

FSC REPEAL AND EXTRATERRITORIAL INCOME EXCLUSION
 ACT OF 2000

SEPTEMBER 13, 2000.—Committed to the Committee of the Whole House on the
 State of the Union and ordered to be printed

Mr. ARCHER, from the Committee on Ways and Means,
 submitted the following

R E P O R T

together with

DISSENTING AND ADDITIONAL VIEWS

[To accompany H.R. 4986]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 4986) to amend the Internal Revenue Code of 1986 to repeal the provisions relating to foreign sales corporations (FSCs) and to exclude extraterritorial income from gross income, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

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The amendment is as follows:

Strike all after the enacting clause and insert the following:

SECTION 1. SHORT TITLE.

(a) **SHORT TITLE.**—This Act may be cited as the “FSC Repeal and Extraterritorial Income Exclusion Act of 2000”.

(b) **AMENDMENT OF 1986 CODE.**—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

SEC. 2. REPEAL OF FOREIGN SALES CORPORATION RULES.

Subpart C of part III of subchapter N of chapter 1 (relating to taxation of foreign sales corporations) is hereby repealed.

SEC. 3. TREATMENT OF EXTRATERRITORIAL INCOME.

(a) **IN GENERAL.**—Part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by inserting before section 115 the following new section:

“SEC. 114. EXTRATERRITORIAL INCOME.

“(a) **EXCLUSION.**—Gross income does not include extraterritorial income.

“(b) **EXCEPTION.**—Subsection (a) shall not apply to extraterritorial income which is not qualifying foreign trade income as determined under subpart E of part III of subchapter N.

“(c) **DISALLOWANCE OF DEDUCTIONS.**—

“(1) **IN GENERAL.**—Any deduction of a taxpayer allocated under paragraph (2) to extraterritorial income of the taxpayer excluded from gross income under subsection (a) shall not be allowed.

“(2) **ALLOCATION.**—Any deduction of the taxpayer properly apportioned and allocated to the extraterritorial income derived by the taxpayer from any transaction shall be allocated on a proportionate basis between—

“(A) the extraterritorial income derived from such transaction which is excluded from gross income under subsection (a), and

“(B) the extraterritorial income derived from such transaction which is not so excluded.

“(d) **DENIAL OF CREDITS FOR CERTAIN FOREIGN TAXES.**—Notwithstanding any other provision of this chapter, no credit shall be allowed under this chapter for any income, war profits, and excess profits taxes paid or accrued to any foreign country or possession of the United States with respect to extraterritorial income which is excluded from gross income under subsection (a).

“(e) **EXTRATERRITORIAL INCOME.**—For purposes of this section, the term ‘extraterritorial income’ means the gross income of the taxpayer attributable to foreign trading gross receipts (as defined in section 942) of the taxpayer.”

(b) **QUALIFYING FOREIGN TRADE INCOME.**—Part III of subchapter N of chapter 1 is amended by inserting after subpart D the following new subpart:

“Subpart E—Qualifying Foreign Trade Income

“Sec. 941. Qualifying foreign trade income.

“Sec. 942. Foreign trading gross receipts.

“Sec. 943. Other definitions and special rules.

“SEC. 941. QUALIFYING FOREIGN TRADE INCOME.

“(a) **QUALIFYING FOREIGN TRADE INCOME.**—For purposes of this subpart and section 114—

“(1) **IN GENERAL.**—The term ‘qualifying foreign trade income’ means, with respect to any transaction, the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of—

“(A) 30 percent of the foreign sale and leasing income derived by the taxpayer from such transaction,

“(B) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction, or

“(C) 15 percent of the foreign trade income derived by the taxpayer from the transaction.

In no event shall the amount determined under subparagraph (B) exceed 200 percent of the amount determined under subparagraph (C).

“(2) ALTERNATIVE COMPUTATION.—A taxpayer may compute its qualifying foreign trade income under a subparagraph of paragraph (1) other than the subparagraph which results in the greatest amount of such income.

“(3) LIMITATION ON USE OF FOREIGN TRADING GROSS RECEIPTS METHOD.—If any person computes its qualifying foreign trade income from any transaction with respect to any property under paragraph (1)(B), the qualifying foreign trade income of such person (or any related person) with respect to any other transaction involving such property shall be zero.

“(4) RULES FOR MARGINAL COSTING.—The Secretary shall prescribe regulations setting forth rules for the allocation of expenditures in computing foreign trade income under paragraph (1)(C) in those cases where a taxpayer is seeking to establish or maintain a market for qualifying foreign trade property.

“(5) PARTICIPATION IN INTERNATIONAL BOYCOTTS, ETC.—Under regulations prescribed by the Secretary, the qualifying foreign trade income of a taxpayer for any taxable year shall be reduced (but not below zero) by the sum of—

“(A) an amount equal to such income multiplied by the international boycott factor determined under section 999, and

“(B) any illegal bribe, kickback, or other payment (within the meaning of section 162(c)) paid by or on behalf of the taxpayer directly or indirectly to an official, employee, or agent in fact of a government.

“(b) FOREIGN TRADE INCOME.—For purposes of this subpart—

“(1) IN GENERAL.—The term ‘foreign trade income’ means the taxable income of the taxpayer attributable to foreign trading gross receipts of the taxpayer.

“(2) SPECIAL RULE FOR COOPERATIVES.—In any case in which an organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products sells qualifying foreign trade property, in computing the taxable income of such cooperative, there shall not be taken into account any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

“(c) FOREIGN SALE AND LEASING INCOME.—For purposes of this section—

“(1) IN GENERAL.—The term ‘foreign sale and leasing income’ means, with respect to any transaction—

“(A) foreign trade income properly allocable to activities which—

“(i) are described in paragraph (2)(A)(i) or (3) of section 942(b), and

“(ii) are performed by the taxpayer (or any person acting under a contract with such taxpayer) outside the United States, or

“(B) 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.

“(2) SPECIAL RULES FOR LEASED PROPERTY.—

“(A) SALES INCOME.—The term ‘foreign sale and leasing income’ includes any foreign trade income derived by the taxpayer from the sale of property described in paragraph (1)(B).

“(B) LIMITATION IN CERTAIN CASES.—Except as provided in regulations, in the case of property which—

“(i) was manufactured, produced, grown, or extracted by the taxpayer, or

“(ii) was acquired by the taxpayer from a related person for a price which was not determined in accordance with the rules of section 482, the amount of foreign trade income which may be treated as foreign sale and leasing income under paragraph (1)(B) or subparagraph (A) of this paragraph with respect to any transaction involving such property shall not exceed the amount which would have been determined if the taxpayer had acquired such property for the price determined in accordance with the rules of section 482.

“(3) SPECIAL RULES.—

“(A) EXCLUDED PROPERTY.—Foreign sale and leasing income shall not include any income properly allocable to excluded property described in subparagraph (B) of section 943(a)(3) (relating to intangibles).

“(B) ONLY DIRECT EXPENSES TAKEN INTO ACCOUNT.—For purposes of this subsection, any expense other than a directly allocable expense shall not be taken into account in computing foreign trade income.

“SEC. 942. FOREIGN TRADING GROSS RECEIPTS.

“(a) FOREIGN TRADING GROSS RECEIPTS.—

“(1) IN GENERAL.—Except as otherwise provided in this section, for purposes of this subpart, the term ‘foreign trading gross receipts’ means the gross receipts of the taxpayer which are—

“(A) from the sale, exchange, or other disposition of qualifying foreign trade property,

“(B) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States,

“(C) for services which are related and subsidiary to—

“(i) any sale, exchange, or other disposition of qualifying foreign trade property by such taxpayer, or

“(ii) any lease or rental of qualifying foreign trade property described in subparagraph (B) by such taxpayer,

“(D) for engineering or architectural services for construction projects located (or proposed for location) outside the United States, or

“(E) for the performance of managerial services for a person other than a related person in furtherance of the production of foreign trading gross receipts described in subparagraph (A), (B), or (C).

Subparagraph (E) shall not apply to a taxpayer for any taxable year unless at least 50 percent of its foreign trading gross receipts (determined without regard to this sentence) for such taxable year is derived from activities described in subparagraph (A), (B), or (C).

“(2) CERTAIN RECEIPTS EXCLUDED ON BASIS OF USE; SUBSIDIZED RECEIPTS EXCLUDED.—The term ‘foreign trading gross receipts’ shall not include receipts of a taxpayer from a transaction if—

“(A) the qualifying foreign trade property or services—

“(i) are for ultimate use in the United States, or

“(ii) are for use by the United States or any instrumentality thereof and such use of qualifying foreign trade property or services is required by law or regulation, or

“(B) such transaction is accomplished by a subsidy granted by the government (or any instrumentality thereof) of the country or possession in which the property is manufactured, produced, grown, or extracted.

“(3) ELECTION TO EXCLUDE CERTAIN RECEIPTS.—The term ‘foreign trading gross receipts’ shall not include gross receipts of a taxpayer from a transaction if the taxpayer elects not to have such receipts taken into account for purposes of this subpart.

“(b) FOREIGN ECONOMIC PROCESS REQUIREMENTS.—

“(1) IN GENERAL.—Except as provided in subsection (c), a taxpayer shall be treated as having foreign trading gross receipts from any transaction only if economic processes with respect to such transaction take place outside the United States as required by paragraph (2).

“(2) REQUIREMENT.—

“(A) IN GENERAL.—The requirements of this paragraph are met with respect to the gross receipts of a taxpayer derived from any transaction if—

“(i) such taxpayer (or any person acting under a contract with such taxpayer) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction, and

“(ii) the foreign direct costs incurred by the taxpayer attributable to the transaction equal or exceed 50 percent of the total direct costs attributable to the transaction.

“(B) ALTERNATIVE 85-PERCENT TEST.—A taxpayer shall be treated as satisfying the requirements of subparagraph (A)(ii) with respect to any transaction if, with respect to each of at least 2 subparagraphs of paragraph (3), the foreign direct costs incurred by such taxpayer attributable to activities described in such subparagraph equal or exceed 85 percent of the total direct costs attributable to activities described in such subparagraph.

“(C) DEFINITIONS.—For purposes of this paragraph—

“(i) TOTAL DIRECT COSTS.—The term ‘total direct costs’ means, with respect to any transaction, the total direct costs incurred by the taxpayer attributable to activities described in paragraph (3) performed at any location by the taxpayer or any person acting under a contract with such taxpayer.

“(ii) FOREIGN DIRECT COSTS.—The term ‘foreign direct costs’ means, with respect to any transaction, the portion of the total direct costs which are attributable to activities performed outside the United States.

“(3) ACTIVITIES RELATING TO QUALIFYING FOREIGN TRADE PROPERTY.—The activities described in this paragraph are any of the following with respect to qualifying foreign trade property—

- “(A) advertising and sales promotion,
- “(B) the processing of customer orders and the arranging for delivery,
- “(C) transportation outside the United States in connection with delivery to the customer,
- “(D) the determination and transmittal of a final invoice or statement of account or the receipt of payment, and
- “(E) the assumption of credit risk.

“(4) ECONOMIC PROCESSES PERFORMED BY RELATED PERSONS.—A taxpayer shall be treated as meeting the requirements of this subsection with respect to any sales transaction involving any property if any related person has met such requirements in such transaction or any other sales transaction involving such property.

“(c) EXCEPTION FROM FOREIGN ECONOMIC PROCESS REQUIREMENT.—

“(1) IN GENERAL.—The requirements of subsection (b) shall be treated as met for any taxable year if the foreign trading gross receipts of the taxpayer for such year do not exceed \$5,000,000.

“(2) RECEIPTS OF RELATED PERSONS AGGREGATED.—All related persons shall be treated as one person for purposes of paragraph (1), and the limitation under paragraph (1) shall be allocated among such persons in a manner provided in regulations prescribed by the Secretary.

“(3) SPECIAL RULE FOR PASS-THRU ENTITIES.—In the case of a partnership, S corporation, or other pass-thru entity, the limitation under paragraph (1) shall apply with respect to the partnership, S corporation, or entity and with respect to each partner, shareholder, or other owner.

“SEC. 943. OTHER DEFINITIONS AND SPECIAL RULES.

“(a) QUALIFYING FOREIGN TRADE PROPERTY.—For purposes of this subpart—

“(1) IN GENERAL.—The term ‘qualifying foreign trade property’ means property—

- “(A) manufactured, produced, grown, or extracted within or outside the United States,
- “(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and
- “(C) not more than 50 percent of the fair market value of which is attributable to—

- “(i) articles manufactured, produced, grown, or extracted outside the United States, and

- “(ii) direct costs for labor (determined under the principles of section 263A) performed outside the United States.

For purposes of subparagraph (C), the fair market value of any article imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation, and the direct costs for labor under clause (ii) do not include costs that would be treated under the principles of section 263A as direct labor costs attributable to articles described in clause (i).

“(2) U.S. TAXATION TO ENSURE CONSISTENT TREATMENT.—Property which (without regard to this paragraph) is qualifying foreign trade property and which is manufactured, produced, grown, or extracted outside the United States shall be treated as qualifying foreign trade property only if it is manufactured, produced, grown, or extracted by—

- “(A) a domestic corporation,
- “(B) an individual who is a citizen or resident of the United States,
- “(C) a foreign corporation with respect to which an election under subsection (e) (relating to foreign corporations electing to be subject to United States taxation) is in effect, or
- “(D) a partnership or other pass-thru entity all of the partners or owners of which are described in subparagraph (A), (B), or (C).

Except as otherwise provided by the Secretary, tiered partnerships or pass-thru entities shall be treated as described in subparagraph (D) if each of the partnerships or entities is directly or indirectly wholly owned by persons described in subparagraph (A), (B), or (C).

“(3) EXCLUDED PROPERTY.—The term ‘qualifying foreign trade property’ shall not include—

- “(A) property leased or rented by the taxpayer for use by any related person,

“(B) patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property,

“(C) oil or gas (or any primary product thereof),

“(D) products the transfer of which is prohibited or curtailed to effectuate the policy set forth in paragraph (2)(C) of section 3 of Public Law 96-72, or

“(E) any unprocessed timber which is a softwood.

For purposes of subparagraph (E), the term ‘unprocessed timber’ means any log, cant, or similar form of timber.

“(4) PROPERTY IN SHORT SUPPLY.—If the President determines that the supply of any property described in paragraph (1) is insufficient to meet the requirements of the domestic economy, the President may by Executive order designate the property as in short supply. Any property so designated shall not be treated as qualifying foreign trade property during the period beginning with the date specified in the Executive order and ending with the date specified in an Executive order setting forth the President’s determination that the property is no longer in short supply.

“(b) OTHER DEFINITIONS AND RULES.—For purposes of this subpart—

“(1) TRANSACTION.—

“(A) IN GENERAL.—The term ‘transaction’ means—

“(i) any sale, exchange, or other disposition,

“(ii) any lease or rental, and

“(iii) any furnishing of services.

“(B) GROUPING OF TRANSACTIONS.—To the extent provided in regulations, any provision of this subpart which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.

“(2) UNITED STATES DEFINED.—The term ‘United States’ includes the Commonwealth of Puerto Rico. The preceding sentence shall not apply for purposes of determining whether a corporation is a domestic corporation.

“(3) RELATED PERSON.—A person shall be related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).

“(4) GROSS AND TAXABLE INCOME.—Section 114 shall not be taken into account in determining the amount of gross income or foreign trade income from any transaction.

“(c) SOURCE RULE.—Under regulations, in the case of qualifying foreign trade property manufactured, produced, grown, or extracted within the United States, the amount of income of a taxpayer from any sales transaction with respect to such property which is treated as from sources without the United States shall not exceed—

“(1) in the case of a taxpayer computing its qualifying foreign trade income under section 941(a)(1)(B), the amount of the taxpayer’s foreign trade income which would (but for this subsection) be treated as from sources without the United States if the foreign trade income were reduced by an amount equal to 4 percent of the foreign trading gross receipts with respect to the transaction, and

“(2) in the case of a taxpayer computing its qualifying foreign trade income under section 941(a)(1)(C), 50 percent of the amount of the taxpayer’s foreign trade income which would (but for this subsection) be treated as from sources without the United States.

“(d) TREATMENT OF WITHHOLDING TAXES.—

“(1) IN GENERAL.—For purposes of section 114(d), any withholding tax shall not be treated as paid or accrued with respect to extraterritorial income which is excluded from gross income under section 114(a). For purposes of this paragraph, the term ‘withholding tax’ means any tax which is imposed on a basis other than residence and for which credit is allowable under section 901 or 903.

“(2) EXCEPTION.—Paragraph (1) shall not apply to any taxpayer with respect to extraterritorial income from any transaction if the taxpayer computes its qualifying foreign trade income with respect to the transaction under section 941(a)(1)(A).

“(e) ELECTION TO BE TREATED AS DOMESTIC CORPORATION.—

“(1) IN GENERAL.—An applicable foreign corporation may elect to be treated as a domestic corporation for all purposes of this title if such corporation waives all benefits to such corporation granted by the United States under any treaty. No election under section 1362(a) may be made with respect to such corporation.

“(2) APPLICABLE FOREIGN CORPORATION.—For purposes of paragraph (1), the term ‘applicable foreign corporation’ means any foreign corporation if—

“(A) such corporation manufactures, produces, grows, or extracts property in the ordinary course of such corporation’s trade or business, or

“(B) substantially all of the gross receipts of such corporation may reasonably be expected to be foreign trading gross receipts.

“(3) PERIOD OF ELECTION.—

“(A) IN GENERAL.—Except as otherwise provided in this paragraph, an election under paragraph (1) shall apply to the taxable year for which made and all subsequent taxable years unless revoked by the taxpayer. Any revocation of such election shall apply to taxable years beginning after such revocation.

“(B) TERMINATION.—If a corporation which made an election under paragraph (1) for any taxable year fails to meet the requirements of subparagraph (A) or (B) of paragraph (2) for any subsequent taxable year, such election shall not apply to any taxable year beginning after such subsequent taxable year.

“(C) EFFECT OF REVOCATION OR TERMINATION.—If a corporation which made an election under paragraph (1) revokes such election or such election is terminated under subparagraph (B), such corporation (and any successor corporation) may not make such election for any of the 5 taxable years beginning with the first taxable year for which such election is not in effect as a result of such revocation or termination.

“(4) SPECIAL RULES.—

“(A) REQUIREMENTS.—This subsection shall not apply to an applicable foreign corporation if such corporation fails to meet the requirements (if any) which the Secretary may prescribe to ensure that the taxes imposed by this chapter on such corporation are paid.

“(B) EFFECT OF ELECTION, REVOCATION, AND TERMINATION.—

“(i) ELECTION.—For purposes of section 367, a foreign corporation making an election under this subsection shall be treated as transferring (as of the first day of the first taxable year to which the election applies) all of its assets to a domestic corporation in connection with an exchange to which section 354 applies.

“(ii) REVOCATION AND TERMINATION.—For purposes of section 367, if—

“(I) an election is made by a corporation under paragraph (1) for any taxable year, and

“(II) such election ceases to apply for any subsequent taxable year,

such corporation shall be treated as a domestic corporation transferring (as of the 1st day of the first such subsequent taxable year to which such election ceases to apply) all of its property to a foreign corporation in connection with an exchange to which section 354 applies.

