WORKING PAPER

No. 01-08G July 2001

"Tax Incentives for International Trade now Available for Entrepreneurs- The Extraterritorial Income Exclusion a Primer for Small Business Engaging in International Trade"

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Tax Incentives for International Trade now Available for Entrepreneurs - The Extraterritorial Income Exclusion A primer For Small Business Engaging in International Trade

Taylor S. Klett and Charles R. B. Stowe*

Abstract

A highly technical but important change to US tax laws now means that smaller businesses and entrepreneurs will enjoy the same incentives to engage in international trade as did large corporate entities. The benefit is not inconsequential as it can amount to a reduction of federal income taxes of 15-30% on eligible foreign-sourced income. This article reveals the benefit to firms that have less than $5 million of eligible foreign earnings. This article reviews the changes to the IRS rules on Foreign Sales Corporations, describes the process for computing the tax savings, and describes the benefits that are now available to different business organizations.

Introduction

Various tax entities and devices have been used over time to obtain certain tax advantages and/or incentives for activities involving foreign sourced income. The most recent entity, known as the Foreign Sales Corporation ("FSC"), has been in use in the United States since 1984, when the FSC regime was adopted into the tax code to offset criticisms of trading partners as to certain aspects of Domestic International Sales Corporations. Generally a FSC is a corporation organized in a foreign jurisdiction that maintains an office in a foreign country, has at least one foreign national on the board of directors, and was engaged in specific exporting activities.[1] The FSC has been a significant tax saving device since part of the FSC income would be considered at least partially exempt from U.S. taxes as long as the income was foreign

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[1] IRC § 922.

sourced. However, there were significant problems or impediments with the FSC for many potential U.S. taxpayers involved in foreign trade. Individual, partnership, S-corporation, or other "pass through" entities were ineligible for the tax benefits derived by the FSC. In addition, the basic requirements of a FSC were so complex as to discourage smaller entities from extracting the tax benefits from taking advantage of that option. What inspired the change in rules favoring smaller businesses was the European Union's request of the World Trade Organization to review the Foreign Sales Corporation provision in the context of the World Trade Organization rules. After some failed appeals by the U.S. to uphold the FSC regime, the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 was enacted by the United States and signed into law November 14, 2000, and became effective for transactions and activities after September 30, 2000. Significantly, no new FSC elections are allowed after September 30, 2000. Existing FSC's will be phased out over a five-year period. In general, the U.S. repealed Internal Revenue Code ("IRC") §§921-927.

One major change was that tax benefits of foreign commerce have now been expanded to individuals, partnerships, S-corporations, LLC's, and other pass-through entities. In addition, several rather technical requirements otherwise required are waived for entities with less than $5,000,000 in gross receipts, which makes the Act even more advantageous to the smaller entrepreneur. Moreover, existing FSC's are not adversely treated during the transition phase. As with any new tax package, new definitions and calculations are added into the Code. There are several aspects of the new Code sections that are not entirely clear and will require clarification by Regulations and other guidance. As a result, any party wishing to avail themselves of the Act should be reasonably diligent, but perhaps conservative, in their initial efforts in claiming the benefits of the act. It is expected that proposed regulations will be available by the end of 2001; however, this delay should not stop any party from investigating and pursuing these provisions.

Benefits of New Laws

In general, eligible taxpayers are able to claim an automatic (i.e., no election is required) exemption of gross income from their 2000 (and forward) tax returns for an "extraterritorial income exclusion." Entities that have foreign sourced income automatically receive an exclusion of the qualified amount of foreign-based income from the foreign income tax base, thereby reducing the amount of income that is taxable. While the exemption is automatic, nonetheless the taxpayer must complete the appropriate tax Form 8873.

