American University International Law Review

Volume 6 | Issue 2 Article 5

1991

The Delaware Shared Foreign Sales Corporation Assistance Program: An Incentive for Small Exporters

Brian Condon

Follow this and additional works at: http://digitalcommons.wcl.american.edu/auilr

Part of the International Law Commons

Recommended Citation
Condon, Brian. "The Delaware Shared Foreign Sales Corporation Assistance Program: An Incentive for Small Exporters." American University International Law Review 6, no. 2 (1991): 251-270.

This Article is brought to you for free and open access by the Washington College of Law Journals & Law Reviews at Digital Commons @ American University Washington College of Law. It has been accepted for inclusion in American University International Law Review by an authorized administrator of Digital Commons @ American University Washington College of Law. For more information, please contact fbrown@wcl.american.edu.

COMMENT

THE DELAWARE SHARED FOREIGN SALES CORPORATION ASSISTANCE PROGRAM: AN INCENTIVE FOR SMALL EXPORTERS

Brian Condon*

INTRODUCTION

Exports play a crucial role in the health of the United States economy. For example, the share of merchandise exports in the Gross National Product (GNP), which in 1988[1] represented two-thirds of all current account transactions by the United States, was 7.4% in 1987.[2] Merchandise exports increased to 8.6% of the GNP in 1988.[3] In 1987, exports accounted for 14.3 cents of every dollar of all goods produced

* J.D. Candidate, 1991, Washington College of Law, The American University.

1. INTERNATIONAL TRADE ADMIN., DEPARTMENT OF COMMERCE, UNITED STATES TRADE PERFORMANCE IN 1988, at 13 (1989) [hereinafter UNITED STATES TRADE PERFORMANCE IN 1988]. In 1988, investment income accounted for 20% of current account transactions, while exported business services only represented approximately 11%. *Id.* During the 1980s, exported business services were only about 30% as large as merchandise exports. *Id.* at 40. The fact that the $148.6 billion decline in the manufactures trade balance between 1981 and 1987 was more than the $129.8 billion decrease in the total merchandise trade imbalance during the same period demonstrates the importance to the overall merchandise trade balance. *Id.* at 18.

2. *Id.* at 6. Merchandise exports' importance to the American economy, as measured by their share of the GNP, increased near the end of the 1980s. In 1970, merchandise exports held only a 2% share of the GNP. *Id.* That figure climbed to only approximately 5.5% by 1979. *Id.*

Merchandise trade is comprised of four major categories—manufactures, mineral fuels, agricultural products, and other goods. *Id.* at 15. In 1988, manufactures represented 79% of the $321.8 billion in American exports. *Id.* The manufactures trade deficit for 1988 accounted for almost 90% of the overall merchandise trade deficit. *Id.* at 16. This demonstrates the importance of manufactures to the improvement of the merchandise trade deficit. *Id.*

3. *Id.* at 6.

in the United States.[4] Exports clearly were a vital component in growth in GNP that occurred during the latter part of the 1980s.[5]

In addition to bolstering the GNP, United States export firms provide a substantial source of employment in the United States,[6] particularly in the manufacturing[7] and agricultural[8] economic sectors. In 1987, every $1 billion of merchandise exports sustained 22,800 jobs.[9] Small and medium sized firms[10] comprise the majority of these export firms.[11] The amount of each firm's exported output is not significant.[12]

---

4. Note, *U.S. Government Export Incentives for Small Business*, 22 INT'L LAW. 791 (1988) [hereinafter *Export Incentives*]. In 1984, an estimated 20 cents of every dollar of American manufacturing output was linked to exports. INTERNATIONAL TRADE ADMIN., DEPARTMENT OF COMMERCE, UNITED STATES TRADE PERFORMANCE IN 1984 AND OUTLOOK 3 (1985) [hereinafter UNITED STATES TRADE PERFORMANCE IN 1984].

5. *See* UNITED STATES TRADE PERFORMANCE IN 1988, *supra* note 1, at 6 (indicating that exports accounted for 29.3% of GNP growth in 1987 and 34.4% of GNP growth in 1988). This is in sharp contrast to 1982 when the export share of GNP was a negative 29.6%. *Id.*

6. *See id.* at 6 (noting that in 1987 export related jobs employed 6.2% of the United States' civilian work force). The term "export related jobs" refers to jobs directly and indirectly generated by exports. *Id.* at 63.

7. *See id.* at 65 (stating that one of every six manufacturing jobs is related to exports); Davis, *Exports Support Growing Number of U.S. Jobs*, BUS. AMERICA, May 8, 1989, at 16 (noting that for every 11 manufacturing jobs created in 1987, 10 jobs were correspondingly created in the service sector).

8. *See* UNITED STATES TRADE PERFORMANCE IN 1988, *supra* note 1, at 65 (noting that exports accounted for one of every seven jobs in the agricultural sector of the economy).

9. *See* Davis, *supra* note 7, at 14 (indicating that the initial statistics for 1988 project that each $1 billion of merchandise exports supported 21,900 jobs).

10. *See Small Business: Obstacles to Exporting: Hearings Before the Subcomm. on Exports, Tourism, and Special Problems of the House Comm. on Small Business*, 100th Cong., 2d Sess. 78-79 (1988) [hereinafter *Hearings*] (testimony of Michael Czinkota, Deputy Assistant Secretary for Trade Information and Analysis, Department of Commerce) (defining small and medium sized firms as those firms with less than 500 employees). *See also Obstacles Faced by Small Business in Obtaining Export Financing: Hearings Before the Subcomm. on Exports, Tax Policy, and Special Problems of the House Comm. on Small Business*, 101st Cong., 1st Sess. 8 (1989) [hereinafter *House Hearings*] (testimony of Leslie Stroh, publisher and editor of *The Exporter*) (declaring that a small firm is one that earns export sales of $250,000 or less every year).

11. *See Hearings*, *supra* note 10, at 37 (explaining that 50% of businesses that export from the United States have less than 100 employees and 79% employ less than 500 people); *House Hearings*, *supra* note 10, at 3 (indicating that 86.6% of American exporters earned an average of $216,000 in export sales in 1987). Almost 70% of American manufacturing facilities that export are small enterprises. INTERNATIONAL TRADE ADMIN., DEPARTMENT OF COMMERCE, U.S. MANUFACTURED EXPORTS AND EXPORT-RELATED EMPLOYMENT: PROFILES OF THE 50 STATES AND 35 SELECTED METROPOLITAN AREAS FOR 1984, at 128 (1988) [hereinafter U.S. MANUFACTURED EXPORTS] (defining a small manufacturing facility as one with 500 or fewer employees).

