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# Transition From DISC to a Foreign Sales Corporation: Tax and Other Considerations

## I. Introduction

Effective January 1, 1985, the benefits of a Domestic International Sales Corporation (DISC) were severely curtailed for most taxpayers. On that date the new Foreign Sales Corporation (FSC) provisions of the Tax Reform Act of 1984 (Tax Act) became effective. These provisions are intended to make United States export incentive legislation compatible to the General Agreement on Tariffs and Trade (GATT) and are based on the GATT rule that a country need not tax income from economic processes occurring outside its territory.<sup>1</sup> This article is designed to assist corporations with export operations to maximize the benefits available under this new FSC legislation.

## II. General Comparison of FSC and DISC

A FSC, like a DISC, is a sales company which is entitled to special United States tax benefits on its export income. Similar to a DISC, export sales may

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1. *Senate Comm. on Finance, 98th Cong., 2d Sess., Explanation of Deficit Reduction Act of 1984* 634-35 (Comm. Print 1984) [hereinafter cited as *Senate Report*]. In short, the GATT Council in 1981 concluded that DISC was in effect an illegal export subsidy which violated GATT because it provided a tax incentive designed to encourage exports. In the 1981 decision, certain criteria for taxing income from export sales was enunciated: a GATT signatory is required to tax income arising within the country, but is not required to tax export income attributable to economic processes occurring outside its territorial limits. See Hibbitt, *Foreign Sales Corporations*, NEWSLETTER OF INTERNATIONAL LAW, SECTION OF STATE BAR OF TEXAS, 3-21 (Oct. 1984).

be made through a FSC on a buy-sell or commission basis.<sup>2</sup> Unlike a DISC, however, a FSC must be incorporated in a foreign jurisdiction.

The DISC provisions generally permit indefinite deferral of United States taxes on a portion of a DISC's income.<sup>3</sup> In contrast, a portion of a FSC's export income (foreign trade income) is permanently exempted from United States taxation. A DISC is not required to have any substance or perform any services in order to obtain its tax deferral benefit.<sup>4</sup> Except for a small FSC generating \$5 million or less in export sales, a FSC qualifies for its tax exemption only if it undertakes certain economic activities outside the United States.

### III. Formal Requirements for FSC Status

Similar to a DISC, it is not difficult to organize a FSC. A FSC simply must meet the following organizational requirements:<sup>5</sup> (1) be organized in a United States possession or a qualifying foreign country;<sup>6</sup> (2) have no more than twenty-five shareholders;<sup>7</sup> (3) not issue preferred stock; (4) maintain an office in a United States possession or a qualifying foreign country and keep records at that office;<sup>8</sup> (5) maintain sufficient records in the United States to meet the general record keeping requirements of section 6001 of the Code; (6) have at least one director who is not a resident of the United States; (7) not be a member of a controlled group of corporations which includes a DISC;<sup>9</sup> (8) have a taxable year which conforms to the taxable year of the shareholder having the highest percentage of voting power (principal shareholder);<sup>10</sup> and (9) file a timely election to be treated as a FSC. Unlike a

2. Rules for a commission basis FSC are to be solely prescribed in regulations. I.R.C. §§ 924(d)(4), 925(b)(1). Since the date this article was submitted to the printer T.D. 7994 which briefly discusses commission basis FSCs was issued. See footnote 70.

3. A DISC itself is not subject to tax, but 57.5 percent and 50 percent of its income generally was taxed currently to its corporate and noncorporate shareholders, respectively, as a deemed distribution. *Id.* § 991 and §§ 995(b)(1)(F)(i), 291(a)(4) (prior to their amendment by the Tax Act).

4. Treas. Reg. §§ 1.992-1(a), 1.993-1(l)(1).

5. I.R.C. §§ 922(a), 441(h).

6. For FSC purposes, a possession of the United States does not include Puerto Rico. *Id.* § 927(d)(5). For the definition of a "qualifying foreign country", see *infra* text accompanying note 55.

7. Several companies may pool together and establish a shared FSC. For example, a business association could establish a FSC for its members.

8. An office must constitute a "permanent establishment" under income tax treaty concepts. More than one FSC may share an office, however, and a FSC's office need not be located in the country in which the FSC is incorporated. *Senate Report* at 637.

9. If any controlled group of corporations which includes a DISC establishes a FSC, then the DISC is treated as having terminated its DISC status. Temp. Treas. Reg. § 1.921-1T(b)(13); § 805(b)(5) of the Tax Act.

10. If a FSC's principal shareholder changes its annual accounting period, or if its voting power is reduced by at least 10 percent and it no longer is the FSC's principal shareholder, the

DISC, a FSC has no minimum capitalization requirement, and there is no qualified "export assets" or "gross receipts" test.<sup>11</sup>

An election to be treated as a FSC for any taxable year must be made during the ninety-day period preceding the beginning of the taxable year.<sup>12</sup> The temporary treasury regulations, however, permit a FSC electing to be treated as a FSC for its first taxable year to make the election within ninety days after the beginning of such taxable year.<sup>13</sup> This special rule was necessary to prevent premature termination of existing DISCs prior to December 31, 1984. Although a FSC must use the same accounting period as its principal shareholder, a FSC need not delay electing FSC status in 1985 until the beginning of its principal shareholder's taxable year. The FSC, however, must then close its first 1985 taxable year and adopt its principal shareholder's accounting period on the first day that such period begins in 1985.<sup>14</sup>

