

Offsets in Defense Trade – Frequently Asked Questions

I. Overview

What are offsets?

Offsets are industrial compensation practices that foreign governments or companies require U.S. firms to enter into as a condition of purchase in either government-to-government or commercial sales of defense articles and/or defense services as defined by the Arms Export Control Act (22 U.S.C. § 2751, et seq.) and the International Traffic in Arms Regulations (22 C.F.R. §§ 120-130). In defense trade, such industrial compensation can include mandatory co-production, licensed production, subcontractor production, technology transfer, and foreign investment.

What is the Bureau of Industry and Security's role in defense offsets?

The Bureau of Industry and Security (BIS) is responsible for submitting an annual report to Congress on the impact of defense offsets on the U.S. defense industrial base. This requirement was initiated in 1984, when Congress enacted amendments, including the addition of Section 723, to the Defense Production Act of 1950, as amended (50 U.S.C. § 4568 (2015)). Pursuant to Section 723, the President is required to submit a report on the impact of offsets on the U.S. defense industrial base to Congress. In 1992, the President directed the Secretary of Commerce to carry out the Section 723 responsibilities, including developing and administering the regulations necessary to collect offset data from U.S. firms. The Secretary of Commerce has delegated this authority to BIS. BIS published the first offset regulation in 1994 and has submitted annual reports to Congress since 1996. The offset regulation is located [here](#).

What offset activities should be reported to BIS and who is responsible for reporting them to BIS?

U.S. firms providing defense articles or defense services to foreign countries or foreign firms under contracts that are associated with offset agreements valued at more than \$5 million should report the offset agreements to BIS. In addition, U.S. firms should report all offset transactions with values greater than \$250,000 that are credited toward an offset agreement to BIS.

Should foreign subsidiaries or foreign affiliates of U.S. firms report their offset activities to BIS?

If a foreign subsidiary or foreign affiliate of a U.S. firm enters into an offset agreement with a foreign entity and is responsible for the fulfillment of that agreement, that agreement should not be reported to BIS. However, if a foreign subsidiary or foreign affiliate of a U.S. firm performs an offset transaction to fulfill an offset agreement for which the U.S. firm is responsible, the U.S. firm that is party to the original offset agreement should report the offset transaction to BIS.

II. Offset Reporting Terms

What is an offset agreement and an offset transaction?

An offset agreement includes an offset agreed to by a U.S. firm in order to conclude a military export sales contract. The agreement is normally reflected in a contract that specifies the percentage of the total defense-related export sale to be offset, the forms of industrial compensation required, the duration of the offset agreement, and penalty clauses, if any.

An offset transaction is any activity for which a U.S. firm claims credit for full or partial fulfillment of an offset agreement. Offset transactions are categorized as “direct,” “indirect” or both.

What is the difference between direct offsets and indirect offsets?

All offset transactions are direct, indirect, or a combination of both. Direct offset transactions are those in which the items or services involved are directly related to the items or services exported or to be exported by the U.S. firm pursuant to the military export sales agreement associated with the offset agreement. Direct offsets are usually in the form of co-production, subcontracting, training, production, licensed production, or possibly technology or financing activities. Conversely, indirect offset transactions are those in which the items or services involved in the transaction are unrelated to the items or services exported or to be exported by the U.S. firm pursuant to the military export sales agreement associated with the offset agreement. The kinds of offsets that may be considered “indirect” include purchases, investment, training, credit assistance, and technology transfer.

What are the different types of offset transactions?

For the purpose of its’ annual report on Offsets in Defense Trade, BIS classifies offset transactions into the following nine categories: co-production, credit assistance, investment, licensed production, purchases, subcontract, technology transfer, training, and other. These categories are defined as follows:

Co-production: Transactions that are based upon government-to-government agreements authorizing the transfer of technology to permit foreign companies to manufacture all or part of U.S.-origin defense articles. Such transactions are based upon agreements specifically referenced in Foreign Military Sales (FMS) Letters of Offer and Acceptance (LOA) and a government-to-government Memorandum of Understanding (MOU). Co-production is always classified as a direct offset.

Credit Assistance: Credit assistance includes direct loans, brokered loans, loan guarantees, assistance in achieving favorable payment terms, credit extensions, and lower interest rates. Credit assistance specifically excludes the use of “banked” offset credits (credits that exceed the requirement of the offset agreement and are permitted, by the terms of the agreement, to be applied to future offset obligation). Credit assistance is nearly always classified as an indirect offset transaction but can also be direct.

Investment: Investment arising from an offset agreement, often taking the form of capital dedicated to the establishment of a foreign entity unrelated to the defense sale or to the expansion of the U.S. firm’s subsidiary or joint venture in the foreign country. Investment can be either a direct or indirect offset.