12. *See Hearings*, *supra* note 10, at 33 (discussing that small and medium sized firms export relatively little of their output). Forty percent of exporting small and me-

The Department of Commerce estimates that 2000 companies account for seventy percent of all exports from the United States.[13]

In the early 1970s, Congress recognized the importance of exports to the United States' economic performance.[14] It sought to establish a tax incentive to promote American exports.[15] Therefore, Congress enacted the Domestic International Sales Corporation (DISC) as part of the Revenue Act of 1971.[16] Unfortunately, some members of the General Agreement on Tariffs and Trade (GATT)[17] attacked DISCs complaining that the DISC was an illegal export subsidy.[18]

In response, Congress established the Foreign Sales Corporation (FSC) as part of the Deficit Reduction Act of 1984.[19] An FSC qualifies for a fifteen percent federal tax exemption on export earnings.[20] An FSC is an American export corporation that must be organized under the laws of a qualified foreign country or a possession of the United States, and take part in substantial economic processes outside the United States in order to qualify for the exemption on export earnings. Congress also provided that up to twenty-five unrelated exporters could

---

dium sized firms only export approximately one percent of their output. *Id.* Only 18% of small and medium sized firms that export, export greater than 10% of their output. *Id.* Only 17.5% of all the small manufacturing facilities in the United States exported 10% or more of their output in 1984. U.S. MANUFACTURED EXPORTS, *supra* note 11, at 128. Only about 8% of all such facilities exported 20% or more of their output in 1984. *Id.*

13. *Hearings*, *supra* note 10, at 33. The Department of Commerce estimates that 17% of all American manufacturers engaged in export activity in 1987. *Id.*

14. *See* McDonnell, *FSC: Fleecing the Small Company*, 29 TAX NOTES 531, 531 (1985) (explaining that the creation of the Domestic International Sales Corporation (DISC) was a reaction to the decreasing trade surpluses of the late 1960s and the sudden deficit in the balance of payments that occurred in 1970).

15. *See* SENATE FINANCE COMM., REVENUE ACT OF 1971, S. REP. No. 437, 92d Cong., 1st Sess. 90 (1971) [hereinafter SENATE FINANCE COMM.] (indicating that Congress enacted the DISC to induce domestic companies to export their products); 129 CONG. REC. S11761 (daily ed. Aug. 4, 1983) (introduction to S. 1804 by Sen. Dole), *reprinted in Dole, Rostenkowski Introduce DISC Replacement Bill*, 20 TAX NOTES 593, 593 (1983) [hereinafter 129 CONG. REC.] (stating that Congress created the DISC to provide American export firms with an opportunity to receive tax treatment of their export income similar to that which many foreign nations give to their exporters).

16. Revenue Act of 1971, Pub. L. No. 92-178, Title V, § 501, 85 Stat. 497, 535-53 (*codified at* I.R.C. §§ 991-97 (1988)).

17. General Agreement on Tariffs and Trade, *opened for signature* Oct. 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 187 [hereinafter GATT].

18. *See* Granwell & Rosensweig, *An Analysis of the Foreign Sales Corporation Provision and Rules*, 28 TAX NOTES 1266, 1267 (1985) (noting that GATT members have criticized the DISC since its enactment).

19. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 801, 98 Stat. 494, 985-1003, *codified at* I.R.C. §§ 921-927 (1988).

20. M. Goldstein & A. Aronoff, Foreign Sales Corporations: Tax Incentives for U.S. Exporters 1 (Sept. 11, 1989) (unpublished work) (copy on file with the author).

hold shares in a single FSC.[21] In 1986, Delaware adopted the shared FSC concept and created an export incentive program targeted at small and medium sized firms.[22]

This Comment focuses on whether the Delaware Shared Foreign Sales Corporation (DSFSC) Assistance Program is a good model for other states or organizations interested in sponsoring FSC programs aimed at small and medium sized firms, as well as whether the program can help reduce the United States trade deficit. Part I of this Comment examines the circumstances that prompted the FSC legislation. Part II explores why the original FSC legislation failed to attract small and medium sized firms. Part III describes the DSFSC Assistance Program and how it is tailored to appeal to small and medium sized firms. Part IV proposes that the DSFSC Assistance Program is an excellent model for states and other organizations to follow if they are interested in encouraging export activity among small and medium sized firms and in reducing the federal trade deficit.

I. THE TRANSITION FROM DISCs TO FSCs

Congress enacted the DISC to reverse the United States' shrinking trade surplus through the promotion of exports.[23] Congress believed that the DISC would remove tax impediments discouraging American companies from exporting.[24] Prior to the DISC legislation, American companies producing their goods in the United States for export were taxed on their export income regardless of where it was earned.[25]

---

21. I.R.C. § 922(a)(1)(B) (West 1988).

22. *See* Wilson, *Delaware's Shared Foreign Sales Corporations Help Small Business Exporters Increase Their Profits*, BUS. AMERICA, May 8, 1989, at 9 (stating that the Delaware program is dedicated to helping small and medium sized exporters become more competitive in the world market).

23. SENATE FINANCE COMM., *supra* note 15, at 90. *See Tariff and Trade Proposals: Hearings Before the House Comm. on Ways and Means*, 91st Cong., 2d Sess., pt. 2, at 500 (1970) (statement of David M. Kennedy, Secretary of the Treasury) (observing that the trade surplus of the United States fell from $6.5 billion in 1964 to less than $1 billion by 1969).

24. *See* 129 CONG. REC., *supra* note 15, at S11761 (emphasizing that the American system of taxation, which taxed the income of American companies on a worldwide basis, served as an export disincentive); *id.* at H6593 (declaring that Congress originally created the DISC to ensure that United States tax policy would not engender a decline in exports from the United States).

25. Recent Development, *Taxation: Foreign Sales Corporations Replace Domestic International Sales Corporations*, 26 HARV. INT'L L.J. 293, 293 (1985). *See* Note, *The Making of a Subsidy, 1984: The Tax and International Trade Implications of the Foreign Sales Corporation*, 38 STAN. L. REV. 1327, 1331 (1986) [hereinafter *The Making of a Subsidy*] (explaining the tax implications for American export firms resulting from worldwide taxation). Prior to the DISC legislation, American firms that produced goods in the United States for export were taxed on a current basis on their

In contrast, many European Community (EC) member nations employ a territorial system of taxation.[26] In a territorial tax system, income earned from activity outside the nation's borders is untaxed.[27] Under the territorial tax system, foreign exporters can establish a subsidiary in a low tax rate haven outside their home-country and therefore incur a much smaller tax liability than an American company that exported from the United States.[28]

Congress believed that by providing a benefit similar to territorial taxation to American firms exporting from the United States,[29] the DISC would equalize the tax treatment of American exporters with respect to their foreign counterparts. This benefit was a tax deferral on 42.5% of the export profits attributed to the DISC.[30] The amount of a parent corporation's export profits attributed to its DISC was calculated either under the arm's length pricing method[31] or under one of two DISC pricing rules.[32] American exporters could thereby defer tax-

---

export income. *Id.* The income of foreign subsidiaries of American companies not engaged in business operations in the United States received favorable tax treatment because that income was not subject to United States tax until it was repatriated. *Id.*

26. *See* Recent Development, *supra* note 25, at 293 (noting that Belgium, France, and the Netherlands use a territorial system of taxation that exempts income earned abroad); 129 CONG. REC., *supra* note 15, at S11761 (indicating that the territorial tax system is widely employed in Europe).

27. Recent Development, *supra* note 25, at 293-94.

28. *See id.* at 1331 (explaining that the American tax system disadvantaged American exporters because it taxed them on a worldwide basis).

29. 129 CONG. REC., *supra* note 15, at S11761. *See The Making of a Subsidy, supra* note 25, at 1331-32 (asserting that the drafters of the DISC legislation envisioned the DISC's tax effect on American based exporters to be comparable to the effect of territorial taxation).

