

## **Fiscal Research Program**

### **A COMPARATIVE ANALYSIS OF SOUTHEASTERN STATES' INCOME TAX TREATMENT OF EXPORTERS**

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**May 1998**

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# A COMPARATIVE ANALYSIS OF SOUTHEASTERN STATES' INCOME TAX TREATMENT OF EXPORTERS

## ABSTRACT

Exporters are vital to the health of the U.S. economy as well as to individual state economies. As such, this study analyzes the export-related provisions of the southeastern states' income tax laws and proposes tax policy changes that could potentially improve the tax environment for exporters while enhancing the overall economic environment in those states.

In order to develop and support tax policy recommendations relating to state's tax treatment of exporters, statistics that highlight the importance of exports to the domestic economy are reviewed. In addition, a summary of Federal tax law incentives available to exporters is provided along with several Treasury Department studies that estimate the impact the federal tax law incentives have had on the volume of exports. Also, key issues under state income tax laws regarding the treatment of export transactions are highlighted while providing a comparative analysis of the southeastern states' treatment of export transactions using foreign sales corporations (FSC).

The results of this study demonstrate not only that disparity among the southeastern states treatment of exporters exists, but also that the method used by state governments to tax FSCs could impact the extent to which corporations find it desirable to export their goods from a particular state. Based on these findings, the authors suggest the adoption of administrative pricing rules (similar to the rules in place for Federal tax purposes) for FSCs by states not currently allowing these rules, which would decrease the effective tax rate on export sales. The reduction in taxes could ultimately provide an incentive for domiciled corporations to increase exporting activities, contributing to increased domestic jobs and overall economic activity.

# **A COMPARATIVE ANALYSIS OF SOUTHEASTERN STATES' INCOME TAX TREATMENT OF EXPORTERS**

## **I. Introduction**

Exports are vital to the health of the U.S. economy. Similarly, sales of goods and services abroad are important to individual state economies. This study analyzes the export-related provisions of the southeastern states' income tax laws and makes a policy recommendation for changes.

Following the introduction, Section II briefly reviews statistics that highlight the importance of exports to the domestic economy. Section III examines the federal tax law incentives to export including the large foreign sales corporation, small foreign sales corporation, shared foreign sales corporation, interest-charge domestic international sales corporation, and sales source rules. Section IV reviews several Treasury Department studies that estimate the impact the federal tax law incentives have had on the volume of exports.

Section V highlights some of the key issues under state income tax laws regarding the treatment of export transactions. Section VI provides a comparative analysis of the southeastern states' treatment of export transactions using foreign sales corporations (FSC). Section VII makes recommendations for states' policies toward exports, and Section VIII provides a summary and conclusion.

## **II. Economic Desirability of U.S. Exports**

The United States actively encourages the export sale of goods and services through sundry programs providing loans, credit guarantees, insurance, and marketing information. Some programs specifically target small businesses, where much of the potential for export growth lies.<sup>1</sup> There are many reasons why the federal government promotes exports, but the

single most important reason is that sales abroad expand the domestic economy. Estimates credit exports with 7.4 percent of the U.S. gross domestic product (GDP).<sup>2</sup> In the early 1990s, growth in U.S. exports accounted for 80 percent of the increase in GDP.<sup>3</sup> The growth in exports has also led to higher employment and better paying jobs. The federal government estimates that every \$1 billion in U.S. exports supports 19,000 domestic jobs. On average, these export-related jobs pay 17 percent more than other domestic jobs.<sup>4</sup>

Since increased exports translate into higher production levels and employment, some state governments pour significant resources into efforts to stimulate exports. A good example of these activities is provided by Florida's export finance corporations. The state government establishes and capitalizes these export finance corporations to facilitate exports from the state. The purposes of export finance corporations are to assist exporters through direct loans, loan guarantees, investments, trade counseling, and technical assistance and to cooperate with other organizations and agencies in promoting export trade.<sup>5</sup> Florida's Division of International Trade and Development in its Department of Commerce also promotes and facilitates exports. Among other things, this division schedules and conducts trade delegations and missions, provides technical assistance through counseling and seminars, coordinates resources available to U.S. exporters, maintains trade data bases, and provides export financing.<sup>6</sup> In short, this agency performs many of the same services as the U.S. Department of Commerce. The services, of course, should be more effective in promoting Floridian exports, since they specifically focus on goods and services produced within the state.

### **III. Federal Tax Law Incentives**

The promotion of exports at the Federal level has a long tradition. In 1971, Congress enacted legislation that provided a tax benefit to encourage U.S. exports. The incentive assumed the form of a tax-exempt entity called a domestic international sales corporation

(DISC). Though the DISC was exempt from federal income tax, its shareholders were taxable on dividends received. Each year, a DISC generally was *deemed* to distribute one-half of its export profits even when no profits were *actually* distributed. Thus, only one-half of the annual export profits earned through a DISC generally were taxable. The untaxed profits were tax deferred until actually distributed, the DISC was liquidated, the DISC ceased to qualify as a DISC, the shareholders sold their DISC stock, or the DISC election was terminated or revoked.<sup>7</sup>

The DISC's deferral tax benefit was significant. The number of DISC elections rapidly climbed from 3,439 in 1972 to 18,717 in 1984 suggesting that many exporters recognized and used the Federal DISC incentive.<sup>8</sup> More revealing of the DISC program's success is the number of federal income tax returns filed each year. In 1976, DISC returns totaled 6,431.<sup>9</sup> By 1983, the number of DISC returns had swelled to 9,663.<sup>10</sup> This 50 percent growth translates into a six percent annual increase. Similarly, the aggregate deferred income of all DISCs at the end of 1976 and 1984 was \$6.946 trillion and \$22.76 trillion, respectively.<sup>11</sup> This 228 percent increase translates into an annual growth rate of 16 percent.

Perhaps the DISC program was a bit too successful. Several major trading partners (e.g., the European Economic Community) complained that the DISC deferral was an illegal export subsidy that violated the General Agreement of Tariffs and Trade (GATT). In response to GATT complaints, the United States replaced the DISC with other export incentives, namely the foreign sales corporation (FSC) and the interest-charge domestic international sales corporation (ICD). These new provisions were enacted as part of the Tax Reform Act of 1984. Since relatively few U.S. exporters use ICDs (less than five percent of exports through FSCs),<sup>12</sup> the focus of this analysis will be on the Federal and state tax treatments of the more extensively utilized FSC.

Interest among U.S. exporters in FSCs was not as great as for the pre-1985 DISCs. Active FSCs totaled 2,341, 2,900, and 2,613 in 1985, 1986, and 1987, respectively.<sup>13</sup> The



decline in 1987 was presumably due to the drop in overall tax rates included in the Tax Reform Act of 1986. The exempt FSC income was \$1.975 billion, \$2.027 billion, and \$2.111 billion over the same three-year period.<sup>14</sup> The small upward trend in FSC elections during the early years and the modest 3.4 percent annual growth in exempt income suggest that, initially, many U.S. exporters were not convinced the FSC benefits outweighed the FSC costs.

Despite the lessened interest in FSCs vis-à-vis pre-1985 DISCs, the U.S. Treasury Department estimated that the FSC program increased U.S. exports by \$1.54 billion, \$1.52 billion, and \$1.2 billion in 1985, 1986, and 1987, respectively. These estimated increases were seven-tenths of one percent of total U.S. exports in 1985 and 1986 and one-half of a percent of total U.S. exports in 1987.<sup>15</sup> In addition to the increase in U.S. exports, the Treasury Department estimated that the FSC program indirectly reduced dependence on U.S. imports of goods and services, increased service exports, and increased income from U.S. investments abroad.<sup>16</sup> The revenue cost of the FSC program was estimated to be \$790 million, \$811 million, and \$760 million in 1985, 1986, and 1987, respectively.<sup>17</sup>

The FSC can operate on either a buy-sell or a commission basis. Most operate on a commission basis, receiving fees from their parent companies in return for facilitating export sales. In addition to this variation, a FSC can be established as either a large FSC (LFSC) or a small FSC (SFSC). More than one U.S. company can export through a single LFSC or SFSC. This latter arrangement reduces the maintenance and operational expenses of each exporter and is known as a shared FSC.

The remainder of this section reviews the tax provisions applicable to the LFSC, SFSC, and shared FSC. In addition, we discuss the sales sourcing rules and their implications for export transactions.

## **A. Large Foreign Sales Corporations**

U.S. exporters with substantial foreign sales can benefit significantly by creating a LFSC. The tax benefit takes the form of an exemption ranging generally between 15 and 30 percent. Assuming a federal tax rate of 34 percent, the effective tax rate on export profits using a FSC ranges between 23.8 and 28.9 percent.<sup>18</sup> In addition, grouping export transactions and using marginal costing techniques sometimes can be used to enhance the FSC tax benefit.<sup>19</sup>

Many of the provisions reviewed below are equally applicable to LFSCs and SFSCs. For those provisions, the more general term "FSC" is used. Notable exceptions are the foreign management, foreign sales participation, and foreign direct cost requirements, which apply only to LFSCs. Provisions peculiar to the SFSC are discussed later.

### **1. Foreign Presence and Other Organization Requirements**

A FSC is a corporation organized in a qualified foreign country or U.S. possession.<sup>20</sup> More than 30 locations outside the United States qualify.<sup>21</sup> However, nearly all FSCs are formed in Barbados, Bermuda, Guam, Jamaica, and the U.S. Virgin Islands because these jurisdictions impose low or no taxes on FSC profits.<sup>22</sup> In addition to foreign organization, a FSC must have a foreign office where it maintains a permanent set of books and other financial records. Specified corporate records also must be kept at some location within the United States.<sup>23</sup>

Federal tax law allows no more than 25 parties to own stock in a FSC.<sup>24</sup> Though no minimum capital is specified under U.S. law, a FSC can have no outstanding preferred stock.<sup>25</sup> The FSC's board of directors must include at least one individual who is not a U.S. resident.<sup>26</sup> Finally, a FSC cannot be a member of a controlled group of corporations that includes an ICD, and the foreign corporation must make a timely election to be a FSC.<sup>27</sup>

## 2. Export Transactions

The following five broad categories of export transactions qualify for the FSC exemption:

1. The sale, exchange, or other disposition of export property;
2. The lease or rental of export property for use abroad;
3. Services related and subsidiary to transactions in categories 1 or 2 above;
4. Engineering and architectural services for construction projects abroad; and
5. Managerial services for unrelated FSCs or DISCs geared toward enhancing the exemption or deferral, respectively, of these unrelated entities.

Only FSCs that receive at least 50 percent of their gross receipts from transactions in categories 1 through 3 during the taxable year are entitled to FSC benefits from rendering managerial services described in category 5.<sup>28</sup>

Notwithstanding the five categories above, the following types of transactions do not qualify for FSC benefits:

1. The properties or services sold are for ultimate use within the United States;
2. A federal law or regulation requires the U.S. government or one of its instrumentalities to use this type of property or service (e.g., made in America);
3. The transaction involves a subsidy from the United States or one of its instrumentalities;
4. The sales proceeds are from another FSC in the same controlled group of corporations as the FSC receiving payment; and
5. The amounts received represent investment income or carrying charges.<sup>29</sup>

Most qualified transactions involve export property. To constitute export property, all of the following requirements must be met:

1. Some party other than a FSC must manufacture, produce, grow, or extract the item within the United States;<sup>30</sup>
2. The item must be held primarily for sale, rental, or lease in the ordinary course of business for direct consumption, use, or other disposition abroad;

3. No more than half of the item's fair market value can be attributed to materials or parts imported into the United States;
4. A FSC cannot lease or rent the item to a related corporation;
5. With some exceptions, the item cannot be an intangible asset used in a manufacturing process or marketing;
6. The item cannot be oil, gas, or a primary product from either oil or gas;
7. The item cannot be on the list of products whose export is prohibited or curtailed under federal law to protect the U.S. economy;
8. The item cannot be unprocessed softwood timber; and
9. The item cannot be property that the U.S. President has declared to be in short supply.<sup>31</sup>

### **3. Foreign Management**

To generate export profits eligible for the tax benefit, a LFSC must be managed outside the United States.<sup>32</sup> Management abroad includes three requirements that must be satisfied throughout the taxable year. Failure to satisfy any one of the requirements means that the LFSC forfeits the benefit of the tax exemption for that year.

