

FOREIGN SALES CORPORATIONS: A NEW FORM OF TAX RELIEF FOR EXPORTERS

Stanley J. Marcuss* and Kathryn Hoff-Patrinis**

More than a decade ago, concern over the U.S. trade deficit prompted Congress to create a special tax incentive for exporting through a vehicle known as the Domestic International Sales Corporation (DISC). Although it was the object of criticism from organized labor, tax reformers, economists and U.S. trading partners, the DISC program was considered an important incentive to U.S. companies to engage in exporting. Indeed, it was considered to be one of this country's major export incentives. It is estimated that, since its inception, the program produced approximately \$13 billion in tax relief for more than 17,000 corporations that took advantage of the program to set up DISCs.¹ Nonetheless, the U.S. trade deficit continued to worsen and climbed to an all-time high of \$123.3 billion in 1984.²

Ironically, just as the U.S. trade deficit was reaching record highs, the DISC was found by a panel of the GATT (the General Agreement on Tariffs and Trade) to be inconsistent with the GATT. Fearful of retaliation by GATT signatories if the DISC were not abandoned or made compatible with the GATT, Congress responded in 1984 by replacing the DISC with a new export incentive known as the Foreign Sales Corporation or FSC. Although intended to provide tax benefits that are comparable to those that had been available through DISCs, the FSC provisions are significantly different from those of the DISC.

The FSC tax benefit consists of a partial exemption from U.S. corporate income tax for income from qualifying transactions, rather than a deferral of recognition of income for U.S. income tax purposes as under the DISC provisions. Unlike a DISC, a FSC must

* J.D., Harvard Law School, 1968; B.A. and M.A., Cambridge University. Partner, Milbank, Tweed, Hadley & McCloy, Washington, D.C. Member of Bar, Connecticut, New York and District of Columbia. Former Senior Deputy Assistant Secretary of the Department of Commerce.

** J.D., Harvard Law School, 1983; S.M., MIT Sloan School of Management. Associate, Milbank, Tweed, Hadley & McCloy, Washington, D.C. Member of Bar, District of Columbia.

1. U.S. DEPT OF TREASURY, *The Operation and Effect of the Domestic International Sales Corporation Legislation*, 1981 ANN. REP. 19, 20 (1983).

2. U.S. Dep't of Com. News, Jan. 30, 1985, at 1.

be incorporated and have an office outside the United States. The FSC also must be managed abroad and incur abroad a substantial amount of the direct cost of processing exports. These differences have caused a good deal of uncertainty among U.S. companies that now must switch to FSCs in order to enjoy tax incentives for their export activities.

I. DISCS AND THE GATT

The DISC was created by the 1971 Revenue Act.³ Under the DISC provision,⁴ a U.S. company could export its products through a subsidiary incorporated and operating in the United States. The DISC might be no more than a shell corporation that acted as a conduit for export earnings. The DISC was required to have a minimum capital of \$2,500 but otherwise needed no corporate substance.⁵ In general, the DISC was required to engage almost exclusively in export sales and related activities,⁶ but in reality, it was its parent company that did all the work.

The DISC itself was not subject to federal income tax.⁷ Originally, half its earnings were deemed to be distributed to its shareholders and taxed on a current basis. But tax on its remaining earnings could be deferred, usually indefinitely, by retaining those earnings within the DISC and using them for specified purposes. Later, the tax benefit was reduced by amendments that limited the deferral to 42.5 percent of DISC income in excess of a base period average income.⁸

In addition, the DISC benefited from special intercompany pricing rules that enabled more income to be attributed to the DISC (rather than to the parent) than would otherwise be permitted under the arm's-length pricing requirements of section 482 of the Internal Revenue Code (Code).⁹ The intercompany pricing rules provided two safe havens that enabled a DISC to earn on resales of export property supplied by its parent the greater of (a) four percent of the qualified export receipts on the resale of such property by the

3. Pub. L. No. 92-178, 85 Stat. 497 (1971).

4. I.R.C. §§ 991-997 (1982).

5. Rev. Rul. 72-166, 1972-1 C.B. 220.

6. I.R.C. § 992 (1982).

7. *Id.* § 991.

