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The Extra-Territorial Income Exclusion Act of 2000
— by Neil E. Harl*

The Extra-Territorial Income Exclusion Act of 2000,¹ which repealed the rules regarding Foreign Sales Corporations,² initially received little attention in the agricultural sector but has picked up steam as the potential tax benefits of the legislation effective September 30, 2000³ have become more widely known. Ironically, the 2000 legislation may be repealed in 2004⁴ under pressure from the World Trade Organization. On January 14, 2002, the WTO ruled that the 2000 legislation was “inconsistent with international trade agreements.”

The legislation applies to both individuals and corporations who are U.S. taxpayers and applies for individual and corporate alternative minimum tax purposes.⁵

The available exclusion

The 2000 legislation specifies that gross income does not include extra-territorial income⁶ to the extent that such income is “qualifying foreign trade income.”⁷ Extra-territorial income is defined as the gross income of the taxpayer attributable to foreign trading gross receipts of the taxpayer.⁸ Note that the taxpayer reports all of its extra-territorial income on its tax return with the exclusion then calculated from income for the portion eligible to be excluded.

“Qualifying foreign trade income” is the amount of gross income which, if excluded, would result in a reduction of taxable income by the greatest of—(1) 15 percent of foreign trade income, (2) 1.2 percent of foreign trading gross receipts or (3) 30 percent of foreign sale and lease income.⁹

“Foreign trade income” is taxable income attributable to foreign trade gross receipts.¹⁰ For cooperatives that are engaged in the marketing of agricultural or horticultural products, in computing taxable income of the cooperative deductions allowed¹¹ for patronage dividends, per-unit retain allocations and non-patronage distributions are not taken into account.¹² For agricultural or horticultural cooperatives, patronage dividends or per-unit retain allocations allocable to qualifying foreign trade income in a written notice mailed to patrons are treated as qualifying foreign trade income for the year.¹³

Under the legislation, the threshold for determining whether gross receipts are treated as foreign trading gross receipts is whether the gross receipts are derived from a transaction involving “qualified foreign trade property.”¹⁴ “Foreign trading gross receipts” are receipts derived from activities in connection with qualifying foreign trade property¹⁵ including the sale, exchange or other disposition of qualifying foreign trade property; the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; for services related to such sale or lease; for engineering or architectural services outside

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the United States; or for the performance of managerial services in the furtherance of the production of foreign trading gross receipts.\textsuperscript{16} It is important to note that “foreign trading gross receipts” does not include receipts of a taxpayer arising from a transaction if the property or services are for ultimate use in the United States\textsuperscript{17} or the transaction is accomplished by a subsidy granted by the government of a country (or instrumentality of the country) in which the property is manufactured, produced, grown or extracted.\textsuperscript{18}

Property is considered qualifying foreign trade property if three requirements are met—(1) the property must be manufactured, produced, grown or extracted within the United States (or outside the U.S. if certain conditions are met), (2) the property must be sold for sale, lease or rental in the ordinary course of a trade or business for direct use, consumption or disposition outside the United States and (3) no more than 50 percent of the fair market value of the property may be attributable to (a) articles manufactured, produced, grown or extracted outside the United States and (b) direct costs for labor performed outside the United States.\textsuperscript{19} Some types of property cannot be qualifying foreign trade property—(1) property leased or rented for use by a related party; (2) patents, inventions, certain copyrights, goodwill, trademarks, trade brands, franchises or like property; (3) oil and gas; (4) any unprocessed timber which is a softwood; and (5) any property that has been designated as in short supply by executive order (so long as the executive order remains in effect).\textsuperscript{20}

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.\textsuperscript{21} The instructions to Form 8873 require that the cost of goods sold allocated to foreign trading gross receipts be calculated.\textsuperscript{22} The deductions, other than those included in figuring cost of goods sold, must also be calculated (this would appear to include Schedule F deductions).\textsuperscript{23}

“Foreign sale and lease income” is foreign trade income that is allocable to transactions in which a person (or person acting under contract with the taxpayer) has participated outside the United States in the solicitation, negotiation or making of the contract relating to the transaction or activities that include advertising and sales promotions, processing of customer orders or arranging for delivery, transportation outside the United States in connection with delivery to a customer, the determination or final transmittal of a final invoice or statement of account or the receipt of payment and the assumption of credit risk.\textsuperscript{24} However, these requirements are considered met if the foreign trading gross receipts of the taxpayer for the year do not exceed $5,000,000.\textsuperscript{25}

Evidence of “foreign trading gross receipts”

A major issue is whether a taxpayer’s commodities must have actually been exported or whether the proportion of a purchaser’s commodities that are exported can be attributed to the taxpayer. The limitation on claiming the exclusion if the “ultimate use [is] in the United States”\textsuperscript{26} suggests that the taxpayer’s commodities must have been actually exported, not merely sold to a purchaser that exports, although that is not clear. The Senate Finance Committee Report on the 2000 legislation states that “... 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.”\textsuperscript{27} Neither the Internal Revenue Service nor the Department of the Treasury has provided guidance on the message or messages that language is supposed to convey.

Returns

Taxpayers claim the extra-territorial income exclusion on Form 8873 which must be attached to the taxpayer’s tax return for the year. The instructions to Form 8873 are helpful in working through the form itself.

FOOTNOTES

\footnotesize{2} I.R.C. § 921-927, repealed by the Extra-Territorial Income Exclusion Act of 2000, note 1 supra.
\footnotesize{3} Extra-Territorial Income Exclusion Act of 2000, Sec. 5(a), note 1 supra.
\footnotesize{6} I.R.C. § 114(a), added by Pub. L. No. 106-519, Sec. 3(a).
\footnotesize{7} See I.R.C. § 114(b).
\footnotesize{8} I.R.C. § 114(c).
\footnotesize{9} I.R.C. § 941(a)(1).
\footnotesize{10} I.R.C. § 941(b)(1).
\footnotesize{11} See I.R.C. § 1382(b), (c).
\footnotesize{12} I.R.C. § 941(b)(2).
\footnotesize{13} I.R.C. § 941(g).
\footnotesize{15} I.R.C. § 942(a).
\footnotesize{16} I.R.C. § 942(a)(1).
\footnotesize{17} I.R.C. § 942(a)(2)(A).
\footnotesize{18} I.R.C. § 942(a)(2)(B).
\footnotesize{19} I.R.C. § 943(a).
\footnotesize{20} I.R.C. § 943(a)(3).
\footnotesize{22} Instructions to Form 8873, page 4.
\footnotesize{23} Id.
\footnotesize{24} I.R.C. § 942(b)(3).
\footnotesize{25} I.R.C. § 942(c)(1).
\footnotesize{26} I.R.C. § 942(a)(2)(A).