TRENDS IN THE LAW

BUSINESS LAW

U.S. Foreign Sales Corporation Challenged by European Union

BY JULIE E. MCGUIRE

The European Union recently challenged the Foreign Sales Corporation as an illegal trading subsidy which violates the subsidies agreement existing among the United States and its European trading partners.

An FSC is a corporation given special tax treatment under the U.S. tax laws. The purpose of the FSC provisions is to promote United States exports in a manner compatible with GATT (General Agreement on Tariffs and Trade).

The firm's practice areas include corporate planning and transactions, tax law, intellectual property, complex litigation, employment law, environmental and natural resources law and legislative law.

Whether the EU's current attack on the FSC will prevail is questionable — given the caution, extensive discussion and considerable deliberation that the U.S. Congress undertook to comply with GATT when first enacting the FSC legislation.

In the mid-1980's, Congress advisedly elected to give up tax revenue when it enacted the FSC provisions (and its predecessor DISC provisions in the early 1970's). Congress made this decision to enable U.S. manufacturers, confronted with a harsh taxing scheme based on worldwide income, to compete with non-U.S. manufacturers who face less onerous taxing schemes, often territorial in scope.

The FSC represents a partial adoption of the territorial approach to taxation.

To create the FSC, Congress established an important exception to the otherwise very sweeping scope of U.S. taxation.

Congress took great care to comply with GATT rules concerning trade subsidies. In fact, the FSC was designed specifically to address the concerns of those trading partners who had alleged that the FSC's predecessor, the DISC, violated GATT's policies surrounding trade subsidies.

The FSC is one of the few great tax benefits left in the U.S. tax code. And it is available to most U.S. exporters. Surprisingly, the FSC has remained underutilized, leaving untapped the opportunity for U.S. exporters to pay less U.S. income tax.

Many businesses mistakenly believe that the FSC has become obsolete, or was at some point statutorily abolished.

In fact, the opposite is true. In 1997, Congress explicitly expanded the definition of qualified export property to include computer software licensed for reproduction abroad. Internal Revenue Code Section 927(a)(2)(B).

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BASIC FSC CONCEPT

Even though the statutory rules surrounding the FSC are somewhat complex, the FSC idea is simple: the U.S. exporter sets up an offshore subsidiary — the FSC — in an approved foreign jurisdiction.

The savings are achieved by "pushing" a portion of export income to the FSC and by exempting a portion of that export income from U.S. tax. This can be done by either:

- having the U.S. parent sell the product to its FSC under regulated pricing rules, with the FSC then reselling to the ultimate customer, or
- having the U.S. parent pay the FSC a commission based on the amount of the FSC's export sales.

Under either structuring, a portion of the export profit is attributable to the FSC — not the U.S. company. Statutorily, a portion of the FSC income is exempted from U.S. tax.

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Without the FSC legislation, this type of profit, simply shifted offshore, would be immediately subject to U.S. tax. The FSC exceptions to the broad worldwide taxation requirements of the U.S. tax law are codified at Sections 921 through 927 of the U.S. Internal Revenue Code.

EXPORT PROPERTY

The U.S. exporter must sell, lease or otherwise dispose of "export property" to benefit from an FSC. Generally, "export property" is defined as property (i) manufactured, produced, grown or extracted in the U.S. by someone other than the FSC (not more than 50% of the fair market value of the property can be attributable to articles imported into the U.S.), and (ii) held primarily for sale, lease or other disposition in the ordinary course of business for direct use or disposition outside the U.S.

Disposition is considered to take place outside the U.S. even if the seller delivers the property within the U.S. as long as the property is ultimately delivered outside the U.S. by the purchaser within one year after sale.

Certain property is statutorily excluded from the definition of "export property" and cannot produce an FSC benefit. The following cannot be export property:

- patents, inventions, models, designs, formulas or processes, whether or not patented;
- goodwill, trademarks, trade brands, franchises or other like property, including copyrights (other than films, tapes, records, or, now, computer software or similar reproductions, for commercial or home use); and
- oil and oil and gas products.

The actual calculations necessary to determine the exemption amount are complex. But the amount on which the exemption is based revolves around "Foreign Trading Gross Receipts."

FTGR are gross receipts of the FSC resulting from the sale or other disposition of "export property."

The most general categories of gross receipts comprising FTGR include gross receipts:

- from the sale of export property;
- from the lease of export property for use by the lessee outside the United States;
- for FSC services which are related and subsidiary to the sale or lease of export property, or
- for engineering or architectural services for construction projects located (or proposed for location) outside the U.S.

FOREIGN MANAGEMENT AND ECONOMIC PROCESSES REQUIREMENTS

The FSC can have FTGR — and therefore qualify for the exemption — only if the FSC meets two additional requirements: (1) the "foreign management" requirement and (2) the "foreign economic processes" requirement.

The "foreign management" requirement is met if:

- all meetings of the board and all meetings of the shareholders are outside the U.S.;
- the principal bank account of the FSC is maintained outside the U.S. at all times during the taxable year; and
- all dividends, legal and accounting fees, and salaries of officers and members of the board of directors disbursed during the taxable year are disbursed out of bank accounts of the FSC maintained outside the U.S.

The "foreign economic processes" requirement is somewhat more complex, but generally requires testing to make certain that activities performed by or *on behalf of* the FSC take place *outside* the U.S. This test focuses on two factors:

- sales activities outside the United States, and
- foreign direct cost activities outside the United States.

FSCs that qualify as "small FSCs" ($5 million (USD) or less in FTGR) do not need to meet the foreign management or foreign economic processes requirements.

PRICING RULES

Finally, the pricing rules included with the FSC provisions are critical to the use — and reaping the benefit — of the FSC. The pricing between the parent and its FSC subsidiary will determine the profit that is shifted offshore and therefore is central to a determination of the amount of tax exempted from U.S. tax.

Because the pricing determines the amount of the exclusion, and because the exclusion itself is a matter of legislative grace, the pricing between the parent and the FSC is controlled by specific and somewhat complicated regulations.

Under these regulations, only a certain amount of the profit can be pushed offshore so that the amount of the tax exemption can be controlled.

Under the pricing regulations, two different pricing "standard" schemes are considered: (1) 23% of Combined Taxable Income Method ("administrative pricing method"); and (2) 1.83% of Foreign Trade Gross Receipts Method ("gross receipts method").

Under the first method, 23% of the combined taxable income of the FSC and its supplier from the export transaction will be considered the FSC's income from that transaction. Under the second method, the profit the FSC is deemed to derive from the export transaction is equal to 1.83% of the foreign trading gross receipts from the transaction.

The U.S. taxpayer is allowed to choose annually that pricing regime resulting in the greatest FSC benefit.

FOREIGN TRADE INCOME EXCLUSION

After the pricing regulations are applied, the gross income of the FSC is called FTI ("foreign trade income"). This is the FSC income attributable to foreign trading gross receipts.

As long as the FSC rules are met, a portion of the FSC's FTI will be exempt from federal income taxation.

The ultimate amount of the exemption is determined by applying a statutory percentage to the FSC's FTI. A special dividend-received deduction allows dividends to be returned tax-free to the U.S. parent, making the FSC structure even more tax-efficient.

U.S. exporters — particularly those with export revenue of $1 million (USD) or more — should evaluate the potential savings opportunity offered by the FSC.

Generally, by using an FSC, a U.S. exporter can lower its effective tax rate on its export income from 35% to just under 30%. ■