The exclusion, based variously on foreign-based income generated and certain elections taken by the taxpayer, could result in a reduction of approximately 15- 30% of a taxpayer's amount owed in federal income taxes resulting from foreign-based income. However, if the entity is an ***existing*** FSC, it must elect to claim the Extraterritorial Income Exclusion. . Many eligible beneficiaries of this new tax provision may be unaware of its existence. Taxpayers who were eligible and missed this tax benefit in FY 2000 (or beyond) should seriously consider amending their tax returns

Eligibility and Computation- Simplified

To qualify for the Extraterritorial Income Exclusion, the taxpayer must be paying income taxes in the United States. This factor may significantly impact certain existing entities, such as foreign corporations.[2] Assuming this most basic condition is met, Internal Revenue Code ("IRC") § 114 sets the standards for the computation alternatives.

The Code is deceptive in its simplicity, which innocently notes "gross income does not include extraterritorial income[3]" *except* that calculation does **not** include "extraterritorial income which is not qualifying foreign trade income."[4] In other words, not all foreign income sources will be eligible for the exclusion.

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[2] However, certain transitional provisions not discussed herein were incorporated into the Code to allow reasonable transition between the old and new Code and existing entities.
[3] IRC §114(a)
[4] IRC §114(b)

Qualifying foreign trade income is defined by the Code[5] as the gross[6] income, if excluded, that reduces the taxable income of the taxpayer equal to the ***greatest*** of:

- 30% of the foreign sale and leasing income of the transaction[7](s)
- 1.2% of the foreign trading gross receipts[8] of the transactions(s) or
- 15% of the foreign trade income[9] of the transaction.

Each of the terms, predictably, involves a different situation, which will be described later. The Code gives the taxpayer the ability to ***maximize*** their potential exclusion.

Expenses Prorated

When the business uses the extraterritorial income exemption, they are not to deduct any direct and overhead (not cost of goods sold) expenses apportioned to Extraterritorial Income. Similarly, the entity (or person) is not permitted any foreign tax credit (otherwise available) related to any extraterritorial income that is excluded. Prorating out any related deductible expenses prevents the taxpayer from realizing a double benefit from the exclusion. The deduction is not allowed as it would provide an illogical benefit to the taxpayer, as the gross income generated has already been excluded, therefore, those deductible expenses associated with or that generated the revenue should also be excluded[10]. Such expenses are generally calculated on a prorata or apportioned basis.

The actual calculation requires that the expenses are "grossed up" or added back into the related qualified (net) income.

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[5] IRC §941(a)

[6] Gross income will have (non deductible) expenses apportioned to the excluded income since the calculation exclusion is dealing with *gross* income as opposed to *net* income. In other words, there can be no deduction for expenses related to the excluded income. IRC § 114(c).

[7] IRC §943(b)(1) states "…transaction means (i) any sale, exchange or other disposition (ii) any lease or rental and (iii) any furnishing of services."

[8] Foreign Trading Gross receipts must be (1) from the sale, exchange or other disposition of qualifying trade property (2) from the lease or rental of qualifying foreign trade property for use by the lessee outside of the United States (3) for services which are related and subsidiary to the sale, exchange, disposition, lease or rental of qualifying foreign trade property (4) for engineering or architectural services for construction projects located outside of the United States (5) or for the performance of certain managerial services for unrelated persons." Joint Comm. JCX-111-00 page 7 and IRC 942(a)(1)

[9] In other words, the foreign trade income- which is the net income (or taxable income). "…taxable income of the taxpayer attributable to foreign trading gross receipts of the taxpayer." IRC §941(b)

[10] IRC § 114(c)

Foreign Trade Income

"Foreign Trade Income" is the taxable income of the taxpayer (determined without regard to the exclusion of qualifying foreign trade income) attributable to foreign trading gross receipts.[11] As in most IRC provisions, this definition requires the understanding of yet other definition or term of art. "Foreign trading gross receipts" are defined as "gross receipts derived from certain activities in connection with qualifying foreign trade property with respect to which certain "economic processes" take place outside of the United States.[12]

While rather technical in definition, in general the intention of Congress was to ensure that the excludable receipts are derived from foreign or trading activities as opposed to domestic-based earnings. The property or service being sold by the entity may not be for use in the United States. The revenue need not be from sale of products alone, as services and rental of property is also considered as part of the definition of foreign trading gross receipts. Part of the language of the Code is specifically designed to prevent obtaining of the tax benefits by manipulation of the manufacturing where the product is assembled or manufactured but ultimately selling the product domestically (i.e., shipping it to various non-domestic locations for assembly, only to ultimately bring the product back into the United States for domestic sale.)