#### IV. Income Eligible for FSC Benefits

The tax benefit provided by the FSC legislation is an exemption from tax for a portion of the FSC's foreign trade income. Foreign trade income is the gross income of a FSC attributable to foreign trading gross receipts.<sup>15</sup> With the exception of investment income and carrying charges, the same types of receipts which qualify for DISC benefits generally give rise to foreign trading gross receipts.<sup>16</sup>

##### A. FOREIGN TRADING GROSS RECEIPTS

Foreign trading gross receipts include receipts from the following types of transactions:<sup>17</sup> (1) the sale, exchange or other disposition of "export property"; (2) the lease or rental of "export property" for use outside the United States; (3) the performance of services that are "related and subsidiary" to the transactions described above at (1) and (2); (4) the performance of engineering or architectural services for construction projects located outside the United States; and (5) the performance of managerial services furthering the production of the income described at (1), (2), and (3) by an

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FSC must change its annual accounting period accordingly. The voting power of the principal shareholder is determined as of the beginning of the FSC's taxable year. Temp. Treas. Reg. § 1.921-1T(b)(6).

11. At least 95 percent of a DISC's income must constitute qualified export receipts, and at least 95 percent of its assets at the close of its taxable year must constitute qualified export assets. I.R.C. §§ 992(a)(1)(A), (a)(1)(B).

12. *Id.* § 927(f)(1)(A).

13. Temp. Treas. Reg. § 1.921-1T(b)(1).

14. *Id.* § 1.921-1T(b)(4).

15. I.R.C. § 923(b).

16. Compare *id.* § 924(a) and *id.* § 993(a).

17. *Id.* § 924(a).

unrelated FSC or DISC, provided the FSC earns at least 50 percent of its gross receipts from activities producing foreign trading gross receipts.

Receipts from the following transactions, however, do not qualify for FSC benefits:<sup>18</sup> (1) the sale of property or services for ultimate use in the United States or for use by a United States instrumentality required to use such property or services; (2) transactions subsidized by the United States or an instrumentality thereof; (3) the sale of property or services to an affiliated FSC; (4) investments by the FSC, including carrying charges; and (5) one-half of the receipts from the sale or lease of military property.

## B. FSC EXPORT PROPERTY

Property which is export property for a DISC essentially is export property for a FSC.<sup>19</sup> Thus, property is export property if: (1) it is manufactured, produced, grown or extracted in the United States by a person other than a FSC; (2) it is held primarily for sale, lease or rental in the ordinary course of business, by or to a FSC, for direct use, consumption or disposition outside the United States;<sup>20</sup> and (3) no more than 50 percent of its fair market value is attributable to articles imported into the United States.<sup>21</sup>

Similar to the DISC rules, the FSC legislation excludes the following property from the definition of export property:<sup>22</sup> (1) property leased or rented by a FSC to an affiliate; (2) intangibles, such as patents, inventions, designs, and copyrights (other than films, tapes, records or similar reproductions); (3) oil or gas and primary products thereof (but not depletable products such as coal); (4) certain products subject to export control restrictions relating to protection of the domestic economy; and (5) property designated by the president as in "short supply" domestically. Since the definition of export property contained in the FSC legislation essentially is the same as that contained in the DISC rules, the uncertainty surrounding the treatment of computer software as export property will carry over to the FSC rules.

18. *Id.* §§ 924(f), 923(a)(5).

19. Compare *id.* § 927(a)(1) and *id.* § 993(c)(1).

20. The destination test is satisfied if the FSC delivers the property to a carrier or freight forwarder for ultimate delivery, use, or consumption outside of the United States without regard to (1) the F.O.B. point or place of passage of title, (2) whether the purchaser is a United States or foreign purchaser, or (3) whether the property is for use of the purchaser or for resale. *Senate Report* at 652. See also Treas. Reg. § 1.993-3(d)(2).

21. The fair market value of any article imported into the United States is its appraised value upon importation, as determined under section 402 of the Tariff Act of 1930 (19 U.S.C. § 1401a). *Senate Report* at 652. See also Treas. Reg. § 1.993-3(e)(4)(i), but note that the FSC regulations are not required to follow the DISC regulations for determining the foreign content of any product. *Senate Report* at 652-53.

22. Compare I.R.C. §§ 927(a)(2),(a)(3) and *id.* §§ 993(c)(2), (c)(3).

## V. Exempt Foreign Trade Income

### A. DETERMINATION OF FOREIGN TRADE INCOME

Similar to determining a DISC's income, a FSC's foreign trade income can be determined by using safe harbor pricing rules (administrative pricing rules), or on an arm's length basis.<sup>23</sup> Under the administrative pricing rules, a FSC can earn foreign trade income in an amount equal to the greater of (1) 23 percent of total pre-tax export profits (combined taxable income of the FSC and its related supplier), or (2) 1.83 percent of the FSC's foreign trading gross receipts (up to a limit of 46 percent of total pre-tax export profits).<sup>24</sup> The 1.83 percent alternative is intended for exporters operating with export profit margins of less than 8 percent.<sup>25</sup> Alternatively, a FSC may determine its foreign trade income on the basis of actual transactions with third parties, or under any method permitted under section 482 of the Code covering transactions between related parties.

