

January 17, 2014

The Honorable Max Baucus
Chairman, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Baucus:

The **Semiconductor Industry Association** (“SIA”) appreciates the opportunity to provide the Committee with comments on the international tax reform and cost recovery discussion drafts (“Drafts”) released in November 2013. We commend you, other Senators and your staff for the work put into the Drafts and the ongoing efforts to improve our tax system. SIA supports efforts to lower the U.S. corporate rate and move toward a territorial international system, but we are concerned that some proposals would harm the U.S. semiconductor industry and impose potentially crippling compliance burdens.

Background on the U.S. Semiconductor Industry

America’s semiconductor industry is critical to our country’s economic growth and recovery. Semiconductors are the fundamental enabling technology for the modern economy and an essential component of our nation’s defense and homeland security, information technology, global finance, transportation, and health care. Our industry has over half of its wafer fabrication capacity located in the U.S., and more than 80% of its sales are outside the United States. Semiconductors have been the United States’ number two manufactured export from 2008 through 2012.

Our industry directly employs nearly 250,000 Americans, at an average salary of \$121,000 – almost 2.5 times higher than the U.S. average. In 2012, U.S. semiconductor companies generated \$146 billion in sales, and the industry supports more than 1 million additional American jobs. In 2012, the industry invested \$32 billion into research and development – 22 percent of sales – and 6 of the top 15 corporate patent recipients were semiconductor companies.

Semiconductor companies generally fall into one of three business models. One consists of companies that own and operate their own manufacturing facilities located in the U.S. and other countries. They invest in operations that perform research and development (R&D) related to product design and manufacturing processes, as well as manufacturing and marketing. Their wafer fabrication facilities are in many cases multi-billion dollar investments representing the most advanced and most costly manufacturing operations in the world.

The second business model includes “fabless” semiconductor companies. They engage in product-related R&D, design and marketing. They contract foundries to manufacture wafers and perform assembly/test. This business model began appearing 25 years ago, when companies capable of manufacturing semiconductor devices from customer designs began to emerge. The evolution of this business model brought on a new era for the industry. Previously, a company could not have access to manufacturing capacity without investing a substantial amount of capital in wafer fabrication and assembly/test facilities. This was a significant barrier to entry into the semiconductor business. However, the evolution of the fabless business model allowed small start-up companies with the ability to develop and market creative new products to have access to manufacturing capacity.

The third business model is the foundry business. Customers bring them designs and they manufacture the semiconductors. They do not develop and sell their own products in the marketplace. Foundries engage in R&D related to manufacturing. In some instances they also help customers with product designs. The foundry business model began with foreign companies headquartered in Asia, and these companies have grown significantly. Today, they are both foreign and U.S. companies; however, they conduct most of their manufacturing services outside the United States.

U.S. semiconductor companies have seen the global markets for their devices grow significantly over the past several decades. Consequently, the industry has had a presence in foreign countries for many years in the form of controlled foreign corporations (“CFCs”) which are the entities through which U.S. chip companies participate in markets and operate abroad. The industry has in particular experienced a high growth rate in markets and operations in Asia, which is not surprising given the high growth rates of Asian economies. Operations include marketing, R&D, manufacturing (which involves wafer fabrication, assembly of wafers into finished semiconductor devices and testing of the devices) and management of vendors that perform manufacturing services under contract (generally referred to as foundries).

We would like to draw the Committee’s attention to the fact that the tax policies of other countries present two tiers of competition for the U.S. semiconductor industry. The first tier is the competitive pressure we face along with other U.S. industries because many foreign countries have more attractive tax systems. The U.S. currently has the highest corporate tax rate in the Organization for Economic Cooperation and Development (OECD). In addition to lower rates, most other OECD countries have a territorial tax system, which means that when their companies invest in subsidiary operations in another country, the tax imposed by that other country on the earnings from the investment will generally be the final tax imposed. Home country tax generally does not apply when the earnings are repatriated. Finally, the U.S. research tax credit has fallen far behind the incentives for research offered by other countries and is currently expired. These features of other tax systems – lower rates, a territorial system and strong research incentives – are imbedded in the tax laws of other countries and are available to any taxpayer with transactions that qualify.