First, all formally-convened board of director and shareholder meetings must be held outside the United States. Whether meetings must be held and other meeting-related issues depend on the local law of the jurisdiction where the LFSC is organized.<sup>33</sup> Second, the LFSC's principal bank account must be maintained in a qualified foreign country or U.S. possession.<sup>34</sup> Third, all cash dividends, legal and accounting fees, and salaries of board members and officers must be paid from a bank account maintained abroad.<sup>35</sup>

### **4. Foreign Economic Processes**

For a given transaction to qualify for the tax exemption, both a sales participation test and a direct cost test must be met.<sup>36</sup> Both are transaction-based. Thus, the failure of one

transaction to qualify does not preclude the tax benefit on another export transaction in the same taxable year.

The tax exemption is allowed only for export transactions in which the LFSC or its agent participates outside the United States. For the participation to occur outside the United States, the sales participation must be initiated abroad.<sup>37</sup> For this purpose, sales participation means solicitation, negotiation, or contracting.<sup>38</sup> Thus, only one of these three activities need be initiated abroad for the related transaction to qualify for FSC tax benefits.

The direct cost test focuses on five activities involving expenses:

1. Advertising and sales promotion;
2. Processing orders and making delivery arrangements;
3. Delivering the export property to the customer;
4. Determining and transmitting the invoice or statement of account and receiving payment; and
5. Assuming credit risk.<sup>39</sup>

For a given export transaction, the direct cost test can be satisfied in two alternative ways. First, the test is met if at least half of the aggregate direct costs the LFSC incurs in the five categories above are foreign direct costs.<sup>40</sup> Second, the test is met if at least 85 percent of the direct costs the LFSC incurs in any two of the five categories above (tested separately) are foreign direct costs.<sup>41</sup>

## **5. Exemption Benefit**

Most FSCs operate on a commission basis. However, the calculation of the tax benefit is easiest to understand in the context of a buy-sell FSC in which a related supplier (usually a sole corporate owner) sells a product to its FSC which, in turn, sells the product to a foreign

consumer. Therefore, the discussion that follows assumes a buy-sell FSC. The results are the same for both forms of FSCs. Generally, two steps are involved.

First, a transfer price between the FSC and its related supplier must be determined. The transfer price is the mechanism that allocates the export profit between the FSC and its related supplier. Three methods exist for calculating the transfer price:

1. The combined taxable income method allocates profit to the FSC in an amount equal to 23 percent of the net profit from the export sale (i.e., the combined taxable income of the FSC and its related supplier).
2. The foreign trading gross receipts method allocates profit to the FSC in an amount equal to the lesser of 1.83 percent of export receipts from the sale to the foreign consumer or 46 percent of the net profit from the export sale.
3. The arm's length method allocates profit to the FSC based on the amount unrelated parties would charge on the same transaction.<sup>42</sup>

To maximize the tax benefit, it is desirable to select the method that allocates the largest profit to the FSC. Most U.S. exporters with FSCs use one or both of the first two methods, which are known as administrative pricing methods.<sup>43</sup> Under these two methods, the profit allocation to the FSC is used to "back into" the transfer price. To use administrative pricing, the FSC or its agent must perform the three sales participation activities and the five direct cost activities discussed above.<sup>44</sup> For this purpose, it does not matter where these eight activities are performed.

Second, the tax exemption is determined based on the transfer price calculated in the first step above. When administrative pricing is used and a corporation owns the FSC, the FSC can exclude 15/23 of its allocated gross profit.<sup>45</sup> Specifically, the transfer price reduces the export receipts from the foreign consumer to obtain gross export profit (or foreign trade income). The FSC exemption is 15/23 of the gross export profit. Thus, when the combined taxable income pricing method is used, the FSC tax benefit is always 15 percent (i.e., 23 percent of the profit allocated to the FSC times 15/23), which results in a 28.9 percent effective tax rate (i.e., 85

percent of the 34 percent statutory rate). The maximum FSC tax benefit under the foreign trading gross receipts method is 30 percent (i.e., 46 percent of the profit allocated to the FSC times 15/23), which results in a 23.8 percent effective tax rate (i.e., 70 percent of the 34 percent statutory rate).

Otherwise allowable deductions properly allocated or apportioned to the FSC exemption are non-deductible.<sup>46</sup> Similarly, a FSC generally is denied a foreign tax credit for foreign taxes paid on export income.<sup>47</sup> This explains why they tend to be located in the Caribbean countries, which do not tax FSCs or tax them very lightly.

Most FSCs have only corporate shareholders and use only administrative pricing rules to determine their tax benefit. When these FSCs remit their export profits as dividends, the corporate shareholders must include the profits in their gross incomes. However, the gross income is entirely offset with a 100 percent dividend received deduction.<sup>48</sup> Thus, dividend distributions received from a FSC generally do not increase the federal income tax liability of the recipients; the tax impact is determined entirely at the FSC level on these exports.

## **B. Small Foreign Sales Corporations**

A less costly alternative to the LFSC is provided through the SFSC. However, the drawback to the SFSC is that only \$5 million of export sales qualify for the tax exemption each year.<sup>49</sup> To qualify as a SFSC, a corporation must meet all the foreign presence and other organization requirements discussed previously for LFSCs, but with two differences. First, the election must state that the corporation wishes to be a SFSC. Second, the corporation cannot be a member of a controlled group of corporations that includes a LFSC.<sup>50</sup>

Unlike a LFSC, a SFSC need not meet the foreign management and foreign economic processes requirements to generate export receipts qualifying for the tax exemption.<sup>51</sup> Thus, shareholder and board meetings can take place in the United States, the principal bank account

can be maintained anywhere, FSC disbursements need not come from the principal bank account, no sales participation activities have to be initiated abroad, and no direct costs need be incurred abroad. In short, the SFSC is less complex and less expensive to operate than the LFSC.

### **C. Shared Foreign Sales Corporations**

A group of 25 or fewer unrelated U.S. companies can establish a single FSC through which to sell their goods and services abroad. To effectively operate a shared FSC it is necessary to establish and maintain separate transaction accounts for each company. The distributions to each company must be based on the amounts in the separate accounts.<sup>52</sup>

The primary advantage of a shared FSC is that it allows the participating exporters to share common expenses, thus, achieving economies of scale. However, only the costs of establishing and operating the FSC are shared among the separate exporters. Profits, trade secrets, and other financial information are not shared. The arrangement is particularly attractive for small companies that might otherwise decide not to export or that might not have sufficient export sales volume to justify using a solo FSC.

### **D. Impact of Sales Source Rules on Tax Benefit**

The United States allows a tax credit for foreign income taxes that U.S. companies pay or accrue. Though export sales generally are not subject to foreign income taxes, all or some of the sales' profit may be foreign source income. As noted below, foreign source income is an important component in calculating the foreign tax credit. Thus, the source of income rules can affect the after-tax return on export sales. After explaining the foreign tax credit mechanism, the impact of the source rules on export sales (both with and without a FSC) is examined.



The United States taxes the worldwide income of its U.S. citizens, residents, and domestic corporations.<sup>53</sup> Thus, the United States taxes both U.S. source and foreign source income of these taxpayers. However, U.S. taxpayers can claim a foreign tax credit for foreign income taxes paid or accrued during the taxable year.<sup>54</sup> The purpose of the credit is to mitigate the effect of the same income being taxed twice--once by the United States (because of the U.S.'s worldwide jurisdiction) and once by a foreign country or U.S. possession.

The credit is permitted only against U.S. income taxes imposed on *foreign source* income. A formulary limitation prevents taxpayers from claiming the foreign tax credit against U.S. income taxes imposed on *U.S. source* income. The general limitation is expressed as follows:

$$\text{Limitation} = \frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \text{U.S. Tax Before Credit}^{55}$$

Foreign income taxes paid or accrued during the taxable year, which are known as creditable taxes, are not allowed as a credit to the extent they exceed the result of the limitation formula. The amounts disallowed are called excess credits. Excess credits can be carried back two taxable years and forward five taxable years.<sup>56</sup> In each carryover year, the excess credit is summed with the creditable taxes for that year. This sum is subject to the result of the limitation formula in the carryover year. Excess credits that are not allowed during the two-year/five-year carryover period are lost.

Generally, a foreign effective tax rate higher than the prevailing effective tax rate in the United States results in excess credits. Since the substantial decrease in U.S. tax rates in 1986, most domestic corporations with foreign operations (e.g., foreign subsidiaries, joint ventures, or branches) have excess credits.<sup>57</sup> If not absorbed during the two-year/five-year carryover period, the credits are forfeited. One means of salvaging excess credits is to engage

in foreign transactions that yield foreign source income (thus, increasing the numerator of the limitation formula) without incurring a foreign income tax. Exporting is a transaction that allows this type of tax planning.

The profit from the export sale of manufactured goods is partially U.S. source and partially foreign source income.<sup>58</sup> The allocation of profit between these two source categories can be based on an independent factory price, if available.<sup>59</sup> An independent factory price has been held not to exist in the absence of a foreign selling or distributing branch.<sup>60</sup> When an independent factory price is not available, 50 percent of the income is sourced according to where the manufacturing occurs and 50 percent is sourced according to where the gross sales occur.<sup>61</sup> Sales generally occur wherever title to goods pass, which depends primarily on the terms of sales contracts.<sup>62</sup> Thus, when manufacturing occurs in the United States and sales contracts are structured so that title to goods transfers abroad, half of the export income is U.S. source and half is foreign source.

As noted above, the foreign source portion of the export income allows the taxpayer to offset the U.S. tax incurred with any excess credits it might possess. Thus, to the extent the taxpayer has excess credits from other foreign operations (e.g., foreign branches) that are expected to be lost, export transactions are one means of using the credits. In other words, the foreign source portion of the export income is subject to U.S. taxation (because of U.S. worldwide jurisdiction), but the U.S. tax is entirely offset with the excess credits that otherwise might be lost. In effect, only half of the export profit is taxable; the foreign source portion of the export profit is exempt. Thus, a U.S. taxpayer normally subject to a 34 percent U.S. tax rate is subject to an effective rate of 17 percent on its export transactions when it has excess credits that are expected to expire.

Because statutory provisions restrict the benefit derived from the source rules to 25 percent when a FSC is used with the 23 percent administrative pricing rule,<sup>63</sup> a U.S.

corporation with excess credits that otherwise will expire generally should not use a FSC for exporting. The rationale for this proposition follows. Since the FSC benefit is generally 15 percent and the use of a FSC when the U.S. exporter has excess credits typically results in a 40 percent benefit, a U.S. taxpayer otherwise subject to a 34 percent tax rate can only reduce the effective rate to 20.4 percent in this situation. On the other hand, the tax benefit of the source rules for exporters with excess credits when a FSC is not used is 50 percent, resulting in an effective rate of 17 percent.

#### **IV. Impact of Federal Tax Legislation on Exports**

By most measures, the DISC was very popular among U.S. exporters between 1971 and 1985. The intent of the DISC legislation was to increase the volume of U.S. exports. Similarly, the purpose of the 1984 legislation replacing the DISC with the FSC (and ICD) was to continue the export incentive (albeit in GATT-proof form) to achieve national economic objectives. The relevant question, however, is not whether U.S. exporters took advantage of the tax incentives, but whether and to what extent these tax incentives were successful at a reasonable cost. More specifically, have the DISC and FSC programs been successful in increasing the volume of U.S. exports? Treasury Department reports, which are discussed below, generally conclude that the programs have been successful (i.e., they have promoted exports at a reasonable cost to U.S. taxpayers.). A study of the export sales source rule and its effect on U.S. exports is also examined below.

##### **A. Pre-1985 DISC Effect on Exports**

Annual Treasury Department reports examined the question of whether the DISC program did, in fact, increase export volume or supply. The conclusions of the eleventh annual report were similar to those in prior years. Based on estimated supply and demand price elasticities

and an assumed effective tax rate of 40 percent, the Treasury estimated that the DISC program increased U.S. exports between \$6 and \$9.2 billion in 1982 and between \$4.8 and \$7.4 billion in 1983.<sup>64</sup> The estimated revenue cost associated with the increase in exports was \$1.52 billion and \$1.24 billion for 1982 and 1983, respectively.<sup>65</sup> Thus, there were between \$3.94 and \$7.42 of exports promoted for every dollar of forgone revenue for 1982 and between \$3.87 and \$5.97 for 1983. These estimates reflected the initial, direct impact of the DISC deferral.

