SEMICONDUCTOR INDUSTRY ASSOCIATION

Comments of the
Semiconductor Industry Association (SIA)
on
"Guidance Related to the Foreign Tax Credit,
Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act"

83 Fed. Reg. 63200 (Dec. 7, 2018)

[REG–105600–18]

RIN 1545–BO62

Submitted February 5, 2019

The Semiconductor Industry Association (SIA) appreciates the opportunity to submit the following comments to Internal Revenue Service (IRS) on "Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act." 83 Fed. Reg. 63200 (Dec. 7, 2018).

SIA is the trade association representing leading U.S. companies engaged in the research, design, and manufacture of semiconductors. Semiconductors are the fundamental enabling technology of modern electronics that has transformed virtually all aspects of our economy, ranging from information technology, telecommunications, health care, transportation, energy, and national defense. Innovations in semiconductor design and manufacturing have resulted in increasingly smaller, more powerful, less expensive, and more energy efficient semiconductors, which has a "multiplier effect" that drives advancements throughout other sectors of the economy, resulting in increased growth, jobs, and productivity. More information about SIA and the semiconductor industry is available at www.semiconductors.org.

SIA member companies conduct their operations globally. Over 80 percent of revenue of U.S. semiconductor companies is derived from sources outside the U.S. and semiconductors are America's fourth largest export. The semiconductor industry in the U.S. is also characterized by high levels of investment in research and experimentation; on average, nearly 20 percent of revenue is invested in research and experimentation ("R&E"), among the highest percentages of any industry sector. Given this profile, effective and clear regulations governing international taxation and the treatment of R&E are high priorities for the global competitiveness of the U.S. semiconductor industry.

SIA's comments focus on three issues: 1) the allocation and apportionment of R&E expenses for purposes of computing both the foreign derived intangible income ("FDII") deduction under Section 250 of the Internal Revenue Code ("Code"),[1] as amended by P.L. 115-97, 2) the Section 904(d)(1)(A) limitation (relating to the calculation of the Section 951A inclusion for global intangible low-taxed income or "GILTI") and 3) a clarification needed to the Foreign Branch Income Attribution Rule in Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(D) to prevent unexpected and unduly harsh consequences from repatriating IP from a CFC to the U.S. We note that Treasury states they will conduct a comprehensive review of allocation and apportionment rules, including

[1] All "Section" references are to the Internal Revenue Code of 1986.

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for R&E expenses,[2] but we nonetheless believe it is important to include these points in our comments on this proposal.

1. <u>R&E Expenses & GILTI Basket</u>

For purposes of Section 904(d)(1)(A), guidance should be issued confirming that allocation and apportionment of U.S.-level R&E expenses to the GILTI basket is not required unless the controlled foreign corporations ("CFC") has an ownership or beneficial interest (hereinafter referred to as ownership) in the intellectual property ("IP") resulting from the R&E. In instances where the ownership of the IP resulting from the R&E is in the United States R&E expenses 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 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. The CFCs do not reasonably expect to receive any benefits from this effort. Because the CFC's income does not include any return to IP, such income should not attract any R&E expense.

2. <u>R&E Expenses and Sales Method/Gross Income Method</u>

More generally, for purposes of Section 904, guidance should be issued to clarify that the sales method of allocating and apportioning U.S.-level R&E expense takes into account only sales by controlled or uncontrolled parties of products involving intangible property that was licensed or sold by the taxpayer to such parties. Similarly, for purposes of Section 904, guidance should be issued to provide that the gross income method of allocating and apportioning U.S.-level R&E expense takes into account only gross income from the exploitation of intangible property, for example (1) royalty income, or (2) income from sales of a product by a taxpayer that owns or licenses intangible property embedded in the product. The changes to the international tax rules, in particular the changes to the foreign tax credit system, have put additional pressure on the appropriate allocation of R&E expense.