8. *Id.* § 995.

9. *See id.* § 994.

DISC or (b) fifty percent of the taxable income the DISC and its parent derived from the resale as determined on a consolidated basis with the DISC.¹⁰ In effect, some of the parent's earnings could thereby be attributed to the DISC and receive the benefits of tax deferral.¹¹

The DISC legislation was criticized both on economic grounds¹² and on the ground that the DISC tax deferral constituted a subsidy on exports in violation of the GATT.¹³

In 1973, the European Community filed a complaint under the GATT against the United States about the DISC.¹⁴ A GATT panel considered the matter in 1976 and concluded that "there was a *prima facie* case of nullification or impairment of the benefits which other contracting parties were entitled to expect under the General Agreement."¹⁵ Among other things, the Panel Report concluded that, while a tax deferral of indefinite length was not necessarily equivalent to a tax exemption, the DISC tax deferral was like an exemption in that the deferred tax was not subject to interest accrual. Moreover, the exemption was given to U.S. corporations that conducted no economic activities abroad.¹⁶ The Panel Report also expressed concern about the provisions for allocating export sales profits between the parent company and its DISC.¹⁷ From the GATT perspective, the result was a direct U.S. government subsidy for export transactions in clear violation of the GATT ideal of export neutrality.

For several years following the Panel Report, the GATT Council had the Panel Report under consideration. Their options were to accept, reject or qualify the Report. Eventually, an arrangement was reached by which the complaints were disposed of without an official decision. Instead, the GATT Council issued the following statements that were intended to suggest ways in which the DISC

10. *Id.* § 994(a)(1), (2).

11. See Anninger, *DISC and GATT: International Trade Aspects of Bringing Deferral Home*, 13 HARV. INT'L L.J. 391, 399 (1972).

12. See, e.g., Considine, *The DISC Legislation: An Evaluation*, 7 INT'L L. & POL. 217 (1974).

13. See, e.g., Anninger, *supra* note 11.

14. See Report of Panel to GATT Council, United States Tax Legislation (DISC), reprinted in 13 TAX NOTES (CCH) No. 21, at 1251 (Nov. 23, 1981).

15. *Id.* at 1258.

16. See *id.*

17. See *id.*

program could be reformed to make it compatible with the GATT: (1) the GATT does not require its signatories to tax economic activity that takes place outside their territorial limits, (2) the GATT does not prohibit the adoption of measures designed to prevent the double taxation of export earnings and (3) the GATT requires the use of arm's-length pricing in connection with the taxation of export transactions.¹⁸

II. FSC PROVISIONS

In an effort to meet the GATT guidelines, the Tax Reform Act (Act) provides that a FSC be incorporated and managed and engage in substantial economic activities outside the United States. In addition, more restrictive intercompany pricing rules have been established.

Special provisions are provided for small export operations. These provisions permit "small" FSCs to avoid the need to be managed and to conduct economic processing outside the United States. In addition, the Act establishes an "interest-charge" DISC that may defer taxes on a large proportion of its income but must pay an interest charge on such deferred amounts.

Because the FSC provisions require certain activities that used to be performed within the United States through the DISC to be performed outside the United States through the FSC, the Act and the regulations promulgated thereunder contemplate that many of the FSC's activities will be performed through agents specially engaged to service the FSC. In fact, a new industry has arisen to perform these activities outside the United States and provide other services to FSCs for a fee.

A. THE FSC TAX BENEFITS

If the FSC buys from independent suppliers or uses arm's-length pricing in purchases from a related supplier, thirty percent of its income from qualified trading transactions will be exempt from U.S. corporate income tax if the FSC has one or more corporate shareholders; otherwise, thirty-two percent will be exempt.¹⁹

18. See 138 TAX NOTES (CCH) No. ____, at 1149 (Nov. 9, 1981).

19. Tax Reform Act of 1984, Pub. L. No. 98-369, Title VIII, § 801, 98 Stat. 494, 986 (to be codified at I.R.C. § 923(a)(2)) [hereinafter cited as I.R.C. (West Supp. 1985)]. The 1985 supplements to the U.S.C.A. are due in April, 1985.

