SIA SEMICONDUCTOR INDUSTRY ASSOCIATION

Comments of the Semiconductor Industry Association
On the
Deduction for Foreign-Derived Intangible Income
and Global Intangible Low-Taxed Income

84 Fed. Reg. 8,188 (March 6, 2019)

[REG–104464–18]

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The Semiconductor Industry Association (SIA) appreciates the opportunity to comment to the Treasury Department and the Internal Revenue Service on the proposed regulations on the deductions for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI) under section 250. 84 Fed. Reg. 8,188 (March 6, 2019).

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, 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 have a "multiplier effect" that drive 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 United States, and semiconductors are America's fourth largest export. In addition, the semiconductor industry in the United States invests, on average, approximately 20 percent of revenue in research and development, among the highest percentage of any industry. Accordingly, the proposed regulations governing the FDII and the GILTI have a potentially significant impact on the global competitiveness of the U.S. semiconductor industry.

1. Definition of "Physical and Material Change"

Under the proposed regulations, the sale of general property is for a foreign use if the property is subject to manufacture, assembly, or other processing outside the United States. To qualify as manufactured, assembled, or processed, general property must meet one of two tests under Proposed Reg. § 1.250(b)-4(d)(2)(iii): (1) it is "subject to a physical and material change," or (2) it is incorporated into another product as a component. We note that this standard appears to incorporate elements from the standards in the regulations under former section 199 and the regulations under section 954. In each of those contexts, the taxpayer is testing whether activities it conducts itself constitute manufacturing, assembly, or other processing. Accordingly, in those cases, the taxpayer will have direct information regarding the extent of physical and material change to property. In the case of section 250, a taxpayer may not know for certain, or be able to demonstrate, the extent of physical or material change to the property being sold to an unrelated party.

For general property sold to an unrelated party, the regulations should incorporate a rebuttable presumption test. By using documentation created in the ordinary course of business (such as the items listed below), a taxpayer must be able to show reasonable documentation regarding the sale to persons outside the United States. The regulations may build off of place-of-use rules that appear elsewhere in existing regulations so that general property which is sold to an unrelated person shall be presumed to have been sold for use, consumption, or disposition in the country of destination of the property sold, unless the taxpayer knows, or has reason to know, that the property will be used in the United States [Reg. § 1.864-6(b)(3)(ii)(a); Reg. § 1.971-1(b)(1)(i); Reg. § 1.956-2(b)(1)(iv)].

Additionally, to address the first of the two tests, we recommend the addition of language to further define a "physical and material change" under Proposed Reg. § 1.250(b)-4(d)(2)(iii)(B). In particular, we recommend that that this test be satisfied where the general property is subject to processing or assembly activities that are substantial in nature and generally considered to constitute the manufacture or production of property that is different than the property which was sold to the customer. This language is similar to the language in Reg. § 1.954-3(a)(4)(iii) applicable to the manufacture of a product when purchased components constitute part of the property. This language could be illustrated by the following example.

> Example 1: U.S. Corporation, Corporation A, manufactures computer chips. The chips are sold to an unrelated foreign party, Corporation B, incorporated under the laws of foreign country X. Corporation B manufactures computers, tablets, and other computer accessories. Corporation B will incorporate the chips purchased from Corporation A in its manufacturing process. Company B's manufacturing process is substantial in nature and is generally considered to constitute the manufacture or production of computers, tablets, and other computer accessories, and not the manufacture of computer chips. The chips are not the same product as the computers, tablets, and other computer accessories. Thus, they qualify as manufactured, assembled, or processed outside the U.S.

2. The Related Party Sales Condition

SIA has concerns about the related party condition in Proposed Reg. § 1.250(b)-6(c)(1)(ii)—which requires that more than 80 percent of the revenues of the foreign related party, with respect to the property, must be from sales to unrelated parties. This test applies where property sold in the related party sale is used in connection with the property sold to the foreign unrelated party (as defined under Proposed Reg. § 1.250(b)-6(b)(5)(iii)). As set forth below, SIA also recommends revising the definitions under Proposed Reg. § 1.250(b)-6(b)(5) to provide further clarity.