The Treasury also considered the impact of long-term factors on the volume of exports. Over time, the DISC program was expected to affect relative prices, capital flows, income, and rates of return. When the long-term factors were considered, the Treasury estimated that the total effect of the DISC program on exports was only two-thirds of the initial, direct impact.<sup>66</sup>

## **B. FSC Effect on Exports**

Treasury used a standard trade model to estimate the impact of the FSC program on U.S. exports in the medium term. The model calculated trade effects for each of several industries. In each industry, the model estimated proportional changes in average export prices based on export supply and demand elasticities, volume of exports, cash flow benefit of FSC exemption, and exchange rate responses to shifts in trade.<sup>67</sup> The model equations assumed that firms view taxes the same as other costs of doing business.<sup>68</sup>

The FSC program was estimated to increase aggregate U.S. exports by \$1.5 billion, \$1.5 billion, and \$1.2 billion in 1985, 1986, and 1987, respectively. In order of impact, the following industries had the largest increases in export volume: transportation equipment, nonelectrical machinery, and electrical machinery.<sup>69</sup>

To estimate the revenue cost of the FSC program, Treasury assumed effective corporate tax rates of 40 percent, 40 percent, and 36 percent for 1985, 1986, and 1987, respectively. It also assumed that the factors of production generating FSC exports would produce the same

level of income without the FSC tax incentive. Based on these assumptions, Treasury estimated that the revenue cost of the FSC program was \$790 million, \$811 million, and \$760 million in 1985, 1986, and 1987, respectively. Thus, the exports promoted per dollar of foregone revenue were \$1.90, \$1.85, and \$1.58 for 1985-87, respectively. Based on an effective corporate tax rate of 32 percent for subsequent years, Treasury projected revenue costs of \$742 million, \$850 million, \$924 million, and \$1,048 million for 1988 through 1991, respectively.<sup>70</sup>

### **C. Effect of Sourcing Rules on Exports**

As discussed earlier, the effective tax rate of U.S. companies with excess foreign tax credits that export directly (i.e., without using a FSC) is generally half the effective rate that would otherwise apply. The lower effective tax rate is a result of the source rules for the sale of produced goods that often treats half the income as foreign source. The foreign source income increases the foreign tax credit limitation formula, which allows the excess credits to be absorbed. Thus, the current source rules sometimes are viewed as an incentive to export.

An alternative to the current sales source rule is an activity-based rule. An activity-based rule sources income according to where economic activity occurs. Treasury used IRS and Commerce Department data and an activity-based rule to treat all export income as from U.S. sources.<sup>71</sup> If the alternative activity-based source rule is required in place of the current source rule, the change would result in no tax benefits to U.S. exporters with excess foreign tax credits.

The current sales source rule (vis-à-vis an activity-based rule) is estimated to increase annual U.S. exports in the medium term between zero and \$4 billion; the best estimate of the increase is \$1.7 billion. However, in the long term, Treasury expects the repeal of the current sales source rule and the accompanying decline in U.S. exports to be matched by a similar decline in U.S. imports. According to these calculations, the repeal of the current sales source

rule should leave the balance of U.S. trade unaffected in the long term.<sup>72</sup> For 1990, the revenue cost of the current sales source rules was \$2.069 billion. In years after 1991, the revenue cost was expected to be lower.<sup>73</sup>

## **V. General Issues in State Taxation of Export Profits**

All but a few states have a state corporate income tax. Usually the levy is called an income tax, but some states refer to it as a franchise, business profits, or license tax. Each state has its own determination of taxable income, but most states “piggyback” on the calculation of the federal income tax base, at least to some degree.

Even those states that piggyback on the federal definition of taxable income vary widely in their treatments of some provisions found in the federal income tax law. In particular, states often take different approaches to the income tax treatment of export transactions. Some states recognize FSCs and afford them benefits similar to those available under federal law. Other states provide their own alternative export incentives or no special treatment. This section discusses several of the more important export-related issues under state tax law.

### **A. Nexus**

From a revenue perspective, nexus establishes a state government's right to impose a tax. Nexus is the link between the entity and the state that gives the state a right to impose its tax. What constitutes nexus varies considerably from one state to another.

Entities incorporated within a state generally have nexus with that state, regardless of where business is actually conducted. At the same time, entities incorporated in one state can have nexus with other states. Similarly, a corporation organized in a foreign country or U.S. possession can have nexus with one or more of the 50 states.

Two definitions of nexus have evolved over the years. Minimum nexus is a concept derived from the due process clause of the U.S. Constitution.<sup>74</sup> Substantial nexus is based on the Constitution's commerce clause and applies to interstate commerce activities.<sup>75</sup>

Minimum nexus exists whenever the state has provided benefits for which it can reasonably expect a return in the form of tax dollars.<sup>76</sup> State benefits generally include intangible services such as the protection that the state's laws provide and favorable business conditions. Thus, an entity that exploits a state's economic market through interstate sales is said to have economic or due process nexus with that state. This type of nexus is sufficient jurisdiction for some types of taxes, such as a net worth tax on capital, but is insufficient for others, particularly a state income tax. For example, Public Law No. 86-272 prohibits a state from taxing the income of a corporation if its only business within the state consists of solicitation of orders for sales of tangible personal property that are sent outside the state for approval and are filled and shipped from outside the state.<sup>77</sup>

Interstate commerce activities cannot be taxed without commerce clause or substantial nexus. Thus, state taxes based on income require substantial nexus, which has been interpreted to mean a "physical presence" within the state.<sup>78</sup> Substantial nexus usually involves financial capital in the state, owned or leased property in the state, employment of one or more persons in the state, or maintenance of an office or other fixed place of business in the state. However, there are several non-universal activities which are used by various states to determine nexus. These activities include, among others, software licensing, phone book listing, and intangible right licensing. Thus, listing a company in a telephone directory will trigger nexus in some states. Since state nexus rules vary considerably, careful examination of the universal and non-universal nexus-creating activities must be considered to determine whether the state has a legitimate right to tax a particular entity.

FSCs are organized outside the United States and generally sell products and services in foreign markets. FSCs generally do not own or lease property in the United States, neither do they usually have employees. Moreover, LFSCs must be managed abroad and must participate in some foreign economic processes. First impressions, therefore, might suggest that most FSCs have no nexus with any of the 50 states. That is, FSCs generally do not have a physical presence within the United States (thus, avoiding substantial nexus).<sup>79</sup>

However, the potential tax revenue from the export income of FSCs is tempting and difficult for some states to disregard. In many cases, the parent companies act on behalf of their FSCs in a variety of contractual capacities (i.e., in meeting the foreign economic process requirements discussed earlier). Some commentators have suggested the possibility that the agency relationships established between a FSC and its parent company could subject the FSC's export profits to state income taxation through attributional nexus.<sup>80</sup> In addition, some states have found other means to tax the export profits of FSCs, as discussed later, even when nexus is lacking.

## **B. Formulary Apportionment**

When an entity (or unitary business as discussed below) has nexus with two or more states, formulary apportionment procedures in each state determine the portion of total business income over which the states can exercise their jurisdictions to tax. The first step is to calculate the apportionable income of the entity as a whole. Apportionable income is the entity's net business income as determined under the state's law. Many states distinguish among allocable and apportionable income. Allocable income, including in many cases income not related to business activities, are fully taxable in the state where the company is domiciled, and for that reason are separated from otherwise apportionable income items. Dividends are generally considered to be allocable income, meaning they are 100 percent taxed where the



company is domiciled. However, dividends may be subject to apportionment when the recipient controls or manages the underlying investment (e.g., dividends from a wholly-owned FSC).<sup>81</sup>

After bifurcating total income into apportionable and allocable income, a ratio is determined for each factor in the state's apportionment formula. The numerator of each ratio includes a measure of business activity from within the state, while the denominator of each ratio includes the same measure for the entity as a whole.<sup>82</sup> Most states use a three-factor apportionment formula that equally weights sales, property, and payroll.<sup>83</sup> However, a common trend among states is to double weight or assign a higher weight to the sales factor. Nevertheless, regardless of the weight assigned to the sales factor, the computation of the factor itself is typically calculated as a ratio, the numerator of which reflects sales made within the state while the denominator includes all sales.<sup>84</sup> Similar ratios are determined for property and payroll. The average of the ratios, known as the apportionment factor, is multiplied by the entity's total apportionable income plus its allocable income to determine how much the apportioning state can tax.

Many states apply throwback rules when calculating the sales ratios for the apportionment factor. A sales throwback treats an out-of-state sale as a sale in the state of shipment or origination if the state where the sale occurs does not tax the transaction (e.g., because of no nexus in state of sale or because the state does not have a state corporate income tax). Thus, the sales ratio for state A (a throwback state from which merchandise is shipped) for sales made into state B (a state imposing no income tax on sales) would include the state B sales along with the state A sales in the numerator of the sales ratio for state A. The effect of the throwback rule is to allow state A to tax a larger portion of the apportionable income.<sup>85</sup>

With a few exceptions, most states with throwback rules do not distinguish in their application between out-of-state sales within the United States and out-of-state foreign sales. Thus, sales abroad that incur no foreign income tax usually are subject to throwback.<sup>86</sup> Export

sales generally are not subject to foreign income tax. Since most FSCs operate on a commission basis, the U.S. parent companies of these entities actually make the export sales and, accordingly, are subject to throwback rules. Thus, throwback rules can increase the apportionment factor and, consequently, state income tax for U.S. exporters in some states.

### **C. Unitary and Combined Income Reporting**

Some states impose income taxes on a unitary business basis. A unitary business is one operated as an integrated unit. It is characterized by functional integration, centralized management, and economies of scale. Unitary theory focuses on the way a business operates rather than on the way it is organized. Thus, two or more affiliated corporations (all separate legal entities) that achieve economies of scale through the way they are organized or operated can be considered one unitary business and, accordingly, are treated as one taxpayer. In states that invoke the unitary business concept, multi-corporate enterprises that meet unitary business criteria are required to use combined income reporting methods. Combined income reporting is a method of taxing a multi-corporate enterprise carrying on a unitary business in the same manner as a single corporation operating through separate divisions.<sup>87</sup>

When the unitary business principle is required by the state or elected by the entity, either a unitary tax return or a combined report must be filed with the state government. It should be noted that both returns use the "combined income reporting" method described above. The type of return filed depends on the particular state's administrative requirements. The distinction between the two types of reports follows.

A unitary tax return treats and taxes the members of a unitary group as a single taxpayer. On the other hand, a combined report is used to determine the proper amount of income reportable by each entity engaged in a single unitary business and includable in its separate return. Thus, a unitary return involves a single return while the combined report is not a return

at all and does not relieve any entity from its duty to file a return.<sup>88</sup> Though the type of tax return used to report a unitary group's state liability is important for adhering to state compliance requirements, the key issue for this analysis is whether the unitary principle can be invoked. In the southeastern region of the U.S., none of the states examined mandate unitary business principles. However, Georgia and Kentucky can force unitary principles on a case-by-case basis. Accordingly, the remainder of this subsection presents a description of how a unitary business tax liability is computed for states using unitary taxation principles.

Unitary states determine apportionable income for the unitary business rather than for each separate legal entity. In addition, the ratios constituting the apportionment formula are computed for the unitary business as a whole, not the separate legal entities comprising the unitary business. Thus, unitary states treat separate corporations that are part of the same unitary business as one taxable unit.

The unitary method can be applied on either a water's edge or worldwide basis. Under water's edge reporting, only domestic activities of corporations (i.e., those organized or created in the United States) are considered part of a unitary business; activities of foreign corporations (in this context, those organized outside the United States) are ignored. In contrast, under worldwide income reporting, foreign corporations can be considered part of a unitary business. The U.S. Supreme Court has upheld the right of a state to require worldwide reporting of a domestic parent company and its foreign subsidiaries.<sup>89</sup> For practical reasons, however, most states with worldwide reporting allow corporations to elect water's edge reporting instead.

Since a U.S. company generally can elect out of worldwide unitary reporting in those states where it applies, it might appear that a parent company with an FSC (which must be organized abroad) can always avoid having the FSC included in its unitary business. However, this may not always be the case. The business activities of the U.S. company's other foreign subsidiaries might make worldwide reporting more attractive than water's edge. Also, the

unitary state might argue that an FSC established in a U.S. possession (e.g., the U.S. Virgin Islands) rather than in a foreign country (e.g., Barbados) can be included in the unitary business of its parent, even under a water's edge approach.<sup>90</sup>

Thus, states applying unitary principles can claim that an FSC (otherwise lacking nexus) is part of a unitary business with its corporate shareholder. Though otherwise shielded from state taxation, this position may cause a portion of the FSC's export profits to be taxable in the combined income or unitary state(s). In the case of a commission FSC (i.e., where the FSC income subject to the exemption are commissions from the sale of products rather than direct revenues from sales as in a buy-sell FSC), whether the parent company is in a unitary or non-unitary state often does not affect the *apportionment factor*. The parent company makes all the sales, and generally the FSC has no property, payroll, or sales in the U.S.; the commission the FSC receives is not added to the numerator of the sales ratio since it is a transfer within the unitary business and is already reflected in the sales of the parent. However, the commission income of the FSC (i.e., its allocable share of export profit) is included in *apportionable income* when the parent company has nexus in a unitary or combined income state and the FSC is considered part of the unitary business. Thus, the combined income and the unitary methods can increase the state taxation of a domestic corporation and its commission FSC. The effect on a U.S. company and its buy/sell FSC is similar.

