Specifically Exclude "Non-binding Intent Agreements" from Section 367(d)

Power (and Other Infrastructure) Industry Problem:

Many U.S. based utility and energy companies have recently been pursuing foreign power projects. U.S. based companies have also been pursuing other types of foreign infrastructure projects (e.g., pipelines, roads, dams, airports).

In the early stages of a foreign infrastructure development project, the potential developer will often sign one or more preliminary non-binding agreements (e.g., a Memorandum of Understanding (MOU), a Letter of Intent (LOI), a Heads of Agreement (HOA), a Joint Development Agreement (JDA)) with potential development partners and/or with the potential foreign customer.

Under the current Section 367(a)(3) and 367(d) rules relative to the outbound transfer of intangibles, there is arguably exposure to U.S. taxation if a U.S. corporation executes a preliminary non-binding agreement and final awarded contracts are executed by a foreign project company. In this case, the IRS might attempt to deem a transfer of the preliminary non-binding agreements from the U.S. company to the foreign project company. If the IRS were successful, the deemed transfer would be taxable to the extent of any gain.

Because of this theoretical Section 367 exposure, U.S. multinationals typically form separate foreign project company structures for each potential foreign infrastructure deal at a very early stage, and all project related agreements and contracts are executed by such foreign project companies. This approach is not just a conservative defensive position adopted by corporate tax department professionals, but is also advocated publicly by experienced counsel.

Many foreign infrastructure business opportunities never result in a final contract. The success rate for most U.S. multinationals is less than 10%. Thus, U.S. multinationals that are engaged in foreign development activities form numerous CFCs that will eventually become dormant and worthless.

The process of forming foreign corporations for opportunities that never materialize into awarded contracts is an administrative, legal, accounting and tax compliance burden. (For example, several major internationally accepted accounting systems cannot accommodate the number of legal entities often owned by infrastructure companies as a result of this issue.) Furthermore, because the potential foreign customer may take several years to decide who should be awarded the project, a U.S. multinational developer is forced to maintain its foreign structures for many years.

In summary, it is expensive, time consuming and counterproductive for U.S. multinationals to form, maintain and eventually liquidate foreign entities with respect to foreign business opportunities that do not progress beyond a preliminary stage. We

estimate that these entities each cost $5,000 to $10,000 per year in administrative and compliance costs.

Proposed Solution:

Specifically exclude preliminary non-binding agreements such as MOUs, LOIs, HOAs, and JDAs from the definition of "intangibles" for purposes of Sections 367 and 482.

Proposed Statutory Language Change:

The Section 963(h)(3)(B) definition of an intangible could be modified to exclude MOUs, LOIs, HOAs, JDAs and similar preliminary non-binding agreements from the definition of a "contract" by adding at the end a new sentence to read as follows:

> "Such term shall not include any preliminary agreement which is not legally enforceable."

The legislative history to this change should indicate that the change is intended to also apply for the cross-referenced purposes of Sections 367 and 482.

(Similar language was included as Section 306 of the International Tax Simplification for American Competitiveness Act of 1998 (S. 2231, H.R. 4173).)

Analysis, Tax Policy and Revenue Impact:

1. There are two key non-tax reasons for supporting this proposal. First, the proposal would reduce the administrative, legal, accounting, tax compliance and other out-of-pocket costs of forming, maintaining, liquidating, etc. foreign corporations for foreign business opportunities that do not progress beyond a preliminary stage.

Second, the current tax rules inhibit the ability of U.S. multinationals to react quickly and efficiently to foreign business opportunities. For example, in the early stages of a development project, a potential foreign customer (e.g., a governmental entity) may not want to execute preliminary agreements with a newly formed foreign affiliate of a U.S. multinational. This puts U.S. multinationals at competitive disadvantage vis-à-vis foreign competitors.

2. The proposed change is best viewed as a technical correction (or clarification of existing law), not a substantive change to Section 367. The proposal is consistent with U.S. tax policy for the following reasons:

> a. Preliminary non-binding agreements are the result of investigatory costs, not valuable intangible property that should be subject to the super-royalty provisions of Section 367(d).

b. Due to the contingent, non-binding nature of MOUs, LOIs, etc., these agreements should have little or no economic value. Thus, even if there were an actual assignment of a MOU, LOI, etc. from a U.S. company to a foreign project company, any Section 367 gain should be negligible.

c. Unlike most Section 367 intangibles, non-binding agreements (LOIs, MOUs, etc.) are usually project or country specific and do not have worldwide application.

d. This proposal would simplify and clarify a provision that is currently a "trap for the unwary".

e. The proposal would avoid tax audit disputes that could be costly and time consuming for both taxpayers and the IRS.

f. Bidding rights, awarded contracts and similar contracts that are executed with customers would continue to be subject to Section 367(d).

3. There should be no revenue cost to the U.S. Treasury since there is usually no tax paid under the current rules for a couple of reasons. First, most U.S. multinational groups cause their foreign project companies to execute all agreements and contracts such that any potential Section 367 taxation is avoided. Second, in the event that a preliminary agreement is inadvertently signed by a U.S. entity and subsequently transferred to a foreign project company, most appraisers would advise that there is little or no taxable gain.

Additionally, there should be no revenue loss since Section 367(d) applies solely to outbound transfers by U.S. transferors. Thus, there is no exposure that this proposal could be used by foreign-owned U.S. companies to avoid U.S. tax.

The proposal would also eliminate IRS and Treasury administrative time associated with processing Forms 5471 for foreign entities that are formed to execute the preliminary agreements.

4. The reference to Section 482 is necessary to avoid inconsistent treatment. For example, extending the change to Section 482 would be necessary to avoid any "whipsaw" to the U.S. Treasury by foreign investors into the U.S.

5. A similar change was included as Section 306 of the International Tax Simplification for American Competitiveness Act of 1999, introduced in the 1st session of the 106th Congress as S. 1164 by Senators Hatch and Baucus and as H.R. 2018 by Representatives Houghton and Levin.

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