Mathematically, Foreign Trade Income may be stated as:

(Qualified) Foreign Trading Gross Receipts

Less: Cost of Goods Sold

Equals: Gross Income

Less: Direct Expenses

Less: Apportioned Overhead Expense

Equals: ***Foreign Trade Income*** (which is the eligible, but yet unadjusted for the exclusion, taxable net income associated with foreign activities).

[11] Joint Committee on Taxation, *Technical Explanation of the Senate Amendment to H.R. 4986, the "FSC Repeal and Extraterritorial Income Exclusion Act of 2000"* (JCX-111-00), November 1, 2000. (herein "Joint Comm. JCX-111-00"), page 10.
[12] Joint Comm. JCX-111-00, page 7.

Please note carefully that "Foreign Trade Income" is NOT the same thing as "Qualifying Foreign Trade Income."

Qualifying Foreign Trade Income

Qualifying Foreign Trade Income is the highest result of three specific calculations[13] which ultimately result in the calculation of the "grossed up" foreign trade income. In essence, statutorily determined percentages ranging of 1.2% of Foreign Trade Gross Receipts, 15% of Foreign Trade Income and 30% of Foreign Sale & Leasing Income are calculated, and then using those calculated values, disallowed expenses (direct expenses and apportioned overhead expense deductions associated with the just calculated income exclusion component) are calculated. These two calculations (calculated reduction of taxable income and "gross up" for disallowed expenses) then are combined. The result of this addition equals Qualifying Foreign Trade Income (the highest value being used).

The highest resulting calculated amount (and its calculated subsections) is then excluded from the entity's gross income, direct expenses, and overhead expense, resulting in the final taxable income of the entity. Effectively, the net taxable income is reduced by this exclusion factor, resulting in significant tax savings. The calculation can be (and is) extremely complicated, but the preceding serves as a rough overview of the process.

Qualifying foreign trade income's definition[14] also includes a reference to a "transaction." The Code defines a "transaction" as (1) any sale, exchange or other disposition (2) any lease or rental; and (3) any furnishing of services.[15] Such a definition of foreign trade income is and leads to a degree of uncertainty. For example, when does a sale or rental actually take place (or perhaps more precisely, when is it appropriately booked?).

Specific Definitions

[13] Actually each computation is composed of two sub computations, as will be observed later.

[14] Qualifying foreign trade income is defined as the gross income, if excluded, that reduces the taxable income of the taxpayer equal to the *greatest* of: 30% of the foreign sale and leasing income of the transaction (s); 1.2% of the foreign trading gross receipts of the transactions(s); or 15% of the foreign trade income of the transaction.

[15] IRC §943(b)(1).

Foreign trading gross receipts are the gross receipts derived from certain activities in connection with qualifying foreign trade property with respect to certain economic processes that take place outside the US.[16] The receipts do not include gross receipts from any transaction whereby the goods or services are ultimately used in the U.S. or by any subsidy granted by the government where manufactured.[17] As might be expected, foreign trading gross receipts must be segregated to be able to calculate the qualifying foreign trade income.