If the FSC does not use arm's-length pricing in purchases from a related supplier, the FSC must use so-called administrative pricing rules. These rules require the FSC to impute a transfer price to the purchased item that results in the FSC deriving taxable income from the resale of the item equal to the greater of (a) 1.83 percent of the gross receipts it derives from the resale or (b) twenty-three percent of the taxable income that its parent derives from the sale of the item as determined on a consolidated basis with the FSC.²⁰ Of that taxable income, 15/23rds is exempt if the FSC has one or more corporate shareholders; otherwise, 16/23rds is exempt.²¹ The FSC need not retain its profits in order to obtain these tax benefits.

Moreover, a domestic corporation will generally be allowed a one hundred percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to non-exempt foreign trade income if the FSC uses administrative pricing rules. As a result, such a FSC's non-exempt foreign trade income will be taxed only once (at the FSC level), and, as indicated, exempt foreign trade income will not be taxed at the corporate level at all. On the other hand, if the FSC has not used administrative pricing rules or if the shareholder is not a corporation, dividends attributable to non-exempt income are taxed at both the FSC and shareholder levels.²²

B. APPROVED FSC HOST COUNTRIES

A FSC must be organized under the law of, and maintain an office in, a country that either is a U.S. possession (other than Puerto Rico) or has entered into an agreement to exchange certain information as authorized under the Caribbean Basin Economic Recovery Act or a bilateral income tax treaty that the Treasury Department has certified for purposes of the FSC legislation.

On November 6, 1984, the Treasury Department released a list of treaty countries that have been certified as eligible FSC hosts.²³ They are as follows:

20. I.R.C. § 925 (West Supp. 1985).

21. *Id.* §§ 291(a)(4), 923(a)(3).

22. *Id.* §§ 245(c), 926.

23. *See* 49 Fed. Reg. 44,844 (1984).

Australia	Korea
Austria	Malta
Belgium	Morocco
Canada	Netherlands
Denmark	New Zealand
Egypt	Norway
Finland	Pakistan
France	Philippines
Germany	South Africa
Iceland	Sweden
Ireland	Trinidad & Tobago
Jamaica	

All the U.S. possessions—Guam, the U.S. Virgin Islands, American Samoa and the Northern Mariana Islands—offer special tax and other incentives to attract FSCs. Many of the certified treaty countries have also adopted special incentives to attract FSCs.

C. ESTABLISHING A FSC

To meet the threshold definition of a FSC, a corporation must meet the following five criteria:²⁴

(1) *Foreign incorporation.* The FSC must be a corporation organized under the laws of one of the foreign countries or U.S. possessions mentioned above. Temporary regulations promulgated by the Internal Revenue Service (IRS) provide that a "corporation" may be an association or joint-stock company (but not an insurance company).²⁵

(2) *Foreign office.* The FSC must maintain an office in one of the foreign countries or U.S. possessions mentioned above. Normally this will be (but need not be) the place of incorporation. Permanent books of account must be maintained at the foreign office, including at least quarterly income statements, an annual balance sheet and copies of invoices.

The temporary regulations provide that such an office must have a fixed location, consist of at least one room, be supplied with

24. I.R.C. § 922 (West Supp. 1985).

25. See FSC General Rules, Requirements, Definitions, and Special Rules, 49 Fed. Reg. 48,283, 48,288 (1984) (to be codified at 26 C.F.R. § 1.922-1(c)) (proposed to be made final, 49 Fed. Reg. 48,322 (1984)).

communication services and be equipped to maintain permanent books of account. The office must be regularly used for some business activity of the FSC and must be operated and owned or leased by the FSC (or an agent for the FSC). If these requirements are met, the office may also be used for activities unrelated to the business of the FSC.²⁶ The records required to be kept in the office, including copies of invoices, may be kept in magnetic form for use in a data processing system.²⁷ The regulations permit a FSC service organization to provide an office, storage for necessary records and economic processing services for a number of FSCs out of one location.

(3) *No more than twenty-five shareholders.* The FSC may have up to twenty-five individual or corporate shareholders (not counting directors' qualifying shares).