Additionally, a second tier of competitive pressures for our industry come from special incentives that are given selectively by governments to taxpayers that bring to the country strategic investments. In our case, governments offer incentives for locating wafer fabrication, assembly/test or R&D. These incentives include full or partial “tax holidays” and other benefits such as loans and reduced utility costs. Countries target the semiconductor industry because they understand that semiconductor manufacturing and R&D operations have a significant positive “spillover” effect on their economies in the form of employment in high tech jobs and the development of an engineering and technology infrastructure. Over time, a package of these incentives usually results in a substantial cost advantage for an operation, compared to a similar operation without one.

SIA Principles for Tax Reform

In light of the competitive pressures that result from the relative weaknesses of the U.S. tax system, SIA believes that the objective of tax reform should be improving the ability of U.S. companies to compete effectively against foreign peers in the global marketplace.

Gregory Lang, President and CEO of PMC-Sierra, Inc., testified on behalf of SIA before the Finance Committee on July 27, 2011. In his testimony, Mr. Lang stated that SIA’s objective for tax reform was a competitive U.S. tax system resting on three key elements. SIA’s tax reform priorities remain the same as those presented in July 2011:

- A significantly lower and competitive corporate tax rate of 25% or less;
- A competitive territorial tax system; and
- Incentives for research and innovation including a permanent and enhanced R&D tax credit and an innovation box, which would be competitive with similar incentives in other countries.

SIA believes that these three reforms will make the U.S. economy and U.S. semiconductor companies more competitive in the global marketplace. In light of the significant changes needed in these areas, we believe that any and all revenue, including transition revenue, derived from changes to the tax code must be reinvested into corporate tax reform to encourage U.S. investment in manufacturing and innovation.

SIA Comments on the Chairman’s Discussion Drafts

We applaud the Chairman for releasing proposals and advancing the cause of tax reform. We are pleased that the discussion drafts embrace a corporate rate reduction as well as movement towards a territorial system. However, several provisions in the drafts would significantly reduce the ability of U.S. semiconductor companies to effectively compete with their foreign peers. SIA is particularly concerned with the proposed expansion of Subpart F to include subsidiaries’ income from direct and indirect sales into the U.S. We also offer comments on the proposed 20 percent tax on accumulated deferred foreign earnings,

changes to U.S. research incentives, repeal of foreign source income title transfer, and elimination of the check-the-box rules.

SIA applauds the drafts’ proposed corporate tax rate reduction and movement toward a territorial international system. As noted above, the U.S. currently has the highest corporate tax rate in the OECD and most OECD nations employ a territorial system. In order for the U.S. to maintain its global leadership in high-tech manufacturing, we must move to an OECD-competitive corporate rate of 25% or less. While a focus on the OECD average tax rate is useful, it’s important to note that U.S. semiconductor companies do not generally compete with companies headquartered in those countries. Our top international competitors are outside of the OECD and their average tax rate is significantly lower. This creates strong competitive advantages for foreign semiconductor companies and we support the Chairman’s efforts to address these critical areas.

Exhibit I below is a simple example of the potential effect from different tax rates. It compares the net profit (i.e., profit after tax) from an investment that earns a hypothetical \$1,000 profit before tax in the U.S., which is subject to a 35% tax rate, to similar profit streams in countries where the rates are 25% (OECD average rate), 12.5 percent (e.g., the corporate rate in Ireland) and zero (e.g., a tax holiday in Singapore). It shows, for example, that a tax holiday can (by virtue of the tax differential) produce 54 percent more profit than U.S. operations.