Qualifying foreign trade property is property manufactured, produced grown or extracted ("manufacturing test[18]") within or outside of the United States that is held primarily for sale, lease or rental in the ordinary course of a trade or business, for direct use, consumption or disposition outside of the United States ("destination test[19]"). In addition, no more than 50% of the value of the transaction is attributable to foreign content or other non U.S. value added. The rules provide that no more than 50 percent of the fair market value of such property can be attributable to the sum of (1) the fair market value of articles manufactured outside of the United States plus (2) the direct costs of labor performed outside of the United States ("foreign content test[20]"). Certain products are specifically excluded from the definition of qualifying foreign trade property, such as oil and gas products, property in short supply, and certain intangible assets, such as a patent, copyright or goodwill. Thus, not every sale or rental, even if the product or service is otherwise export related, will not necessarily meet the qualifying tests established by the Code.

"***Certain economic processes***" (or foreign economic processes) compares foreign **direct** costs to total direct costs. Total direct costs in question are *not* limited to cost of goods sold. Total direct costs may include non-U.S. costs such as certain sales activities (such as soliciting customers outside the US) and actual foreign direct costs. If 50% of the direct costs are incurred outside the US, the test is met. Examples of such costs include advertising, processing of orders,

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[16] Joint Comm. JCX-111-00, page 7
[17] Joint Comm. JCX-111-00, page 7
[18] IRC §934(a)(1)(A)
[19] The destination test is to assure that fixed assets of the company are not given preferential treatment, i.e., the test is to assure that normal goods for sale (inventory or manufactured goods) are given the preferential treatment, and to assure the proper use of the goods outside of the US. This aspect could have a significant effect upon products that are manufactured outside the US.
[20] The foreign content includes not only tangible content but also intangible content. The foreign content rule becomes exceptionally important if the item is partially assembled or constructed at various locations, domestic and foreign. Joint Comm. JCX-111-00. page 9

transportation, determination of final invoice and receipt of payment, and assumption of credit risk[21] Maintaining such records may be a burdensome expense for a smaller taxpayer. Larger companies who are already taking advantage of FSC will find these rules are merely an extension of already existing FSC rules.

Previously, many FSC's had contracted with overseas entities to provide these services, which might create unacceptable extra costs to a smaller entity. Interestingly, it is now mandatory, *if* such another entity is used, that there is a written contract between the parties.[22] Such a *written* contract was not previously an explicit Code requirement.

Fortunately, for smaller businesses, the Code allows a most significant exception in cases where the foreign trading gross receipts are below $5,000,000. This exception allows a tremendous opportunity for smaller entities to participate in the Extraterritorial Income Exclusion without satisfying the more technical requirements of the foreign economic processes requirements[23]. Thus, as long as the taxpayer's foreign trading gross receipts do not exceed $5,000,000, the Code treats the taxpayer as having met the foreign economic processes requirement automatically and without the need for the taxpayer to perform the burdensome calculations and maintain the associated records/activities otherwise necessary. Note, however, that the $5,000,000 exception applies to all "related persons." For example, in a partnership, the exclusion is compared to the entity at the partnership level, and thus, for example, if a three partner entity generated $15,000,000 of foreign gross receipts, it could not be claimed that the three partners each aggregate separately $5,000,000, or $15,000,000 in gross receipts ($15,000,000/3 = $5,000,000/partner) and be thereby be eligible for the exception.

Foreign Sales and Leasing Income is the amount of the taxpayer's foreign trade income (with respect to a transaction) that is properly allocable to activities (including rentals) that constitute foreign economic processes.[24] The committee's example notes that it is the **profit** from the sale of qualifying foreign trade property that is associated with foreign economic processes, such as

[21] Joint Comm. JCX-111-00, page 8
[22] IRC §942(b)
[23] Principally the tests of foreign sales activities and 50% of the total direct costs of the transaction; such tests which must be achieved annually. There is also an alternative 85% test not discussed herein. IRC § 942(b)
[24] Joint Comm. JCX-111-00, page 10

sales activities, including the solicitation of the sale, advertising, transportation, etc. In this case, only *direct* allocable expenses are taken into account for calculation of the foreign trade income. Apportioned overhead expenses are ignored for this calculation.

