

## **2006 Instructions for Form 8873 Extraterritorial Income Exclusion**

- Purpose:** This is the first circulation of the 2006 Instructions for Form 8873, Extraterritorial Income Exclusion. See below for a discussion of the major changes.
- TPCC Meeting:** None scheduled, but may be arranged if requested.
- Prior Revision:** The 2005 Instructions for Form 8873 are available at:  
<http://publish.no.irs.gov/INSTRS/PDF/31661Y05.PDF>
- Form:** The 2006 Form 8873 was circulated on April 21, 2006 and is available at:  
[http://taxforms.web.irs.gov/Products/Drafts/2006/06df8873\\_d1.pdf](http://taxforms.web.irs.gov/Products/Drafts/2006/06df8873_d1.pdf)
- Other products:** Circulations of draft tax forms and instructions are posted at:  
[http://taxforms.web.irs.gov/draft\\_products.html](http://taxforms.web.irs.gov/draft_products.html).  
Draft publications are not available.
- Comments:** Please e-mail, fax, call, or mail any comments by **Friday, November 17, 2006**.

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### **Description of Major Changes**

1. We've added a "What's New" section to alert filers to changes made by section 513 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), which repealed the ETI binding contract exception.
2. We amended the binding contract exception rules to reflect the amendments made by section 513 of TIPRA.



# Instructions for Form 8873

## Extraterritorial Income Exclusion

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

### What's New

The Tax Increase Prevention and Reconciliation Act of 2005 repealed the extraterritorial income (ETI) binding contract exception. See *Binding contract exception* below for details.

## General Instructions

### Purpose of Form

Use this form to figure the amount of extraterritorial income (defined below) excluded from gross income for the tax year. Attach the form to your income tax return.

**Note.** The amount figured on the form is net of the disallowed deductions.

### ETI Repeal

The American Jobs Creation Act of 2004 repealed the ETI exclusion provisions generally for transactions after 2004, subject to transition rules.

### Transition Rule and Binding Contract Exception

**Transition rule.** Taxpayers may claim 80% and 60% of the otherwise applicable pre-repeal ETI exclusion for transactions during 2005 and 2006, respectively. See *80% transactions and 60% transactions* below for additional information.

**Binding contract exception.** The binding contract exception has been repealed for tax years beginning after May 17, 2006. For tax years beginning before May 18, 2006, the following rules apply: The taxpayer may claim a 100% exclusion with respect to transactions in the ordinary course of a trade or business under a binding contract if such contract is between the taxpayer and an unrelated person (defined below) and such contract was in effect on September 17, 2003, and at all times thereafter.

For these purposes, a binding contract includes a purchase option, renewal option, or replacement option that is included in such contract and that is enforceable against the seller or lessor. For this purpose, a replacement option will be considered enforceable against a lessor notwithstanding the fact that a lessor retained approval of the replacement lessee.

**Unrelated person.** An unrelated person is a person that is not a related person as defined in *Qualifying Foreign Trade Property* on page 2.

### Definitions

**100% transactions** are (a) transactions under a binding contract that meets the requirements described in *Binding contract exception* above or (b) transactions before 2005.

**80% transactions** are transactions during 2005 to which the *Binding contract exception* (described above) does not apply.

**60% transactions** are transactions during 2006 to which the *Binding contract exception* (described above) does not apply.

### Pre-Repeal ETI Exclusion Rules

#### Who Qualifies for the Exclusion

##### Eligible Taxpayers

Individuals, corporations (including S corporations), partnerships, and other pass-through entities are entitled to the exclusion if they have extraterritorial income.

**Special rule for DISCs.** The extraterritorial income exclusion does not apply to any taxpayer for any tax year if, at any time during the tax year, the taxpayer is a member of a controlled group of corporations (as defined in section 927(d)(4), as in effect before its repeal) of which a DISC (Domestic International Sales Corporation) is a member.

##### Eligible Transactions

Generally, the extraterritorial income exclusion applies to taxpayers with respect to transactions after September 30, 2000. However, the exclusion does not apply to any transaction in the ordinary course of a trade or business involving a FSC (Foreign Sales Corporation) that is under a binding contract that is in effect on September 30, 2000, and at all times thereafter, and that is between the FSC (or a person related to the FSC) and a person other than a related person.