“(C) ELIGIBILITY FOR ELECTION.—The Secretary may by regulation designate one or more classes of corporations which may not make the election under this subsection.

“(f) RULES RELATING TO ALLOCATIONS OF QUALIFYING FOREIGN TRADE INCOME FROM SHARED PARTNERSHIPS.—

“(1) IN GENERAL.—If—

“(A) a partnership maintains a separate account for transactions (to which this subpart applies) with each partner,

“(B) distributions to each partner with respect to such transactions are based on the amounts in the separate account maintained with respect to such partner, and

“(C) such partnership meets such other requirements as the Secretary may by regulations prescribe,

then such partnership shall allocate to each partner items of income, gain, loss, and deduction (including qualifying foreign trade income) from any transaction to which this subpart applies on the basis of such separate account.

“(2) SPECIAL RULES.—For purposes of this subpart, in the case of a partnership to which paragraph (1) applies—

“(A) any partner’s interest in the partnership shall not be taken into account in determining whether such partner is a related person with respect to any other partner, and

“(B) the election under section 942(a)(3) shall be made separately by each partner with respect to any transaction for which the partnership maintains separate accounts for each partner.

“(g) EXCLUSION FOR PATRONS OF AGRICULTURAL AND HORTICULTURAL COOPERATIVES.—Any amount described in paragraph (1) or (3) of section 1385(a)—

“(1) which is received by a person from an organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products, and

“(2) which is designated by the organization as allocable to qualifying foreign trade income in a written notice mailed to its patrons during the payment period described in section 1382(d), shall be treated as qualifying foreign trade income of such person for purposes of section 114. The taxable income of the organization shall not be reduced under section 1382 by reason of any amount to which the preceding sentence applies.”

SEC. 4. TECHNICAL AND CONFORMING AMENDMENTS.

(1) The second sentence of section 56(g)(4)(B)(i) is amended by inserting before the period “or under section 114”.

(2) Section 245 is amended by adding at the end the following new subsection:

“(d) CERTAIN DIVIDENDS ALLOCABLE TO QUALIFYING FOREIGN TRADE INCOME.—In the case of a domestic corporation which is a United States shareholder (as defined in section 951(b)) of a controlled foreign corporation (as defined in section 957), there shall be allowed as a deduction an amount equal to 100 percent of any dividend received from such controlled foreign corporation which is distributed out of earnings and profits attributable to qualifying foreign trade income (as defined in section 941(a)).”

(3) Section 275(a) is amended—

(A) by striking “or” at the end of paragraph (4)(A), by striking the period at the end of paragraph (4)(B) and inserting “, or”, and by adding at the end of paragraph (4) the following new subparagraph:

“(C) such taxes are paid or accrued with respect to qualifying foreign trade income (as defined in section 941).”, and

(B) by adding at the end the following new sentence: “A rule similar to the rule of section 943(d) shall apply for purposes of paragraph (4)(C).”

(4) Paragraph (3) of section 864(e) is amended—

(A) by striking “For purposes of” and inserting:

“(A) IN GENERAL.—For purposes of”, and

(B) by adding at the end the following new subparagraph:

“(B) ASSETS PRODUCING EXEMPT EXTRATERRITORIAL INCOME.—For purposes of allocating and apportioning any interest expense, there shall not be taken into account any qualifying foreign trade property (as defined in section 943(a)) which is held by the taxpayer for lease or rental in the ordinary course of trade or business for use by the lessee outside the United States (as defined in section 943(b)(2)).”

(5) Section 903 is amended by striking “164(a)” and inserting “114, 164(a)”,.

(6) Section 999(c)(1) is amended by inserting “941(a)(5),” after “908(a)”,.

(7) The table of sections for part III of subchapter B of chapter 1 is amended by inserting before the item relating to section 115 the following new item:

“Sec. 114. Extraterritorial income.”

(8) The table of subparts for part III of subchapter N of chapter 1 is amended by striking the item relating to subpart E and inserting the following new item:

“Subpart E. Qualifying foreign trade income.”

(9) The table of subparts for part III of subchapter N of chapter 1 is amended by striking the item relating to subpart C.

SEC. 5. EFFECTIVE DATE.

(a) IN GENERAL.—The amendments made by this Act shall apply to transactions after September 30, 2000.

(b) NO NEW FSCS; TERMINATION OF INACTIVE FSCS.—

(1) NO NEW FSCS.—No corporation may elect after September 30, 2000, to be a FSC (as defined in section 922 of the Internal Revenue Code of 1986, as in effect before the amendments made by this Act).

(2) TERMINATION OF INACTIVE FSCS.—If a FSC has no foreign trade income (as defined in section 923(b) of such Code, as so in effect) for any period of 5 consecutive taxable years beginning after December 31, 2001, such FSC shall cease

to be treated as a FSC for purposes of such Code for any taxable year beginning after such period.

(c) **TRANSITION PERIOD FOR EXISTING FOREIGN SALES CORPORATIONS.—**

(1) **IN GENERAL.—**In the case of a FSC (as so defined) in existence on September 30, 2000, and at all times thereafter, the amendments made by this Act shall not apply to any transaction in the ordinary course of trade or business involving a FSC which occurs—

(A) before January 1, 2002, or

(B) after December 31, 2001, pursuant to a binding contract—

(i) which is between the FSC (or any related person) and any person which is not a related person, and

(ii) which is in effect on September 30, 2000, and at all times thereafter.

For purposes of this paragraph, a binding contract shall include a purchase option, renewal option, or replacement option which is included in such contract and which is enforceable against the seller or lessor.

(2) **ELECTION TO HAVE AMENDMENTS APPLY EARLIER.—**A taxpayer may elect to have the amendments made by this Act apply to any transaction by a FSC or any related person to which such amendments would apply but for the application of paragraph (1). Such election shall be effective for the taxable year for which made and all subsequent taxable years, and, once made, may be revoked only with the consent of the Secretary of the Treasury.

(3) **RELATED PERSON.—**For purposes of this subsection, the term “related person” has the meaning given to such term by section 943(b)(3) of such Code, as added by this Act.

(d) **SPECIAL RULES RELATING TO LEASING TRANSACTIONS.—**

(1) **SALES INCOME.—**If foreign trade income in connection with the lease or rental of property described in section 927(a)(1)(B) of such Code (as in effect before the amendments made by this Act) is treated as exempt foreign trade income for purposes of section 921(a) of such Code (as so in effect), such property shall be treated as property described in section 941(c)(1)(B) of such Code (as added by this Act) for purposes of applying section 941(c)(2) of such Code (as so added) to any subsequent transaction involving such property to which the amendments made by this Act apply.

(2) **LIMITATION ON USE OF GROSS RECEIPTS METHOD.—**If any person computed its foreign trade income from any transaction with respect to any property on the basis of a transfer price determined under the method described in section 925(a)(1) of such Code (as in effect before the amendments made by this Act), then the qualifying foreign trade income (as defined in section 941(a) of such Code, as in effect after such amendments) of such person (or any related person) with respect to any other transaction involving such property (and to which the amendments made by this Act apply) shall be zero.

I. SUMMARY AND BACKGROUND

A. PURPOSE AND SUMMARY

PURPOSE

The bill, H.R. 4986, the “FSC Repeal and Extraterritorial Income Exclusion Act of 2000,” repeals the foreign sales corporation provisions of the Internal Revenue Code to comply with decisions of a World Trade Organization dispute panel and Appellate Body regarding a dispute brought before the World Trade Organization (“WTO”) by the European Union. To retain a competitive balance for U.S. businesses that compete in the world market, the bill modifies the taxation of foreign trade income to comply with the standards set forth in the decisions of the WTO dispute panel and Appellate Body.

SUMMARY

H.R. 4986 repeals sections 921 through 927 of the Internal Revenue Code of 1986 (“the Code”). These sections of the Code relate to foreign sales corporations (“FSCs”).

H.R. 4986 provides that gross income for U.S. tax purposes does not include extraterritorial income. Deductions allocated to such excluded income generally are disallowed. Because the exclusion of such extraterritorial income is a means of avoiding double taxation, no foreign tax credit is allowed for income taxes paid with respect to such excluded income. An exception from this general rule is provided for extraterritorial income that is not qualifying foreign trade income.

In general, H.R. 4986 is effective for transactions entered into after September 30, 2000, and no corporation may elect to be a FSC after September 30, 2000.

B. BACKGROUND AND NEED FOR LEGISLATION

In July 1998, the European Union¹ requested that a WTO dispute panel determine whether the FSC regime of sections 921 through 927 of the Code complies with WTO rules, including the Agreement on Subsidies and Countervailing Measures. A WTO dispute settlement panel (“the Panel”) was established in September, 1998, to address these issues. On October 8, 1999, the Panel ruled that the FSC regime was not in compliance with WTO obligations.² The Panel specified that “FSC subsidies must be withdrawn at the latest with effect from 1 October 2000.”³ On February 24, 2000, the Appellate Body affirmed the lower panel’s ruling.⁴

C. LEGISLATIVE HISTORY

The Committee on Ways and Means marked up the provisions of the bill on July 27, 2000, and approved the provisions, with an amendment, on July 27, 2000, by a roll call vote of 34 yeas and 1 nay, with a quorum present.

II. EXPLANATION OF THE BILL

A. REPEAL OF FSC PROVISIONS AND EXCLUSION FOR EXTRATERRITORIAL INCOME

PRESENT LAW

Summary of U.S. income taxation of foreign persons

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person.⁵ The in-

¹The European Union comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom. Canada and Japan made third-party submissions to the subsequently established dispute settlement panel in support of the European Union position.

²United States—Tax Treatment for “Foreign Sales Corporations,” Report of the Panel, October 8, 1999 (“Panel Decision”).

³Panel Decision at 334.

⁴United States—Tax Treatment for “Foreign Sales Corporations,” Report of the Appellate Body, February 24, 2000 (“Appellate Body Decision”).

⁵A variety of anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation. The Code sets forth the following anti-deferral regimes: the controlled foreign corporation rules of subpart F (secs. 951–954), the passive foreign investment company rules (secs. 1291–1298), the foreign personal holding company rules (secs. 551–558),

come is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. An indirect foreign tax credit may reduce the U.S. tax imposed on such income.

Foreign sales corporations

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

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

A FSC generally is not subject to U.S. tax on its exempt foreign trade income. The exempt foreign trade income of a FSC is 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 is 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 is subject to U.S. tax currently and is treated as U.S.-source income for purposes of the foreign tax credit limitation.

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

The term "export property" generally means 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" does 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

the personal holding company rules (secs. 541-547), the accumulated earnings tax rules (secs. 531-537), and the foreign investment company rules (sec. 1246). Detailed rules for coordination among the anti-deferral regimes are provided to prevent a U.S. person from being subject to U.S. tax on the same item of income under multiple regimes.

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 excludes property designated by the President as being in short supply.

If export property is sold to a FSC by a related person (or a commission is paid by a related person to a FSC with respect to export property), the income with respect to the export transactions must be allocated between the FSC and the related person. The taxable income of the FSC and the taxable income of the related person are computed based upon a transfer price determined under section 482 or under one of two formulas.

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

A FSC is not required or deemed to make distributions to its shareholders. Actual distributions are treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits. Any distribution made by a FSC out of earnings and profits attributable to foreign trade income to a foreign shareholder is treated as U.S.-source income that is effectively connected with a business conducted through a permanent establishment of the shareholder within the United States. Thus, the foreign shareholder is subject to U.S. tax on such a distribution.

A U.S. corporation generally is 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 is not allowed for nonexempt foreign trade income determined under section 482 pricing.

REASONS FOR CHANGE

In general

On February 24, 2000, the Appellate Body, over the objections of the United States, upheld the finding of the Panel that had found that the FSC provisions of sections 921 through 927 of the Code constitute a prohibited export subsidy under the WTO Agreement on Subsidies and Countervailing Measures and under the Agreement on Agriculture. The Panel specified that "FSC subsidies must be withdrawn at the latest with effect from 1 October 2000."⁶

The purpose of this legislation is to comply with the recommendations and rulings of the Panel and the Appellate Body, as adopted by the WTO Dispute Settlement Body, in the dispute before the World Trade Organization entitled United States—Tax Treatment for "Foreign Sales Corporations," WT/DS108/R, WT/DS108/AB/R, Report of the Panel, as modified by the Appellate Body, adopted March 20, 2000.

⁶Report of the Panel at 334.

The legislation complies with the Panel and Appellate Body Decisions by repealing the FSC provisions of the Code, thereby eliminating the measures which the Panel and Appellate Body found to be prohibited export subsidies. The legislation makes fundamental adjustments to the Code that move the U.S. tax system in the direction of many European tax systems by incorporating certain of the territorial features of those systems.

Before turning to the details of this legislation, however, the Committee feels compelled to make certain observations regarding the history of the FSC dispute, the actions of the European Union in initiating the dispute, and the decision of the Appellate Body. The origins of this dispute go back many years, and arise, in part, out of certain fundamental differences between tax systems. There are two basic types of income tax systems: (1) a residence-based (or “worldwide”) system; and (2) a territorial system. Under a worldwide system, such as that of the United States, all of the income earned by a resident (e.g., a corporation incorporated in one of the fifty states or the District of Columbia) is subject to tax, regardless of where that income is earned. Under a territorial system, such as those of a number of European countries, only income earned within the borders of the taxing jurisdiction is subject to tax. In practice, neither the United States nor the member states of the European Union employ a “pure” territorial system or a “pure” worldwide system, as most countries employ some combination of the two concepts.

It is important to note that each type of system generally uses a different method to avoid double taxation of foreign-source income. Although this is an oversimplification, in a worldwide system, the “credit method” typically is used; that is, a tax credit is provided for taxes paid to foreign governments on income earned abroad. In a territorial system, the “exemption method” is used; that is, income earned abroad is simply not subject to tax. While tax policy arguments can be used to justify the superiority of one method over the other, both methods are accepted internationally, and it also is accepted internationally that a country is free to use either method or both. However, it also is recognized internationally—and, as the Committee understands it, was acknowledged by the European Union in the course of the FSC dispute—that the exemption method tends to result in exports being taxed more favorably than comparable domestic transactions.

Turning to the history of the FSC dispute, in 1971, the United States enacted the Domestic International Sales Corporation (“DISC”) legislation, which provided a special tax exemption for exports. The European Communities challenged the DISC in the General Agreement on Tariffs and Trade (“GATT”), alleging that it constituted an export subsidy because it resulted in exports being taxed more favorably than comparable domestic transactions. In response, the United States challenged the tax regimes of Belgium, France and the Netherlands, alleging that the use of the exemption method by those countries constituted an export subsidy because it also resulted in exports being taxed more favorably than comparable domestic transactions. In 1976, a GATT panel ruled against the DISC provisions, but also ruled against the European regimes, finding, as a factual matter, that those regimes did tax exports more favorably than comparable domestic transactions.

Following the issuance of the panel rulings, those rulings languished unadopted as the European Communities refused to accept that their regimes provided export subsidies. The European Communities' criticisms of the panel rulings, however, focused on the panel's legal reasoning, not on the panel's factual findings that the European regimes taxed exports more favorably than comparable domestic transactions. Eventually, the disputes were resolved based on the negotiation of an "Understanding" which was adopted by the GATT Council in 1981. Essentially, this Understanding—elements of which already had been incorporated into the Tokyo Round Subsidies Code—provided that countries did not provide an export subsidy when they refrained from taxing foreign-source income, even if this resulted in exports being taxed more favorably than comparable domestic transactions. The European countries in question interpreted the Understanding as overruling the panel and sanctioning their use of the exemption method. Subsequently, using the principles set forth in the Understanding as a guide, the United States enacted the FSC legislation, the objective being to reap the export-enhancing benefits of the exemption method.

Many years later, the European Union abruptly challenged the FSC provisions in the WTO. Notwithstanding the fact that the FSC provisions were intended to emulate certain elements of a territorial tax system—namely, the use of the exemption method—the Panel and the Appellate Body ruled that the manner in which the United States sought to achieve this objective conflicted with the rules of the WTO Agreement on Subsidies and Countervailing Measures ("SCM Agreement") and the Agreement on Agriculture. However, neither body said that the use of the exemption method itself was an impermissible one, nor did either body rule that a WTO member may not maintain a tax regime that includes features of both worldwide and territorial tax systems. What the Committee is intending to do with this legislation is once again to incorporate elements of a territorial tax system into the U.S. system of worldwide taxation, this time in a manner which does not conflict with WTO rules.

Turning to the actions of the European Union in this dispute, it is the Committee's understanding that this dispute did not arise out of private sector complaints, but instead was initiated by the European Union primarily as a response to its losses in the so-called "bananas" and "beef" disputes. Indeed, it is the Committee's understanding that during the course of this dispute, European Union officials failed, when asked, to provide a single example of actual commercial harm suffered by a European firm as a result of the FSC provisions. In light of this, the Committee finds the European Union's decision to walk away from the 1981 Understanding deeply troubling and provocative as well as threatening to the international trading system.

Notwithstanding these concerns, the United States has moved quickly to comply with the decisions of the Panel and Appellate Body. With the adoption of this legislation, the United States will have met the short deadline set by the Panel under the pressures and constraints of an election year. More significantly, in order to comply with a decision that significantly affects issues of national tax policy, the United States has made fundamental modifications to its tax structure, including features that are common to many

European tax systems. The Committee hopes and expects that the European Union will regard this legislation as a faithful and responsible implementation of the WTO rulings in this dispute, understanding that each WTO member enjoys a sovereign right to decide its own system of taxation within the parameters of its international obligations. The Committee also hopes and expects that the European Union will appreciate the extremely detrimental consequences which a prolongation of this dispute would bring both to our bilateral relations and the successful functioning of the multilateral trading system. The Committee expects the United States to strongly pursue its rights under the WTO, including, as appropriate, the initiation of cases challenging tax systems that exclude certain income from taxation.

The Committee strongly believes that the substantial modification to U.S. tax law provided in this bill is WTO compliant. While the Committee believes it is important for all nations to honor their trade agreements and the obligations those agreements may impart, the Committee also believes it is important that U.S. business interests not be foreclosed from opportunities abroad because of differences in the tax laws in the United States compared to tax laws in other countries. Indeed, the Committee believes that the WTO was not established to conform and restructure tax systems of contracting parties.

Compliance with WTO rulings

In its ruling, the Panel raised the following objections to the FSC provisions of the Code. First, the Panel found that “but for” the existence of the FSC provisions, revenue that otherwise would be fully taxable under the Code enjoyed a lower rate of taxation. Thus, the Panel found the FSC provisions to be a subsidy because partial tax exemptions accorded by the FSC provisions represented, in its view, a forgoing of “government revenue that is otherwise due.” Second, the Panel found that the FSC provisions constituted a prohibited export subsidy because only exports receive preferential tax treatment.

The Administration has informed the Committee that the European Union has expressed additional concerns regarding the FSC provisions, even though they were not addressed in the Appellate Body Decision or Panel Decision. Among the European Union’s many allegations are that the FSC administrative pricing rules violated the arm’s-length pricing provisions of the Subsidies Agreement and that the FSC structure encouraged the use of tax havens.

