SEMICONDUCTOR INDUSTRY ASSOCIATION

July 17, 2018

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable David J. Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Lafayette G. "Chip" Harter III
Deputy Assistant Secretary (International Tax Affairs)
Department of the Treasury

The Honorable William M. Paul
Principal Deputy Chief Counsel and Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Douglas L. Poms
International Tax Counsel
Department of the Treasury

Dear Sirs:

The Semiconductor Industry Association (SIA) is the voice of the U.S. semiconductor industry. While SIA supported the Tax Cuts and Jobs Act (TCJA), we believe important clarifications are needed to provide the certainty necessary to comply with the TCJA. SIA respectfully requests the Treasury Department (Treasury) and the Internal Revenue Service (IRS) issue guidance on the allocation and apportionment of research and experimentation (R&E) expenses for purposes of computing both the foreign derived intangible income (FDII) deduction under section 250 of the Internal Revenue Code (Code), as amended by P.L. 115-97, and the Code section 904(d)(1)(A) limitation (relating to the calculation of the Code section 951A inclusion for global intangible low tax income, or GILTI). We ask that Treasury and the IRS consistently apply the expense allocation rules to R&E expenses for both GILTI and FDII determination purposes. The GILTI and FDII were made comparable by design, and therefore the rules governing the two provisions should generally align as they relate to the allocation and apportionment of R&E expenses. In addition, we request formal guidance on various other aspects of the GILTI and FDII determinations, as set forth below.

Global Intangible Low-Taxed Income

U.S.-level R&E expense allocation and apportionment

For purposes of Section 904(a)(1)(D), guidance should be issued confirming that allocation and apportionment of U.S.-level R&E expenses to the GILTI basket is generally not required. R&E expenses, particularly in instances where the ownership of the intellectual property (IP) is in the United States, should only be allocated to classes of income that are directly created or earned by the activities of the U.S. IP owner. Put another way, in these contexts, R&E expenses should not be allocated to the class of income constituting deemed dividends from controlled foreign corporations (CFCs). In particular, when a U.S. parent owns the IP and contracts with its CFCs solely to perform support functions (whether those functions include sales, manufacturing or other support), the only taxpayer benefitting from the income derived from the R&E is the U.S. parent, and not the foreign CFC. In this context, income earned by the CFCs arises solely from their functions, and not from any IP generated by the R&E expenses ultimately borne by the U.S. parent.

We respectfully request that Treasury and the IRS issue guidance clarifying, in the GILTI context, that existing Treasury Regulations allow the taxpayer to allocate R&E expenses only to those classes of income that are reasonably expected to benefit from the underlying research activity. Specifically, under existing Treas. Reg. §1.861-17, the rules require allocation solely to classes of gross income that can "reasonably be expected to benefit, directly or indirectly, from the taxpayer's research expense". Treasury should clarify that if the income of a CFC is not benefitting from U.S.-level research expenses, then U.S.-incurred R&E expenses do not have to be allocated to either deemed or actual dividends received from such a CFC.

Illustrative Example

U.S. Parent (USP) conducts R&E in the U.S. and manufactures and sells product X, both in the U.S. and globally. USP owns all relevant IP. USP engages its wholly owned subsidiary, CFC, to distribute products outside the U.S. USP sells its products to CFC, which in turn sells them to unrelated customers. CFC earns a return based on its sales and distribution functions. Under the new law, at least some portion of CFC's income each year will very likely be treated as a deemed dividend to USP, as either GILTI or Subpart F. USP should not be required to allocate any of its R&E expenses to the class of income constituting deemed dividends from CFC, as that class of income did not benefit from USP's research expenses.

<u>Loss Relief and Recapture</u>

We respectfully request that Treasury and the IRS issue guidance under Section 250 that permits a U.S. corporate shareholder to establish a GILTI recapture account to the extent a Section 250 deduction is disallowed against current year GILTI income as a result of the application of the taxable income limitation in Section 250(a)(2). The GILTI provisions, in combination with the Section 250 deduction, are intended to have an interactive effect so that the rate of tax (whether U.S. or foreign) is comparable. Without a GILTI recapture account, the taxable income limitation of Section 250(a)(2) can result in disparate U.S. cumulative tax based on the timing of when income is generated.

Illustrative Example – unintended tax disparity with no GILTI recapture account

USP generates a <$100x> net operating loss (NOL) in Year 1, $100x operating profit in Year 2, and a $100x GILTI inclusion in Year 3. USP will incur cumulatively $10.50x of U.S. tax (21% of the net $50x GILTI inclusion in Year 3). However, if the sequence of operating profit and GILTI were reversed, USP would incur cumulatively $21x of US tax.