(4) *No preferred stock.* The FSC may have no outstanding preferred stock at any time during the year but may have multiple classes of common stock for business (not tax avoidance) reasons. As an example of tax avoidance, the temporary regulations cite the use of separate classes of common stock to direct dividends from exempt foreign trade income to shareholders with taxable income and dividends from non-exempt income to shareholders with net operating loss carryovers. In such a case, the IRS will disregard the differences in rights between the two classes.²⁸

(5) *Foreign director.* At all times during the year, the FSC must have at least one director that is a nonresident of the United States. The director may be a nonresident U.S. citizen and need not be a resident of the country of incorporation. The temporary regulations provide that if the only nonresident director resigns or dies, the FSC may appoint a new nonresident director within thirty days without losing FSC status. This obviates the need for the FSC to have more than one director that is a nonresident of the United States.²⁹

(6) *FSC election.* In addition to meeting the foreign organization requirements, the corporation must elect to be treated as a

26. *Id.* § 1.922-1T(h).

27. *Id.* § 1.922-1T(i).

28. *Id.* § 1.922-1T(g).

29. *Id.* § 1.922-1T(j).

FSC within ninety days of the beginning of its first taxable year.³⁰ All shareholders must consent to the FSC's election. If the corporation fails to meet the requisite organizational criteria in any one year, it loses its FSC tax benefits for that year. The election is automatically terminated if the corporation does not meet the qualifying criteria for five consecutive tax years.³¹

D. MANAGING THE FSC OUTSIDE THE UNITED STATES

Once established, the FSC is entitled to FSC tax benefits only for the years in which the FSC (unless the FSC is a small FSC) is managed outside the United States. The FSC fulfills this requirement if it meets the following three criteria:³²

(1) *Meetings.* All formal meetings of the shareholders and the board of directors must be held outside the United States. These meetings need not be in the place of incorporation, but they must comply with the local business laws of the country of incorporation determining such matters as quorum requirements or the use of proxies.³³ The location of a meeting is determined by the location of persons exercising a majority of the voting power participating in a meeting.³⁴

(2) *Bank account.* The principal bank account of the FSC must be maintained outside the United States at all times during the year. The temporary regulations provide that the bank account may be maintained in a U.S. banking organization, so long as it is maintained in a branch outside the United States. Instructions providing for deposit into or disbursement out of the account may originate within the United States without violating the requirement. In addition, an account fulfills the requirement even if it has a zero balance for some days during the year.³⁵

(3) *Disbursements.* All dividends, legal and accounting fees and salaries of officers and directors must be disbursed out of bank ac-

30. I.R.C. § 927(f) (West Supp. 1985). See 49 Fed. Reg. 40,011, 40,014 (1984) (to be codified at 26 C.F.R. § 1.921-1T(b)(1)).

31. I.R.C. § 927(f)(3)(B) (West Supp. 1985).

32. *Id.* § 924(c).

33. Foreign Management and Foreign Economic Processes Requirements of a Foreign Sales Corporation, 49 Fed. Reg. 48,273, 48,275 (1984) (to be codified at 26 C.F.R. § 1.924(c)-1T(b)) (proposed to be made final, 49 Fed. Reg. 48,321 (1984)) [hereinafter cited as Temporary FSC Rules (Management and Processing)].

34. *Id.*

35. *Id.* § 1.924(c)-1T(c).

counts maintained outside the United States. The temporary regulations require that these amounts be paid from the principal bank account of the FSC described above.³⁶

E. TRANSACTIONS QUALIFYING FOR THE FCS TAX BENEFIT

FSC tax benefits are available only for qualified foreign trading transactions.³⁷ To qualify as a foreign trading transaction for these purposes, the transaction must consist of (1) the sale, exchange or other disposition of export property, (2) the lease or rental of export property for use by a lessee outside the United States, (3) the rendering of services related to such sales or leases, (4) the rendering engineering or architectural services for construction projects located outside the United States or (5) the rendering of managerial services for an unrelated FSC so long as at least fifty percent of the gross receipts of the FSC that renders such services are derived from its own sales or leases of export property and the rendering of related services.