The recommended rule can be illustrated in the following example:

A U.S. company performs R&E and owns all intangible property resulting from the R&E. The U.S. company contracts with a foreign affiliate, CFC 1, to manufacture products using the IP. CFC 1 has no rights to sell the products to third parties. CFC 1 sells these products to U.S. company. U.S. company sells the products to U.S. customers, and to another affiliate, CFC 2, for on-sale to foreign customers. Under the sales method for allocating R&E expense, the sales by CFC 1 and CFC 2 are not considered because CFC 1 and CFC 2 have not licensed or acquired any intangible property resulting from the R&E. The sales of the U.S. company to customers and to CFC 2, and the sales of CFC 2 to customers, are considered, consistent with the current rule against double counting in Treas. Reg. §1.861-17(c)(3)(iii). Under the gross income method for allocating R&E expense, only the gross income of the U.S. company from the sale of products to U.S. customers and to CFC 2 is considered, because neither CFC 1 nor CFC 2 have licensed or acquired any intangible property resulting from the R&E.

[2] See 83. Fed. Reg. at 63201.

It should also provide that the election to use either the sales or gross income method be made on an annual basis.

3. R&E Expenses and Gross Income Method

For purposes of Section 904, guidance should be issued to clarify that the gross income used for allocating and apportioning U.S.-level "R&E" under the gross income method does not include gross income that is treated as exempt income based on the section 250 deduction. This is consistent with the rule in Proposed Treas. Reg. §1.861–8(d)(2)(ii)(C)(1). An explicit reference to this rule should be provided in Treas. Reg. §1.861-17(d), or an explicit reference to Treas. Reg. § 1.861-17(d) should be provided in Proposed Treas. Reg. §1.861–8(d)(2)(ii)(C)(1).

4. Section 960 Subpart F Income Groups

Prop Treas. Reg. §1.960-1(d)(2)(ii)(B) creates multiple general limitation subpart F income groups for purposes of Section 960(a). The proposed regulations provide that no foreign taxes attributable to a subpart F income group are deemed paid by the U.S. shareholder unless there is positive net subpart F income in that subpart F income group. This can result in stranded foreign taxes due to timing differences even when there is a general limitation subpart F inclusion, thereby resulting in double taxation of general limitation subpart F income over time.

SIA recommends that the IRS should issue guidance to provide that all items of general limitation subpart F income should be considered one item for purpose of determining whether foreign income taxes are "properly attributable" to subpart F income under section 960(a).

5. Foreign Branch Income Attribution Rule in Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(D)

Prop. Treas. Reg. §1.904-4(f)(2)(vi)(D) requires income arising from intangible property that has been transferred to or from a foreign branch to be attributed back to the foreign branch or foreign branch owner. This rule should be modified so that it does not unfairly negatively impact companies based on the form in which they repatriated, or the form in which they will repatriate, IP from a CFC to the United States.

If the form of IP repatriation was to A) check the box on a CFC and then immediately transfer the IP to a U.S. corporation (Form A), rather than to B) transfer the IP to a U.S. corporation and then check the box on the CFC (Form B), under a literal reading, the proposed regulation would result in increased foreign branch income for the U.S. corporation, with the U.S. corporation's Section 250 deduction for FDII being correspondingly reduced. In Form A, there is a transitory "ownership" of the IP by the branch and no basis step up, but in Form B, the branch never "owns" the IP, the U.S. corporation may get a basis step up, and Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(D) does not apply.

A goal of the 2017 tax legislation was to disincentivize taxpayers from keeping IP offshore. Consistent with this goal, many companies repatriated, or are currently contemplating a repatriation of, IP (and associated income) to the United States to reduce foreign taxes and address BEPS concerns by aligning IP profits with the so-called DEMPE functions. While these companies considered it worthwhile for the income to be taxed at the higher FDII rate rather than the Global Intangible Low-Taxed Income ("GILTI") rate to reduce foreign taxes and address BEPS concerns, they did not expect and could not have reasonably expected the income to be assigned to (and taxed in) the foreign branch income basket. Repatriating IP to the U.S. should be regarded and not resourced as foreign branch income regardless of the ordering or form of this transfer.

The stated purpose of the reattribution provision of the proposed regulation is to guard against "non-economic reallocations of gross income attributable to the foreign branch category." There is no non-economic reallocation in repatriation Form A): the U.S. corporation simply repatriated IP to the United States which was a goal of Congress in enacting the FDII deduction and aligns with BEPS concerns.