The secretary is authorized to promulgate regulations allowing the inter-company pricing rules to be applied on the basis of groups or transactions based on product lines or recognized industry or trade usages.<sup>26</sup> It is expected that these rules will closely parallel the grouping rules contained in the current DISC regulations.<sup>27</sup>

### B. DETERMINATION OF EXEMPT FOREIGN TRADE INCOME

The amount of a FSC's foreign trade income which is exempt from United States taxation depends upon whether the FSC determines its income under the administrative pricing rules or on an arm's length basis. If a FSC determines its income under the administrative pricing rules, 15/23 and

23. Compare *id.* § 994(a)(1) and *id.* § 925(a). In order to use the administrative pricing rules, however, a FSC or its agent must engage (within or without the United States) in all the sales and direct costs activities of the economic processes requirements. See *infra* notes 64-69 and accompanying text.

24. I.R.C. §§ 925(a),(d). Limiting the 1.83 percent method to twice the amount allowable under the 23 percent method effectively incorporates the DISC "no-loss" rule. See Treas. Reg. § 1.994-1(e)(1). The Secretary also is directed to promulgate marginal costing rules for determining combined taxable income under the 23 percent method. I.R.C. § 925(b)(2). These rules should operate in much the same manner as the DISC marginal costing rules. See Treas. Reg. § 1.994-2.

25. Gross export sales	\$100.00
Operating profit margin (8%)	\$8.00
23% × export profit (\$8)	\$1.84
1.83% × sale price (\$100)	\$1.83

If the operating profit margin is less than 8 percent, 1.83 percent of gross sales will exceed 23 percent of export profits.

26. I.R.C. § 927(d)(2)(B).

27. See Treas. Reg. § 1.994-1(c)(7).

16/23 of the income is exempt for corporate and non-corporate shareholders, respectively.<sup>28</sup> For a corporate shareholder, therefore, 15 percent of total pre-tax export profit generally is exempt from United States taxation. For a non-corporate shareholder 16 percent of total pre-tax export profit is exempt. This exemption effectively reduces the United States tax rate imposed on the total export profit of a FSC and a corporate shareholder from 46 percent to 39 percent  $[(100 \text{ percent} - (23 \text{ percent} \times 15/23)) \times 46 \text{ percent}]$ .

Alternatively, for companies with profit margins of less than 8 percent, the exemption for a corporate and non-corporate shareholder, respectively, is 1.19 percent  $(15/23 \times 1.83 \text{ percent})$  and 1.27 percent  $(16/23 \times 1.83 \text{ percent})$  of the FSC's foreign gross receipts.

If a FSC determines its income on an arm's length basis, 30 percent and 32 percent of the FSC's foreign trade income is exempt for corporate and non-corporate shareholders, respectively.<sup>29</sup> If a FSC earns 100 percent of the total export profit this exemption effectively reduces the United States tax rate imposed on the total export profit of a FSC and a corporate shareholder from 46 percent to 32 percent  $[(100 \text{ percent} - 30 \text{ percent}) \times 46 \text{ percent}]$ . This could result, for example, if the FSC had an independent sales organization and did not acquire products from a related party. However, if a FSC earns 50 percent of the total export profit the United States tax rate is reduced only to 39 percent  $[(100 \text{ percent} - (30 \text{ percent} \times 50 \text{ percent})) \times 46 \text{ percent}]$ . Thus, the arm's length pricing rules only would offer an advantage over the administrative pricing rules where a FSC may earn more than 50 percent of the total export profit on an arm's length basis.

## VI. U.S. Taxation of FSC Income

### A. FOREIGN TRADE INCOME

For purposes of United States taxation a FSC's foreign trade income may conveniently be grouped into the following four categories: (1) exempt income under the administrative pricing rules; (2) non-exempt income under the administrative pricing rules; (3) exempt income under an arm's length pricing method; and (4) non-exempt income under an arm's length pricing method.

#### 1. Safe Harbor Exempt Income

A FSC's exempt foreign trade income determined under the administrative pricing rules is treated as foreign source income "not effectively"

28. I.R.C. §§ 923(a)(3), 291(a)(4)(B). Any deductions of the FSC are allocated on a proportionate basis between the FSC's exempt and non-exempt foreign trade income. *Id.* § 921(b). Since exempt foreign trade income is an exclusion from a FSC's gross income, deductions allocable to exempt foreign trade income may not be used to reduce a FSC's taxable income.

29. *Id.* §§ 923(a)(2), 291(a)(4)(A).

connected with a United States trade or business.<sup>30</sup> Thus, the income is exempt from United States corporate taxation in the hands of a FSC.<sup>31</sup> Such income also is not subject to the rules of subpart F.<sup>32</sup>

A FSC's exempt foreign trade income is further exempt from United States taxation upon distribution to a United States corporate shareholder by permitting such shareholder a 100 percent dividends received deduction.<sup>33</sup> A United States individual or other non-corporate shareholder is not permitted such a deduction. Thus, the only significant United States tax advantage of a FSC to a United States non-corporate shareholder is the shelter from United States corporate taxation of 16/23, rather than 15/23, of a FSC's foreign trade income. A foreign corporation or non-resident alien also is subject to United States taxation upon distributions made by a FSC out of its exempt foreign trade income, since such distributions are treated as United States source income effectively connected with a United States trade or business.<sup>34</sup>

## 2. Safe Harbor Non-exempt Income

A FSC's non-exempt foreign trade income determined under the administrative pricing rules is treated as United States source income effectively connected with a United States trade or business.<sup>35</sup> Consequently, it is subject to current United States taxation at the regular corporate rates.<sup>36</sup> This non-exempt foreign trade income, however, is not subject to the rules of subpart F.<sup>37</sup>

To avoid double taxation with respect to a United States corporate shareholder, such shareholder is permitted a 100 percent dividends received deduction for distributions out of a FSC's non-exempt foreign trade income.<sup>38</sup> No similar deduction is permitted for a United States individual or other non-corporate shareholder, and any distribution to a foreign corpora-

30. *Id.* § 921(a).