**Line 2 election.** The taxpayer may elect to apply the exclusion rules for the transactions described above involving a FSC. To make the election, check the box on line 2. See the instructions for line 2 for more details.

### Extraterritorial Income

Extraterritorial income is the gross income of the taxpayer attributable to foreign trading gross receipts (defined below). The taxpayer reports all of its extraterritorial income on its tax return. It then uses Form 8873 to calculate its exclusion from income for extraterritorial income that is qualifying foreign trade income.

### Qualifying Foreign Trade Income

Generally, qualifying foreign trade income is the amount of gross income that, if excluded, would result in a reduction of taxable income by the greatest of:

- 15% of foreign trade income,
- 1.2% of foreign trading gross receipts, or
- 30% of foreign sale and leasing income.

See definitions below and on page 2.

### Foreign Trading Gross Receipts

A taxpayer is treated as having foreign trading gross receipts (FTGR) derived from certain activities in connection with qualifying foreign trade property (defined on page 2) only if it meets the foreign economic process requirements (described on page 2). Foreign trading gross receipts are the taxpayer's gross receipts that are:

1. From the sale, exchange, or other disposition of qualifying foreign trade property;
2. From the lease or rental of qualifying foreign trade property for use by the lessee outside the United States;
3. For services that are related and subsidiary to (a) any sale, exchange, or other disposition of qualifying foreign trade property by such taxpayer or (b) any lease or rental of qualifying foreign trade property for use by the lessee outside the United States;
4. For engineering or architectural services for construction projects located (or proposed for location) outside the United States; or
5. For the performance of managerial services for a person other than a related person connected with the production of foreign trading gross receipts described in items 1, 2, or 3 above. Item 5 does not apply to a taxpayer for any tax year unless at least 50% of its foreign trading gross receipts (determined without regard to this sentence) for such tax year are derived from the activities described in items 1, 2, or 3 above.

**Excluded receipts.** Foreign trading gross receipts do not include the receipts of a taxpayer from a transaction if:

- The qualifying foreign trade property or services are for ultimate use in the United States;
- The qualifying foreign trade property or services are for use by the United States or any instrumentality of the United States and such use is required by law or regulation;
- Such transaction is accomplished by a subsidy granted by the government (or any instrumentality) of the country or possession in which the property is manufactured, produced, grown, or extracted; or

- The taxpayer has elected to exclude the receipts under section 942(a)(3). See the instructions for line 1 for more details.

## Foreign Economic Process Requirements

You are generally treated as having foreign trading gross receipts from a transaction only if certain economic processes take place outside the United States with respect to that transaction. However, see *\$5 million gross receipts exception* below.

Generally, a transaction will qualify if two requirements are met:

- 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.

For purposes of determining whether your gross receipts qualify as foreign trading gross receipts, the foreign economic process requirements are treated as satisfied if any related person has met the economic process requirements with respect to the same qualifying foreign trade property.

### Participation outside the United States in the sales portion of the transaction.

Generally, the foreign economic process requirements are met for your gross receipts derived from any transaction if you have (or any person acting under a contract with you has) participated outside the United States in the solicitation (other than advertising), negotiation, or the making of the contract relating to the transaction.

**50% foreign direct cost test.** You meet this test if the foreign direct costs you incurred that are attributable to the transaction equal or exceed 50% of the total direct costs you incurred attributable to the transaction.

**Total direct costs** are those costs for any transaction that are attributable to the following activities you (or any person acting under a contract with you) performed at any location with respect to qualifying foreign trade property:

- Advertising and sales promotion,
- Processing of customer orders and arranging for delivery,
- Transportation outside the United States in connection with delivery to the customer,
- Determination and transmittal of a final invoice or statement of account or the receipt of payment, and
- Assumption of credit risk.

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

**Alternative 85% foreign direct cost test.** You meet this test if, for any two of the activities listed above, the foreign direct costs equal or exceed 85% of the total direct costs attributable to that activity.

