SEMICONDUCTOR INDUSTRY ASSOCIATION

Comments of the Semiconductor Industry Association (SIA) on
Guidance Related to the Allocation and Apportionment of Deductions and Foreign Taxes, Financial Services Income, Foreign Tax Redeterminations, Foreign Tax Credit Disallowance Under Section 965(g), and Consolidated Groups

84 Fed. Reg. 69124 (December 17, 2019)

[REG–105495–19]
RIN 1545–BP21

Submitted February 18, 2020

The Semiconductor Industry Association (SIA)[1] appreciates the opportunity to submit the following comments to the Department of Treasury (Treasury) and the Internal Revenue Service (IRS) to the proposed regulations under 84 Fed. Reg. 69124 (December 17, 2019) on "Guidance Related to the Allocation and Apportionment of Deductions and Foreign Taxes, Financial Services Income, Foreign Tax Redeterminations, Foreign Tax Credit Disallowance Under Section 965(g), and Consolidated Groups."

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 have a potentially significant impact on the global competitiveness of the U.S. semiconductor industry.

SIA's comments focus on:

1) Allocation and Apportionment of R&E expenditure (Prop. Reg. 1.861-17), including Gross Intangible Income, Optional Gross Income Method, Exclusive Apportionment;
2) Redetermination of Foreign Tax Credits (Prop. Reg. 1.905-3, 1.905-4, 1.905-5, and 301.6689-1);
3) Redetermination of Foreign Tax Credits (Prop. Reg. 1.905-5); Allocation and Apportionment of Foreign Income Taxes (Prop. Reg. 1.861-20), including Base Difference and Return of Capital, and Disregarded transfer of appreciated property (Prop. Reg. 1.861-20(g)(11));
4) Tested Income (Prop. Reg. 1.960-1 (d)(3)(ii)(C))

[1] 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.

1101 K Street NW, Suite 450 Washington, DC 20005
p: 202-446-1700 www.semiconductors.org

5) Redetermination of passive and general baskets for high tax kickout (Prop. Reg. 1.904-4)
6) Stewardship Expenses (Prop. Reg. 1.861-8(e)(4)(ii))

1. Prop. Reg. 1.861-17, Allocation and Apportionment of R&E expenditures

Gross Intangible Income

As proposed, the regulations exclude GILTI income from the definition of "gross intangible income." This exclusion, however, does not apply to Foreign Derived Intangible Income ("FDII"). Congress designed the FDII deduction to approximate the combined tax burden on GILTI so that the provisions would work in conjunction to discourage base erosion. Under the proposed regulations, R&E expenses would be allocated or apportioned to FDII, thereby significantly reducing FDII benefits. Unfortunately, this allocation may discourage taxpayers from performing R&E and retaining IP in the U.S. or, from transferring IP rights back to the US. By reducing the potential FDII deduction, taxpayers that hold IP rights in the US may be incented to increase R&E activities offshore, which runs counter to the policy intent of the FDII.

SIA Recommendation: To mitigate the negative impact on the FDII and provide parity with the GILTI, we recommend that the regulations exclude FDII from the definition of "gross intangible income." Since FDII and GILTI utilize many of the same concepts in their calculations and methodology and to further bolster the position that section 250 is meant to be applied in totality, treating FDII and GILTI consistently (as not constituting gross intangible income) with reference to the 2019 proposed regulations for R&E expense allocation and apportionment is appropriate.

Optional Gross Income Method

As proposed, the existing gross income method would be eliminated in allocating and apportioning R&E expenses. Instead, gross receipts from sales of products or service (i.e. the sales method) is the only available and mandatory method.

SIA Recommendation: The final regulations should retain the optional gross income method. This elective allocation and apportionment method may align more closely with a taxpayer's business and should continue to be a valid method going forward. Taxpayers should be provided the option to use alternative methodologies under the existing 1.861-17 so long as those methodologies are reasonable and applied consistently for all operative Code sections.

Exclusive Apportionment

As proposed, the exclusive apportionment has limited application only when Section 904 is the operative section. However, in calculating the FDII deduction, the proposed Section 250 regulations provide that 1. 861-17 shall apply without the exclusive apportionment rule. This mechanical discrimination may result in an over-allocation of R&E expenses to FDDEI and fail to properly measure the income derived from conducting R&E activities in the U.S. in the service of foreign markets. The regulations should make it clear that to the extent of a U.S. sourced loss created by exclusive apportionment of R&D to U.S. income, the loss should be allocated back to the separate limitation income that the R&D would have been allocated to but for exclusive apportionment of R&D.

