BACKGROUND AND HISTORY OF THE TRADE DISPUTE RELATING TO THE PRIOR-LAW FOREIGN SALES CORPORATION PROVISIONS AND THE PRESENT-LAW EXCLUSION FOR EXTRATERRITORIAL INCOME AND A DESCRIPTION OF THESE RULES

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on February 27, 2002

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

February 25, 2002
JCX-10-02

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides background and history relating to the European Union's actions to challenge the legality under international trade agreements of the prior-law foreign sales corporation ("FSC") rules and the present-law extraterritorial income ("ETI") rules (as well as predecessor rules), and the current status of the trade dispute over the ETI rules before the World Trade Organization ("WTO"). The document also provides summary descriptions of the FSC and ETI rules.

[1] This document may be cited as follows: Joint Committee on Taxation, *Background and History of the Trade Dispute Relating to the Prior-Law Foreign Sales Corporation Provisions and the Present-Law Exclusion for Extraterritorial Income and a Description of These Rules*, (JCX-10-02), February 25, 2002.

A. Overview

Like many other countries, the United States has long provided export-related benefits under its tax law. In the United States, for most of the last two decades, these benefits were provided under the FSC regime. In 2000, the European Union ("EU") succeeded in having the FSC regime declared a prohibited export subsidy by the WTO. In response to this WTO ruling, the United States repealed the FSC rules and enacted the ETI regime. The EU immediately challenged the ETI regime in the WTO, and in January of 2002 a WTO Appellate Body held that the ETI regime also constituted a prohibited export subsidy under the relevant trade agreements. The EU is seeking authorization from a WTO arbitration panel to impose over $4 billion in trade sanctions. The United States is currently deciding how it will respond to these latest developments.

B. Background and History of the Trade Dispute Over the FSC and ETI Regimes

The "DISC" dispute and enactment of the FSC regime

Prior to the enactment of the FSC regime, the United States provided a different system of export-related tax benefits, which applied to certain export-intensive corporations known as "domestic international sales corporations" ("DISCs").[2] Under this regime, DISCs were incorporated as domestic corporations, but DISC income was exempt from corporate income tax, and the shareholder-level tax on that income was in part deferred. Shortly after the DISC regime's enactment in 1971, certain signatories to the General Agreement on Tariffs and Trade ("GATT") challenged the regime as a prohibited export subsidy. In 1976, a GATT panel sustained these challenges, as well as U.S. challenges to certain export tax incentives provided by France, Belgium, and the Netherlands. These rulings of the panel proved controversial and remained unadopted by the relevant signatory countries for a number of years.

In 1981, without conceding that the DISC regime violated the GATT, the United States agreed to adopt the general findings of the GATT panel, subject to a 1981 GATT Council Decision (the "1981 Understanding"), which was understood to qualify those findings. The 1981 Understanding had three main components: (1) GATT signatories are not required to tax export income that is attributable to economic processes occurring outside their territorial limits; (2) "arm's length" transfer pricing principles should be observed in transactions between exporting enterprises and related foreign buyers; and (3) the GATT does not prohibit the adoption of measures to avoid the double taxation of foreign-source income.

A debate subsequently ensued as to whether the DISC regime violated the GATT, as interpreted in light of the 1981 Understanding. The European Communities ("EC") argued that the DISC regime constituted an illegal export subsidy because it provided tax benefits for export income earned within the United States. The United States defended the regime on the grounds that, as applied to exports, it merely approximated the effect of a territorial tax system of the kind

[2] Another export incentive in turn preceded the DISC regime -- under provisions enacted in 1962, controlled foreign corporations that qualified as "export trade corporations" were permitted to reduce their subpart F income by the amount of certain export trade income.

commonly used by European countries, which in turn was considered acceptable under the 1981 Understanding. A majority of GATT Council members sided with the EC and urged the United States to bring the DISC regime into compliance with the GATT. In addition, the EC took steps toward seeking approval for the imposition of trade sanctions against the United States, and other signatories indicated that they would seek compensation from the United States. In late 1982, the United States made a commitment to the GATT Council to develop legislation that would address these concerns, and in early 1983, the President set forth a proposal to replace the DISC regime with a new system that was thought to be GATT-compliant (without conceding that the DISC regime was not GATT-compliant).