30. I.R.C. § 994 (1982). *See* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 204(a), 96 Stat. 423 (*codified at* I.R.C. § 291(a)(4) (West Supp. 1985)) (lowering the amount of tax deferrable DISC profits from 50% to 42.5%). In 1976, Congress altered the DISC provisions so that the tax deferral accorded to DISC income was limited to income made on increased exports. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1061, 90 Stat. 1649 (*codified at* I.R.C. § 995 (1982)). Increased exports were defined as the amount of exports that exceeded 67% of the average amount of exports within a four-year base period beginning seven years prior to the tax year at issue. *Id.*

Upon the close of the DISC's taxable year, 57.5% of the DISC's export profits for that year and 100% of all other profits were treated as distributed to the DISC's shareholders. I.R.C. § 995(b) (West Supp. 1984). This deemed distribution was taxed to these shareholders. *The Making of a Subsidy, supra* note 25, at 1332. The other 42.5% of the DISC's export profits for that year were deferred from taxation. I.R.C. § 995 (1982).

31. *See* I.R.C. § 482 (1982) (defining "arm's length" as the exchange price established for an exchange between two unrelated parties).

32. *See* I.R.C. § 994(a)(1), (a)(2) (establishing that a DISC could determine its income under either of the following methods: 1) four percent of qualified export receipts; or 2) 50% of the combined taxable income of the DISC and the related supplier of the export).

ation on between seventeen and eighteen percent of their export profits through the use of a DISC.[33]

A corporation was a DISC eligible for the deferral if: (1) it incorporated in the United States;[34] (2) it issued only one class of stock with a par value of at least $2,500;[35] (3) ninety-five percent of its gross receipts derived from exports;[36] and (4) ninety-five percent of its assets were export related.[37] Once an entity qualified as a DISC, the tax on 42.5% of DISC income was deferred while it was retained within the DISC.[38] This deferral contained no time limits.[39] Consequently, as long as the DISC observed the retention requirements, it could indefinitely defer taxation on 42.5% of its income.[40] This deferred tax liability accrued no interest.[41] The retention requirements permitted this deferral until the occurrence of any of the following: (1) DISC income was actually distributed; (2) a shareholder disposed of its DISC stock; (3) the DISC was liquidated, distributed, exchanged, or sold; (4) the entity failed to qualify as a DISC; or (5) the DISC election was revoked or terminated.[42]

---

33. *See* Hudec, *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 72 MINN. L. REV. 1443, 1446 (1988) (stating that prior to the DISC amendment in 1976, which reduced the amount of deferrable DISC income from 50% to 42.5%, the typical American exporter could defer as much as 25% of its export profits by using a DISC).

The tax benefit that resulted from the operation of a DISC was typically achieved by establishing a domestically incorporated subsidiary with no purpose other than to generate tax savings. *Id.* The parent sold its export products to the DISC which then sold these goods to a foreign purchaser. *Id.* The earnings would then be split between the parent and the DISC pursuant to either an arm's length pricing arrangement or one of two DISC pricing rules. *Id.*

34. I.R.C. § 992(a)(1) (1982).

35. *Id.* § 992(a)(1)(C).

36. *Id.* § 992(a)(1)(A). Gross receipts earned on the sale or lease of export property for use outside the United States qualified as export receipts. *Id.* § 993(a)(1)(A). Receipts earned on the supply of services related or subsidiary to the sale or lease of export property also qualified as export receipts. *Id.* § 993(a)(1)(C).

37. *Id.* § 992(a)(1)(B). Qualified export related assets included inventories of export property, necessary operational equipment and supplies, trade receivables from export sales, producer's loans to a related supplier, working capital, investments in related foreign export corporations, and certain obligations of the Export-Import Bank. *Id.*

38. I.R.C. § 995 (1982).

39. Hudec, *supra* note 33, at 1446.

40. *See id.* (noting that American exporters employing a DISC chose not to recognize this deferred tax liability). Instead, these firms recognized the annual tax savings as a permanent gain to be recorded as part of its earnings. *Id.*

41. *Id.*

42. *Id.*

The DISC legislation prompted immediate criticism from the United States' foreign trading partners, especially from EC member nations.[43] These nations filed a formal complaint in 1973, contending that the DISC represented an illegal export subsidy under GATT.[44] The GATT Council appointed a panel to determine whether the DISC constituted such an illegal export subsidy.[45] In 1976, the panel concluded that the interest free deferral of taxes on a portion of DISC income constituted an illegal export subsidy under Article XVI:4 of the GATT.[46]

In 1981, the GATT Council accepted the panel's conclusions, but the GATT Council also approved an Understanding which exempted GATT members from taxes on export income derived from economic processes located outside their territorial limits.[47] The United States never agreed that the DISC represented an illegal export subsidy under GATT.[48] In 1982, however, the Reagan administration bowed to international pressure and announced plans to introduce legislation that would replace the DISC with a substitute not violative of GATT.[49] The administration proposed the Foreign Sales Corporation Act (FSC)

43. Kotran, *Of DISCs and FSCs*, 24 TAX NOTES 8, 8 (1984). *See* 129 CONG. REC., *supra* note 15, at H6580 (reporting that the controversy over DISCs began at their inception).

44. Caplan, *Legislative Developments: The Abolishment of DISCs and the Creation of FSCs*, 15 DEN. J. INT'L L. & POL'Y 95, 98 (1985).

45. *Id.*

46. *Id. See* Recent Development, *supra* note 25, at 296 (explaining that GATT article XVI:4 forbids the use of subsidies to lower the price of exported goods which are similar to goods sold for domestic consumption). Although the GATT has never specifically defined what the word "subsidy" means, in 1960 a GATT working party determined that the selective exemption or remission of income taxes on export income was an export subsidy within the meaning of GATT article XVI:4. Hudec, *supra* note 33, at 1450.

47. *See* Caplan, *supra* note 44, at 98 (explaining that the Understanding also mandated that transactions between export entities and foreign entities under common control must be established under an arm's length arrangement and that the GATT does not forbid using measures to avoid double taxation of foreign source income).

48. 129 CONG. REC., *supra* note 15, at H6580. *See* Recent Development, *supra* note 25, at 297 (indicating that the Reagan administration proposed legislation targeted at eliminating the worries of its trading partners); Note, *Foreign Sales Corporations: A Viable Solution to the DISC Controversy?*, 11 SYR. J. INT'L L. & COM. 47, 58 (1984) [hereinafter *A Viable Solution*] (explaining that the United States believed the DISC provisions permitted a tax deferral and not a tax exemption).

49. *See* Letter from U.S. Treasury Secretary Donald T. Regan to the GATT Council, *reprinted in* 17 TAX NOTES 708, 708 (1982) (indicating United States willingness to acquiesce to a consensus among GATT members and develop a DISC alternative that would comply with GATT as well as promote American trade interests).

which was introduced in Congress in August 1983[50] and later enacted as part of the Deficit Reduction Act of 1984.[51]

II. THE FSC AND THE SMALL EXPORTER

The FSC represents a United States attempt to create an export tax incentive comporting with the GATT Council Understanding (the Understanding).[52] Thus, Congress created the FSC provisions to ensure that each FSC would have a substantial foreign presence.[53] To qualify as an FSC, an entity must follow a number of basic formation requirements that demand a foreign presence.[54]

An FSC must incorporate under the laws of a foreign nation that has a bilateral or multilateral exchange of information agreement with the United States, or is a party to a tax treaty with the United States that allows for the exchange of information.[55] An FSC can also incorporate under the laws of an eligible possession of the United States.[56] Furthermore, an FSC must maintain a foreign office,[57] keep a set of permanent

50. H.R. 3810, 98th Cong., 1st Sess., 129 CONG. REC. 23, 234-36 (1983); S. 1804, 98th Cong., 1st Sess., 129 CONG. REC. 22, 966-72 (1983).

51. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 801, 98 Stat. 494, 985-1003 (*codified at* I.R.C. §§ 921-27 (West 1988)).

52. Note, *DISC to FSC: A Small Business Alternative?*, 15 GA. J. INT'L & COMP. L. 351, 358 (1985). *See* Letter from U.S. Treasury Deputy Assistant Secretary Ronald A. Pearlman to Senator Dole and Representative Rostenkowski, *reprinted in* 22 TAX NOTES 440, 441 (1984) [hereinafter Pearlman Treasury Letter] (explaining that a major objective of the FSC legislation was to ensure United States compliance with its GATT obligations).

53. *See A Viable Solution*, *supra* note 48, at 63 (explaining that the theory underlying the FSC is that the export income of domestic companies derived from foreign economic processes does not have to be taxed).

54. I.R.C. § 922(a) (1988). Foreign presence is not the sole basic formation requirement. *Id.* An FSC can have no more than 25 shareholders. *Id.* § 922(a)(1)(B). In addition, an FSC cannot issue any preferred stock. *Id.* § 922(a)(1)(C). An FSC must also maintain a duplicate set of permanent books of account in the United States. *Id.* § 922(a)(1)(D)(iii). An FSC cannot be a member of a controlled group of corporations that include a DISC as a member. *Id.* § 922(a)(1)(F). Finally, an FSC must elect to receive FSC treatment. *Id.* § 922(a)(2). This election must be made during the 90 day period preceding the beginning of the taxable year and all shareholders must consent to the election. *Id.* § 927(f)(1)(A), (B).

55. *Id.* § 922(a)(1)(A)(i).

56. *Id.* § 922(a)(1)(A)(ii). The United States Virgin Islands, American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands are United States possessions eligible for FSC incorporation. *Id.* § 927(d)(5).

57. *Id.* § 922(a)(1)(D)(i).

books of account at this office,[58] and have at least one person on its board of directors who is not a resident of the United States.[59]

Once an entity qualifies as an FSC, it must adhere to certain foreign management[60] and economic processes[61] requirements in order to produce foreign trading gross receipts (FTGR).[62] FTGR production by an FSC is vital because an FSC obtains tax exempt treatment on a percentage of the income it earns from its FTGR or foreign trade income (FTI).[63] The percentage of FTI that is tax exempt is calculated under rules conforming to the GATT Council's decision, enunciated in the Understanding, that an export firm must observe arm's length pricing practices in transactions with foreign entities under its control.[64] For example, a FSC that purchases export property from an independent

---

58. *Id.* § 922(a)(1)(D)(ii). *See* Stillabower, Buck & Cigler, *Foreign Sales Corporations: The DISC Replacement*, 15 TAX ADVISER 710, 711 (1984) [hereinafter Stillabower] (listing invoices, quarterly income statements, and a year-end balance sheet as minimum requirements for permanent account books for FSC purposes).

59. I.R.C. § 922(a)(1)(E) (1988). *See* Stillabower, *supra* note 58, at 711 (noting that a nonresident United States citizen satisfies this nonresident requirement).

60. I.R.C. § 924(c) (1988). To meet the foreign management requirements, an FSC must conduct all board of directors and shareholders' meetings outside of the United States. *Id.* § 924(c)(1). An FSC must also keep its principal bank account in a qualified foreign nation or in an eligible United States possession throughout the taxable year. *Id.* § 924(c)(2). Finally, an FSC must disburse all dividends, legal and accounting fees, and salaries of officers and directors from a bank account maintained outside the United States. *Id.* § 924(c)(3).

61. *Id.* § 924(d). An FSC must either solicit, negotiate, or arrange the contract that pertains to an export transaction outside the United States. *Id.* § 924(d)(1)(A). An FSC must also incur at least 50% of the total direct costs of an export transaction outside the United States. *Id.* § 924(d)(1)(B). Total direct costs include: (1) advertising and sales promotion; (2) processing of customer orders and arranging for delivery of export property; (3) transportation from the time of acquisition by the FSC; (4) billing and collection; and (5) assumption of credit risk. *Id.* § 924(d)(3)(A). Alternatively, an FSC can incur at least 85% of the direct costs of any two of the five activities listed above. *Id.* § 924(d)(2). The economic processes requirements must be met on a transaction-by-transaction basis. *Id.* § 924(d)(1).

An FSC can have an agent perform any of the five activities described above if the FSC bears the cost. M. Goldstein & A. Aranoff, *supra* note 20, at 4. An FSC agent need not be related to the FSC. *Id.*

62. I.R.C. § 924(b) (1988). FTGRs are the gross receipts of any FSC that result from: (1) the sale, exchange, or other disposition of export property for use outside the United States; (2) the lease or rental of export property for use by the lessee outside the United States; (3) the performance of services that are related or subsidiary to any of the § 924(d) direct cost transactions; (4) earned from engineering or architectural services for construction projections outside the United States; or (5) from managerial services performed for an unrelated FSC to aid in the production of FTGR. *Id.* § 924(a).

63. *Id.* § 923(b).

64. *See A Viable Solution*, *supra* note 48, at 66 (explaining that an FSC must follow either arm's length pricing practices or administrative pricing rules designed to approximate arm's length pricing when it purchases export property from a related supplier).

supplier or buys such property from a related supplier at an arm's length price can calculate its FTI on the basis of the actual sales price of the export property.[65] Thirty-two percent of such FTI is exempt from taxation in the United States.[66]

An FSC that purchases export property from a related supplier can also employ one of two transfer pricing rules to determine its taxable income.[67] The first transfer pricing rule states that an FSC's FTI is 1.83 percent of the FTGR derived from the FSC's sale of export property.[68] The second transfer pricing rule provides that an FSC's FTI is twenty-three percent of the combined taxable income of the FSC and the related supplier attributable to the FTGR derived from the FSC's sale of export property.[69] If an FSC calculates its FTI using either of the transfer pricing rules, then 16/23 of the FSC's FTI is exempt from taxation in the United States.[70] An FSC or its agent must perform all the economic processes requirements in order to use either of the transfer pricing rules.[71] Generally, if an FSC is eligible to use either of the transfer pricing rules, then approximately fifteen percent of its income is exempt from taxation in the United States.[72]

Where an FSC employs either of the transfer pricing rules, the FSC pays tax on non-exempt FTI.[73] An FSC shareholder does not pay tax on any FSC income until he or she receives such income in a distribution.[74] When an FSC distributes income to a corporate FSC shareholder, the shareholder receives a 100% dividends-received deduction for amounts out of the FSC's earnings and profits attributable to both exempt and non-exempt FTI.[75] As a result of this 100% dividends-

65. I.R.C. § 925(a)(3) (1988).

66. *Id.* § 923(a)(2). If the FSC has any corporate shareholders then only 30% of the FTI attributable to such shareholders is tax exempt. Treas. Reg. § 1.923-1T(b)(1)(ii) (1984).

67. I.R.C. § 925(a) (1988).

68. *Id.* § 925(a)(1). If an FSC uses this transfer pricing rule then its FTI cannot exceed two times the combined taxable income of itself and its related supplier. *Id.* § 925(d).

69. *Id.* § 925(a)(2). The FSC then pays tax in the United States on 8/23 of the 23% of the CTI allocated to it on an export sale. Stillabower, *supra* note 58, at 714. The FSC's related supplier then pays tax in the United States on the remaining 77% of CTI. *Id.*

70. I.R.C. § 923(a)(3) (1988). If an FSC has any corporate shareholders then only 15/23 of its FTI is tax exempt. Treas. Reg. § 1.923-1T(b)(1)(i) (1985).

