



Comments for the House Committee on Ways and Means
By the Semiconductor Industry Association
On the International Tax Reform Discussion Draft of October 26, 2011

March 14, 2012

The Honorable Dave Camp
Chairman, House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Camp:

The **Semiconductor Industry Association** ("SIA") appreciates the opportunity to provide the Committee with comments on the international tax reform discussion draft ("Draft") that the Committee released last October. We commend you, other members and your staff for the work they put into the Draft and their ongoing efforts to improve our tax system.

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 and technology, global finance, transportation, health care, and many other sectors of our economy. Our industry has approximately two-thirds of its wafer fabrication capacity located in the US, and more than 80% of its sales going outside the US. Consequently, the industry has been the number one export industry over the last six years.

The positive impact of a robust semiconductor industry has not been overlooked by other governments. The economic development arms of other governments have placed priorities on growing domestic chip industries, which have led to increased investments in R&D and manufacturing capacity outside the US, and more competition in overseas markets. One example here is China, which specifically targeted development of its semiconductor industry in its recent five-year plan. Today, semiconductors are China's number one import, exceeding its imports of oil.

As we provide our views to the Committee on the Draft, there are two preliminary points we would like to make. First, there have been many criticisms made in the course of debating international tax policy to the effect that taxpayers set up overseas investments to avoid U.S. tax. The commentary of critics often appears to lump together cases where companies or individuals use foreign investments as devices to avoid U.S. tax illegally with cases where global companies operate overseas in complete and transparent compliance with U.S. and foreign laws. To be sure, SIA and its members support the government's efforts to enforce U.S. law against taxpayers engaged in tax evasion. Second, there has been some dialogue about the potentially adverse financial statement impact of tax reform if tax reform includes a significant reduction of the tax rate. Specifically, if the U.S. corporate rate were to be reduced to, for example, the Draft's proposed 25 percent, accounting principles would require that companies write down their related deferred tax assets and liabilities to reflect a drop from

a valuation under a 35 percent tax system to one under a 25 percent system (for example, the tax value of a future tax deduction of \$1,000 would be \$350 under current law and would be \$250 under the new law). SIA and its members are fully aware of these potential accounting adjustments and we urge the committee to pursue a significant and immediate reduction in the corporate tax rate without any concern for these adjustments. Corporate tax rate reduction will provide much greater long term benefit to the U.S. economy than one-time/short-term accounting adjustments.

Background on the U.S. Semiconductor Industry

As U.S. semiconductor companies, we have seen the global markets for our devices grow significantly over the past several decades. Consequently, we have had a presence in foreign countries for many years in the form of controlled foreign corporations (“CFCs”) which are the entities through which we participate in markets and operations abroad. We have in particular experienced a high growth rate in markets and operations in Asian countries. This is not surprising given the high growth rates of Asian economies. Our operations include marketing, R&D, manufacturing (which in our industry 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).

Semiconductor companies generally fall into one of three business models. One consists of companies that own and operate their own manufacturing facilities, which are located in the U.S. and other countries. These companies invest in operations that perform R&D related to product design, R&D related to manufacturing processes, 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 the wafers and perform assembly/test. This business model began appearing about 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 made up of those in the foundry business. Customers bring them the designs and they manufacture the devices. They do not develop and sell their own products in the marketplace. Foundries engage in R&D related to manufacturing processes and manufacturing. In some instances they also help customers with product designs. The foundry business model began with foreign companies headquartered in Asia. These companies have grown significantly. Today, they are both foreign and U.S. companies; however, they conduct most of their manufacturing services outside the U.S.

Principles for Tax Reform

Tax policy in our view is a very important and very viable tool for improving our economy. Our members are engaged in the semiconductor business all over the world. They know quite well the

effects of tax policies that other countries follow. It is self-evident that the tax policy of the U.S. is very important and should be shaped by important principles that are intended advance our economy.

