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U.S. Foreign Sales Corporation ("FSC") Challenged By European Union

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

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 § 927 (a)(2)(B).

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 (1) 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 (2) 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. 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 a FSC. Generally, "export property" is defined as property (i) manufactured, produced, grown or extracted in the