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Eli Lilly and Company
Lilly Corporate Center
Indianapolis, IN 46285
U.S.A.

Phone 317 276 2000

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The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue, NW
Suite 2100
Washington, DC 20220

Dear Chairman Connie Mack and Vice-Chairman John Breaux:

Eli Lilly and Company welcomes the opportunity to submit the attached paper regarding the concept of a "territorial tax system" to the President's Advisory Panel on Federal Tax Reform. We understand that the Advisory Panel is seriously considering a territorial tax reform recommendation as part of its final report. Therefore, our intention with this submission is to provide the fundamentals of a territorial tax system that, we believe, represents sound tax policy and a viable option within the business community. In that pursuit, this paper puts forth a substantive alternative to other territorial or dividend exemption proposals, such as that recently released by the Joint Committee on Taxation. Our proposal advances a territorial tax system that:

- attempts to achieve improved competitiveness of U.S. multinational corporations in the global marketplace,
- reduces complexity in the current U.S. tax code related to the taxation of foreign income, and
- eliminates provisions that would create serious adverse impacts on U.S. research and innovation intensive companies.

We hope the ideas set forth in this paper will be helpful to the Advisory Panel as it considers a "territorial" or "dividends exemption" system for the taxation of foreign income earned by U.S. multinational companies.

Please feel free to contact me if you have further questions or comments regarding this submission. I can be reached at (317) 276-5310.

Respectfully submitted,

David P. Lewis
Executive Director, Global Taxes
and Chief Tax Executive

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Attachment

White Paper on Proposed Territorial Tax System for the United States

Introduction

The purpose of this submission is to outline for the President's Advisory Panel on Federal Tax Reform a territorial exemption proposal that eliminates some of the problems and complexities of the territorial exemption reform recently proposed by the Joint Committee on Taxation (JCT). The current worldwide system – with its disincentives to repatriation and byzantine foreign tax credit (FTC) rules -- arguably imposes on U.S. companies a greater degree of complexity than that faced by their competitors in countries with exemption systems.[1] A territorial tax system, *if done right*, can reduce the considerable headaches associated with international taxes and improve the global competitiveness of U.S. companies in the process. A territorial tax system should also enable the achievement of FASB/IASB convergence without harming U.S. companies in the global marketplace.

Below, we outline a proposal for a territorial system that is based on the following key principles: (a) two categories of foreign income (foreign income exempt from taxation and foreign income taxed under a modernized subpart F), (b) allowance of most critical business expenses (some allocation of interest; no allocation of R&D, sales and marketing, G&A and stewardship expenses), (c) a lower rate of tax applicable to royalty income to provide an incentive for U.S.-based R&D (and to ameliorate the costs associated with the loss of cross-crediting), and (d) extended and practical transition rules (allowing taxpayers to plan for the changes inherent in a move to territoriality).

An Outline of a Workable Territorial Proposal

<u>The Taxation of Income Generally</u>: Under our proposal, like the JCT proposal, income earned abroad by controlled foreign corporations (CFCs) or branches of U.S. parent corporations would fall into one of two categories: (1) passive and other highly mobile income, which would be taxed to the U.S. parent on a current basis under subpart F; or (2) all other income – i.e., active, less-mobile income not subject to subpart F – which would be exempt from U.S. tax and thus could be repatriated free of any tax impediment.

<u>SubPart F – Narrow Its Coverage</u>: One question we think is crucial under such a system is what income items will fall into the subpart F category. We disagree with the JCT claim that "the desirability of various proposals that the Congress may wish to consider in th[e] area [of subpart F] is largely independent

[1] Indeed, one study estimates that nearly 40 percent of the income tax compliance costs of U.S. multinationals are attributable to the taxation of foreign source income, even though foreign operations account for only about 20 percent of these companies' economic activity. Marsha Blumenthal & Joel B. Slemrod, *The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications*, 2 INT'L TAX & PUB FIN. 37 (August, 1995).

of the question of whether to adopt a dividend exemption system." Rather, any competitive advantages that a territorial system could bring will be thwarted by casting the subpart F net too wide, so that large amounts of foreign income are taxed currently. Thus, any territorial system proposal should be accompanied by a narrowing, not an expansion, of subpart F in order to realize necessary simplification, eliminate provisions the JCT itself recognizes are outmoded and distortionary, and help offset the effective tax increases that territoriality (as conceived by the JCT) would otherwise impose on U.S. multinational companies.