F. FOREIGN ECONOMIC PROCESSING

To receive FSC tax benefits, "economic processes" with respect to qualifying transactions must take place outside the United States (unless the FSC is a small FSC).³⁸ This requirement has two parts: (1) the FSC must participate outside the United States in the solicitation (other than advertising), negotiation or the making of the contract related to the transaction; *and* (2) a substantial amount of the direct costs incurred by the FSC with respect to five activities relating to the disposition of export property must be attributable to activities outside the United States.

The second part of this requirement may be met by incurring outside the United States either (a) at least fifty percent of the aggregate direct costs of five prescribed activities or (b) at least eighty-five percent of the direct costs of each of any two of the five activities.

These five activities are:

- (i) advertising and sales promotion;

36. *Id.* § 1.924(c)-1T(d).

37. I.R.C. § 924 (West Supp. 1985).

38. *Id.* § 924(d).

- (ii) processing of customer orders and arranging for delivery of the export property;
- (iii) transportation from the time of acquisition by the FSC to delivery to the customer;
- (iv) determining, transmitting and receiving payment for a final invoice or statement of account; and
- (v) the assumption of credit risk.

The FSC may meet these requirements by having these activities performed outside the United States by a person acting under contract to the FSC.

Under the temporary regulations, the location of the activity is generally determined by the place where the activity is initiated by the FSC (or contractor) and not by the location of any person transmitting instructions to the FSC (or contractor).³⁹

1. *Solicitation, Negotiation or Making the Sale*

For purposes of the foreign economic processing requirement, the temporary regulations define "solicitation (other than advertising)" as any communication to a specific, targeted customer during the twelve months immediately preceding the execution of a contract that specifically addresses the customer's attention to the product covered by the transaction. "Negotiation" is defined to mean a communication to the customer of the terms of a transaction, but does not include mere receipt of an order that includes the terms of the sale. "Making a contract" includes making or accepting an offer. A written confirmation by the FSC that confirms variable contract terms or specifies additional terms is within the definition of "making a contract."⁴⁰

2. *The Direct Costs of Disposing of Export Property*

"Direct costs" are defined in the temporary regulations as those costs that are "incident to and necessary for" the performance of one of the listed activities. Such costs may include the cost of materials, labor, equipment and facilities associated directly with the activity but not the cost of overhead, administrative or supervisory expenses.⁴¹

39. Temporary FSC Rules (Management and Processing), *supra* note 33, § 1.924(d)-1T(a).

40. *Id.* § 1.924(d)-1T(c).

41. *Id.* § 1.924(d)-1T(d)(2).

Direct costs that relate to more than one activity may be attributed to each activity in any manner that is consistently applied and that reasonably reflects the relative cost that would be incurred by performing each activity independently. Similarly, if the costs of an activity are attributable to more than one transaction, the costs may be allocated among the transactions in any manner that is consistently applied and that reasonably reflects the relative cost that would be incurred by performing the activity independently with respect to each transaction.⁴²

To use the fifty percent test, the FSC must incur direct costs in each of at least three of the five categories of activities; otherwise, it must use the eighty-five percent test. All categories of activities in which any foreign direct costs are incurred are aggregated under the fifty percent test.⁴³

For purposes of these requirements, transactions may be grouped according to, for example, product line, customer or contract.⁴⁴

"Advertising" is defined to include only communication in some mass medium. It does not include communications intended solely to build a favorable image of the company or communications directed primarily at customers in the United States. The location of advertising is the location to which the information is conveyed to potential customers.⁴⁵

"Processing of customer orders" is defined as notification to the supplier of the existence of the order and the requirements for delivery. "Arranging for delivery" includes communications with the freight forwarder or carrier to arrange transportation for the export property and communications with the customer to notify it of the time and place of delivery. It does not include packaging for shipment or transportation costs.⁴⁶

"Transportation" includes shipping costs only during the period in which the FSC owns the export property or is in a commission relationship with respect to the export property.⁴⁷

42. *Id.*

43. *Id.* § 1.924(d)-1T(d)(5).