In that light, we urge the Committee take a fundamental look at our tax system in the context of these principles:

- The purpose of the tax code is to raise the necessary revenues to support the activities of the government.
- It should be perceived as fair, which has generally been interpreted as a tax with a low rate and broad tax base.
- It should be understandable, stable and predictable for both taxpayers and the government.
- It should be linked to the long-term economic goals of the U.S.
- It should allow US companies to compete effectively against foreign companies in the global marketplace.

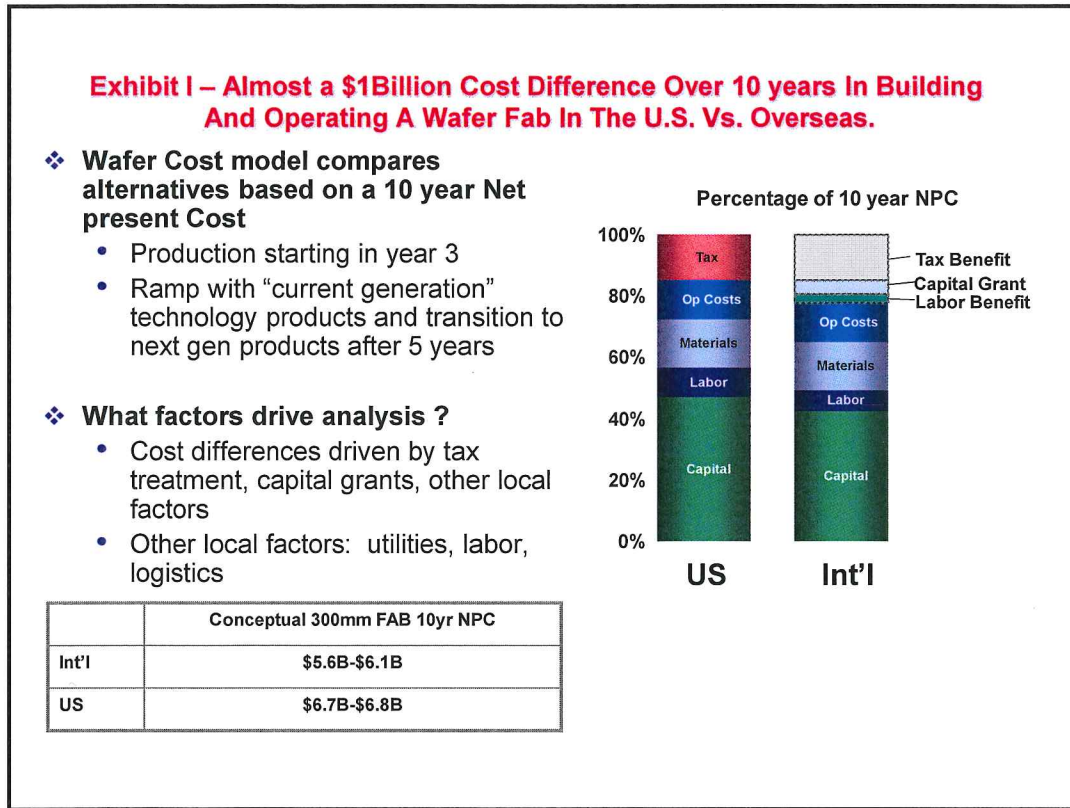
Let's focus on one aspect of the last principle: the system should allow US companies to compete effectively against foreign companies in the global marketplace. This principle is critical for us because, first, the foreign semiconductor markets are substantial and very competitive, and every SIA member has to serve those markets. Second, to serve those markets, every company has to rationalize where to locate its critical economic functions such as R&D, product, design, manufacturing, marketing and administration. This process of rationalizing a location means that the company must understand and comprehend factors such as access to infrastructure, human resources, logistics and cost. Taxation is of course comprehended as part of cost. All of the factors go toward the goal producing products with competitive features at competitive costs, delivering them when customers want them and providing customer service.