First, to be consistent with the very concept of territoriality, subpart F would have to be narrowed to, at a minimum, exclude CFC dividends and repeal the deemed-repatriation rules of section 956 (both changes the JCT proposal includes). In addition, the foreign base company sales rules and the foreign base company services income rules are ripe for reform, as they are, to quote the JCT, "ineffective as a practical matter in promoting capital export neutrality and reinforcing transfer pricing rules." Another desirable subpart F "narrower" would be to make permanent the exception for active financial services income,[2] which the JCT states will "promote greater certainty and stability in the tax law." Further, although not included in the ultimate conference agreement on the American Jobs Creation Act, subpart F should be reformed to provide look-through treatment for payments between related CFCs, as passed by both the House and Senate in 2004. Finally, the subpart F de minimis rule should be expanded and the member states of the European Union should be treated as one country for purposes of subpart F.

<u>Minority Ownership Investments</u>: Another question that must be addressed in a territorial system is how active business income earned abroad by non-CFCs in which a U.S. company-taxpayer owns at least 10% of the voting stock but U.S. shareholders (i.e., those owning at least 10% of the voting stock) as a group own 50% or less of the stock -- commonly referred to as "10-50 companies" – should be taxed. The JCT proposes that companies should effectively be able to choose between treating 10-50 investments as a portfolio-type investment or as a direct, CFC-type investment, an approach we think is sound. Thus, taxpayers could elect to have the investment treated as eligible for dividend exemption but subject to subpart F with an FTC or as fully taxed on dividends with no FTC (except for withholding taxes) and no subpart F treatment (but possibly subject to the passive foreign investment company (PFIC) rules).

<u>Sale of CFC Stock</u>: Yet another area of concern is how to tax gain on the sale of CFC stock. We propose that these capital gains should either be exempt altogether (as is the case in most OECD territorial systems[3]) or exempt with an exception for gains or losses attributable to increases or decreases in the value

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[2] *See* § 954(h), (i) and § 953(e)

[3] Even those OECD countries that traditionally did not exempt such capital gains, such as England and France, have enacted statutes providing for such exemption.

of passive assets.[4] By contrast, the JCT proposal would exclude a U.S. corporation's gain on the sale of CFC stock only to the extent of undistributed exempt earnings. The JCT itself admits that such an approach would not be consistent with an exemption system, as it would tax some gain relating to appreciation of assets that would have generated exempt income. Exempting gains on the sale of CFC stock from both direct U.S. tax and from subpart F inclusion would substantially simplify U.S. multinationals' efforts to restructure their foreign operations to achieve business and foreign tax planning goals.

Simplifications Achieved: The above approach accomplishes the following simplifications to the U.S. international tax rules:

- Two primary categories of foreign income
- Narrowed FTC regime (to passive income only)
- Repeal of separate FTC limitation categories of Section 904
- Repeal of the indirect FTC of Section 902 (except as it applies to subpart F inclusions)
- Repeal of Section 956
- Substantially reduced need for foreign exchange translations
- Substantially reduced need for E&P pools
- Repeal of foreign base company sales/services income rules
- Permanent exception for active financial services income
- Look-through treatment for payments between related CFCs
- Expansion of subpart F de minimis rule
- Treatment of EU members as one country for subpart F purposes
- Elimination of subpart F inclusion with respect to CFC restructuring transactions

Expenses Should Be Deductible

R&D, Sales & Marketing, G&A and Stewardship Expenses – Fully Deductible: Under our proposal, research and development (R&D) expenses, sales and marketing expenses, general administration (G&A) expenses and stewardship expenses would be fully deductible. The JCT, by contrast, would disallow deductions for R&D, G&A and stewardship expenses, as well as interest expense, to the extent allocable to exempt CFC earnings, a proposal we think is misconceived and inappropriate.