A GILTI recapture account would remove the potential distortion of U.S. tax driven by the timing of losses and income and would ensure equitable tax treatment for U.S. corporate shareholders of CFCs.

Illustrative Example – proposed GILTI recapture account

In Year 1, USP has taxable income of $50x (without regard to the Section 250 deduction), which includes $140x of GILTI and <$90x> of other current year operating losses. The Section 250 taxable income limitation would reduce the $140x of GILTI to $50x for

> purposes of determining the Section 250 deduction allowed for Year 1. USP would establish a GILTI recapture account of $90x. In Year 2, USP has taxable income $200x (without regard to the Section 250 deduction), which includes $80x of GILTI. The 120x of excess taxable income in Year 2 is recharacterized as GILTI limited to the lesser of (i) the total balance in the GILTI recapture account, or (ii) the excess taxable income for this purpose. After applying the GILTI recapture, USP has $170x of GILTI in Year 2, and the ending balance in USP's GILTI recapture account is $0x.

Treasury and the IRS should also consider establishing a recapture account for purposes of the Section 250 deduction related to FDII, as similar distortions can occur based on the timing of when income is generated.

<u>Foreign Derived Intangible Income</u>

Allocation and Apportionment of Expenses for Purposes of Computing FDII

With respect to the allocation and apportionment of expenses for purposes of determining FDII, we request that Treasury and the IRS apply a reasonable and consistent methodology. The regulations should provide that section 250 is an operative section of the Code for purposes of Reg. 1.861-8. The rules established to enforce section 250 should be generally consistent and look to other well-established parts of the Code, such as the section 861 rules. Therefore, in general, a taxpayer should, for FDII purposes, allocate and apportion its expenses under the rules of Reg. 1.861-8 through Reg. 1.861-17.

In the interest of administrative convenience, the regulations should provide the taxpayer the option to use alternative methodologies to properly allocate expenses to determine deduction eligible income (DEI). For example, where a taxpayer's books and records provide additional detail, or where the taxpayer uses its books and records for regulatory purposes, taxpayers should be permitted to allocate expenses in a manner consistent with such books and records, provided that the taxpayer maintains its books and records in the ordinary course of business and that such books and records are unaffected by considerations of tax liability. Specifically, under this alternative methodology, a taxpayer should be able to allocate and apportion selling, general, and administration (SG&A), R&E, and other IP development expenses as reflected in its books and records. Precedent for similar uses of a taxpayer's books and records can be found in regulations under sections 863(b) and 987.

Allocation of FDII Deduction

Treasury and IRS should clarify that the FDII deduction itself is not allocated or apportioned against the net foreign source income in the GILTI basket. As the FDII is designed to be a taxpayer benefit for U.S. activities, it should only be allocated against classes of income giving rise to FDII. Because GILTI income, by definition, cannot give rise to FDII, the FDII deduction should not be allocated or apportioned to the GILTI basket. Under section 861 (Treasury Regulations §1.861-8), Treasury has broad, existing authority to provide the necessary clarification regarding the computation of taxable income from various sources and activities. Treasury has general authority under sections 250 and 861 to write rules in this area.

Foreign Use

Lastly, Section 250(b) (5)(A) defines "foreign use" as "any use, consumption, or disposition which is not within the United States." U.S. semiconductor companies are the first link in the global electronics supply chain. In general, substantial transformation is production that results in a new and different good, which then has a name, character, use, and tariff code different from those of its constituent materials.

The conference report to P.L. 115-97 provides a further explanation of the statute that, if adopted in formal guidance, would give greater certainty. Therefore, we respectfully request that Treasury and IRS incorporate Footnote 1522 of the legislative conference report into formal guidance. The footnote states, *"If property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture or assembly) outside the United States by such person, then the property is for a foreign use."*

Semiconductors are component parts that are substantially transformed in manufacturing processes performed by unrelated parties. For example, a semiconductor may be manufactured by a taxpayer in Ireland and incorporated by an unrelated customer into a new consumer device, such as a smart phone. This new device has a name, character, use, and tariff code different from those of all the rest of its constituent materials, including the semiconductor. We respectfully request Treasury and the IRS implement this guidance as intended by Congress.

We appreciate the time and effort it takes to craft a strong regulatory framework. We are thankful for the opportunity to provide feedback and look forward to answering any questions you may have.

Sincerely,

John Neuffer
President and CEO