The Committee believes the approach of H.R. 4986 complies with the Appellate Body and Panel Decisions and modifies the U.S. tax system in a WTO-consistent manner. In addition, the legislation addresses other concerns raised by the European Union that were not decided by the Panel or Appellate Body. The legislation complies with the WTO decisions by repealing the FSC provisions of the Code, thereby eliminating the FSC subsidies issue. Furthermore, the replacement regime achieves WTO-consistency. The legislation responds to both of the determinative findings in the Panel and Appellate Body Decisions—(1) the conclusion that the FSC constitutes a “subsidy,” and (2) the conclusion that it constitutes an “export contingent subsidy.” The legislation also goes further than the decisions and addresses additional concerns raised by the Euro-

pean Union by eliminating the use of administrative pricing rules to establish transfer prices and by eliminating the arguable encouragement for the use of tax haven entities.

FSC repeal

The Committee believes that H.R. 4986 complies with the deadline set by the Panel, upheld by the Appellate Body, that “FSC subsidies must be withdrawn at the latest with effect from 1 October 2000.” The legislation repeals the FSC provisions thereby eliminating the subsidy at issue in the Panel Decision. By repealing the FSC provisions, the United States has withdrawn what the WTO has found to be a subsidy.

H.R. 4986 confers no “subsidy”

The Panel and Appellate Body ruled that the FSC provisions constitute a “subsidy” because “government revenue that is otherwise due” is forgone. The Appellate Body has acknowledged that a WTO member has the sovereign right to not tax certain categories of income, whether foreign or domestic. Indeed, pure territorial tax systems exclude all foreign source income, including export income, from tax. WTO rules do not compel members to adopt pure territorial tax regimes. Accordingly, the United States, like European Union countries with territorial tax systems (whether pure territorial systems or partial territorial systems) must be free to elect not to tax certain categories of income.

In determining whether revenue forgone is “otherwise due,” the Panel, in an analysis upheld by the Appellate Body, examined “the fiscal treatment that would be applicable ‘but for’ the measures in question.”⁷ The Appellate Body, in reviewing the Panel Decision, stated that “[t]here must * * * be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised ‘otherwise.’” Thus, the appropriate analysis requires the identification of a prevailing standard of taxation for a particular category of income and a determination of whether this standard is applied consistently to income falling within that category.

The Panel ruled that the FSC provisions excepted certain types of income from the Code’s general rule that worldwide income is taxable and, thus, from the taxes that would be due in the absence of the FSC provisions. The Appellate Body, however, confirmed that a WTO member is free to determine how broadly to assert its general taxing authority and “has the sovereign authority to tax any particular categories of revenue it wishes.” The Appellate Body Decision also specifically stated that a WTO member is “free not to tax any particular categories of revenues.”

H.R. 4986 modifies the general rule of U.S. taxation by fundamentally amending the definition of gross income. Under the Code, the definition of “gross income” defines the outer boundaries of U.S. income taxation. The bill excludes income derived from cer-

⁷The Appellate Body considered the “but for” test a “sound basis for comparison because it is not difficult to establish in what way the foreign-source income of a FSC would be taxed ‘but for’ the contested measure.” However, the Appellate Body cautioned that “we have certain abiding reservations about applying any legal standard, such as this ‘but for’ test, in the place of the actual treaty language.” The Appellate Body observed that the application of a “but for” test is most effective when there is a general rule that applies formally to the revenues in question, absent the contested measures.

tain activities performed outside the United States, referred to as “extraterritorial income,” from the definition of gross income and, thus, modifies the extent to which the United States seeks to tax such income. This new general rule thus becomes the normative benchmark for taxing income derived in connection with certain activities performed outside the United States. This general rule applies to foreign trade income, whether the goods are manufactured in the United States or abroad—a substantially broader category of income than that which was exempted from tax under the FSC provisions. The Committee believes that it is important that the activities giving rise to excludable extraterritorial income involve real economic activity, or “economic processes,” performed outside the United States. The Committee also believes that it is appropriate to except certain forms of extraterritorial income from the exclusion; however, the Committee emphasizes that the taxation of certain forms of extraterritorial income are exceptions to the general rule of not taxing extraterritorial income.

The Committee emphasizes that, consistent with the Appellate Body Decision, the United States is exercising its sovereign authority not to tax a category of revenue. Because of this substantive change in U.S. income taxation, the exclusion of extraterritorial income becomes the United States’ general rule with respect to this category of income. Therefore, the exclusion of such income from taxation does not constitute revenue forgone that is otherwise due and, accordingly, does not give rise to a “subsidy” within the meaning of the WTO rules.

H.R. 4986 does not provide “export-contingent” benefits

In addition to ensuring that the FSC replacement regime is not a “subsidy,” the Committee believes that, in order to ensure WTO compatibility, it is important that the new regime not confer export-contingent benefits.⁸ To achieve this goal, the Committee has relied on the WTO Appellate Body’s interpretation of the meaning of “contingent” for purposes of the Agreement on Subsidies and Countervailing Measures in crafting this legislation.⁹ It is the Committee’s intent and belief that the exclusion of extraterritorial income from U.S. gross income is not dependent on such income arising from export activities. Accordingly, the Committee has determined that it is appropriate to treat all foreign sales alike, whether the goods were manufactured in the United States or abroad. A taxpayer would receive the same U.S. tax treatment with respect to its foreign sales regardless of whether it exports. As a result, the exclusion for certain extraterritorial income is not “conditional” or “dependent” on whether an entity exports; therefore, it clearly is not export contingent.

⁸Under Article 3.1(a) of the Agreement on Subsidies and Countervailing Measures, subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, are prohibited. This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. However, the mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

⁹See Canada—Measures Affecting the Export of Civilian Aircraft; see also Canada—Certain Measures Affecting the Automotive Industry. In these cases, the WTO Appellate Body has found the term “contingent” to have its ordinary meaning of “conditional” or “dependent for its existence on something else.”

The Committee emphasizes that the extraterritorial income excluded by this legislation from the scope of U.S. income taxation is parallel to the foreign-source income excluded from tax under most territorial tax systems. Under neither the U.S. tax system as modified by this legislation nor many European tax systems is the income excluded from taxation limited to income earned through exporting. At the same time, under both systems, exporting is one way to earn foreign source income that is excluded from taxation, and exporters under both systems are among those who can avail themselves of the limitations on the taxing authority of both systems. While exporters may be among those who are eligible for the exclusion, this fact does not make that exclusion “export contingent.” If it did, every general exclusion from tax applicable to, among others, exporters would become a prohibited export subsidy.

Addressing other European Union concerns

The Administration has informed the Committee that during the course of the WTO litigation and subsequent consultations with European Union officials, the European Union also raised certain issues relating to the FSC rules that the Panel and Appellate Body did not consider. In this regard, the European Union argued that the administrative pricing rules used to determine the amount of exempt income generated by FSCs were in violation of the arm’s-length transfer price provisions in the SCM Agreement. In addition, the European Union alleged that the companies established as FSCs were essentially “sham” corporations and that the FSCs were often located in tax haven countries.

The Committee wants to be clear that because neither the Panel nor the Appellate Body made recommendations with respect to these complaints, the United States is under no obligation to address these issues. Nonetheless, the Committee believes that there is some benefit to be achieved by removing these issues as a source of contention. In addition, the Committee believes that addressing these issues provides an opportunity to simplify the administration of the tax law as well as corporate record keeping.

First, unlike the FSC regime, the bill does not require the use of a separate foreign entity such as the FSC. Therefore, it cannot be argued that the new legislation encourages the formation of “sham” corporations in tax-haven jurisdictions. Second, because there is no separate entity required, there are no transfers required between related domestic and foreign companies. The administrative pricing rules are therefore eliminated as transfer pricing mechanisms. If there are transfers between related parties, general arm’s-length principles apply. Further, the Committee notes that the elimination of the need for a separate foreign entity simplifies the administration of the tax law from the perspective of both the IRS and the taxpayer.

Conclusion

The Committee believes that this legislation complies with the WTO decisions and honors U.S. obligations under the WTO. The Committee is of the view that repealing the FSC provisions provides an opportunity to revise the Code in a manner that rationalizes tax treatment for extraterritorial income. The Committee is confident that, should the bill be challenged in WTO dis-

pute settlement proceedings, the legislation would withstand scrutiny under the trade agreements. The Committee contrasts the timely and thorough action by the United States represented by this legislation with the response of certain foreign nations to findings of other WTO dispute settlement panels in recent cases involving trade in beef and bananas—findings dealing with pure trade issues and not with the fundamental nature of a country’s tax regime.

It is the Committee’s sincere hope that through this legislation the United States will be able to resolve this dispute.

EXPLANATION OF PROVISIONS

Repeal of the FSC rules

The bill repeals the present-law FSC rules found in sections 921 through 927 of the Code.

Exclusion of extraterritorial income

The bill provides that gross income for U.S. tax purposes does not include extraterritorial income. Because the exclusion of such extraterritorial income is a means of avoiding double taxation, 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 bill applies 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

Under the bill, 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,¹⁰ (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 one of the three calculations that 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. Although these calculations are determined by reference to a reduction of taxable income (a net income concept), qualifying foreign trade income is an exclusion from gross income. Hence, once a taxpayer determines the appropriate reduction of

¹⁰The term “transaction” means (1) any sale, exchange, or other disposition; (2) any lease or rental, and (3) any furnishing of services.

taxable income, that amount must be “grossed up” for related expenses in order to determine the amount of gross income excluded.¹¹

If a taxpayer uses 1.2 percent of foreign trading gross receipts to determine the amount of qualifying foreign trade income with respect to a transaction, the taxpayer or any other related persons will be treated as having no qualifying foreign trade income with respect to any other transaction involving the same property.¹² For example, assume that a manufacturer and a distributor of the same product are related persons. The manufacturer sells the product to the distributor at an arm’s-length price of \$80 (generating \$30 of profit) and the distributor sells the product to an unrelated customer outside of the United States for \$100 (generating \$20 of profit). If the distributor chooses to calculate its qualifying foreign trade income on the basis of 1.2 percent of foreign trading gross receipts, then the manufacturer will be considered to have no qualifying foreign trade income and, thus, would have no excluded income. The distributor’s qualifying foreign trade income would be 1.2 percent of \$100, and the manufacturer’s qualifying foreign trade income would be zero. This limitation is intended to prevent a duplication of exclusions from gross income because the distributor’s \$100 of gross receipts includes the \$80 of gross receipts of the manufacturer. Absent this limitation, \$80 of gross receipts would have been double counted for purposes of the exclusion. If both persons were permitted to use 1.2 percent of their foreign trading gross receipts in this example, then the related-person group would have an exclusion based on \$180 of foreign trading gross receipts notwithstanding that the related-person group really only generated \$100 of gross receipts from the transaction. However, if the distributor chooses to calculate its qualifying foreign trade income on the basis of 15 percent of foreign trade income (15 percent of \$20 of profit), then the manufacturer would also be eligible to calculate its qualifying foreign trade income in the same manner (15 percent of \$30 of profit).¹³ Thus, in the second case, each related person may exclude an amount of income based on their respective profits. The total foreign trade income of the related-person group is \$50. Accordingly, allowing each person to calculate the exclusion based on their respective foreign trade income does not result in duplication of exclusions.

Under the bill, 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. Under the grouping method, the Committee intends that taxpayers be given reasonable flexibility to identify product lines or groups on the basis of recognized industry or trade usage. In general, provided that the taxpayer’s grouping is not unreasonable, it will not be rejected merely because the grouped products fall within more than one of the two-digit Standard Industrial

¹¹For an example of these calculations, see the General Example, below.

¹²Persons are considered to be related if they are treated as a single employer under section 52(a) or (b) (determined without taking into account section 1563(b), thus including foreign corporations) or section 414(m) or (o).

¹³The manufacturer also could compute qualifying foreign trade income based on 30 percent of foreign sale and leasing income.

Classification codes.¹⁴ The Secretary of the Treasury is granted authority to prescribe rules for grouping transactions in determining qualifying foreign trade income.

Qualifying foreign trade income must be reduced by illegal bribes, kickbacks and similar payments, and by a factor for operations in or related to a country associated in carrying out an international boycott, or participating or cooperating with an international boycott.

In addition, the bill directs the Secretary of the Treasury to prescribe rules for marginal costing in those cases in which a taxpayer is seeking to establish or maintain a market for qualifying foreign trade property.

Foreign trading gross receipts

Under the bill, “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 of 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 of 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. Consistent with the policy adopted in the Taxpayer Relief Act of 1997,¹⁵ this includes the license of computer software for reproduction abroad.

Foreign trading gross receipts do not include gross receipts from a transaction if the qualifying foreign trade property or services are for ultimate use in the United States, or for use by the United States (or an instrumentality thereof) and such use is required by law or regulation. Foreign trading gross receipts also do not include gross receipts from a transaction that is accomplished by a subsidy granted by the government (or any instrumentality thereof) of the country or possession in which the property is manufactured.

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 utilize any related foreign tax credits in lieu of the exclusion as a means of avoiding double taxation. It is intended that this election be accomplished by the taxpayer’s treatment of such items on its tax return for the taxable year. Provided that the taxpayer’s taxable year is still open under the statute of limitations for making claims for refund under section 6511, a taxpayer can make redeterminations as to whether the gross receipts from a transaction constitute foreign trading gross receipts.

¹⁴By reference to Standard Industrial Classification codes, the Committee intends to include industries as defined in the North American Industrial Classification System.

¹⁵The Taxpayer Relief Act of 1997, Public Law 105–34.

Foreign economic processes

Under the bill, gross receipts from a transaction are foreign trading gross receipts only if certain economic processes take place outside of 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 of 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.¹⁶ For this purpose, foreign direct costs include only those costs incurred in the following categories of activities: (1) advertising and sales promotion; (2) the processing of customer orders and the arranging for delivery; (3) transportation outside of the United States in connection with delivery to the customer; (4) the determination and transmittal of a final invoice or statement of account or the receipt of payment; and (5) the assumption of credit risk. An exception from the foreign economic processes requirement is provided for taxpayers with foreign trading gross receipts for the year of \$5 million or less.¹⁷

The foreign economic processes requirement must be satisfied with respect to each transaction and, if so, any gross receipts from such transaction could be considered as foreign trading gross receipts. For example, all of the lease payments received with respect to a multi-year lease contract, which contract met the foreign economic processes requirement at the time it was entered into, would be considered as foreign trading gross receipts. On the other hand, a sale of property that was formerly a leased asset, which was not sold pursuant to the original lease agreement, generally would be considered a new transaction that must independently satisfy the foreign economic processes requirement.

A taxpayer's foreign economic processes requirement is treated as satisfied with respect to a sales transaction (solely for the purpose of determining whether gross receipts are foreign trading gross receipts) if any related person has satisfied the foreign economic processes requirement in connection with another sales transaction involving the same qualifying foreign trade property.

Qualifying foreign trade property

Under the bill, the threshold for determining if gross receipts will be treated as foreign trading gross receipts is whether the gross receipts are derived from a transaction involving "qualifying foreign trade property." Qualifying foreign trade property is property manufactured, produced, grown, or extracted ("manufactured") within or outside of the United States that is held primarily for sale, lease, or rental,¹⁸ in the ordinary course of a trade or business, for direct use, consumption, or disposition outside of the United

¹⁶The foreign direct costs attributable to the transaction generally must exceed 50 percent of the total direct costs attributable to the transaction, but the requirement also will be satisfied if, with respect to at least two categories of direct costs, the foreign direct costs equal or exceed 85 percent of the total direct costs attributable to each category.

¹⁷For this purpose, the receipts of related persons are aggregated and, in the case of pass-through entities, the determination of whether the foreign trading gross receipts exceed \$5 million is made both at the entity and at the partner/shareholder level.

¹⁸In addition, consistent with the policy adopted in the Taxpayer Relief Act of 1997, computer software licensed for reproduction is considered as property held primarily for sale, lease, or rental.

States.¹⁹ 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 of the United States plus (2) the direct costs of labor performed outside of the United States.²⁰

The Committee understands that under current industry practice, the purchaser of an aircraft contracts separately for the aircraft engine and the airframe, albeit contracting with the airframe manufacturer to attach the separately purchased engine. The Committee intends that an aircraft engine be qualifying foreign trade property (assuming that all other requirements are satisfied) if (1) it is specifically designed to be separated from the airframe to which it is incorporated without significant damage to either the engine or the airframe, (2) it is reasonably expected to be separated from the airframe in the ordinary course of business (other than by reason of temporary separation for servicing, maintenance, or repair) before the end of the useful life of either the engine or the airframe, whichever is shorter, and (3) the terms under which the aircraft engine was sold were directly and separately negotiated between the manufacturer of the aircraft engine and the person to whom the aircraft will be ultimately delivered. By articulating this application of the foreign destination test in the case of certain separable aircraft engines, the Committee intends no inference with respect to the application of any destination test under present law or with respect to any other rule of law outside this bill.²¹

The bill excludes certain property 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,²² (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. In addition, it is the intention of the Committee that property that is leased or licensed to a related person who is the lessor, licensor, or seller of the same property in a sublease, sublicense, or sale to an unrelated person for the ultimate and predominate use by the unrelated person outside of the United States is not excluded property by reason of such lease or license to a related person.

With respect to property that is manufactured outside of the United States, rules are provided to ensure consistent U.S. tax treatment with respect to manufacturers. The bill requires that property manufactured outside of the United States 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

¹⁹“United States” includes Puerto Rico for these purposes because Puerto Rico is included in the customs territory of the United States.

²⁰For this purpose, the fair market value of any article imported into the United States is its appraised value as determined under the Tariff Act of 1930. In addition, direct labor costs are determined under the principles of section 263A and do not include costs that would be treated as direct labor costs attributable to “articles,” again applying principles of section 263A.

²¹See, e.g., sections 927(a)(1)(B) and 993(c)(1)(B).

²²The intangibles that are treated as excluded property under the bill are: patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property. Computer software that is licensed for reproduction outside of the United States is not excluded from the definition of qualifying foreign trade property.

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.²³

Foreign trade income

Under the bill, “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. Certain dividends-paid deductions of cooperatives are disregarded in determining foreign trade income for this purpose.

Foreign sale and leasing income

Under the bill, “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 (as described above). For example, a distribution company’s profit from the sale of qualifying foreign trade property that is associated with sales activities, such as solicitation or negotiation of the sale, advertising, processing customer orders and arranging for delivery, transportation outside of the United States, and other enumerated activities, would constitute foreign sale and leasing income.

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 of the United States. Income from the sale, exchange, or other disposition of qualifying foreign trade property that is or was subject to such a lease²⁴ (i.e., the sale of the residual interest in the leased property) gives rise to foreign sale and leasing income. Except as provided in regulations, a special limitation applies to leased property that (1) is manufactured by the taxpayer or (2) is acquired by the taxpayer from a related person for a price that was other than arm’s length. In such cases, foreign sale and leasing income may not exceed the amount of foreign sale and leasing income that would have resulted if the taxpayer had acquired the leased property in a hypothetical arm’s-length purchase and then engaged in the actual sale or lease of such property. For example, if a manufacturer leases qualifying foreign trade property that it manufactured, the foreign sale and leasing income derived from that lease may not exceed the amount of foreign sale and leasing income that the manufacturer would have earned with respect to that lease had it purchased the property for an arm’s-length price on the day that the manufacturer entered into the lease. For purposes of calculating the limit on foreign sale and leasing income, the manufacturer’s basis and, thus, depreciation would be based on this hypothetical arm’s-length price. This limitation is intended to prevent foreign sale and leasing income from including profit associated with manufacturing activities.