Under the JCT proposal, the amount of R&D expenses allocated to foreign-source income would be further allocated, first, to taxable royalties and

[4] Such an approach is used in Australia, where the rules, in the absence of tax treaty relief, look through to tax gains on the sale of assets that give rise to Australia's equivalent of subpart F income, to the extent of the gain on the sale of shares (each in proportion to the shareholder's percentage ownership of the company).

similar payments (e.g., cost-sharing or royalty-like sale payments), and then, pro rata, to exempt and non-exempt CFC earnings.[5] However, allocating R&D expenses to exempt CFC earnings ignores the fact that the CFC has separately paid a royalty (or similar payments) for the use of any intangible property created by R&D and that this royalty would be taxable in most cases. Given this fact, R&D expenses should be allocated only between non-exempt foreign source income and domestic source income. Allocations to non-exempt foreign source income should be tolerable because that allocation would only affect the FTC on that income (e.g. royalties and interest), which would likely only be subject to withholding tax; hence, U.S. companies would almost always have FTC limitations in excess of creditable foreign taxes.

The JCT proposal to allocate G&A expenses suffers from essentially the same oversight. The JCT would allocate G&A expenses to exempt CFC earnings in the same proportion that exempt CFC earnings of the group bears to overall earnings of the group. However, under section 482 principles as reflected most recently in the proposed rules for pricing intercompany services,[6] multi-national companies are required to and should be charging out G&A services, and thus CFCs would have separately paid for (and U.S. parents would have paid taxes on) reimbursed G&A expenses. The same section 482 charge-out requirements apply to sales, marketing and other services that may be performed by U.S. companies for their foreign affiliates.[7] Since all income reflecting G&A, sales and marketing, and other services expenses is subject to U.S. tax, all related expenses used to generate such income must be deductible to avoid overtaxation.

Thus, a principled approach to a territorial system dictates that R&D, sales and marketing and G&A expenses not be allocated to exempt CFC income. Further, sound policy dictates that Congress should not create disincentives for companies to keep R&D and G&A jobs at home, given the importance of the service sector to the U.S. economy. A similar policy argument favors not allocating stewardship expenses to exempt CFC income. While stewardship is a "no charge" activity under section 482, the revenue raised by allocating this relatively small amount of expense is arguably not worth the added complexity and the increased risk of losing such jobs to low-tax jurisdictions.

We acknowledge that today many foreign jurisdictions do not permit U.S. companies to charge out their G&A costs. To deal with this issue, the proposal might also include an expansion of permitted cost sharing agreements under

[5] R&D expenses would first be allocated between U.S. and foreign-source income under rules similar to those of present law. *See* Sec. 864(f).

[6] *See* Prop. Reg. §1.482-9

[7] As Treas. Reg. §1.482-2(b)(1) states, "Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge … the district director may make appropriate allocations to reflect an arm's length charge for such services."

section 482 to G&A expenses. Alternatively, we could mirror a number of other territorial systems and suggest a proposal that allows for a modest cutback on the exemption (say, a 97 percent exemption) as a proxy for disallowing expenses allocable to exempt income. This approach also has the benefit of achieving increased simplification**.**

Allocation of Interest Expense: Some allocation of interest most likely would be necessary to prevent U.S. companies from financing with debt at home and using only equity financing abroad. The rules of allocation proposed by the JCT – adopting immediately the interest allocation changes made by the American Jobs Creation Act of 2004 --- appear to be relatively fair and workable, although several technical changes to the statute are likely to be necessary.[8]

Loss of Cross-Crediting

Under the current system, taxpayers that repatriate high-tax earnings can often use excess FTCs arising from these repatriations to offset the U.S. tax on lower-tax items of foreign source income, such as royalties received for the use of intangible property. Under a territorial system such "cross-crediting" of higher-tax dividends with lower-tax royalties or interest would no longer be possible because the high-tax dividend would be exempt.