If you incur no direct costs with respect to any activity listed above, that activity is not taken into account for purposes of determining whether you have met either the 50% or 85% foreign direct cost test.

**\$5 million gross receipts exception.** The foreign economic process requirements do not apply to taxpayers whose foreign trading gross receipts for the tax year are \$5 million or less. For tax years of less than 12 months, the test is determined on an

annualized basis. For purposes of the exception, all related persons are treated as one taxpayer and, therefore, only one \$5 million limit applies.

In the case of a partnership, S corporation, or other pass-through entity, the limit applies to both the pass-through entity and its partners, shareholders, or other owners. The pass-through entity must advise its partners, shareholders, or other owners if and how the entity met the foreign economic process requirements.

## Qualifying Foreign Trade Property

Generally, qualifying foreign trade property is property that meets all three of the following conditions.

- The property must be held primarily for sale, lease, or rental, in the ordinary course of a trade or business, for direct use, consumption, or disposition outside the United States and Puerto Rico.
- Not more than 50% of the fair market value of the property can be attributable to (a) articles manufactured, produced, grown, or extracted outside the United States and Puerto Rico and (b) direct costs of labor performed outside the United States and Puerto Rico.
- The property generally must be manufactured, produced, grown, or extracted within the United States and Puerto Rico. However, property manufactured, produced, grown, or extracted outside the United States and Puerto Rico is qualifying foreign trade property if the property was manufactured, produced, grown, or extracted by:
  1. A domestic corporation,
  2. An individual who is a citizen or resident of the United States,
  3. A foreign corporation that elects to be treated as a domestic corporation under section 943(e), or
  4. A partnership or other pass-through entity all of the partners or owners of which are described in items 1, 2, or 3 above.

**Excluded property.** The following property is excluded from the definition of qualifying foreign trade property:

- Property with respect to which a related person (defined below) has calculated its exclusion using the 1.2% of foreign trading gross receipts method,
- Property you lease or rent for use by any related person,
- Certain intangibles described in section 943(a)(3)(B),
- Oil or gas (or any primary product of oil or gas),
- Any log, cant, or similar form of unprocessed softwood timber,
- Products the transfer of which is prohibited or curtailed to carry out the policy stated in paragraph (2)(C) of section 3 of Public Law 96-72, The Export Administration Act of 1979, and
- Property designated by an Executive order of the President as in short supply because the property is insufficient to meet the requirements of the domestic economy (beginning with the date specified in the Executive order).

**Related person.** Generally, a person is considered related to another person, for

purposes of the extraterritorial income exclusion, if the persons are treated as a single employer under section 52(a) or (b) or section 414(m) or (o). For this purpose, determinations under section 52(a) and (b) are made without regard to section 1563(b).

## Foreign Trade Income

Foreign trade income (FTI) is your taxable income (determined without regard to the extraterritorial income exclusion) attributable to foreign trading gross receipts. See section 941(b)(2) for special rules for cooperatives.

## Foreign Sale and Leasing Income

Foreign sale and leasing income (FSLI) is generally the amount of your foreign trade income for a transaction that is:

- Properly allocable to activities that constitute foreign economic processes (described above),
- Derived by you from the lease or rental of qualifying foreign trade property for use by the lessee outside the United States, or
- Derived by you from the sale of qualifying foreign trade property formerly leased or rented for use by the lessee outside the United States.

Only directly allocable expenses are taken into account in figuring your foreign sale and leasing income. Income properly allocable to certain intangibles is excluded from foreign sale and leasing income. See sections 941(c)(2)(B) and 941(c)(3) for special rules related to foreign sale and leasing income.

## Reporting of Transactions

Generally, you may report transactions (including sale transactions and leasing transactions) either on a transaction-by-transaction basis or on the basis of groups of transactions based on product lines or recognized industry or trade usage. See the instructions for line 5c for rules concerning grouping elections that may be made with respect to transactions. However, you may not group sales and leases together, and you may not report foreign sale and leasing income in column (b) of Part II of the form on the basis of groups.

