2000

Department of the Treasury
Internal Revenue Service

Instructions for Form 1120-FSC

U.S. Income Tax Return of a Foreign Sales Corporation

Section references are to the Internal Revenue Code unless otherwise noted.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form and related schedule will vary depending on individual circumstances. The estimated average times are:

Form	Recordkeeping	Learning about the law or the form	Preparing and sending the form to the IRS
1120-FSC	93 hr., 59 min.	18 hr., 30 min.	36 hr., 24 min.
Sch. P (1120-FSC)	9 hr., 48 min.	1 hr., 29 min.	1 hr., 43 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form and related schedule simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do not** send the tax form to this office. Instead, see **Where To File** on page 4.

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Changes To Note

- The FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (the Act) repealed the rules for FSCs, effective for transactions after September 30, 2000. A new extraterritorial income exclusion applies to taxpayers for transactions after September 30, 2000. In addition, the Act provides a transition period for existing FSCs. For details, including transition rules and elections, see **FSC Repeal and Extraterritorial Income Exclusion** on page 2.
- A FSC is required to attach a statement to its income tax return to disclose its participation in certain transactions that have tax shelter characteristics or are structured to avoid tax. See **Corporate tax shelters** on page 5.
- Generally, if a FSC's average annual gross receipts for the 3 prior tax years are $1 million or less, it may be eligible to adopt or change to the cash method of accounting. If the FSC makes this change, it will not be required to account for inventories. Instead, the FSC may treat inventory in the same manner as costs of materials and supplies that are not incidental. For details, see the instructions for **Schedule A, Cost of Goods Sold Related to Foreign Trading Gross Receipts**, on page 8.
- FSCs now use the list of codes based on the North American Industry Classification System to complete **Schedule P (Form 1120-FSC)**, Transfer Price or Commission. See the instructions for Schedule P (Form 1120-FSC) for details and exceptions.

Photographs of Missing Children

The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in instructions on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1-800-THE-LOST** (1-800-843-5678) if you recognize a child.

Unresolved Tax Issues

If the FSC has attempted to deal with an IRS problem unsuccessfully, it should contact the Taxpayer Advocate. The Taxpayer Advocate independently represents the FSC's interests and concerns within the IRS by protecting its rights and resolving problems that have not been fixed through normal channels.

While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that the FSC's case is given a complete and impartial review.

The FSC's assigned personal advocate will listen to its point of view and will work with the corporation to address its concerns. The FSC can expect the advocate to provide:

- A “fresh look” at a new or on-going problem.
- Timely acknowledgment.

- The name and phone number of the individual assigned to its case.
- Updates on progress.
- Timeframes for action.
- Speedy resolution.
- Courteous service.

When contacting the Taxpayer Advocate, the FSC should provide the following information:

- The FSC's name, address, and employer identification number.
- The name and telephone number of an authorized contact person and the hours he or she can be reached.
- The type of tax return and year(s) involved.
- A detailed description of the problem.
- Previous attempts to solve the problem and the office that had been contacted.
- A description of the hardship the FSC is facing (if applicable).

The FSC may contact a Taxpayer Advocate by calling a toll-free number, **1-877-777-4778**. Persons who have access to TTY/TDD equipment may call 1-800-829-4059 and ask for Taxpayer Advocate assistance. If the FSC prefers, it may call, write, or fax the Taxpayer Advocate office in its area. See **Pub. 1546,** The Taxpayer Advocate Service of the IRS, for a list of addresses and fax numbers.

How To Get Forms and Publications

Personal computer. You can access the IRS Web Site 24 hours a day, 7 days a week, at **www.irs.gov** to:

- Download forms, instructions, and publications.
- See answers to frequently asked tax questions.
- Search publications on-line by topic or keyword.
- Send us comments or request help by e-mail.
- Sign up to receive local and national tax news by e-mail.

You can also reach us using file transfer protocol at **ftp.irs.gov**.

CD-ROM. Order **Pub. 1796,** Federal Tax Products on CD-ROM, and get:

- Current year forms, instructions, and publications.
- Prior year forms, instructions, and publications.
- Popular tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- The Internal Revenue Bulletin.

Buy the CD-ROM on the Internet at **www.irs.gov/cdorders** from the National Technical Information Service (NTIS) for $21 (no handling fee), or call **1-877-CDFORMS** (1-877-233-6767) toll-free to buy the CD-ROM for $21 (plus a $5 handling fee).

By phone and in person. You can order forms and publications 24 hours a day, 7 days a week, by calling **1-800-TAX-FORM** (1-800-829-3676). You can also get most forms and publications at your local IRS office.

General Instructions

Purpose of Form

Use Form 1120-FSC to report income, gains, losses, deductions, and credits of a FSC. It is also used to figure the FSC's income tax liability or to claim a refund.

FSC Repeal and Extraterritorial Income Exclusion

In general, for transactions after September 30, 2000, the FSC Repeal and Extraterritorial Income Exclusion Act of 2000:

- Repealed the FSC rules,
- Provides taxpayers with an exclusion, which is figured on **Form 8873**, Extraterritorial Income Exclusion, and
- Provides transition rules for existing FSCs (see **Transition Rules** below).

Transition Rules

In general, a FSC in existence on September 30, 2000, will continue to use the FSC rules for qualifying transactions in the ordinary course of business before January 1, 2002. Furthermore, a FSC will continue to use the FSC rules after December 31, 2001, for transactions pursuant to a binding contract that the FSC (or a person related to the FSC) has entered into with a person other than a related person if that binding contract was in effect on September 30, 2000. A binding contract includes a purchase, renewal, or replacement option that is enforceable against a lessor or seller (provided the option is part of a contract that is binding and in effect on September 30, 2000).

The mere entering into of a single transaction, such as a lease, would not, in and of itself, prevent the transaction from being in the ordinary course of business.

Election To Apply Exclusion Rules

Taxpayers may elect to apply the new extraterritorial income exclusion rules instead of the FSC rules for transactions occurring during the transition period. The election is:

- Made by checking the box on line 2 of Form 8873,
- Effective for the tax year for which it is made and for all subsequent tax years,
- Not applicable to transactions entered into before October 1, 2000, and
- Revocable only with the consent of the IRS.

Taxpayers use Form 8873 to determine their extraterritorial income exclusion.

Election To Be Treated as a Domestic Corporation

A FSC in existence on September 30, 2000, may elect to be treated as a domestic corporation if either:

- It manufactures, produces, grows, or extracts property in the ordinary course of its trade or business or
- Substantially all of its gross receipts are foreign trading gross receipts.

The election, which cannot be effective before October 1, 2000, is made by checking the box on line 3 of Form 8873. An electing corporation files **Form 1120**, U.S. Corporation Income Tax Return, or **Form 1120-A**, U.S. Corporation Short-Form Income Tax Return. Once made, the election applies to the tax year made and remains in effect for all subsequent years unless the election is revoked or terminated. If the election is revoked or terminated, the corporation would be a foreign corporation that files **Form 1120-F,** U.S. Income Tax Return of a Foreign Corporation. Furthermore, the foreign corporation would not be eligible to reelect to be treated as a domestic corporation for 5 tax years beginning with the first tax year for which the original election is not in effect as a result of the revocation or termination.

Effect of election. A FSC that elects to be treated as a domestic corporation ceases to be a FSC for any tax year to which the election applies (and for any subsequent tax year).

FSC Election

No corporation may elect to be a FSC or a small FSC after September 30, 2000. However, a FSC election is considered to occur on the formation of an otherwise eligible electing corporation, provided the corporation formed before October 1, 2000, and filed the election within 90 days of formation. For details, see Temporary Regulations section 1.921-1T(b)(1).

Termination of Inactive FSCs

If a FSC has no foreign trade income (see definition on page 3) for any 5 consecutive tax years beginning after December 31, 2001, the FSC will no longer be treated as a FSC for any tax year beginning after that 5-year period.

FSC Rules

Definition of a Foreign Sales Corporation (FSC)

Under section 922(a), a FSC is defined as a corporation that has met **all** of the following rules.

1. It must be a corporation created or organized under the laws of a qualifying foreign country or any U.S. possession other than Puerto Rico.

Qualifying U.S. possessions include Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands.

A qualifying foreign country is a foreign country that meets the exchange of information rules of section 927(e)(3)(A) or (B). All U.S. possessions other than Puerto Rico are also certified to have met these rules.

The countries listed below are the qualifying foreign countries that have met the exchange of information rules of section 927(e)(3)(A) or 927(e)(3)(B).

- Australia, Austria, Barbados, Belgium, Bermuda, Canada, Costa Rica, Cyprus,
- Denmark, Dominica, the Dominican Republic, Egypt, Finland, France, Germany,

- Grenada, Guyana, Honduras, Iceland, Ireland, Jamaica, Korea, Malta,
- The Marshall Islands, Mexico, Morocco, the Netherlands, New Zealand, Norway, and
- Pakistan, Peru, the Philippines, St. Lucia, Sweden, and Trinidad and Tobago.

2. It had no more than 25 shareholders at any time during the tax year.

3. It had no preferred stock outstanding at any time during the tax year.

4. During the tax year, the FSC must maintain:

- An office in one of the qualifying foreign countries or U.S. possessions listed above,
- A set of permanent books of account (including invoices) at that office, and
- The books and records required under section 6001 at a U.S. location to sufficiently establish the amount of gross income, deductions, credits, or other matters required to be shown on its tax return.

5. It must have at least one director, at all times during the tax year, who is not a resident of the United States.

6. It must not be a member, at any time during the tax year, of a controlled group of which a DISC is a member.

7. It must have elected to be a FSC or small FSC (defined below), and the election must have been in effect for the tax year.

Small FSC. Section 922(b) defines a small FSC as a corporation that:

- Elected small FSC status and has kept the election in effect for the tax year and
- Is not a member, at any time during the tax year, of a controlled group that includes a FSC (unless that other FSC is also a small FSC).

A small FSC is exempt from the foreign management and foreign economic process requirements. See the instructions for **Foreign Management Rules** and the **Foreign Economic Process Rules** below.

$5 million limit. Generally, any foreign trading gross receipts of a small FSC for the tax year that exceed $5 million are not to be considered in determining its exempt foreign trade income. The $5 million limit is reduced if the small FSC has a short tax year. It may also be reduced if the small FSC is a member of a controlled group that contains other small FSCs. See Regulations section 1.921-2(b) for more information.

Tax Treatment of a FSC

A FSC is not taxed on its exempt **foreign trade income.** Section 923 defines foreign trade income as the gross income of a FSC attributable to foreign trading gross receipts (defined below).

The percentage of foreign trade income exempt from tax is figured differently for income determined under the administrative pricing rules (for details, see the instructions for Schedule P (Form 1120-FSC)) and income determined without regard to the administrative pricing rules. (These percentages are computed on Schedule E, page 4, Form 1120-FSC, and carried over to lines 9a and 9b of Schedule B, page 3, Form 1120-FSC to figure taxable income or (loss).)

See section 923(a)(4) for a special rule for foreign trade income allocable to a **cooperative**. See section 923(a)(5) for a special rule for **military property**.

Tax treaty benefits. A FSC may not claim any benefits under any income tax treaty between the United States and any foreign country.

Foreign Trading Gross Receipts

A FSC is treated as having foreign trading gross receipts (defined in section 924) only if it has met certain foreign management and foreign economic process requirements.

