; engineering and architectural services for projects outside the United States; and export management services. Investment income and carrying charges are excluded from the definition of foreign trading gross receipts.

The term "export property" generally means property (1) which is manufactured, produced, grown or extracted in the United States by a person other than a foreign sales corporation, (2) which is held primarily for sale, lease, or rental in the ordinary course of a trade or business for direct use or consumption outside the United States, and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. The term "export property" does not include property leased or rented by a foreign sales corporation for use by any member of a controlled group of which the foreign sales corporation is a member; patents, copyrights (other than films, tapes, records, similar reproductions, and other than computer software, whether or not patented), and other intangibles; oil or gas (or any primary product thereof); unprocessed softwood timber; or products the export of which is prohibited or curtailed. Export property also excludes property designated by the President as being in short supply.

If export property is sold to a foreign sales corporation by a related person (or a commission is paid by a related person to a foreign sales corporation with respect to export property), the income with respect to the export transactions must be allocated between the foreign sales corporation and the related person. The taxable income of the foreign sales corporation and the taxable income of the related person are computed based upon a transfer price determined under section 482 or under one of two formulas.

The portion of a foreign sales corporation's foreign trade income that is treated as exempt foreign trade income depends on the pricing rule used to determine the income of the foreign sales corporation. If the amount of income earned by the foreign sales corporation is based on section 482 pricing, the exempt foreign trade income generally is 30 percent of the foreign trade income the foreign sales corporation derives from a transaction. If the income earned by the foreign sales corporation is determined under one of the two formulas specified in the foreign sales corporation provisions, the exempt foreign trade income generally is 15/23 of the foreign trade income the foreign sales corporation derives from the transaction.

A foreign sales corporation is not required or deemed to make distributions to its shareholders. Actual distributions are treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits. Any

distribution made by a foreign sales corporation out of earnings and profits attributable to foreign trade income to a foreign shareholder is treated as U.S.-source income that is effectively connected with a business conducted through a permanent establishment of the shareholder within the United States. Thus, the foreign shareholder is subject to U.S. tax on such a distribution.

A U.S. corporation generally is allowed a 100 percent dividends-received deduction for amounts distributed from a foreign sales corporation out of earnings and profits attributable to foreign trade income. The 100 percent dividends-received deduction is not allowed for nonexempt foreign trade income determined under section 482 pricing.

**III. DESCRIPTION OF H.R. 4986
(THE “FSC REPEAL AND EXTRATERRITORIAL
INCOME EXCLUSION ACT OF 2000”)**

Description of Bill

Repeal of the foreign sales corporation rules

The bill repeals the present-law foreign sales corporation rules.

Exclusion of extraterritorial income

The bill provides that gross income for U.S. tax purposes does not include extraterritorial income. Because the exclusion of such extraterritorial income is a means of avoiding double taxation, no foreign tax credit is allowed for income taxes paid with respect to such excluded income.⁵ Extraterritorial income is eligible for the exclusion to the extent that it is “qualifying foreign trade income.” Because U.S. income tax principles generally deny deductions for expenses related to exempt income, otherwise deductible expenses that are allocated to qualifying foreign trade income generally are disallowed.

The bill applies in the same manner with respect to both individuals and corporations who are U.S. taxpayers. In addition, the exclusion from gross income applies for individual and corporate alternative minimum tax purposes.

Qualifying foreign trade income

Qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of (1) 1.2 percent of the “foreign trading gross receipts” derived by the taxpayer from the transaction,⁶ (2) 15 percent of the “foreign trade income” derived by the taxpayer from the transaction, or (3) 30 percent of the “foreign sale and leasing income” derived by the taxpayer from the transaction. The amount of qualifying foreign trade income determined using 1.2 percent of the foreign trading gross receipts is limited to 200 percent of the qualifying foreign trade income that would result using 15 percent of the foreign trade income. Instead of calculating qualifying foreign trade income in a manner that results in the greatest reduction in taxable income, a taxpayer may choose instead to use one of the other two calculations. If a taxpayer uses 1.2 percent of foreign trading gross receipts to determine the amount of qualifying foreign trade income with respect to a transaction, the taxpayer or any other related persons will be treated as having no qualifying foreign trade income with respect to any

⁵ Certain foreign withholding taxes determined on a gross basis are fully allocated to nonqualifying foreign trade income.

⁶ The term “transaction” means (1) any sale, exchange, or other disposition; (2) any lease or rental, and (3) any furnishing of services.

other transaction involving the same property.⁷ Qualifying foreign trade income must be reduced by illegal bribes, kickbacks and similar payments, and by a factor for operations in or related to a country associated in carrying out an international boycott, or participating or cooperating with an international boycott.

A taxpayer may determine the amount of qualifying foreign trade income either on a transaction-by-transaction basis or on an aggregate basis for groups of transactions, so long as the groups are based on product lines or recognized industry or trade usage. The Secretary of the Treasury is granted authority to prescribe rules for grouping transactions in determining qualifying foreign trade income. In addition, the Secretary of the Treasury is directed to prescribe rules for marginal costing in those cases in which a taxpayer is seeking to establish or maintain a market for qualifying foreign trade property.