²³ Except as provided by the Secretary of the Treasury, tiered partnerships or pass-through entities will be considered as partnerships or pass-through entities for purposes of this rule if each of the partnerships or entities is directly or indirectly wholly-owned by persons described in (1), (2), or (3) above.

²⁴ For this purpose, such a lease includes a lease that gave rise to exempt foreign trade income under the FSC provisions.

For purposes of determining foreign sale and leasing income, only directly allocable expenses is taken into account in calculating the amount of foreign trade income. In addition, income properly allocable to certain intangibles is excluded for this purpose.

General Example

The following is an example of the calculation of qualifying foreign trade income.

XYZ Corporation, a U.S. corporation, manufactures property that is sold to unrelated customers for use outside of the United States. XYZ Corporation satisfies the foreign economic processes requirement through conducting activities such as solicitation, negotiation, transportation, and other sales-related activities outside of the United States with respect to its transactions. During the year, qualifying foreign trade property was sold for gross proceeds totaling \$1,000. The cost of this qualifying foreign trade property was \$600. XYZ Corporation incurred \$275 of costs that are directly related to the sale and distribution of qualifying foreign trade property. XYZ Corporation paid \$40 of income tax to a foreign jurisdiction related to the sale and distribution of the qualifying foreign trade property. XYZ Corporation also generated gross income of \$7,600 (gross receipts of \$24,000 and cost of goods sold of \$16,400) and direct expenses of \$4,225 that relate to the manufacture and sale of products other than qualifying foreign trade property. XYZ Corporation also incurred \$500 of overhead expenses. XYZ Corporation's financial information for the year is summarized as follows:

	Total	Other property	QFTP ²⁵
Gross receipts	\$25,000.00	\$24,000.00	\$1,000.00
Cost of goods sold	17,000.00	16,400.00	600.00
Gross income	8,000.00	7,600.00	400.00
Direct expenses	4,500.00	4,225.00	275.00
Overhead expenses	500.00		
Net income	3,000.00		

²⁵ "QFTP" refers to qualifying foreign trade property.

Illustrated below is the computation of the amount of qualifying foreign trade income that is excluded from XYZ Corporation's gross income and the amount of related expenses that are disallowed. In order to calculate qualifying foreign trade income, the amount of foreign trade income first must be determined. Foreign trade income is the taxable income (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts. In this example, XYZ Corporation's foreign trading gross receipts equal \$1,000. This amount of gross receipts is reduced by the related cost of goods sold, the related direct expenses, and a portion of the overhead expenses in order to arrive at the related taxable income.²⁶ Thus, XYZ Corporation's foreign trade income equals \$100, calculated as follows:

²⁶ Overhead expenses must be apportioned in a reasonable manner that does not result in a material distortion of income. In this example, the apportionment of the \$500 of overhead expenses on the basis of gross income is assumed not to result in a material distortion of income and is assumed to be a reasonable method of apportionment. Thus, \$25 (\$500 of total overhead expenses multiplied by 5 percent, i.e., \$400 of gross income from the sale of qualifying foreign trade property divided by \$8,000 of total gross income) is apportioned to qualifying foreign trad-

Continued

Foreign trading gross receipts	\$1,000.00
Cost of goods sold	600.00
Gross income	400.00
Direct expenses	275.00
Apportioned overhead expenses	25.00
Foreign trade income	100.00

Foreign sale and leasing income is defined as an amount of foreign trade income (calculated taking into account only directly-related expenses) that is properly allocable to certain specified foreign activities. Assume for purposes of this example that of the \$125 of foreign trade income (\$400 of gross income from the sale of qualifying foreign trade property less only the direct expenses of \$275), \$35 is properly allocable to such foreign activities (e.g., solicitation, negotiation, advertising, foreign transportation, and other enumerated sales-like activities) and, therefore, is considered to be foreign sale and leasing income.

Qualifying foreign trade income is the amount of gross income that, if excluded, will result in a reduction of taxable income equal to the greatest of (1) 30 percent of foreign sale and leasing income, (2) 1.2 percent of foreign trading gross receipts, or (3) 15 percent of foreign trade income. Thus, in order to calculate the amount that is excluded from gross income, taxable income must be determined and then “grossed up” for allocable expenses in order to arrive at the appropriate gross income figure. First, for each method of calculating qualifying foreign trade income, the reduction in taxable income is determined. Then, the \$275 of direct and \$25 of overhead expenses, totaling \$300, attributable to foreign trading gross receipts is apportioned to the reduction in taxable income based on the proportion of the reduction in taxable income to foreign trade income. This apportionment is done for each method of calculating qualifying foreign trade income. The sum of the taxable income reduction and the apportioned expenses the respective qualifying foreign trade income (i.e., the amount of gross income excluded) under each method, as follows:

	1.2% FTGR ²⁷	15% FTI ²⁸	30% FS&LI ²⁹
Reduction of taxable income:			
1.2% of FTGR (1.2% × \$1,000)	12.00		
15% of FTI (15% × \$100)		15.00	
30% of FS&LI (30% × \$35)			10.50
Gross-up for disallowed expenses:			
\$300 × (\$12/\$100)	36.00		
\$300 × (\$15/\$100)		45.00	
\$275 × (\$10.50/\$100) ³⁰			28.88
Qualifying foreign trade income	48.00	60.00	39.38

²⁷ “FTGR” refers to foreign trading gross receipts.

²⁸ “FTI” refers to foreign trade income.

²⁹ “FS&LI” refers to foreign sale and leasing income.

³⁰ Because foreign sale and leasing income only takes into account direct expenses, it is appropriate to take into account only such expenses for purposes of this calculation.

In the example, the \$60 of qualifying foreign trade income is excluded from XYZ Corporation’s gross income (determined based on 15 percent of foreign trade income).³¹ In connection with excluding

ing gross receipts. The remaining \$475 (\$500 of total overhead expenses less the \$25 apportioned to qualifying income) is apportioned to XYZ Corporation’s other income.

³¹ Note that XYZ Corporation could choose to use one of the other two methods notwithstanding that they would result in a smaller exclusion.

\$60 of gross income, certain expenses that are allocable to this income are not deductible for U.S. Federal income tax purposes. Thus, \$45 (\$300 of related expenses multiplied by 15 percent, i.e., \$60 of qualifying foreign trade income divided by \$400 of gross income from the sale of qualifying foreign trade property) of expenses are disallowed.³²

	Other property	QFTP	Excluded/dis- allowed	Total
Gross receipts	\$24,000.00	\$1,000.00
Cost of goods sold	16,400.00	600.00
Gross income	7,600.00	400.00	(60.00)	7,940.00
Direct expenses	4,225.00	275.00	(41.25)	4,458.75
Overhead expenses	475.00	25.00	(3.75)	496.25
Taxable income	2,985.00

XYZ Corporation paid \$40 of income tax to a foreign jurisdiction related to the sale and distribution of the qualifying foreign trade property. A portion of this \$40 of foreign income tax is treated as paid with respect to the qualifying foreign trade income and, therefore, is not creditable for U.S. foreign tax credit purposes. In this case, \$6 of such taxes paid (\$40 of foreign taxes multiplied by 15 percent, i.e., \$60 of qualifying foreign trade income divided by \$400 of gross income from the sale of qualifying foreign trade property) is treated as paid with respect to the qualifying foreign trade income and, thus, is not creditable.

The results in this example are the same regardless of whether XYZ Corporation manufactures the property within the United States or outside of the United States through a foreign branch. If XYZ Corporation were an S corporation or limited liability company, the results also would be the same, and the exclusion would pass through to the S corporation owners or limited liability company owners as the case may be.

Other rules

Foreign-source income limitation

The bill provides a limitation 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.

This foreign-source income limitation is determined in one of two ways depending on whether the qualifying foreign trade income is calculated based on 1.2 percent of foreign trading gross receipts or on 15 percent of foreign trade income. If the qualifying foreign trade income is calculated based on 1.2 percent of foreign trading gross receipts, the related amount of foreign-source income may not exceed the amount of foreign trade income that (without taking

³²The \$300 of allocable expenses includes both the \$275 of direct expenses and the \$25 of overhead expenses. Thus, the \$45 of disallowed expenses represents the sum of \$41.25 of direct expenses plus \$3.75 of overhead expenses. If qualifying foreign trade income was determined using 30 percent of foreign sale and leasing income, the disallowed expenses would include only the appropriate portion of the direct expenses.

into account this special foreign-source income limitation) would be treated as foreign-source income if such foreign trade income were reduced by 4 percent of the related foreign trading gross receipts.

For example, assume that foreign trading gross receipts are \$2,000 and foreign trade income is \$100. Assume also that the taxpayer chooses to determine qualifying foreign trade income based on 1.2 percent of foreign trading gross receipts. Taxable income after taking into account the exclusion of the qualifying foreign trade income and the disallowance of related deductions is \$76. Assume that the taxpayer manufactured its qualifying foreign trade property in the United States and that title to such property passed outside of the United States. Absent a special sourcing rule, under section 863(b) (and the regulations thereunder) the \$76 of taxable income would be sourced as \$38 U.S. source and \$38 foreign source. Under the special sourcing rule, the amount of foreign-source income may not exceed the amount of the foreign trade income that otherwise would be treated as foreign source if the foreign trade income were reduced by 4 percent of the related foreign trading gross receipts. Reducing foreign trade income by 4 percent of the foreign trading gross receipts (4 percent of \$2,000, or \$80) would result in \$20 (\$100 foreign trade income less \$80). Applying section 863(b) to the \$20 of reduced foreign trade income would result in \$10 of foreign-source income and \$10 of U.S.-source income. Accordingly, the limitation equals \$10. Thus, although under the general sourcing rule \$38 of the \$76 taxable income would be treated as foreign source, the special sourcing rule limits foreign-source income in this example to \$10 (with the remaining \$66 being treated as U.S.-source income).

If the qualifying foreign trade income is calculated based on 15 percent of foreign trade income, the amount of related foreign-source income may not exceed 50 percent of the foreign trade income that (without taking into account this special foreign-source income limitation) would be treated as foreign-source income.

For example, assume that foreign trade income is \$100 and the taxpayer chooses to determine its qualifying foreign trade income based on 15 percent of foreign trade income. Taxable income after taking into account the exclusion of the qualifying foreign trade income and the disallowance of related deductions is \$85. Assume that the taxpayer manufactured its qualifying foreign trade property in the United States and that title to such property passed outside of the United States. Absent a special sourcing rule, under section 863(b) the \$85 of taxable income would be sourced as \$42.50 U.S. source and \$42.50 foreign source. Under the special sourcing rule, the amount of foreign-source income may not exceed 50 percent of the foreign trade income that otherwise would be treated as foreign source. Applying section 863(b) to the \$100 of foreign trade income would result in \$50 of foreign-source income and \$50 of U.S.-source income. Accordingly, the limitation equals \$25, which is 50 percent of the \$50 foreign-source income. Thus, although under the general sourcing rule \$42.50 of the \$85 taxable income would be treated as foreign source, the special sourcing rule

limits foreign-source income in this example to \$25 (with the remaining \$60 being treated as U.S.-source income).³³

Treatment of withholding taxes

The bill generally provides that no foreign tax credit is 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.³⁴ Accordingly, the bill's denial of foreign tax credits would not apply to such taxes. For this purpose, the term "withholding tax" refers to any foreign tax that is imposed on a basis other than residence and that is otherwise a creditable foreign tax under sections 901 or 903.³⁵ It is intended that such taxes would be similar in nature to the gross-basis taxes described in sections 871 and 881.

If, however, qualifying foreign trade income is determined based on 30 percent of foreign sale and leasing income, the special rule for withholding taxes is not applicable. Thus, in such cases foreign withholding taxes may be treated as paid or accrued with respect to qualifying foreign trade income and, accordingly, are not creditable under the bill.

Election to be treated as a U.S. corporation

The bill provides that 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 reasonably may be expected to be foreign trading gross receipts. For this purpose, "substantially all" is based on the relevant facts and circumstances.

In order to be eligible to make this election, the foreign corporation must waive all benefits granted to such corporation by the United States pursuant to a treaty.³⁶ Absent such a waiver, it would be unclear, for example, whether the permanent establishment article of a relevant tax treaty would override the electing corporation's treatment as a domestic corporation under this provision. A foreign corporation that elects to be treated as a domestic corporation is not permitted to make an S corporation election. The Secretary is granted authority to prescribe rules to ensure that the electing foreign corporation pays its U.S. income tax liabilities and to designate one or more classes of corporations that may not make

³³The foreign-source income limitation provisions also apply when source is determined solely in accordance with section 862 (e.g., a distributor of qualifying foreign trade property that is manufactured in the United States by an unrelated person and sold for use outside of the United States).

³⁴With respect to the withholding taxes that are paid or accrued (a prerequisite to the taxes being otherwise creditable), the provision in the bill treats such taxes as not being paid or accrued with respect to qualifying foreign trade income.

³⁵This also would apply to any withholding tax that is creditable for U.S. foreign tax credit purposes under an applicable treaty.

³⁶The waiver of treaty benefits applies to the corporation itself and not, for example, to employees of or independent contractors associated with the corporation.

such an election.³⁷ If such an election is made, for purposes of section 367 the foreign corporation is treated as transferring (as of the first day of the first taxable year to which the election applies) all of its assets to a domestic corporation in connection with an exchange to which section 354 applies.

If a corporation fails to meet the applicable requirements, described above, for making the election to be treated as a domestic corporation for any taxable year beginning after the year of the election, the election will terminate. In addition, a taxpayer, at its option and at any time, may revoke the election to be treated as a domestic corporation. In the case of either a termination or a revocation, the electing foreign corporation will not be considered as a domestic corporation effective beginning on the first day of the taxable year following the year of such termination or revocation. For purposes of section 367, if the election to be treated as a domestic corporation is terminated or revoked, such corporation is treated as a domestic corporation transferring (as of the first day of the first taxable year to which the election ceases to apply) all of its property to a foreign corporation in connection with an exchange to which section 354 applies. Moreover, once a termination occurs or a revocation is made, the former electing corporation may not again elect to be taxed as a domestic corporation under the provisions of the bill for a period of five tax years beginning with the first taxable year that begins after the termination or revocation.

For example, assume a U.S. corporation owns 100 percent of a foreign corporation. The foreign corporation manufactures outside of the United States and sells what would be qualifying foreign trade property were it manufactured by a person subject to U.S. taxation. Such foreign corporation could make the election under this provision to be treated as a domestic corporation. As a result, its earnings no longer would be deferred from U.S. taxation. However, by electing to be subject to U.S. taxation, a portion of its income would be qualifying foreign trade income.³⁸ The requirement that the foreign corporation be treated as a domestic corporation (and, therefore, subject to U.S. taxation) is intended to provide parity between U.S. corporations that manufacture abroad in branch form and U.S. corporations that manufacture abroad through foreign subsidiaries. The election, however, is not limited to U.S.-owned foreign corporations. A foreign-owned foreign corporation that wishes to qualify for the treatment provided under the bill could avail itself of such election (unless otherwise precluded from doing so by Treasury regulations).

Shared partnerships

The bill provides rules relating to allocations of qualifying foreign trade income by certain shared partnerships. To the extent that such a partnership (1) maintains a separate account for transactions involving foreign trading gross receipts with each partner, (2) makes distributions to each partner based on the amounts in the separate account, and (3) meets such other requirements as the Treasury Secretary may prescribe by regulations, such partnership

³⁷For example, the Secretary of the Treasury may prescribe rules to prevent “per se” corporations under the entity-classification rules from making such an election.

³⁸The sourcing limitation described above would not apply to this example because the property is manufactured outside of the United States.

then would allocate to each partner items of income, gain, loss, and deduction (including qualifying foreign trade income) from such transactions on the basis of the separate accounts. It is intended that with respect to, and only with respect to, such allocations and distributions (i.e., allocations and distributions related to transactions between the partner and the shared partnership generating foreign trading gross receipts), these rules would apply in lieu of the otherwise applicable partnership allocation rules such as those in section 704(b). For this purpose, a partnership is a foreign or domestic entity that is considered to be a partnership for U.S. Federal income tax purposes.

Under the bill, any partner's interest in the shared partnership is not taken into account in determining whether such partner is a "related person" with respect to any other partner for purposes of the bill's provisions. Also, the election to exclude certain gross receipts from foreign trading gross receipts must be made separately by each partner with respect to any transaction for which the shared partnership maintains a separate account.

Certain assets not taken into account for purposes of interest expense allocation

The bill also provides that 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 allocation purposes.

Distributions of qualifying foreign trade income by cooperatives

Agricultural and horticultural producers often market their products through cooperatives, which are member-owned corporations formed under Subchapter T of the Code. At the cooperative level, the bill provides the same treatment of foreign trading gross receipts derived from products marketed through cooperatives as it provides for foreign trading gross receipts of other taxpayers. That is, the qualifying foreign trade income attributable to those foreign trading gross receipts is excluded from the gross income of the cooperative. Absent a special rule, however, patronage dividends or per-unit retain allocations attributable to qualifying foreign trade income paid to members of cooperatives would be taxable in the hands of those members. The Committee believes that this would disadvantage agricultural and horticultural producers who choose to market their products through cooperatives relative to those individuals who market their products directly or through pass-through entities such as partnerships, limited liability companies, or S corporations. Accordingly, the bill provides that 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). In order to qualify, such amount must be designated by the organization as allocable to qualifying foreign trade income in a written notice mailed to its patrons not later than the payment period described in section 1382(d). The coopera-

tive cannot reduce its income (e.g., cannot claim a “dividends-paid deduction”) under section 1382 for such amounts.

Certain dividends allocable to qualifying foreign trade income

Under the bill, a U.S. corporation may claim a 100 percent dividends-received deduction with respect to any dividend that is distributed out of earnings and profits of a controlled foreign corporation (as defined in section 957), but only if such dividend is attributable to qualifying foreign trade income. Only U.S. corporations that are also U.S. shareholders (as defined in section 951(b)) are eligible for this 100 percent dividends-received deduction.

Gap period before administrative guidance is issued

The Committee recognizes that there may be a gap in time between the enactment of the bill and the issuance of detailed administrative guidance. It is intended that during this gap period before administrative guidance is issued, taxpayers and the Internal Revenue Service may apply the principles of present-law regulations and other administrative guidance under sections 921 through 927 to analogous concepts under the bill. Some examples of the application of the principles of present-law regulations to the bill are described below. These limited examples are intended to be merely illustrative and are not intended to imply any limitation regarding the application of the principles of other analogous rules or concepts under present law.

Marginal costing and grouping

Under the bill, the Secretary of the Treasury is provided authority to prescribe rules for using marginal costing and for grouping transactions in determining qualifying foreign trade income. It is intended that similar principles under present-law regulations apply for these purposes.³⁹

Excluded property

The bill provides that qualifying foreign trade property does not include property leased or rented by the taxpayer for use by a related person. It is intended that similar principles under present-law regulations apply for this purpose. Thus, excluded property does not apply, for example, to property leased by the taxpayer to a related person if the property is held for sublease, or is subleased, by the related person to an unrelated person and the property is ultimately used by such unrelated person predominantly outside of the United States.⁴⁰ In addition, consistent with the policy adopted in the Taxpayer Relief Act of 1997, computer software that is licensed for reproduction outside of the United States is not excluded property. Accordingly, the license of computer software to a related person for reproduction outside of the United States for

³⁹ See, e.g., Treas. Reg. sec. 1.924(d)-1(c)(5) and (e); Treas. Reg. sec. 1.925(a)-1T(c)(8); Treas. Reg. sec. 1.925(b)-1T.