The following expands an example taken from the Conference Committee's discussion on foreign sales and leasing income.[25] A domestic company has "properly" generated a foreign trade profit (but before allocating overhead expenses) of $125. After a review of the various foreign activities of (but not limited to) solicitation, negotiation, transportation and other foreign "sourced" expenses, from a cost accounting perspective, $35 of that $125 profit is directly allocable to (or, stated another way, earned as the result of) such foreign expenses. It is this $35 (out of the $125) that is considered to be the foreign sales and leasing income. Thus, the higher the overseas direct expense that generates foreign profit, the higher the base for the exclusion component.

An aggressive interpretation of what foreign sale and leasing income entails is that it represents all foreign income that satisfies the foreign economic process tests or is derived from leasing of qualified property outside of the U.S. This would mean exporters could potentially double the existing tax benefits. Stated differently, the $35 in the above example could be vastly larger if the entity only exports its products and has no domestic activities. While it is not clear if this is the intention of the law, it certainly gives pause to consider such a situation[26]. However, with the trade deficit problems of the U.S., perhaps the apparent inducement is intentional. Foreign Sales and Leasing Income is perhaps the hardest area to quantify and defend, and regulations do not yet exist to clarify certain uncertainties. However, it also represents a tremendous opportunity due to the high exclusion ratio if such a calculation can be justified and substantiated.

Computing the Benefits

Computing the benefit of the extraterritorial tax exclusion is somewhat complicated. However, an examination and expansion of an example from the Conference Committee's report reveals potential pitfalls and opportunities.[27] The same fact scenario and the other underlying

[25] Joint Comm. JCX-111-00, page 13
[26] The FSC/DISC Tax Association & Council for International Tax Education have questioned this election's results particularly as relating to export companies. Taxpayers preparing returns in the 2000 tax year also were uncertain as to the proper election and ultimate result particularly if they were principally exporting companies.
[27] Joint Comm. JCX-111-00, pages 11-15

tenants from the Conference Committee's example are presented. However, the data and computations have been rearranged, expanded and explained in a different fashion to clarify the example.

In general, the Committee's examples describes a U.S. company that is selling qualified property to nonrelated customers[28] for the customer's use of the product outside the US. The company meets all of the technical requisites to legally take advantage of the benefit of the new rules.

Calculation of the benefits requires the following five steps:

Step 1: Basic data is presented. Qualified foreign trade property sold to a customer by the company for $1,000. The cost of goods sold of the foreign trade property was $600. The company incurred $275 of costs directly related (direct costs) to the sale and distribution of the product. The Company paid $40 in foreign income taxes. The Company also generated **other** gross receipts (presumably domestic) of $24,000, related cost of goods sold of $16,400, with gross income of $7,600. Direct costs for the nonforeign sales were $4,225. The company had $500 of overhead costs. These two segments are then combined to provide totals in the categories.

Step 2: The basic data (recall it is assumed all such data conform to the requirements) is rearranged or restated to conform to the definitions and terms of art to calculate foreign trade income. In general, gross receipts are recast as foreign trading gross receipts, and overhead expenses are apportioned to the calculation, which results in foreign trade income (net income). In calculating foreign trade income, overhead is apportioned to the calculation as explained in the footnote. Foreign taxes are ignored in both step 1 and step 2 and are discussed later.

Step 3: Calculate and compare the various options to compute qualified foreign trade income, which includes two sub calculations: the calculation to compute the reduction of taxable income and the gross up for disallowed expenses.

Regarding the 30% computation, it is assumed that out of $125 of foreign trade income (i.e., ***before*** being apportioned overhead expenses), $35 of the $125 foreign trade income is directly related to the foreign activities of solicitation, negotiation, advertising, foreign

[28] The customer must be unrelated so as to not give undue advantage to the overall corporate entity by manipulating activities through the corporate hierarchy through subsidiaries and the like; this tenant pervades the Code.

transportation and such. This particular calculation requires a significant amount of cost accounting information to arrive at such an allocation. There are no revenue procedures or regulations[29] on this calculation, and taxpayers have noted certain incongruent results[30]. Due to various uncertainties of this particular portion of the calculation, despite the seemingly straightforward appearance in the committee example, one should proceed cautiously if using this approach.

