SEMICONDUCTOR INDUSTRY ASSOCIATION

September 3, 2021

Comments of the Semiconductor Industry Association (SIA) on the Senate Finance Committee draft of legislative text, "*Modification of Rules Relating to the Taxation of Global Income*

SIA appreciates the opportunity to provide comments regarding the international tax proposals outlined in the recently released discussion draft of legislative text, *Modification of Rules Relating to the Taxation of Global Income* (the "Discussion Draft").[1]

As you know, this is a critical time for the U.S. semiconductor industry. There is growing bipartisan recognition of the strategic nature of the semiconductor industry and the need to maintain U.S. leadership in semiconductor R&D, design, and manufacturing technology. But the industry faces strong global competition challenging this leadership. In 2020, only 12% of global semiconductor manufacturing capacity was in the United States, down from 37% in 1990 due mostly to massive overseas incentives ranging from full/partial tax holidays, favorable loans, reduced utility costs, and direct global subsidies.[2] And while global demand for semiconductors is anticipated to require a 56 percent increase in manufacturing capacity over the next 10 years, our analysis indicates the U.S. share of manufacturing will continue to decline to only 10 percent of the global share by 2030 without government incentives to make the U.S. a more competitive destination to invest. In addition to providing well-paying jobs, semiconductors are crucial in the supply chain of all modern electronics we use in our daily lives and will enable the technological advancements of the future like artificial intelligence, quantum computing, clean energy, medical technologies, and 5G/6G. At the same time, while the U.S. semiconductor industry invests heavily to innovate and maintain technology leadership – the industry invests nearly 20 percent of revenues in research and development, amounting to $44 billion in 2020 – our technology leadership is at risk as global competitors increase their own investments.

Congress understands the criticality of our industry to national security, technology leadership, and economic prosperity. Earlier this year Congress authorized incentives for semiconductor manufacturing and investments in semiconductor research as part of the Creating Helpful Incentives to Produce Semiconductors for America (CHIPS) Act in the FY 2021 National

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1 *International Taxation Overhaul Discussion Draft (August 2021)*; *available at* https://www.finance.senate.gov/chairmans-news/wyden-brown-warner-unveil-international-taxation-overhaul-discussion-draft.

2 OECD, *Measuring distortions in international markets: The semiconductor value chain*, *OECD Trade Policy Papers*, No. 234 (2019), *available at* https://doi.org/10.1787/8fe4491d-en. Additional information on semiconductor incentives offered by foreign governments is available at https://www.semiconductors.org/global-governments-ramp-up-pace-of-chip-investments/. Semiconductor Industry Association and Boston Consulting Group, *Government Incentives and U.S. Competitiveness in Semiconductor Manufacturing*: https://www.semiconductors.org/wp-content/uploads/2020/09/Government-Incentives-and-US-Competitiveness-in-Semiconductor-Manufacturing-Sep-2020.pdf. (September 2020).

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Defense Authorization Act,[3] and a strong bipartisan majority in the Senate passed funding of the CHIPS Act as part of the U.S. Competitiveness and Innovation Act (USICA) in June of this year.[4] Funding for the CHIPS Act, along with the bipartisan Facilitating American-Built Semiconductors (FABS) Act (S.2107), which would provide an investment tax credit (ITC) for the industry, would strengthen the competitive position of the U.S. semiconductor ecosystem at this critical time.

SIA is concerned these positive steps could be neutralized and our competitive position further degraded by the Discussion Draft. To better explain the impact of the Discussion Draft on our industry, we offer these comments for your consideration.

First, SIA would like to commend the Committee on several aspects of the Discussion Draft which it believes significantly relieve the inappropriate outcomes under current law. Namely, we applaud the proposal to restore the full value of general business credits in the context of the BEAT. While we urge the Committee not to impose a "haircut" for foreign tax credits associated with subpart F and foreign branch income, as discussed below, we very much appreciate the Committee's consideration of removing the 20% haircut for foreign tax credits attributable to the foreign income taxed under the so-called global inclusion of low-tax income regime ("GILTI"). Further, we appreciate the Committee's interest in addressing potential timing mismatches in applying country-by-country rules.

The remainder of our comments focuses on the proposed modifications to the foreign-derived intangible income regime ("FDII"), as well as to other proposals relating to GILTI, subpart F and foreign branches. These comments are summarized immediately below:

- The current law version of FDII is critically important to supporting innovation in the United States, which in turn promotes domestic jobs in research and development, manufacturing, and other productive activities. Accordingly, we believe that the FDII regime should be retained without modification.
- We encourage the Committee to reconsider the proposed repeal of the qualified business asset investment ("QBAI") exemption from GILTI. The QBAI exemption is consistent with emerging international standards coming out of the OECD Pillar Two work and serves as a way of recognizing that foreign operations of US companies are entitled to a routine return on their real investment free from U.S. taxation in addition to applicable local tax.
- Moreover, we urge the Committee to reconsider the exigency with which it seeks modify the current GILTI regime to align it with the international standards being developed in the OECD's Pillar Two work. The United States is the only major economy that has already enacted a form of a global minimum tax, and exacerbating the existing rules before the other trading partners move forward with implementing an as-yet unagreed OECD framework would put US companies, and the US economy, at an even bigger disadvantage.