In 1984, the Congress enacted legislation along the general lines proposed by the President, creating the FSC regime. Unlike the DISC regime, the FSC regime provided tax benefits for export-related income earned by foreign corporations that were required to have a foreign presence and to perform export-related activities outside the United States. Transfer pricing principles were also set forth for the measurement of FSC income. In light of these features, which caused the FSC regime to emulate more closely certain aspects of an exemption-method territorial tax system, the FSC regime was thought to fall directly within the terms of the 1981 Understanding.

The FSC regime had been in existence for approximately 14 years when the EU brought a case against it in the WTO in mid-1998.

The FSC dispute and enactment of the ETI regime

In 1999, a WTO panel agreed with the EU that the FSC regime constituted a prohibited export subsidy under the relevant WTO agreements, and in early 2000 a WTO Appellate Body upheld that finding. The rulings held that the FSC rules constituted a subsidy because under those rules the government refrained from collecting revenue that was "otherwise due"; the rulings held that this subsidy was prohibited because it was export-contingent. The EU also expressed additional objections to the FSC regime that were not addressed by the WTO -- specifically, that the FSC transfer pricing rules were not "arm's length," and that the FSC regime encouraged the use of tax havens.

In an effort to comply with these rulings (and to address the additional concerns raised by the EU), in late 2000 the United States repealed the FSC regime and enacted the ETI regime.

Under the ETI regime, an exclusion from gross income applies with respect to "extraterritorial income," which is a taxpayer's gross income attributable to "foreign trading gross receipts." This income is eligible for the exclusion to the extent that it is "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, (2) 15 percent of the

"foreign trade income" derived by the taxpayer from the transaction,[3] or (3) 30 percent of the "foreign sale and leasing income" derived by the taxpayer from the transaction.[4]

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 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 the United States; or (5) for the performance of certain managerial services for unrelated persons. A taxpayer may elect to treat gross receipts from a transaction as not foreign trading gross receipts. As a result of such an election, a taxpayer may use any related foreign tax credits in lieu of the exclusion.

Qualifying foreign trade property generally is property manufactured, produced, grown, or extracted within or outside 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 the United States. No 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 the United States and (2) the direct costs of labor performed outside the United States. With respect to property that is manufactured outside the United States, certain rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers.

Even before Congress enacted the ETI regime, the EU informed the United States that it intended to challenge the regime before the WTO.

The ETI dispute

Two days after the President signed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 into law, the EU brought its case against the ETI regime in the WTO. In August of 2001, a WTO panel (the "Panel") held that the ETI regime constituted a prohibited export subsidy under the relevant WTO agreements,[5] and a WTO Appellate Body (the

[3] "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.

[4] "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. 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 the United States.

[5] United States -- Tax Treatment for "Foreign Sales Corporations" -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, August 20, 2001.

"Appellate Body") later affirmed the Panel's findings (but modified the Panel's reasoning in part).[6]

Overview of the Appellate Body decision

In general

The Appellate Body reviewed and upheld several findings of the Panel, including the findings that the ETI legislation: (1) involves the forgoing of revenue which is otherwise due and thus gives rise to a "financial contribution" (i.e., a subsidy); (2) includes subsidies contingent on export performance; (3) does not qualify for the exception from treatment as a prohibited export subsidy as a measure to avoid double taxation of foreign-source income; (4) is inconsistent with other U.S. trade obligations because it accords less favorable treatment to imported products as compared with like products of U.S. origin; and (5) did not fully withdraw the FSC rules that were previously found to constitute a prohibited export subsidy.[7]

Subsidy

The Panel found that the ETI rules constitute a subsidy under the Agreement on Subsidies and Countermeasures (the "SCM Agreement"). Under that agreement, a subsidy is deemed to exist if there is a financial contribution by a government, and a benefit is thereby conferred. A financial contribution by a government exists where government revenue that is otherwise due is forgone or not collected.