31. *Id.* §§ 881, 882.

32. *Id.* § 951(e). The secretary also is authorized to exclude property related to the export activities of a FSC from the subpart F rules relating to investments in United States property. *Id.* § 956(b)(2)(i). Generally, under the subpart F rules the United States shareholders of a controlled foreign corporation are taxed constructively on the foreign corporation's (1) trading income earned on purchases from a parent or affiliate for resale abroad and on investment income, and (2) investments in United States property. *Id.* § 951(a)(1).

33. *Id.* § 245(c)(1).

34. *Id.* §§ 926(b), 882(a)(1), 871(b).

35. *Id.* § 921(d)(1).

36. *Id.* § 882(a)(1).

37. *Id.* § 951(e).

38. *Id.* § 245(c)(1). A FSC's foreign trade income should be carefully computed under the safe harbor rules, since any income allocated to a FSC in excess of the amount permitted may be subject to double taxation; first, in the hands of the FSC and, second, upon distribution to the FSC's shareholders. Subject to the issuance of final regulations, however, such distribution should be treated as out of non-exempt income and, therefore, subject to the 100 percent dividends received deduction.



tion or non-resident alien is treated as income effectively connected with a United States trade or business.<sup>39</sup> Thus, there are no benefits to a non-corporate shareholder or a foreign shareholder with respect to that income.

### 3. *Arm's Length Exempt Income*

A FSC's exempt foreign trade income resulting from an arm's length transaction is subject to the same United States tax treatment as a FSC's exempt foreign trade income determined under the administrative pricing rules.<sup>40</sup> Thus, such income is exempt from corporate taxation and from the rules of subpart F. Moreover, this income is further exempt from taxation upon distribution to United States corporate shareholders, but is subject to taxation upon distribution to United States non-corporate and foreign shareholders.

### 4. *Arm's Length Non-exempt Income*

The taxation of a FSC's non-exempt foreign trade income resulting from an arm's length transaction is determined in the same manner as for a foreign corporation which is not a FSC.<sup>41</sup> If a FSC should purchase export property from a parent or affiliate, therefore, such non-exempt foreign trade income generally would be passed through to the FSC's United States shareholders under the subpart F rules and, thus, would be subject to current United States taxation.

## B. INVESTMENT INCOME

A FSC's investment income and carrying charges are subject to double taxation and, thus, a FSC should avoid earning such income. Such passive income is subject to current United States corporate taxation by treating it as foreign source income effectively connected with a United States trade or business.<sup>42</sup> A distribution of this income generally also is taxed to the FSC's corporate and non-corporate shareholders, since there is no dividends received deduction.<sup>43</sup> In order to avoid a third level of taxation, however, a FSC's investment income and carrying charges are excluded from subpart F treatment.<sup>44</sup>

39. *Id.* § 926(b).

40. *Id.* §§ 921(a), 951(e), 245(c)(1), 926(b).

41. *Id.* §§ 921(d), 951(e).

42. *Id.* §§ 921(d)(2),(d)(3), 882(a)(1).

43. *Id.* § 245(c)(2).

44. For subpart F purposes, an FSC's investment income and carrying charges are treated as United States source income. *Id.* § 951(e)(1). Subpart F income does not include any item of income from United States sources which is effectively connected with a United States trade or business. *Id.* § 952(b).

### C. OTHER NONFOREIGN TRADE INCOME

The other non-foreign trade income of a FSC is taxed in the same manner as income earned by a foreign corporation that is not a FSC.<sup>45</sup> Consequently, such income would be subject to United States effectively connected and subpart F rules. Non-foreign trade income, therefore, probably could be more effectively sheltered from United States taxation through the use of other entities.

### VII. Creditability of Foreign Taxes

The FSC provisions are designed to discourage incorporation of a FSC in a jurisdiction which imposes foreign taxes on the FSC's foreign trade income or withholding taxes on distributions of such income. Consequently, the ability of a FSC and its shareholders to claim credits or deductions for foreign taxes paid with respect to a FSC's foreign trade income is severely curtailed.

First, except with respect to non-exempt income resulting from an arm's length transaction, a FSC is not allowed a credit or deduction for foreign taxes paid with respect to its foreign trade income,<sup>46</sup> and such income is subject to a separate foreign tax credit limitation.<sup>47</sup> Second, except with respect to non-exempt income resulting from an arm's length transaction, dividends declared by a FSC to its United States shareholders out of foreign trade income carry no creditable foreign taxes for the United States recipient,<sup>48</sup> and such dividends also are subject to a separate foreign tax credit limitation.<sup>49</sup> By virtue of these separate limitations, a FSC's foreign source foreign trade income generally cannot be used to increase the permissible credit of foreign taxes against United States taxes due by either the FSC or its shareholders.<sup>50</sup>

Finally, the FSC legislation provides a special rule governing the source of income (and thus the foreign tax credit limitation) from sales by a person related to a FSC upon which the FSC earns income. Under this rule the related person's foreign source income from export transactions involving the FSC may not exceed the amount which would be treated as foreign

45. *Id.* §§ 921(d), 951(e).