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[3] Pub. L. No. 116-283, § 9902 (2021)

[4] United States Innovation and Competition Act (USICA) of 2021, S. 1260, 117th Cong. § 1002 (2021)

- Finally, as noted above, we would encourage the Committee to reconsider applying a foreign tax credit haircut in the context of the subpart F and foreign branch rules. The concerns that led to the 20% GILTI haircut do not apply in the case of foreign earnings taxed at full U.S. rates, and reducing the foreign tax credits available would simply result in double taxation of these earnings – an outcome that Congress has repeatedly sought to alleviate via continued endorsement of the credit (as opposed to the exemption) method.[5] To the extent parity is important, the 20% GILTI foreign tax credit should be eliminated.

<u>FDII</u>

SIA urges the preservation of the current law version of FDII without modification. As previewed in the White Paper[6] released earlier this year, the Committee remains critical of FDII and asserts that by providing a preferential rate on intangible income determined in a formulaic manner, FDII encourages the offshoring of tangible assets. The Discussion Draft proposes to refocus FDII by providing a benefit measured by reference to domestically incurred innovation expenses, determined by reference to research and experimental (R&E) expenditures taken into account under section 174 and those related to worker training. An amount equal to a share of innovation expenses will be treated as deemed innovation income, a concept that will replace that of deemed intangible income currently contained in FDII. The Discussion Draft is still preliminary in nature and does not provide what share of such expenses will be deemed innovation income subject to a preferential rate or provide the preferential rate.

We share the Committee's goal of encouraging productive U.S. investments and activity. And we believe the key elements of current-law FDII provide a critical incentive to engage in productive domestic activities, with substantial positive spillover effects on U.S. investment and jobs. Providing a preferential rate on intangible income, consistent with the analogous systems of many major U.S. trading partners, encourages and rewards successful research and development, domestic manufacturing, and other productive activities that result in innovation without prescribing the specific types of activities that merit a benefit. Innovation can result not only from research and development, but also from design, engineering, manufacturing, marketing, management, and other activities related to the operation of a business, all of which incidentally produce advances and positive externalities. These advances generate the supernormal profits that are widely recognized to be attributable to intangible property creation and ownership. Providing an incentive to develop and own intangible property in the U.S. provides positive effects on the domestic economy by encouraging and supporting the location of related activities, including manufacturing of products utilizing the intangible property. In this respect, FDII complements the expenditure-based preferences already enshrined in the tax Code, such as the research and experimentation credit, other general business credits, and accelerated cost recovery. Income-based benefits and expenditure-based benefits incentivize productive activities

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[5] *See, e.g.*, Sen. Rep. No. 94–938, Part I, Tax Reform Act of 1976, P.L. 94–445, § 1031(a).

[6] *Overhauling International Taxation: A framework to invest in the American people by ensuring multinational corporations pay their fair share (April 2021)*; *available at* https://www.finance.senate.gov/imo/media/doc/040121%20Overhauling%20International%20Taxation.pdf.

and investment in different ways, and together can contribute to a positive tax environment that encourages productive U.S. activities and investment.

To predicate foreign derived innovation income on R&E expenditures diminishes the value of the current law income-based benefit and will inhibit the industry's ability to make continued significant investments. Since FDII's enactment, taxpayers in the semiconductor industry have restructured operations to repatriate valuable IP; announced $56 billion of investments in domestic manufacturing facilities over the next several years; and made commitments to continue investing in domestic research and development activity in an effort to alleviate supply chain pressures brought to bear by the COVID-19 pandemic. These trends are consistent with independent analyses that have found that U.S. technology companies have shifted IP ownership, and the accompanying activities and profits back to the U.S. as a result of FDII and related changes put in place in 2017.[7] To repeal FDII only four years after it was introduced, when positive results are being achieved, is short-sighted and disregards the significant, long-range investment commitments that taxpayers have made – oftentimes largely in reliance on the benefit.

Finally, we would like to raise serious and legitimate concerns with respect to the administrability of the Committee's proposal, particularly as it relates to expenses tied to worker training. The Discussion Draft calls for several types of expenses attributable to, *inter alia*, employer-sponsored training programs; community college degree programs; and certified apprenticeship programs, some of which are determined by reference to non-tax statutes. In light of the significant and well-documented resource constraints under which the IRS is currently operating, we are concerned that the audit burden will only be increased with the fact-intensive and onerous criteria proposed as determinants of eligibility for the deduction. Further, the Discussion Draft calls for worker training expenses only for employees making no more than $82,000 annually. In an industry such as ours, most entry-level positions involved in companies' efforts to continuously innovate are compensated above that cap, as that is the level of remuneration demanded by a competitive market.