#### **D. Divergence from Federal Rules**

To this point, the discussion has focused on whether any of a FSC's export profits are taxable. In non-combination and non-unitary states, a FSC is not required to file a return as long as nexus is lacking and, as discussed in a later section, the FSC is recognized as a bona fide entity, separate and distinct from its parent company. In combined income and unitary

states that use reporting requirements, FSC export profits are subject to tax only if the FSC is part of a unitary business with its U.S. parent company.

Thus, the existence of either nexus or a unitary business means that a FSC's export profits are includable in apportionable income. Then the question is *how much* of the export profits should be includable in apportionable income. Some states require that all of a FSC's profits be included, even the 15 to 30 percent of the profits that are exempt from federal income tax. Others permit any income exempt from federal taxation to be exempt from state income tax also.

Still other states seek means to shift export income away from FSCs to companies with nexus. Though the absence of nexus and a unitary business shields FSCs from direct taxation,<sup>91</sup> states can use methods to allocate income away from FSCs to their parent companies that are subject to state taxation. These methods are discussed below.

## **1. Recognition of Administrative Pricing Rules**

Even when both nexus and a unitary business (for states providing for water's edge reporting) is lacking, some states can shift most of the profits otherwise allocable to a FSC to the export entity's domestic parent company with which the state does have nexus. One means of shifting the income is to disallow the use of the administrative pricing rules that federal law permits. Recall that federal law generally allows a U.S. exporter to allocate either 23 percent of export profits or the profits allocable to 1.83 percent of export receipts to its FSC.

While recognizing FSCs as separate entities from their parent companies, states that do not permit administrative pricing argue that such methods result in an unfair allocation of profit between the related entities. Disallowing administrative pricing means that the FSC and its domestic parent must use arm's length pricing. Under arm's length pricing, the FSC can be allocated a portion of the export profit commensurate with the economic functions it performs.

In the great majority of cases, a FSC performs little or no substantial economic function. Thus, the use of arm's length pricing generally allows the FSC little or no profit allocation; that is, the bulk of the profit otherwise allocable to the FSC is shifted to the domestic parent company.<sup>92</sup> Income that might otherwise escape state taxation, therefore, becomes taxable to the parent company.

## **2. Deduction of Commissions**

Most FSCs are established as commission entities. That is, they do not take physical or legal possession of export goods. Instead, FSCs facilitate the export sales of their parent companies' goods and, in return for their services, receive commissions.

Some states do not consider FSCs that perform little or no substantial economic functions as bona fide entities. As a result, these states deny deductions to the parent companies for commissions paid to their FSCs. Consequently, all of the income otherwise attributable to the FSCs (i.e., the commissions) is effectively shifted to their parent companies.<sup>93</sup> Rather than avoiding state taxation through lack of nexus or a water's edge unitary business, commissions paid to FSCs are, in effect, taxable to the parent companies of these export entities.

## **3. Allowance of Dividend Received Deduction**

For federal purposes, a FSC is a taxable entity, and export profits remitted to a FSC's corporate parent generally are, in effect, exempt. Though the parent company must report FSC dividends as gross income, it is entitled to a dividend received deduction equal to the inclusion in income.<sup>94</sup> Most FSCs annually remit all or nearly all of their export profits as dividends because a FSC's retention and investment of export profits results in some double taxation.<sup>95</sup>

State laws vary in their tax treatments of dividends between corporations. Some do not distinguish between dividends from FSCs and dividends from other entities. Other states have

special provisions that apply to dividends received from export entities. When a dividend received deduction is disallowed (or when a received dividend is only partially deductible), the FSC's commission income is taxable to its corporate parent (in part or in full) when remitted as a dividend.

#### **4. Impact of Foreign Source Income**

As noted earlier, U.S. taxpayers with excess foreign tax credits for federal purposes often are better off exporting without an FSC. While the FSC generally returns a tax benefit of 40 percent (i.e., 15 percent through the FSC provision and 25 percent through the sourcing rules), exporting without an FSC can provide a 50 percent tax benefit through the impact of the sourcing rules on the foreign tax credit.

Very few states allow a deduction for foreign income taxes claimed as a credit on the federal return.<sup>96</sup> Still fewer allow a credit for such taxes. However, several states do allow a deduction if foreign tax payments also are claimed as a deduction (rather than as a credit) on the federal return.<sup>97</sup> In most cases, however, taxpayers prefer to treat foreign income taxes as a credit on the federal return. Thus, the federal strategy of exporting without an FSC whenever the taxpayer has excess foreign tax credits provides no tax benefits in most states. The next section provides a comparative analysis of how the southeastern states tax FSCs, and what incentives are provided to exporters.

### **VI. Comparative Analysis: Southeastern States' Taxation of FSCs**

To facilitate a comparative analysis among the southeastern states, the following assumptions have been made:

1. The FSC's corporate parent has nexus only in the state in question.<sup>98</sup>
2. All the parent company's property and payroll are located in the state of nexus.

3. All export sales are made through the parent's FSC, and all other sales are made within the state in question.
4. Export sales are ten percent of total sales.<sup>99</sup> (Thus, the apportionment factor is the average of one for the property ratio, one for the payroll ratio, and the outcome of the sales ratio, which depends on whether a throwback rule applies to FSC sales and whether the sales factor is double weighted.)<sup>100</sup>
5. The states' highest marginal tax rates are applicable to export sales (in states with progressive rate structures).
6. FSCs use the combined taxable income method to calculate the exemption benefit, which results in a federal tax benefit of 15 percent.<sup>101</sup>

#### **A. Alabama**

Alabama's tax law makes no explicit reference to FSCs. Presumably, FSCs and their related suppliers are treated the same as other parent-subsidary groups.

Alabama does not tax on a unitary or combined income basis.<sup>102</sup> Foreign corporations generally have no nexus with the state unless they do business in or derive income from the state.<sup>103</sup> However, FSCs may have to file Alabama income tax returns if their parent corporations are located within the state.<sup>104</sup> Even if a return with Alabama must be filed, the state does not tax a foreign corporation's income from sources outside the state and, thus, income allocable to FSCs usually is exempt.<sup>105</sup>

Though treated as separate corporations, FSCs can be denied use of administrative pricing.<sup>106</sup> Therefore, all or nearly all export profits can be allocated to FSCs' parent companies. When FSCs distribute their export profits to parent companies with nexus in Alabama, no dividend received deduction generally is allowed.<sup>107</sup> Nonetheless, since the remitted earnings were previously taxed directly to the parent company, no further state income tax should result.

Alabama uses an equal weight three-factor apportionment formula.<sup>108</sup> The sales factor is based on gross receipts and includes dividends received.<sup>109</sup> The state's throwback rule causes



export sales to be included in the numerator of the sales ratio unless sufficient nexus in the foreign country of sale can be demonstrated.<sup>110</sup> Thus, the apportionment factor is 100 percent after considering the assumptions mentioned earlier, and the state is entitled to tax 100 percent of total export profits. At the highest state marginal rate of five percent, the state's effective income tax rate on export profits is five percent.<sup>111</sup> See Table 1 for a summary of Alabama's taxation of export profits.

## **B. Florida**

Florida does not permit unitary or combined reporting taxation.<sup>112</sup> Thus, any export profits allocable to a FSC are not directly taxable in Florida unless the FSC has established nexus in that state.

The tax law in Florida contains no provision denying use of administrative pricing for FSCs or denying deductions for commissions paid to FSCs.<sup>113</sup> Federal law allocates 77 percent of export profits to a FSC's parent company and the residual to the FSC. Therefore, Florida permits 23 percent of export profits to be allocable to FSCs. Lacking nexus, Florida does not tax FSCs on this 23 percent portion. However, parent companies with nexus in Florida may be taxable on the portion of these profits (allocable to FSCs) they receive as dividends from their FSCs. To determine the export profits available for dividends, the federal tax imposed on FSCs must be considered since this tax reduces the FSC's earnings and profits available for distribution and, consequently, the dividends a parent company receives.

Under federal law, 15/23 of a FSC's allocable profits or 15 percent of total export profits are exempt (i.e., 23 percent allocable to FSC times 15/23 exemption rate). Thus, eight percent of total export profits are taxable to the FSC (i.e., 23 percent allocable to FSC less 15 percent exemption). Assuming a federal tax rate of 34 percent, the federal tax on a FSC's export profits

**TABLE 1**  
**STATE TAXATION OF EXPORT PROFITS**  
**ADMINISTRATIVE PRICING NOT ALLOWED**

	ALABAMA	GEORGIA	KENTUCKY	LOUISIANA	MISSISSIPPI	TENNESSEE	VIRGINIA
	Sales Throwback Rule Applies	Double Weighted Sales Factor	Double Weighted Sales Factor	Equal Weighted Factors	Sales Throwback Rules Applied	Equal Weighted Factors	Foreign Sales Thrown Out
PERCENT OF TOTAL EXPORT PROFIT							
<b>Part I - Export Profit of FSC</b>							
a. Export profits allocable to FSC	0.000%	0.000%	0.000%	0.000%	0.000%	0.000%	0.000%
<b>Part II - Export Profit of FSC's Parent Company</b>							
b. Export profits allocable to parent	100.000%	100.000%	100.000%	100.000%	100.000%	100.000%	100.000%
c. Dividend from FSC	0.000%	0.000%	0.000%	0.000%	0.000%	0.000%	0.000%
d. Parent's dividend received deduction	0.000%	0.000%	0.000%	0.000%	0.000%	0.000%	0.000%
e. Apportionable export profits (line b + line c - line d)	100.000%	100.000%	100.000%	100.000%	100.000%	100.000%	100.000%
<b>Part III - Effective Tax Rate</b>							
f. Apportionment factor	100.000%	95.000%	95.000%	96.667%	100.000%	96.667%	100.000%
g. State's taxable export profits (Line e * line f)	100.000%	95.000%	95.000%	96.667%	100.000%	96.667%	100.000%
h. State's maximum statutory income tax rate	5.000%	6.000%	8.250%	8.000%	5.000%	6.000%	6.000%
i. Effective tax rate on export profits (line g * line h)	5.000%	5.700%	7.838%	7.733%	5.000%	5.800%	6.000%

are 2.72 percent of total export profits (i.e., 8 percent export profits taxable to FSC times 34 percent federal tax rate). Thus, the after-federal-tax export profits that are distributed to a FSC's parent company are 20.28 percent (i.e., 23 percent allocable to FSC less 2.72 percent of federal tax) of total export profits.

When FSCs distribute these profits to their parent companies with nexus in Florida, the same dividend received deduction percentage permitted under federal law generally is allowed for state income tax purposes.<sup>114</sup> Thus, the parent is entitled to a dividend received deduction under Florida law equal to the dividend received. The dividend does not increase the parent company's apportionable income. Therefore, only 77 percent of total export profits are included in the parent's apportionable income.

Florida uses a three-factor apportionment formula in which sales are doubled.<sup>115</sup> The state has no throwback rule; thus, export sales are excluded from the numerator of the sales ratio.<sup>116</sup> The apportionment factor is 95 percent after considering the assumptions mentioned earlier (i.e., 3.8 divided by 4.0), and the state is entitled to tax 73.15 percent of total export profits (i.e., 77 percent included in apportionable income times 95 percent apportionment factor). At a state income tax rate of 5.5 percent, the state's effective income tax rate on total export profits is 4.023 percent (i.e., 73.15 percent of export profits taxed at highest marginal rate of 5.5 percent).<sup>117</sup> See Table 2 for a summary of Florida's taxation of export profits.