# Specific Instructions

## Part I—Elections and Other Information

**Line 1.** Check the box if the taxpayer is electing, under section 942(a)(3), to exclude a portion of its gross receipts from treatment under the extraterritorial income exclusion provisions. Attach a schedule that lists the transactions being omitted.

**Note.** A foreign tax credit may be available for foreign taxes paid on the receipts the taxpayer excludes from treatment under the extraterritorial income exclusion provisions.

**Line 2.** Check the box if the taxpayer is electing to apply the extraterritorial income exclusion provisions to certain transactions involving a FSC (see *Eligible Transactions* on page 1).



**Note.** The extraterritorial income exclusion provisions and the FSC provisions may not be applied to the same transaction.

Attach a schedule listing those transactions. Once the election is made with respect to a transaction, the election applies to the tax year for which it was made and all later tax years. The election may be revoked only with IRS consent. See Rev. Proc. 2001-37, 2001-1 C.B. 1327.

**Line 3.** Check the box if the taxpayer is an "applicable foreign corporation" that elects to be treated as a domestic corporation under section 943(e). To be eligible, the foreign corporation must waive the right to claim all benefits granted to it by the United States under any treaty. If the election is made, the corporation will be treated as a domestic corporation for all purposes of the Internal Revenue Code. However, the corporation may not elect to be an S corporation.

An "applicable foreign corporation" is a foreign corporation that:

1. Manufactures, produces, grows, or extracts property in the ordinary course of the corporation's trade or business or
2. Substantially all of its gross receipts are foreign trading gross receipts.

Once made, the election applies to the tax year made and remains in effect for all subsequent years unless revoked or terminated. Any revocation or termination applies to tax years beginning after the tax year during which the election was made. The election will automatically terminate if the corporation fails to meet either of the requirements listed above. If an election is revoked by the corporation or is automatically terminated, the corporation (and any successor corporation) may not elect to be a domestic corporation again for 5 tax years beginning with the first tax year after the revocation or termination. See Rev. Proc. 2001-37.

**Effect of election.** For purposes of section 367, a foreign corporation that has elected to be a domestic corporation is generally treated as transferring, as of the first day of the first tax year to which the election applies, all of its assets to a domestic corporation in an exchange under section 354.

**Exception for old earnings and profits of certain corporations.** If the exception described in section 5(c)(3) of the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 applies, attach a statement indicating the basis for your entitlement, if any, to that exception.

**Effect of revocation or termination.** If a foreign corporation has elected to be a domestic corporation and the election ceases to apply for any subsequent tax year, the corporation is treated as a domestic corporation transferring, as of the first day of the subsequent tax year to which the election no longer applies, all of its property to a foreign corporation in an exchange under section 354.

**Line 4.** Before completing lines 4a and 4b, see *Foreign Economic Process Requirements* on page 2.

**Line 5a.** Enter the six-digit code that best describes the business activity for which the form is being filed from the list of Principal

Business Activity Codes included in your tax return instructions.

**Line 5b.** Enter your product or product line that meets one of the two standards below.

- The product or product line based on the North American Industry Classification System (NAICS) or
- A recognized industry or trade usage.

**Line 5c.** Check the applicable box to indicate the basis on which the amounts on Form 8873 are determined using either the transaction-by-transaction basis or an election to group transactions. Use one of the following formats.

**(1) Transaction-by-transaction.** If your determination is based on each transaction rather than an election to group transactions, check box (1)(a), (1)(b), or (1)(c), depending on your preferred reporting format.

**(a) Aggregate on Form 8873.** If you choose to aggregate your transactions on one or more Forms 8873, check box (1)(a) of line 5c. Aggregate on one Form 8873 those transactions for which the same method is applied, provided all the transactions (other than foreign sale and leasing income transactions) are included in the same product or product line indicated on line 5b. If a different method is applied to some of the transactions in one or more of the separate product lines, additional Forms 8873 must be filed.

**Example.** If you have no foreign sale and leasing income and you apply the 15% of foreign trade income method to all transactions in three separate product lines, you would file three aggregate Forms 8873. However, if you use the 1.2% of foreign trading gross receipts method for some of the transactions in one of the product lines, you would then file four aggregate Forms 8873.