Foreign trading gross receipts **do not** include:

- Certain excluded receipts (defined in section 924(f)).
- Receipts attributable to property excluded from export property under section 927(a)(2).
- Investment income (defined in section 927(c)).
- Carrying charges (defined in section 927(d)(1)).

Note: *Computer software licensed for reproduction abroad is not excluded from export property under section 927(a)(2). Therefore, receipts attributable to the sale, lease, or rental of computer software and services related and subsidiary to such transactions qualify as foreign trading gross receipts.*

Foreign Management Rules

A FSC (other than a small FSC) is treated as having foreign trading gross receipts for the tax year only if the management of the FSC during the year takes place outside the United States. These management activities include:

- Meetings of the board of directors and meetings of the shareholders.
- Disbursing cash, dividends, legal and accounting fees, salaries of officers, and salaries or fees of directors from the principal bank account (see below).
- Maintaining the principal bank account at all times during the tax year.

Meetings of directors and meetings of the shareholders. All meetings of the board of directors of the FSC and all meetings of the shareholders of the FSC that take place during the tax year must take place outside the United States.

In addition, all such meetings must comply with the local laws of the foreign country or U.S. possession in which the FSC was created or organized. The local laws determine whether a meeting must be held, when and where it must be held (if it is held at all), who must be present, quorum requirements, use of proxies, etc.

Principal bank accounts. See Regulations section 1.924(c)-1(c) for information regarding principal bank accounts.

Foreign Economic Process Rules

A FSC (other than a small FSC) has foreign trading gross receipts from any transaction only if certain economic processes for the transaction take place outside the United States. Section 924(d) and Regulations section 1.924(d)-1 set forth the rules for determining whether a sufficient amount of the economic processes of a transaction takes place outside the United States.

Generally, a transaction will qualify if the FSC satisfies two requirements:

- Participation outside the United States in the sales portion of the transaction and
- Satisfaction of either the 50% or the 85% foreign direct cost test.

The activities comprising these economic processes may be performed by the FSC or by any other person acting under contract with the FSC.

Participation outside the United States in the sales portion of the transaction. Generally, the requirement of section 924(d)(1)(A) is met for the gross receipts of a FSC derived from any transaction if the FSC has participated outside the United States in the following sales activities relating to the transaction: (1) solicitation (other than advertising), (2) negotiation, and (3) making a contract.

1. Solicitation (other than advertising) is any communication (including, but not limited to, telephone, telegraph, mail, or in person) by the FSC, to a specific, targeted customer or potential customer.

2. Negotiation is any communication by the FSC to a customer or potential customer aimed at an agreement on one or more of the terms of a transaction, including, but not limited to, price, credit terms, quantity, or time or manner of delivery.

3. Making a contract refers to performance by the FSC of any of the elements necessary to complete a sale, such as making or accepting an offer.

Grouping transactions. Generally, the sales activities described above are to be applied on a transaction-by-transaction basis. However, a FSC may make an annual election to apply any of the sales activities on the basis of a group. To make the election, check the box on line 11a, **Additional Information,** on page 2 of Form 1120-FSC. See Regulations section 1.924(d)-1(c)(5) for details.

Satisfaction of either the 50% or 85% foreign direct cost test. To qualify as foreign trading gross receipts, the foreign direct costs incurred by the FSC attributable to the transaction must equal or exceed 50% of the total direct costs incurred by the FSC attributable to the transaction.

Direct costs are costs that:

- Are attributable to the activities described in the five categories of section 924(e).

Instead of satisfying the 50% foreign direct cost test, the FSC may incur foreign direct costs attributable to activities described in each of two of the section 924(e) categories. The costs must equal or exceed 85% of the total direct costs incurred by the FSC attributable to the activity described in each of the two categories. If no direct costs are incurred by the FSC in a particular category, that category is not taken into account for purposes of determining whether the FSC has met either the 50% or 85% foreign direct cost test.

- Are incident to and necessary for the performance of any activity described in section 924(e);
- Include the cost of materials consumed in the performance of the activity and the cost of labor that can be identified or associated directly with the performance of the activity (but only to the extent of wages, salaries, fees for professional services, and other amounts paid for personal services actually rendered, such as bonuses or compensation paid for services on the basis of a percentage of profits); and
- Include the allowable depreciation deduction for equipment or facilities (or the rental cost for its use) that can be specifically identified or associated with the activity, as well as the contract price of an activity performed on behalf of the FSC by a contractor.

Total direct costs means all of the direct costs of any transaction attributable to activities described in any paragraph of section 924(e).

50% foreign direct cost test. For the 50% test of section 924(d)(1)(B), total direct costs are based on the direct costs of all activities described in all paragraphs of section 924(e).

85% foreign direct cost test. For the 85% test of section 924(d)(2), however, the total direct costs are determined separately for each paragraph of section 924(e).

Foreign direct costs means the portion of the total direct costs of any transaction attributable to activities performed outside the United States.

50% foreign direct cost test. For purposes of the 50% test, foreign direct costs are based on the direct costs of all activities described in all paragraphs of section 924(e).

85% foreign direct cost test. For purposes of the 85% test, however, foreign direct costs are determined separately for each paragraph of section 924(e).

For more details, see Regulations section 1.924(d)-1(d).

Check the applicable box(es) on line 11b, **Additional Information**, on page 2 of the form, to indicate how the FSC met the foreign direct costs requirement.

Grouping transactions. Generally, the foreign direct cost tests under Regulations section 1.924(d)-1(d) are applied on a transaction-by-transaction basis. However, the FSC may make an annual election (on line 11d, **Additional Information**, on page 2 of the form) to apply the foreign direct cost tests on a customer, contract, or product or product line grouping basis. Any grouping used must be supported by adequate documentation of performance of activities and costs of activities relating to the grouping used. See Regulations section 1.924(d)-1(e) for details.

Exception for foreign military property. The economic process rules do not apply to any activities performed in connection with foreign military sales except those activities described in section 924(e). See Regulations section 1.924(d)-1(f) for details.

Section 925(c) Rule

To use the administrative pricing rules to determine the FSC's (or small FSC's) profit on a transaction or group of transactions, the FSC must perform (or contract with another person to perform) all of the economic process activities relating to the transaction or group of transactions. All of the direct and indirect expenses relating to the performance of those activities must be reflected on the books of the FSC and on Form 1120-FSC.

Under Temporary Regulations section 1.925(a)-1T(b)(2)(ii), an election may be made to include on the FSC's books all expenses, other than cost of goods sold, that are necessary to figure combined taxable income for the transaction or group of transactions. The expenses must be identified on Schedule G on the applicable line.

Who Must File

File Form 1120-FSC if the corporation elected to be treated as a FSC or small FSC, and the election is still in effect.

Note: *A FSC that elects to be treated as a domestic corporation under section 943(e)(1) does not file Form 1120-FSC. Instead, it files Form 1120 (or Form 1120-A).*

When To File

Generally, a corporation must file Form 1120-FSC by the 15th day of the 3rd month after the end of the tax year. A new FSC filing a short-period return must generally file by the 15th day of the 3rd month after the short period ends. A FSC that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved.

If the due date falls on a Saturday, Sunday, or legal holiday, the FSC may file by the next business day.

Private delivery services. FSCs can use certain private delivery services designated by the IRS to meet the “timely mailing as timely filing/paying” rule for tax returns and payments. The most recent list of designated private delivery services was published by the IRS in August 1999. The list includes only the following:

- Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, Second Day Service.
- DHL Worldwide Express (DHL): DHL “Same Day” Service, DHL USA Overnight.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2 Day.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M.

The private delivery service can tell you how to get written proof of the mailing date.

Extension of time to file. File **Form 7004,** Application for Automatic Extension of Time To File Corporation Income Tax Return, to request a 6-month extension of time to file.

Where To File

File Form 1120-FSC with the Internal Revenue Service Center, Philadelphia, PA 19255.

Who Must Sign

The return must be signed and dated by:

- The president, vice president, treasurer, assistant treasurer, chief accounting officer or
- Any other corporate officer (such as tax officer) authorized to sign.

Receivers, trustees, or assignees must also sign and date any return filed on behalf of a corporation.

If a corporate officer completes Form 1120-FSC, the Paid Preparer's space should remain blank. Anyone who prepares Form 1120-FSC but does not charge the corporation should not sign the return. Generally, anyone who is paid to prepare the return must sign it and fill in the Paid Preparer's Use Only area.

The paid preparer must complete the required preparer information and—

- Sign the return, by hand, in the space provided for the preparer's signature (signature stamps and labels are not acceptable).
- Give a copy of the return to the taxpayer.

Other Forms, Returns, Schedules, and Statements That May Be Required

The FSC may have to file some of the following forms. See the form for more information.

Employment Tax Returns

Form 940 or **Form 940-EZ,** Employer's Annual Federal Unemployment (FUTA) Tax Return. The FSC may be liable for FUTA tax and may have to file Form 940 or 940-EZ if either of the following applies.

1. It paid wages of $1,500 or more in any calendar quarter in 1999 or 2000 or

2. It had at least one employee who worked for the FSC for some part of a day in any 20 or more different weeks in 1999 or 20 or more different weeks in 2000.

Form 941, Employer's Quarterly Federal Tax Return, or **Form 943**, Employer's Annual Tax Return for Agricultural Employees. Employers must file these forms to report income tax withheld, and employer and employee social security and Medicare taxes. Also, see **Trust fund recovery penalty** on page 8.

Form 945, Annual Return of Withheld Federal Income Tax. File Form 945 to report income tax withholding from nonpayroll distributions or payments, such as the following income:

- Pensions, annuities, IRAs, military retirement, gambling winnings and
- Indian gaming profits and backup withholding.

See **Trust fund recovery penalty** on page 8.

Information Returns

Form W-2, Wage and Tax Statement and **Form W-3,** Transmittal of Wage and Tax Statements. Use these forms to report withheld income, wages, tips, other compensation, social security, and Medicare taxes for an employee.

Form 1096, Annual Summary and Transmittal of U.S. Information Returns.

Form 1098, Mortgage Interest Statement. Use this form to report the receipt from any individual of $600 or more of mortgage interest (including points) in the course of the FSC's trade or business and reimbursements of overpaid interest.

Forms 1099. Use these information returns to report the following:

- **Form 1099-A.** Acquisitions and abandonments of secured property.
- **Form 1099-B.** Proceeds from broker and barter exchange transactions.
- **Form 1099-C.** Cancellation of a debt.
- **Form 1099-DIV.** Certain dividends and distributions.
- **Form 1099-INT.** Interest income.
- **Form 1099-LTC.** Certain payments made under a long-term care insurance contract and certain accelerated death benefits.
- **Form 1099-MISC.** Miscellaneous income (e.g., payments to certain fishing boat crew members; payments to providers of health and medical services; rent or royalty payments; nonemployee compensation, etc.).

Note: *Every FSC must file Form 1099-MISC if it makes payments of rents, commissions, or other fixed or determinable income (see section 6041) totaling $600 or more to any one person in the course of its trade or business during the calendar year.*

- **Form 1099-MSA.** Distributions from a medical savings account (MSA) or Medicare+Choice MSA.
- **Form 1099-OID.** Original issue discount.
- **Form 1099-PATR.** Distributions from cooperatives to their patrons.
- **Form 1099-R.** Distributions from pensions, annuities, retirement or profit-sharing plans, individual retirement arrangements (IRAs) (including SEPs, SIMPLEs, Roth IRAs, Ed IRAs, Roth conversions, and IRA recharacterizations), or insurance contracts.
- **Form 1099-S.** Gross proceeds from the sale or exchange of real estate transactions.