### **C. Georgia**

Georgia adopts much of the federal tax law for corporations and piggybacks on the federal computation with some minor adjustments.<sup>118</sup> Since FSC provisions are reflected in federal taxable income, it might appear at first glance that Georgia implicitly adopts the FSC provisions and provides significant benefits to U.S. exporters. However, administrative practice

**TABLE 2**  
**STATE TAXATION OF EXPORT PROFITS**  
**ADMINISTRATIVE PRICING ALLOWED**

	FLORIDA	NORTH CAROLINA	SOUTH CAROLINA	WEST VIRGINIA
	Double Weighted Sales Factor	Double Weighted Sales Factor	Double Weighted Sales Factor	Foreign Sales Thrown Out
PERCENT OF TOTAL EXPORT PROFIT				
<b>Part I - Export Profit of FSC</b>				
a. Export profits allocable to FSC (same as federal)	23.000%	23.000%	23.000%	23.000%
b. Federal exemption (15/23 of line a)	15.000%	15.000%	15.000%	15.000%
c. FSC's export profits subject to federal tax (line a less line b)	8.000%	8.000%	8.000%	8.000%
d. Federal tax on FSC's share of export profits (34% of line c)	2.720%	2.720%	2.720%	2.720%
<b>Part II - Export Profit of FSC's Parent Company</b>				
e. Export profits allocable to parent (same as federal)	77.000%	77.000%	77.000%	77.000%
f. Dividend from FSC (Line a less line d)	20.280%	20.280%	20.280%	20.280%
g. Parent's dividend received deduction	20.280%	20.280%	20.280%	20.280%
h. Profit added back to parent's taxable income (line c), if any	N/A	8.000%	N/A	N/A
i. Apportionable export profits (Line e + line f - line g + line h)	77.000%	85.000%	77.000%	77.000%
<b>Part III - Effective Tax Rate</b>				
j. Apportionment factor	95.000%	95.000%	96.667%	100.000%
k. State's taxable export profits (line i * line j)	73.150%	80.750%	74.434%	77.000%
l. State's maximum statutory income tax rate	5.500%	7.750%	5.000%	9.000%
m. Effective tax rate on export profits (line k * line l)	4.023%	6.258%	3.722%	6.930%

often varies from the initial impressions derived from a reading of the statutory law. Such is the case here.

Georgia has not adopted unitary or combined reporting tax concepts, per se.<sup>119</sup> However, on a case-by-case basis the state can force the unitary business concept.<sup>120</sup> Since Georgia does not subscribe to worldwide reporting for unitary purposes, the taxation of FSCs as separate entities depends entirely on whether nexus exists. Under Georgia law, a corporation must be doing business within the state for nexus to exist. Doing business includes any activities or transactions engaged in for the purpose of profit or gain.<sup>121</sup> Since FSCs are organized outside the United States, typically conduct all business abroad, and generally maintain no U.S. office or U.S. employees, FSCs are not considered to be doing business in Georgia. Thus, most FSCs will not have nexus in Georgia and will be exempt from Georgia income tax. The fact that a FSC's parent company, a separate entity, might be organized in or doing business in Georgia is irrelevant. Thus, FSCs generally are not taxable under the Georgia income tax law. This conclusion is limited to the export profits (if any) allocable to these FSC.

Georgia tax law provides that adjustments to a taxpayer's taxable income can be made to clearly reflect income of the entity.<sup>122</sup> Further, Georgia does not allow the administrative pricing methods normally adopted between FSCs and their parent companies.<sup>123</sup> Thus, Georgia can require arm's length pricing to funnel export profits back to the parent company, even though the federal tax law permits the generally more favorable administrative pricing structures. This disallowance of the administrative pricing rules can ultimately be used to allocate nearly all export profits to the Georgia-based parent company of a FSC.

Assuming that 100 percent is allocated to the parent company, the entire export profit increases apportionable income. Formulary apportionment procedures are used to determine the portion of export profits Georgia can include in taxable income. Apportionable income

includes all income other than nonbusiness or investment income. Georgia uses a three-factor apportionment formula in which sales are doubled. The state has no throwback of either out-of-state sales or payroll. The sales ratio in the formula is based on gross receipts but does not include dividends. Foreign sales are omitted from the numerator but generally are included in the denominator.<sup>124</sup>

Georgia allows a dividend received deduction similar to that available for federal tax purposes. Foreign source dividends are treated the same as dividends received from U.S. sources.<sup>125</sup> However, since arm's length pricing allocates essentially all export profits to the parent company, a FSC is not considered to have any earnings and profits under Georgia law. Thus, no portion of dividends received from FSCs should be includable in the recipient parent company's gross income. In summary, Georgia can allocate 100 percent of export profits to a FSC's corporate parent. Almost no export profits are allocable to the FSC; consequently, dividends from the FSC would not be included in the parent's gross income.

Given the stated assumptions above, the sales ratio is equal to 90 percent since no throwback rule applies in Georgia. Thus, the apportionment factor is equal to 95 percent (i.e., 3.8 divided by 4.0), and taxable income from exporting is 95 percent of export profits (100 percent of export profits times 95 percent). Georgia's highest statutory tax rate on corporations is six percent. Thus, the effective tax rate on export profits from using a FSC is 5.7 percent (i.e., 95 percent times six percent). Table 1 summarizes Georgia's taxation of export profits when export sales are through a FSC.

#### **D. Kentucky**

Kentucky allows unitary taxation as an option for both taxpayers and the state. The state can apply unitary principles on a water's edge basis whenever a related company is determined to be a shell or sham.<sup>126</sup> Since FSCs are considered foreign entities, they normally would be

beyond the reach of a water's edge approach. However, Kentucky may include a FSC in a combined report if organized in a U.S. possession rather than in a foreign country.<sup>127</sup>

Though Kentucky treats FSCs as separate legal entities, the state denies use of administrative pricing.<sup>128</sup> Thus, little or no export profits are allocated to most FSCs under state law. In this analysis, all export profits are assumed allocable to a FSC's parent company with nexus in Kentucky.

Kentucky uses a three factor apportionment factor in which sales are doubled.<sup>129</sup> The sales factor includes gross sales receipts in the ordinary course of business but generally does not include dividends.<sup>130</sup> No throwback rule applies in calculating the sales ratio.<sup>131</sup> However, a strict destination test applies in determining where sales occur.<sup>132</sup> Thus, sales to an intermediate Kentucky party that, in turn, will export the property may be considered in-state sales. For this analysis, it is assumed that all export sales are destined for some point outside the United States. Thus, the apportionment factor is 95 percent (i.e., 3.8 divided by 4.0), and 95 percent of total export profits are taxable (i.e., 100 percent allocable to parent times 95 percent apportionment factor).

The highest marginal income tax rate in Kentucky is 8.25 percent.<sup>133</sup> Thus, the effective tax rate on export profits is 7.8375 percent (i.e., 95 percent of export profits taxable times 8.25 percent statutory rate). Table 1 summarizes the calculations discussed above.

## **E. Louisiana**

Louisiana does not apply unitary or combined income principles.<sup>134</sup> Subsidiaries are treated as separate corporations as long as they are "viable."<sup>135</sup> Thus, if a FSC is deemed inviable, it can be ignored, and its export profits will be attributable to its U.S. parent. Louisiana law also reallocates income and expenses when necessary to reflect "true income."<sup>136</sup> Even when considered a separate entity, a FSC that does not perform substantial economic functions

may have its export profits reallocated to its U.S. parent company. In addition to these possibilities, Louisiana disallows the use of administrative pricing.<sup>137</sup> As in other states, the use of arm's length pricing generally results in the allocation of almost all export profits to the FSC's U.S. parent company.

The apportionment formula in Louisiana follows a three-factor formula with equal weights.<sup>138</sup> The sales factor includes gross receipts from regular business sales but excludes dividends received.<sup>139</sup> Foreign sales are included in the denominator of the sales ratio but not the numerator.<sup>140</sup> Louisiana does not have a sales throwback rule.<sup>141</sup> Thus, the apportionment factor is 96.667 percent (i.e., 2.9 divided by 3.0), which also is the percentage of export profits taxable in Louisiana (i.e., 100 percent allocable to parent times 96.667 percent apportionment factor).

Louisiana applies a corporate tax rate of eight percent to taxable incomes of \$200,000 or more.<sup>142</sup> Thus, the effective corporate tax rate on export profits is 7.733 percent (i.e., 96.667 percent of export profits taxable times eight percent statutory rate). Table 1 summarizes these calculations.

## **F. Mississippi**

Though Mississippi can apply water's edge unitary principles in some situations, it treats most corporations as separate entities.<sup>143</sup> Thus, FSCs are generally exempt from state income taxation. The state is not obligated to follow administrative pricing and, presumably, requires arm's length pricing. So even though FSCs are exempt from tax, practically all export profits can be allocated away from FSCs to their U.S. parent companies.<sup>144</sup>

Mississippi uses a three-factor apportionment factor in which the sales factor is doubled for retail sales.<sup>145</sup> Foreign sales are included in the denominator of the sales ratio but are omitted from the numerator.<sup>146</sup> However, a sales throwback rule applies to export sales not



subject to foreign taxation.<sup>147</sup> Thus, practically all FSC-related sales are thrown back into the numerator of the sales ratio, and the apportionment factor is equal to one.

The statutory income tax rate in Mississippi on taxable income of \$10,000 or more is five percent.<sup>148</sup> Thus, the effective tax rate on export profits is five percent. Table 1 summarizes these calculations.

### **G. North Carolina**

FSCs are treated as separate entities in North Carolina; unitary reporting is not allowed.<sup>149</sup> FSCs must file a return when their parents are located within the state, even if there is no nexus.<sup>150</sup> However, FSCs lacking nexus should be exempt from state taxation.

North Carolina accepts administrative pricing rules, and deductions are not denied for commissions paid to FSCs. Thus, 23 percent of export profits are attributable to FSCs in North Carolina. As in Florida, 15/23 of a FSC's allocable profits are exempt. Only 8/23 of the FSC's profits are taxable. Thus, the federal tax on the FSC's profits is 2.72 percent of total export profits (i.e., 34 percent federal tax rate times eight percent of total export profits).

The after-tax earnings and profits are 20.28 percent of total export profits (i.e., 23 percent allocable profits less 2.72 percent of total profits paid as taxes), which are remitted as dividends. North Carolina does not follow the dividend received deduction procedure of federal law.<sup>151</sup> The federal deduction for dividends received is added back to taxable income; then, a state-determined dividend received deduction is subtracted.<sup>152</sup> This deduction is the same for dividends received from FSCs as it is for dividends from other corporations.<sup>153</sup> When a parent company commercially domiciled in North Carolina receives a dividend from a 50 percent-controlled subsidiary, the state permits a 100 percent dividend received deduction.<sup>154</sup>

Notwithstanding the rules above, North Carolina can require that a FSC's parent company add back to its own taxable income the net profits of the FSC (presumably after considering the

FSC tax exemption).<sup>155</sup> Thus, the apportionable export profits will be 85 percent of total export profits (i.e., 77 percent profits allocable to parent company plus 20.28 percent of export profits received as a dividend less a dividend received deduction equal to the dividend received plus the eight percent of the FSC's federal taxable profits).

North Carolina uses a three-factor apportionment factor that doubles the sales ratio.<sup>156</sup> Foreign sales are included in the denominator (but not the numerator) of the sales ratio.<sup>157</sup> North Carolina does not use a sales throwback rule.<sup>158</sup> Thus, the apportionment factor under the assumptions mentioned earlier is 95 percent (i.e., 3.8 divided by 4.0). The state taxes 80.75 of export profits (i.e., 85 percent of export profits apportionable to parent company times 95 percent apportionment factor). The state's corporate income tax rate is 7.75 percent.<sup>159</sup> Thus, the effective income tax rate on export profits is 6.258 percent (i.e., 80.75 percent of export profits times 7.75 percent statutory tax rate). Table 2 summarizes these calculations.

## H. South Carolina

South Carolina is not a unitary principle state; absent nexus, FSCs are exempt from taxation.<sup>160</sup> Administrative pricing is allowed.<sup>161</sup> Other methods that some states use to shift income from a FSC to its U.S. parent are not used in South Carolina. As with several other states that recognize the federal allocation of export profits, 77 percent of export profits are allocable to the U.S. parent company, and the after-federal-tax earnings and profits of the FSC available for dividends is 20.28 percent of total export profits.

South Carolina follows the federal treatment of dividends received.<sup>162</sup> The dividend received deduction completely offsets the dividends received. Thus, the parent company's apportionable export profits are 77 percent.