In light of the foregoing policy and practical concerns, we reiterate our position that current law FDII should be preserved.

<u>GILTI</u>

The Discussion Draft proposes to repeal the exemption attributable to ten percent of the qualified business asset investment ("QBAI") under the current GILTI framework, and further proposes to determine the net tested income of CFCs on a country-by-country basis. As an initial matter, we urge the Committee to avoid forging ahead with undue haste to enact modifications to conform the existing provision to international standards that have yet to be agreed upon, let alone implemented, among our global trading partners. The U.S. was the first to adopt a version of a global minimum tax, in the form of current law GILTI, and in the intervening four years, no

[7] See Martin Sullivan, Big Tech Is Moving Profit to the United States, Tax Notes posted on August 23, 2021 (noting that "domestic profits as a share of combined worldwide profits for 20 tech companies from 2016 through 2020 jumped…15 percentage points in 2020 (from about 40 percent to 55 percent").

other trading partner has adopted a similar rule into its domestic law. Before the Committee seeks to make modifications to current law GILTI that would in fact render it harsher than its analog under the OECD Pillar Two framework, it should wait to determine whether, to what extent, and how soon the OECD discussions will result in actual enactment of income inclusion rules across the globe.

Further, the proposed QBAI repeal reflects the Committee's belief that the formulaic calculation of intangible income results in an incentive to offshore tangible assets, such as factories and buildings, a belief to which we vigorously object and for which there is no supporting data. In the GILTI context, the exemption amounting to ten percent of a US shareholder's pro rata share of CFCs' QBAI is meant to approximate a routine return on the investment in tangible property used to generate tested income.[8] Moreover, to the extent taxpayers may feel incentivized to enter into transactions meant to artificially increase QBAI to increase their portion of exempted income, Treasury has issued and finalized anti-abuse regulations permitting the IRS to disregard such transactions.[9] To repeal QBAI would in fact render our international tax regime even more of an outlier among developed countries in that it would be the only country to subject all of a CFC's active foreign earnings to US taxation – moving the country in the wrong direction. Moreover, it is noteworthy that the international standards under development in the OECD Pillar Two work contemplate the inclusion of substance based carve-outs analogous to, and in some ways more generous than, the QBAI exemption.

Moreover, in calculating the effective tax rates of foreign operations to determine whether income qualifies for the proposed high-tax exclusion, we encourage the Committee 1) to give due regard to ways in which the impact of losses incurred might be mitigated to avoid harsh and uneven results year-over-year; and 2) reconsider the impact a foreign tax credit haircut would have on the effective tax rate calculation. With regard to losses, carryforward or credit regimes would help smooth out the impact of losses for cyclical businesses and more clearly reflect the reality of business operations. And we would encourage the Committee to accord the foreign taxes paid on GILTI their full value in the context of the effective tax rate calculation, to avoid the distortive effects the proposed approach would have. If a portion of the foreign taxes paid on GILTI are disallowed when calculating the effective tax rate, double taxation will result on that income to the extent the high-tax exclusion is not satisfied.

Finally, we encourage the Committee to fully consider the increased administrative burden the IRS will be facing, given the complexity introduced by the introduction of country-by-country calculations and a revised approach to the high tax exclusion determination. As discussed in the context of FDII, the IRS is already facing significant resource constraints and even if additional funds are appropriated, they will be immediately spent on personnel training, new forms and other administrative costs associated with enforcing novel tax laws.

Subpart F/Foreign Branches

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[8] *See,* Senate Budget Committee, S. Prt. 115-20, *Reconciliation Recommendations Pursuant to H. Con. Res. 71,* at 373.

[9] *See, e.g.,* the temporary ownership and disregarded basis rules under Treas. Reg. § 1.951A-3(h) (2019).

The Discussion Draft contemplates a possible haircut to foreign tax credits attributable to subpart F and foreign branch income, in an amount ranging from zero to 20 percent. It is not clear why parity is an objective in this context, given that subpart F and foreign branch income are subject to taxation currently at full U.S. rates. To the extent parity is desired, the current law 20 percent GILTI foreign tax credit haircut should be eliminated, especially if an increase to the GILTI rate and a country-by-country approach are being contemplated. The purpose of the GILTI foreign tax credit haircut was to discourage foreign countries from imposing "soak up" taxes to bring foreign rates up to a level just high enough to absolve foreign subsidiaries of any potential GILTI liability. That objective seems irrelevant in the current policy environment, given that a stated purpose of the OECD Pillar Two work, which the Administration endorses, is to encourage countries to adopt minimum tax systems. Foreign tax credit haircuts result in double taxation of the same income, undermining the congressionally sanctioned mechanism to alleviate double taxation.

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We commend the Committee for leading the way by inviting public comments on your Discussion Draft and look forward to working with you as substantive details are refined and considered.

Please contact Erik Pederson at epederson@semiconductors.org with any questions or comments you may have.