The Appellate Body reviewed the Panel's finding that the ETI rules involve the forgoing of revenue that is otherwise due and thus give rise to a financial contribution. The Appellate Body stated that the term "otherwise due" implies a comparison with a "defined, normative benchmark," to distinguish situations where revenue forgone is "otherwise due" and situations where such revenue is not "otherwise due." The Appellate Body further stated that the normative benchmark for the ETI rules consists of the other rules of taxation applicable to the foreign-source income of U.S. citizens and residents earned through the sale or lease of property, or through the performance of related services.

The Appellate Body stated that the United States taxes U.S. citizens and residents, in principle, on all foreign-source income, subject to permissible deductions and allowable foreign tax credits. The Appellate Body further stated that, under the ETI rules, certain extraterritorial income (i.e., "qualifying foreign trade income") is excluded from U.S. taxation, and that taxpayers may elect to apply this exclusion or be subject to tax under the other rules applicable to

[6] United States -- Tax Treatment for "Foreign Sales Corporations" -- Recourse to Article 21.5 of the DSU by the European Communities, WT/DS108/RW, Report of the Panel, as modified by the Appellate Body, January 14, 2002, adopted January 29, 2002 (the "Appellate Body Decision").

[7] The Appellate Body also reviewed and upheld other findings of the Panel, including a finding that the ETI rules involve prohibited export subsidies under the Agreement on Agriculture.

such income. The Appellate Body further stated that where a taxpayer elects to apply the ETI rules, "the amount of tax paid by the taxpayer will very likely be less than the tax which the taxpayer would have paid, on that income, under the rules 'otherwise' applicable to foreign-source income, if the taxpayer did not elect to use the ETI measure."[8] The Appellate Body concluded that "the definitive exclusion from tax of [qualifying foreign trade income], compared with the taxation of other foreign-source income, and coupled with the right of election for taxpayers to use the rules of taxation most favourable to them, means that, under the contested measure, the United States foregoes revenue on [qualifying foreign trade income] which is otherwise due."[9]

Export contingency

The Appellate Body upheld the Panel's finding that the ETI rules include subsidies contingent on export performance. The SCM Agreement prohibits "subsidies contingent, in law or in fact, whether solely or as one of several conditions, upon export performance." The Panel found that the ETI rules involve subsidies contingent in law upon exports in relation to property produced in the United States.

The Appellate Body concluded that the ETI rules grant a tax exemption as to certain transactions involving two different types of property: (1) property that is produced within the United States and held for use outside the United States, and (2) property that is produced outside the United States and held for use outside the United States. The Appellate Body reasoned that the division of the ETI rules into these two separate circumstances is supported by provisions in the ETI rules themselves, each addressing a particular factual situation: specifically, certain foreign-source limitation rules that apply only to property produced in the United States and certain consistency rules that apply only to property produced outside the United States. The Appellate Body concluded that the portion of the ETI rules that provides a tax exemption for property produced in the United States and held for use outside the United States is export-contingent.[10]

Exception for measures to avoid double taxation

Under the SCM Agreement, even a subsidy that is contingent on exports is not prohibited if it is found to be a measure designed to avoid the double taxation of foreign-source income (often referred to as the "Footnote 59" exception, after its location in the SCM Agreement). The Appellate Body rejected the U.S. argument that the ETI regime qualified for the Footnote 59 exception, because it found that the regime applied not only to foreign-source income that could potentially be subjected to double taxation, but also to a broad class of U.S.-source income that

[8] Appellate Body Report at 32.

[9] Id.

[10] The Appellate Body did not opine on the issue of whether the portion of the ETI rules that applies to property produced outside the United States and held for use outside the United States is export-contingent.

faced no such threat of double taxation (e.g., income attributable to manufacturing activities in the United States).