71. I.R.C. § 925(c)(2) (1988).

72. *Id.* § 923(a)(3).

73. Stillabower, *supra* note 58, at 714.

74. *Id.*

75. I.R.C. § 245(c) (1988). Any distribution to a shareholder out of the FSC's earnings and profits is deemed as made first out of such earnings and profits attributable to FTI and then out of other earnings and profits. *Id.* § 926(a).

received deduction, there is no corporate level taxation of exempt FTI, and only a single level corporate tax levied on the FSC, on non-exempt FTI.[76]

A goal of the FSC legislation was to encourage small and medium sized businesses to take advantage of the FSC.[77] Aware that America's small business community was not active in the export market and that American exports would not increase unless this changed,[78] Congress included a small FSC provision[79] and a shared FSC provision in the FSC legislation.[80] Otherwise similar to a regular FSC, a small FSC limits eligibility for the FSC tax exemption to no more than $5 million in FTGR per tax year.[81] The primary incentive for firms to form a small FSC is that small FSCs need not fulfill any of the management or economic processes requirements outside the United States. The small FSC nonetheless qualifies for the same tax treatment given to regular FSCs.[82]

A shared FSC is an FSC that is owned by twenty-five or fewer unrelated exporters.[83] The amount of FTGR that a shared FSC can earn in a tax year is unlimited.[84] What is "shared" are the expenses incurred in the formation and operation of that shared FSC.[85] Thus, the primary advantage of the shared FSC is that each shareholder obtains the full tax benefit provided by the FSC but at a lower cost.

Many believed that the FSC, particularly the small FSC and the shared FSC, would serve as an attractive tax vehicle for small and me-

---

76. Stillabower, *supra* note 58, at 714.

77. *See* Pearlman Treasury Letter, *supra* note 52, at 441 (asserting that the FSC proposal was designed to provide incentives for small businesses to export).

78. *See* SENATE COMM. ON SMALL BUSINESS, SURVEY OF FINDINGS ON OBSTACLES TO EXPORTING FACED BY SMALL BUSINESSES, S. REP. No. 249, 97th Cong., 2d Sess. 1 (1982) (noting that 200 firms dominate approximately 80% of the American export trade and that American exports would increase only if the 20,000 small companies with export potential began to export aggressively).

79. *See* I.R.C. § 922(b) (1988) (defining a small FSC). A small FSC must elect small FSC treatment and cannot be a member of a controlled group of corporations which includes a regular FSC. *Id.*

80. *Id.* § 922(a)(1)(B). A shared FSC is a single FSC with up to 25 shareholders. *Id.*

81. *Id.* § 924(b)(2)(B)(i). FTGR that exceeds $5 million for a tax year is not considered for purposes of calculating a small FSC's FTI. *Id.*

82. *Id.* § 924(b)(2)(A). A small FSC must still comply with the same formation requirements governing regular FSCs. *Id.* § 922(a).

83. *See supra* note 78 and accompanying text (enumerating requirements of a shared FSC).

84. DELAWARE DEVELOPMENT OFFICE, GOVERNOR'S INTERNATIONAL TRADE COUNCIL, DELAWARE-SPONSORED SHARED FOREIGN SALES CORPORATIONS: INFORMATION SHEET 2 (Price Waterhouse 1988) [hereinafter INFORMATION SHEET].

85. *Id.*

dium sized firms.[86] Few small and medium sized firms, however, including those already involved in the export market, selected any of the FSC options.[87] In 1989, an estimated 3,500 FSCs existed and roughly 2,500 of them were regular FSCs while the remainder were small FSCs.[88] Shared FSCs achieved even less success.[89] There were approximately 100,000 firms that exported from the United States in 1987.[90]

There are two main reasons why the original FSC legislation, respecting the small and regular FSCs, failed to attract the small and medium sized firm. First, despite the best efforts of Congress,[91] the FSC provisions were complicated.[92] Second, many American firms be-

---

86. *See Export Incentives*, *supra* note 4, at 801 (asserting that FSCs and small FSCs provide incentives for small firms to enter the export market). The shared FSC was seen as an excellent vehicle through which small companies could share FSC maintenance costs and obtain certain economies of scale. *Id. See also Tax Proposals to Foster Small Business Exports: Hearings Before the Subcomm. on Tax, Access to Equity Capital and Business Opportunities of the House Comm. on Small Business*, 98th Cong., 2d Sess. 29-30 (1984) (statement of Andre Fogarasi, Principal, Office of Federal Tax Services, Arthur Andersen & Co.) (contending that the FSC would appeal to small exporters because FSC qualification requirements are less complicated than those of the DISC); *Shared FSCs One Way to Boost Small Business Exports through State and Local Initiatives*, 5 Int'l Trade Rep. (BNA) No. 19, at 684 (May 11, 1988) (statement of John J. Korbel, Partner, Price Waterhouse) (insisting that 20 states sponsor a shared FSC program). Korbel also stated that up to 240 shared FSCs could be formed from the pool of exporters remaining after the FSC legislation phased out 6,000 DISCs. *Id.*

87. *See* W.T. O'Keefe & D. O'Keefe, *Foreign Sales Corporations: Exporter Reactions*, 37 TAX EXECUTIVE 309, 309-22 (1985) (assessing the reaction of 330 companies to the FSC). Thirteen percent of the firms surveyed had no export sales, 20.9% had less than $5 million in export sales, and 13% had between $5 million and $10 million in export sales. *Id.* at 311. Ninety-three percent of the firms that formed FSCs had over $10 million in export sales. *Id.* at 310. Seventy-three percent of the firms forming FSCs had between $20 million and $500 million in export sales. *Id.* at 312. Of the firms that had qualifying export sales, 32.4% chose not to form an FSC. *Id.* Less than 32% of the firms earning under $5 million in export sales decided to form a small FSC. *Id.* Forty-three percent of the firms that decided against forming a FSC earned less than $5 million in export sales. *Id.* at 320. Firms with under $5 million in export sales composed only 33.9% of the firms in this survey. *Id.* at 312. The survey data indicates that the small exporter community contemplated in the FSC legislation composed the majority of firms that chose not to form FSCs. *Id.* at 320.

88. *House Hearings*, *supra* note 10, at 57 (testimony of Leslie Stroh).

89. *See* Merrion, *State Weighs Export Plan, but Will Companies Bite?*, CRAIN'S CHICAGO BUSINESS, Sept. 8, 1986, at 3 (observing that although certain states were studying the possibility of a shared FSC program, no state had implemented such a program).

90. *House Hearings*, *supra* note 10, at 57 (testimony of Leslie Stroh).

91. *See* 129 CONG. REC., *supra* note 15, at H6581 (introduction to H.R. 3810 by Rep. Conable) (mandating that Congress reduce the complexity of the newly introduced FSC bill).