First, with respect to Proposed Reg. § 1.250(b)-6(c)(1)(ii), we are concerned that the proposal could have a cliff effect—in other words, if a company falls below 80 percent, that company would derive no benefit. Approximately 83 percent of all sales of U.S. semiconductor companies are outside the United States, which is currently above the 80 percent threshold. But market conditions may shift in the future, and therefore the 80 percent threshold could impose a very restrictive condition for some companies.

Second, with respect to Proposed Reg. § 1.250(b)-6(b)(5) and the definitions thereunder, we believe that the distinction between Proposed Reg. § 1.250(b)-6(b)(5)(ii) and Proposed Reg. § 1.250(b)-6(b)(5)(iii) should be further clarified. We note that Proposed Reg. § 1.250(b)-

6(b)(5)(iii), in describing sales of property that are used in connection with the property sold to a foreign unrelated party, carves out property described in Proposed Reg. § 1.250(b)-6(b)(5)(ii), namely components. However, questions remain. For example, is the sale of a wafer manufactured in the United States and sold to a CFC who engages in further manufacturing and then sells to unrelated customers for use outside the U.S. controlled by Proposed Reg. § 1.250(b)-6(b)(5)(ii) or by Proposed Reg. § 1.250(b)-6(b)(5)(iii)? Is the wafer "property sold [as] a component of property", or, rather, is the wafer "property used in connection with the property sold"? The better interpretation of the proposed regulations is that this example is governed by Proposed Reg. § 1.250(b)-6(b)(5)(ii), but confirmation would be helpful.

Third, because of the ambiguity in the proposed regulations regarding the use of the term "component" in Proposed Reg. § 1.250(b)-6(b)(5)(ii), SIA recommends the following language, which is adapted from the Preamble, be included in the final regulations at the end of Proposed Reg. § 1.250(b)-6(b)(5)(iv):

> For purposes of this paragraph, whether property is a component of another property that is subsequently sold in an unrelated party transaction is determined without regard to the rule defining a component for purposes of determining whether general property is subject to manufacturing, assembly, or other processing contained in Reg. § 1.250(b)-4(d)(2)(iii)(C).

Fourth, there is uncertainty regarding the application of the 80-percent test. Consider the following example.

> Example 2: A U.S. semiconductor company sells tooling used in the manufacturing of semiconductor products to a foreign related party. The foreign related party then undertakes back-end manufacturing (utilizing the purchased tooling) to turn wafers into finished products ready for customer sale, a process known as "assembly, test, and packaging". In some cases, the foreign related party sells the finished product back to the domestic corporation, which then sells the product to a third party.

The 80-percent test applies because the tooling is used in the creation of the finished products. Depending on how the 80 percent is determined, the company could be above this threshold. But there is significant ambiguity about how the 80 percent is determined. Is it based on the price of all sales to a final customer? Or is it based on end-customer pricing for foreign unrelated sales? Or is it some other (transfer price) amount for related party sales (for instance, back to the United States)? Guidance on this issue would be helpful. The 80 percent test has a cliff effect. As an alternative, a test that did not have such a high threshold or contained a sliding scale upon a minimum level would be preferable.

3. Expense Allocation and Apportionment of Research and Experimentation Expenses

SIA believes the tax laws should provide enhanced incentives for research in the United States and retaining intellectual property (IP) in the U.S. As proposed, taxpayers must allocate research and experimentation (R&E) expenses against FDII income and, correspondingly, to GILTI under the rules of Reg. § 1.861-17 (without regard to the exclusive geographic apportionment rule of Reg. § 1.861-17(b) that allows such expenses to be allocated to the geographic area where the research is performed). Although Treasury is generally attempting to apply reasonable and consistent methodology, this mechanical allocation may discourage taxpayers from performing R&E and retaining or transferring IP rights back to the United States.

By reducing the potential FDII deduction and also reducing any potential foreign tax credit (FTC) associated with foreign/GILTI income, taxpayers that hold IP rights in the U.S. may be incented to increase R&E activities offshore, which runs counter to the policy intent of the provision.