Exhibit I – An Example of International Tax Treatment

Earnings	U.S.35% Tax Rate	Country With 25% Tax Rate	Country With 12.5% Tax Rate	Country With Tax Holiday
Profit before tax	\$1000	\$1000	\$1000	\$1000
Tax	350	250	125	0
Profit after tax	650	750	875	1000
% of foreign profit increase over US profit	-0-	15%	35%	54%

The economic consequences of this after-tax income differential result in our competitors having more funds for investment, more for R&D, and more of a profit cushion so they can drop prices when competing against U.S. semiconductor manufacturers. And importantly, if cash flow from our overseas operations is more valuable in their hands than in ours simply because of tax differences such as a worldwide versus territorial system, it is likely that, over time, they will seek to acquire our operations, or more U.S. economic activity will migrate offshore. With higher after-tax profit margins, cost of capital is reduced creating financing, offshore hiring, and capital investment advantages. Corporate tax reform must attempt to level the multinational competitive landscape for U.S. companies and reinstate the U.S. as an attractive investment location by reducing the U.S. corporate tax rate and moving toward a territorial international tax system.

Returning and Retaining U.S. Intangible Property

SIA supports a temporary transition rule to allow U.S. multinationals to bring intangible property held by their foreign subsidiaries back to the United States on a tax neutral basis. To encourage intangible property repatriation, tax reform should contain a provision like the “carrot” in House Ways and Means Committee Chairman Dave Camp’s Option C proposal (regarding the taxation of intangible property held by domestic corporations and sold for use outside the U.S.). Otherwise, the incentive remains to transfer or keep intangible property outside the United States.

SIA believes the maximum U.S. tax on income from products and services sold into foreign markets should be no higher than 60% of the U.S. corporate tax rate, and should apply to foreign income earned by a domestic company as well as foreign income earned by a CFC. A low minimum tax on CFC income coupled with the same tax on foreign income earned by a domestic corporation will eliminate the tax incentive to migrate intangible property or move jobs overseas because it will tax the foreign income at the same reduced rate regardless of whether the income is earned by a U.S. company or by a controlled foreign corporation. It would allow U.S. multinationals to bring intangible property held by their foreign subsidiaries back to the United States avoiding foreign tax on the intangible income (and consequently the allowance of U.S. foreign tax credits). A low minimum tax is critical for SIA companies to be competitive in foreign markets where we compete against foreign corporations subject to a territorial system with no minimum tax.

Subpart F inclusion for United States Related Income

SIA is most significantly concerned with Subpart B, Section 03 of Option Y: Inclusion of United States Related Income in Subpart F Income. This would add to Subpart F income “United States Related Income”. United States Related Income (USRI) is defined as imported property income derived in connection with the manufacture, production, or sale of:

1. Property imported by a CFC, or
2. ANY property sold to ANY person if when sold it was reasonable for the CFC to expect that such property would be used in the manufacture or production, or as a component part in, other property which would be imported into the U.S.

Semiconductors are component parts in nearly every product with an on/off switch. They are components in nearly every product in the trillion dollar global electronics market. Nearly all of the \$144 billion 2012 industry revenue was derived from sales of semiconductors that would become components of other property, and more than 80% of industry sales are made outside the United States. SIA is extremely concerned that a large and unquantifiable amount of industry sales could be captured as United States Related Income, imposing an additional level of Subpart F tax that moves the U.S. further away from a territorial system, rather than towards it.

