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Q–5: Under what circumstances may an electing ETC transfer its assets to a FSC without incurring any tax liability on the transfer?

A–5: An electing ETC will recognize no income, gain, or loss on a transfer of its assets to a FSC but only if all of the following conditions are met:

(i) The assets transferred were held by the ETC on August 4, 1983, and were transferred by the ETC to the FSC in a transfer completed before January 1, 1986; and

(ii) The assets are transferred in a transaction which would qualify for nonrecognition under subchapter C of chapter 1 of the Code, or would so qualify but for section 367 of the Code.

In such case, section 367 shall not apply to the transfer. In addition, other provisions of subchapter C will apply to the transfer such as section 358 (basis to shareholders), section 362 (basis to corporation) and section 381 (carryovers in corporate acquisitions). In determining whether a transfer by an ETC to a FSC qualifies for nonrecognition under subchapter C, a liquidation of the assets of the ETC into a parent corporation followed by a transfer by the parent of those assets to the FSC will be treated as a transaction described in section 368(a)(1)(D).

(Secs. 803 and 805 of the Tax Reform Act of 1984 (98 Stat. 1001) and sec. 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805); sec. 805 (b)(3)(C) and (D) of the Tax Reform Act of 1984 (98 Stat. 1002), and sec. 7805 of the Code (68A Stat. 917; 26 U.S.C. 7805); secs. 367, 927, and 7805 of the Internal Revenue Code of 1954 (98 Stat. 662, 26 U.S.C. 367; 98 Stat. 663, 26 U.S.C. 367; 98 Stat. 993, 26 U.S.C. 927; 98 Stat. 994, 26 U.S.C. 927; and 68A Stat. 917, 26 U.S.C. 7805); sec. 805 of the Tax Reform Act of 1984 (Pub. L. 98–69, 98 Stat. 1000))

[T.D. 7983, 49 FR 40013, Oct. 12, 1984, as amended by T.D. 7992, 49 FR 48283, Dec. 12, 1984; T.D. 7993, 49 FR 48291, Dec. 12, 1984; T.D. 7992, 49 FR 49450, Dec. 20, 1984; T.D. 8126, 52 FR 6434, 6435, Mar. 3, 1987; T.D. 8515, 59 FR 2984, Jan. 20, 1994; T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001]

§ 1.921–2 Foreign Sales Corporation—general rules.

(a) *Definition of a FSC and the Effect of a FSC Election.*

Q–1. What is the definition of a Foreign Sales Corporation (hereinafter referred to as a ''FSC'' (All references to FSCs include small FSCs unless indicated otherwise))?

A–1. As defined in section 922(a), an FSC must satisfy the following eight requirements.

(i) The FSC must be a corporation organized or created under the laws of a foreign country that meets the requirements of section 927(e)(3) (a ''qualifying foreign country'') or a U.S. possession other than Puerto Rico (an ''eligible possession''). See Q&As 3, 4, and 5 of § 1.922–1.

(ii) A FSC may not have more than 25 shareholders at any time during the taxable year. See Q&A 6 of § 1.922–1.

(iii) A FSC may not have any preferred stock outstanding during the taxable year. See Q&As 7 and 8 of § 1.922–1.

(iv) A FSC must maintain an office outside of the United States in a qualifying foreign country or an eligible possession and maintain a set of permanent books of account (including invoices or summaries of invoices) at such office. See Q&As 9, 10, 11, 12, 13, 14, and 15 of § 1.922–1.

(v) A FSC must maintain within the United States the records required under section 6001. See Q&A 16 of § 1.922–1.

(vi) The FSC must have a board of directors which includes at least one individual who is not a resident of the United States at all times during the taxable year. See Q&As 17, 18, 19, 20, and 21 of § 1.922–1.

(vii) A FSC may not be a member, at any time during the taxable year, of any controlled group of corporations of which an interest charge DISC is a member. See Q&A 2 of this section and Q&A 13, of § 1.921–1T(b)(13).

(viii) A FSC must have made an election under section 927(f)(1) which is in effect for the taxable year. See Q&A 1 of § 1.921–1T(b)(1) and § 1.927(f)–1.

In addition, under section 441(h), the taxable year of a FSC must conform to the taxable year of its principal shareholder. See Q&A 4 of § 1.921–1T(b)(4).

Q–2. Does the reference to a DISC under section 922(a)(1)(F) which provides that a FSC cannot be a member, at any time during the taxable year, of any controlled group of corporations of

which a DISC is a member refer solely to an interest charge DISC?

A–2. Yes.

(b) *Small FSC*.

Q–3. What is a small FSC?

A–3. A small FSC is a Foreign Sales Corporation which meets the requirements of section 922(a)(1) enumerated in Q&A 1 of this section as well as the requirements of section 922(b). Section 922(b) requires that a small FSC make a separate election to be treated as a small FSC. See Q&A 1 of §1.921–1T(b) and §1.927(f)–1. In addition, section 922(b) requires that the small FSC not be a member, at any time during the taxable year, of a controlled group of corporations which includes a FSC unless such FSC is a small FSC.

Q–4. What is the effect of an election as a small FSC?

A–4. Under section 924(b)(2), a small FSC need not meet the foreign management and economic processes tests of section 924(b)(1) in order to have foreign trading gross receipts. However, in determining the exempt foreign trade income of a small FSC, any foreign trading gross receipts for the taxable year in excess of $5 million are not taken into account. If the foreign trading gross receipts of a small FSC for the taxable year exceed the $5 million limitation, the FSC may select the gross receipts to which the limitation is allocated. In order to use the administrative pricing rules under section 925(a), a small FSC must satisfy the activities test under section 925(c). In addition, under section 441(h), the taxable year of a small FSC must conform to the taxable year of its principal shareholder (defined in Q&A 4 of §1.921–1T(b)(4) as the shareholder with the highest percentage of its voting power).