We believe Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(D) should be clarified to exclude transfers of IP from a CFC to a U.S. corporation where the IP is transitorily owned by a branch, as in Form A). Our suggestion for revision is:

(D) *Certain transfers of intangible property.* For purposes of applying this paragraph (f)(2)(vi), the amount of gross income attributable to a foreign branch (and the amount of gross income attributable to its foreign branch owner) that is not passive category income must be adjusted under the principles of paragraph (f)(2)(vi)(B) of this section to reflect all transactions that are disregarded for Federal income tax purposes in which property described in section 367(d)(4) is transferred to or from a foreign branch, whether or not a disregarded payment is made in connection with the transfer. ***Transitory ownership by a foreign branch that neither enhances nor exploits the section 367(d)(4) property will not be considered a transfer for purposes of this paragraph (f)(2)(vi)(D).*** For purposes of this paragraph, transitory ownership shall be considered ownership for a period of 10 days or less. In determining the amount of gross income that is attributable to a foreign branch that must be adjusted by reason of this paragraph (f)(2)(vi)(D), the principles of sections 367(d) and 482 apply. For example, if a foreign branch owner transfers property described in section 367(d)(4), the principles of section 367(d) are applied by treating the foreign branch as a separate corporation to which the property is transferred in exchange for stock of the corporation in a transaction described in section 351.

The treatment could also be clarified in an example:

Proposed Treas. Reg. §1.904-4(f)(2)(i) Example (4) Certain transfers of intangible property:

(A) Facts. P, a domestic corporation, owns FDE, a disregarded entity that is a foreign branch within the meaning of paragraph (f)(3)(iii) of this section. FDE's develops and exploits property described in section 367(d)(4), which it transfers to P for exploitation by P. Under Proposed Treas. Reg. §1.904-4(f)(2)(vi)(D), income of FDE must be increased and income of P must be decreased annually to reflect the income earned by A from the transferred intangible property.

(B) Facts. P, a domestic corporation, owns CFC1, a regarded foreign entity. CFC1 develops and exploits property described in section 367(d)(4). In order to repatriate the intangible property to the US, P makes an election to treat CFC1 as a disregarded entity. The next day CFC1, which has become an FDE, distributes the IP to P. Since the ownership of the IP by FDE is transitory and the IP was neither enhanced nor exploited by FDE, no gross income is adjusted under Proposed Treas. Reg. §1.904-4(f)(2)(vi)(D) because of the transfer.

6. Notice 2019-1, Section 3.02 Ordering Rule for Distributions of Section 965 Previously Taxed Earnings & Profits (PTEP)

Notice 2019-1 (the "Notice") generally provides that the distributions come out of the various PTEP groupings on a last-in/first-out basis, consistent with rules for distributions more generally. This ordering has been in existence for over fifty years in the Code and Regulations. An exception to this rule is now provided for Section 965 PTEP – distributions are treated first as coming out of 965 PTEP, and then on a LIFO basis from the other groupings. We think this is revenue driven given the FTC haircut for withholding taxes on distributions of 965 PTEP.

SIA recommends that the IRS should issue guidance should be issued to provide taxpayers an election to source distributions from previously taxed earnings and profits ("PTEP") from the various groups of PTEP based on a last in, first out ("LIFO") approach, consistent with the longstanding approach of section 959(c) and Section 316. The mandatory priority rule for PTEP arising by reason of section 965, announced in the Notice, is not appropriate. The administrative concerns cited by the Notice could be addressed by permitting taxpayers an election to source distributions from the various groups of PTEP based on a LIFO approach. There is no policy reason to depart from the longstanding LIFO approach for sourcing distributions from earnings and profits – there is no suggestion in the text of Section 965 or its legislative history that such a departure was intended or is necessary or appropriate to carry out the provision of Section 965. A LIFO approach does not impose additional administrative burdens on taxpayers – once a taxpayer has determined its Section 965 PTEP, the additional burden of maintaining that information is trivial. To the extent taxpayers prefer to exhaust Section 965 PTEP first for administrative reasons, an election could be provided.

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SIA appreciates the time and effort that it takes to craft a strong regulatory framework, and SIA is thankful for the opportunity to comment on this proposal. For more information, please contact David Isaacs at 202-446-1709 or disaacs@semiconductors.org.