**Note.** Taxpayers that check box (1)(a) of line 5c may aggregate 60% transactions, 80% transactions, and 100% transactions on the same Form 8873 only if they are applying the same method (for example, 15% of FTI, 1.2% of FTGR, 30% of FSLI) to all transactions reported on the form and the transactions (other than foreign sale and leasing income transactions) are included in the same product or product line.

**(b) Aggregate on tabular schedule.** You may choose to aggregate your transactions on a tabular schedule rather than on Form 8873. To do so, file one Form 8873 entering only your name and identifying number at the top of the form. Also check box (1)(b) of line 5c. Attach a tabular schedule to the partially completed Form 8873 reporting all information as if a separate form were filed for each aggregate of transactions described in (1)(a) above. Also see *Format of tabular schedules* on page 4.

**Note.** To be eligible for either of the aggregate reporting formats described in (1)(a) or (b) above, you must maintain a supporting schedule that contains all information that would be reported if a separate Form 8873 were filed for each transaction, including identification of each transaction as either a 100% transaction, an 80% transaction, or a 60% transaction. The supporting schedule should not be filed with the Form 8873.

**(c) Tabular schedule of transactions.** Instead of aggregate reporting, you may choose to report transactions on a tabular schedule. File one Form 8873 entering only your name and identifying number at the top of the form. Also check box (1)(c) of line 5c. Attach a tabular schedule to the partially completed Form 8873 reporting all information as if a separate Form 8873 were filed for each transaction. Also, see *Format of tabular schedules* on page 4.

**(2) Group of transactions.** You may elect to group transactions (other than foreign sale and leasing income transactions) by product or product line. The grouping of transactions applies to all transactions completed during the tax year for that product or product line.

To make the election, complete one Form 8873 entering only your name and identifying number at the top of the form. Also check box (2) of line 5c. Attach a tabular schedule to the partially completed Form 8873 reporting all information as if a separate Form 8873 were filed for each group of transactions. See *Format of tabular schedules* on page 4.

**Note.** If a grouping basis is elected, aggregate reporting is not permitted.

Attach Form 8873 to your tax return. Once the election is made, grouping redeterminations are permitted until one year after the later of:

1. The due date of your timely filed return (including extensions) or
2. In the event of an examination of your return by the IRS, notification by the IRS of such examination (provided you agree to extend the statute of limitations for assessment by one year).

**Note.** If your foreign trading gross receipts are \$5 million or less for the tax year, you may file a separate Form 8873 for each group of transactions instead of filing a tabular schedule.

**Note.** If you are electing to group transactions, 100% transactions, 80% transactions, and 60% transactions must be grouped separately. Therefore, transactions must be grouped both by product or product line and by type of transaction (that is, 100%, 80%, or 60%).

**Format of tabular schedules.** If a tabular schedule is attached to Form 8873, the schedule must:

- Be in spreadsheet or similar format,
- List your name and identifying number on each numbered page,
- Be formatted in columns that correspond to each line item of Form 8873, and
- Show totals in each column.

## Part II—Foreign Trade Income and Foreign Sale and Leasing Income

**Lines 6 through 14.** Enter your foreign trading gross receipts identified on lines 6 through 14 using the rules outlined under *Foreign Trading Gross Receipts* beginning on page 1.

**Line 14, column (b).** Enter on this line only the sum of those portions of the amounts on lines 6, 9, 12, and 13, column (a), that are attributable to foreign economic processes

(see definition on page 2). Because only foreign trading gross receipts attributable to foreign economic processes are included in line 14, column (b), the amount entered on line 14, column (b), will not necessarily equal the total of the foreign trading gross receipts amounts entered on lines 6, 9, 12, and 13, column (a).

**Line 17.** For lines 17a through 17h, compute your cost of goods sold allocated to your foreign trading gross receipts. See the instructions for the tax return to which this form is attached for basic rules for determining cost of goods sold.

**Line 19.** Enter on line 19, column (a), the deductions, other than those you included in figuring your cost of goods sold, that are allocable to the amount reported on line 15.