46. *Id.* §§ 901(h), 906(b)(5).

47. *Id.* § 904(d)(1)(C).

48. *Id.* §§ 901(h), 906(b)(5); *Senate Report* at 639.

49. I.R.C. § 904(d)(1)(D).

50. A taxpayer's allowable foreign tax credit is limited by the following formula:

$$\frac{\text{Foreign source taxable income}}{\text{worldwide taxable income}} \times \text{United States tax on worldwide taxable income}$$

*Id.* § 904(a). Thus, any increase in foreign source income increases the limitation.

source income earned by that person if the analogous DISC income allocation rules were applied.<sup>51</sup> For this purpose, the DISC "50-50" income allocation rule is analogous to the FSC "23 percent" of total pre-tax export profits method, and the DISC "4 percent" of gross receipts rule is analogous to the FSC "1.83 percent" of foreign trading gross receipts method.<sup>52</sup>

The creditability of foreign taxes relating to a FSC's (1) non-exempt foreign trade income resulting from an arm's length transaction; (2) investment income; and (3) other non-foreign trade income, are determined in the same manner as for a foreign corporation which is not a FSC.

### VIII. Place of Incorporation

A FSC must be incorporated in a possession of the United States or in a "qualifying foreign country."<sup>53</sup> For this purpose a United States possession includes Guam, American Samoa, the United States Virgin Islands, and the Northern Mariana Islands, but not Puerto Rico.<sup>54</sup> Qualifying foreign countries include: (1) countries which have executed an exchange of information agreement with the United States equivalent to that required by the Caribbean Basin legislation in section 274(h)(6)(C) of the Code; and (2) countries which have a tax treaty with the United States certified by the Treasury as having adequate exchange of information provisions.<sup>55</sup>

It is essential that the country in which a FSC is incorporated impose no or a nominal tax on the FSC's foreign trade income without regard to treaty benefits.<sup>56</sup> As discussed above, no credits generally are allowed for foreign taxes paid with respect to a FSC's foreign trade income. Thus, a FSC which pays any foreign taxes will reduce the United States tax savings on export sales on a dollar for dollar basis.<sup>57</sup> Presently a zero foreign tax on foreign

51. *Id.* § 927(e)(1). When a United States exporter passes title outside the United States on its export sales, generally 50 percent of its taxable income from the sales is foreign source income. *Id.* § 863(b)(2). Absent the FSC special rule governing source of income, a United States exporter selling export property through a FSC at a profit of \$100 would have total income of \$77 if it uses the 23 percent FSC pricing rule and foreign source income of \$38.50. This rule limits the United States exporter's foreign source income to \$25, one-half of the total income which could have been earned by the United States exporter under the DISC 50-50 income allocation rule (§50).

52. *Senate Report* at 655.

53. I.R.C. § 922(a)(1)(A). Note that a bill was introduced in the last Congress which would have made it mandatory for FSCs to locate in a United States possession. H.R. 6104, 98th Cong., 2d Sess. (1984).

54. *Id.* § 927(d)(5).

55. *Id.* § 927(e)(3).

56. A FSC may not claim the benefits of any income tax treaty between the United States and any foreign country. *Id.* § 927(e)(4).

57. Assume a FSC is incorporated in a foreign country where its income is subject to an effective 10 percent foreign tax rate. If the FSC and its related supplier earn \$1 million in total pre-tax export profits, under the administrative pricing rules 15 percent or \$150,000 would be exempt from United States taxation, resulting in a United States tax savings of \$69,000.

trade income can be achieved by incorporating a FSC in a United States possession, since the FSC legislation prohibits any possession from taxing a FSC's foreign trade income derived before January 1, 1987.<sup>58</sup> In addition, a number of foreign countries have passed or are considering special legislation to reduce the tax on a FSC's foreign trade income to zero.<sup>59</sup>

### IX. Required FSC Activities

Unlike a DISC, a FSC (with the exception of a "small FSC")<sup>60</sup> is entitled to the described tax benefits only if it performs certain managerial activities and economic processes outside the United States. These "foreign presence" requirements are designed to ensure that the FSC's exempt income arises from foreign economic activities in accordance with GATT principles. With the exception of certain binding agreements executed prior to 1985, no costs incurred or activities performed prior to January 1, 1985, are taken into account for purposes of satisfying these requirements.<sup>61</sup>

The management of a FSC must take place outside the United States.<sup>62</sup> Management of a FSC is treated as occurring outside the United States if the FSC: (1) holds all meetings of its board of directors and shareholders outside the United States; (2) maintains its principal bank account outside the United States at all times during the taxable year; and (3) makes all disbursements of dividends, legal and accounting fees, officers' salaries, and directors' fees from a bank account maintained outside the United States.<sup>63</sup> A FSC should be able to meet these managerial requirements with little difficulty. For example, the directors' and shareholders' meetings could be conducted by proxy, and the FSC's principal bank account could be established with a foreign branch of a United States bank.