44. *Id.* § 1.924(d)-1T(e).

45. *Id.* § 1.924(e)-1T(a).

46. *Id.* § 1.924(e)-1T(b).

47. *Id.* § 1.924(e)-1T(c).

"Determination and transmittal of a final invoice or statement of account" means the assembly of the invoice or statement and the forwarding of the document to the customer. "Receipt of payment" is the crediting of the proceeds of the transaction to the FSC's bank account. The FSC will be considered to have received payment outside the United States if funds paid directly to a related supplier are transferred to the FSC's foreign account within five business days.⁴⁸

The direct costs of the "assumption of credit risk" include uncollectible debts and additions to bad debt reserves, the cost of insurance against the risk of nonpayment (but only if obtained from an unrelated insurer) and the cost of letters of credit. If the FSC bears the risk of loss itself, it is considered to have performed this activity with respect to a group of transactions if it incurs an actual bad debt loss on any transaction in that group in at least one of three consecutive years.⁴⁹

III. INCENTIVES FOR SMALL EXPORTERS

A. SMALL FSCS

A corporation may elect to be treated as a small FSC, so long as no regular FSC is a member of the same controlled group of corporations. A small FSC (or all small FSCs that are members of the same controlled group of corporations) is limited to receiving tax benefits on no more than five million dollars of foreign trade income. Small FSCs need not be managed outside the United States or engage in economic processing outside the United States.⁵⁰

B. INTEREST-CHARGE DISCS

Small exporters may opt to defer taxes on up to ten million dollars in export income annually by continuing to export through a new type of DISC, the "interest-charge DISC."⁵¹ As all DISCs are automatically deemed to revoke their election as of December 31, 1984, the exporter must elect to be an interest-charge DISC in the same manner as it would elect to be a FSC.⁵² A controlled group

48. *Id.* § 1.924(e)-1T(d).

49. *Id.* § 1.924(e)-1T(e).

50. I.R.C. §§ 922(b), 924(b)(2) (West Supp. 1985).

51. *Id.* § 995(b)(1)(F).

52. Transition Rules for DISCs and FSCs, 49 Fed. Reg. 40,011, 40,014 (1984) (to be codified at 26 C.F.R. § 1.921-1T(b)(1)) [hereinafter cited as Transition Rules].

of corporations may not include both an interest-charge DISC and a FSC.⁵³ The interest-charge DISC will be deemed to distribute only one-seventeenth (rather than one-half) of its income each year, allowing it to defer taxes on 16/17ths of its income.⁵⁴ However, it must pay to the Treasury an annual interest charge (based on the Treasury bill rate) on deferred tax amounts.⁵⁵ The annual charge is deductible as interest. This provision is designed to comply with GATT rules allowing tax deferrals for domestic corporations as long as an appropriate rate of interest is charged.

IV. INTERNATIONAL BOYCOTTS AND ILLEGAL PAYMENTS

The Code provides that regulations shall be issued that bar FSC benefits for FSCs that agree to participate in international boycotts, as determined under section 999 of the Code, or make illegal payments, as determined under section 162(c) of the Code.⁵⁶ While such regulations have not yet been issued, they are expected to be similar to existing DISC-related provisions, which require that DISC shareholders be deemed to receive a distribution taxable as a dividend as a consequence of agreeing to participate in international boycotts or making illegal payments.

V. TRANSITION FROM DISC TO FSC

The Internal Revenue Service has published temporary regulations relating to transition rules for DISCs and FSCs.⁵⁷ Under the transition rules, the 1984 taxable year for all DISCs will be deemed to terminate on December 31, 1984, and all DISC elections will be deemed to be revoked as of that date.⁵⁸ Corporations that qualify as DISCs on December 31, 1984, may treat their accumulated DISC income as previously taxed income; therefore, this income may be distributed to shareholders tax free after that date.⁵⁹ In addition, deemed distributions for the last taxable year of the DISC may be

53. I.R.C. § 992(a)(1)(E) (West Supp. 1985).

54. *Id.* § 995(b)(1)(F).

55. *Id.* § 995(f).

56. *Id.* § 927(e)(2).