For example, take the case where a semiconductor is sold by a CFC of a U.S. company operating in Singapore to a company in China, which manufactures a sound system for cars. That Chinese company sells its sound systems to car manufacturers in Germany, Japan and Mexico. Those car manufacturers sell some of their cars in the U.S. The proposal would impose U.S. tax on the Singapore CFC profits from semiconductors that end up in cars sold in the U.S. – even when the CFC’s sale may be several transactions removed from the product actually imported into the United States. This result presents two significant problems. First, the additional tax burden raises costs on the CFC operations that a foreign-owned competitor located right across the street with the same product flow would not have. Second, the proposal would impose a potentially crippling compliance burden for U.S. semiconductor companies to determine which of its CFC sales entail a reasonable expectation that the semiconductors would become components in any property imported by any person into the United States. U.S. chip-makers have very little ability to track the final destination of the products for which their chips are components when they are sold to unrelated third party entities, especially when the third party’s products are incorporated into another entity’s end products.

U.S. semiconductor companies are the first link in the global electronics supply chain. We locate manufacturing facilities in foreign locations via CFCs to be close to our customers – foreign companies that use semiconductors as components in their products – since more than 80% of industry sales are outside the United States. Our CFCs and foreign manufacturing locations are not designed to minimize U.S. operations and exports. As noted earlier, our industry employs 250,000 Americans and semiconductors have been the United States’ number two manufactured export from 2008 through 2012. This provision is overbroad and overreaching by attempting to levy additional U.S. tax on components produced and sold abroad to unrelated foreign customers that manufacture abroad. It runs counter to needed reforms moving the U.S. toward a territorial system and would make U.S. semiconductor companies less competitive relative to their foreign peers by seeking to levy additional taxes on income from transactions that do not touch the U.S. market.

At a minimum, this rule should be modified so that it only applies where the CFC knows that a component will be used in the manufacture or production of property in the U.S. The test should be made on an individual component basis (for example where the component has specific design features applicable only for the U.S. market), and should not be applied where a component has been substantially transformed by further manufacturing by an unrelated party. The test should not simply be based on knowledge that the offshore electronics manufacturer imports some of their products into the U.S. market.

20 Percent Tax on All Deferred Foreign Earnings

The proposed 20 percent tax on all accumulated pre-effective date deferred foreign earnings is also a concern for SIA. Semiconductor manufacturing is a very capital-intensive industry where members may have reinvested a significant portion of those earnings in high-cost capital equipment. Companies that have invested in capital assets outside the United States to address the needs of a global marketplace and the cost of capital advantages associated with offshore investment could face a significant tax liability without any corresponding increased cash flow to pay the tax. Although companies would be allowed to pay the tax liability over eight years, it would still impose additional costs and financial statement liability on U.S. companies while their competitors would face no comparable burden during the same period. This may lead to foreign acquisitions of U.S. companies and mergers of U.S. and foreign companies resulting in more offshore headquarters.

SIA opposes this proposal because of the negative impact it will have on the competitiveness of our member companies. We believe the 5.25 percent transition tax on accumulated deferred foreign earnings in House Ways and Means Chairman Dave Camp's proposal is more competitive and workable.

R&D Provisions and Credit Expiration

SIA's third tax reform priority is the creation of robust incentives for research and innovation that are competitive with incentives in other countries. In 2012, the semiconductor industry invested \$32 billion into research and development – 22 percent of sales – and 6 of the top 15 corporate patent recipients were semiconductor companies.

The discussion draft on cost recovery proposed requiring taxpayers to amortize R&D expenditures over a 5-year period rather than allowing the costs to be deducted in the year incurred. Expensing R&D expenditures reflects the tax and accounting realities inherent in bringing a new product to market. With R&D, amounts are expended to create an asset with a future benefit. In most other instances this would result in the capitalization and recovery through amortization of such costs. The inherent issue with expenses incurred in R&D is whether an asset of any value is being (or will be) created. At the time the amounts are expended, such a determination is often impossible. Further, R&D costs usually are

incurred with the goal of creating a new or improved product, service, process or technique, but more often than not, the efforts do not result in success. U.S. GAAP does not require the capitalization and amortization of R&D costs.

Proposals to further limit the ability of companies to deduct the costs of U.S.-based research activities will act as a disincentive to research investment, particularly for small firms with limited cash flow, and combined with the failure to permanently extend and strengthen the R&D tax credit, will put current jobs at risk of moving abroad and jeopardize the expenditure of R&D funds in the U.S.