Foreign trading gross receipts

“Foreign trading gross receipts” are gross receipts derived from certain activities in connection with “qualifying foreign trade property” with respect to which certain "economic processes" take place outside of the United States. Specifically, the gross receipts must be (1) from the sale, exchange, or other disposition of qualifying foreign trade property; (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside of the United States; (3) for services which are related and subsidiary to the sale, exchange, disposition, lease, or rental of qualifying foreign trade property (as described above); (4) for engineering or architectural services for construction projects located outside of the United States; or (5) for the performance of certain managerial services for unrelated persons. Foreign trading gross receipts do not include gross receipts from a transaction if the qualifying foreign trade property or services are for ultimate use in the United States, or for use by the United States (or an instrumentality thereof) and such use is required by law or regulation. Foreign trading gross receipts also do not include gross receipts from a transaction that is accomplished by a subsidy granted by the government (or any instrumentality thereof) of the country or possession in which the property is manufactured. A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a consequence of such an election, the taxpayer could utilize any related foreign tax credits in lieu of the exclusion as a means of avoiding double taxation.

Foreign economic processes

Gross receipts from a transaction are foreign trading gross receipts only if certain economic processes take place outside of the United States. The foreign economic processes requirement is satisfied if the taxpayer (or any person acting under a contract with the taxpayer) participates outside of the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to such transaction and incurs a specified amount of foreign

⁷ Persons are considered to be related if they are treated as a single employer under section 52(a) or (b) (determined without taking into account section 1563(b), thus including foreign corporations) or section 414(m) or (o).

direct costs attributable to the transaction.⁸ For this purpose, foreign direct costs include only those costs incurred in the following categories of activities: (1) advertising and sales promotion; (2) the processing of customer orders and the arranging for delivery; (3) transportation outside of the United States in connection with delivery to the customer; (4) the determination and transmittal of a final invoice or statement of account or the receipt of payment; and (5) the assumption of credit risk. A taxpayer's foreign economic processes requirement is treated as satisfied with respect to a sales transaction (solely for the purpose of determining whether gross receipts are foreign trading gross receipts) if any related person has satisfied the foreign economic processes requirement in connection with another sales transaction involving the same qualifying foreign trade property. An exception from the foreign economic processes requirement is provided for taxpayers with foreign trading gross receipts for the year of \$5 million or less.⁹

Qualifying foreign trade property

The threshold for determining if gross receipts will be treated as foreign trading gross receipts is whether the gross receipts are derived from a transaction involving "qualifying foreign trade property." Qualifying foreign trade property is property manufactured, produced, grown, or extracted ("manufactured") within or outside of the United States that is held primarily for sale, lease, or rental, in the ordinary course of a trade or business, for direct use, consumption, or disposition outside of the United States.¹⁰ In addition, not more than 50 percent of the fair market value of such property can be attributable to the sum of (1) the fair market value of articles manufactured outside of the United States plus (2) the direct costs of labor performed outside of the United States.¹¹

Certain property is excluded from the definition of qualifying foreign trade property. The excluded property is (1) property leased or rented by the taxpayer for use by a related person, (2)

⁸ The foreign direct costs attributable to the transaction generally must exceed 50 percent of the total direct costs attributable to the transaction, but the requirement also will be satisfied if, with respect to at least two categories of direct costs, the foreign direct costs equal or exceed 85 percent of the total direct costs attributable to each category.

⁹ For this purpose, the receipts of related persons are aggregated and, in the case of pass-through entities, the determination of whether the foreign trading gross receipts exceed \$5 million is made both at the entity and at the partner/shareholder level.

¹⁰ "United States" includes Puerto Rico for these purposes because Puerto Rico is included in the customs territory of the United States.

¹¹ For this purpose, the fair market value of any article imported into the United States is its appraised value as determined under the Tariff Act of 1930. In addition, direct labor costs are determined under the principles of section 263A and do not include costs that would be treated as direct labor costs attributable to articles manufactured outside the United States.

certain intangibles,¹² (3) oil and gas (or any primary product thereof), (4) unprocessed softwood timber, (5) certain products the transfer of which are prohibited or curtailed to effectuate the policy set forth in Public Law 96-72, and (6) property designated by Executive order as in short supply.

With respect to property that is manufactured outside of the United States, rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers. The bill requires that property manufactured outside of the United States be manufactured by (1) a domestic corporation, (2) an individual who is a citizen or resident of the United States, (3) a foreign corporation that elects to be subject to U.S. taxation in the same manner as a U.S. corporation, or (4) a partnership or other pass-through entity all of the partners or owners of which are described in (1), (2), or (3) above.¹³

Foreign trade income

“Foreign trade income” is the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts. Certain dividends-paid deductions of cooperatives are disregarded in determining foreign trade income for this purpose.