To address this concern and pending a more general review of Reg. § 1.861-17, SIA recommends that the regulations provide the taxpayer with additional flexibility to better align with the GILTI rules. As the FDII and GILTI were designed to work in conjunction with one another, providing an elective option to utilize exclusive apportionment would allow for a similar approach that would further ensure that a consistent approach is applied between the two provisions.

4. Election for R&D Expense Allocation

As outlined in the preamble, the proposed regulations do not address the existing Reg. § 1.861-17 and indicate that a more general review of Reg. § 1.861-17 will occur at a later date. Under Reg. § 1.861-17, taxpayers may currently use either the sales method or gross income method to allocate R&E expenses, but they must use the elected method consistently for five years before changing to another method. For tax years beginning after December 31, 2017, Proposed Reg. § 1.861-17(e)(3), which was issued as part of the foreign tax credit regulation package, provides taxpayers a one-time ability to change apportionment methods without regard to the five-year restriction. However, this one-time change of method constitutes a binding election to use the chosen method for a five-year period.

As taxpayers work to comply with the new system as well as existing and potential future changes to Reg. § 1.861-17, we request that consideration be given to allowing taxpayers to make this election on an annual basis. Alternatively, we request that the one-time election under Proposed Reg. § 1.861-17(e)(3) be nonbinding for at least one additional year. With many of the relevant regulations in a proposed status, providing a nonbinding election on an ongoing basis, or for at least one additional year, will better enable taxpayers to understand and comply with the new system, and to better assess the impact of the election in light of the many changes to the foreign tax credit rules, the introduction of section 250, and other relevant changes.

5. Extension of Transition Period for Documentation Requirements

The proposed regulations currently provide a transition period that allows taxpayers to demonstrate that property or services have been provided to a foreign person for foreign use using "any reasonable documentation maintained in the ordinary course of business". This type of approach allows a taxpayer to use existing business documents (e.g., commercial invoices, purchase orders, packing slips, bills of lading, etc.) without the creation of unnecessary recordkeeping. The transition period only covers the period of time up to when the regulations are published; following this period, taxpayers are required to create and maintain additional documentation that may not be necessary or accessible in the ordinary course of business. Unfortunately, several of the items listed in Proposed Reg. § 1.250(b)-4(c)(2) and (d)(2) and Proposed Reg. § 1.250(b)-5 would not be created or available to a taxpayer in the ordinary course of business or otherwise and may not be readily provided by the foreign recipient. Additionally, for taxpayers with longer contract cycles, certain documentation (such as a binding contract) will not be able to be obtained by the taxpayer "no earlier than one year before the date of the sale or service."

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For administrative ease, SIA recommends that consideration should be given to extending the transition period for the documentation-requirements rules to take effect and determining the extent to which, if any, such rules prove deficient or problematic in practice once taxpayers and the IRS have some experience complying with or administering the rules. Identifying and potentially implementing new documentation requirements will take time, particularly for business models with longer-term contracts; lengthening the transition period to at least five years would provide greater certainty in the near term, accommodate different business models, and ease the ability to get new compliance systems or contract provisions in place if necessary. Providing a longer transition period would allow taxpayers a sufficient amount of time to develop and improve internal administrative systems as well as enhance the stability of the new system.

6. Documentation Requirements and Qualifying Documents

The documentation requirements, particularly the documentation requirements around establishing the status of a customer as a foreign person in Proposed Reg. § 1.250(b)-4(c)(2), could be a very significant administrative burden. SIA fears that the requirements needed to establish foreign status for all foreign customers in a form that meets one of the outlined conditions could be especially challenging given that a large volume of sales are done through a purchase order rather than an individual, specific contract.

The transition period only covers the period of time up to when the regulations are published, and then, following this period, companies are required to provide additional documentation. Unfortunately, several of the items listed in Proposed Reg. § 1.250(b)-4(c)(2) and (d)(2) and Proposed Reg. § 1.250(b)-5 would not be able to be obtained by a taxpayer in the ordinary course of business (nor would it be offered or possibly provided by the recipient).