⁴⁰ See Treas. Reg. sec. 1.927(a)-1T(f)(2)(i). The bill also provides that oil or gas or primary products from oil or gas are excluded from the definition of qualifying foreign trade property. It is intended that similar principles under present-law regulations apply for these purposes. Thus, for this purpose, petrochemicals, medicinal products, insecticides, and alcohols are not considered primary products from oil or gas and, thus, are not treated as excluded property. See Treas. Reg. sec. 1.927(a)-1T(g)(2)(iv).

sale, sublicense, lease, or rental to an unrelated person for use outside of the United States is not treated as excluded property by reason of the license to the related person.

Foreign trading gross receipts

Under the bill, foreign trading gross receipts are gross receipts from, among other things, the sale, exchange, or other disposition of qualifying foreign trade property, and from the lease of qualifying foreign trade property for use by the lessee outside of the United States. It is intended that the principles of present-law regulations that define foreign trading gross receipts apply for this purpose. For example, a sale includes an exchange or other disposition and a lease includes a rental or sublease and a license or a sublicense.⁴¹

Foreign use requirement

Under the bill, property constitutes qualifying foreign trade property if, among other things, the property is held primarily for lease, sale, or rental, in the ordinary course of business, for direct use, consumption, or disposition outside of the United States.⁴² It is intended that the principles of the present-law regulations apply for purposes of this foreign use requirement. For example, for purposes of determining whether property is sold for use outside of the United States, property that is sold to an unrelated person as a component to be incorporated into a second product which is produced, manufactured, or assembled outside of the United States will not be considered to be used in the United States (even if the second product ultimately is used in the United States), provided that the fair market value of such seller's components at the time of delivery to the purchaser constitutes less than 20 percent of the fair market value of the second product into which the components are incorporated (determined at the time of completion of the production, manufacture, or assembly of the second product).⁴³

In addition, for purposes of the foreign use requirement, property is considered to be used by a lessee outside of the United States during a taxable year if it is used predominantly outside of the United States.⁴⁴ For this purpose, property is considered to be used predominantly outside of the United States for any period if, during that period, the property is located outside of the United States more than 50 percent of the time.⁴⁵ An aircraft or other property used for transportation purposes (e.g., railroad rolling stock, a vessel, a motor vehicle, or a container) is considered to be used outside of the United States for any period if, for the period, either the property is located outside of the United States more than 50 percent of the time or more than 50 percent of the miles traveled in the use of the property are traveled outside of the United States.⁴⁶

⁴¹ See Treas. Reg. sec. 1.924(a)-1T(a)(2).

⁴² Foreign trading gross receipts eligible for exclusion from the tax base do not include gross receipts from a transaction if the qualifying foreign trade property is for ultimate use in the United States.

⁴³ See Treas. Reg. sec. 1.927(a)-1T(d)(4)(ii).

⁴⁴ See Treas. Reg. sec. 1.927(a)-1T(d)(4)(v).

⁴⁵ See Treas. Reg. sec. 1.927(a)-1T(d)(4)(vi).

⁴⁶ Id.

An orbiting satellite is considered to be located outside of the United States for these purposes.⁴⁷

Foreign economic processes

Under the bill, gross receipts from a transaction are foreign trading gross receipts eligible for exclusion from the tax base only if certain economic processes take place outside of the United States. The foreign economic processes requirement compares foreign direct costs to total direct costs. It is intended that the principles of the present-law regulations apply during the gap period for purposes of the foreign economic processes requirement including the measurement of direct costs. The Committee recognizes that the measurement of foreign direct costs under the present-law regulations often depend on activities conducted by the FSC, which is a separate entity. The Committee is aware that some of these concepts will have to be modified when new guidance is promulgated as a result of the bill's elimination of the requirement for a separate entity.

EFFECTIVE DATE

In general

The bill is effective for transactions entered into after September 30, 2000. In addition, no corporation may elect to be a FSC after September 30, 2000.

The bill also provides a rule requiring the termination of a dormant FSC when the FSC has been inactive for a specified period of time. Under this rule, a FSC that generates no foreign trade income for any five consecutive years beginning after December 31, 2001, will cease to be treated as a FSC.

Transition rules

The bill provides a transition period for existing FSCs and for binding contractual agreements. The new rules do not apply to transactions in the ordinary course of business⁴⁸ involving a FSC before January 1, 2002. Furthermore, the new rules do not apply to transactions in the ordinary course of business after December 31, 2001, if such transactions are pursuant to a binding contract between a FSC (or a person related to the FSC on September 30, 2000) and any other person (that is not a related person) and such contract is in effect on September 30, 2000, and all times thereafter. For this purpose, binding contracts include purchase options, renewal options, and replacement options that are enforceable against a lessor or seller (provided that the options are a part of a contract that is binding and in effect on September 30, 2000).

Similar to the limitation on use of the gross receipts method under the bill's operative provisions, the bill provides a rule that limits the use of the gross receipts method for transactions after the effective date of the bill if that same property generated foreign trade income to a FSC using the gross receipts method. Under the rule, if any person used the gross receipts method under the FSC regime, neither that person nor any related person will have quali-

⁴⁷ Id.

⁴⁸ The mere entering into of a single transaction, such as a lease, would not, in and of itself, prevent the transaction from being in the ordinary course of business.

fyng foreign trade income with respect to any other transaction involving the same item of property.

Notwithstanding the transition period, FSCs (or related persons) may elect to have the rules of the bill apply in lieu of the rules applicable to FSCs. Thus, for transactions to which the transition rules apply, taxpayers may choose to apply either the FSC rules or the amendments made by this bill, but not both.

III. VOTES OF THE COMMITTEE

In compliance with clause 3(b) of rule XIII of the Rules of the House of Representatives, the following statements are made concerning the votes of the Committee on Ways and Means in its consideration of the bill, H.R. 4986.

MOTION TO REPORT THE BILL

The bill, H.R. 4986, was ordered favorably reported, with an amendment by a roll call vote of 34 yeas to 1 nay (with a quorum being present). The vote was as follows:

Representatives	Yea	Nay	Representatives	Yea	Nay
Mr. Archer	X		Mr. Rangel	X	
Mr. Crane	X		Mr. Stark		X
Mr. Thomas	X		Mr. Matsui	X	
Mr. Shaw	X		Mr. Coyne		
Mrs. Johnson	X		Mr. Levin	X	
Mr. Houghton	X		Mr. Cardin		
Mr. Heger	X		Mr. McDermott	X	
Mr. McCreery	X		Mr. Kleczka		
Mr. Camp	X		Mr. Lewis (GA)	X	
Mr. Ramstad	X		Mr. Neal	X	
Mr. Nussle	X		Mr. McNulty	X	
Mr. Johnson	X		Mr. Jefferson	X	
Ms. Dunn	X		Mr. Tanner	X	
Mr. Collins	X		Mr. Becerra	X	
Mr. Portman	X		Mrs. Thurman	X	
Mr. English	X		Mr. Doggett	X	
Mr. Watkins	X				
Mr. Hayworth	X				
Mr. Weller	X				
Mr. Hulshof	X				
Mr. McClinnis	X				
Mr. Lewis (KY)	X				
Mr. Foley					

IV. BUDGET EFFECTS OF THE BILL

A. COMMITTEE ESTIMATE OF BUDGETARY EFFECTS

In compliance with clause 3(d)(2) of rule XIII of the Rules of the House of Representatives, the following statement is made concerning the affects on the budget of the revenue provisions of the bill, H.R. 4986, as reported.

The bill is estimated to have the following effects on budget receipts for fiscal years 2001–2005:

ESTIMATED REVENUE EFFECTS OF H.R. 4986, THE "FSC REPEAL AND EXTRATERRITORIAL INCOME EXCLUSION ACT OF 2000," AS REPORTED BY THE COMMITTEE ON WAYS AND MEANS, FISCAL YEARS 2001–2005

[In millions of dollars]

Provision	Effective	2001	2002	2003	2004	2005	2001–5
Extraterritorial Income Exclusion; FSC Repeal.	generally ta 9/30/00	–153	–315	–348	–384	–423	–1,623

Note: Details may not add to totals due to rounding.
Legend for "Effective" column: ta = transactions after.

B. STATEMENT REGARDING NEW BUDGET AUTHORITY AND TAX EXPENDITURES

Budget authority

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee states that the bill involves no new or increased budget authority.

Tax expenditures

In compliance with clause 2(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee states that the revenue-reducing income tax provisions involve increased tax expenditures. (See amounts in table in Part IV.A., above.)

C. COST ESTIMATE PREPARED BY THE CONGRESSIONAL BUDGET OFFICE

In compliance with clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, requiring a cost estimate prepared by the Congressional Budget Office (CBO), the following statement by CBO is provided.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, September 13, 2000.

Hon. BILL ARCHER,
*Chairman, Committee on Ways and Means,
House of Representatives, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 4986, the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. This estimate reflects the impact of changes made to the bill after it was ordered reported on July 27, 2000.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Erin Whitaker.

Sincerely,

BARRY B. ANDERSON
(For Dan L. Crippen, Director).

Enclosure.

H.R. 4986—FSC Repeal and Extraterritorial Income Exclusion Act of 2000

Summary: H.R. 4986 would repeal present-law foreign sales corporation (FSC) rules. Under current law, U.S. firms generally are subject to U.S. tax on their worldwide income, but they are allowed

tax credits for a portion of the income taxes they pay to foreign governments on that income. Within that general framework, U.S. law permits the use of FSCs, through which a portion of domestic firms' export income is characterized as foreign source and is exempted from U.S. tax. Under the proposal, U.S. firms could elect to exclude certain qualifying foreign trade income from their taxable income, with qualifying foreign trade income defined to include a portion of income attributable to sales by U.S. taxpayers. To be eligible for the exclusion, firms would not be allowed tax credits for income taxes paid to foreign governments on the qualifying foreign trade income. Qualifying foreign trade income would be calculated by using one of several formulas. The remaining portion of income earned from sources abroad would be taxed in a similar manner as under current law.

The Joint Committee on Taxation (JCT) estimates that the bill would reduce revenues by \$153 million in 2001, by about \$1.6 billion over the 2001–2005 period, and by about \$4.5 billion over the 2001–2010 period. Because the bill would affect receipts, pay-as-you-go procedures would apply.

H.R. 4986 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would not affect the budgets of state, local, or tribal governments.

Estimated cost to the Federal Government: The estimated budgetary impact of H.R. 4986 is shown in the following table. Estimates of all provisions in H.R. 4986 were provided by JCT.

	By fiscal year, in millions of dollars—					
	2000	2001	2002	2003	2004	2005
CHANGES IN REVENUES						
Estimated revenues	0	-153	-315	-348	-384	-423

Source: Joint Committee on Taxation

Pay-as-you-go considerations: The Balanced Budget and Emergency Deficit Control Act sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. The net changes in governmental receipts that are subject to pay-as-you-go procedures are shown in the following table. For the purposes of enforcing pay-as-you-go procedures, only the effects in the current year, the budget year, and the succeeding four years are counted.

	By fiscal year, in millions of dollars—										
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Changes in receipts	0	-153	-315	-348	-384	-423	-466	-514	-566	-623	-687
Changes in outlays											Not applicable

Intergovernmental and private-sector impact: H.R. 4986 contains no intergovernmental or private-sector mandates as defined in UMRA and would not affect the budgets of state, local, or tribal governments.

Previous CBO estimate: On September 8, 2000, CBO transmitted a cost estimate for H.R. 4986 as ordered report by the House Committee on Ways and Means on July 27, 2000. This estimate supercedes that previous estimate, and it reflects several changes to the bill that were made after it was ordered reported. These changes would further reduce revenues, relative to the earlier

version of H.R. 4986, by \$15 million in 2001, \$124 million over the 2001–2005 period, and \$293 million over the 2001–2010 period.

Estimate prepared by: Erin Whitaker.

Estimate approved by: G. Thomas Woodward, Assistant Director for Tax Analysis.

V. OTHER MATTERS TO BE DISCUSSED UNDER THE RULES OF THE HOUSE

A. COMMITTEE OVERSIGHT FINDINGS AND RECOMMENDATIONS

With respect to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives (relating to oversight findings), the Committee advises that it was a result of the Committee's oversight review of the application of the Federal tax rules relating to FSCs in light of the WTO rulings that the Committee concluded that it is appropriate and timely to enact the revenue provisions included in the bill as reported.

B. SUMMARY OF FINDINGS AND RECOMMENDATIONS OF THE COMMITTEE ON GOVERNMENT REFORM

With respect to clause 3(c)(4) of rule XII of the Rules of the House of Representatives, the Committee advises that no oversight findings or recommendations have been submitted to this Committee by the Committee on Government Reform with respect to the provisions contained in the bill.

C. CONSTITUTIONAL AUTHORITY STATEMENT

With respect to clause 3(d)(1) of rule XIII of the Rules of the House of Representatives (relating to Constitutional Authority), the Committee states that the Committee's action in reporting this bill is derived from Article I of the Constitution, Section 8 ("The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises * * *"), and from the 16th Amendment to the Constitution.

D. INFORMATION RELATING TO UNFUNDED MANDATES

This information is provided in accordance with section 423 of the Unfunded Mandates Act of 1995 (P.L. 104–4).

The Committee has determined that the bill does not impose a Federal private sector mandate or a Federal intergovernmental mandate on State, local, and tribal governments.

E. APPLICABILITY OF HOUSE RULE XXI5(b)

Rule XXI5(b) of the Rules of the House of Representatives provides, in part, that "No bill or joint resolution, amendment, or conference report carrying a Federal income tax rate increase shall be considered as passed or agreed to unless determined by a vote of not less than three-fifths of the Members." The Committee has carefully reviewed the provisions of the bill, and states that the provisions of the bill do not involve any Federal income tax rate increase within the meaning of the rule.

F. TAX COMPLEXITY ANALYSIS

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the “IRS Reform Act”) requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the House Committee on Ways and Means, the Senate Committee on Finance, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Code and has “widespread applicability” to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Code and that have widespread applicability to individuals or small businesses.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE OF 1986

* * * * *

Subtitle A—Income Taxes

* * * * *

CHAPTER 1—NORMAL TAXES AND SURTAXES

* * * * *

Subchapter A—Determination of Tax Liability

* * * * *

PART VI—ALTERNATIVE MINIMUM TAX

* * * * *

SEC. 56. ADJUSTMENTS IN COMPUTING ALTERNATIVE MINIMUM TAXABLE INCOME.

(a) * * *

* * * * *

(g) ADJUSTMENTS BASED ON ADJUSTED CURRENT EARNINGS.—

(1) * * *

* * * * *

(4) ADJUSTMENTS.—In determining adjusted current earnings, the following adjustments shall apply:

(A) * * *

(B) INCLUSION OF ITEMS INCLUDED FOR PURPOSES OF COMPUTING EARNINGS AND PROFITS.—

(i) IN GENERAL.—In the case of any amount which is excluded from gross income for purposes of computing alternative minimum taxable income but is taken into account in determining the amount of earnings and profits—

(I) * * *

* * * * *

The preceding sentence shall not apply in the case of any amount excluded from gross income under section 108 (or the corresponding provisions of prior law) or under section 114. In the case of any insurance company taxable under section 831(b), this clause shall not apply to any amount not described in section 834(b).

* * * * *

Subchapter B—Computation of Taxable Income

* * * * *

PART III—ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

* * * * *

Sec. 101. Certain death benefits.

* * * * *

Sec. 114. Extraterritorial income.

* * * * *

SEC. 114. EXTRATERRITORIAL INCOME.

(a) EXCLUSION.—Gross income does not include extraterritorial income.

(b) EXCEPTION.—Subsection (a) shall not apply to extraterritorial income which is not qualifying foreign trade income as determined under subpart E of part III of subchapter N.

(c) DISALLOWANCE OF DEDUCTIONS.—

(1) IN GENERAL.—Any deduction of a taxpayer allocated under paragraph (2) to extraterritorial income of the taxpayer excluded from gross income under subsection (a) shall not be allowed.

(2) ALLOCATION.—Any deduction of the taxpayer properly apportioned and allocated to the extraterritorial income derived by the taxpayer from any transaction shall be allocated on a proportionate basis between—

(A) the extraterritorial income derived from such transaction which is excluded from gross income under subsection (a), and

(B) the extraterritorial income derived from such transaction which is not so excluded.

(d) DENIAL OF CREDITS FOR CERTAIN FOREIGN TAXES.—Notwithstanding any other provision of this chapter, no credit shall be allowed under this chapter for any income, war profits, and excess profits taxes paid or accrued to any foreign country or possession of

the United States with respect to extraterritorial income which is excluded from gross income under subsection (a).

(e) EXTRATERRITORIAL INCOME.—For purposes of this section, the term “extraterritorial income” means the gross income of the taxpayer attributable to foreign trading gross receipts (as defined in section 942) of the taxpayer.

* * * * *

PART VIII—SPECIAL DEDUCTIONS FOR CORPORATIONS

* * * * *

SEC. 245. DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.

(a) * * *

* * * * *

(d) CERTAIN DIVIDENDS ALLOCABLE TO QUALIFYING FOREIGN TRADE INCOME.—In the case of a domestic corporation which is a United States shareholder (as defined in section 951(b)) of a controlled foreign corporation (as defined in section 957), there shall be allowed as a deduction an amount equal to 100 percent of any dividend received from such controlled foreign corporation which is distributed out of earnings and profits attributable to qualifying foreign trade income (as defined in section 941(a)).

* * * * *

PART IX—ITEMS NOT DEDUCTIBLE

* * * * *

SEC. 275. CERTAIN TAXES.

(a) GENERAL RULE.—No deduction shall be allowed for the following taxes:

(1) * * *

* * * * *

(4) INCOME, WAR PROFITS, AND EXCESS PROFITS TAXES IMPOSED BY THE AUTHORITY OF ANY FOREIGN COUNTRY OR POSSESSION OF THE UNITED STATES IF—

(A) the taxpayer chooses to take to any extent the benefits of section 901, **[or]**

(B) such taxes are paid or accrued with respect to foreign trade income (within the meaning of section 923(b)) of a FSC~~...~~, or

(C) *such taxes are paid or accrued with respect to qualifying foreign trade income (as defined in section 941).*

A rule similar to the rule of section 943(d) shall apply for purposes of paragraph (4)(C).

* * * * *

Subchapter N—Tax Based on Income From Sources Within or Without the United States

* * * * *

**PART I—SOURCE RULES AND OTHER GENERAL RULES
RELATING TO FOREIGN INCOME**

* * * * *

SEC. 864. DEFINITIONS AND SPECIAL RULES.

(a) * * *

* * * * *

(e) **RULES FOR ALLOCATING INTEREST, ETC.**—For purposes of this subchapter—

(1) * * *

* * * * *

(3) **TAX-EXEMPT ASSETS NOT TAKEN INTO ACCOUNT.**—**[For purposes of]**

(A) *IN GENERAL.*—For purposes of allocating and apportioning any deductible expense, any tax-exempt asset (and any income from such an asset) shall not be taken into account. A similar rule shall apply in the case of the portion of any dividend (other than a qualifying dividend as defined in section 243(b)) equal to the deduction allowable under section 243 or 245(a) with respect to such dividend and in the case of a like portion of any stock the dividends on which would be so deductible and would not be qualifying dividends (as so defined).