Also use these returns to report amounts received as a nominee for another person.

Form 5498, IRA Contribution Information. Use this form to report contributions (including rollover contributions) to any IRA, including a SEP, SIMPLE, Roth IRA, Ed IRA, Roth conversion, and IRA recharacterization, and the fair market value of the account.

Form 5498-MSA, MSA or Medicare+Choice MSA Information. Use this form to report contributions to a medical savings account (MSA) and the fair market value of an MSA or Medicare+Choice MSA.

For more information, see the Instructions for Forms 1099, 1098, 5498, and W-2G.

Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business. Use this form to report the receipt of more than $10,000 in cash or foreign currency in one transaction or a series of related transactions.

International Forms

Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and

Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding. Use these forms to report and send withheld tax on payments or distributions made to nonresident alien individuals, foreign partnerships, or foreign corporations.

Also see **Pub. 515,** Withholding of Tax on Nonresident Aliens and Foreign Corporations, and sections 1441 and 1442.

Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. This form may have to be filed by certain officers, directors, or U.S. shareholders of a FSC.

Form 5471 does not have to be filed when the FSC is organized. However, this form may be required for subsequent changes in ownership (see section 6046 and the related regulations). If a Form 1120-FSC is filed, Form 5471 is not required to be filed to satisfy the requirements of section 6038 (see Temporary Regulations section 1.921-1T(b)(3)). However, if the FSC is involved in other than FSC activities, Form 5471 and the applicable schedules may have to be filed.

Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Generally, a FSC that is engaged in a trade or business in the United States that had a reportable transaction with a foreign-or domestic-related party during the tax year must file Form 5472.

For purposes of who must file Form 5472, a FSC is considered to be **controlled** by a foreign person if it is owned, directly or indirectly, by a foreign person who owns at least:

1. 25% of the total voting power of all classes of stock entitled to vote or

2. 25% of the total value of all classes of stock.

Form 5713, International Boycott Report. FSCs that had operations in, or related to, certain “boycotting” countries file Form 5713.

Schedule P (Form 1120-FSC), Transfer Price or Commission. Complete and attach Schedule P, as appropriate, using the administrative pricing rules of section 925.

Other Forms

Form 8264, Application for Registration of a Tax Shelter. Tax shelter organizers use this form to receive a tax shelter registration number from the IRS.

Form 8271, Investor Reporting of Tax Shelter Registration Number. Taxpayers, who have acquired an interest in a tax shelter that is required to be registered, use this form to report the tax shelter's registration number. Form 8271 must be attached to any tax return (including an application for tentative refund (Form 1139) and an amended Form 1120-FSC) on which a deduction, credit, loss, or other tax benefit attributable to a tax shelter is taken or any income attributable to a tax shelter is reported.

Form 8275, Disclosure Statement, and **Form 8275-R,** Regulation Disclosure Statement. Disclose items or positions taken on a tax return that are not otherwise adequately disclosed on a tax return or that are contrary to Treasury regulations (to avoid parts of the accuracy-related penalty or certain preparer penalties).

Form 8810, Corporate Passive Activity Loss and Credit Limitations. Closely held FSCs (and FSCs that are personal service corporations) must use this form to compute the passive activity loss and credit allowed under section 469.

Note: *The credits allowed on Form 1120-FSC are not subject to the limits of section 469.*

Form 8842, Election To Use Different Annualization Periods for Corporate Estimated Tax. FSCs use Form 8842 for each year they want to elect one of the annualization periods in section 6655(e)(2) for figuring estimated tax payments under the annualized income installment method.

Form 8866, Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method. Figure the interest due or to be refunded under the look-back method of section 167(g)(2) for property placed in service after September 13, 1995, that is depreciated under the income forecast method.

Statements

Corporate tax shelters. A FSC is required to disclose its participation in certain tax shelters:

- By attaching a disclosure statement to its income tax return for a reportable transaction for each tax year its income tax liability is affected by its participation in the transaction and
- For the first tax year a disclosure statement is attached to its tax return, by sending a copy of the disclosure statement to the Internal Revenue Service, LM:PFTG:OTSA, 1111 Constitution Ave., NW, Washington, DC 20224.

Disclosure is required for reportable transactions that are: **(a)** listed transactions that the IRS has identified as tax avoidance transactions and **(b)** other reportable transactions that have tax shelter characteristics. A listed transaction must be reported if it is expected to reduce the taxpayer's income tax liability by more than $1 million in a single tax year or by a total of more than $2 million for any combination of years. For other reportable transactions, the threshold increases to $5 million for a single tax year and to $10 million for any combination of years. Generally, reporting is not required for customary business transactions or transactions with tax benefits that the IRS has no reasonable basis to challenge.

See Temporary Regulations section 1.6011-4T for details, including:

- The definitions of a reportable transaction and a listed transaction,
- The relevant tax shelter characteristics for other reportable transactions,
- The form and content of the disclosure statement, and
- The filing requirements of the disclosure statement.

Also see Notice 2000-15, 2000-12 I.R.B. 826 and Notice 2000-44, 2000-36 I.R.B. 255, for certain listed transactions determined to have a tax avoidance purpose and the intended tax benefits that are subject to disallowance. The listed transactions in these notices may be updated from time to time when other tax avoidance transactions are identified.

Personal Holding Companies and Foreign Personal Holding Companies

Personal holding company. A FSC that is a personal holding company (as defined in section 542) but not a foreign personal holding company, must file **Schedule PH (Form 1120),** U.S. Personal Holding Company (PHC) Tax, with Form 1120-FSC. On line 8, Schedule J, Form 1120-FSC, the FSC reports the personal holding company tax. See section 542 and Schedule PH (Form 1120) for details.

Foreign personal holding company. Regulations section 1.551-4 requires certain shareholders of the FSC that is a foreign personal holding company (as defined in section 552) to attach a statement to their personal returns containing the information required by section 551(c).

Form 5471. Section 6035 and the related regulations require certain officers, directors, and shareholders of a foreign personal holding company to file **Schedule N (Form 5471),** Return of Officers, Directors, and 10% or More Shareholders of a Foreign Personal Holding Company, and the appropriate schedules of Form 5471. See the Instructions for Form 5471 for additional information.

Assembling the Return

After page 6, Form 1120-FSC, assemble any schedules and other forms in the FSC tax return in the following order.

1. Form 4136, Form 4626, and Form 851.

2. Additional schedules in alphabetical order.

3. Additional forms in numerical order.

Complete every entry applicable space on Form 1120-FSC. Do not write “See attached” instead of completing the entry spaces. If more space is needed on the forms or schedules, attach separate sheets using the same size and format as the printed forms. If there are supporting statements and attachments, arrange them in the same order as the schedules or forms they support and attach them last. Show the totals on the printed forms. Also, be sure to enter the FSC's name and EIN on each supporting statement or attachment.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported.

Figure taxable income using the method of accounting regularly used in keeping the FSC's books and records. Generally, permissible methods include:

- Cash,
- Accrual, or
- Any other method authorized by the Internal Revenue Code.

In all cases, the method used must clearly show taxable income. If inventories are required, the accrual method must be used for sales and purchases of merchandise. See **Schedule A, Cost of Goods Sold Related to Foreign Trading Gross Receipts**, on page 8.

A member of a controlled group cannot use an accounting method that would distort any group member's income, including its own. For example, a FSC acts as a commission agent for property sales by a related corporation that uses the accrual method and pays the FSC its commission more than 2 months after the sale. In this case, the FSC should not use the cash method because that method would materially distort its income.

Generally, a FSC (other than a qualified personal service corporation) must use the accrual method of accounting if its average annual gross receipts exceed $5 million. See section 448(c).

Under the accrual method, an amount is includible in income when:

- All the events have occurred that fix the right to receive the income, which is the earliest of the date: **(a)** the required performance takes place, **(b)** payment is due, or **(c)** payment is received; and
- The amount can be determined with reasonable accuracy.

See Regulations section 1.451-1(a) for details.

Generally, an accrual basis taxpayer can deduct accrued expenses in the tax year when:

- All events that determine the liability have occurred,
- The amount of the liability can be figured with reasonable accuracy, and
- Economic performance takes place with respect to the expense.

There are exceptions to the economic performance rule for certain items, including recurring expenses. See section 461(h) and the related regulations for the rules for determining when economic performance takes place.

Long-term contracts (except for certain real property construction contracts) must generally be accounted for using the percentage of completion method described in section 460. See section 460 for general rules on long-term contracts.

Mark-to-market accounting method. Generally, dealers in securities must use the mark-to-market accounting method described in section 475. Under this method, any security that is inventory to the dealer must be included in inventory at its fair market value (FMV). Any security held by a dealer that is not inventory and that is held at the close of the tax year is treated as sold at its FMV on the last business day of the tax year. Any gain or loss must be taken into account in determining gross income. The gain or loss taken into account is generally treated as ordinary gain or loss. For details, including exceptions, see section 475, the related regulations, and Rev. Rul. 94-7, 1994-1 C.B. 151.

Dealers in commodities and traders in securities may elect to use the mark-to-market accounting method. To make the election, the FSC must file a statement describing the election, the first tax year the election is to be effective, and, in the case of an election for traders in securities or commodities, the trade or business for which the election is made. Except for new taxpayers, the statement must be filed by the due date (not including extensions) of the income tax return for the tax year immediately **preceding** the election year and attached to that return, or if applicable, to a request for an extension of time to file that return. For more details, see Rev. Proc. 99-17, 1999-1 C.B. 503, and sections 475(e) and (f).

Change in accounting method. Generally, the FSC must get IRS consent to change the method of accounting used to report taxable income (for income as a whole or for any material item). To do so, it must file **Form 3115,** Application for Change in Accounting Method. For more information, see **Pub. 538,** Accounting Periods and Methods.

Accounting Periods

A FSC must figure its taxable income on the basis of a tax year. The tax year is the annual accounting period the FSC uses to keep its records and report its income and expenses. Generally, FSCs can use a calendar year or a fiscal year. Personal service corporations, however, must generally use a calendar year.

For more information about accounting periods, see Temporary Regulations sections 1.441-1T, 1.441-2T, and Pub. 538.

Note: *The tax year of a FSC must be the same as the tax year of the* ***principal shareholder*** *which, at the beginning of the FSC tax year, has the highest percentage of voting power. If two or more shareholders have the highest percentage of voting power, the FSC must have a tax year that conforms to any 1 tax year of the principal shareholders. See section 441(h)(1).*

Calendar year. If the calendar year is adopted as the annual accounting period, the FSC must maintain its books and records and report its income and expenses for the period from January 1 through December 31 of each year.

Fiscal year. A fiscal year is 12 consecutive months ending on the last day of any month except December. A 52-53 week year is a fiscal year that varies from 52 to 53 weeks.

Adoption of tax year. A FSC adopts a tax year when it files its first income tax return. It must adopt a tax year by the due date (not including extensions) of its first income tax return.

Change of tax year. Generally, a FSC must get the consent of the IRS before changing its tax year by filing **Form 1128,** Application To Adopt, Change, or Retain a Tax Year. However, under certain conditions, a FSC (other than a personal service corporation) may change its tax year without getting the consent. See Regulations section 1.442-1 and Pub. 538.