The draft also noted that the Committee is considering “expanding and making permanent the research and development credit” and requested comments on these proposals. SIA believes that making the credit permanent, retaining the expensing provisions, renewing the research credit retroactively to January 1, 2014, and increasing the alternative simplified research credit (ASC) from 14 percent to 20 percent are all needed to make U.S. policy related to R&D internationally competitive.

The U.S. R&D tax credit is primarily a jobs credit; 70 percent of credit dollars are used to pay salaries of U.S.-based researchers. When the credit was first enacted in 1981, the U.S. was the world’s leader in robust research incentives. However, as the credit has lapsed many times and other nations have begun to offer tax credits up to 40% of research expenses and super deductions up to 200% of expenses, the U.S. has fallen to 24th place in research incentives among OECD nations.

Tax reform must make the U.S. a much more competitive location to perform cutting edge R&D that is the lifeblood of the semiconductor industry, and a vital component of U.S. economic growth and vitality. Proposals to further limit the ability of companies to deduct the costs of U.S.-based research activities and the failure to permanently extend and strengthen the R&D tax credit will put current jobs at risk of moving abroad, and jeopardize the expenditure of R&D funds in the U.S. The certainty of a strengthened, permanent credit and the continued option to deduct research expenses currently rather than amortize those costs over several years, is critical to maintaining U.S. leadership in advanced research and encouraging companies to continue to spend R&D funds here in the United States. SIA urges Congress to pass a seamless, permanent extension of the R&D credit retroactive to January 1, 2014, and to raise the ASC rates from 14 to 20 percent.

Title Transfer Passage for Inventory Property

As noted earlier, the U.S. semiconductor industry is heavily export-oriented. Because of the industry’s capital intensity and product cycles, a tremendous amount of research and development accompanies the manufacturing function. Sourcing income generated from U.S. exports as foreign source income helps to mitigate the tax cost of operating in the U.S. and multiple foreign countries. Repeal of the foreign source income rule would place upward pressure on the after-tax cost of performing manufacturing and related research

activity functions in the U.S. The foreign source income rule helps to mitigate the noncompetitive U.S. corporate rate in a WTO-compliant manner.

U.S. government policies that discourage these domestic activities risk impeding very desirable attributes and drivers in the U.S. economy. The elimination or scaling back of the foreign source income rule will have a negative tax impact on U.S. semiconductor companies that export U.S. manufactured product, and for many companies, this could result in added disincentive to manufacture in the U.S.

Repeal of Check-the-Box Rules

SIA is also concerned with the draft's proposed elimination of parts of the check the box (CTB) rule under which U.S. multinationals can effectively combine certain foreign subsidiaries for U.S. tax purposes. A CTB election allows U.S. multinationals to establish structures that minimize foreign taxes imposed on their operations which are, in many instances, the same structures that foreign competitors establish to minimize their foreign taxes. These structures are viable for foreign competitors because the U.S. tax cost under the Subpart F income rules is generally not imposed on them. A CTB election helps place U.S. companies on a level playing field with foreign competitors by providing an opportunity to minimize those same foreign tax costs. SIA is concerned the proposed repeal would unravel long-standing tax planning tools and potentially harm U.S. multinationals competing in the global semiconductor market.

Conclusion

A strong U.S. semiconductor industry plays an important role in the American economy. Our member companies engage in a wide range of government policy issues all over the world, including tax policy. We recognize and appreciate that the Drafts' proposed steps toward a more competitive corporate tax rate and territorial tax system represent very positive steps for global semiconductor companies. SIA believes that U.S. tax reform should attempt to provide incentives for keeping intellectual property generation and manufacturing in the U.S., and we would be pleased to assist the Committee as it continues in its efforts to improve our tax system.