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 other countries have more attractive tax systems. We realize the Committee has previously heard that the U.S. has the second highest tax rate within the OECD and other key developing countries. And probably everyone concerned with global tax policy is aware that, come April 1st, Japan will implement the first of its scheduled rate reductions, which will move the U.S. up to the top of the list. In addition to lower rates, other 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 on those earnings. Home country tax generally does not apply when the earnings are repatriated. And lastly, as the Committee has no doubt heard many times, the US research tax credit has fallen far behind the incentives for research offered by other countries (in fact, as of the date of this letter, the US has no research tax credit). These features of other tax systems – lower rates, a territorial system and research incentives – are imbedded in the tax laws of other countries and are available to any taxpayer with transactions that qualify.

Additionally, however, there is a second tier of competitive pressures for our industry that can be substantial. It is in the form of special incentives that are not available to all taxpayers, but are only given selectively by governments to taxpayers who are selected because they bring to the country strategic investments. In our case, governments offer incentives for locating wafer fabrication, assembly/test or R&D within their countries. 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. An example of this advantage is in **Exhibit I** below. It is an analysis prepared several years ago that illustrates the cost differential of a wafer fabrication operation located in the U.S. vs. one located in a country that offers a tax holiday.

Exhibit I – Profit Impact of Tax Rates



This analysis shows that there is almost a one billion dollar cost advantage in operating the facility in the foreign location. It is based a 10 year net present cost; it assumes production starting in the third year with “current generation” technology products and a transition to the next generation of products after five years. The cost differences result from tax savings, capital grants and other factors such as labor, utilities and logistics. Note, however, that the overwhelming cost advantage is the tax savings. We do not offer this example as a basis for asking the U.S. to go down the path of providing tax holidays to selected companies for locating operations in the U.S. Rather, we offer it to illustrate that in our industry, a country’s tax rate isn’t always an indicator of a competitor’s tax cost. Tax holidays often drive the effective rates on operations far below the statutory rates, sometimes to zero. The competitive effect of these programs is to provide a significant cost advantage from operating semiconductor manufacturing and R&D facilities in other countries. It is worth noting that this cost advantage is also available to companies that operate as foundries, which can mean that, as market pressures operate over time, a company with its own in-house manufacturing capacity may find that it is more cost-effective to outsource manufacturing to a foundry with these incentives.

To put in all of this into perspective, **Exhibit II** 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 US, 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 the tax holiday operation can simply by virtue of the tax differential earn 54 percent more profit than the US operation.

Exhibit II – 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 having competition enjoy significant profit differences go beyond just “OK, so they make more money than we do.” “They” have more funds for investment, more for R&D and more of a profit cushion so they can drop prices against “us.” And importantly, if cash flow from our overseas operations is more valuable in their hands instead of ours, simply because of tax differences, it is likely that, over time, they will seek to acquire our operations, or more U.S. economic activity will migrate offshore. This is just how markets work.

Comments on Chairman Camp’s Territorial Draft

Therefore, all this being said, our analysis brings us back to our core principles for a competitive tax system. We submit our three priorities for the Committee to consider as it evaluates fundamental tax reform in the light of a competitive tax system.

They are:

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

The first two are addressed in the Draft. We applaud the Draft's proposal for movement to a 25 percent corporate tax rate. As noted in Exhibit 1, as a capital intensive industry we face a significant cost disadvantage against our foreign competitors in locating our fabrication facilities in the U.S. 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 lower. We applaud the additional proposal for a 95 percent deduction in respect of foreign source dividends from a CFC. We generally support the Draft's approach to transition rules for existing CFC earnings. While a focus on the OECD average is useful, it's important to understand that US semiconductor companies do NOT generally compete with companies headquartered in those countries. Our top international competitors are outside of the OECD and their average rate is significantly lower.