Rounding Off to Whole Dollars

A FSC may show amounts on the return and accompanying schedules as whole dollars. To do so, drop amounts less than 50 cents and increase amounts from 50 cents through 99 cents to the next higher dollar.

Recordkeeping

Keep the FSC's records for as long as they may be needed for administration of any provision of the Internal Revenue Code. Usually, records that support an item of income, deduction, or credit on the return must be kept for 3 years from the date the return is due or filed, whichever is later. Keep records that verify the FSC's basis in property for as long as they are needed to figure the basis of the original or replacement property.

The FSC should keep copies of all filed returns. They help in preparing future returns and amended returns.

Depository Method of Tax Payment

The FSC must pay the tax due in full no later than the 15th day of the 3rd month after the end of the tax year. The method for payment of the tax due depends upon whether the FSC has an office or place of business in the United States. Some FSCs that maintain an office or place of business in the United States (described in **2** below) are required to electronically deposit all depository taxes, including FSC income tax payments.

1. FSCs that **do not** maintain an office or place of business in the United States must pay the tax due directly to an IRS office (i.e., do not use the depository method of tax payment described in **2** below). The tax may be paid by check or money order, payable to the "United States Treasury". To help ensure proper crediting, write the FSC's employer identification number (EIN), "Form 1120-FSC," and the tax period to which the payment applies on the check or money order. Enclose the payment when Form 1120-FSC is filed with the Internal Revenue Service Center, Philadelphia, PA 19255.

2. FSCs that **do** maintain an office or place of business in the United States must pay the tax due using a qualified depositary. The two methods of depositing corporate taxes are discussed below.

Electronic Deposit Requirement

The FSC must make electronic deposits of **all** depository taxes (such as employment tax, excise tax, and corporate income tax) using the Electronic Federal Tax Payment System (EFTPS) in 2001 if:

- The total deposits of such taxes in 1999 were more than $200,000 or
- The FSC was required to use EFTPS in 2000.

If the FSC is required to use EFTPS and fails to do so, it may be subject to a 10% penalty. If the FSC is not required to use EFTPS, it may participate voluntarily. To enroll in or get more information about EFTPS, call 1-800-555-4477 or 1-800-945-8400.

Depositing on time. For deposits made by EFTPS to be on time, the FSC must initiate the transaction at least 1 business day before the date the deposit is due.

Deposits With Form 8109

If the FSC does not use EFTPS, deposit FSC income tax payments (and estimated tax payments) with **Form 8109,** Federal Tax Deposit Coupon. If you do not have a preprinted Form 8109, use Form 8109-B to make deposits. You can get this form **only** by calling 1-800-829-1040. Be sure to have your EIN ready when you call.

Do not send deposits directly to an IRS office; otherwise, the FSC may have to pay a penalty. Mail or deliver the completed Form 8109 with the payment to an authorized depositary, i.e., a commercial bank or other financial institution authorized to accept Federal tax deposits.

Make checks or money orders payable to the depositary. To help ensure proper crediting, write the FSC's EIN, the tax period to which the deposit applies, and "Form 1120-FSC" on the check or money order. Be sure to darken the "1120" box on the coupon. Records of these deposits will be sent to the IRS.

For more information on deposits, see the instructions in the coupon booklet (Form 8109) and **Pub. 583,** Starting a Business and Keeping Records.

CAUTION *If the FSC owes tax and maintains an office or place of business in the United States when it files Form 1120-FSC, do not include the payment with the tax return. Instead, mail or deliver the payment with Form 8109 to an authorized depositary, or use EFTPS, if applicable.*

Estimated Tax Payments

Generally, the following rules apply to the FSC's payments of estimated tax.

- The FSC must make installment payments of estimated tax if it expects its estimated tax (income tax minus credits) to be $500 or more.
- The installments are due by the 15th day of the 4th, 6th, 9th, and 12th months of the tax year. If any date falls on a Saturday, Sunday, or legal holiday, the installment is due on the next regular business day.
- Use **Form 1120-W,** Estimated Tax for Corporations, as a worksheet to compute estimated tax.
- If the FSC does not have to use EFTPS, use the deposit coupons (Forms 8109) to make deposits of estimated tax.
- A FSC that maintains an office or place of business in the United States must use the deposit coupons (Forms 8109) to make deposits of estimated tax.
- A FSC that does not maintain an office or place of business in the United States must pay the estimated tax due directly to an IRS office.

For information on estimated tax payments, including penalties that apply if the FSC fails to make required payments, see the instructions for **Line 3. Estimated tax penalty** on page 8.

Overpaid estimated tax. If the FSC overpaid estimated tax, it may be able to get a quick refund by filing **Form 4466,** Corporation Application for Quick Refund of Overpayment of Estimated Tax. The overpayment must be at least 10% of the FSC's expected income tax liability and at least $500. File Form 4466 before the 16th day of the 3rd month after the end of the tax year, but before Form 1120-FSC is filed. Do not file Form 4466 before the end of the FSC's tax year.

Interest and Penalties

Interest. Interest is charged on taxes paid late even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, negligence, fraud, gross valuation overstatements, and substantial understatements of tax from the due date (including extensions) to the date of payment. The interest charge is figured at a rate determined under section 6621.

Penalty for late filing of return. A FSC that does not file its tax return by the due date, including extensions, may be penalized 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is over 60 days late is the smaller of the tax due or $100. The penalty will not be imposed if the FSC can show that the failure to file on time was due to reasonable cause. FSCs that file late must attach a statement explaining the reasonable cause.

Penalty for late payment of tax. A FSC that does not pay the tax when due generally may be penalized ½ of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the FSC can show that the failure to pay on time was due to reasonable cause.

Trust fund recovery penalty. This penalty may apply if certain income, social security, and Medicare taxes that must be collected or withheld are not collected or withheld, or these taxes are not paid to the IRS. These taxes are generally reported on Forms 941, 943, or 945 (see **Other Forms, Returns, Schedules, and Statements That May Be Required** on page 4). The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to have been responsible for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so. The penalty is equal to the unpaid trust fund tax. See **Pub. 15** (Circular E), Employer's Tax Guide, or **Pub. 51** (Circular A), Agricultural Employer's Tax Guide, for details, including the definition of responsible person.

Other penalties. Other penalties can be imposed for negligence, substantial understatement of tax, and fraud. See sections 6662 and 6663.

A FSC may also be subject to a penalty (under section 6686) of $100 for each instance it fails to furnish the information required under section 6011(c), up to a maximum of $25,000. This penalty will not apply if the FSC can show that the failure to furnish the required information was due to reasonable cause.

Specific Instructions

Period covered. File the 2000 return for calendar year 2000 and fiscal years that begin in 2000 and end in 2001. For a fiscal year, fill in the tax year space at the top of the form.

Note: *The 2000 Form 1120-FSC may also be used if:*

- *The FSC has a tax year of less than 12 months that begins and ends in 2001 and*
- *The 2001 Form 1120-FSC is not yet available at the time the FSC is required to file its return. The FSC must show its 2001 tax year on the 2000 Form 1120-FSC and take into account any tax law changes that are effective for tax years beginning after December 31, 2000.*

Name. Print or type the FSC's true name (as set forth in the charter or other legal document creating it).

Address. Enter the U.S. address where the FSC maintains, at a location in the United States, the records required under section 6001. Include the suite, room, or other unit number after the street address.

If the Post Office does not deliver mail to the street address and the FSC has a P.O. box, show the box number instead.

Note: *If a change of address occurs after the return is filed, use **Form 8822,** Change of Address, to notify the IRS of the new address.*

Employer identification number (EIN). Show the correct EIN in Item C on page 1 of Form 1120-FSC. If the FSC does not have an EIN, it should apply for one on **Form SS-4,** Application for Employer Identification Number. If the FSC has not received its EIN by the time the return is due, write "Applied for" in the space for the EIN. See Pub. 583 for details.

Item A. Foreign Country or U.S. Possession of Incorporation. See **Definition of a Foreign Sales Corporation (FSC)** on page 2 of the instructions.

Item E. Total assets. Enter the FSC's total assets (as determined by the accounting method regularly used in keeping the FSC's books and records) at the end of the tax year of the FSC from page 6, Schedule L, column (d), line 15. If there are no assets at the end of the tax year, enter the assets as of the beginning of the tax year.

Item F. Initial return, final return, change of address, or amended return.

- If this is the FSC's first return, check the "Initial return" box.
- If the corporation ceases to exist, file Form 1120-FSC and check the "Final return" box.
- If the FSC has changed its address since it last filed a return, check the box for "Change of address."
- If the FSC is amending its return, check the box for "Amended return."

FSC Information

Line 1. Principal shareholder. Complete lines **1a** through **1h** for the shareholder (individual, corporation, partnership, trust, or estate) that was the principal shareholder at the beginning of the FSC's tax year. See the information on principal shareholder on page 6 under the discussion of **Accounting Periods.**

Foreign address. Enter the information in the following order: city, province or state, and country. Follow the country's practice for entering the postal code. **Do not** abbreviate the country name.

Line 2. Parent-subsidiary controlled group. If the FSC is a subsidiary in a parent-subsidiary controlled group and the principal shareholder is not the common parent of the group, complete lines 2a through 2g for the common parent. Enter the consolidated total assets on line 2d for a group that files a consolidated return; otherwise, enter only the common parent's total assets.

Note: *Check the "Yes" box on line 2 if the FSC is a subsidiary in a parent-subsidiary controlled group. This applies even if the FSC is a subsidiary member of one group and the parent corporation of another.*

The term "parent-subsidiary controlled group" means one or more chains of corporations connected through stock ownership (sections 927(d)(4) and 1563(a)(1)). Both of the following requirements must be met.

1. More than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of all classes of stock of each corporation in the group (except the parent) must be owned by one or more of the other corporations in the group.

2. The common parent must own more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of all classes of stock of at least one of the other corporations in the group.

Stock owned directly by other members of the group is not counted when computing the voting power or value.

See sections 927(d)(4) and 1563(d)(1) for the definition of "stock" for purposes of determining stock ownership above.

Tax and Payments

Line 2h. Backup withholding. If the FSC had income tax withheld from any payments it received because, for example, it failed to give the payer its correct EIN, include the amount withheld in the total for line 2h. This type of withholding is called backup withholding. Show the amount withheld in the blank space in the right-hand column between lines 1 and 2h, and write "backup withholding."

Note: *Backup withholding does not include amounts reportable on line 2g for taxes paid or withheld at source.*

Line 3. Estimated tax penalty. A FSC that does not make estimated tax payments when due may be subject to an underpayment penalty for the period of underpayment. Generally, a FSC is subject to the penalty if its tax liability is $500 or more and it did not timely pay the smaller of:

- Its tax liability for 2000 or
- Its prior year's tax.

See section 6655 for details and exceptions, including special rules for large corporations.

Use **Form 2220,** Underpayment of Estimated Tax by Corporations, to see if the FSC owes the penalty and to figure the amount of the penalty. Generally, a FSC does not have to file this form because the IRS can figure the amount of any penalty and bill the FSC for it. However, even if the FSC does not owe the penalty, complete and attach Form 2220 if:

- The annualized income or adjusted seasonal installment method is used or
- The FSC is a large corporation computing its first required installment based on the prior year's tax. (See the Form 2220 instructions for the definition of a large corporation.)