Foreign sale and leasing income

“Foreign sale and leasing income” is the amount of the taxpayer’s foreign trade income (with respect to a transaction) that is properly allocable to activities that constitute foreign economic processes (as described above). Foreign sale and leasing income also includes foreign trade income derived by the taxpayer in connection with the lease or rental of qualifying foreign trade property for use by the lessee outside of the United States. Income from the sale, exchange, or other disposition of qualifying foreign trade property that is or was subject to such a lease¹⁴ (i.e., the sale of the residual interest in the leased property) gives rise to foreign sale and leasing income. Except as provided in regulations, a special limitation applies to leased property that (1) is manufactured by the taxpayer or (2) is acquired by the taxpayer from a related person for a price that was other than arm’s length. In such cases, foreign sale and leasing income may

¹² The intangibles that are treated as excluded property under the bill are: patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property.

¹³ Except as provided by the Secretary of the Treasury, tiered partnerships or pass-through entities will be considered as partnerships or pass-through entities for purposes of this rule if each of the partnerships or entities is directly or indirectly wholly-owned by persons described in (1), (2), or (3) above.

¹⁴ For this purpose, a lease includes a lease that gave rise to exempt foreign trade income under the FSC provisions.

not exceed the amount of foreign sale and leasing income that would have resulted if the taxpayer had acquired the leased property in a hypothetical arm's-length purchase and then engaged in the actual sale or lease of such property.

For purposes of determining foreign sale and leasing income, only directly allocable expenses are taken into account in calculating the amount of foreign trade income. In addition, income properly allocable to certain intangibles is excluded for this purpose.

Other rules

The bill provides a limitation with respect to the sourcing of taxable income applicable to certain sale transactions giving rise to foreign trading gross receipts. This limitation only applies with respect to sale transactions involving property that is manufactured within the United States. The special source limitation does not apply if qualifying foreign trade income is determined using 30 percent of the foreign sale and leasing income from the transaction.

The bill provides that certain foreign corporations may elect to be treated as domestic corporations. The election applies to the taxable year when made and all subsequent taxable years unless revoked by the taxpayer or terminated for failure to qualify for the election. Such election is available for a foreign corporation (1) that manufactures property in the ordinary course of such corporation's trade or business, or (2) if substantially all of the gross receipts of such corporation reasonably may be expected to be foreign trading gross receipts. Once a termination occurs or a revocation is made, the former electing corporation may not again elect to be taxed as a domestic corporation under the provisions of the bill for a period of five tax years beginning with the first taxable year that begins after the termination or revocation.

The bill provides rules relating to allocations of qualifying foreign trade income by certain shared partnerships. To the extent that such a partnership (1) maintains a separate account for transactions involving foreign trading gross receipts with each partner, (2) makes distributions to each partner based on the amounts in the separate account, and (3) meets such other requirements as the Treasury Secretary may prescribe by regulations, such partnership then would allocate to each partner items of income, gain, loss, and deduction (including qualifying foreign trade income) from such transactions on the basis of the separate accounts.

The bill also provides that qualifying foreign trade property that is held for lease or rental, in the ordinary course of a trade or business, for use by the lessee outside of the United States is not taken into account for interest allocation purposes.

The bill provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative (to which Part I of Subchapter T applies), which is allocable to qualifying foreign trade income of the cooperative, is treated as qualifying foreign trade income of the member (and, thus, excludable from such member's gross income). The cooperative cannot reduce its income (e.g., cannot claim a "dividends-paid deduction") under section 1382 for such amounts.

Under the bill, a U.S. corporation may claim a 100 percent dividends-received deduction with respect to any dividend that is distributed out of earnings and profits of a controlled foreign corporation (as defined in section 957), but only if such dividend is attributable to qualifying foreign trade income. Only U.S. corporations that are also U.S. shareholders (as defined in section 951(b)) are eligible for this 100 percent dividends-received deduction.

Effective Date

In general

The bill would be effective for transactions entered into after September 30, 2000. In addition, no corporation may elect to be a FSC after September 30, 2000.

The bill also provides a rule requiring the termination of a dormant FSC when the FSC has been inactive for a specified period of time. Under this rule, a FSC that generates no foreign trade income for any five consecutive years beginning after December 31, 2001, will cease to be treated as a FSC.

Transition rules

The bill provides a transition period for existing FSCs and for binding contractual agreements. The new rules do not apply to transactions in the ordinary course of business involving a FSC before January 1, 2002. Furthermore, the new rules do not apply to transactions in the ordinary course of business after December 31, 2001, if such transactions are pursuant to a binding contract between a FSC (or a person related to the FSC on September 30, 2000) and any other person (that is not a related person) and such contract is in effect on September 30, 2000, and all times thereafter. For this purpose, binding contracts include purchase options, renewal options, and replacement options that are enforceable against a lessor or seller (provided that the options are a part of a contract that is binding and in effect on September 30, 2000). Notwithstanding the transition period, FSCs (or related persons) may elect to have the new rules apply in lieu of the rules applicable to FSCs.

Similar to the limitation on use of the gross receipts method under the new rules, the use of the gross receipts method for transactions after the effective date of the bill is limited if that same property generated foreign trade income to a FSC using the gross receipts method. Under this limitation, if any person used the gross receipts method under the FSC provisions, neither that person nor any related person will have qualifying foreign trade income with respect to any other transaction involving the same item of property.