In addition, certain economic processes with respect to each transaction must take place outside the United States.<sup>64</sup> These economic processes requirements are satisfied with respect to any transaction if the FSC, or any

Non-creditable foreign taxes imposed on the FSC would be \$23,000 (\$230,000 allocated to the FSC times 10 percent). Thus, the total United States tax savings would be reduced to \$46,000 (\$69,000 minus \$23,000).

58. I.R.C. § 927(e)(5). The United States Virgin Islands, Guam, American Samoa and the Northern Mariana Islands have passed legislation which extend favorable tax treatment to FSCs beyond December 31, 1986.

59. Jamaica and Barbados have in fact passed such legislation. The Netherlands, Belgium and Northern Ireland have been granting favorable rulings for FSCs. Costa Rica is considering FSC legislation.

60. See *infra* notes 76-79 and accompanying text.

61. Temp. Treas. Reg. §§ 1.921-1T(b)(8)-(b)(10), (b)(12). See also § 805(a)(2) of the Tax Act.

62. I.R.C. § 924(b)(1)(A).

63. *Id.* § 924(c). Since this article was submitted to the printer T.D. 7994 was issued which sets forth temporary regulations governing foreign management requirements. See footnote 70.

64. *Id.* § 924(b)(1)(B).

related or unrelated person acting under contract with the FSC: (1) participates in the solicitation, negotiation, *or* making of the contract outside the United States (sales activities test); and (2) performs activities outside the United States accounting for 50 percent of the direct costs associated with all five specified categories of activities relating to the disposition of export property, or 85 percent of the direct costs associated with each of two of the activities (direct costs test).<sup>65</sup> The five activities are: (1) advertising and sales promotion; (2) processing of customer orders and arranging for delivery; (3) transportation from the time of acquisition by the FSC, or the beginning of a commission relationship, until delivery to the customer; (4) determination and transmittal of a final invoice or statement and the receipt of payment; and (5) assumption of credit risk.<sup>66</sup>

Use of the administrative pricing rules also is keyed into these economic processes requirements. In order to use the administrative pricing rules a FSC or its agent must perform all the above sales and direct costs activities, although for this purpose the activities may be performed within or without the United States.<sup>67</sup> A FSC, however, is exempted from this requirement for (1) export property which was transferred from a related supplier to a DISC before December 31, 1984, and sold by the FSC after the DISC's termination,<sup>68</sup> and (2) certain binding agreements executed prior to January 1, 1985.<sup>69</sup>

## X. Satisfying the Economic Processes Requirements<sup>70</sup>

As a general rule, companies engaged in export transactions should be able to meet both the sales activities test and the direct costs test without much difficulty. It will be necessary, however, for a FSC dealing with its related supplier under the administrative pricing rules rather than at arm's length to enter into written agreements which provide that other parties are performing all the export activities on behalf of the FSC and for an arm's length charge. In addition, all personnel charged with operating the FSC should have full knowledge of the procedures that must be followed in order to satisfy the economic processes requirements.

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65. *Id.* § 924(c).

66. *Id.* § 924(e).

67. *Id.* § 925(c). See *Senate Report* at 646.

68. Temp. Treas. Reg. § 1.921-1T(b)(11).

69. § 805(a)(2) of the Tax Act; Temp. Treas. Reg. § 1.921-1T(b)(8)-(b)(10).

70. At the time this article was submitted to the printer, the temporary treasury regulations relating to the economic processes requirements were not yet issued. The discussion on this subject, therefore, is based upon the *Senate Report*. By T.D. 7994 the Treasury has since issued temporary regulations pertaining to foreign economic processes. Printing constraints have prevented a discussion of the temporary regulations. The text, however, has been reviewed for consistency with the temporary treasury regulations released to date.

### A. SALES ACTIVITIES TEST

With respect to the "sales activities test," the solicitation and negotiation of a contract may be made through any form of communication, including telephone, telegraph, telex or mail. The "making of a contract" includes the performance of any of the elements necessary to complete a sale, such as making or accepting a sale. In addition, written confirmation to a customer of an oral agreement which confirms variable contract terms or specifies (directly or by cross reference) additional contract terms is considered the making of a contract.<sup>71</sup>

In performing any of these activities, the FSC may act upon standing instructions from its principal. The location of the solicitation, negotiation or making of a contract is determined by the place where the FSC or its agent initiates the activity.<sup>72</sup> Thus, acceptance of orders through a computer terminal located in the foreign office of the FSC (or its agent) would be an easy way to satisfy the sales activity portion of the economic processes requirements. Such acceptance of an order by a FSC, however, must be made directly to a customer.

### B. DIRECT COSTS TEST

The direct costs test can be met if at least 85 percent of the FSC's total direct costs related to performing any two of the specified five export activities are attributable to activities performed outside the United States. Most companies, therefore, should be able to meet this test without too much difficulty. It will be necessary, however, for each company to evaluate its exporting operations to determine which two of the five activities can have 85 percent of their costs attributable to activities performed outside the United States.