If Form 2220 is attached, check the box on line 3, page 1, Form 1120-FSC, and enter the amount of any penalty on this line.

Schedule A Cost of Goods Sold Related to Foreign Trading Gross Receipts

Complete Schedule A only for the cost of goods sold deduction related to foreign trading gross receipts reported on lines 1 through 5 of Schedule B.

Complete column **(a)** to show the cost of goods sold for inventory acquired in transactions using the administrative pricing rules. Complete column **(b)** to show the cost of goods sold for inventory acquired in transactions that did not use the administrative pricing rules. For details on administrative or nonadministrative pricing rules, see the Instructions for Schedule P (Form 1120-FSC).

If the FSC acts as another person's commission agent on a sale, do not enter any amount on Schedule A for the sale.

Small FSCs will have to make two separate computations for cost of goods sold if their foreign trading gross receipts exceed the limitation amount on line 6e of Schedule B. In this case, a deduction for cost of goods sold will be figured separately for the income on line 6h of Schedule B, and separately for the income on line 7 of Schedule F.

Generally, inventories are required at the beginning and end of each tax year if the production, purchase, or sale of merchandise is an income-producing factor. See Regulations section 1.471-1.

However, if a FSC's average annual gross receipts for the 3 prior tax years are $1 million or less and the FSC is an eligible taxpayer that adopts or changes to the cash method of accounting, it will not be required to account for inventories. If the FSC is not required to account for inventories and does not want to do so, it must treat inventory in the same manner as costs of materials and supplies that are not incidental. Under this rule, inventory costs for raw materials purchased for use in producing finished goods and merchandise purchased for resale are deductible in the year the finished goods or merchandise is sold (or, if later, the year the FSC paid for the raw materials or merchandise). Enter amounts paid for all raw materials and merchandise during the tax year on line 2. The amount the FSC can deduct for the tax year is figured on line 8.

If the FSC wants to change to the cash method of accounting, it must file Form 3115. It may also have to make an adjustment to prevent amounts of income or expense from being duplicated or omitted. This is called a section 481(a) adjustment, which is taken into account over a period not to exceed 4 years. For example, if the FSC accrued sales in 1999 for which it received payment in 2000, it must report those sales in both years as a result of changing its accounting method and will make a section 481(a) adjustment to prevent duplication of income. See Rev. Proc. 99-49, 1999-2 C.B. 725, to figure the amount of this adjustment for the tax year.

For eligibility requirements and further details on changing to the cash method of accounting, see Rev. Proc. 2001-10, 2001-2 I.R.B. 272, and **Pub. 553,** Highlights of 2000 Tax Changes.

All FSCs should see the uniform capitalization rules of section 263A discussed in the instructions for Schedule G on page 12. See those instructions before completing Schedule A.

Line 1. Inventory at beginning of year. If the FSC is changing its method of accounting from accrual to cash for the current tax year and it does not want to account for inventories, it must refigure last year's closing inventory using the cash method and enter the result on line 1. If there is a difference between the closing inventory and the refigured amount, attach an explanation and take it into account when figuring the FSC's section 481(a) adjustment (explained above).

Line 4. Additional section 263A costs. An entry is required on this line only for FSCs that have elected a simplified method of accounting.

For FSCs that have elected the **simplified production method,** additional section 263A costs are generally those costs, other than interest, that were not capitalized under the FSC's method of accounting immediately prior to the effective date of section 263A but are now required to be capitalized under section 263A. For details, see Regulations section 1.263A-2(b).

For FSCs that have elected the **simplified resale method,** additional section 263A costs are generally those costs incurred with respect to the following categories.

- Off-site storage or warehousing.
- Purchasing; handling, such as processing, assembling, repackaging, and transporting.
- General administrative costs (mixed service costs).

For details, see Regulations section 1.263A-3(d).

Enter on line 4 the balance of section 263A costs paid or incurred during the tax year that were not includable on lines 2, 3, and 5.

Line 5. Other costs. Enter on line 5 any costs paid or incurred during the tax year not entered on lines 2 through 4.

Line 7. Inventory at end of year. See Regulations section 1.263A-1 through 1.263A-3 for details on figuring the amount of additional section 263A costs to be included in ending inventory.

If the FSC is using the cash method of accounting and it does not want to account for inventories, enter on line 7 the portion of its raw materials and merchandise purchased for resale that are included on line 6 and were not sold during the year.

Lines 9a through 9f. Inventory valuation methods. Inventories can be valued at:

- Cost;
- Cost or market value (whichever is lower); or
- Any other method approved by the IRS that conforms to the requirements of the applicable regulations cited below.

However, the FSC is required to use cost if it is using the cash method of accounting.

Producers whose average annual gross receipts are $1 million or less that use the cash method of accounting and choose not to account for inventories may currently deduct expenditures for direct labor and all indirect costs that would otherwise be included in inventory costs.

The average cost (rolling average) method of valuing inventories generally does not conform to the requirements of the regulations. See Rev. Rul. 71-234, 1971-1 C.B. 148.

FSCs that use erroneous valuation methods must change to a method permitted for Federal income tax purposes. To make this change, use Form 3115.

On line 9a, check the method(s) used for valuing inventories. Under lower of cost or market, the term “market” (for normal goods) means the current bid price prevailing on the inventory valuation date for the particular merchandise in the volume usually purchased by the taxpayer. For a manufacturer, market applies to the basic elements of cost—raw materials, labor, and burden. If section 263A applies to the taxpayer, the basic elements of cost must reflect the current bid price of all direct costs and all indirect costs properly allocable to goods on hand at the inventory date.

Inventory may be valued below cost when the merchandise is unsalable at normal prices or unusable in the normal way because the goods are subnormal because of damage, imperfections, shopwear, etc., within the meaning of Regulations section 1.471-2(c). The goods may be valued at the current bona fide selling price, minus direct cost of disposition (but not less than scrap value) if such a price can be established.

If this is the first year the last-in, first-out (LIFO) inventory method was either adopted or extended to inventory goods not previously valued under the LIFO method provided in section 472, attach **Form 970,** Application To Use LIFO Inventory Method, or a statement with the information required by Form 970. Also check the LIFO box on line 9c. On line 9d, enter the amount or the percent of total closing inventories covered under section 472. Estimates are acceptable.

If the FSC changed or extended its inventory method to LIFO and had to write up the opening inventory to cost in the year of election, report the effect of the writeup as other income (as appropriate on Schedule F, line 16), proportionately over a 3-year period that begins with the year of the LIFO election (section 472(d)).

For more information on inventory valuation methods, see **Pub. 538,** Accounting Periods and Methods.

Additional Information

Line 2. Show any tax-exempt interest received or accrued. Include any exempt-interest dividends received as a shareholder in a mutual fund or other regulated investment company.

Line 4. See section 542 for the definition of personal holding company and section 552 for the definition of foreign personal holding company. Also, see **Personal Holding Companies and Foreign Personal Holding Companies** on page 6 for information and other details if the FSC meets the definition of either.

Line 6. If the FSC owned at least a 10% interest, directly or indirectly, in any foreign partnership, attach a statement listing the following information for each foreign partnership.

1. Name and EIN (if any) of the foreign partnership;

2. Identify which, if any, of the following forms the foreign partnership filed for its tax year ending with or within the FSC's tax year: Form 1042, 1065 or 1065-B, or 8804;

3. Name of the tax matters partner (if any); and

4. Beginning and ending dates of the foreign partnership's tax year.

Line 7. Check the box on line 7 if the FSC elects under section 172(b)(3) to forego the carryback period for a net operating loss (NOL). If the box is checked, do not attach the statement described in Temporary Regulations section 301.9100-12T(d).

Line 8. Enter the amount of the NOL carryover to the tax year from prior years, even if some of the loss is used to offset income on this return. The amount to enter is the total of all NOLs generated in prior years but not used to offset income (either as a carryback or carryover) to a tax year prior to 2000. Do not reduce the amount by any NOL deduction reported on line 19a, Part II of Schedule B.

Pub. 536, Net Operating Losses, has a worksheet for figuring a FSC's NOL carryover.

Lines 9c and 10b(2). See **Definition of a Foreign Sales Corporation (FSC)** on page 2 of the instructions for definitions of qualifying foreign country and U.S. possession.

Line 10. All FSCs (except small FSCs) must answer these questions. For more information, see **Foreign Management Rules** on page 3 of the instructions.

Line 11. All FSCs (except small FSCs) must answer line 11b. Indicate how they met the foreign direct costs requirement of section 924(d) for all transactions that generated foreign trading gross receipts reported on lines 1 through 5 of Schedule B. Also, answer line 11a and/or line 11d to make an election to use either of the annual grouping election(s) indicated. See the instructions for **Foreign Economic Process Rules** on page 3 for details.

Schedule B Taxable Income or (Loss)

Use Schedule B to compute taxable income from all sources.

Part I

Use Part I to compute net income attributable to nonexempt foreign trade income. Income and expenses on lines 1 through 15 are reported in column **(a)** if the administrative pricing rules were used in the transaction that produced the income.

Report in column **(b)** all foreign trade income from all transactions in which the administrative pricing rules were not used. Attach a schedule showing the computation of the taxable and nontaxable income included on line 15, column (b). Only the taxable amount of line 15, column (b) is included on line 16.

Lines 1 through 5. Enter foreign trading gross receipts identified on lines 1 through 5. See section 924(a) and **Foreign Trading Gross Receipts** on page 3 of these instructions for receipts that are excluded and other details. Report commission income on line 1 or line 2 based on the sale, lease, or rental of property on which that commission arose.

Line 5. If the 50% gross receipts test of section 924(a)(5) is **not** met, report the FSC's gross receipts that would have otherwise qualified under that section on line 16, Schedule F, instead of line 5, Schedule B.

Lines 6b through 6h. See section 924(b)(2)(B) for the rules regarding the limitation on the amount of foreign trading gross receipts that a small FSC may take into account in determining its exempt foreign trade income.

Line 6d. Temporary Regulations section 1.921-1T(b)(5) indicates that, in the case of a small FSC having a short tax year, the dollar limitation reported on line 6b or 6c is to be prorated on a daily basis. A small FSC having a short tax year must divide the number of days in its short tax year by the number of days that would have made up a full tax year and enter the resulting fraction on line 6d as a decimal less than 1.00000.

Example. For its 2000 calendar year tax year, a small FSC has a short tax year of 73 days. The FSC enters 0.199 (73/366) on line 6d.

Line 6f. If commission income is reported in the total for line 6a of Schedule B, total receipts for purposes of line 6f are figured as follows:

1.	Enter total of columns (a) and (b), line 6a, Schedule B	**1.** ______
2.	Enter total commission income reported on line 1 or line 2, Schedule B	**2.** ______
3.	Subtract line 2 from line 1	**3.** ______
4.	For the commission income reported on line 2 above, enter total gross receipts on the sale, lease, or rental of property on which the commission income arose (section 927(b)(2))	**4.** ______
5.	Add lines 3 and 4. Enter here and on line 6f, Schedule B	**5.** ______

Line 6h. If the small FSC's foreign trading gross receipts for the tax year (line 6f, Schedule B) exceed its allowable limitation (line 6e, Schedule B), the small FSC may select the gross receipts to which the limitation is allocated. In such a case, allocate the amount on line 6g between columns (a) and (b) on line 6h based on whether the administrative pricing rules were used for the gross receipts selected. See Regulations section 1.921-2(b) Q&A-4.