92. *See* Stillabower, *supra* note 58, at 715 (asserting that the substitution of FSCs for DISCs resulted in substantial complications for American export firms); W.T. O'Keefe & D. O'Keefe, *supra* note 87, at 312 (noting that the FSC is the most complicated export incentive offered by the United States government).

lieve that exporting is complex and expensive.[93] There is some basis for this belief in the case of a regular FSC because it must incur certain expenses abroad in order to comply with the foreign management and foreign economic processes requirements.[94] Such expenditures can make the regular FSC a prohibitive option for many small and medium sized firms.[95] Small FSCs, despite their exemption from the foreign management and foreign economic processes requirements, are also an expensive alternative for the small and medium sized firm.[96] Furthermore, many of these firms are convinced that the costs associated with a small FSC exceed the corresponding tax benefits.[97]

Because there was a great deal of confusion concerning how to determine a shared FSC's tax liability, shared FSCs were unpopular in the years following passage of the FSC legislation.[98] Much of the confusion centered on the following three issues: (1) whether the shareholders of a shared FSC could employ the transfer pricing rules;[99] (2) whether

93. *See* W.T. O'Keefe & D. O'Keefe, *supra* note 87, at 320 (finding that 60.8% of the firms that decided not to form an FSC, small FSC, or interest charge DISC did so because of the belief that the regulations governing these export incentives were overly complex). Of these same firms, 76.1% reported that they felt that the costs associated with these export incentives would exceed any benefits. *Id. See also Hearings, supra* note 10, at 14-15 (testimony of John C. Rennie, President and CEO, Pacer Systems United, Inc., on behalf of the National Small Business United) (stating that most small business executives believe federal and state governments offer no "hard" financial incentives to export and that their businesses would bear most export costs).

94. *See supra* notes 60-61 (describing the requirements of a qualified FSC).

95. *See House Hearings, supra* note 10, at 57 (testimony of Leslie Stroh) (explaining that the consensus is that an FSC becomes an option only when an exporter attains $1 million in annual export sales). Approximately 60% of American exporters gross less than $500,000 annually in export sales. *Id. See also Hearings, supra* note 10, at 58 (statement of John C. Rennie) (insisting that the FSC is a poor incentive for firms with less than $1 million in annual export sales).

96. *See supra* note 95 (noting that the small FSC is not an option for almost two-thirds of American exporters). *See also House Hearings, supra* note 10, at 60 (testimony of Leslie Stroh) (recommending that amendments to the FSC provisions focus on firms with approximately $115,000 in annual export sales to afford them an opportunity to enjoy the tax benefits of FSCs).

97. *See* W.T. O'Keefe & D. O'Keefe, *supra* note 87, at 317 (finding that 67.5% of the firms choosing not to form a small FSC did because they believed FSC costs exceeded FSC benefits). Of the firms that chose not to form a small FSC, 52.6% did so because they earned less than $5 million in annual export sales. *Id.*

98. *See* Letter from Andre P. Fogarasi, Richard A. Gordon, and John Venuti of Arthur Andersen & Co. to Steven E. Shay of the U.S. Treasury, *reprinted in* TAX NOTES 1173, 1173-74 (1986) (asserting the impracticability of a small company participating in a shared FSC due to uncertainties in shared FSC pricing rules and grouping requirements for FSC shareholders).

99. *See id.* at 1173 (noting that I.R.C. § 925(a) limits the use of the transfer pricing rules to transactions between an FSC and a "related party"). The FSC regulations define a "related person" as a person "owned or controlled directly or indirectly by the same interests." *Id.* As a result, Arthur Andersen & Co. believed it was unlikely that a single shareholder in a 25 shareholder FSC would be deemed a "related person" under

distributions from the shared FSC would correspond to the export income earned by each shareholder;[100] and (3) whether the shared FSC could group the transactions of each shareholder for the transfer pricing rules, the foreign economic processes, and management requirements.[101] Congress resolved this confusion when it amended the FSC provisions as part of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).[102] TAMRA permits a shared FSC to issue each shareholder a separate class of stock and to make distributions based on each shareholder's proportionate stock interest.[103] TAMRA, however, does not treat each class of stock as a separate corporation for purposes of the FSC qualification requirements, the foreign management and foreign economic processes requirements, or for the election of FSC or small FSC status.[104] TAMRA does provide Delaware with the impetus to move forward sponsorship of a shared FSC program.[105]

III. THE DELAWARE SHARED FOREIGN SALES CORPORATION (DSFSC) ASSISTANCE PROGRAM

A DSFSC is a shared FSC managed in accordance with the DSFSC Assistance Program (Program). Any corporation that is incorporated in one of the fifty states, the District of Columbia, or Puerto Rico is eligible to participate in a DSFSC.[106] There are tax disadvantages, how-

---

the above definition. *Id.* Consequently, a single shareholder in a shared FSC could not use the transfer pricing rules. *Id.*

100. *See id.* at 1173-74 (asking Congress to enact regulations allowing a shared FSC to make distributions calculated with reference to the export sales run through it by its shareholders). Absent such regulations, firms that participated in a shared FSC might be forced to share the income derived on their export sales with unrelated shareholders. *Id.* at 1173. Furthermore, Arthur Andersen & Co. was concerned that the same firm might bear losses incurred by another unrelated shareholder. *Id.*

101. *See id.* at 1174 (recommending that use of grouping rules be optional to shared FSCs).

102. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1012(b)(8)(A), 102 Stat. 3536 (*codified at* I.R.C. § 927(g) (West Supp. 1989)).

103. I.R.C. § 927(g)(3). A shared FSC is presently defined as any FSC maintaining a separate account for transactions with each shareholder, basing its distributions to each shareholder upon the amounts in these separate accounts, and adhering to any other requirements the Treasury Department may prescribe. *Id.*

104. *Id.* § 927(g)(2).

105. *See* M. Goldstein & A. Aranoff, *supra* note 20, at 7 (noting that TAMRA clarified the treatment to be given to shared FSCs); DELAWARE DEVELOPMENT OFFICE, GOVERNOR'S INTERNATIONAL TRADE COUNCIL, DELAWARE-SPONSORED SHARED FOREIGN SALES CORPORATIONS: QUESTIONS & ANSWERS 4 (1988) [hereinafter QUESTIONS & ANSWERS] (observing that TAMRA clarified the tax treatment of FSCs).

106. DELAWARE DEVELOPMENT OFFICE, GOVERNOR'S INTERNATIONAL TRADE COUNCIL, PARTICIPATION INFORMATION MEMORANDUM, SHARED FOREIGN SALES CORPORATION ASSISTANCE PROGRAM 11 (Sept. 1, 1989) [hereinafter PARTICIPATION INFORMATION MEMORANDUM].

ever, for "S" corporations,[107] that participate in the program.[108] Individuals, partnerships, estates, and trusts also face disadvantages.[109] These entities are discouraged from participating because only a "C" corporation is eligible to receive the 100% dividends-received deduction.[110]

The Program provides participants with a double tax benefit. A DSFSC receives the fifteen percent federal tax exemption on export earnings, and its shareholders are exempt from Delaware state tax.[111] Delaware has no ownership interest in, nor does it manage any DSFSC.[112] Instead, Delaware acts primarily as the promoter of the Program, providing information describing the Program, as well as providing the necessary documents to an interested American firm.[113] Furthermore, Delaware provides a DSFSC with access to all necessary managerial and supervisory support services.[114]

---

107. *See* I.R.C. § 1361(a) (defining an "S corporation" as a small business corporation electing treatment as an "S corporation" for the taxable year). A small business corporation is a domestic corporation which is not an ineligible corporation and which does not: (1) have more than 35 shareholders; (2) have anyone other than an individual, an estate or a qualified trust as a shareholder; (3) have a nonresident alien as a shareholder; and (4) have more than one class of stock. *Id.* § 1361(b)(1). An ineligible corporation is any corporation that is: (1) a member of an affiliated group; (2) a financial institution that is a bank; (3) an insurance company; (4) a corporation to which an election under § 936 applies; or (5) a DISC or former DISC. *Id.* § 1361(b)(2).