SIA Recommendation*:* Taxpayers should be provided with an option to apply the exclusive apportionment when Section 250 is the operative section. As previously studied by the U.S. Treasury, the greater value of research and development is in the "place of performance."[2] As such, allocating or apportioning R&E to sales or services rendered outside the U.S. does not follow the economics of the transactions or the intent of the FDII legislation. Exclusive apportionment was introduced in the section 904 context to recognize the economic reality that for taxpayers that perform a preponderance of their R&D in the U.S., their foreign income should not be fully burdened with the R&E expense. Removing this same logic and methodology from the FDII calculations is not in line with the data showing the value of R&E resides where it is performed and there is a technology lag in "exporting" such R&E.

2. **Prop. Reg. 1.905-3, 1.905-4, 1.905-5, and 301.6689-1 Redetermination of Foreign Tax Credits**

Proposed regulations require a redetermination of U.S. shareholder's U.S. tax liabilities when there is a redetermination of foreign taxes with respect to a controlled foreign corporation (CFC), including tax law changes in various jurisdictions. With the increased complexity of the international taxation and subsequent changes in foreign tax laws, the frequency of redeterminations of foreign taxes will continue to increase. Consequently, the U.S. taxpayer's compliance and administrative burdens are even more challenging. Additionally, the penalties for failure to provide notice of the redeterminations on such a complicated process are significant. Prop. Reg. Sec. 1.905-4(b)(4)(i)(E) unfortunately removes the necessary flexibility for notification requirements by taxpayers under examination within the jurisdiction of Large Business and International Division jurisdiction.

SIA Recommendation: Given the increased complexity of the U.S. tax and global tax environment, Treasury should consider simplifying the redetermination process for the use of foreign tax credits. Treasury should consider establishing higher threshold levels for redeterminations below certain level (e.g., less than 10% of foreign taxes as originally accrued), taxpayers would be relieved of the notification and re-filing requirements. Taxpayers could amend when adjustments exceeded 10% of the original tax or wait and accumulate changes until they felt they all had been made. This process as it is currently proposed could result in not only numerous federal amended returns, but also associated amended state income tax returns. The administrative burden and cost related to these efforts could be significant. The accuracy of U.S. tax liability would not be jeopardized, especially Prop. Reg. 1.905-4 (b)(4)(iii) has already asked the taxpayer to verify the information under penalty of perjury.

[2] "The Relationship between US Research and Development and Foreign Income", US Treasury Study dated May 19, 1995.

3. **<u>Prop. Reg. 1.905-5 Redetermination of Foreign Tax Credits (relates to taxable years of a foreign corporation before Jan.1, 2018)</u>**

The 2019 proposed regulations require a redetermination of post 1986 undistributed earnings and profits any time there is a redetermination of foreign taxes with respect to a CFC for any taxable year before 2018. The 2017 TCJA imposed a one- time transition tax on such earnings under Section 965, according to which only partial foreign tax credits were available to offset the U.S. taxpayers' Section 965 liabilities. The penalties for failure to notify and incorporate the impact of any foreign tax redeterminations are severe. Furthermore, taxpayers have already made multiple installment payments based on prior Treasury proposed and final regulations issued earlier than this.

SIA Recommendation: Given the increased complexity of the U.S. tax and global tax environment, Treasury should consider simplifying the redetermination process for the use of foreign tax credits in the Section 965 area. Treasury should consider establishing higher reporting threshold levels such that redeterminations below a certain level (e.g., less than 10% of foreign taxes as originally accrued) do not require a redetermination or adjustment of U.S. Section 965 liabilities. The net result of this higher reporting threshold would not result in significant U.S. tax liabilities change especially such foreign taxes are only partially creditable pursuant to authorities under Section 965. In addition to a threshold limitation, Treasury should consider additional simplification measures such as permitting the taxpayer to apply the redetermination to the current year taxes versus requiring the taxpayer to amend the past federal and state tax filings. The accuracy of U.S. tax liability would not be jeopardized especially if the proposed regulations required the taxpayer to verify the information under penalty of perjury.

4. **<u>Prop. Reg. 1.861-20, Allocation and Apportionment of Foreign Income Taxes</u>**

Base Difference and Return of Capital

Proposed Reg. 1.861-20(d)(2)(ii)(6) listed a distribution of property to the extent of Section 301(c)(2) as a base difference, and as such foreign withholding taxes attributable to this portion would not be creditable. This is contrary to the Treasury and IRS' long standing historical positions that base differences are rare and unusual. This further conflicts with the final Treasury regulation 1.904-6(a)(1)(iv) which only included gifts and life insurance proceeds as base differences.

SIA Recommendation: As such, we recommend Proposed Reg. 1.861-20(d)(2)(ii)(6) be removed from the regulation list of base differences. In normal circumstances, the nature of foreign taxes imposed on distribution of property should be determined by the foreign law, rather than the U.S. tax law. If the foreign country imposes tax on the distribution (e.g., withholding tax), a portion of the distribution may be beyond the CFC's E&P under U.S. tax principals, therefore this portion should be a timing difference as opposed to base difference.