If you have **commission income** and you completed the line 6f worksheet above, only the related commission income portion of the amount entered on line 6g is allocated to line 6h.

Part II

Line 19a. Net operating loss deduction. A FSC may use the net operating loss (NOL) incurred in one tax year to reduce its taxable income in another tax year. Generally, a FSC may carry an NOL back to each of the 2 years preceding the year of the loss and then carry any remaining amount over to each of the 20 years (15 years for NOLs incurred in tax years beginning before August 6, 1997) following the year of the loss (but see **Waiving the carryback period** below). For exceptions to the general rule, see **Special carryback periods for certain losses** below.

Enter on line 19a the total NOL carryovers from prior tax years, but do not enter more than the FSC's taxable income (after special deductions). An NOL deduction cannot be taken in a year in which the FSC has a negative taxable income. Attach a schedule showing the computation of the NOL deduction. Also complete line 8 in **Additional Information** on page 2 of the form.

For more information about NOLs and the NOL deduction, see Pub. 536.

Carryback and carryover rules. To carry back the loss and obtain a quick refund of taxes, use **Form 1139,** Corporation Application for Tentative Refund. Form 1139 must be filed within 12 months after the close of the tax year of the loss. See section 6411 for details. Do not attach Form 1139 to the FSC's income tax return. Mail it in a separate envelope to the Internal Revenue Service Center, Philadelphia, PA 19255.

For carryback claims filed later than 12 months after the close of the tax year of the loss, file an amended Form 1120-FSC instead of Form 1139.

After the FSC applies the NOL to the first tax year to which it may be carried, the taxable income of that year is modified (as described in section 172(b)) to determine how much of the remaining loss may be carried to other years. See section 172(b) and the related regulations for details.

Special NOL rules apply when:

- An ownership change occurs (i.e., the amount of the taxable income of a loss corporation that can be offset by pre-change NOL carryovers is limited). See section 382 and the related regulations. Also see Temporary Regulations section 1.382-2T(a)(2)(ii), which requires that a loss corporation file an information statement with its income tax return for each tax year that it is a loss corporation and certain shifts in ownership occurred. See Regulations section 1.382-6(b) for details on how to make the closing-of-the-books election.
- A FSC acquires control of another corporation (or acquires its assets in a reorganization) and the amount of pre-acquisition losses that may offset recognized built-in gains is limited. See section 384.

Waiving the carryback period. A FSC may make an irrevocable election to forego the carryback period and instead carry the NOL forward to years following the year of the loss. To make this election, check the box on line 7 in **Additional Information** on page 2 of the form. Form 1120-FSC must be timely filed (including extensions).

Special carryback periods for certain losses. The regular 2-year carryback period generally does not apply to the following losses.

- **Specified liability losses,** including a product liability loss. The part of an NOL that is attributable to a specified liability loss may be carried back 10 years. The FSC may, however, elect to treat such a loss as if it were not a specified liability loss. If the FSC makes this election, the loss carryback period will be 2, 3, or 5 years, whichever applies. Make the election by attaching a statement to a timely filed return (including extensions, however, see **Exception** below). Also see section 172(b)(1)(C).

- **Farming losses.** An NOL attributable to any farming business may be carried back 5 years. However, the FSC may elect to treat the loss as if it were not a farming loss. If the FSC makes this election, the loss carryback period will be 2 years or 3 years, whichever applies. Make the election by attaching a statement to a timely filed return (including extensions, however, see **Exception**). Also, see sections 172(b)(1)(G) and 172(i).

Exception. If the FSC timely filed its return for the loss year without making the election for **Specified liability losses** on page 10 or **Farming losses** above, the FSC may still make the election by filing an amended return within 6 months of the due date of the loss year return (excluding extensions). Attach the election to the amended return and write “Filed pursuant to section 301.9100-2” on the election statement. File the amended return at the same address the original return was filed. Once made, the election is irrevocable.

- **Eligible losses.** The part of an NOL that is attributable to an eligible loss may be carried back 3 years. An “eligible loss” is an NOL attributable to a Presidentially declared disaster if, for the tax year in which the NOL arose, the FSC was **(a)** engaged in a farming business or **(b)** a small business that met the gross receipts test of section 448(c). An eligible loss does not include any farming loss or specified liability loss described above.

Line 19b. Dividends-received deduction. A FSC may be entitled to a deduction for dividends it receives from other corporations. See the instructions below for the dividend worksheet (on page 12) to figure the allowable dividends-received deduction. Attach the dividend worksheet to Form 1120-FSC.

Schedule E Exemption Percentages Used in Figuring Exempt Foreign Trade Income

For purposes of the **Note** at the top of Schedule E, a C corporation is a corporation other than an S corporation. Shareholders, other than C corporations, are individuals, partnerships, S corporations, trusts, and estates.

Use lines 2a through 2d to figure the exemption percentage for foreign trade income determined by not using the administrative pricing rules (see section 923(a)(2)).

Use lines 3a through 3d to figure the exemption percentage for foreign trade income that was determined by using the administrative pricing rules (see section 923(a)(3)). See section 923(a)(4) for a special rule for foreign trade income allocable to a cooperative.

Schedule F Net Income From Nonexempt Foreign Trade Income and Taxable Nonforeign Trade Income

Note: *All FSCs should see the uniform capitalization rules of section 263A discussed in the instructions for Schedule G on page 12 before completing line 5 of Schedule F.*

Part I

Enter net income from nonexempt foreign trade income and related expenses in Part I.

Line 2. Enter FSC income that resulted from the FSC's cooperation with an international boycott. See Form 5713 for reporting requirements for any FSC with operations in or related to a boycotting country. See section 927(e)(2).

Line 3. Enter the amount, if any, paid for illegal payments, bribes, or kickbacks that the FSC paid, directly or indirectly, to government officials, employees, or agents. See section 927(e)(2).

Line 5. See the instructions for Schedule A before completing this line.

Part II

Enter the taxable portion of gross income of the FSC that was derived from nonexempt foreign trading gross receipts. This type of income includes:

- Small FSCs only. Amounts specifically excluded from foreign trade income because of the small FSC limitation (the amount by which line 6f of Schedule B exceeds line 6e of Schedule B). (Enter the excess, if any, on line 7 of Schedule F.)
- Investment type income. (Enter on lines 8 through 12 of Schedule F.)
- Income from property that is subsidized, deemed in short supply, or destined for use in the United States. (Enter on lines 13 and 14 of Schedule F.)
- Amounts from transactions that did not meet the foreign economic process requirements. (Enter on line 15 of Schedule F.)
- Other income. (Enter on line 16 of Schedule F.) For more details, see sections 924(f) and 927(a)(2) and (3).

Line 9. Complete the dividend worksheet on page 12 to figure the total dividends to report on line 9. Attach to Form 1120-FSC a schedule similar to the worksheet on page 12.

Line 18. Enter the deductions allocated or apportioned to income on line 17. Attach to Form 1120-FSC a schedule listing each type of deduction. Show deductions related to cost of goods sold separately.

Passive activity limitations. Section 469 generally limits the deduction of passive activity losses for closely held FSCs and FSCs that are personal service corporations. See section 469 and the instructions for Form 8810 for details.

Instructions for Dividends and Dividends-Received Deduction Worksheet (on page 12)

For purposes of the 20% ownership test on lines 1 through 7, the percentage of stock owned by the FSC is based on voting power and the value of the stock. Preferred stock described in section 1504(a)(4) is not taken into account.

Line 1, Column (a)

Enter dividends (except those received on debt-financed stock acquired after July 18, 1984—see section 246A) that:

- Are received from less-than-20%-owned domestic corporations subject to income tax and
- Qualify for the 70% deduction under section 243(a)(1).

Also include on line 1 dividends (except those received on debt-financed stock acquired after July 18, 1984) from a regulated investment company (RIC). The amount of dividends eligible for the dividends-received deduction under section 243 is limited by section 854(b). The FSC should receive a notice from the RIC specifying the amount of dividends that qualify for the deduction.

Report so-called dividends or earnings received from mutual savings banks, etc., as interest. Do not treat them as dividends.

Line 2, Column (a)

Enter dividends (except those received on debt-financed stock acquired after July 18, 1984) that are received from 20%-or-more-owned domestic corporations subject to income tax and that are subject to the 80% deduction under section 243(c).

Line 3, Column (a)

Enter dividends that are:

- Received on debt-financed stock acquired after July 18, 1984, from domestic and foreign corporations subject to income tax that would otherwise be subject to the dividends-received deduction under section 243(a)(1), 243(c), or 245(a). Generally, debt-financed stock is stock that the FSC acquired by incurring a debt (e.g., it borrowed money to buy the stock).
- Received from a RIC on debt-financed stock. The amount of dividends eligible for the dividends-received deduction is limited by section 854(b). The FSC should receive a notice from the RIC specifying the amount of dividends that qualify for the deduction.

Line 3, Columns (b) and (c)

Dividends received on debt-financed stock acquired after July 18, 1984, are not entitled to the full 70% or 80% dividends-received deduction. The 70% or 80% deduction is reduced by a percentage that is related to the amount of debt incurred to acquire the stock. See section 246A. Also, see section 245(a) before making this computation for an additional limitation that applies to dividends received from foreign corporations. Attach a schedule to Form 1120-FSC showing how the amount on line 3, column (c), was figured.

Line 4, Column (a)

Enter dividends received on the preferred stock of a less-than-20%-owned public utility that is subject to income tax and is allowed the deduction provided in section 247 for dividends paid.

Line 5, Column (a)

Enter dividends received on preferred stock of a 20%-or-more-owned public utility that is subject to income tax and is allowed the deduction provided in section 247 for dividends paid.

Line 6, Column (a)

Enter the U.S.-source portion of dividends that:

- Are received from less-than-20%-owned foreign corporations and
- Qualify for the 70% deduction under section 245(a). To qualify for the 70% deduction, the FSC must own at least 10% of the stock of the foreign corporation by vote and value.

Line 7, Column (a)

Enter the U.S.-source portion of dividends that are received from 20%-or-more-owned foreign corporations and that qualify for the 80% deduction under section 245(a).

Line 8, Column (c)

Limitation on dividends-received deduction. Generally, line 8 of column (c) may not exceed the amount on line 10 (**Dividends-received deduction after limitation (sec. 246(b)**) from the worksheet below. However, in a year in which an NOL occurs, this limitation does not apply even if the loss is created by the dividends-received deduction. See sections 172(d) and 246(b).

1. Refigure line 18, Part II, Schedule B (page 3 of Form 1120-FSC) without any adjustment under section 1059 and without any capital loss carryback to the tax year under section 1212(a)(1) .... **1.** ________

2. Multiply line 1 by 80%.................... **2.** ________

3. Add lines 2, 5, and 7, column (c), and the part of the deduction on line 3, column (c), that is attributable to dividends from 20%-or-more-owned corporations . **3.** ________

4. Enter the smaller of line 2 or 3. If line 3 is greater than line 2, stop here; enter the amount from line 4 on line 8, column (c), and do not complete lines 5-10 below .... **4.** ________

5. Enter the total amount of dividends from 20%-or-more-owned corporations that are included on lines 2, 3, 5, and 7, column (a) ..... **5.** ________

6. Subtract line 5 from line 1 .... **6.** ________

7. Multiply line 6 by 70%.................... **7.** ________

8. Subtract line 3 above from line 8 of column (c) .... **8.** ________

9. Enter the smaller of line 7 or line 8 .... **9.** ________

10. Dividends-received deduction after limitation (sec. 246(b)). Add lines 4 and 9. Enter the result here and on line 8, column (c).............. **10.** ________

Line 9, Column (a)

Enter foreign dividends not reportable on lines 3, 6, and 7 that do not qualify for a dividends-received deduction.