108. *See* PARTICIPATION INFORMATION MEMORANDUM, *supra* note 106, at 11 (recommending that in the absence of IRS regulations, "S corporations" should not join a shared FSC); QUESTIONS & ANSWERS, *supra* note 105, at 5 (noting the confusion over the quantity of stock an "S corporation" can own in a shared FSC). An "S corporation" cannot own all of the stock in a shared FSC, and it is unclear whether it can own less than 80% of the stock in a shared FSC. *Id.*

109. PARTICIPATION INFORMATION MEMORANDUM, *supra* note 106, at 11.

110. QUESTIONS & ANSWERS, *supra* note 105, at 5. The Treasury has not clarified whether "S corporations" are entitled to the 100% dividends-received deduction. *Id.*

111. PARTICIPATION INFORMATION MEMORANDUM, *supra* note 106, at 5.

112. INFORMATION SHEET, *supra* note 84, at 1.

113. *Id.* The documents that a prospective member of a DSFSC must prepare include a signed copy of the following: (1) the Participation Agreement; (2) the Board of Directors Designation; (3) the Subscription Agreement; (4) the Shareholders' Agreement; (5) the Commission Agreement; (6) the Activities Agreement; and (7) the Separate Consent Statement. PARTICIPATION INFORMATION MEMORANDUM, *supra* note 106, at 1. A person executing these documents is obligated to join a DSFSC. *Id.* at 2. The choice of an individual to serve as a representative on the DSFSC's board of directors is optional to each DSFSC shareholder. *Id.*

114. *See* INFORMATION SHEET, *supra* note 84, at 2 (discussing the Program's "turn-key" approach, and exploring how that approach ensures that elements imperative to the operation of a DSFSC are supplied). Delaware provides each DSFSC with supervision and management services, overseas service providers, and banking assistance. *Id.*

Delaware provides only limited services because it does not participate in the management of the daily operations of a DSFSC.[115] Instead, MTI Export Management, Inc. (MTI), a private corporation, contracted with Delaware to serve as the Program Administrator as well as the manager for all DSFSCs.[116] As Program Administrator, MTI is responsible for the assignment of each Program participant to a particular DSFSC.[117] MTI selects the foreign nation or United States possession most suitable for incorporation and then incorporates the DSFSC.[118] Additionally, MTI is responsible for each DSFSC's accounting, legal, tax, and financial services.[119] Finally, MTI ensures that each DSFSC complies with the applicable foreign management and foreign economic processes requirements.[120]

MTI does not provide funding. The shareholders fund each DSFSC. The costs incurred by the individual DSFSC shareholder are calculated with reference to the year of incorporation. In a DSFSC's first year, each shareholder must purchase one share of a separate class of common stock for $500.[121] One dollar of the amount paid is designated as paid-in-capital and the remainder is considered non-refundable paid-in

115. *See supra* note 112 and accompanying text (noting that Delaware does not participate in the management of a DSFSC).

116. PARTICIPATION INFORMATION MEMORANDUM, *supra* note 106, at 18.

117. *See id.* at 3, 7 (explaining that the Program Administrator groups Program participants into small DSFSCs and regular DSFSCs at its discretion). The Program Administrator's judgment is final and binding, and such judgment may be made arbitrarily, without considering such indices as the type of product that a Program participant exports, or the foreign markets to which it exports. *Id.*

118. *Id.* at 3.

119. *See id.* at 18 (explaining that MTI contracts with various service providers). MTI contracts with Price Waterhouse for the preparation of each DSFSC's tax return as well as for the information required for entry into each DSFSC member's tax return. *Id.* MTI contracts with Chase Manhattan Bank and Chase Trade, Inc. for the establishment of foreign bank accounts and the electronic transfer of monies in order to meet certain foreign economic processes requirements. *Id.*

120. *See id.* at 16 (describing how a DSFSC incurs foreign direct costs pursuant to the economic processes requirements set forth in I.R.C. § 924(e)). The typical DSFSC incurs its foreign direct costs by engaging in the following § 924(e) activities: (1) advertising and sales promotion; (2) determination and transmittal of a statement of account and receipt of payment. *Id.* A DSFSC incurs its advertising and sales expenditures when the DSFSC manager advertises the shareholders' export property at foreign trade fairs. *Id.* A DSFSC computes and transmits a statement of account to the shareholders' buyers annually. *Id.* The foregoing is the manner in which a DSFSC incurs expenses with respect to the determination and transmittal of a statement. *Id.* A DSFSC incurs costs regarding the receipt of payment through the electronic "sweep" of export receipts between each DSFSC shareholder and the DSFSC. *Id.*

121. *See id.* at 14-15 (indicating that a DSFSC's capital consists of no par voting common stock). The number of separate classes of such no par voting common stock is equal to the number of shareholders in the DSFSC. *Id.* at 14.

surplus.[122] Each shareholder must pre-pay its share of the DSFSC's operation expenses in the amount of $2,500.[123] Shareholders who have over $2.5 million in gross export receipts must also pay an amount equal to 0.1 percent of its export gross receipts less $2,500 at the end of the DSFSC's tax year.[124]

In the DSFSC's second year and thereafter, each shareholder pays its share of the DSFSC's yearly operation expenses, anticipated to annually average the greater of $2,500-$2,750 or 0.1 percent of export gross receipts.[125] Each DSFSC operates on a commission basis.[126] A shareholder pays the DSFSC a commission from its export earnings in accordance with the transfer pricing rules.[127] The DSFSC then distributes to the shareholder the tax exempt portion of this commission, less the individual shareholder's part of the DSFSC's annual operation expenses[128] in the form of a tax exempt dividend.[129]

IV. THE DSFSC AS AN AID TO SMALL EXPORTERS AND A MEANS TO REDUCE THE TRADE DEFICIT

Typically, there are three obstacles that prevent most small and medium sized firms from entering the export market: (1) lack of financial incentives; (2) the perception that exporting is complex and expensive; and (3) lack of information.[130] In its effort to attract small and medium

122. *Id.* at 15.

123. *See id.* at 3 (noting that this $2,500 payment can be considered an additional non-refundable paid-in surplus).

124. *Id. See* QUESTIONS & ANSWERS, *supra* note 105, at 2-3 (detailing the costs incurred by a DSFSC). A shareholder of a first year DSFSC with $2.5 million in export gross receipts during that first year pays $3,000 upon the DSFSC's incorporation. *Id.* A shareholder of a first year DSFSC with $3 million in export gross receipts during that first year pays $3,000 upon the DSFSC's incorporation and an additional $500 at the close of the DSFSC's tax year. *Id.*

125. INFORMATION SHEET, *supra* note 84, at 4.

126. *See id.* at 2 (explaining that in a commission basis shared FSC each shareholder receives dividends in the amount of commissions they contributed to the DSFSC).