(B) *ASSETS PRODUCING EXEMPT EXTRATERRITORIAL INCOME.*—For purposes of allocating and apportioning any interest expense, there shall not be taken into account any qualifying foreign trade property (as defined in section 943(a)) which is held by the taxpayer for lease or rental in the ordinary course of trade or business for use by the lessee outside the United States (as defined in section 943(b)(2)).

* * * * *

**PART III—INCOME FROM SOURCES WITHOUT THE
UNITED STATES**

Subpart A. Foreign tax credit.

* * * * *

[Subpart C. Taxation of foreign sales corporation.]

* * * * *

Subpart E. Qualifying foreign trade income.

* * * * *

Subpart A—Foreign Tax Credit

* * * * *

SEC. 903. CREDIT FOR TAXES IN LIEU OF INCOME, ETC., TAXES.

For purposes of this part and of sections **[164(a)] 114, 164(a), and 275(a)**, the term “income, war profits, and excess profits taxes” shall include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

* * * * *

[Subpart C—Taxation of Foreign Sales Corporations

- 【Sec. 921. Exempt foreign trade income excluded from gross income.
- 【Sec. 922. FSC defined.
- 【Sec. 923. Exempt foreign trade income.
- 【Sec. 924. Foreign trading gross receipts.
- 【Sec. 925. Transfer pricing rules.
- 【Sec. 926. Distributions to shareholders.
- 【Sec. 927. Other definitions and special rules.

[SEC. 921. EXEMPT FOREIGN TRADE INCOME EXCLUDED FROM GROSS INCOME.

【(a) EXCLUSION.—Exempt foreign trade income of a FSC shall be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States.

【(b) PROPORTIONATE ALLOCATION OF DEDUCTIONS TO EXEMPT FOREIGN TRADE INCOME.—Any deductions of the FSC properly apportioned and allocated to the foreign trade income derived by a FSC from any transaction shall be allocated between—

【(1) the exempt foreign trade income derived from such transaction, and

【(2) the foreign trade income (other than exempt foreign trade income) derived from such transaction, on a proportionate basis.

【(c) DENIAL OF CREDITS.—Notwithstanding any other provision of this chapter, no credit (other than a credit allowable under section 27(a), 33, or 34) shall be allowed under this chapter to any FSC.

【(d) FOREIGN TRADE INCOME, INVESTMENT INCOME, AND CARRYING CHARGES TREATED AS EFFECTIVELY CONNECTED WITH UNITED STATES BUSINESS.—For purposes of this chapter—

【(1) all foreign trade income of a FSC other than—

【(A) exempt foreign trade income, and

【(B) section 923(a)(2) non-exempt income,

【(2) all interest, dividends, royalties, and other investment income received or accrued by a FSC, and

【(3) all carrying charges received or accrued by a FSC,

shall be treated as income effectively connected with a trade or business conducted through a permanent establishment of such corporation within the United States. Income described in paragraph (1) shall be treated as derived from sources within the United States.

[SEC. 922. FSC DEFINED.

【(a) FSC DEFINED.—For purposes of this title, the term “FSC” means any corporation—

【(1) which—

【(A) was created or organized—

【(i) under the laws of any foreign country which meets the requirements of section 927(e)(3), or

【(ii) under the laws applicable to any possession of the United States,

【(B) has no more than 25 shareholders at any time during the taxable year,

【(C) does not have any preferred stock outstanding at any time during the taxable year,

【(D) during the taxable year—

[(i) maintains an office located outside the United States in a foreign country which meets the requirements of section 927(e)(3) or in any possession of the United States,

[(ii) maintains a set of the permanent books of account (including invoices) of such corporation at such office, and

[(iii) maintains at a location within the United States the records which such corporation is required to keep under section 6001,

[(E) at all times during the taxable year, has a board of directors which includes at least one individual who is not a resident of the United States, and

[(F) is not a member, at any time during the taxable year, of any controlled group of corporations of which a DISC is a member, and

[(2) which has made an election (at the time and in the manner provided in section 927(f)(1)) which is in effect for the taxable year to be treated as a FSC.

[(b) SMALL FSC DEFINED.—For purposes of this title, a FSC is a small FSC with respect to any taxable year if—

[(1) such corporation has made an election (at the time and in the manner provided in section 927(f)(1)) which is in effect for the taxable year to be treated as a small FSC, and

[(2) such corporation is not a member, at any time during the taxable year, of a controlled group of corporations which includes a FSC unless such other FSC has also made an election under paragraph (1) which is in effect for such year.

[SEC. 923. EXEMPT FOREIGN TRADE INCOME.

[(a) EXEMPT FOREIGN TRADE INCOME.—For purposes of this subpart—

[(1) IN GENERAL.—The term “exempt foreign trade income” means the aggregate amount of all foreign trade income of a FSC for the taxable year which is described in paragraph (2) or (3).

[(2) INCOME DETERMINED WITHOUT REGARD TO ADMINISTRATIVE PRICING RULES.—In the case of any transaction to which paragraph (3) does not apply, 32 percent of the foreign trade income derived from such transaction shall be treated as described in this paragraph. For purposes of the preceding sentence, foreign trade income shall not include any income properly allocable to excluded property described in subparagraph (B) of section 927(a)(2) (relating to intangibles).

[(3) INCOME DETERMINED WITH REGARD TO ADMINISTRATIVE PRICING RULES.—In the case of any transaction with respect to which paragraph (1) or (2) of section 925(a) (or the corresponding provisions of the regulations prescribed under section 925(b)) applies, $\frac{16}{23}$ of the foreign trade income derived from such transaction shall be treated as described in this paragraph.

[(4) SPECIAL RULE FOR FOREIGN TRADE INCOME ALLOCABLE TO A COOPERATIVE.—

[(A) IN GENERAL.—In any case in which a qualified cooperative is a shareholder of a FSC, paragraph (3) shall be applied with respect to that portion of the foreign trade in-

come of such FSC for any taxable year which is properly allocable to the marketing of agricultural or horticultural products (or the providing of related services) by such cooperative by substituting "100 percent" for "16/23".

[(B) PARAGRAPH ONLY TO APPLY TO AMOUNTS FSC DISTRIBUTES.—Subparagraph (A) shall not apply for any taxable year unless the FSC distributes to the qualified cooperative the amount which (but for such subparagraph) would not be treated as exempt foreign trade income. Any distribution under this subparagraph for any taxable year—

[(i) shall be made before the due date for filing the return of tax for such taxable year, but

[(ii) shall be treated as made on the last day of such taxable year.

[(5) SPECIAL RULE FOR MILITARY PROPERTY.—Under regulations prescribed by the Secretary, that portion of the foreign trading gross receipts of the FSC for the taxable year attributable to the disposition of, or services relating to, military property (within the meaning of section 995(b)(3)(B)) which may be treated as exempt foreign trade income shall equal 50 percent of the amount which (but for this paragraph) would be treated as exempt foreign trade income.

[(6) CROSS REFERENCE.—

[For reduction in amount of exempt foreign trade income, see section 291(a)(4).

[(b) FOREIGN TRADE INCOME DEFINED.—For purposes of this subpart, the term "foreign trade income" means the gross income of a FSC attributable to foreign trading gross receipts.

[SEC. 924. FOREIGN TRADING GROSS RECEIPTS.

[(a) IN GENERAL.—Except as otherwise provided in this section, for purposes of this subpart, the term "foreign trading gross receipts" means the gross receipts of any FSC which are—

[(1) from the sale, exchange, or other disposition of export property,

[(2) from the lease or rental of export property for use by the lessee outside the United States,

[(3) for services which are related and subsidiary to—

[(A) any sale, exchange, or other disposition of export property by such corporation, or

[(B) any lease or rental of export property described in paragraph (2) by such corporation,

[(4) for engineering or architectural services for construction projects located (or proposed for location) outside the United States, or

[(5) for the performance of managerial services for an unrelated FSC or DISC in furtherance of the production of foreign trading gross receipts described in paragraph (1), (2), or (3).

Paragraph (5) shall not apply to a FSC for any taxable year unless at least 50 percent of its gross receipts for such taxable year is derived from activities described in paragraph (1), (2), or (3).

[(b) FOREIGN MANAGEMENT AND FOREIGN ECONOMIC PROCESS REQUIREMENTS.—

[(1) IN GENERAL.—Except as provided in paragraph (2)—

[(A) a FSC shall be treated as having foreign trading gross receipts for the taxable year only if the management of such corporation during such taxable year takes place outside the United States as required by subsection (c), and

[(B) a FSC has foreign trading gross receipts from any transaction only if economic processes with respect to such transaction take place outside the United States as required by subsection (d).

[(2) EXCEPTION FOR SMALL FSC.—

[(A) IN GENERAL.—Paragraph (1) shall not apply with respect to any small FSC.

[(B) LIMITATION ON AMOUNT OF FOREIGN TRADING GROSS RECEIPTS OF SMALL FSC TAKEN INTO ACCOUNT.—

[(i) IN GENERAL.—Any foreign trading gross receipts of a small FSC for the taxable year which exceed \$5,000,000 shall not be taken into account in determining the exempt foreign trade income of such corporation and shall not be taken into account under any other provision of this subpart.

[(ii) ALLOCATION OF LIMITATION.—If the foreign trading gross receipts of a small FSC exceed the limitation of clause (i), the corporation may allocate such limitation among such gross receipts in such manner as it may select (at such time and in such manner as may be prescribed in regulations).

[(iii) RECEIPTS OF CONTROLLED GROUP AGGREGATED.—For purposes of applying clauses (i) and (ii), all small FSC's which are members of the same controlled group of corporations shall be treated as a single corporation.

[(iv) ALLOCATION OF LIMITATION AMONG MEMBERS OF CONTROLLED GROUP.—The limitation under clause (i) shall be allocated among the foreign trading gross receipts of small FSC's which are members of the same controlled group of corporations in a manner provided in regulations prescribed by the Secretary.

[(c) REQUIREMENT THAT FSC BE MANAGED OUTSIDE THE UNITED STATES.—The management of a FSC meets the requirements of this subsection for the taxable year if—

[(1) all meetings of the board of directors of the corporation, and all meetings of the shareholders of the corporation, are outside the United States,

[(2) the principal bank account of the corporation is maintained in a foreign country which meets the requirements of section 927(e)(3) or in a possession of the United States at all times during the taxable year, and

[(3) all dividends, legal and accounting fees, and salaries of officers and members of the board of directors of the corporation disbursed during the taxable year are disbursed out of bank accounts of the corporation maintained outside the United States.

[(d) REQUIREMENT THAT ECONOMIC PROCESSES TAKE PLACE OUTSIDE THE UNITED STATES.—

[(1) IN GENERAL.—The requirements of this subsection are met with respect to the gross receipts of a FSC derived from any transaction if—

[(A) such corporation (or any person acting under a contract with such corporation) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction, and

[(B) the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50 percent of the total direct costs attributable to the transaction.

[(2) ALTERNATIVE 85-PERCENT TEST.—A corporation shall be treated as satisfying the requirements of paragraph (1)(B) with respect to any transaction if, with respect to each of at least 2 paragraphs of subsection (e), the foreign direct costs incurred by such corporation attributable to activities described in such paragraph equal or exceed 85 percent of the total direct costs attributable to activities described in such paragraph.

[(3) DEFINITIONS.—For purposes of this subsection—

[(A) TOTAL DIRECT COSTS.—The term “total direct costs” means, with respect to any transaction, the total direct costs incurred by the FSC attributable to activities described in subsection (e) performed at any location by the FSC or any person acting under a contract with such FSC.

[(B) FOREIGN DIRECT COSTS.—The term “foreign direct costs” means, with respect to any transaction, the portion of the total direct costs which are attributable to activities performed outside the United States.

[(4) RULES FOR COMMISSIONS, ETC.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection and subsection (e) in the case of commissions, rentals, and furnishing of services.

[(e) ACTIVITIES RELATING TO DISPOSITION OF EXPORT PROPERTY.—The activities referred to in subsection (d) are—

[(1) advertising and sales promotion,

[(2) the processing of customer orders and the arranging for delivery of the export property,

[(3) transportation from the time of acquisition by the FSC (or, in the case of a commission relationship, from the beginning of such relationship for such transaction) to the delivery to the customer,

[(4) the determination and transmittal of a final invoice or statement of account and the receipt of payment, and

[(5) the assumption of credit risk.

[(f) CERTAIN RECEIPTS NOT INCLUDED IN FOREIGN TRADING GROSS RECEIPTS.—

[(1) CERTAIN RECEIPTS EXCLUDED ON BASIS OF USE; SUBSIDIZED RECEIPTS AND RECEIPTS FROM RELATED PARTIES EXCLUDED.—The term “foreign trading gross receipts” shall not include receipts of a FSC from a transaction if—

[(A) the export property or services—

[(i) are for ultimate use in the United States, or

[(ii) are for use by the United States or any instrumentality thereof and such use of export property or services is required by law or regulation,

[(B) such transaction is accomplished by a subsidy granted by the United States or any instrumentality thereof, or

[(C) such receipts are from another FSC which is a member of the same controlled group of corporations of which such corporation is a member.

In the case of gross receipts of a FSC from a transaction involving any property, subparagraph (C) shall not apply if such FSC (and all other FSC's which are members of the same controlled group and which receive gross receipts from a transaction involving such property) do not use the pricing rules under paragraph (1) of section 925(a) (or the corresponding provisions of the regulations prescribed under section 925(b)) with respect to any transaction involving such property.

[(2) INVESTMENT INCOME; CARRYING CHARGES.—The term “foreign trading gross receipts” shall not include any investment income or carrying charges.

[SEC. 925. TRANSFER PRICING RULES.

[(a) IN GENERAL.—In the case of a sale of export property to a FSC by a person described in section 482, the taxable income of such FSC and such person shall be based upon a transfer price which would allow such FSC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

[(1) 1.83 percent of the foreign trading gross receipts derived from the sale of such property by such FSC,

[(2) 23 percent of the combined taxable income of such FSC and such person which is attributable to the foreign trading gross receipts derived from the sale of such property by such FSC, or

[(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

Paragraphs (1) and (2) shall apply only if the FSC meets the requirements of subsection (c) with respect to the sale.

[(b) RULES FOR COMMISSIONS, RENTALS, AND MARGINAL COSTING.—The Secretary shall prescribe regulations setting forth—

[(1) rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and

[(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a FSC is seeking to establish or maintain a market for export property.

[(c) REQUIREMENTS FOR USE OF ADMINISTRATIVE PRICING RULES.—A sale by a FSC meets the requirements of this subsection if—

[(1) all of the activities described in section 924(e) attributable to such sale, and

[(2) all of the activities relating to the solicitation (other than advertising), negotiation, and making of the contract for such sale, have been performed by such FSC (or by another person acting under a contract with such FSC).

[(d) LIMITATION ON GROSS RECEIPTS PRICING RULE.—The amount determined under subsection (a)(1) with respect to any transaction shall not exceed 2 times the amount which would be

determined under subsection (a)(2) with respect to such transaction.

[(e) TAXABLE INCOME.—For purposes of this section, the taxable income of a FSC shall be determined without regard to section 921.

[(f) SPECIAL RULE FOR COOPERATIVES.—In any case in which a qualified cooperative sells export property to a FSC, in computing the combined taxable income of such FSC and such organization for purposes of subsection (a)(2), there shall not be taken into account any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

[SEC. 926. DISTRIBUTIONS TO SHAREHOLDERS.

[(a) DISTRIBUTIONS MADE FIRST OUT OF FOREIGN TRADE INCOME.—For purposes of this title, any distribution to a shareholder of a FSC by such FSC which is made out of earnings and profits shall be treated as made—

[(1) first, out of earnings and profits attributable to foreign trade income, to the extent thereof, and

[(2) then, out of any other earnings and profits.

[(b) DISTRIBUTIONS BY FSC TO NONRESIDENT ALIENS AND FOREIGN CORPORATIONS TREATED AS UNITED STATES CONNECTED.—For purposes of this title, any distribution by a FSC which is made out of earnings and profits attributable to foreign trade income to any shareholder of such corporation which is a foreign corporation or a nonresident alien individual shall be treated as a distribution—

[(1) which is effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States, and

[(2) of income which is derived from sources within the United States.

[(c) FSC INCLUDES FORMER FSC.—For purposes of this section, the term “FSC” includes a former FSC.

[SEC. 927. OTHER DEFINITIONS AND SPECIAL RULES.

[(a) EXPORT PROPERTY.—For purposes of this subpart—

[(1) IN GENERAL.—The term “export property” means property—

[(A) manufactured, produced, grown, or extracted in the United States by a person other than a FSC,

[(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business, by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and

[(C) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

For purposes of subparagraph (C), the fair market value of any article imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation.

[(2) EXCLUDED PROPERTY.—The term “export property” shall not include—

[(A) property leased or rented by a FSC for use by any member of a controlled group of corporations of which such FSC is a member,

[(B) patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), good will, trademarks, trade brands, franchises, or other like property,

[(C) oil or gas (or any primary product thereof),

[(D) products the export of which is prohibited or curtailed to effectuate the policy set forth in paragraph (2)(C) of section 3 of the Export Administration Act of 1979 (relating to the protection of the domestic economy), or

[(E) any unprocessed timber which is a softwood.

For purposes of subparagraph (E), the term “unprocessed timber” means any log, cant, or similar form of timber.

[(3) PROPERTY IN SHORT SUPPLY.—If the President determines that the supply of any property described in paragraph (1) is insufficient to meet the requirements of the domestic economy, he may by Executive order designate the property as in short supply. Any property so designated shall not be treated as export property during the period beginning with the date specified in the Executive order and ending with the date specified in an Executive order setting forth the President’s determination that the property is no longer in short supply.

[(4) QUALIFIED COOPERATIVE.—The term “qualified cooperative” means any organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products.

[(b) GROSS RECEIPTS.—

[(1) IN GENERAL.—For purposes of this subpart, the term “gross receipts” means—

[(A) the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of trade or business, and

[(B) gross income from all other sources.

[(2) GROSS RECEIPTS TAKEN INTO ACCOUNT IN CASE OF COMMISSIONS.—In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of this subpart as gross receipts shall be the gross receipts on the sale, lease, or rental of the property on which such commissions arose.

[(c) INVESTMENT INCOME.—For purposes of this subpart, the term “investment income” means—

[(1) dividends,

[(2) interest,

[(3) royalties,

[(4) annuities,

[(5) rents (other than rents from the lease or rental of export property for use by the lessee outside of the United States),

[(6) gains from the sale or exchange of stock or securities,

[(7) gains from futures transactions in any commodity on, or subject to the rules of, a board of trade or commodity exchange (other than gains which arise out of a bona fide hedging trans-

action reasonably necessary to conduct the business of the FSC in the manner in which such business is customarily conducted by others),

[(8) amounts includible in computing the taxable income of the corporation under part I of subchapter J, and

[(9) gains from the sale or other disposition of any interest in an estate or trust.