Line 10, Column (a)

If the FSC claims the foreign tax credit, the tax that is deemed paid under sections 902 and 960 is treated as a dividend received from the foreign corporation. See sections 78 and 906(b)(4).

Line 11, Column (a)

Include the following:

1. Dividends (other than capital gain dividends and exempt-interest dividends) that are received from regulated investment companies and that are not subject to the 70% deduction.

2. Dividends from tax-exempt organizations.

3. Dividends (other than capital gain dividends) received from a real estate investment trust that, for the tax year of the trust in which the dividends are paid, qualifies under sections 856 through 860.

4. Dividends not eligible for a dividends-received deduction because of the holding period of the stock or an obligation to make corresponding payments with respect to similar stock.

Two situations in which the dividends-received deduction will not be allowed on any share of stock are:

- If the FSC held the stock less than 46 days during the 90-day period beginning 45 days before the stock became ex-dividend with respect to the dividend (see section 246(c)(1)(A)) or
- To the extent the FSC is under an obligation to make related payments for substantially similar or related property.

5. Any other taxable dividend income not properly reported above (including distributions under section 936(h)(4)).

If patronage dividends or per-unit retain allocations are included on line 11, column (a), identify the total of these amounts in a schedule attached to Form 1120-FSC.

Schedule G Deductions Attributable to Foreign Trade Income Other Than Foreign Trade Income Reported on Schedule F

Limitations on deductions

Section 263A uniform capitalization rules. The uniform capitalization rules of section 263A require FSCs to capitalize, or include in inventory costs, certain costs incurred in connection with:

- The production of real property and tangible personal property held in inventory or held for sale in the ordinary course of business.

Dividends and Dividends-Received Deduction Worksheet
(See instructions that begin on page 11.)

		(a) Dividends received	(b) %	(c) Dividends-received deduction: (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations that are subject to the 70% deduction (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations that are subject to the 80% deduction (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations (section 246A)		See Inst.	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations that are subject to the 70% deduction		70	
7	Dividends from 20%-or-more-owned foreign corporations that are subject to the 80% deduction		80	
8	**Total dividends-received deduction.** Add lines 1 through 7. See instructions for limitation. Enter here and on line 19b, Schedule B ▶			
9	Other dividends from foreign corporations not included on lines 3, 6, and 7			
10	Foreign dividend gross up (section 78)			
11	Other dividends			
12	**Total dividends.** Add lines 1 through 11. Enter here and on line 9, Schedule F ▶			

- Real property or personal property (tangible and intangible) acquired for resale.
- The production of real property and tangible personal property by a FSC for use in its trade or business or in an activity engaged in for profit.

Tangible personal property produced by a FSC include a film, sound recording, videotape, book, or similar property.

FSCs subject to the section 263A uniform capitalization rules are required to capitalize:

1. Direct costs and

2. An allocable part of most indirect costs (including taxes) that **(a)** benefit the assets produced or acquired for resale or **(b)** are incurred by reason of the performance of production or resale activities.

For inventory, some of the **indirect expenses** that must be capitalized are:

- Administrative expenses.
- Taxes.
- Depreciation.
- Insurance.
- Compensation paid to officers attributable to services.
- Rework labor.
- Contributions to pension, stock bonus, and certain profit-sharing, annuity, or deferred compensation plans.

Regulations section 1.263A-1(e)(3) specifies other indirect costs that relate to production or resale activities that must be capitalized and those that may be currently deductible.

Interest expense paid or incurred during the production period of designated property must be capitalized and is governed by special rules. For more details, see Regulations section 1.263A-8 through 1.263A-15.

The costs required to be capitalized under section 263A are not deductible until the property (to which the costs relate) is sold, used, or otherwise disposed of by the FSC.

Exceptions. Section 263A **does not** apply to:

- Personal property acquired for resale if the FSC's average annual gross receipts for the 3 prior tax years were $10 million or less.
- Timber.
- Most property produced under a long-term contract.
- Certain property produced in a farming business.
- Research and experimental costs under section 174.
- Intangible drilling costs for oil, gas, and geothermal property.
- Mining exploration and development costs.
- Inventory of a cash method FSC that does not account for inventories. See Schedule A on page 8 for details.

For more details on the uniform capitalization rules, see Regulations sections 1.263A-1 through 1.263A-3 and section 1.263A-4 for rules on property produced in a farming business.

Transactions between related taxpayers. Generally, an accrual basis taxpayer may only deduct business expenses and interest owed to a related party in the year the payment is included in the income of the related party. See sections 163(e)(3), 163(j), and 267 for limitations on deductions for unpaid interest and expenses.

Golden parachute payments. A portion of the payments made by a FSC to key personnel that exceeds their usual compensation may not be deductible. This occurs when the FSC has an agreement (golden parachute) with these key employees to pay them these excessive amounts if control of the FSC changes. See section 280G.

Business startup expenses. Business startup expenses must be capitalized unless an election is made to amortize them over a period of 60 months. See section 195 and Regulations section 1.195-1.

Line 1. Enter only foreign direct costs on lines 1a through 1e. See section 924(e) and Regulations sections 1.924(e)-1(a) through (e) for definitions and rules on direct activity costs related to foreign trade income.

Line 4. Depreciation. Besides depreciation, include on line 4 the part of the cost that the FSC elected to expense under section 179 for certain tangible property placed in service during tax year 2000 or carried over from 1999. See **Form 4562,** Depreciation and Amortization, and its instructions.

Line 5. Salaries and wages. Enter the amount of salaries and wages paid for the tax year. Do not include salaries and wages deductible elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement or a SIMPLE IRA plan.

Line 10. Compensation of officers. Enter any officers' deductible compensation on line 10. Do not include compensation deductible elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement or a SIMPLE IRA plan.

Disallowance of deduction for employee compensation in excess of $1 million. Publicly held FSCs may not deduct compensation of a “covered employee” to the extent that the compensation exceeds $1 million. Generally, a covered employee is:

- The chief executive officer of the FSC (or an individual acting in that capacity) as of the end of the tax year or
- An employee whose total compensation must be reported to shareholders under the Securities Exchange Act of 1934 because the employee is among the four highest compensated officers for that tax year (other than the chief executive officer).

For this purpose, compensation does not include the following:

- Income from certain employee trusts, annuity plans, or pensions and
- Any benefit paid to an employee that is excluded from the employee's income.

The deduction limit does not apply to:

- Commissions based on individual performance,
- Qualified performance-based compensation, and
- Income payable under a written binding contract in effect on February 17, 1993.

The $1 million limit is reduced by amounts disallowed as excess parachute payments under section 280G.

For details, see section 162(m) and Regulations section 1.162-27.

Line 11. Bad debts. Enter the total debts that became worthless in whole or in part during the tax year.

Caution: *A cash basis taxpayer may not claim a bad debt deduction unless the amount was previously included in income.*

Line 14. Other deductions. Attach a schedule, listing by type and amount, all allowable deductions that are not deductible elsewhere on Form 1120-FSC. Enter the total of other deductions on this line.

Examples of other deductions include:

- Amortization of pollution control facilities, organization expenses, etc. (see Form 4562).
- Insurance premiums.
- Legal and professional fees.
- Supplies used and consumed in the business.
- Utilities.

Also see **Special rules** below for limits on certain other deductions.

Do not deduct:

- Fines or penalties paid to a government for violating any law.
- Any amount that is allocable to a class of exempt income. See section 265(b) for exceptions.

Special rules apply to the following expenses:

Travel, meals, and entertainment. Subject to limitations and restrictions discussed below, the FSC can deduct ordinary and necessary travel, meals, and entertainment expenses paid or incurred in its trade or business. Also, special rules apply to deductions for gifts, skybox rentals, luxury water travel, convention expenses, and entertainment tickets. For details, see section 274 and **Pub. 463,** Travel, Entertainment, Gift, and Car Expenses.

Travel. The FSC cannot deduct travel expenses of any individual accompanying a corporate officer or employee, including a spouse or dependent of the officer or employee, unless:

- That individual is an employee of the corporation and
- His or her travel is for a bona fide business purpose and would otherwise be deductible by that individual.

Meals and entertainment. Generally, the FSC can deduct only 50% of the amount otherwise allowable for meals and entertainment expenses paid or incurred in its trade or business. In addition (subject to exceptions under section 274(k)(2)):

- Meals must not be lavish or extravagant,
- A bona fide business discussion must occur during, immediately before, or immediately after the meal; and
- An employee of the FSC must be present at the meal.

See section 274(n)(3) for a special rule that applies to expenses for meals consumed by individuals subject to the hours of service limits of the Department of Transportation.

Membership dues. The FSC may deduct amounts paid or incurred for membership dues in civic or public service organizations, professional organizations (such as bar and medical associations), business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards. However, no deduction is allowed if a principal purpose of the organization is to entertain, or provide entertainment facilities for, members or their guests. In addition, FSCs may not deduct membership dues in any club organized for business, pleasure, recreation, or other social purpose. This includes country clubs, golf and athletic clubs, airline and hotel clubs, and clubs operated to provide meals under conditions favorable to business discussion.

Entertainment facilities. The FSC cannot deduct an expense paid or incurred for a facility (such as a yacht or hunting lodge) used for an activity usually considered entertainment, amusement, or recreation.

Note. *The FSC may be able to deduct otherwise nondeductible meals, travel, and entertainment expenses if the amounts are treated as compensation and reported on Form W-2 for an employee or on Form 1099-MISC for an independent contractor.*

Schedule J Tax Computation

Note: *Members of a controlled group must attach a statement showing the computation of the tax entered on line 3.*

Lines 1 and 2

Members of a controlled group. A member of a controlled group, as defined in section 927(d)(4), must check the box on line 1 and complete lines 2a and 2b of Schedule J, Form 1120-FSC.

Line 2a. Members of a controlled group are entitled to one $50,000, one $25,000, and one $9,925,000 taxable income bracket amount (in that order) on line 2a.

When a controlled group adopts or later amends an apportionment plan, each member must attach to its tax return a copy of its consent to this plan. The copy (or an attached statement) must show the part of the amount in each taxable income bracket apportioned to that member. See Regulations section 1.1561-3(b) for other requirements and for the time and manner of making the consent.

Unequal apportionment plan. Members of a controlled group may elect an unequal apportionment plan and divide the amount in each taxable income bracket as they want. There is no need for consistency among taxable income brackets. Any member may be entitled to all, some, or none of the amount in a taxable income bracket. However, the total amount for all members cannot be more than the total amount in each taxable income bracket.

Equal apportionment plan. If no apportionment plan is adopted, members of a controlled group must divide the amount in each taxable income bracket equally among themselves. For example, controlled group AB consists of Corporation A and Corporation B. They do not elect an unequal apportionment plan. Therefore, each corporation is entitled to:

- $25,000 (one-half of $50,000) on line 2a(1),
- $12,500 (one-half of $25,000) on line 2a(2), and
- $4,962,500 (one-half of $9,925,000) on line 2a(3).