Generally, the advertising and sales promotion test may be met if the FSC or its agent places advertisements for its products in foreign countries or holds trade shows and customer meetings at foreign locations. The processing of orders and arranging for delivery test may be met if the FSC or its agent notifies the related supplier of the orders and makes transportation arrangements through a forwarding agent from its foreign office. The transportation test may be met if the FSC or its agent acquires the export property and assumes the costs of shipping the property after it has left the United States. If the FSC is acting as a commission agent, this test may be met if the commission relationship begins after the property leaves the United States and the FSC assumes the shipping costs.<sup>73</sup>

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71. *Senate Report* at 641.

72. *Id.*

73. *Id.* at 642-43.

The final invoice or statement of account and receipt of payment test may be met if the FSC or its agent assembles the final invoices or statements at a foreign office and mails them to customers from that office, and if it assumes the cost of maintaining the bank account into which the customers' payments are deposited. Such deposits may be made to a United States branch of a foreign bank if the funds are immediately transferred to the foreign bank. The assumption of credit risk test may be met if the FSC contractually bears such risk and if the FSC's export income is appropriately reduced when a debt becomes uncollectible. The assumption of credit risk test, however, cannot be satisfied in the third year if no bad debts are incurred over a three year period.<sup>74</sup>

The secretary is authorized to promulgate regulations allowing for the grouping of transactions on the basis of product lines or recognized industry or trade usage. These grouping rules apply for purposes of satisfying the economic processes requirements and, thus, should ease the burden of meeting these requirements.<sup>75</sup>

## XI. Small Business Provisions

### A. SMALL FSC

A corporation qualifying as a FSC can choose to be treated as a "small FSC" if: (1) it files an election to be treated as a small FSC; and (2) it is not a member of a controlled group of corporations which includes a FSC (unless the other FSC is a small FSC.)<sup>76</sup> The major advantage of small FSC treatment is that a small FSC does not have to comply with the foreign management and economic processes requirements in order to be entitled to FSC benefits.<sup>77</sup> A small FSC, however, only is entitled to FSC tax benefits on \$5 million of foreign trading gross receipts.<sup>78</sup>

If a small FSC realizes more than \$5 million in foreign trading gross

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74. *Id.* at 644-45.

75. I.R.C. § 927(d)(2)(B). *See* T.D. 7994 which provides for grouping based on either recognized industry or trade usage, two digit major groups (or inferior classifications thereof) of the Standard Industrial Classification or by transactions with a particular customer during a taxable year.

76. *Id.* § 922(b). The timing requirements for making a small FSC election are the same as those for a regular FSC election. *Id.* § 927(f)(1)(A); Temp. Treas. Reg. § 1.921-1T(b)(1). *See supra* notes 12-14 and accompanying text.

77. I.R.C. § 924(b)(2)(A). In order to use the administrative pricing rules, however, a small FSC or its agent must engage (within or without the United States) in all the sales and direct costs activities of the economic processes requirements. *See supra* notes 64-69 and accompanying text.

78. *Id.* § 924(b)(2)(B)(i). If a small FSC has a short taxable year in 1985 because it elects to be treated as a small FSC prior to the beginning of its principal shareholder's taxable year, the \$5 million limitation on foreign trading gross receipts is to be prorated on a daily basis. Temp. Treas. Reg. § 1.921-1T(b)(5).

receipts during the year, it cannot terminate its small FSC election and elect FSC or DISC status for the year. The FSC can, however, choose which gross receipts qualify for the \$5 million limitation in order to obtain high profit margin sales to maximize its exempt income. For purposes of applying the \$5 million limitation, the foreign gross receipts of affiliated small FSCs are aggregated.<sup>79</sup> Thus, multiple small FSCs cannot be used to circumvent the \$5 million foreign trading gross receipts limitation.

## B. INTEREST CHARGE DISC

A corporation still may elect to be treated as a DISC under modified rules, which impose an annual interest charge on the cumulative tax liability deferred through the DISC.<sup>80</sup> Under these modified rules, deferral of United States taxes only is available for DISC income attributable to export gross receipts of \$10 million or less. Receipt of qualified export receipts in excess of \$10 million results in a deemed distribution of the income attributable to the excess, although such excess receipts will not disqualify the DISC.<sup>81</sup> Similar to the small FSC, the qualified export receipts of affiliated DISCs are aggregated for purposes of this \$10 million limitation.<sup>82</sup> Thus, multiple DISCs cannot be used to circumvent the \$10 million export receipts limitation.

Although the present DISC rules generally apply to an interest charge DISC, there are several important differences. First, the incremental rules calling for a deemed distribution of DISC income by reference to a "base period" do not apply to an interest charge DISC.<sup>83</sup> Second, the normal deemed distribution of DISC income is reduced to one-seventeenth (5.9 percent) of the DISC's taxable income.<sup>84</sup> In addition, an interest charge DISC must have a taxable year which conforms to the taxable year of its principal shareholder.<sup>85</sup>

The most significant change, however, is that a deductible interest charge is imposed on the DISC's shareholders based upon their deferred tax liability on earnings retained by the DISC. The interest charge is equal to the

79. I.R.C. § 924(b)(2)(B).

80. The timing requirements for making an interest charge DISC election are the same as those for a FSC or small FSC. *Id.* § 992(b)(1); Temp. Treas. Reg. § 1.921-1T(b)(1). *See supra* notes 12-14 and accompanying text.

81. I.R.C. § 995(b)(1)(E).

82. *Id.* § 995(b)(4).