While the Appellate Body acknowledged that countries must be given latitude to develop their own definitions of foreign-source income, it held that, at a minimum, such income must have some functional connection to a foreign country sufficient to create some possibility of taxation in that foreign country. While the ETI regime's foreign economic processes requirement ensures that transactions qualifying for benefits under the ETI regime involve some link to activities conducted abroad, the Appellate Body held that that requirement was insufficient to ensure that all of the income generated in those transactions (and benefited by the ETI regime) possessed such a link. In particular, the Appellate Body examined the three main methods for calculating "qualifying foreign trade income" under the ETI regime and noted that, of the three methods, only the one applicable to "foreign sale and leasing income" includes any allocation rule to distinguish income connected with foreign activities from income connected with domestic activities. The other two methods employ formulas based on flat percentages (1.2 percent of "foreign trading gross receipts" or 15 percent of "foreign trade income") and thus, in the Appellate Body's view, do not sufficiently distinguish between foreign-source and domestic-source income in providing the ETI benefit. In addition, the foreign economic processes requirement does not apply at all to "small" taxpayers (i.e., those with $5 million or less of "foreign trading gross receipts"), and thus, according to the Appellate Body, no effort at all is made to distinguish foreign-source and domestic-source income with respect to these taxpayers.

The Appellate Body further noted that the ETI regime is elective, and that taxpayers are allowed to choose between the ETI regime and the foreign tax credit regime generally provided under U.S. law to mitigate double taxation, making it difficult in the Appellate Body's view to maintain that the United States designed and enacted the ETI regime with a view toward avoiding double taxation.

Limitation on foreign content

The Appellate Body upheld the Panel's finding that the ETI rules accord less favorable treatment to imported products as compared with like products of U.S. origin and thus violate the GATT 1994, which broadly prohibits discrimination against imports. The ETI rules require that not more than 50 percent of the fair market value of qualifying foreign trade property may be attributable to articles produced or direct labor performed outside the United States. In the Appellate Body's view, this foreign-content limitation on the ETI tax benefit constitutes discrimination against imports in violation of the GATT 1994, because taxpayers seeking ETI benefits have an incentive to use U.S. inputs instead of foreign inputs in order to ensure that they comply with the foreign-content limitation.

Withdrawal of FSC rules

The Appellate Body upheld the Panel's finding that the United States has not fully withdrawn the FSC rules previously found to be prohibited export subsidies. In the FSC dispute, the WTO panel recommended that the United States withdraw the FSC subsidies by October 1, 2000; the WTO Dispute Settlement Body acceded to a U.S. request to modify the time period in that dispute to expire on November 1, 2000. Although the FSC rules have been largely repealed,

transition rules apply to certain existing FSCs and to certain pre-existing binding contractual arrangements involving FSCs. The Appellate Body concluded that the FSC rules were required to be fully withdrawn without delay, and that there was no basis to extend the time period for the United States to fully withdraw the FSC rules.

Arbitration proceedings on trade sanctions

WTO rules allow complaining countries to impose countermeasures against countries that are found to violate their WTO obligations. In this dispute, the EU has requested authorization from a WTO arbitration panel to impose trade sanctions in the amount of $4.043 billion per year against U.S. exports. The EU bases this figure on estimates of the total cost to the United States of providing the subsidy, not on any estimate of actual trade harm to the EU itself. The United States argues in its submission to the arbitration panel that the EU figure is disproportionate to any possible harm to the EU itself and is therefore inappropriate, and that the maximum level of permissible sanctions in this case is $956 million per year.

The parties filed their initial submissions on the sanctions issue in early February of 2002. Rebuttal briefs are due on February 26, 2002, and oral argument before the arbitration panel is scheduled for March 7, 2002. The arbitration panel's decision is expected by the end of April 2002.