For example, as proposed in Proposed Reg. §1.250(b)-4(c)(2), absent a taxpayer's ability to obtain the types of documents listed, a taxpayer will default to "other forms of documentation as prescribed by the Secretary." In lieu of providing a restricted list which may not be flexible enough to address many different business models, we recommend that the qualifying documents that must be obtained be expanded to include additional documents that can more readily be obtained from a customer and are utilized in the ordinary course of business, such as (but not limited to) commercial invoices, packaging slips, Form W-8BEN, shipping documents and bills of lading, or purchase orders. In addition, we recommend providing a catchall that allows the taxpayer to provide any other similar documentation or evidence that can reasonably establish that the recipient is a foreign person to the satisfaction of the Secretary.

Similar concepts and principles should be applied for satisfying the documentation requirements under Proposed Reg. §1.250(b)-4(d)(2) and -5, as applicable.

7. Definition of Foreign Use for Intangible Income

SIA has more general concerns with Proposed Reg. § 1.250(b)-4(e)(2), which provides that, for purposes of determining whether a sale of intangible property is for a foreign use, the location where revenue is earned is generally determined based on the location of end-user customers licensing the intangible property or purchasing products for which the intangible property was used in development, manufacture, sale, or distribution. The underlying provision upon which this is based is section 250(b)(5)(A), which defines foreign use of property "as any use, consumption, or disposition which is not in the United States." This definition makes no distinction between tangible and intangible property and should apply equally to both.

This proposed regulation is inconsistent with the rule for tangible property (referred to as general property) in Proposed Reg. § 1.250(b)-4(d)(2)(i)(B). The property is for a foreign use if it is subject to manufacture, assembly, or other processing outside the United States before the property is subject to a domestic use. The preamble asks for comments on whether a rule for intangible property similar to Proposed Reg. § 1.250(b)-4(d)(2)(i)(B) is appropriate for intangible property. SIA believes it is appropriate for the two to be similar.

The preamble to the proposed regulation explains the distinction based on footnote 1522 of the Conference Report, which provides that, "[i]f 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." The preamble goes on to state "Intangible property is not 'subject to' manufacture, assembly, or processing, and there is no other discussion in the Conference Report that indicates an intent to provide an analogous rule for intangible property otherwise used in the manufacturing process."

SIA believes that the focus on the words "subject to" in footnote 1522 of the Conference Report is misplaced and the conclusion that patents are not "subject to" manufacture, assembly, or processing is incorrect. SIA believes that if the intangibles are used in the manufacture or production of products in a foreign location, the location of manufacture should be considered the location of use.

8. Qualification of Intangible Income as FDII—Who is the End User?

If Proposed Reg. § 1.250(b)-4(e)(2) is not changed, nonetheless SIA seeks clarification with respect to royalties received from the manufacturer of a component for purposes of the foreign use test. We believe the end-user of the component is the finished good manufacturer, not the customer of the finished good manufacturer.

> Example 3: Assume a U.S. corporation licenses technology to a related or unrelated foreign corporation. The foreign corporation manufactures chips outside the United States and pays a royalty to the U.S. corporation. The chip is then sold to an unrelated computer manufacturer who manufactures outside the United States and sells the computers both within and outside the United States.

SIA believes 100 percent of the royalty qualifies for FDII. SIA believes that looking through to the sale of the computer to determine whether the royalty on the chip qualifies for FDII treatment is flawed and would be almost impossible as a practical matter for companies to know or to track. The preamble to the Proposed Regulations states that the purpose of the FDII regime is to help "neutralize" the incentive that the GILTI regime provides to U.S. corporations to conduct business activities directed at foreign markets through CFCs rather than directly from the United States. SIA believes that such an approach could significantly hamper the intent of FDII provisions to encourage companies to bring back intellectual property to the United States.

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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. By their very nature, 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 the United States and then incorporated by an unrelated customer located in a foreign jurisdiction into a new consumer device, such as a smart phone or computer. 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 that Treasury take this business model into consideration as you work to finalize these regulations.

We appreciate the time and effort that it takes to craft a strong regulatory framework. SIA appreciates the opportunity to submit this feedback, and we look forward to answering any questions you may have.