South Carolina uses a three-factor, equally-weighted apportionment factor.<sup>163</sup> The sales ratio does not consider dividends received.<sup>164</sup> The numerator of the sales ratio excludes foreign

sales even though these sales do appear in the denominator.<sup>165</sup> South Carolina does not use a sales throwback rule.<sup>166</sup> Thus, the apportionment factor is 96.667 percent (i.e., 2.9 divided by 3.0). The state taxes 74.434 percent of total export profits (i.e., apportionable export profits of 77 percent times the 96.667 apportionment factor). At the state's flat corporate tax rate of five percent, the effective tax rate on export profits is 3.722 percent (i.e., taxable export profits of 74.434 percent times the five percent statutory rate).<sup>167</sup> Table 2 summarizes these calculations.

### I. Tennessee

Tennessee does not follow unitary principles but treats FSCs as separate corporations.<sup>168</sup> If nexus does not exist, any income allocable to a FSC, with a parent company in Tennessee, is exempt from the state income tax.

However, survey data indicate that the state will not follow FSC administrative pricing rules.<sup>169</sup> Assuming arm's length pricing, virtually all export profit is allocable to FSC parent companies organized in Tennessee. Since all export profit is allocable to parent companies of FSCs, any dividend from export profits is ignored.

Tennessee's apportionment factor is composed of three equally-weighted factors.<sup>170</sup> Foreign sales are included in the denominator but not the numerator.<sup>171</sup> No throwback rule applies to sales.<sup>172</sup> Thus, the apportionment factor is 96.667 percent (i.e., 2.9 divided by 3.0), and 96.667 percent of total export profits are subject to state income taxation (i.e., 100 percent of export profits apportioned times the apportionment factor of 96.667 percent).

The state income tax rate is a flat six percent.<sup>173</sup> When multiplied by the portion of export profits subject to Tennessee taxation, an effective tax rate of 5.8 percent results (i.e., 96.667 percent of taxable export profits times statutory tax rate of six percent). Table 1 summarizes these calculations.

## **J. Virginia**

Virginia has not adopted unitary taxation.<sup>174</sup> Each entity is treated separately, including FSCs. Thus, most FSCs are not subject to the Virginia income tax.

Nonetheless, Virginia may require that non-arm's length transactions between a FSC and its parent company be adjusted to clearly reflect income.<sup>175</sup> Assuming that arm's length pricing is imposed, practically all export profits are allocable to the parent company organized in Virginia.

Virginia uses an equally-weighted, three-factor apportionment factor.<sup>176</sup> No throwback rule applies.<sup>177</sup> Unlike most states, however, foreign sales are excluded from both the numerator and denominator.<sup>178</sup> Based on the earlier assumption that export sales are ten percent of total sales, the apportionment factor is one (i.e., 2.9 divided by 2.9).

The corporate income tax rate in Virginia is a flat six percent.<sup>179</sup> Thus, the effective tax rate on total export profits is six percent (i.e., 100 percent of export profits subject to taxation in Virginia times the statutory tax rate of six percent). Table 1 summarizes these calculations.

## **K. West Virginia**

In West Virginia, taxpayers can request unitary treatment and, in some cases, West Virginia can force taxpayers to adopt the unitary method on a water's edge basis.<sup>180</sup> Since FSCs are foreign entities, they should not be included in unitary reporting. Thus, FSCs are exempt from West Virginia taxation.

The state does allow administrative pricing between a FSC and its U.S. parent company.<sup>181</sup> Thus, 23 percent of export profits is allocable to FSCs for state purposes. After payment of the federal income tax on the non-exempt portion of the FSC's allocable profit, 20.28 percent of the total export profits is available for distribution to the U.S. parent. West Virginia follows the federal law's treatment of dividends received. Thus, dividends received

from a wholly-owned subsidiary are offset with a 100 percent dividend received deduction.<sup>182</sup> The fact that the dividend is from a subsidiary beyond the reach of state income taxation is irrelevant. In summary, 77 percent of the total export profits is apportionable income.

West Virginia follows a three-factor apportionment formula that doubles the sales ratio.<sup>183</sup> Sales not subject to taxation in the state of destination, however, are thrown out of both the numerator and the denominator of the sales ratio.<sup>184</sup> Thus, the apportionment ratio is one (i.e., 4 divided by 4). Seventy-seven percent of the total export profits are subject to taxation in West Virginia (i.e., apportionable income equal to 77 percent of total export profits times an apportionment factor of one).

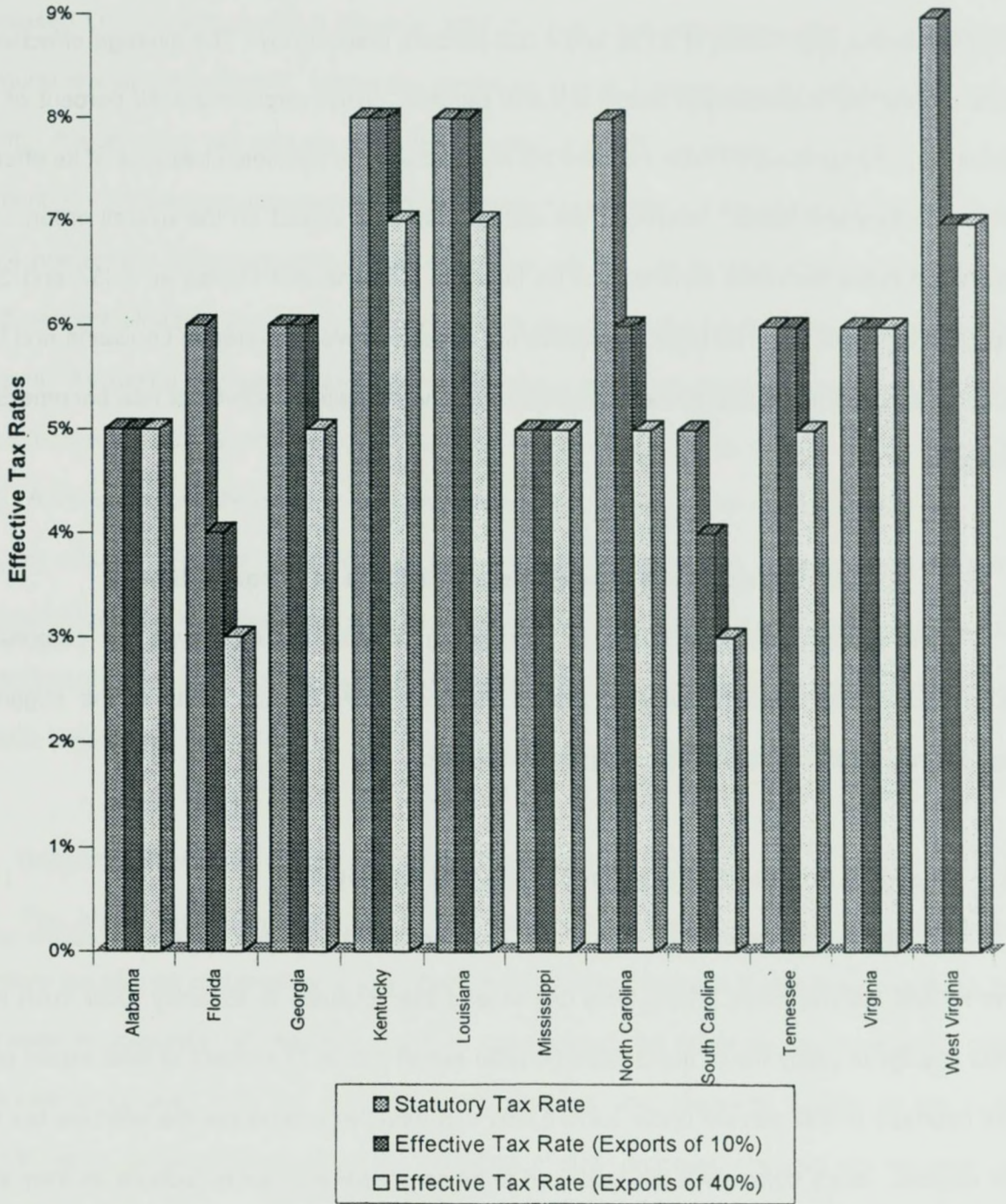
The corporate income tax rate in West Virginia is a flat nine percent.<sup>185</sup> The effective tax rate on export profits is 6.93 percent (i.e., 77 percent of export profits that are taxable times the statutory tax rate of nine percent). Table 2 summarizes these calculations.

#### **L. Summary and Sensitivity Analysis**

Table 1 summarizes the calculation of effective tax rates for all states not allowing administrative pricing for FSCs. In contrast, the calculations for all states that do allow administrative pricing appears in Table 2. A review of Table 1 reveals that the use of a FSC for exporting reduces the effective rate of taxation very little or not at all for the seven southeastern states listed (i.e., when comparing the last two rows). On average, the use of a FSC reduces the effective tax rate in these seven states by 2.7 percent. In contrast, the effective tax rate in the four states appearing in Table 2 (where administrative pricing is allowed) is, on average, 23.2 percent lower when a FSC is used.

Figure 1 summarizes the effective tax rate imposed on export profits in each southeastern state under two scenarios. The first scenario assumes export sales of 10 percent, while the

**FIGURE 1**  
**SOUTHEASTERN STATES' TAX RATES ON EXPORT PROFITS**



second scenario assumes export sales of 40 percent. The purpose of increasing the export sales is to determine the sensitivity of the effective tax rate to this factor.

When exports are 10 percent of total sales, the highest effective tax rates are found in Kentucky and Louisiana at 7.838 and 7.733 percent, respectively. The lowest rates are in South Carolina and Florida at 3.722 and 4.023 percent, respectively. The average effective tax rate among the Southeastern states is 5.819 percent. When exports are 40 percent of total sales, the change lowered most effective tax rates across the southeast because of its effect on the apportionment factor. However, the change had little impact on the overall order. The lowest effective tax rates continued to be in South Carolina and Florida at 3.337 and 3.388 percent, respectively. The highest effective tax rates, however, resulted in Louisiana and West Virginia at 6.933 and 6.930 percent, respectively. The average effective tax rate became 5.351 percent.

## **VII. Should States Provide More Incentives to Export Activities**

This section discusses a simple strategy to provide tax incentives for corporations domiciled in southeastern states to export. However, the revenue costs of the suggested change and its effectiveness also must be considered.

### **A. Impact of Proposed Change on Exports and Employment**

To attract or maintain FSC operations, southeastern states that currently disallow use of the federal administrative pricing laws can amend their statutes to explicitly allow such rules. This change in policy would make apportionable export profits 77 percent of total export profits (as opposed to 100 percent under current law) and effectively decrease the effective tax rates on exports. Since companies are assumed to be as sensitive to tax reductions as they are to any other decline in business expenses, this policy change would presumably function as an

incentive for domiciled corporations to increase exporting activities. The U.S. Treasury Department used this assumption to estimate the impact of the FSC program on U.S. exports.<sup>186</sup>

The U.S. Treasury Department estimated that the federal tax exemption for FSCs increased U.S. exports by \$1.2 billion in 1987.<sup>187</sup> The applicable federal tax rate in 1987 for corporations was 36 percent. Under the combined taxable income method of allocating export profits, the effective tax rate on the export profits of a U.S. company with a FSC was 30.6 percent (i.e., 36 percent statutory rate times 85 percent taxable portion of export profits). Thus, a 5.4 percentage point reduction in the federal tax rate (i.e., 36 percent statutory rate less the 30.6 percent effective tax rate on export profits) stimulated the \$1.2 billion increase in U.S. exports. Assuming a linear relationship between these variables, each percentage point drop in the effective tax rate resulted in a \$222 million increase in exports (i.e., \$1.2 billion divided by 5.4). A similar procedure could be performed to estimate the impact for state tax purposes.

In addition, Federal estimates are that every \$1 billion in U.S. exports support 19,000 domestic jobs.<sup>188</sup> Thus, the potential to increase domestic employment within each state serves as an incentive for state governments to consider developing a more "tax friendly" environment for U.S. exporters.

## **B. Impact of Proposed Change on State Tax Revenues**

The above incentives certainly do not come without economic trade-offs. Since the effective tax rate on corporations drops, there is a resulting decrease in revenue. However, the decrease in corporate tax revenue could, to some extent, be offset by the increase in other revenues associated with the increase in employment and economic activity in the state. Unfortunately, generalizations about the net effect of such proposed changes are not possible.



Revenue impacts must be computed on a state-by-state basis. For example, states with individual income taxes stand a better chance of revenue offsets from increased employment.