83. *Compare id.* § 995(b)(1)(E) before and after its amendment by the Tax Act.

84. *Id.* § 995(b)(1)(F)(i). Prior to their amendment by the Tax Act, sections 995(b)(1)(F)(i) and 291(a)(4) of the Code provided for a normal deemed distribution of 57.5 percent for corporate shareholders and 50 percent for non-corporate shareholders.

85. *Id.* § 441(h). The same rules applicable to a change in the accounting period or voting power of a FSC's principal shareholder apply to an interest charge DISC's principal shareholder. Temp. Treas. Reg. § 1.921-1T(b)(6). *See supra* note 10.



average investment yield of Treasury bills with one year maturity dates sold over a one year period. Interest is charged with respect to retained DISC income which is not distributed within one year following the close of the DISC's taxable year. Retained DISC income for one year is considered distributed if distributions in the following year or years exceed the DISC's net income for those years.<sup>86</sup> For small exporters, interest charge DISCs are likely to be attractive due to the low interest rate, one-year time lag and low administrative costs involved, since no United States or foreign substance is required.

Qualified tax-free trusts and cooperatives should continue to own DISCs. The interest charge rules permit a trust to operate its DISC with the same tax benefits as under the prior DISC rules. All deemed distributions of the DISC (including any distributions attributable to qualified export receipts in excess of \$10 million) and all actual distributions would be received tax free by a qualified trust.<sup>87</sup> In addition, there generally should be no interest charge on income retained by a DISC for the account of an exempt trust which has no taxes deferred.

## **XII. Transition from DISC to FSC**

On December 31, 1984, the 1984 taxable year of all existing DISCs was deemed terminated, and all DISC elections were deemed revoked.<sup>88</sup> Any accumulated DISC income as of December 31, 1984, which was or will be distributed after that date, is permanently exempt from United States taxation. Such distributions are treated as previously taxed income which increases a shareholder's basis in its DISC stock.<sup>89</sup> This forgiveness of United States taxation on accumulated DISC income, however, only applies to DISCs which were qualified DISCs on December 31, 1984.<sup>90</sup> In determining whether a DISC was qualified on December 31, 1984, the "qualified export assets test" is waived and related suppliers are not required to pay commissions to a DISC with respect to that year.<sup>91</sup> Otherwise, a DISC must meet all the other requirements set out in the DISC provisions.

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86. I.R.C. § 995(f).

87. *Id.* § 501(a).

88. § 805(b)(1)(A) of the Tax Act; Temp. Treas. Reg. § 1.921-1T(a)(1).

89. § 805(b)(2)(A) of the Tax Act; I.R.C. § 996(e)(1); Temp. Treas. Reg. § 1.921-1T(a)(7). A deficiency or qualifying distribution which is made to satisfy the qualified export receipts test for a DISC's December 31, 1984, taxable year, however, is not treated as previously taxed income. Temp. Treas. Reg. §§ 1.921-1T(a)(8), (a)(9).

90. § 805(b)(2)(B) of the Tax Act. If a DISC was disqualified, but had requalified as of December 31, 1984, any accumulated DISC income previously required to be taken into income upon the prior disqualification is not entitled to forgiveness from United States taxation. All accumulated DISC income earned subsequent to reclassification, however, is entitled to forgiveness. Temp. Treas. Reg. § 1.921-1T(a)(6).

91. § 805(b)(1)(A) of the Tax Act; Temp. Treas. Reg. § 1.921-1T(a)(3),(a)(4).

The normal deemed distribution rules apply to the DISC's December 31, 1984, deemed terminated year, with two significant modifications. First, if the deemed termination resulted in a short taxable year, the export receipts must be annualized for purposes of computing the incremental distribution.<sup>92</sup> Second, the December 31, 1984 deemed distribution may be included in the shareholder's income in ten equal annual installments where the DISC's taxable year differs from its shareholder's (unless the shareholder elects a shorter period).<sup>93</sup> The first annual installment is deemed distributed either in (1) the shareholder's second taxable year beginning in 1984, or (2) the shareholder's first taxable year beginning in 1985 if the shareholder only had one taxable year beginning in 1984.<sup>94</sup>

Section 367 of the Code does not apply to a DISC's transfer of its assets to a FSC if the DISC held the assets on August 4, 1983, and the transfer is completed before January 1, 1986.<sup>95</sup> Thus, a DISC will not recognize gain or loss if such assets are transferred to a FSC in a tax-free transaction. For this purpose, a liquidation of the DISC's assets into a parent corporation followed by the parent's transfer of those assets to the FSC is treated as a tax-free reorganization under section 368(a)(1)(D) of the Code.<sup>96</sup>

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92. Temp. Treas. Reg. § 1.921-1T(a)(2).

93. § 805(b)(3) of the Tax Act; Temp. Treas. Reg. § 1.921-1T(a)(10). The transition rules of the Tax Act only permit the ten-year installment treatment where the DISC's first taxable year in 1984 commenced after its shareholder's first taxable year in 1984.

94. Temp. Treas. Reg. § 1.921-1T(a)(10). A DISC shareholder is required to attach a statement to its taxable year which includes December 31, 1984, indicating the period over which it will spread its pro rata share of the December 31, 1984 deemed distribution. *Id.*

95. *Id.* § 1.921-1T(b)(7).

96. *Id.*