After calculating the 1.2% of Foreign Trade Gross Receipts, 15% of Foreign Trade Income, and the 30% of Foreign Sale & Leasing Income, the associated amount of previously deducted expenses are added back in (or grossed up) into the taxable income. The use of this calculation represents the potential reduction of **taxable** income - the income remaining after related expenses are deducted against the gross income. The combination of the two calculations results in the Qualifying Foreign Trade Income (which is simply the **gross** income excluded).

The gross up for disallowed expenses simply allocates a percentage of the disallowed expenses (here the $275 of direct expenses plus the $25 apportioned overhead expenses = $300) versus the amount that is reduced from taxable income versus the total foreign trade income. For example, in the case of the 15% of foreign trade income calculation, the disallowed expenses are $300 ($275 of direct expenses and $25 of apportioned overhead expenses) multiplied by $15/100 (the reduction of taxable income amount of $15 divided by the foreign trade income of $100), which results in $45 of disallowed expenses. This result conforms to the earlier mentioned tax benefit rule, where these proportionate expenses should not be allowed if a reduction in the income has also been allowed.

As in the Committee example, the largest exclusion is the 15% of foreign trade income, providing the largest exclusion base of the three options.

Step 4: This step illustrates the exclusion and disallowance computation. The process then reduces the $60 exclusion of qualifying foreign trade income and related $41.25 of direct and $3.75 of indirect disallowed amounts, and compares the original status versus the excluded and disallowed adjustments. The $60 of qualifying foreign trade income (the gross amount) is deducted from the corresponding gross income, and the disallowed expenses (both the direct and

[29] While Rev. Proc. 2001-37 is scheduled to appear in Internal Revenue Bulletin 2001-24, dated June 11, 2001, it does not deal with this computation.

[30] See previous discussion in the text and footnote 27.

apportioned overhead expenses) are also deducted or reduced from the corresponding amounts. The $41.25 and $3.75 equals the "gross up" amount of $45 from step 3. The two calculations are merely allocated albeit in slightly more detail than in step 3. The purpose of Step 3 was to determine the Qualifying Foreign Trade income. The purpose of Step 4 is to continue the allocation but with a bit more detail. When the calculation is complete, the end result under total taxable income reduces (taxable) net income by $15, or, as a check figure, the 15% of the $100 foreign trade income. The tax savings to the entity is based on whatever the tax rate is applied to the entity's taxable income.

The Committee's example is based on a business that has significant domestic activity. The real advantage of the extraterritorial income exclusion becomes more apparent for businesses that have a large percentage of exports. Assuming $2,900 the tax exclusion would leap to $435, (assuming 15% of foreign trade income), or a taxable amount of $2565 [$100 (domestic) + $2,900 foreign - $435= $2565] versus an original taxable amount of $3000. A sizable amount of this figure could also be considered foreign sale & leasing income, which would be subject to the 30% exclusion rate, potentially doubling the exclusion if the primary activity of the entity is export.

Step 5: This step is not included in the Conference Committee's example, but is valuable to business owners and managers. This step involves comparing tax payable after the exclusion versus the tax payable without the exclusion. In this case, it must be remembered that the amount is rather small due to the other very large (presumably domestic related or other ineligible) income. A moment of extrapolating the savings if the income was principally foreign sourced illustrates the tremendous tax saving opportunities possible resulting from this new tax Act (i.e., approximately $435 * 35% or $152.25 in tax savings).

Not shown in the computation exhibit example is the effect of the foreign income tax payment of $40 as established in the Committee's example. In general, recall this is also a tax benefit normally deductible, which accordingly must be reduced. The calculation would be as follows:

> $60 of qualifying foreign trade income (reference [g] in the computation) divided by $400 (reference [c]) of gross income from foreign sale times the given $40 credit, or

$60/400 = 15% * $40 = $6. Accordingly, the six dollars would not be creditable against taxes, again as a result of the tax benefit rule.