The loss of cross-crediting will result in an effective tax increase on royalty income and consequently on the activities generating such income, including R&D. Consideration must be given to changes that would avoid the effective tax increase on royalty income inherent in a territorial system. For example, one option might be to reduce the tax rate applicable to royalties such as taxing royalty income received by corporations and individuals at a 15% rate, consistent with the treatment of capital gains and dividends for individuals.[9] Such action to address this concern would also reduce the likelihood that royalty-generating activities will be lured to other countries offering significant tax and economic incentives for investments in such activities. The panel must bear in mind that the global competition for high-paying R&D and similar "21st Century" jobs is intense – action should not be taken that undermines the ability of the U.S. to ensure these jobs are created and retained within the United States. Further, to the extent any revenue remains available from the adoption of a territorial system, such revenue should be used for further reduction in the tax rate applicable to royalties, other enhanced R&D incentives or for reduction in the U.S. corporate income tax rate.

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[8] *See, e.g.*, American Jobs Creation Act of 2004, Pub. L. No. L 108-357, § 401 (codified as amended in § 864(f)(1)(B)) (2004). Following these rules, the JCT proposal would allocate interest expense first between U.S. and foreign-source income. The amount of interest expense allocated to foreign-source income under these rules then would be further allocated between exempt CFC earnings and other foreign-source income on a pro rata basis, based on assets. The current interest allocation rules still need to be amended to deal with related party debt.

[9] France has a regular corporate rate of about 34 percent but levies a reduced rate of 19 percent on royalty income from patents.

Transition Matters

By allowing exemption only with respect to CFC earnings generated after the effective date and applying the present-law system to pre-effective-date earnings, the JCT proposal creates undue complexity. We believe a simpler alternative would be to provide for a 5-year phase-in period, during which time companies could make a one-time, permanent election into the territorial system. After five years, the territorial exemption system described above would become mandatory for all taxpayers. Exemption would begin with election-year CFC E&P, while prior years' E&P would receive simplified section 965 treatment (simplified by the repeal of the APB 23 limitation, the Domestic Reinvestment Plan and related rules, the base dividends requirement, etc.) This 5-year phase-in approach would have the advantage of giving companies the flexibility to use up any accumulated FTCs during the transition period (without any section 965 credit disallowance prior to election) and providing companies with sufficient time to complete the necessary tax planning to prepare for a territorial system.

Treaties

Existing treaties generally require the U.S. to allow FTCs for taxes paid to the foreign treaty partner. Legislation adopting a territorial system would supercede these treaties. Revisions to these treaties would thus have to be negotiated to reflect the U.S. conversion to a territorial exemption system, but such negotiations could be done in the ordinary course of negotiations over time, given that no treaty partner is likely to terminate a treaty on the grounds that the U.S. is providing an exemption in lieu of an FTC. The JCT proposal shares this perspective.

Conclusion

Territoriality, if done right, can achieve greater tax simplification and global competitiveness. We believe a territorial tax system based upon the key principles discussed above is the best approach, i.e., (a) two categories of foreign income (foreign income exempt from taxation and foreign income taxed under a modernized subpart F), (b) allowance of most critical business expenses (some allocation of interest; no allocation of R&D, sales and marketing, G&A and stewardship expenses), (c) a lower rate of tax applicable to royalty income to provide an incentive for U.S.-based R&D (and to ameliorate the costs of the loss of cross-crediting), and (d) extended and practical transition rules (allowing taxpayers to plan for the loss of cross-crediting and other implications). Any territorial exemption proposal made by the Tax Reform Panel should include these key principles so that the potential advantages of a territorial system can be realized.