A harder question to answer is whether states should offer tax incentives to particular activities rather than just lowering taxes across the board and, more particularly, whether states should offer tax incentives to export activities as opposed to domestic activities. Nonetheless, in recent years, many states, in particular southeastern states, have invested substantial resources in attracting new business. With this behavior toward domestic (within the United States) business activities, state governments are engaged in a zero-sum game, or actually a negative-sum game given the business development transaction costs. The provision of incentives for export activities are collectively more in the nature of a positive-sum game. Thus, the above proposals do not appear to run contrary to the desired economic development of these states and make more sense for the country as a whole.

## ENDNOTES

<sup>1</sup> A. Ali and P.M. Swiercz, *Firm Size and Export Behavior: Lessons from the Midwest*, 29 *Journal of Small Business Management*, 71 (1991).

<sup>2</sup> *U.S. Exports: Hearing Before the House of Representatives Subcommittee on Rural Enterprises, Exports and the Environment of the Committee on Small Business*, 103rd Congr. , 1st Sess., 8 (1993).

<sup>3</sup> *Department of Commerce First Annual Report on the Internatioinal Economic Position of the United States—1993: Hearing before the U.S. Senate Committee on Bankings, Housing, and Urban Affairs*, 103rd Cong. , 1st Session, 66 (1993).

<sup>4</sup> *Ibid.*

<sup>5</sup> Fla. Stat. §288.741.

<sup>6</sup> Fla. Stat. §288.025.

<sup>7</sup> Congress made statutory changes to the original DISC legislation in 1975, 1976, and 1982. For a more detailed discussion of the DISC's legislative history, see U.S. Department of Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation: July 1, 1981 to June 30, 1983*, 2-5 (1988).

<sup>8</sup> U.S. Department of Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation: July 1, 1981 to June 30, 1983*, 19 (1988).

<sup>9</sup> U.S. Department of Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation: 1979 Annual Report*, 27 (1981).

<sup>10</sup> U.S. Department of Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation: July 1, 1981 to June 30, 1983*, 25 (1988).

<sup>11</sup> U.S. Department of Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation: 1979 Annual Report*, 27 (1981) and U.S. Department of Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation: July 1, 1981 to June 30, 1983*, 25 (1988).

<sup>12</sup> U.S. Department of Treasury, *The Operation and Effect of the Foreign Sales Corporation Legislation: January 1, 1985 to June 30, 1988*, 6 (1993).

<sup>13</sup> *Ibid.* The volume of exports through ICDs in 1987 was less than five percent of those through FSCs.

<sup>14</sup> U.S. Department of Treasury, *The Operation and Effect of the Foreign Sales Corporation Legislation: January 1, 1985 to June 30, 1988*, 20 (1993).

<sup>15</sup> *Ibid.*, 14-15.

<sup>16</sup> *Ibid.*

<sup>17</sup> *Ibid.*, 18.

<sup>18</sup>Corporations with taxable incomes over \$335,000 but no more than \$10 million have a marginal tax rate of 34 percent. IRC §11(b)(1).

<sup>19</sup>IRC §§925(b), 927(d)(2)(B). These special topics are beyond the scope of this study. For detailed analyses of grouping and marginal costing, see: Ernest R. Larkins and Fred A. Jacobs, *Grouping for FSCs Reduces Taxable Profits*, 5 *Journal of International Taxation*, 159-67 (April 1994), and Ernest R. Larkins, *Marginal Costing for Foreign Sales Corporations: A Simulation*, Unpublished Manuscript on file at Georgia State University, Atlanta, GA, (1997).

<sup>20</sup>IRC §922(a)(1)(A).

<sup>21</sup>For a list that includes most of the qualified foreign countries and U.S. possessions where FSCs can be created, see Notices 87-52, 1987-2 Cumulative Bulletin (CB) 362 and 87-53, 1987-2 CB 363.

<sup>22</sup>For in-depth analysis of the rules in Barbados and Guam, see: Ernest R. Larkins, *Recent Changes Enhance Barbados's Image as a Foreign Sales Corporation Domicile*, 7, *Journal of International Taxation*, 58-65 (February 1996) and Ernest R. Larkins, *Export Incentives: Guam's Increasing Attractiveness for Foreign Sales Corporations*, 9 *Tax Notes International*, 719-22 (September 5, 1994).

<sup>23</sup>IRC §922(a)(1)(D).

<sup>24</sup>IRC §922(a)(1)(B).

<sup>25</sup>IRC §922(a)(1)(C).

<sup>26</sup>IRC §922(a)(1)(E).

<sup>27</sup>IRC §922(a)(1)(F), (2).

<sup>28</sup>IRC §924(a).

<sup>29</sup>IRC §924(f).

<sup>30</sup>For this purpose, the term "United States" includes Puerto Rico. IRC §927(d)(3).

<sup>31</sup>IRC §927(a)(1)-(3). For more information on this topic see Ernest R. Larkins, *FSC Benefits Depend On Complex Export Property Rules*, 7 *Journal of International Taxation*, 212-21 (May 1996).

<sup>32</sup>IRC §924(b)(1)(A).

<sup>33</sup>IRC §924(c)(1); Treas. Reg. §1.924(c)-1(b).

<sup>34</sup>IRC §924(c)(2); Treas. Reg. §1.924(c)-1(c).

<sup>35</sup>IRC §924(c)(3); Treas. Reg. §1.924(c)-1(d).

<sup>36</sup>IRC §924(b)(1)(B).

<sup>37</sup>Treas. Reg. §1.924(d)-1(a).

<sup>38</sup>IRC §924(d)(1)(A).

<sup>39</sup>IRC §924(e).

<sup>40</sup>IRC §924(d)(1)(B).

<sup>41</sup>IRC §924(d)(2).

<sup>42</sup>IRC §925(a), (d).

<sup>43</sup>The combined taxable income allocates more profit to the FSC than the foreign trading gross receipts method when the export sale's profit margin is at least eight percent. Conversely, the foreign trading gross receipts method generally is preferred when the profit margin dips below eight percent.

<sup>44</sup>IRC §925(c).

<sup>45</sup>IRC §923(a)(3) as modified by IRC §291(a)(4)(B) and Treas. Reg. §1.923-1T. The exemption is only 30 percent of the gross profit when arm's length pricing is used.

<sup>46</sup>IRC §921(b); Temp. Treas. Reg. §1.921-3T(b).

<sup>47</sup>IRC §906(b)(5).

<sup>48</sup>IRC §245(c)(1)(A).

<sup>49</sup>IRC §924(b)(2)(B)(i).

<sup>50</sup>IRC §922(b).

<sup>51</sup>IRC §924(b)(2)(A).

<sup>52</sup>IRC §927(g)(3).

<sup>53</sup>Treas. Reg. §§1.1-1(b), 1.11-1(a).

<sup>54</sup>IRC §901(b). Like other credits, the foreign tax credit is a dollar-for-dollar reduction in U.S. tax liability.

<sup>55</sup>IRC §904(a).

<sup>56</sup>IRC §904(c).

<sup>57</sup>MYRON S. SCHOLLES AND MARK A. WOLFSON, *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* (Englewood Cliffs, New Jersey, Prentice Hall, 1992), p. 287.

<sup>58</sup>IRC §863(b)(2). U.S. exporters that purchase (rather than produce) the goods they sell abroad are subject to a different source rule than the one described here. The entire amount of export income is U.S. source or foreign source depending on where the sale occurs. Thus, the income from sales that occur outside the United States is all foreign source. See IRC §§861(a)(6), 862(a)(6), 865(b).

<sup>58</sup>Treas. Reg. §1.863-1(b) and Notice 89-10, 1989-1 CB 173, clarify the meaning of an independent factory price.

<sup>59</sup>Rev. Rul. 88-73, 1988-2 CB 173, states that an independent factory price must be used to allocate profit when one exists.

<sup>60</sup>Intel Corporation, 100 TC 616 (1993) aff'd 9th Cir. (1995), 67 F.3d 1445.

<sup>61</sup>Treas. Reg. §1.863-3(b).

<sup>62</sup>A.P. Green Export Company v. U.S. (Ct.Cl., 1960), 284 F.2d 383.

<sup>63</sup>IRC §§927(e)(1), 994(a)(2).

<sup>64</sup>U.S. Department of Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation: July 1, 1981 to June 30, 1983*, 9-10 (1988). The decline from 1982 to 1983 presumably resulted from provisions included in the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). ERTA introduced the Accelerated Cost Recovery System, which greatly

accelerated depreciation rates and increased the benefits of the investment tax credit. These two provisions lowered effective tax rates for both domestic and export production activities. Provisions that lower the effective tax rate across the board tend to reduce the relative advantage of the DISC deferral. In addition, TEFRA decreased the DISC deferral benefit by 15 percent for corporate shareholders.

<sup>65</sup> U.S. Department of Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation: July 1, 1981 to June 30, 1983*, 12 (1988).

<sup>66</sup> *Ibid.*, 11.

<sup>67</sup> *Ibid.*, 31.

<sup>68</sup> U.S. Department of Treasury, *The Operation and Effect of the Foreign Sales Corporation Legislation: January 1, 1985 to June 30, 1988*, 13 (1993).

<sup>69</sup> *Ibid.*, 14.

<sup>70</sup> *Ibid.*, 17-18..

<sup>71</sup> U.S. Department of Treasury. *Report to Congress on the Sales Source Rules*, 18 (1993).

<sup>72</sup> *Ibid.*, 2.

<sup>73</sup> *Ibid.*, 27.

<sup>74</sup>The due process clause is found in the 14th amendment to the U.S. Constitution. It states that no state shall “deprive any person of life, liberty, or property without due process of law . . . .” *Miller Bros. Co. v. Maryland*, 347 U.S. 340 at 344-45 (1954), explained that due process nexus “requires some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax.”

<sup>75</sup>Section 8 of Article 1 in the U.S. Constitution states that “the Congress shall have power . . . to regulate commerce with foreign nations, and among the several States, and with the Indian tribes.”

<sup>76</sup>*Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 at 444 (1940) clarified that a state has no jurisdiction to tax unless “the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question [for due process nexus] is whether the state has given anything for which it can ask return.”

<sup>77</sup> WILLIAM A. RAABE AND KAREN J. BOUCHER , *MULTISTATE CORPORATE TAX GUIDE*, 39, Volume 1 (New York, Aspen Publishers, 1996).

<sup>78</sup>*Complete Auto Transit v. Brady*, 430 U.S. 274 at 279 (1977) indicated that any tax on interstate commerce is valid only if the taxed activity has “substantial nexus” with the state. *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992), clarified that substantial nexus means physical presence.

<sup>79</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER , *MULTISTATE CORPORATE TAX GUIDE*, 351, Volume 1 (New York, Aspen Publishers, 1996).

<sup>80</sup> Stephen Gray, *State Taxation of Foreign Sales Corporation and Their Corporate Shareholders*, 8 , *Journal of State Taxation*, 165, 168 (Fall 1989) ; Ernest R. Larkins, *State Tax Treatment of FSCs and DISCs: A Guide to Planning*, 16 *International Tax Journal*, 239 (Summer 1990); WILLIAM A. RAABE AND KAREN J.

BOUCHER, *MULTISTATE CORPORATE TAX GUIDE*, 343, Volume 1 (New York, Aspen Publishers, 1996) suggests that contracting with an independent FSC management company to perform economic functions, rather than with the domestic parent company, generally should establish that the FSC is a separate and distinct entity with no nexus to the parent's state. Even when contracts are entered with the domestic parent company, the payment of an arm's length fee for services rendered generally should be sufficient for the FSC to avoid nexus.

<sup>81</sup>Section 1(a) of the Uniform Division of Income for Tax Purposes Act (UDITPA) defines business income to include "income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Further, the Multistate Tax Commission Reg. IV.1(a) provides that accounting terms such as dividends are "no aid in determining whether income is business or nonbusiness income." Also, see WILLIAM A. RAABE AND KAREN J. BOUCHER, *MULTISTATE CORPORATE TAX GUIDE*, 544-545, Volume 1 (New York, Aspen Publishers, 1996).

<sup>82</sup>For a more detailed explanation of formula apportionment, see Karen J. Boucher, *Multistate Corporate Tax-Saving Strategies*, 14 *International Tax Journal*, 23-57 (Winter 1993).

<sup>83</sup>Some states double weight the sales factor, while a few states omit the property and payroll factors altogether. Other states have adopted still other weighting schemes.

<sup>84</sup>In addition to sales, the sales ratio usually includes gross business receipts such as rents, royalties, interest, and dividends.