[(d) OTHER DEFINITIONS.—For purposes of this subpart—

[(1) CARRYING CHARGES.—The term “carrying charges” means—

[(A) carrying charges, and

[(B) under regulations prescribed by the Secretary, any amount in excess of the price for an immediate cash sale and any other unstated interest.

[(2) TRANSACTION.—

[(A) IN GENERAL.—The term “transaction” means—

[(i) any sale, exchange, or other disposition,

[(ii) any lease or rental, and

[(iii) any furnishing of services.

[(B) GROUPING OF TRANSACTIONS.—To the extent provided in regulations, any provision of this subpart which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.

[(3) UNITED STATES DEFINED.—The term “United States” includes the Commonwealth of Puerto Rico.

[(4) CONTROLLED GROUP OF CORPORATIONS.—The term “controlled group of corporations” has the meaning given to such term by section 1563(a), except that—

[(A) “more than 50 percent” shall be substituted for “at least 80 percent” each place it appears therein, and

[(B) section 1563(b) shall not apply.

[(5) POSSESSIONS.—The term “possession of the United States” means Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States.

[(6) SECTION 923(a)(2) NON-EXEMPT INCOME.—The term “section 923(a)(2) non-exempt income” means any foreign trade income from a transaction with respect to which paragraph (1) or (2) of section 925(a) does not apply and which is not exempt foreign trade income. Such term shall not include any income which is effectively connected with the conduct of a trade or business within the United States (determined without regard to this subpart).

[(e) SPECIAL RULES.—

[(1) SOURCE RULES FOR RELATED PERSONS.—Under regulations, the income of a person described in section 482 from a transaction giving rise to foreign trading gross receipts of a FSC which is treated as from sources outside the United States shall not exceed the amount which would be treated as foreign source income earned by such person if the pricing rule under section 994 which corresponds to the rule used under section

925 with respect to such transaction applied to such transaction.

[(2) PARTICIPATION IN INTERNATIONAL BOYCOTTS, ETC.—Under regulations prescribed by the Secretary, the exempt foreign trade income of a FSC for any taxable year shall be limited under rules similar to the rules of clauses (ii) and (iii) of section 995(b)(1)(F).

[(3) EXCHANGE OF INFORMATION REQUIREMENTS.—For purposes of this title, the term “FSC” shall not include any corporation which was created or organized under the laws of any foreign country unless there is in effect between such country and the United States—

[(A) a bilateral or multilateral agreement described in section 274(h)(6)(C) (determined by treating any reference to a beneficiary country as being a reference to any foreign country and by applying such section without regard to clause (ii) thereof), or

[(B) an income tax treaty which contains an exchange of information program—

[(i) which the Secretary certifies (and has not revoked such certification) is satisfactory in practice for purposes of this title, and

[(ii) to which the FSC is subject.

[(4) DISALLOWANCE OF TREATY BENEFITS.—Any corporation electing to be treated as a FSC under subsection (f)(1) may not claim any benefits under any income tax treaty between the United States and any foreign country.

[(5) COORDINATION WITH POSSESSIONS TAXATION.—

[(A) EXEMPTION.—No tax shall be imposed by any possession of the United States on any foreign trade income derived before January 1, 1987. The preceding sentence shall not apply to any income attributable to the sale of property or the performance of services for ultimate use, consumption, or disposition within the possession.

[(B) CLARIFICATION THAT POSSESSION MAY EXEMPT CERTAIN INCOME FROM TAX.—Nothing in any provision of law shall be construed as prohibiting any possession of the United States from exempting from tax any foreign trade income of a FSC or any other income of a FSC described in paragraph (2) or (3) of section 921(d).

[(C) NO COVER OVER OF TAXES IMPOSED ON FSC.—Nothing in any provision of law shall be construed as requiring any tax imposed by this title on a FSC to be covered over (or otherwise transferred) to any possession of the United States.

[(f) ELECTION OF STATUS AS FSC (AND AS SMALL FSC).—

[(1) ELECTION.—

[(A) TIME FOR MAKING.—An election by a corporation under section 922(a)(2) to be treated as a FSC, and an election under section 922(b)(1) to be a small FSC, shall be made by such corporation for a taxable year at any time during the 90-day period immediately preceding the beginning of the taxable year, except that the Secretary may give his consent to the making of an election at such other times as he may designate.

[(B) MANNER OF ELECTION.—An election under subparagraph (A) shall be made in such manner as the Secretary shall prescribe and shall be valid only if all persons who are shareholders in such corporation on the first day of the first taxable year for which such election is effective consent to such election.

[(2) EFFECT OF ELECTION.—If a corporation makes an election under paragraph (1), then the provisions of this subpart shall apply to such corporation for the taxable year of the corporation for which made and for all succeeding taxable years.

[(3) TERMINATION OF ELECTION.—

[(A) REVOCATION.—An election under this subsection made by any corporation may be terminated by revocation of such election for any taxable year of the corporation after the first taxable year of the corporation for which the election is effective. A termination under this paragraph shall be effective with respect to such election—

[(i) for the taxable year in which made, if made at any time during the first 90 days of such taxable year, or

[(ii) for the taxable year following the taxable year in which made, if made after the close of such 90 days, and for all succeeding taxable years of the corporation. Such termination shall be made in such manner as the Secretary shall prescribe by regulations.

[(B) CONTINUED FAILURE TO BE A FSC.—If a corporation is not a FSC for each of any 5 consecutive taxable years of the corporation for which an election under this subsection is effective, the election to be a FSC shall be terminated and not be in effect for any taxable year of the corporation after such 5th year.

[(g) TREATMENT OF SHARED FSC'S.—

[(1) IN GENERAL.—Except as provided in paragraph (2), each separate account referred to in paragraph (3) maintained by a shared FSC shall be treated as a separate corporation for purposes of this subpart.

[(2) CERTAIN REQUIREMENTS APPLIED AT SHARED FSC LEVEL.—Paragraph (1) shall not apply—

[(A) for purposes of—

[(i) subparagraphs (A), (B), (D), and (E) of section 922(a)(1),

[(ii) paragraph (2) of section 922(a),

[(iii) subsections (b), (c), and (e) of section 924, and

[(iv) subsection (f) of this section, and

[(B) for such other purposes as the Secretary may by regulations prescribe.

[(3) SHARED FSC.—For purposes of this subsection, the term “shared FSC” means any corporation if—

[(A) such corporation maintains a separate account for transactions with each shareholder (and persons related to such shareholder),

[(B) distributions to each shareholder are based on the amounts in the separate account maintained with respect to such shareholder, and

[(C) such corporation meets such other requirements as the Secretary may by regulations prescribe.]

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Subpart E—Qualifying Foreign Trade Income

Sec. 941. Qualifying foreign trade income.

Sec. 942. Foreign trading gross receipts.

Sec. 943. Other definitions and special rules.

SEC. 941. QUALIFYING FOREIGN TRADE INCOME.

(a) **QUALIFYING FOREIGN TRADE INCOME.**—For purposes of this subpart and section 114—

(1) **IN GENERAL.**—The term “qualifying foreign trade income” means, with respect to any transaction, the amount of gross income which, if excluded, will result in a reduction of the taxable income of the taxpayer from such transaction equal to the greatest of—

(A) 30 percent of the foreign sale and leasing income derived by the taxpayer from such transaction,

(B) 1.2 percent of the foreign trading gross receipts derived by the taxpayer from the transaction, or

(C) 15 percent of the foreign trade income derived by the taxpayer from the transaction.

In no event shall the amount determined under subparagraph (B) exceed 200 percent of the amount determined under subparagraph (C).

(2) **ALTERNATIVE COMPUTATION.**—A taxpayer may compute its qualifying foreign trade income under a subparagraph of paragraph (1) other than the subparagraph which results in the greatest amount of such income.

(3) **LIMITATION ON USE OF FOREIGN TRADING GROSS RECEIPTS METHOD.**—If any person computes its qualifying foreign trade income from any transaction with respect to any property under paragraph (1)(B), the qualifying foreign trade income of such person (or any related person) with respect to any other transaction involving such property shall be zero.

(4) **RULES FOR MARGINAL COSTING.**—The Secretary shall prescribe regulations setting forth rules for the allocation of expenditures in computing foreign trade income under paragraph (1)(C) in those cases where a taxpayer is seeking to establish or maintain a market for qualifying foreign trade property.

(5) **PARTICIPATION IN INTERNATIONAL BOYCOTTS, ETC.**—Under regulations prescribed by the Secretary, the qualifying foreign trade income of a taxpayer for any taxable year shall be reduced (but not below zero) by the sum of—

(A) an amount equal to such income multiplied by the international boycott factor determined under section 999, and

(B) any illegal bribe, kickback, or other payment (within the meaning of section 162(c)) paid by or on behalf of the taxpayer directly or indirectly to an official, employee, or agent in fact of a government.

(b) **FOREIGN TRADE INCOME.**—For purposes of this subpart—

(1) *IN GENERAL.*—The term “foreign trade income” means the taxable income of the taxpayer attributable to foreign trading gross receipts of the taxpayer.

(2) *SPECIAL RULE FOR COOPERATIVES.*—In any case in which an organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products sells qualifying foreign trade property, in computing the taxable income of such cooperative, there shall not be taken into account any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

(c) *FOREIGN SALE AND LEASING INCOME.*—For purposes of this section—

(1) *IN GENERAL.*—The term “foreign sale and leasing income” means, with respect to any transaction—

(A) foreign trade income properly allocable to activities which—

(i) are described in paragraph (2)(A)(i) or (3) of section 942(b), and

(ii) are performed by the taxpayer (or any person acting under a contract with such taxpayer) outside the United States, or

(B) 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.

(2) *SPECIAL RULES FOR LEASED PROPERTY.*—

(A) *SALES INCOME.*—The term “foreign sale and leasing income” includes any foreign trade income derived by the taxpayer from the sale of property described in paragraph (1)(B).

(B) *LIMITATION IN CERTAIN CASES.*—Except as provided in regulations, in the case of property which—

(i) was manufactured, produced, grown, or extracted by the taxpayer, or

(ii) was acquired by the taxpayer from a related person for a price which was not determined in accordance with the rules of section 482,

the amount of foreign trade income which may be treated as foreign sale and leasing income under paragraph (1)(B) or subparagraph (A) of this paragraph with respect to any transaction involving such property shall not exceed the amount which would have been determined if the taxpayer had acquired such property for the price determined in accordance with the rules of section 482.

(3) *SPECIAL RULES.*—

(A) *EXCLUDED PROPERTY.*—Foreign sale and leasing income shall not include any income properly allocable to excluded property described in subparagraph (B) of section 943(a)(3) (relating to intangibles).

(B) *ONLY DIRECT EXPENSES TAKEN INTO ACCOUNT.*—For purposes of this subsection, any expense other than a directly allocable expense shall not be taken into account in computing foreign trade income.

SEC. 942. FOREIGN TRADING GROSS RECEIPTS.

(a) *FOREIGN TRADING GROSS RECEIPTS.*—

(1) *IN GENERAL.*—Except as otherwise provided in this section, for purposes of this subpart, the term “foreign trading gross receipts” means the gross receipts of the taxpayer which are—

(A) from the sale, exchange, or other disposition of qualifying foreign trade property,

(B) from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States,

(C) for services which are related and subsidiary to—

(i) any sale, exchange, or other disposition of qualifying foreign trade property by such taxpayer, or

(ii) any lease or rental of qualifying foreign trade property described in subparagraph (B) by such taxpayer,

(D) for engineering or architectural services for construction projects located (or proposed for location) outside the United States, or

(E) for the performance of managerial services for a person other than a related person in furtherance of the production of foreign trading gross receipts described in subparagraph (A), (B), or (C).

Subparagraph (E) shall not apply to a taxpayer for any taxable year unless at least 50 percent of its foreign trading gross receipts (determined without regard to this sentence) for such taxable year is derived from activities described in subparagraph (A), (B), or (C).

(2) *CERTAIN RECEIPTS EXCLUDED ON BASIS OF USE; SUBSIDIZED RECEIPTS EXCLUDED.*—The term “foreign trading gross receipts” shall not include receipts of a taxpayer from a transaction if—

(A) the qualifying foreign trade property or services—

(i) are for ultimate use in the United States, or

(ii) are for use by the United States or any instrumentality thereof and such use of qualifying foreign trade property or services is required by law or regulation, or

(B) such transaction is accomplished by a subsidy granted by the government (or any instrumentality thereof) of the country or possession in which the property is manufactured, produced, grown, or extracted.

(3) *ELECTION TO EXCLUDE CERTAIN RECEIPTS.*—The term “foreign trading gross receipts” shall not include gross receipts of a taxpayer from a transaction if the taxpayer elects not to have such receipts taken into account for purposes of this subpart.

(b) *FOREIGN ECONOMIC PROCESS REQUIREMENTS.*—

(1) *IN GENERAL.*—Except as provided in subsection (c), a taxpayer shall be treated as having foreign trading gross receipts from any transaction only if economic processes with respect to such transaction take place outside the United States as required by paragraph (2).

(2) *REQUIREMENT.*—

(A) *IN GENERAL.*—The requirements of this paragraph are met with respect to the gross receipts of a taxpayer derived from any transaction if—

(i) such taxpayer (or any person acting under a contract with such taxpayer) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction, and

(ii) the foreign direct costs incurred by the taxpayer attributable to the transaction equal or exceed 50 percent of the total direct costs attributable to the transaction.

(B) *ALTERNATIVE 85-PERCENT TEST.*—A taxpayer shall be treated as satisfying the requirements of subparagraph (A)(ii) with respect to any transaction if, with respect to each of at least 2 subparagraphs of paragraph (3), the foreign direct costs incurred by such taxpayer attributable to activities described in such subparagraph equal or exceed 85 percent of the total direct costs attributable to activities described in such subparagraph.

(C) *DEFINITIONS.*—For purposes of this paragraph—

(i) *TOTAL DIRECT COSTS.*—The term “total direct costs” means, with respect to any transaction, the total direct costs incurred by the taxpayer attributable to activities described in paragraph (3) performed at any location by the taxpayer or any person acting under a contract with such taxpayer.

(ii) *FOREIGN DIRECT COSTS.*—The term “foreign direct costs” means, with respect to any transaction, the portion of the total direct costs which are attributable to activities performed outside the United States.

(3) *ACTIVITIES RELATING TO QUALIFYING FOREIGN TRADE PROPERTY.*—The activities described in this paragraph are any of the following with respect to qualifying foreign trade property—

(A) advertising and sales promotion,

(B) the processing of customer orders and the arranging for delivery,

(C) transportation outside the United States in connection with delivery to the customer,

(D) the determination and transmittal of a final invoice or statement of account or the receipt of payment, and

(E) the assumption of credit risk.

(4) *ECONOMIC PROCESSES PERFORMED BY RELATED PERSONS.*—A taxpayer shall be treated as meeting the requirements of this subsection with respect to any sales transaction involving any property if any related person has met such requirements in such transaction or any other sales transaction involving such property.

(c) *EXCEPTION FROM FOREIGN ECONOMIC PROCESS REQUIREMENT.*—

(1) *IN GENERAL.*—The requirements of subsection (b) shall be treated as met for any taxable year if the foreign trading gross receipts of the taxpayer for such year do not exceed \$5,000,000.

(2) *RECEIPTS OF RELATED PERSONS AGGREGATED.*—All related persons shall be treated as one person for purposes of paragraph (1), and the limitation under paragraph (1) shall be allo-

cated among such persons in a manner provided in regulations prescribed by the Secretary.

(3) *SPECIAL RULE FOR PASS-THRU ENTITIES.*—In the case of a partnership, S corporation, or other pass-thru entity, the limitation under paragraph (1) shall apply with respect to the partnership, S corporation, or entity and with respect to each partner, shareholder, or other owner.

SEC. 943. OTHER DEFINITIONS AND SPECIAL RULES.

(a) *QUALIFYING FOREIGN TRADE PROPERTY.*—For purposes of this subpart—

(1) *IN GENERAL.*—The term “qualifying foreign trade property” means property—

(A) manufactured, produced, grown, or extracted within or outside the United States,

(B) held primarily for sale, lease, or rental, in the ordinary course of trade or business for direct use, consumption, or disposition outside the United States, and

(C) not more than 50 percent of the fair market value of which is attributable to—

(i) articles manufactured, produced, grown, or extracted outside the United States, and

(ii) direct costs for labor (determined under the principles of section 263A) performed outside the United States.

For purposes of subparagraph (C), the fair market value of any article imported into the United States shall be its appraised value, as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation, and the direct costs for labor under clause (ii) do not include costs that would be treated under the principles of section 263A as direct labor costs attributable to articles described in clause (i).

(2) *U.S. TAXATION TO ENSURE CONSISTENT TREATMENT.*—Property which (without regard to this paragraph) is qualifying foreign trade property and which is manufactured, produced, grown, or extracted outside the United States shall be treated as qualifying foreign trade property only if it is manufactured, produced, grown, or extracted by—

(A) a domestic corporation,

(B) an individual who is a citizen or resident of the United States,

(C) a foreign corporation with respect to which an election under subsection (e) (relating to foreign corporations electing to be subject to United States taxation) is in effect, or

(D) a partnership or other pass-thru entity all of the partners or owners of which are described in subparagraph (A), (B), or (C).

Except as otherwise provided by the Secretary, tiered partnerships or pass-thru entities shall be treated as described in subparagraph (D) if each of the partnerships or entities is directly or indirectly wholly owned by persons described in subparagraph (A), (B), or (C).

(3) *EXCLUDED PROPERTY.*—The term “qualifying foreign trade property” shall not include—

(A) property leased or rented by the taxpayer for use by any related person,

(B) patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, and other than computer software (whether or not patented), for commercial or home use), goodwill, trademarks, trade brands, franchises, or other like property,

(C) oil or gas (or any primary product thereof),

(D) products the transfer of which is prohibited or curtailed to effectuate the policy set forth in paragraph (2)(C) of section 3 of Public Law 96-72, or

(E) any unprocessed timber which is a softwood.

For purposes of subparagraph (E), the term "unprocessed timber" means any log, cant, or similar form of timber.

(4) **PROPERTY IN SHORT SUPPLY.**—If the President determines that the supply of any property described in paragraph (1) is insufficient to meet the requirements of the domestic economy, the President may by Executive order designate the property as in short supply. Any property so designated shall not be treated as qualifying foreign trade property during the period beginning with the date specified in the Executive order and ending with the date specified in an Executive order setting forth the President's determination that the property is no longer in short supply.

(b) **OTHER DEFINITIONS AND RULES.**—For purposes of this subpart—

(1) **TRANSACTION.**—

(A) **IN GENERAL.**—The term "transaction" means—

- (i) any sale, exchange, or other disposition,
- (ii) any lease or rental, and
- (iii) any furnishing of services.

(B) **GROUPING OF TRANSACTIONS.**—To the extent provided in regulations, any provision of this subpart which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.

(2) **UNITED STATES DEFINED.**—The term "United States" includes the Commonwealth of Puerto Rico. The preceding sentence shall not apply for purposes of determining whether a corporation is a domestic corporation.

(3) **RELATED PERSON.**—A person shall be related to another person if such persons are treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414, except that determinations under subsections (a) and (b) of section 52 shall be made without regard to section 1563(b).

(4) **GROSS AND TAXABLE INCOME.**—Section 114 shall not be taken into account in determining the amount of gross income or foreign trade income from any transaction.