Licensed Production: Licensed production consists of the overseas production of a U.S.-origin defense article based upon transfer of technical information under direct commercial arrangements between a U.S. manufacturer and a foreign government or producer. Licensed production is not pursuant to a co-production government-to-government MOU. In addition, licensed production almost always involves a part or component for a defense system, rather than a complete defense system. Licensed production transactions can be either direct or indirect.

Purchases: Purchases involve the procurement of off-the-shelf items from the offset recipient. Purchases are indirect transactions.

Subcontracting: In the offset context, subcontracting is the overseas production of a part or component of a U.S.-origin defense article. The subcontract does not necessarily involve the license of technical information. Instead, it is usually a direct commercial arrangement between the defense prime contractor and the foreign producer.

Technology Transfer: Transfer of technology that occurs as a result of an offset agreement and that may take the form of research and development conducted abroad, technical assistance provided to the subsidiary or joint venture of overseas investment, or other activities under direct commercial arrangement between the defense prime contractor and a foreign entity.

Training: Generally includes training related to the production or maintenance of the exported defense item. Training, which can be either direct or indirect, may be required in unrelated areas, such as computer training, foreign language skills, or engineering capabilities.

Other: An offset transaction other than co-production, credit assistance, licensed production, investment, purchase, subcontracting, technology transfer, or training.

What is the difference between the “actual value” and “credit value” of an offset transaction?

The actual value of an offset transaction is the U.S. dollar value of the products and services provided without taking into account multipliers or intangible factors. The credit value of an offset transaction is the U.S. dollar value that the U.S. firm is credited by application of a multiplier, any intangible factors, or other methods by the foreign entity, in acknowledgement of the fulfillment of the U.S. firm’s offset obligations. The credit value may be greater than, equal to, or less than the actual value of the offset transaction.

What is the difference between co-production and licensed production in the context of BIS’s annual report on *Offsets in Defense Trade*?

Both co-production and licensed production categories involve overseas production of U.S.-origin defense articles; however, co-production is based upon a government-to-government agreement that authorizes co-production. In other words, the offset transaction must be the result of a Foreign Military Sale (FMS) in which the Letter of Offer and Acceptance (LOA) authorized co-production, and the terms of the agreement were further detailed in a co-production MOU between the Department of Defense and the foreign country.

If the FMS and LOA are silent on co-production, the offset transaction should be classified as licensed production or another offset transaction category that best describes the transaction.

What is the difference between a subcontract and a purchase in the context of BIS’s annual report on *Offsets in Defense Trade*?

BIS defines subcontracting as overseas production of a part or component of a U.S.-origin defense article, when the sale of the defense article is subject to an offset agreement. Therefore, all subcontracting transactions are direct offset transactions.

BIS defines purchases as the procurement of off-the-shelf items from the offset recipient of a transaction. Purchases are indirect offset transactions.

One of my offset transactions included a combination of technology transfer, training and co-production. How should I classify this transaction to BIS?

If more than one transaction type was used to complete a transaction, please indicate under “transaction type” the category that best represents the majority of the transaction and include the other categories under “additional information”.

What are performance measures and non-performance penalties?

In order to measure the effectiveness of government programs, many government agencies require grantees and contract holders to report on specific performance measures related to their activities. Non-performance penalties are fines incurred by service providers when they breach service levels, fail to perform as agreed to, or fail to perform the services on time. The offset regulation requires U.S. firms to report offset agreement performance measures and non-performance penalties to better understand the trends in offset activities in defense trade.

III. The December 23, 2009 Rule

When does the December 23, 2009 rule go into effect?

The effective date of the amended regulation is January 22, 2010. U.S. firms are required to incorporate the new requirements under the amended offset regulation in their submissions to BIS for offset activity in calendar year 2009 and onward, reportable to BIS by June 15th of each year.

What are the major changes to the offset regulation included in the December 23, 2009 rule?

The most significant change in the amended regulation is the new requirement that companies report the appropriate North American Industry Classification System (NAICS) code(s) for each military sale that triggers an offset agreement and for each offset transaction reported under the regulation.

Additionally, certain definitions have been updated to reflect the offset activities frequently reported to BIS (see the [“Offset Reporting Definitions”](#) section). In addition, for each offset transaction reported, companies are required to provide the month and year that the related offset agreement was signed.

What is the North American Industrial Classification System (NAICS) and why does BIS use the NAICS?

Federal statistical agencies use the NAICS to classify business establishments for the collection and analysis of data used to measure U.S. economic activity. NAICS replaced the Standard Industrial Classification (SIC) system in 1997. NAICS facilitates economic analyses which include producing information on inputs and outputs, industrial performance, productivity, unit labor costs, and employment. More information on the NAICS is found [here](#).

The U.S. Census Bureau’s (Census) website describes the NAICS as a six-digit hierarchical classification system, offering five levels of detail. Each digit in the code is part of a series of categories, with more digits in the code signifying greater classification detail. The first two digits designate the economic sector, the third digit identifies the sub-sector, the fourth digit classifies the industry group, the fifth digit designates the NAICS industry, and the sixth digit is the national industry. A complete and valid NAICS code contains six digits.

