FOREIGN SALES CORPORATIONS

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Facing the possibility of $4 billion in tariff retaliations on U.S. products by the EU, Congress and the White House have created legislation that will repeal the Foreign Sales Corporation (FSC) provisions of the internal revenue code. The new legislation replaces the FSC provisions with incentives similar in scope and effect, but designed to comply with World Trade Organization (WTO) rules. For U.S. companies, the proposed changes are a win-win situation—the statute provides equal treatment for all foreign sales, whether the goods are manufactured in the U.S. or abroad, as long as 50 percent of the fair market value of the goods is produced within the United States. This marks a significant change from the current FSC provisions, which apply only to goods made in the U.S. exported by American companies and not to goods made and sold overseas by U.S. firms. The changes to the FSC provisions aim to bring the U.S. into compliance with WTO requirements, benefit U.S. companies, and, hopefully, avoid a trade war.

"THE WORLD TRADE ORGANIZATION GAVE THE U.S. UNTIL OCTOBER 1, 2000 TO CHANGE THE TAX CODE."

A BRIEF HISTORY

The FSC program was originally sponsored by the Department of Commerce as an incentive to increase exports by U.S. manufacturers. Since the Department did not have the necessary funds to finance the program, alternative financing was established through the Tax Reform Act of 1984, which provided for a reduction in income taxes on net foreign profit realized from exports. Due to GATT limitations, the export promotion program could only be implemented through a related corporation formed in a foreign county. Hence, the birth of foreign sales corporations (FSCs).

In order to receive benefits under the FSC program, an exporter needed to have an offshore corporation with a resident director in a country having a reciprocity agreement with the U.S. Treasury. The FSC was a subsidiary to the exporter's parent company. However, typically no money, sales or shipments ran through the FSC. To qualify for tax savings, an exporter transferred export earnings to an overseas account and then transferred the funds back to the mainland. Allocations were made through journal entries with the benefit realized through reduced taxes. Since the program's inception, over 7,000 U.S. exporters have formed FSCs, saving approximately $4 billion in taxes annually.

WTO/FSC CONTROVERSY

In July 1998, the EU petitioned the WTO claiming that the FSC tax provisions constitute a prohibited export subsidy since the FSC provisions grant tax breaks which are exclusive to U.S. exporters. The WTO dispute settlement panel agreed and, in January 2000, issued a final dispute settlement report concluding that the FSC provisions were in violation of the WTO's rules on subsidies. The report held that the FSC program violated WTO rules since it enabled the U.S. to offer domestic exporters a lower tax rate on export profits than was available on import and domestic profits. The WTO also noted that the tax break was a breach of WTO rules because the subsidy acted to distort international trade.

The WTO gave the U.S. until October 1, 2000, to change the tax code. The EU subsequently agreed to extend the date to November 1, 2000. Under WTO rules, if the FSC provisions in the tax code were not changed, or if the changes did not fully address the WTO violations, the EU could, on November 17, 2000, submit a request for authorization to impose sanctions on U.S. products.

In November, the United States Congress replaced the FSC provisions with legislation designed to comply with WTO rules.

AVOIDING A TRADE WAR

During July 2000, legislation was introduced in Congress that sought to remedy the subsidy created by the existing FSC provisions of the tax code. In addition to providing tax savings for U.S. exporters who had created FSCs, the new statute expanded the scope to apply to income from foreign manufactures as long as 50 percent of the content of the goods sold is of U.S. content. Also foreign companies would not be prohibited from receiving the tax exemption if the foreign companies agree to be subject to U.S. tax. Under the proposed changes, companies would be able to receive the same tax benefits with respect to U.S. or foreign manufacture provided the property is used abroad.

On November 16, President Clinton signed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (H.R. 4986). At present, it is unclear whether the EU will accept the provisions under the new law as being WTO compliant.

The EU has announced that it plans to ask the WTO for permission to impose 100 percent tariffs on a list of about $4 billion worth of goods imported annually from the United States unless the FSC provisions are deemed WTO compliant. The European Commission trade spokesman, Anthony Gooch said on November 1, "regardless of what happens, we will be publishing our list of sanctions on November 17th. As we have stated in the past, if the U.S. has a new FSC plan, we will request the WTO to halt its arbitration over our list of sanctions." If the WTO approves the EU's sanction request, sanctions are not likely to be imposed before the middle of 2001.

Now that the changes to the FSC provisions have been approved by the President, the Internal Revenue Service and the Treasury Department will provide assistance to U.S. businesses.

For further information about changes to the FSC legislation and how to take advantage of the provisions of the new statute, contact Elizabeth Beck, Office of the Associate Chief Counsel (International), Tel: (202) 874-1490, or Dirk Siringa, Office of Tax Policy, Treasury, Tel: (202) 622-1779.

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