C. Description of Prior-Law FSC Rules

Under prior law, the income of an eligible FSC was partially subject to U.S. income tax and partially exempt from U.S. income tax. In addition, a U.S. corporation generally was not subject to U.S. income tax on dividends distributed from the FSC out of certain earnings.

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

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

Foreign trade income, other than exempt foreign trade income, generally was 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 FSC's income, other than exempt foreign trade income, generally was subject to U.S. tax on a current basis and was treated as U.S.-source income for purposes of the foreign tax credit limitation.

Foreign trade income of a FSC was defined as the FSC's gross income attributable to foreign trading gross receipts. Foreign trading gross receipts generally were 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 were excluded from the definition of foreign trading gross receipts.

The term "export property" generally meant property (1) which is manufactured, produced, grown or extracted in the United States by a person other than a FSC; (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" did not include property leased or rented by a FSC for use by any member of a controlled group of which the FSC 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 excluded property designated by the President as being in short supply.

If export property was sold to a FSC by a related person (or a commission was paid by a related person to a FSC with respect to export property), the income with respect to the export transaction was required to be allocated between the FSC and the related person. The taxable income of the FSC and the taxable income of the related person were computed based upon a transfer price determined under section 482 or under one of two formulas specified in the FSC provisions.

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

A FSC was not required or deemed to make distributions to its shareholders. Actual distributions were treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits. A U.S. corporation generally was allowed a 100 percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to foreign trade income. The 100 percent dividends-received deduction was not allowed for nonexempt foreign trade income determined under section 482 pricing. Any distribution made by a FSC out of earnings and profits attributable to foreign trade income to a foreign shareholder was treated as U.S.-source income effectively connected with a business conducted through a permanent establishment of the shareholder within the United States. Thus, the foreign shareholder was subject to U.S. tax on such a distribution.

D. Description of Present-Law ETI rules

Overview -- exclusion of extraterritorial income

Gross income for U.S. tax purposes does not include extraterritorial income. No foreign tax credit is allowed for income taxes paid with respect to such excluded income. 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 rules apply 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, (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. Notwithstanding the general rule that qualifying foreign trade income is based on whichever of the three calculations results in the greatest reduction in taxable income, a taxpayer may choose instead to use one of the other two calculations that does not result in the greatest reduction in taxable income. 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.

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 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 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 the United States; or (5) for the performance of certain managerial services for unrelated persons. Gross receipts from the lease or rental of qualifying foreign trade property include gross receipts from the license of qualifying foreign trade property (e.g., the license of computer software for reproduction abroad). 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 use 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 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 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 direct costs attributable to the transaction.

Qualifying foreign trade property

Qualifying foreign trade property is property manufactured, produced, grown, or extracted (collectively, "manufactured") within or outside 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. 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 the United States plus (2) the direct costs of labor performed outside the United States.

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) certain intangibles, (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 the United States, rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers. Property manufactured outside the United States must 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.

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 expense allocation purposes.

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.

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.

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 the United States. Income from the sale, exchange, or other disposition of qualifying foreign trade property that is or was subject to such a lease (i.e., the sale of the residual interest in the leased property) gives rise to foreign sale and leasing income.

Other rules

A limitation applies 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 when qualifying foreign trade income is determined using 30 percent of the foreign sale and leasing income from the transaction.

Foreign tax credits generally are not allowed for foreign taxes paid or accrued with respect to qualifying foreign trade income (i.e., excluded extraterritorial income). In determining whether foreign taxes are paid or accrued with respect to qualifying foreign trade income, foreign withholding taxes generally are treated as not paid or accrued with respect to qualifying foreign trade income.

Certain foreign corporations may elect, on an original return, 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 are foreign trading gross receipts.

Special rules apply to allocations of qualifying foreign trade income by certain shared partnerships.

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).

Certain transition rules apply with respect to certain existing FSCs and for certain pre-existing binding contractual arrangements. For transactions to which the transition rules apply, taxpayers may elect to apply the ETI rules instead of the FSC rules.