Q–5. What is the effect on a small FSC (or FSC) (''target'') if it is acquired, directly or indirectly, by a corporation if that acquiring corporation (''acquiring''), or a member of the acquiring corporation's controlled group, is a FSC (or small FSC)?

A–5. Unless the corporations in the controlled group elect to terminate the FSC (or small (FSC) election of the acquiring corporation, the target's small FSC's (or FSC's) taxable year and election will terminate as of the day preceding the date the target small FSC and acquiring FSC became members of the same controlled group. The target small FSC will receive FSC benefits for the period prior to termination, but the $5 million small FSC limitation will be reduced to the amount which bears the same ratio to the $5 million as the number of days in the short year created by the termination bears to 365. The due date of the income tax return for the short taxable year created by this provision will be the date prescribed by section 6072(b), including extensions, starting with the last day of the short taxable year. If the short taxable year created by this provision ends prior to March 3, 1987, the filing date of the tax return for the short taxable year will be automatically extended until the earlier of May 18, 1987 or the date under section 6072 (b) assuming a short taxable year had not been created by these regulations.

(c) *Comparison of FSC to DISC*.

Q–6. How does a FSC differ from a DISC?

A–6. A DISC is a domestic corporation which is not itself taxable while a FSC must be created or organized under the laws of a jurisdiction which is outside of the United States (including certain U.S. possessions) and may be taxable on its income except for its exempt foreign trade income. The DISC provisions enable a shareholder to obtain a partial deferral of tax on income from export sales and certain services, if 95 percent of its receipts and assets are export related. The FSC provisions contain no assets test, but a portion of income for export sales and certain services is exempt from U.S. taxes if the FSC satisfies certain foreign presence, foreign management, and foreign economic processes tests.

(d) *Organization of a FSC*.

Q–7. Under the laws of what countries may a FSC be organized?

A–7. A FSC may not be created or organized under the laws of the United States, a state, or other political subdivision. However, a FSC may be created or organized under the laws of a possession of the United States, including Guam. American Samoa, the Commonwealth of the Northern Mariana Islands and the Virgin Islands of the United States, but not Puerto Rico. These eligible possessions are located

outside the U.S. customs territory. In addition, a FSC may incorporate under the laws of a foreign country that is a party to—

(i) An exchange of information agreement that meets the standards of the Caribbean Basin Economic Recovery Act of 1983 (Code section 274(h)(6)(C)), or

(ii) A bilateral income tax treaty with the United States if the Secretary certifies that the exchange of information program under the treaty carries out the purpose of the exchange of information requirements of the FSC legislation as set forth in section 927(e)(3), if the company is covered under the exchange of information program under subdivision (i) or (ii). The Secretary may terminate the certification. Any termination by the Secretary will be effective six months after the date of the publication of the notice of such termination in the FEDERAL REGISTER.

(e) *Foreign Trade Income.*

Q–8. How is foreign trade income defined?

A–8. Foreign trade income, defined in section 923(b), is gross income of an FSC attributable to foreign trading gross receipts. It includes both the profits earned by the FSC itself from exports and commissions earned by the FSC from products and services exported by others.

(f) *Investment Income and Carrying Charges.*

Q–9. What do the terms ''investment income'' and ''carrying charges'' mean?

A–9.

(i) Investment income means:

(A) Dividends,

(B) Interest,

(C) Royalties,

(D) Annuities,

(E) Rents (other than rents from the lease or rental of export property for use by the lessee outside of the United States);

(F) Gains from the sale of stock or securities,

(G) Gains from future 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 transaction reasonably necessary to conduct the business of the FSC in the manner in which such business is customarily conducted by others),

(H) Amounts includable in computing the taxable income of the corporation under part I of subchapter J, and

(I) Gains from the sale or other disposition of any interest in an estate or trust.

(ii) Carrying charges means:

(A) Charges that are imposed by a FSC or a related supplier and that are identified as carrying charges, (''stated carrying charges'') and

(B)(*1*) Charges that are considered to be included in the price of the property or services sold by an FSC or a related supplier, as provided under Q&As 1 and 2 of §1.927(d)–1, and

(*2*) Any other unstated interest.

Q–10. How are investment income and carrying charges treated?

A–10. Investment income and carrying charges are not foreign trading gross receipts. Investment income and carrying charges are includable in the taxable income of an FSC, except in the case of a commission FSC where carrying charges are treated as income of the related supplier, and are treated as income effectively connected with a trade or business conducted through a permanent establishment within the United States. The source of investment income and carrying charges is determined under sections 861, 862, and 863 of the Code.

(g) *Small Businesses.*

Q–11. What options are available to small businesses engaged in exporting?

A–11. A small business may elect to be treated as either a small FSC or an interest charge DISC. See Q&As 3 & 4 of §1.921–2 relating to a small FSC. Rules with respect to interest charge DISCs are the subject of another regulations project.

[T.D. 8127, 52 FR 6469, Mar. 3, 1987]

§ 1.921–3T Temporary regulations; Foreign sales corporation general rules.

(a) *Exclusion*—(1) *Classifications of income.* The extent to which income of a FSC (any further reference to a FSC in this section shall include a small FSC unless indicated otherwise) is subject to the corporate income tax of section 11, or, in the alternative, section