<sup>85</sup>A few states also have a payroll throwback rule.

<sup>86</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, *MULTISTATE CORPORATE TAX GUIDE*, 482-492, Volume 1 (New York, Aspen Publishers, 1996).

<sup>87</sup>*Ibid.*, 525.

<sup>88</sup>Benjamin F. Miller, *Worldwide Unitary Combination: The California Practice*, *The State Corporate Income Tax: Issues in Worldwide Unitary Combination*, 136-137 (Charles E. McLure, Jr. Ed., Hoover Institution Press 1984).

<sup>89</sup>*Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983), 103 S.Ct. 2933.

<sup>90</sup>Though few states have adopted this position to date, other states may decide to follow. See the discussion of New York's attempt in Joseph M. Erwin, *States Take Various Approaches in Taxing Income from Foreign Sales Corporations*, 4 *Journal of Multistate Taxation*, 268-269 (January/February 1995).

<sup>91</sup>K. Lynch, *FSCs: State Taxation*, *Multistate Tax News for Multinationals*, 11 (November 1995).

<sup>92</sup>Temp. Treas. Reg. §1.925(a)-1T(a)(3)(ii).

<sup>93</sup>For example, see *Bunge Corp. v. Commissioner of Revenue*, 305 N.W.2d 779 (Minn., 1981); *M. Lowenstein & Sons v. South Carolina Tax Commissioner*, 290 S.E.2d 812 (1982); *Bolt Technology Corp. v. Commissioner of Revenue Services*, 567 A.2d 371 (Conn., 1989), and *General Motors Corporation v. Arizona Department of Revenue*, 1993 Ariz. Tax LEXIS 41 (Ariz. 1993). Though each of these decisions involve pre-1985 DISCs or post-1984 ICDs, the rationale of each could be applied to FSCs. More recently, *Kimberly-Clark*

Corporation v. Wisconsin Department of Revenue, 1994 Wis. Tax LEXIS 13 (Wisc. 1994), held that commissions paid to a Virgin Islands FSC were deductible because the FSC was not merely a paper corporation but had real economic substance. The economic substance existed through the FSC's compliance with federal tax law. In contrast, SLI International Corp. v. CIR, 1994 Conn. Super. LEXIS 2076 (Conn. 1994), held that a portion of the commission paid to a FSC should be disallowed since the FSC was a mere paper entity.

<sup>94</sup>This outcome is based on the assumption that the FSC uses administrative pricing. See IRC §245(c)(1)(A).

<sup>95</sup>Investment income that a FSC earns is fully taxable to the FSC. It also is partially taxable to the FSC's parent company because, when distributed, the parent must report it as gross income but receives only an 80 percent (or, in some cases, 70 percent) dividend received deduction. Thus, part of the export profits when retained and invested are eventually taxed at two levels. See IRC §245(c)(1)(B).

<sup>96</sup>In the Southeast, only Florida allows such a deduction. Fla. Stat. §220.13.

<sup>97</sup>In the Southeast, Tennessee permits a state tax deduction for foreign income taxes deducted on the federal return. WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 248, Volume 1 (New York, Aspen Publishers, 1996).

<sup>98</sup> This assumption eliminates the distinction mentioned earlier about classifying dividends as allocable versus apportionable income. In multi-state situations, dividends are typically considered allocable income to the domicile of the corporation.

<sup>99</sup>This assumption is not inconsistent with the findings in Rebecca M. Winders, Export Development in Gwinnett County, Small Business Development Center, Institute of Community and Area Development, University of Georgia, 4 (October 1994), and Rebecca M. Winders, Export Development in Southwest Georgia, Small Business Development Center, Institute of Community and Area Development, University of Georgia, 5 (September 1994) in which nearly two-thirds of exporters made ten percent or less of their sales to foreign markets.

<sup>100</sup> Of the southeastern states in this analysis, Florida, Georgia, Kentucky, North Carolina, and West Virginia all double weight the sales factor.

<sup>101</sup>The majority of U.S. exporters with FSCs use the combined taxable income method to allocate export profits. In 1987, 54 percent of FSCs used only the combined taxable income method while another 12 percent used the combined taxable income method in conjunction with the foreign trading gross receipts method. These two groups of FSCs, representing 66 percent of all FSCs, accounted for 86.6 percent of all FSC export receipts. See: U.S. Department of Treasury, *The Operation and Effect of the Foreign Sales Corporation Legislation: January 1, 1985 to June 30, 1988*, 18 (1993).

<sup>102</sup>Ala. Code, 1975, §40-18-39.

<sup>103</sup>Ala. Stat. §40-18-2.

<sup>104</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 356, Volume 1 (New York, Aspen Publishers, 1996).

<sup>105</sup>Ala. Stat. §40-18-34; Ala. Reg. §810-3-31.02(3). Under IRC §861(a)(3), the commission a FSC receives for facilitating an export sale is sourced according to where the services are performed. Though a question of fact, generally the services can be considered rendered outside the United States.

<sup>106</sup>Ala. Code, 1975, §40-27-1; Also, see Ala. Prop. Reg. 810-3-31-.02, which would treat dividends from foreign subsidiaries as apportionable income.

<sup>107</sup>Ala. Stat. §§40-18-35(a)(14), 36.

<sup>108</sup>Ala. Reg. §810-3-31.02 and Ala. Stat. §40-27-1.

<sup>109</sup>Ala. Reg. 810-3-31.02 and Ala. Stat. §40-27-1.

<sup>110</sup>Ala. Reg. 810-3-31.02.

<sup>111</sup>Ala. Code §§40-18-31, 33, 34.

<sup>112</sup>Fla. Stat. §220.135, repealed in December 1984.

<sup>113</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 346, Volume 1 (New York, Aspen Publishers, 1996) indicate that administrative pricing is allowed.

<sup>114</sup>Fla. Stat. §220.13.

<sup>115</sup>Fla. Stat. §220.15.

<sup>116</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 483, Volume 1 (New York, Aspen Publishers, 1996).

<sup>117</sup>Fla. Stat. §§220.11, 12.

<sup>118</sup>Ga. Code Ann. §48-7-21.

<sup>119</sup>Ga. Code Ann. §§48-7-21, 31, 35, 51. Nonetheless, the state can force the taxpayer to determine its tax liability under unitary principles in some cases according to WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 533, Volume 1 (New York, Aspen Publishers, 1996).

<sup>120</sup>Ibid., p. 532.

<sup>121</sup>Ga. Code Ann. §48-7-31.

<sup>122</sup>Ga. Code Ann. §§48-7-58(a) and 48-7-31(d)(30)(E).

<sup>123</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 356, Volume 1 (New York, Aspen Publishers, 1996).

<sup>124</sup>Ga. Code Ann. §48-7-31. Separate accounting is allowed only with permission from the state. But see WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 471, 478, Volume 1 (New York, Aspen Publishers, 1996).

<sup>125</sup>Ga. Code Ann. §48-7-21.

<sup>126</sup>Ky. Rev. Stat. Ann. §141.205; 41P225.

<sup>127</sup>Ky. Rev. Stat. Ann. §47: 287.734.

<sup>128</sup>Ky. Rev. Stat. Ann. §47:287.734.

<sup>129</sup>Ky. Rev. Stat. Ann. §141.120.



<sup>130</sup>Ky. Rev. Stat. Ann. §141.120(8).

<sup>131</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 483, Volume 1 (New York, Aspen Publishers, 1996).

<sup>132</sup>Ky. Rev. Stat. Ann. §141.120 (8).

<sup>133</sup>Ky. Rev. Stat. Ann. §141.010, 040.

<sup>134</sup>La. Rev. Stat. Ann. §§47:287.480 and 47:287.733.

<sup>135</sup>La. Rev. Stat. Ann. §47:287.733.

<sup>136</sup>La. Rev. Stat. Ann. §47:287.734.

<sup>137</sup>La. Rev. Stat. Ann. §47:287.734.

<sup>138</sup>La. Rev. Stat. Ann. §§47:287.92-95.

<sup>139</sup>La. Rev. Stat. Ann. §47:287.94-95.

<sup>140</sup>La. Rev. Stat. Ann. §47:287.94-95.

<sup>141</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 484, Volume 1 (New York, Aspen Publishers, 1996).

<sup>142</sup>La. Rev. Stat. Ann. §§47:287.12, 47:287.61.

<sup>143</sup>Miss. Code Ann. §27-7-23; Miss. Reg. 805.

<sup>144</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 352, Volume 1 (New York, Aspen Publishers, 1996).

<sup>145</sup>Miss. Code Ann. §27-7-23; Miss. Reg. 806.

<sup>146</sup>Miss. Code Ann. §27-7-23.

<sup>147</sup>Miss. Code Ann. §27-7-23.

<sup>148</sup>Miss. Code Ann. §27-7-5.

<sup>149</sup>N.C. Gen. Stat. §105-130.3.

<sup>150</sup>N.C. Gen. Stat. §105-130.5.

<sup>151</sup>N.C. Gen. Stat. §§105-130.5, 105-130.7.

<sup>152</sup>N.C. Gen. Stat. §105-130.5, 105-130.7.

<sup>153</sup>N.C. Gen. Stat. §105-130.5.

<sup>154</sup>N.C. Gen. Stat. §105-130.5.

<sup>155</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 352, Volume 1 (New York, Aspen Publishers, 1996).

<sup>156</sup>N.C. Gen. Stat. §105.130.4.

<sup>157</sup>N.C. Gen. Stat. §105.130.4.

<sup>158</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 485, Volume 1 (New York, Aspen Publishers, 1996).

<sup>159</sup>N.C. Gen. Stat. §§105.130.2, 105.130.3.

<sup>160</sup>S.C. Code Ann. §12-6-40 and Reg. 117-77.

<sup>161</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 359, Volume 1 (New York, Aspen Publishers, 1996).

<sup>162</sup>S.C. Code Ann. §§ 12-7-415, 12-7-430.

<sup>163</sup>S.C. Code Ann. §12-7-1140 and 12-6-2250.

<sup>164</sup>S.C. Code Ann. §12-7-1120.

<sup>165</sup>S.C. Code Ann. §12-7-1170.

<sup>166</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 486, Volume 1 (New York, Aspen Publishers, 1996).

<sup>167</sup>S.C. Code Ann. §§12-7-230, 12-7-415.

<sup>168</sup>Tenn. Code Ann. §67-4-812.

<sup>169</sup>Tenn. Code Ann. §67-4-806.

<sup>170</sup>Tenn. Code Ann. §§67-4-809, 67-4-810, 67-4-811.

<sup>171</sup>Tenn. Code Ann. §67-4-811.

<sup>172</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 486, Volume 1 (New York, Aspen Publishers, 1996).

<sup>173</sup>Tenn. Code Ann. §§67-4-805, 67-4-806.

<sup>174</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 537, Volume 1 (New York, Aspen Publishers, 1996).

<sup>175</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 352, 359 Volume 1

(New York, Aspen Publishers, 1996).

<sup>176</sup>Va. Code Ann. §§58.1-406, 58.1-408.

<sup>177</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 486, Volume 1 (New York, Aspen Publishers, 1996).

<sup>178</sup>Va. Code Ann. §§58.1-415, 58.1-416; WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 486, Volume 1 (New York, Aspen Publishers, 1996). This procedure is sometimes called a throwout rule.

<sup>179</sup>Va. Code Ann. §§58.1-400, 58.1-402.

<sup>180</sup>W. Va. Code §§11-24-7(h), 11-24-13a(f).

<sup>181</sup>WILLIAM A. RAABE AND KAREN J. BOUCHER, MULTISTATE CORPORATE TAX GUIDE, 359, Volume 1 (New York, Aspen Publishers, 1996).

<sup>182</sup>W. Va. Code §11-24-6.

<sup>183</sup>W. Va. Code §11-24-7.

<sup>184</sup>W. Va. Code §11-24-7.

<sup>185</sup>W. Va. Code §§11-24-4, 11-24-6.

<sup>186</sup> U.S. Department of Treasury, *The Operation and Effect of the Foreign Sales Corporation Legislation: January 1, 1985 to June 30, 1988*, 13 (1993).

<sup>187</sup> U.S. Department of Treasury, *The Operation and Effect of the Foreign Sales Corporation Legislation: January 1, 1985 to June 30, 1988*, 14-15 (1993).

<sup>188</sup> *Department of Commerce First Annual Report on the International Economic Position of the United States—1993: Hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 103rd Cong., 1st. Sess., 66 (1993).

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