(c) **SOURCE RULE.**—Under regulations, in the case of qualifying foreign trade property manufactured, produced, grown, or extracted within the United States, the amount of income of a taxpayer from

any sales transaction with respect to such property which is treated as from sources without the United States shall not exceed—

(1) in the case of a taxpayer computing its qualifying foreign trade income under section 941(a)(1)(B), the amount of the taxpayer's foreign trade income which would (but for this subsection) be treated as from sources without the United States if the foreign trade income were reduced by an amount equal to 4 percent of the foreign trading gross receipts with respect to the transaction, and

(2) in the case of a taxpayer computing its qualifying foreign trade income under section 941(a)(1)(C), 50 percent of the amount of the taxpayer's foreign trade income which would (but for this subsection) be treated as from sources without the United States.

(d) TREATMENT OF WITHHOLDING TAXES.—

(1) IN GENERAL.—For purposes of section 114(d), any withholding tax shall not be treated as paid or accrued with respect to extraterritorial income which is excluded from gross income under section 114(a). For purposes of this paragraph, the term “withholding tax” means any tax which is imposed on a basis other than residence and for which credit is allowable under section 901 or 903.

(2) EXCEPTION.—Paragraph (1) shall not apply to any taxpayer with respect to extraterritorial income from any transaction if the taxpayer computes its qualifying foreign trade income with respect to the transaction under section 941(a)(1)(A).

(e) ELECTION TO BE TREATED AS DOMESTIC CORPORATION.—

(1) IN GENERAL.—An applicable foreign corporation may elect to be treated as a domestic corporation for all purposes of this title if such corporation waives all benefits to such corporation granted by the United States under any treaty. No election under section 1362(a) may be made with respect to such corporation.

(2) APPLICABLE FOREIGN CORPORATION.—For purposes of paragraph (1), the term “applicable foreign corporation” means any foreign corporation if—

(A) such corporation manufactures, produces, grows, or extracts property in the ordinary course of such corporation's trade or business, or

(B) substantially all of the gross receipts of such corporation may reasonably be expected to be foreign trading gross receipts.

(3) PERIOD OF ELECTION.—

(A) IN GENERAL.—Except as otherwise provided in this paragraph, an election under paragraph (1) shall apply to the taxable year for which made and all subsequent taxable years unless revoked by the taxpayer. Any revocation of such election shall apply to taxable years beginning after such revocation.

(B) TERMINATION.—If a corporation which made an election under paragraph (1) for any taxable year fails to meet the requirements of subparagraph (A) or (B) of paragraph (2) for any subsequent taxable year, such election shall not apply to any taxable year beginning after such subsequent taxable year.

(C) *EFFECT OF REVOCATION OR TERMINATION.*—If a corporation which made an election under paragraph (1) revokes such election or such election is terminated under subparagraph (B), such corporation (and any successor corporation) may not make such election for any of the 5 taxable years beginning with the first taxable year for which such election is not in effect as a result of such revocation or termination.

(4) *SPECIAL RULES.*—

(A) *REQUIREMENTS.*—This subsection shall not apply to an applicable foreign corporation if such corporation fails to meet the requirements (if any) which the Secretary may prescribe to ensure that the taxes imposed by this chapter on such corporation are paid.

(B) *EFFECT OF ELECTION, REVOCATION, AND TERMINATION.*—

(i) *ELECTION.*—For purposes of section 367, a foreign corporation making an election under this subsection shall be treated as transferring (as of the first day of the first taxable year to which the election applies) all of its assets to a domestic corporation in connection with an exchange to which section 354 applies.

(ii) *REVOCATION AND TERMINATION.*—For purposes of section 367, if—

(I) an election is made by a corporation under paragraph (1) for any taxable year, and

(II) such election ceases to apply for any subsequent taxable year,

such corporation shall be treated as a domestic corporation transferring (as of the 1st day of the first such subsequent taxable year to which such election ceases to apply) all of its property to a foreign corporation in connection with an exchange to which section 354 applies.

(C) *ELIGIBILITY FOR ELECTION.*—The Secretary may by regulation designate one or more classes of corporations which may not make the election under this subsection.

(f) *RULES RELATING TO ALLOCATIONS OF QUALIFYING FOREIGN TRADE INCOME FROM SHARED PARTNERSHIPS.*—

(1) *IN GENERAL.*—If—

(A) a partnership maintains a separate account for transactions (to which this subpart applies) with each partner,

(B) distributions to each partner with respect to such transactions are based on the amounts in the separate account maintained with respect to such partner, and

(C) such partnership meets such other requirements as the Secretary may by regulations prescribe, then such partnership shall allocate to each partner items of income, gain, loss, and deduction (including qualifying foreign trade income) from any transaction to which this subpart applies on the basis of such separate account.

(2) *SPECIAL RULES.*—For purposes of this subpart, in the case of a partnership to which paragraph (1) applies—

(A) any partner's interest in the partnership shall not be taken into account in determining whether such partner is a related person with respect to any other partner, and

(B) the election under section 942(a)(3) shall be made separately by each partner with respect to any transaction for which the partnership maintains separate accounts for each partner.

(g) EXCLUSION FOR PATRONS OF AGRICULTURAL AND HORTICULTURAL COOPERATIVES.—Any amount described in paragraph (1) or (3) of section 1385(a)—

(1) which is received by a person from an organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products, and

(2) which is designated by the organization as allocable to qualifying foreign trade income in a written notice mailed to its patrons during the payment period described in section 1382(d), shall be treated as qualifying foreign trade income of such person for purposes of section 114. The taxable income of the organization shall not be reduced under section 1382 by reason of any amount to which the preceding sentence applies.

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PART V—INTERNATIONAL BOYCOTT DETERMINATIONS

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SEC. 999. REPORTS BY TAXPAYERS; DETERMINATIONS.

(a) * * *

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(c) INTERNATIONAL BOYCOTT FACTOR.—

(1) INTERNATIONAL BOYCOTT FACTOR.—For purposes of sections 908(a), 941(a)(5), 952(a)(3), and 995(b)(1)(F)(ii), the international boycott factor is a fraction, determined under regulations prescribed by the Secretary, the numerator of which reflects the world-wide operations of a person (or, in the case of a controlled group (within the meaning of section 993(a)(3)) which includes that person, of the group) which are operations in or related to a group of countries associated in carrying out an international boycott in or with which that person or a member of that controlled group has participated or cooperated in the taxable year, and the denominator of which reflects the world-wide operations of that person or group.

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VII. DISSENTING AND ADDITIONAL VIEWS

DISSENTING VIEWS

As the only member of the Ways and Means to vote against H.R. 4986, the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, I must explain the reasons for my vote.

I believe that this bill will not suffice under the scrutiny of the World Trade Organization. H.R. 4986 is as much of a subsidy as the current FSC. The entire process was undemocratic, constituting backroom consultations with private industry and select members of Congress. Finally, the bill is expanded and additional taxpayer dollars will be lost under the new scheme. It is not right that we ask U.S. taxpayers to pay for an export subsidy for large pharmaceutical corporations when the U.S. pharmaceutical industry is charging less in wealthy foreign markets for the same prescription drugs that our seniors are unable to afford here.

PROCESS

Select members of the House Ways and Means Committee and Senate Finance Committee were consulted on revising the Foreign Sales Corporation (FSC) prior to the World Trade Organization's October 2000 deadline. In addition, those who will benefit from the new subsidy were also consulted—private industry. However, there were many members of the Ways & Means Committee who were not consulted on the details of the new proposal. This hardly reflects the democratic process under which this legislative body is supposed to operate.

I was one of the members who was not consulted on repealing and replacing the current FSC for a new plan, yet I was one of the members who was here to vote in 1984 to repeal the Domestic International Sales Corporation and replace it with the Foreign Sales Corporation.

BENEFITS TO MILITARY WEAPONS EXPORTERS

In 1976, I led Congress in voting to decrease the benefit to weapons dealers. Therefore, I was dismayed to see that the new FSC benefit will actually be expanded to increase the benefit of the subsidy to military weapons exporters.

The U.S. already spends about \$8 billion annually to subsidize U.S. weapons manufacturers. These subsidies include taxpayer-backed loans, grants, and government promotional activities that assist U.S. weapons makers to sell their products to foreign customers. Under the current Foreign Sales Corporation scheme, weapons exporters may qualify for up to 50% of the FSC benefit. Under the new scheme, arms dealers will be able to reap the full benefit of the subsidy. It is incomprehensible that we would allow

an industry that already receives more than its fair share of pork barrel spending to receiving subsidies through the new FSC plan.

BENEFITS TO PHARMACEUTICAL INDUSTRY

The pharmaceutical industry is another branch of corporate American that clearly does not need an export subsidy at the expense of the American taxpayer. H.R. 4986 offers export incentives to pharmaceutical companies who sell their products to other developed countries for less than the U.S. consumer can purchase the exact same drugs.

Drug companies already reap huge tax benefits that lowered their average effective tax rates nearly 40% relative to other major U.S. industries from 1990 to 1996. Fortune magazine again rated the pharmaceutical industry the most profitable industry in 1999. Merck, the richest drug company, had greater profits than the entire airline industry and more than twice the profits of the engineering-construction industry. Drug spending increased more than 15% in 1998, 18% in 1999 and is expected to continue to increase at phenomenal rates in the future. Yet, studies have shown that American seniors without drug coverage often pay about twice as much as people in Canada & Mexico.

The Ways and Means Committee rejected my amendment which would have prohibited pharmaceutical companies from receiving the full FSC benefit if they discounted more than 5% to foreign consumers relative to U.S. consumers. This amendment simply makes sense. It is only fair to the millions of U.S. seniors who go without their much needed prescription drugs. Why subsidize an industry already receiving huge corporate tax credits? We should have exempted pharmaceutical companies from the new FSC scheme. The members of the Ways and Means Committee chose otherwise. This is an insult not only to American seniors, but to all U.S. taxpayers.

EXPORT SUBSIDY

Finally, H.R. 4986 does not address the concerns of the WTO dispute panel. The new scheme attempts to allay the European Unions' concerns by allowing some foreign operations to also receive the subsidy. The new scheme eliminates the requirement on a firm to sell its exports through a separately chartered foreign corporation in order to receive the benefit. The only portion that is eliminated is the paper subsidiary. Instead of creating a tax haven, U.S. exporters will be able to receive the benefit outright. The new scheme doesn't prevent arms exporters or any other industry from receiving the entire of the subsidy.

The new scheme essentially leaves the export benefit in place but now the U.S. Treasury will forego an additional \$300 million per year to subsidize U.S. exporters. The U.S. Treasury will forego more than \$3 billion per year to help companies like Boeing and R.J. Reynolds peddle their products. Exporters will continue to receive a lower tax rate on income from export sales than from domestic sales. This is clearly prohibited under the WTO Agreement on Subsidies and Countervailing Measures.

It is said commentary on the Ways and Means Committee that is willing to fight a WTO ruling all in the name of corporate profits but ignores environmental, human rights, and labor interests.

PETE STARK.

ADDITIONAL VIEWS

In what is hardly a model of the way the democratic process should operate, this legislation has involved no public participation, no hearings, and non involvement of any but a handful of Committee members. This bill is basically a product of meetings between the Treasury Department and groups that will benefit from preferential tax treatment. The Chairman even went so far as to attempt to preclude the Committee members from making comments or offering amendments. The members were even denied the right to question Secretary Eizenstat, the principal Administration official responsible for this bill.

The cost of this legislation to the Treasury, which must be paid for by American taxpayers, is between \$4 billion and \$6 billion per year, and growing. In response to the European community's criticism that tax advantages to American businesses are illegal, this legislation seeks to generously increase those advantages by \$300 million a year.

With this legislation, the Committee has basically made a public policy statement that local stores, which sell groceries or clothing to customers within our country, should pay higher taxes than multinational corporations, which sell cigarettes or machine guns abroad. Contrary to proponents' arguments that small and medium sized businesses share significantly in this tax break, the Internal Revenue Service Statistics of Income Division reports that 78% of FSC tax benefits go to companies with assets exceeding \$1 billion. Another study based on a sample of corporate financial statements published in Tax Notes, August 14, 2000, indicates that, "the top 20% of FSC beneficiaries (ranked by size of reported FSC benefit in 1998) obtained 87% of the FSC benefits."

Moreover, there is substantial question as to the benefits that Americans truly will receive from this legislation. The Congressional Research Service summarized the most recent Treasury analysis of the Foreign Sales Corporation tax benefit by concluding that "[r]epealing this provision would have a negligible effect on the trade balance." Treasury determined that such a repeal would reduce U.S. exports by $\frac{3}{10}$ of one percent and U.S. imports by $\frac{2}{10}$ of one percent.

ENCOURAGING FOREIGN ARMAMENTS SALES

Because the benefits to ordinary Americans of this costly tax advantage are at best remote, every aspect of this law deserves the type of scrutiny that was wholly lacking during Committee consideration. One glaring example of both what is wrong with this legislation and what is wrong with the process that produced it is the generosity shown to arms manufacturers. Their tax savings are doubled by this bill. The supposed justification for such largesse to

those who promote arms sales abroad was previously rejected by the Treasury Department in August 1999:

We have seen no evidence that granting full FSC benefits would significantly affect the level of defense exports, and indeed, we are given to understand that other factors, such as the quality of the product and the quality and level of support services, tend to dominate a buyer's decision whether to buy a U.S. defense product.

Ironically, in 1997, the Congressional Budget Office, whose director was appointed by Republican leaders had reached a similar conclusion:

U.S. defense industries have significant advantages over their foreign competitors and thus should not need additional subsidies to attract sales. Because the U.S. defense procurement budget is nearly twice that of all Western European countries combined, U.S. industries can realize economics of scale not available to other combined, U.S. industries can realize economics of scale not available to other competitors. The U.S. defense research and development budget is five times that of all Western European countries combined, which ensures that U.S. weapon systems are and will remain technologically superior to those of other suppliers.

Even the Department of Defense conceded the same in 1994:

The forecasts support a continuing strong defense trade performance for U.S. defense products through the end of the decade and beyond. In a large number of cases, the U.S. is clearly the preferred provider, and there is little meaningful competition with suppliers from other countries. An increase in the level of support the U.S. government currently supplies is unlikely to shift the U.S. export market share outside a range of 53 to 59 percent of worldwide arms trade.

In 1999, without the bonanza provided by this bull, U.S. defense contractors sold almost \$11.8 billion in weapons overseas—more than a third of the world's total and more than all European countries combined.

A paper prepared for the Cato Institute in August 1999 by William D. Hartung, President's Fellow at the World Policy Institute, highlights the bad judgment shown here: "If the government wanted to level the playing field between the weapons industry and other sectors, it would have to reduce weapons subsidies, not increase them." (These subsidies include thousands of federal employees at the Pentagon and other agencies whose very purpose is to increase arms sales). He continued, "Considering those massive subsidies to weapons manufacturers, granting additional tax breaks to an industry that is being so pampered by the U.S. government makes no sense."

With no evidence to warrant its action, the Committee rejected fiscal responsibility in favor of wholly unjustified preferential tax treatment that means millions in savings to defense contractors. This costly decision is also bad for our country's true security inter-

ests. Instead of subsidizing arms promotion, our nation should be encouraging arms control. American armaments too often contribute to one arm race after another around the globe.

Doubling this subsidy only encourages the sales of more arms overseas and creates more challenges to the maintenance of our own “military superiority”—and, of course, more pressure for additional costly increases in the defense budget. As Lawrence Korb, President Reagan’s Assistant Secretary for Defense for Manpower, Reserve Affairs, Installations and Logistics, has said:

It has become a money game: an absurd spiral in which we export arms only to have to develop more sophisticated ones to counter those spread out all over the world * * * It is very hard for us to tell other people—the Russians, the Chinese, the French—not to sell arms, when we are out there peddling and fighting to control the market.

Former Costa Rican President and 1987 Nobel Peace Prize winner, Oscar Arias offers another reason for rejecting the Committee’s decision to increase the arms subsidy:

By selling advanced weaponry throughout the world, wealthy military contractors not only weaken national security and squeeze taxpayers at home but also strengthen dictators and human misery abroad.

LLOYD DOGGETT.

ADDITIONAL VIEWS BY MESSRS. DOGGETT, LEWIS, AND
STARK

PROMOTING TOBACCO RELATED DISEASE AND DEATH

The way in which this legislation was rushed through the Committee avoided any explanation as to why American taxpayers should continue to subsidize the tobacco industry, whose product actually kills one third of the people who use it. The Committee ignored the pleas of the American Medical Association, the American Cancer Society, the American Heart Association, Campaign for Tobacco-Free Kids, and other public health groups that tobacco should be denied a tax benefit. It also rejected the written request of 97 Members of Congress that tobacco be excluded.

Nicotine addiction represents a public health crisis. Within 20 years, almost 10 million people are expected to die annually from tobacco-related illnesses. Seventy percent of these deaths will occur in the developing countries that are being targeted by big tobacco's continued addiction to making money at the expense of human lives. In fact, tobacco will soon become the leading cause of disease and premature death worldwide—bypassing communicable diseases such as AIDS, malaria and tuberculosis.

Instead of being accountable for its deadly products, the tobacco industry has responded by conspiring to undermine the efforts of the World Health Organization to cope with this global pandemic. During recent litigation, Philip Morris was forced to produce documents, which can be found at the Minnesota Tobacco Document Depository, stating that the company sought to “discredit key individuals” and “allocate the resources to stop [WHO] in their tracks.” An August 2000 WHO report entitled, *Tobacco Company Strategies to Undermine Tobacco Control Activities at the World Health Organization* states:

The [industry] documents also show that tobacco company strategies to undermine WHO relied heavily on international and scientific exports with hidden financial ties to the industry. Perhaps most disturbing, the documents show that tobacco companies quietly influenced other U.N. agencies and representatives of developing countries to resist WHO's tobacco control initiatives.

Geoffrey C. Bible, Chairman of Philip Morris, a company that has often hidden its malicious tobacco influence through its holdings in Kraft Foods, even wrote in 1988 of the “need to think through how we can use our food companies [to help governments] with their food problems and give us more balanced profile with the government than we now have against WHO's powerful influence.”

The tobacco industry certainly cannot justify the public subsidy offered through this proposed legislation. Philip Morris, R.J. Rey-

nolds, and Brown and Williamson have acquired tremendous marketing expertise from decades of success in targeting American children. This offers them tremendous advantage over foreign competitors in addicting children around the world; they hardly need help from the American taxpayer in order to spread death and disease to children in developing countries.

Philip Morris spends millions in American television advertising to contend that it no longer markets to youth. It finally claims to have abandoned tobacco company billboards, transit ads, cartoon characters, cigarette-branded apparel and merchandise, paid placement of its products in movies and television shows, and most brand sponsorship of team sports and entertainment events. But, it has steadfastly declined to apply these modest safeguards in its international operations; indeed, it relies heavily on these and other tactics to target the world's children.

Both petroleum and unprocessed timber are excluded from this legislation. Yet tobacco, the single largest public health menace, will continue to be subsidized at a cost of American taxpayers of about \$100 million per year. This legislation constitutes just another way of forcing American taxpayers to be partners in this export of death and disease. Little wonder that there was so much eagerness to silence discussion of this disgrace.

LLOYD DOGGETT.

PETE STARK.

JOHN LEWIS.

