State of South Carolina
Department of Revenue
301 Gervais Street, P.O. Box 125, Columbia, South Carolina 29214

SC REVENUE RULING #98-14

SUBJECT:	Deductibility of Commissions Paid to Foreign Sales Corporations (Income Tax)
EFFECTIVE DATE:	Applies to all periods open under the statute.
SUPERSEDES:	All previous documents and any oral directives in conflict herewith.
REFERENCES:	S. C. Code Ann. Section 12-6-580 (Supp. 1997) S.C. Code Ann. Section 12-6-2220 (Supp. 1997)
AUTHORITY:	S. C. Code Ann. Section 12-4-320 (Supp. 1997) SC Revenue Procedure #97-8
SCOPE:	A Revenue Ruling is the Department of Revenue's official advisory opinion of how laws administered by the Department are to be applied to a specific issue or a specific set of facts, and is provided as guidance for all persons or a particular group. It is valid and remains in effect until superseded or modified by a change in the statute or regulations or a subsequent court decision, Revenue Ruling or Revenue Procedure.

Question:

Are commissions paid to a foreign sales corporation (hereinafter referred to as an "FSC") deductible in determining South Carolina taxable income or are they treated as an expense related to dividends requiring that the commission expense be allocated to the state of a corporation's principal place of business or to the domicile of an individual taxpayer pursuant to Section 12-6-2220 of the South Carolina Code of Laws ("Code")?

Conclusion:

Provided that the FSC has economic substance and is properly incorporated and in operation in accordance with Sections 921 through 927 of the Internal Revenue Code (hereinafter referred to as "IRC"), the commissions paid to the FSC will be deductible and will not be considered an expense related to dividends.

Discussion:

Before the Tax Reform Act of 1984, U.S. businesses doing business in foreign markets used Domestic International Sales Corporations (referred to as DISCs) to defer a portion of their foreign income from taxation in the United States. However, the advent of the General Agreement on Tariffs and Trade (commonly referred to as "GATT") led many to believe that DISC's created an "illegal export subsidy" for companies that were in reality doing business in the United States. In response to this criticism, Congress severely limited the use of DISCs and created a new type of entity referred to as a foreign sales corporation ("FSC"). The creation and governing rules concerning FSC's are contained in Sections 921 through 927 of the IRC.[1]

Typically, the FSC operates as a wholly owned subsidiary of a U.S. producer and sells products supplied by the U.S. parent/producer in foreign markets. To qualify as an FSC, a corporation must comply with numerous complex statutes and regulations that require FSCs to meet strict guidelines for incorporation and operation. If a FSC meets all of the requirements, a portion of its income will be exempt from federal tax and any dividends that it pays to its domestic corporate shareholders out of earnings and profits attributable to "foreign trade income" will receive a dividends received deduction under Section 245 of the IRC.

The FSC provisions contain a number of requirements and qualifications designed to insure that an FSC has a presence outside the United States and that its income which is exempt from U.S. tax is attributable to substantial commercial activity conducted outside the United States. See, Gustafson, Peroni & Pugh, *Taxation of International Transactions*, pg. 666 (First Ed. 1997).

To qualify as an FSC the corporation must meet the requirements of Section 922(a) of the IRC. These requirements are: (1) The FSC must be a corporation created or organized under the laws of a foreign country (in order to be a qualifying foreign country the country must have a Treasury approved exchange of information program) or a possession of the United States; (2) The FSC must not have more than 25 shareholders at any time during the taxable year; (3) The FSC must not have any preferred stock outstanding during the taxable year; (4) The FSC must maintain an office in a foreign country or in a possession of the United States. At this office, the FSC must maintain a set of permanent books and records of its own accounts (if the office is located in a foreign country, it must be located in a country that has a Treasury approved exchange of information program); (5)The FSC must maintain records sufficient to meet the requirements of Section 6001 of the IRC in a location in the U.S.; (6) The FSC must have a board of directors that includes at least one individual who is not a resident of the United States; (7) The FSC must not be a member of any controlled group of corporations of which a DISC is a member; and, (8) the corporation must have elected to be treated as an FSC.