127. *See* QUESTIONS & ANSWERS, *supra* note 105, at 3 (asserting that a shareholder transfers 23% of its export income to the DSFSC in the form of a commission at the close of the DSFSC's tax year). Twenty-three percent of the CTI of the FSC and its related supplier is allocated to the FSC. I.R.C. § 925(a)(2) (1988). A DSFSC's export income consists entirely of its shareholders' commission payments. QUESTIONS & ANSWERS, *supra* note 105, at 3. Approximately, 65% of a DSFSC's export income is exempt from taxation. *Id.* This tax exempt income is then distributed to the shareholders and is not taxed. *Id.* The result is that approximately 15% of export income (65% of 23%) is tax exempt for both the DSFSC and its shareholders. *Id.*

128. PARTICIPATION INFORMATION MEMORANDUM, *supra* note 106, at 9.

129. QUESTIONS & ANSWERS, *supra* note 105, at 3.

130. *See Hearings*, *supra* note 10, at 57 (statement of John C. Rennie) (declaring that he has discovered three "stoppers" that serve as obstacles to small business export

sized firms into the export market, the Program addresses these obstacles.

First, the Program provides a strong financial incentive through its double tax benefit and the reduced cost at which an exporter can achieve that benefit. For example, a DSFSC shareholder who enjoys export income of $500,000 and a pre-tax profit margin of twenty percent saves $5,823 in federal taxes.[131] A shareholder in a first year DSFSC incurs $1,260 less in start-up and operation expenses than a shareholder in a solo small FSC.[132] Those savings amount to $8,030 with respect to the shareholder in a solo regular FSC.[133] Furthermore, Delaware's "turn-key" approach regarding the organization and management of each DSFSC ensures that Program participants need only worry about their products and not about the cost of obtaining all the services that are ancillary to the export of their product.[134]

To combat the second and third obstacles, Delaware aggressively markets and promotes the Program.[135] Delaware attempts, via these promotional efforts, to educate small and medium sized exporters about the tax benefits offered through participation in shared FSCs.[136] Delaware also uses its promotional efforts to combat the perception that the compliance costs with respect to the economic processes requirements exceed the tax benefits associated with FSCs.[137]

---

activity). The first of these "stoppers" is a lack of incentives, particularly "hard" financial incentives such as tax incentives and subsidies. *Id.* at 58. The second "stopper" is the lack of education regarding the export process and organizations available to assist the small exporter. *Id.* at 58-59. Many small business executives possess no international experience and believe that one is either not involved or is heavily involved in export activity. *Id.* Third, small firms have little information about the foreign markets they could potentially service. *Id.* at 60. This is primarily due to ignorance of foreign languages and a lack of market gathering resources. *Id.*

131. INFORMATION SHEET, *supra* note 84, at 3. A DSFSC shareholder who earns $1 million in export income and has a pre-tax profit margin of 30% saves $16,023 in federal taxes. *Id.* In 1988, a DSFSC shareholder earning $5 million in export income with a pre-tax profit margin of 20% saved over $46,000 in taxes after the DSFCS's first year expenses were deducted. Wilson, *supra* note 22, at 9.

132. *See* INFORMATION SHEET, *supra* note 84, at 4 (indicating that a DSFSC's expenses are less than the expenses of a small or regular solo FSC because of shared expenses and economies of scale).

133. *Id.*

134. *See supra* notes 114-20 and accompanying text (describing the services Delaware and its contractors provide).

135. *See supra* note 111, at 14-15 (describing Delaware's marketing strategies). Delaware furnishes the information regarding DSFSCs free of charge to interested firms. INFORMATION SHEET, *supra* note 84, at 1.

136. Wilson, *supra* note 22, at 9. Delaware instituted the Program following a survey they conducted among small and medium sized exporters that indicated that most firms were ignorant about shared FSCs. *Id.*

137. *See id.* (observing that Delaware markets and promotes DSFSCs through news articles, stories in trade magazines, and targeted direct mail campaigns).

The DSFSC Program is a model export incentive program for reducing the trade deficit because it focuses on increasing the number of small and medium sized firms that participate in the export market.[138] There is a great deal of untapped potential in these firms.[139] Without the participation of small and medium sized firms, it will be difficult to sustain the recent growth in exports from the United States.[140] Much credit for the decrease in the trade deficit is attributable to this recent surge in exports.[141] In fact, further reduction of the trade deficit depends primarily on maintaining strong export growth.[142] The DSFSC is simply a mechanism through which to accomplish this task.

CONCLUSION

As international trade assumes an increasingly large role in the United States economy,[143] United States exports must increase in order to lower the trade deficit. Most of this increase must come from small and medium sized firms possessing little or no export experience. Many of these firms are unfamiliar with the export process, and many have

---

138. *Id.*

139. *See House Hearings*, *supra* note 10, at 55 (testimony of John C. Rennie) (contending that 300,000 companies in the United States produce exportable goods). Rennie estimates that only 25,000 of these companies are actually engaged in the export trade. *Id.* Of these 25,000 companies, approximately one percent are responsible for most of the manufactures exports from the United States. *Id. See* Wilson, *supra* note 22, at 9 (stating that fewer than 10% of all American manufacturers able to export do so). *See also Hearings*, *supra* note 10, at 37 (testimony of Stanley B. Parrish, Associate Deputy Administrator for Special Programs, Small Business Administration) (discussing how small business is the driving force behind the American economy). Small business accounts for approximately 54% of jobs in the United States and represents 98% of all American businesses. *Id.* Two-thirds of the technical innovations in goods and services take place in the small business sector. *Id.*

140. *See* UNITED STATES TRADE PERFORMANCE IN 1984, *supra* note 4, at 2 (reporting that the United States exported $218 billion in merchandise in 1984); UNITED STATES TRADE PERFORMANCE IN 1988, *supra* note 1, at 5 (noting that in 1988 the United States exported $321.8 billion in merchandise). Exports from the United States increased by 15% in 1987 and by nearly 22% in 1988. *Id.* at vii. The United States' share of the global export market increased from 10.2% in 1987 to 11.3% in 1988. *Id.*

141. *See* UNITED STATES TRADE PERFORMANCE IN 1988, *supra* note 1, at vii (stating that the 21.2% decrease in the trade deficit was due predominantly to the 26.6% growth in exports).

142. *See id.* at 17 (observing that the United States imported 42% more manufactured goods than the United States exported). This disparity existed despite the fact that American manufactures exports reached a record $255.3 billion in 1988. *Id.* To prevent the merchandise trade deficit from increasing, United States manufactures exports must multiply 1.4 times more rapidly than United States merchandise imports. *Id.*

143. *See Hearings*, *supra* note 10, at 39 (testimony of Stanley B. Parrish) (estimating that international trade will increase from 26% of the United States GNP in 1989 to roughly 35% of GNP in the year 2000).

little knowledge about the foreign markets they hope to serve. Further, many executives who manage small and medium sized firms fear that exporting involves a maze of regulatory hurdles. Additionally, many of these executives believe that the costs of exporting outweigh any possible benefits.

Consequently, states and international trade organizations must develop an export incentive program attractive to the small and medium sized firm. Such a program must offer exporters a "hard" financial incentive, such as a tax exemption or a direct subsidy. The costs of participating in the program must not preclude the involvement of small and medium sized firms. The sponsors of the program must aggressively seek to educate these firms about their program.

Delaware's Program meets all of the above requirements. The shared FSC enables exporters to obtain the full tax benefit of an FSC at a reduced cost. Delaware also provides an additional tax incentive in the form of an exemption of the DSFSC and its shareholders from state taxation. The costs of participating in a shared FSC are lowered under Delaware's Program because of the "turn-key" approach. Delaware's relentless promotion of the DSFSC Program throughout the United States addresses the misconceptions shared by many small companies regarding the complexities and costs associated with exporting in general and the shared FSC in particular. Delaware's approach represents a formula for success.