57. *See* Transition Rules, *supra* note 52.

58. *Id.* § 1.921-1T(a)(1).

59. *See* Tax Reform Act of 1984, Pub. L. No. 98-369, Title VIII, § 805(b)(2), 98 Stat 484, 1001; Transition rules, *supra* note 52, § 1.921-1T(a)(6).

taken into income by the DISC's shareholders in equal installments over a ten-year period where the taxable years of the DISC and the parent do not coincide.⁶⁰

A parent that wishes to change its DISC or Export Trade Corporation (ETC) to a FSC must elect FSC treatment within ninety days of the beginning of the FSC's first taxable year.⁶¹ Because the FSC is required to adopt the same tax year as its principal shareholder, the temporary regulations permit the FSC to close its first taxable year so as to conform to that of its parent.⁶²

A DISC or an ETC may transfer certain of its assets to a FSC without incurring tax liability under section 367 of the Code, which otherwise would require a United States person transferring assets to a foreign corporation to establish that the transfer is not for tax-avoidance purposes. To qualify for exemption from section 367, the assets must have been held by the DISC or ETC on August 4, 1983, and must be transferred to the FSC before January 1, 1986, in a transfer that would qualify for nonrecognition under Subchapter C of Chapter 1 of the Internal Revenue Code⁶³ (or that would so qualify but for section 367 of the Code).⁶⁴ Such nonrecognition transfers include the liquidation of a DISC into the parent, followed by a transfer of those assets to a FSC, and reorganizations through an exchange of stock or securities or an exchange of property for stock or securities. Other provisions of Subchapter C, such as provisions determining basis and carryovers, also apply.⁶⁵

VI. FSCS AND THE GATT

It is an open question whether the FSC provisions meet all the objections made under the GATT concerning DISCs, or whether any GATT signatory will raise objections to the FSC. In January of 1985, the United States agreed to consultations with GATT signatories and the European Community to explore whether the

60. See Tax Reform Act of 1984, Pub. L. No. 98-369, Title VIII, § 805(b)(3), 98 Stat. 494, 1002; Transition Rules, *supra* note 52, § 1.921-1T(a)(10), amended by Installment Treatment of Certain Deemed Distributions to DISC Shareholders, 49 Fed. Reg. 48,282, 48,283 (1984).

61. Transition Rules, *supra* note 52, § 1.921-1T(b)(1).

62. *Id.* § 1.921-1T(b)(4).

63. I.R.C. § 301-385 (1982).

64. Transition Rules, *supra* note 52, § 1.921-1T(b)(7), (c)(5).

65. *Id.*

FSC provisions are consistent with the informal guidelines issued by the GATT Council in 1981.⁶⁶ Questionable provisions may include the administrative pricing rules, which, while less favorable than the DISC safe-harbor rules, do not require strict arm's-length pricing in transactions between related companies.⁶⁷ These rules are "intended to approximate arm's-length pricing."⁶⁸ Further, small FSCs may benefit from the tax exemption even if they do no economic processing outside the United States. Perhaps most important, although the United States argued to the GATT Council that the DISC tax deferral was not an exemption, the transition rules provide that all accumulated DISC income may be treated as previously taxed and distributed tax-free to DISC shareholders. This rule is expected to produce approximately \$11 billion in tax savings for U.S. corporations that previously had DISCs.⁶⁹

VII. CONCLUSION

The FSC legislation and regulations are quite complex and extremely technical in nature. They require careful attention to the precise form that the export transaction takes, as well as careful record-keeping with respect to the location and costs of various aspects of the transaction. The objective is to reduce the tax on exports; hitting the target will tax the ingenuity of lawyers and accountants alike.

66. Inside U.S. Trade, Feb. 1, 1985.

67. I.R.C. § 925 (West Supp. 1985).

68. Report of Senate Finance Committee, Apr. 2, 1984, reprinted in *TAX REFORM ACT OF 1984—LAW & CONTROLLING COMMITTEE REPORTS (CCH)* ¶ 2285, at 1110.

69. Inside U.S. Trade, Feb. 1, 1985, at 5, 6.