BIS utilizes the NAICS because it is the standard used by Federal statistical agencies in classifying business establishments for the purpose of collecting, analyzing, and publishing statistical data related to the U.S. business economy. Standard use of NAICS by federal agencies provides for a high level of comparability within and among industries.

How do I determine the appropriate NAICS code based on the SIC code?

Census provides detailed conversion (concordance) tables on its website [here](#). Census provides spreadsheet files that can be used to cross-reference SIC codes with the corresponding 2002 NAICS code only. NAICS codes are reviewed and updated every five years; therefore, to ensure that you have the

most current NAICS code, enter the 2002 NAICS code into Census' "NAICS Search" on the left side of the webpage.

Another useful website to convert SIC codes to NAICS codes is [here](#). On this site, enter your SIC code into the search field on the left hand side of the webpage and the website will generate the corresponding NAICS code. However, because this is not an official U.S. Government website, BIS cannot guarantee the accuracy of the conversion results.

My company has never classified our products against the NAICS or SIC. How do I know which codes are appropriate?

To determine the classification of your products that have not been previously classified against the SIC, access Census' [NAICS website](#). Enter keywords that best describe your products, and the website will generate the corresponding NAICS code(s).

Do I need to submit NAICS codes for offset agreements and transactions that were reported to BIS in previous years?

No. BIS only requires that submissions due by June 15, 2010 and forward include NAICS codes.

Why did BIS amend the offset regulation?

BIS amended the offset regulation partly in response to recommendations by the Government Accountability Office relating to enhancing the assessment of the economic effects of offsets in defense trade by clarifying the information that BIS seeks to receive and by requiring more precise information on the industry sectors in which offset activity occurs.

IV. Reporting

Where should a U.S. firm offset report submission be sent, when should they be submitted, and in what format should the report be in?

U.S. firms must submit their offset reports in hardcopy to the Offset Program Manager, U.S. Department of Commerce, Bureau of Industry and Security, Room 3876, 14th Street and Constitution Avenue, N.W., Washington, DC 20230, and as an email attachment to OffsetReport@bis.doc.gov. The deadline for reporting all new offset agreements and transactions signed and executed is June 15th of the subsequent year in which they occurred. Email attachments must include the information in a computerized spreadsheet or database format. All submissions must include a point of contact (name and telephone number). You may contact Ron DeMarines, Offset Program Manager, at (202) 482-3755 or (202) 482-4506 or by email (ronald.demarines@bis.doc.gov) for assistance.

My company completed a transaction in one year but the foreign offset authority has not approved the transaction by the end of the year. In which year should I report that offset transaction?

In this situation, the U.S. firm should report the transaction to BIS in the year in which the transaction took place. If, for example, the transaction took place in 2009, but the foreign offset authority did not officially grant credit for the transaction until sometime in 2010, the U.S. firm should include the transaction in its calendar year 2009 submission, due to BIS by June 15, 2010.

Estimates are acceptable for actual values and credit values and should be designated with an "E" next to the U.S. dollar value. If the estimated dollar values differ from the values granted from the foreign offset authority, the U.S. firm may submit an amended report to BIS with the correct dollar values.

My firm previously reported offset agreements and transactions to BIS, but did not enter into any new agreements or claim credit on transactions for the previous calendar year. Do I still need to submit something to BIS?

Yes, please submit a letter to BIS indicating that your company does not have offset agreements and/or offset transactions to report for the respective calendar year.

V. General

How does BIS ensure that business proprietary information submitted by U.S. firms is protected from public disclosure?

As provided by Section 723(c) of the Defense Production Act, and § 701.5 of the offset regulation, BIS is precluded from publicly disclosing the specific information it receives from U.S. companies. As a result, BIS highly aggregates the offset-related information it collects from defense contractors, to the extent that the activities of individual companies cannot be determined. In recent years, BIS has also revised the annual report to remove certain sections that were identified as beneficial to foreign governments and made other sections of the report available only within the U.S. Government. BIS continues to consider additional measures specific to this concern.

What are the penalties if a company does not comply with the new offset regulation?

Pursuant to the Defense Production Act (50 U.S.C. § 4568), willful violation of the offset regulation may result in punishment by fine or imprisonment, or both. The maximum penalty is a \$10,000 fine, one year in prison, or both. The U.S. Government may also seek an injunction from a court to prohibit the continuance of any violation of, or to enforce compliance with, the Defense Production Act.

What is the U.S. government policy on offsets in defense trade?

The U.S. Government views offsets to be economically inefficient and market distorting.

Where can I get a copy of the annual report to congress prepared by BIS?

Every annual report that BIS has submitted to Congress can be found online [here](#).