Line 2b. Members of a controlled group are treated as one group to figure the applicability of the additional 5% tax and the additional 3% tax. If an additional tax applies, each member will pay that tax based on the part of the amount used in each taxable income bracket to reduce that member's tax. See section 1561(a). If an additional tax applies, attach a schedule showing the taxable income of the entire group and how it figured its share of the additional tax.

Line 2b(1). Enter the corporation's share of the additional 5% tax on line 2b(1).

Line 2b(2). Enter the corporation's share of the additional 3% tax on line 2b(2).

Line 3

A FSC that **is not** a member of a controlled group (see worksheet below) or a qualified personal service corporation must compute its tax on its taxable income as follows:

Tax Rate Schedule

If taxable income (Schedule B, line 20) is:

Over—	*But not over—*	*Tax is:*	*Of the amount over—*
$0	$50,000	**15%**	$0
50,000	75,000	**$ 7,500 + 25%**	50,000
75,000	100,000	**13,750 + 34%**	75,000
100,000	335,000	**22,250 + 39%**	100,000
335,000	10,000,000	**113,900 + 34%**	335,000
10,000,000	15,000,000	**3,400,000 + 35%**	10,000,000
15,000,000	18,333,333	**5,150,000 + 38%**	15,000,000
18,333,333	- - - - -	**35%**	0

Qualified personal service corporations. A qualified personal service corporation is taxed at a flat rate of 35% on its taxable income. A FSC is a qualified personal service corporation if it meets **both** of the following tests:

- Substantially all of the FSC's activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and
- At least 95% of the corporation's stock, by value, is owned, directly or indirectly, by **(1)** employees performing the services, **(2)** retired employees who had performed the services listed above, **(3)** any estate of the employee or retiree described above, or **(4)** any person who acquired the stock of the FSC as a result of the death of an employee or retiree (but only for the 2-year period beginning on the date of the employee or retiree's death). See Temporary Regulations section 1.448-1T(e) for details.

Note: *If the FSC meets these tests, check the box on line 3, Schedule J, Form 1120-FSC.*

Additional tax under section 197(f). A FSC that elects to pay tax on the gain from the sale of an intangible under the

Tax Computation Worksheet for Members of a Controlled Group
(keep for your records)

Note: *Each member of a controlled group (except a qualified personal service corporation) must compute the tax using this worksheet.*

1.	Enter taxable income (Schedule B, line 20)	**1.**
2.	Enter line 1 or the FSC's share of the $50,000 taxable income bracket, whichever is less	**2.**
3.	Subtract line 2 from line 1	**3.**
4.	Enter line 3 or the FSC's share of the $25,000 taxable income bracket, whichever is less	**4.**
5.	Subtract line 4 from line 3	**5.**
6.	Enter line 5 or the FSC's share of the $9,925,000 taxable income bracket, whichever is less	**6.**
7.	Subtract line 6 from line 5	**7.**
8.	Multiply line 2 by 15%	**8.**
9.	Multiply line 4 by 25%	**9.**
10.	Multiply line 6 by 34%	**10.**
11.	Multiply line 7 by 35%	**11.**
12.	If the taxable income of the controlled group exceeds $100,000, enter this member's share of the smaller of 5% of the taxable income in excess of $100,000, or $11,750 (See the instructions for line 2b above.)	**12.**
13.	If the taxable income of the controlled group exceeds $15 million, enter this member's share of the smaller of 3% of the taxable income in excess of $15 million, or $100,000 (See the instructions for line 2b above.)	**13.**
14.	**Total.** Add lines 8 through 13. Enter here and on Schedule J, line 3	**14.**

related-person exception to the anti-churning rules should include any additional tax due under section 197(f)(9)(B) in the amount entered on line 3. On the dotted line next to line 3, write “Section 197” and the amount. For more information, see **Pub. 535,** Business Expenses.

Line 4

Alternative minimum tax (AMT). Unless the FSC is treated as a small corporation exempt from the AMT, it may owe the AMT if it has any of the adjustments and tax preference items listed on **Form 4626,** Alternative Minimum Tax–Corporations. The FSC must file Form 4626 if its taxable income (loss) combined with these adjustments and tax preference items is more than the smaller of $40,000 or the FSC's allowable exemption amount (from Form 4626).

For this purpose, taxable income does not include the NOL deduction. See Form 4626 for details.

Exception for small corporations. A FSC is treated as a small corporation exempt from the AMT for its tax year beginning in 2000 if that year is the FSC's first tax year in existence (regardless of its gross receipts) **or:**

1. It was treated as a small corporation exempt from the AMT for all prior tax years beginning after 1997 **and**

2. Its average annual gross receipts for the 3-tax-year period (or portion thereof during which the FSC was in existence) ending before its tax year beginning in 2000 did not exceed $7.5 million ($5 million if the FSC had only 1 prior tax year).

Line 6

Foreign tax credit. Generally, a FSC may not claim a foreign tax credit. It may, however, claim a foreign tax credit for any foreign taxes imposed on foreign source taxable nonforeign trade income (Schedule F, Part II) that is treated as effectively connected with a U.S. trade or business under section 921(d). See Temporary Regulations section 1.921-3T(d)(2) for more details.

Line 8

Personal holding company tax. See the instructions on page 6, **Personal Holding Companies** and **Foreign Personal Holding Companies.**

Line 9

Total tax. Interest on tax deferred under the installment method for certain nondealer installment obligations. If an obligation arising from the disposition of property to which section 453A applies is outstanding at the close of the year, the FSC must include the interest due under section 453A(c) in the amount on line 9, Schedule J. On the dotted line to the left of line 9, Schedule J, write “Section 453A(c) interest” and the amount. Attach a schedule showing the computation.

Schedule L
Balance Sheets per Books

The balance sheet should agree with the FSC's books and records. Include certificates of deposit as cash on line 1, Schedule L.

Line 5. Tax-exempt securities. Include on this line:

1. State and local government obligations, the interest on which is excludible from gross income under section 103(a) and

2. Stock in a mutual fund or other regulated investment company that distributed exempt-interest dividends during the tax year of the corporation.

Line 27. Adjustments to shareholders' equity. Some examples of adjustments to report on this line include:

- Unrealized gains and losses on securities held “available for sale.”
- Foreign currency translation adjustments.
- The excess of additional pension liability over unrecognized prior service cost.
- Guarantees of employee stock (ESOP) debt.
- Compensation related to employee stock award plans.

If the total adjustment to be entered on line 27 is a negative amount, enter the amount in parentheses.

Schedule M-1

Reconciliation of Income (Loss) per Books With Income per Return

Line 5c. Travel and entertainment. Include on line 5c any of the following:

- 50% of the meals and entertainment not allowed under section 274(n).
- Expenses for the use of an entertainment facility.
- The part of business gifts over $25.
- Expenses of an individual over $2,000, which are allocable to conventions on cruise ships.
- Employee achievement awards over $400.
- The cost of entertainment tickets over face value (also subject to 50% disallowance under section 274(n)).
- The cost of skyboxes over the face value of nonluxury box seat tickets.
- The part of luxury water travel not allowed under section 274(m).
- Expenses for travel as a form of education.
- Other travel and entertainment expenses not allowed as a deduction.

For more information, see **Pub. 542,** Corporations.

Line 7a. Tax-exempt interest. Include as interest on line 7a any exempt-interest dividends received as a shareholder in a mutual fund or other regulated investment company.

Principal Business Activity Codes

This list of principal business activities and their associated codes is designed to classify an enterprise by the type of activity in which it is engaged to facilitate the administration of the Internal Revenue Code. These principal business activity codes are based on the North American Industry Classification System.

Using the list of activites and codes below, determine from which activity the FSC derives the largest percentage of its "total receipts." Total receipts is defined as the sum of the foreign trading gross receipts on Form 1120-FSC, page 3, Schedule B, line 6a, and the total income on page 4, Schedule F, lines 4 and 17. If the FSC's largest percentage of its total receipts is derived from the wholesale trading of durable goods, the FSC must use one of the corresponding codes from the list below (421100-421990).

Once the principal business activity is determined, entries must be made on Form 1120-FSC, page 2, Additional Information, lines 1a, 1b, and 1c. For the business activity code number, enter the six-digit code from the list below. On line 1b, enter a brief description of the FSC's business activity. Finally, enter a description of the principal product or service of the FSC on line 1c.

Wholesale Trade

Code

Wholesale Trade, Durable Goods

421100 Motor Vehicle & Motor Vehicle Part, & Supplies Wholesalers
421200 Furniture & Home Furnishing Wholesalers
421300 Lumber & Other Construction Materials Wholesalers
421400 Professional & Commercial Equipment & Supplies Wholesalers
421500 Metal & Mineral (except Petroleum) Wholesalers
421600 Electrical Goods Wholesalers
421700 Hardware, & Plumbing & Heating Equipment & Supplies Wholesalers
421800 Machinery, Equipment, & Supplies Wholesalers
421910 Sporting & Recreational Goods & Supplies Wholesalers
421920 Toy & Hobby Goods & Supplies Wholesalers
421930 Recyclable Material Wholesalers
421940 Jewelry, Watch, Precious Stone, & Precious Metal Wholesalers
421990 Other Miscellaneous Durable Goods Wholesalers

Code

Wholesale Trade, Nondurable Goods

422100 Paper & Paper Product Wholesalers
422210 Drugs & Druggists' Sundries Wholesalers
422300 Apparel, Piece Goods, & Notions Wholesalers
422400 Grocery & Related Product Wholesalers
422500 Farm Product Raw Material Wholesalers
422600 Chemical & Allied Products Wholesalers
422700 Petroleum & Petroleum Products Wholesalers
422800 Beer, Wine, & Distilled Alcoholic Beverage Wholesalers
422910 Farm Supplies Wholesalers
422920 Book, Periodical, & Newspaper Wholesalers
422930 Flower, Nursery Stock, & Florists' Supplies Wholesalers
422940 Tobacco & Tobacco Product Wholesalers
422950 Paint, Varnish, & Supplies Wholesalers
422990 Other Miscellaneous Nondurable Goods Wholesalers

Information

Code

Publishing Industries

511110 Newspaper Publishers
511120 Periodical Publishers
511130 Book Publishers
511140 Database & Directory Publishers
511190 Other Publishers
511210 Software Publishers

Motion Picture and Sound Recording Industries

512100 Motion Picture & Video Industries (except video rental)
512200 Sound Recording Industries

Broadcasting and Telecommunications

513100 Radio & Television Broadcasting
513200 Cable Networks & Program Distribution
513300 Telecommunications (including paging, cellular, satellite, & other telecommunications)

Information Services and Data Processing Services

514100 Information Services (including news syndicates, libraries, & on-line information services)
514210 Data Processing Services

Rental and Leasing

Code

Rental and Leasing Services

531114 Cooperative Housing
532100 Automotive Equipment Rental & Leasing
532400 Commercial & Industrial Machinery & Equipment Rental & Leasing

Lessors of Other Nonfinancial Assets

533110 Lessors of Nonfinancial Intangible Assets (except Copyrighted Works)

Professional, Scientific and Technical Services

Architectural and Engineering Services

541310 Architectural Services
541330 Engineering Services