Disregarded Payments under Prop. Reg. 1.861-20(d)(3)(ii)

Prop. Reg. 1.861-20(d)(3) sets forth complex rules with respect to disregarded payments. When a foreign disregarded entity makes a disregarded payment (such as interest) to its CFC owner, *See* Prop. Reg. 1.861-20(g)(4) example 9, the foreign taxes associated with such payment is allocated based on the tax book value of assets owned by the foreign disregarded entity. In the specific example where the foreign disregarded entity owned another CFC stock, the tax book value of such stock was utilized to determine how much of the foreign tax was allocable to passive income basket. This rule contradicts the long-standing U.S. tax principal that a disregarded entity should be disregarded for all U.S. tax law purposes. This proposed change would treat a disregarded entity as if it was regarded. A disregarded entity's profits and losses are typically already included in the CFC's income which is already taxed in the U.S. (either under subpart F income or GILTI inclusion). Therefore, the disregarded payment should indeed be disregarded. By segregating the taxes imposed on such a disregarded payment from the profits and losses that are already taxed in the U.S. creates unnecessary complexity and undue burden to the taxpayer.

SIA Recommendation: The disregarded payment rules not apply to situations where the payment is made from a foreign disregarded entity to its CFC owner, or to another disregarded entity under the same CFC owner. This can be accomplished by removing the sentence of Prop. Reg. 1.861-20(d)(3)(ii)(D), where it states that a foreign branch owner could be a foreign corporation. This removal would not interfere with other rules with respect to foreign branches which typically applies where the owner is a person (including a foreign or domestic partnership or other pass through entity) as laid out in Treasury final Reg. 1.904-4(f)(viii).

Disregarded transfer of appreciated property - Prop. Reg. 1.861-20(g)(11) Example 10

Post-acquisition restructuring is often performed to better align a multinational's legal structure with its commercial operations, in many cases this includes the inbounding of appreciated property. However, the proposed regulations, would require a U.S. taxpayer to allocate withholding taxes imposed on the transfer of assets based on the tax book value of assets owned by a foreign disregarded entity of a U.S. parent. Such allocation creates complexity and uncertainty in post- acquisition integrations and provide a significant disincentive to move business assets back to the U.S.

SIA Recommendation: Regulations should permit companies to engage in post-acquisition restructuring to transfer appreciated assets to the U.S. following acquisitions and permit taxpayers to fully credit its foreign tax payments. The final Treas. Reg. 1.904-4(f)(2)(vi)(D)(3) provided transitory ownership rules when IP is involved. Treasury should consider adopting similar transitory ownership rule to business assets used in ordinary course of business.

Prop. Reg. 1.904-4, Redetermination of passive and general baskets for high tax kickout

As the result of the TCJA and proposed regulations under Section 905(c), global companies must frequently redetermine their foreign tax credits based on any foreign tax changes. The proposed regulation creates unnecessary complexity for taxpayers by requiring them to redetermine subpart F, tested income, and previously taxed earnings and profits (PTEP) changes whenever there is a redetermination of foreign taxes, including redetermining categories of subpart F income. With the increased complexity of the global tax environment, the likelihood of redetermining foreign tax credits is dramatically increased. Asking taxpayers to go back redetermining all attributes on a year by year basis, especially such redetermination can date back ten years, creates great uncertainty and administrative burden for taxpayers (as well as the IRS).

SIA Recommendation: Given the increased complexity of the U.S. tax code, Treasury should consider simplifying the redetermination process for the use of foreign tax credits. Treasury should consider establishing minimum levels of foreign tax redeterminations that require the detailed analysis of all tax related attributes. For tax redeterminations below a minimum level, taxpayers could perform some simplified procedures to account for tax redeterminations. In addition to a threshold limitation, Treasury should consider additional simplification measures such as permitting the taxpayer to apply the redetermination to the current year taxes. To ensure accuracy, the taxpayer, could be asked to verify the information under penalty of perjury.

Prop. Reg. 1.861-8(e)(4)(ii), Stewardship Expenses

Comments are solicited on definitions of stewardship expense, and the preamble acknowledges the difficulty distinguishing stewardship expenses from "supportive" or "duplicative" activities. The regulations also require that a taxpayer allocate and apportion stewardship based on the stock basis of CFCs.

SIA Recommendation: As it is difficult for a taxpayer to readily distinguish certain expenses, greater flexibility should be provided for identifying stewardship expenses and methods used to the allocation and apportionment of such. Specifically, companies should be allowed to utilize a facts and circumstances method similar to Reg. Sec. 1.861-8. A facts & circumstances approach can better align to the underlying business and books and records.

\+ \+ \+

SIA appreciates the opportunity to submit this feedback, and we look forward to answering any questions you may have. Please contact Erik Pederson at epederson@semiconductors.org if you request any additional information relating to these comments.