If a corporation is eligible to be an FSC, a portion of the FSC's "foreign trade income" is exempt from U.S. income tax. Income qualifies as "foreign trade income" only if it is gross income

[1]From a paper prepared by Ann N. Boyd presented for State and Local Tax Course at the South Carolina University School of Law (April 3, 1997).

attributable to “foreign trading gross receipts”. An FSC is treated as having “foreign trading gross receipts” only if: (1) the management of the FSC is carried on outside the United States and (2) the economic processes from which the income is derived takes place outside the United States. See, Section 924 of the IRC. Excluded from the definition of “foreign trade receipts” are certain types of income from property, as well as investment income (including dividends, interest, royalties, annuities, and rent) and carrying charges. See, Sections 921 through 927 of the IRC.

In addition, the income of the FSC must be determined on the basis of actual arm’s length prices under Section 482 of the Internal Revenue Code or on the basis of special administrative formulas provided for in the statutes. If the FSC uses the arm’s length Section 482 method, 30% of the FSC’s “foreign trade income” will be exempt from federal income tax if the shareholder of the FSC is a U.S. corporation (32% in all other cases). If the FSC uses the administrative pricing methods set forth in the statute, 15/23rds of the “oreign trade income” will be exempt from federal taxes if the shareholder is a U.S. corporation (16/23rds in all other cases). See, Section 923 and 291 of the IRC.

FSCs exist in one of two forms. A commission FSC usually contracts with a principal (often a U.S. corporation) to sell the goods of the U.S. corporation in a foreign market. In turn, the company that is producing the product will pay the FSC a commission for selling the product. A buy-sell FSC actually buys the exported product from the U.S. corporation and then sells it in a foreign market.[2]

For example, assume that Corporation A, has a wholly owned FSC. Corporation A pays the FSC a commission to sell Corporation A’s product overseas. Corporation A is entitled to deduct the commission expense as an ordinary and necessary business expense under Section 162 of the Internal Revenue Code. Additionally, assuming the FSC has met all the requirements for foreign management and foreign economic processes, the commission expense received by FSC is considered “foreign trade income”, 15/23rds of which is exempt from federal tax. The FSC pays Corporation A a dividend out of the earnings and profits attributable to “foreign trade income” and the dividend is 100% deductible under Section 245(c)(1) of the IRC.[3]

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[2]Either a commission FSC or a buy-sell FSC may elect to be treated as a small FSC under Section 922(b) of the IRC if they meet the requirements of the statute. An FSC that elects to be a small FSC does not have to meet the foreign management or the foreign economic process requirements set forth in Section 924 of the IRC in order to have foreign trading gross receipts.

However, in determining the small FSC’s foreign trade income, foreign trading gross receipts that exceed $5 million are not taken into account. Additionally, a small FSC is only allowed to use the administrative pricing rules set forth in IRC Section 925(1) and (2) and may not use the arm’s length method of pricing. See, *Taxation of International Transactions*, supra at p. 690.

[3]A domestic corporation is entitled to a 100% dividends received deduction for a distribution of earnings and profits attributable to “foreign trade income”, other than Section 923(a)(2) non-exempt income. See, Section 245(c)(1)(A) of the IRC. Individuals do not receive a dividends

South Carolina has adopted Section 245 and Sections 921-927 of the IRC. (See, Code Section 12-6-50 for those provisions of the IRC which have not been adopted by South Carolina). Furthermore, Code Section 12-6-580 provides that a corporation's South Carolina taxable income and the unrelated business income of a corporation exempt from taxation under Internal Revenue Code section 501, et. seq. is computed as determined under the Internal Revenue Code with the modifications provided in Article 9 of this chapter and subject to allocation and apportionment as provided in Article 17 of this chapter. For federal income tax purposes, the commission expense is usually deductible as an ordinary and necessary business expense pursuant to Section 162 of the IRC.

Section 12-6-2220 of the Code provides that :

> The following items of income must be directly allocated and excluded from the apportioned income and the apportionment factors:
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> > "...(2) Dividends received from corporate stock owned, <u>less all related expenses</u>, are allocated to the state of the corporation's principal place of business as defined in Section 12-6-20(9) or the domicile of an individual taxpayer."

