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LEVETT ROCKWOOD
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NEWSLETTER
A Courtesy To Our Clients and Friends
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Tax Benefits for Exporters Continue Despite World Trade Organization Objections

For many years U.S. businesses with foreign sales have been able to receive certain tax benefits under the Foreign Sales Corporation ("FSC") program. In response to a finding by the World Trade Organization ("WTO") that the FSC program provides U.S. companies with unfair export subsidies, the United States developed a new program, the Extraterritorial Income ("ETI") exclusion, that is intended to do three things: (i) address the WTO's objections, (ii) simplify the record-keeping requirements of the FSC program, and (iii) enable U.S. businesses with foreign sales to continue to receive certain tax benefits.

Unfortunately, the WTO recently ruled that the ETI exclusion, like the FSC program, constitutes a prohibited export subsidy. The Bush Administration is expected to move to appeal the ruling. In the meantime, the ETI program remains available to benefit U.S. and certain foreign corporations, partnerships and individuals.

Key Features of ETI Exclusion

Who qualifies? Under the ETI exclusion rules, U.S. exporters who sell qualified property and have the appropriate level of foreign activity generally receive a 5.25% federal tax reduction on eligible ETI. This exclusion is available to *all* taxpayers who sell, lease or rent property outside the U.S., rather than just C corporations as was the case under the FSC program.

What's covered? The ETI exclusion applies to gross income, not net income or taxable income. However, it is available only for "qualifying foreign trade income," which generally means taxable income of the taxpayer attributable to receipts from foreign trade property if not more than 50% of the fair market value of such property is attributable to foreign articles and direct costs for labor. (Only property that is largely U.S.-made will qualify.)

Transaction-by-Transaction Option. Taxpayers are able to choose whether to apply the ETI exclusion to particular transactions, or alternatively to take advantage of the foreign tax credit provisions. As with the FSC program, certain activities associated with the transaction must occur outside the U.S. Until regulations are promulgated, the foreign economic process requirements of the FSC program may be used as guidelines.

Election. U.S.-controlled foreign corporations can elect to be taxed as U.S. corporations, provided they waive applicable treaty benefits. In such cases, no deduction will be allowed for expenses apportioned to ETI and no foreign tax credit is allowed for excluded ETI. A foreign corporation is eligible to make such an election if it is actively engaged in manufacturing or production activities and substantially all of its income is derived from foreign trade gross receipts.

Phase-Out of FSC. Initial FSC elections may no longer be filed. A transition rule allows existing FSCs to elect either to continue under the FSC program until December 31, 2001 or to begin using the ETI exclusion provisions after September 30, 2000. FSC benefits will still apply to transactions in the ordinary course of business occurring after December 31, 2001, provided that (i) sales are pursuant to a contract between a FSC and an unrelated party, (ii) the contract was in effect on September 30, 2000, and (iii) the contract continues to be in effect.

Recommendations

Taxpayers who currently use a FSC should be prepared for the FSC phase-out on December 31, 2001. It is important to decide before then whether a FSC will be continued or dissolved, and whether an election should be made to begin using the new ETI exclusion.

If you would like us to assist you in planning for the FSC phase-out or for the most tax-effective use of the ETI exclusion program for your business, please feel free to contact Cheryl L. Johnson or Mary Chang of our office at (203) 222-0885 or *cjohnson@levettrockwood.com* or *mchang@levettrockwood.com*.

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