Our third priority, incentives for research and innovation that are competitive with incentives in other countries, would be achieved if the research tax credit is enhanced and made permanent. We support proposals for making it permanent credit and for increasing the alternative simplified research credit from 14 percent to 20 percent. Because the US presently has no research credit, we urge the Committee to pass a bill as soon as possible to reinstate the credit retroactively to January 1, 2012. We also note that the third option under the proposed "base erosion" proposals, which provides for a 40 percent deduction for a domestic company for the foreign income it earns in respect of its US intangibles, touches on the concept of a patent box or innovation box, along the lines of the incentives for research and innovation that exist in nine other countries.¹ As an industry that invests heavily in R&D, we find this to be an interesting concept, and we would like to work with the Chairman and the Members of the Committee on a version of an innovation incentive or Innovation box proposal that fosters investment and innovation in the U.S.

Finally, we also want to comment on the Draft's base erosion proposals, especially as they are evaluated against the principle of having a competitive tax system for companies that operate globally. They are best described in the Committee's summary that accompanied the release of the Draft:

[T]he Committee has included three possible anti-abuse rules for consideration: (1) President Obama's "excess returns" proposal; (2) a variation on the low effective tax rate test used in other countries such as Japan; and (3) an option that would lower the corporate tax rate for all foreign intangible income (whether earned by a U.S. parent or its CFCs) to only 15 percent, but would treat a CFC's foreign intangible income as subpart F income if it is taxed at a rate less than 13.5 percent (90 percent of the U.S. rate). This last option combines the carrot of an "innovation box" and royalty relief with the "stick" of a current (subpart F) inclusion for intangibles-related income of CFCs in low-tax jurisdictions.

These three proposals are a concern for our members because they represent a partial and potentially arbitrary repeal of deferral of a portion of CFC earnings. From a tax policy standpoint, they are offered as anti-abuse rules. Thus, they infer that an abuse is present under varying scenarios which involve whether revenues exceed 150 percent of designated costs, whether the foreign tax on CFC earnings falls below a certain rate, whether intangibles are present and whether the CFC has qualifying business activities where it is incorporated. All three options would operate under mechanical tests. If the CFC's facts fit the thresholds, tax would be imposed on CFC profits. It is important to note that these proposals would impose tax on the active business earnings of a CFC even though the CFC has otherwise earned its profits from legitimate transactions which have a business purpose and economic substance, and which satisfy the intercompany pricing rules under section 482. They would even impose tax when the level of the CFC's profits have been approved beforehand under an Advance Pricing Agreement with

the IRS, and when, in the case of the first and third proposals, the CFC's intangible property, which is impliedly one of the ingredients of a purportedly abusive scheme, was paid for in full at fair market value by the CFC under arm's length standards. In fact, because these proposals would be a new category of Subpart F income, the bona fides of the CFC's transactions would be neither relevant nor available to the taxpayer as a defense against tax imposed under these proposals.

We understand the Committee's legitimate interest in tax policies that guard against abusive transactions. But we urge the Committee to consider two points. First, the IRS already has a long list of legislative and administrative tools available to it for pursuing cases of international tax avoidance (e.g., required pricing studies; disclosure procedures for Uncertain Tax Positions; understatement penalties; tax opinion penalties, recently enacted codification of the economic substance doctrine and the US network of tax treaties).

Second, we urge the Committee to look at other countries and explore how these proposals would fit within the norms of international taxation, and how these proposals fit within a goal for a competitive tax system. It appears to us that they would not fit. Additionally, they would seem to bring on new complexity in tax administration, in that they will invite new issues and disputes over cost allocations, calculating effective tax rates and identifying intangibles, determining the ownership of intangibles and, in particular, the task of identifying how much of a CFC's income is attributable to intangibles.

A strong US semiconductor industry has the potential to play an important role in the future of the US 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 Draft's proposed steps toward a competitive tax rate and territorial tax system represent very positive steps for global companies. We would be pleased to assist the Committee as it continues in its efforts to improve our tax system.

Very Respectfully,



William B. Blaylock
Chairman, SIA Tax Committee

CC: House Ways and Means Committee Ranking Member

ⁱ Belgium, China, France, Hungary, Ireland, Luxembourg, the Netherlands, Spain, and Switzerland. In addition, the UK enacted a patent box that will become effective April 1, 2013.