Step 1

Basic Data

	Non Foreign Or Domestic	Qualified. Foreign Trade Property	Total
Gross receipts	24,000	1,000 [a]	$25,000
CGS	16,400	600 [b]	17,000
Gross income	7,600	400 [c]	8,000
Direct Expenses	4,225	275 [d]	4500
Overhead Expense			500
Net Income			3,000

Step 4 Exclusion Computation

LESS *Excluded/disallowed*	*Total Taxable Income*
(60.00) [g]	7,940.00
(41.25) [h]	4,458.75
(3.75) [h]	496.25
(15.00) [i]	2,985.00 i.e. 15% of $100 [i] **(Final Taxable Income)**

Step 2

Thus, restated data to calculate Foreign Trade Income

Foreign Trading Gross Receipts	1,000 [a]
CGS	600 [b]
Gross income	400 [c]
Direct Expenses	275 [d]
Apportioned overhead Expenses[31]	25 [e]
Foreign Trade Income	100. [f]

Step 5: Comparison of Tax (simplified)

Original Net Income ($3000 * 35%=)	1050.00
Final Taxable Income ($2,985 *35%=)	1044.75
Tax Savings (assuming 35% rate)	5.25

Step 3

Calculation of Exclusions- Qualified Foreign Trade Income:

(a) Reduction of Taxable Income	**1.2% of Frgn Trade Gross Rcpts**	**15% of Foreign Trade Income**	**30% of Foreign Sale & Leasing Income**
1.2% of FTGR[32] (1.2% * 1,000[a])	12.00		
15% of FTI[33] (15%* $100[f])		15.00 [i]	
30% of FS&LI[34] (30%* $35[35])			10.50
(b) Gross up for disallowed expenses			
$300 [d+e] * ($12/100)	36.00		
$300 [d+e]* ($15/100)		45.00 [h]	
$300[d+e] * ($10.50/100)			28.88
(a+b) =**Qualifying Foreign Trade Income**	48.00	60.00 [g]	39.38

In this case, 15% is preferable as it has the higher total exclusion.

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[31] $500 /overhead expense * 5%. The 5% is calculated as. $400 of gross income from sale of Qualifying foreign trade property divided by $8000 of total gross income). Thus, $25 is apportioned to foreign activity, the remainder of the overhead ($500 – $25) or $475 is apportioned to the other income.

[32] FTGR means Foreign Trade Gross Receipts

[33] FTI means Foreign Trade Income

[34] FS&LI means Foreign Sale and Leasing Income

[35] We are to assume here that of the $125 of Foreign Trade Income calculated in step 2 (but **before** the allocation of overhead expenses of $25), $35 is properly allocable to such foreign activities such as solicitation, negotiation, foreign transportation, and the like. See text.

Summary

With the availability of the world wide web at a reasonable cost, many smaller firms have access to the world market. The recent change to the U.S. Federal Tax laws provides tax incentives to smaller firms that quality for the extraterritorial income exclusion that were once only available to fairly large firms with sophisticated tax and foreign trade specialists. While the recent law does require that the firm have the accounting system capable of documenting foreign related expenses, improvements in computer-based accounting systems for small businesses reduce the administrative effort required to reap the financial rewards from taking advantage of the exclusion. If the cost of tax savings is consumed by additional administrative and tax preparation expenses, there is little reason to pursue this incentive. This article has not attempted to discuss exhaustively the Extraterritorial Income Exclusion- particularly existing larger entities nor FSC entity transition. Rather, we have attempted to concentrate on the basic structure of the new law as it might relate to the smaller entrepreneur who might otherwise not recognize the tax benefits of this Act. However, this article clearly illustrates that even with the vague language and uncertainties of a new law, small businesses that engage in international trade would be wise to take advantage of the Extraterritorial Income Exclusion.