One salient point about commission FSCs is that in many instances, the primary source of an FSC's income is the commissions it receives. It is possible that this might be the only income from which the FSC may pay dividends to its shareholders. The shareholder who is receiving the dividend is also the company that is paying the commission to the FSC. (In some instances, the commission may be being paid by another corporation such as a brother-sister corporation.) This has lead some parties to question whether the commission expense which is deductible by the party paying the commission, is an expense related to dividends and therefore, allocable to the principal place of business of the corporation or to the domicile of the individual.

Thus, the question becomes whether the commission expense is an expense related to the generation of the dividend or whether the commission expense is a legitimate business expense in payment for services rendered by the FSC. The answer to this question, in part, hinges on whether the FSC itself is a corporation of substance, such that the payment of an expense to the corporation would be considered a legitimate business deduction. As a general rule, if a corporation has substance, the corporate form will be upheld.

In <u>Lowenstein v. South Carolina Tax Commission</u>, 277 S.C. 561, 290 S.E. 2d 812 (1982), the South Carolina Supreme Court refused to recognize the legitimacy of commission payments made to a commission DISC, finding that in this particular instance, the DISC was a mere "paper corporation" which lacked economic substance. Therefore, the court disallowed the deduction of the commission expense finding that it was not an ordinary and necessary business expense.

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received deduction.

Recently, two separate tribunals have considered whether commissions paid to FSCs are deductible. In SLI International Corporation v. Crystal, 236 Conn. 156, 671 A. 2d 813 (1996), the Connecticut Supreme Court considered whether the commission paid by a brother-sister corporation of an FSC was an expense related to dividends, when the parent corporation received a dividend from the FSC. The Connecticut court in that instance found that the federally qualified FSC was a corporation with economic substance because it had an office in a foreign county, it had income other than the commissions received from its brother-sister corporation and the FSC had legitimate business expenses. Furthermore, the commission expenses that were paid by the brother-sister corporation to the FSC for its services were valid business expenses and thus, these commission expenses were eligible to be deducted in determining the brother-sister corporation's Connecticut corporate business tax.

The Connecticut Supreme Court concluded that because FSCs in general, and the one in the case before them in particular, have economic substance and necessarily had expenses and other potential sources of income, the FSC could not be disregarded and the commission expense was properly deductible.

In Kimberly Clark Corporation as Successor to Kimtech, Ltd. v. Wisconsin Department of Revenue, 1994 WL 128957 (Wis. Tax App. Comm.), the Wisconsin Tax Appeals Commission determined that the Kimberly Clark Sales Corporation (an FSC) was formed for substantial business reasons and carried on substantial business activities. The commission further determined that the FSC had earned the commissions paid to it and therefore there was no basis to deny the corporation that paid the commission a deduction for that commission.

In both SLI International Corporation and Kimberly Clark Corporation, the tribunals took pains to distinguish prior state court decisions involving DISCs where the corporate form of the DISC was found to be a "mere paper corporation". In their decisions, the tribunals noted that it was clear, that unlike prior DISC law, in order for a corporation to properly qualify as a FSC it must have economic substance because of the substantial requirements relating to a foreign presence.

In instances where an FSC has economic substance and performs the function of selling the U.S. producer's product in foreign markets and incurs expenses in connection with that function, the commission expense is a legitimate business expense to compensate the FSC for its services. The fact that the commission itself may constitute all, or part, of the earnings and profits of which the FSC may pay dividends to its shareholders does not convert it into an expense related to dividends. To hold otherwise, would subject every potentially deductible payment that is made from a parent to a subsidiary to the possibility of being disallowed as an expense related to dividends.

NOTE: While this document specifically deals with the deductibility of commissions paid to a commission FSC that is not a small FSC, the legitimacy of transactions of buy-sell FSC's will be upheld if the buy-sell FSC has economic substance and is properly formed and operated in accordance with IRC Sections 921- 927. Likewise, the legitimacy of transactions involving small FSC's will depend on whether the small FSC has economic substance and whether it is properly formed and operated in accordance with Sections 921 - 927 of the IRC.

SOUTH CAROLINA DEPARTMENT OF REVENUE

s/Burnet R. Maybank III
Burnet R. Maybank, III, Director

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