Enter on line 19, column (b), the deductions, other than those you included in figuring your cost of goods sold, that are directly allocable to the amount reported on line 16.

**Note.** Do not include your allocable portion of general and administrative expenses on line 19, column (b).

For both column (a) and column (b), attach to Form 8873 a schedule listing these amounts. See the instructions for the tax return to which this form is attached for basic rules for determining expenses.

### Part III—Marginal Costing

Marginal costing is a method under which only direct production costs of producing a particular product or product line are taken into account for purposes of computing your qualifying foreign trade income. Complete this section to see if you will benefit by using marginal costing. If you do not wish to use this method, skip Part III and complete Part IV using the instructions below.

### Part IV—Extraterritorial Income Exclusion

**Line 45.** Generally, your qualifying foreign trade income is based on the greatest of lines 33, 36, 38, 42, or 44. Under the alternative computation, however, you may instead choose to enter on line 45 the amount from any of those five lines (33, 36, 38, 42, or 44). For example, although line 42 may produce the greatest exclusion for you, use of that line could eliminate or reduce the exclusion for a related person because of the limitation under section 941(a)(3) on the use of the 1.2% of foreign trading gross receipts method. Therefore, to maximize the

combined exclusion for you and that related person, you may prefer to enter on line 45 the greatest of lines 33, 36, 38, or 44 (instead of the amount on line 42).

**Line 50.** If you had any operations in or related to a country associated with carrying out an international boycott or you participated in or cooperated with an international boycott, your extraterritorial income exclusion may be reduced. See the separate instructions for Form 5713, International Boycott Report, for definitions and other details and to find out if you are required to file Form 5713. If you are required to file Form 5713, also complete Schedule A (Form 5713), International Boycott Factor (Section 999(c)(1)), and Schedule C (Form 5713), Tax Effect of the International Boycott Provisions. Enter the amount from Schedule C (Form 5713), line 6c, on Form 8873, line 50.



*The exception from filing Form 5713 that generally applies to foreign persons does not apply to a foreign person that is claiming the extraterritorial income exclusion.*

Also include on line 50 the total of any illegal bribes, kickbacks, or other payments (within the meaning of section 162(c)) paid by or on behalf of the taxpayer directly or indirectly to government officials, employees, or agents.

**Line 53.** For definitions of “100% transactions,” “80% transactions,” and “60% transactions,” see *Definitions* on page 1.

You may report 100% transactions, 80% transactions, and 60% transactions on the same Form 8873 only if you are reporting on a transaction-by-transaction basis. If you are reporting on a grouping basis, you must use a separate Form 8873 for each type of transaction. See the instructions for line 5c on page 3 for more details and for other restrictions that apply with respect to reporting on a transaction-by-transaction basis or on a grouping basis.

**Line 53b.** Determine the amount to enter on this line using the following two steps:

1. Determine the amount from line 52 that is attributable to 80% transactions.
2. Multiply the amount in step 1 by 80% and enter the result on line 53b.

**Line 53c.** Determine the amount to enter on this line using the following two steps:

1. Determine the amount from line 52 that is attributable to 60% transactions.
2. Multiply the amount in step 1 by 60% and enter the result on line 53c.

**Line 54.** Add lines 53a through 53c. Report the total as follows: Although the total is an exclusion from income and not a deduction, include it on the “Other deductions” or “Other expenses” line of your tax return or schedule. If you are filing Schedule C (Form 1040), enter “Extraterritorial income exclusion from Form 8873” on a line in Part V of Schedule C. For filers of Form 1120, include the amount on Form 1120, page 1, line 26.

**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 will vary depending on individual circumstances. The estimated time burden for individual taxpayers filing this form is approved under OMB control number 1545-0074 and is included in the estimates shown in the instructions for their individual income tax return. The estimated burden for all other taxpayers who file this form is shown below.

<b>Recordkeeping</b> . . . . .	21 hr., 19 min.
<b>Learning about the law or the form</b> . . . . .	1 hr., 40 min.
<b>Preparing the form, copying, assembling, and sending the form to the IRS</b> . . . . .	2 hr., 6 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for the tax return with which this form is filed.