

April 14, 2015

**Submission of the Semiconductor Industry Association
International Tax Working Group
Committee on Finance
United States Senate**

The **Semiconductor Industry Association** (“SIA”) appreciates the opportunity to provide the International Tax Working Group with comments regarding our priorities for comprehensive tax reform. We commend the chairs of the Working Group, other Senators and staff for your ongoing efforts to improve our tax system. SIA supports efforts to lower the U.S. corporate rate and move toward a territorial international system, and enhance U.S. incentives for research and development.

Background on the U.S. Semiconductor Industry

America’s semiconductor industry is critical to U.S. economic growth. Semiconductors are the fundamental enabling technology for the modern economy and an essential component of our nation’s defense and homeland security, information technology, global finance, transportation, and health care. Our industry has over half of its wafer fabrication capacity located in the U.S., and more than 80% of its sales are outside the United States. Semiconductors have been the United States’ number two manufactured export from 2008 through 2012.

Our industry directly employs nearly 250,000 Americans, at an average salary of \$121,000 – almost 2.5 times higher than the U.S. average. In 2014, U.S. semiconductor companies generated \$173 billion in sales, and the industry supports more than 1 million additional American jobs. In 2013, the industry invested \$33 billion into research and development – 19 percent of sales and the highest share of revenue of any U.S. industry.

Semiconductor companies generally fall into one of three business models. One consists of companies that own and operate their own manufacturing facilities, called “fabs”, which are located in the U.S. and other countries. These companies invest in operations that perform research and development (R&D) related to product design and manufacturing processes, as well as 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 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 employed by foundries. Customers bring them designs and they manufacture the semiconductors. They do not develop and sell their own products in the marketplace. Foundries engage in R&D related to manufacturing. In some instances they also help customers with product designs. The foundry business model began with foreign companies headquartered in Asia, and these companies have grown significantly. Today, they are both foreign and U.S. companies; however, they conduct most of their manufacturing services outside the United States.

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

We would like to draw the working group’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 many foreign countries have more attractive tax systems. The U.S. currently has the highest corporate tax rate in the Organization for Economic Cooperation and Development (OECD). In addition to lower rates, most other OECD 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. Home country tax generally does not apply when the earnings are repatriated. Finally, the U.S. research tax credit has fallen far behind the incentives for research offered by other countries and is currently expired. These features of other tax systems – lower rates, a territorial system and strong research incentives – are imbedded in the tax laws of other countries and are available to any taxpayer with transactions that qualify.

Additionally, a second tier of competitive pressures for our industry come from special incentives that are given selectively by governments to taxpayers that bring to the country strategic investments. In our case, governments offer incentives for locating wafer fabrication, assembly/test or R&D. 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 such incentives.

SIA Principles for Tax Reform

In light of the competitive pressures that result from the relative weaknesses of the U.S. tax system, SIA believes that the objective of tax reform should be improving the ability of U.S. companies to compete effectively against foreign peers in the global marketplace.

Gregory Lang, President and CEO of PMC-Sierra, Inc., testified on behalf of SIA before the Finance Committee on July 27, 2011. In his testimony, Mr. Lang stated that SIA’s objective for tax reform was a competitive U.S. tax system resting on three key elements, and these remain SIA’s top tax reform priorities:

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

SIA believes that these three reforms will make the U.S. economy and U.S. semiconductor companies more competitive in the global marketplace. In light of the significant changes needed in these areas, we believe that any and all revenue, including transition revenue, derived from changes to the tax code must be reinvested into corporate tax reform to encourage U.S. investment in manufacturing and innovation.

Moving the U.S. toward a territorial international tax system and the treatment of component products under Subpart F are policies within the purview of the International Tax Working Group that have a significant impact on the U.S. semiconductor industry.

Moving Toward a Territorial International Tax System

The current U.S. international tax system has been widely criticized. By attempting to tax foreign revenues of U.S. CFCs at the statutory rate of 35%, it impedes U.S. companies from competing in foreign markets and discourages U.S. companies from investing in the U.S. revenue generated overseas. Most OECD nations employ a territorial system. In order for the U.S. to maintain its global leadership in high-tech manufacturing, it must move toward a more competitive territorial international tax system.

SIA believes the maximum U.S. tax on CFC income from products and services sold into foreign markets should be no higher than 15 percent, and should apply to foreign income

earned by a domestic company as well as foreign income earned by a CFC. A low minimum tax on CFC income coupled with the same tax on foreign income earned by a domestic corporation will eliminate the tax incentive to migrate intangible property or move jobs overseas because it will tax the foreign income at the same reduced rate regardless of whether the income is earned by a U.S. company or by a controlled foreign corporation. It would allow U.S. multinationals to bring intangible property held by their foreign subsidiaries back to the United States, avoiding foreign tax on the intangible income (and consequently the allowance of U.S. foreign tax credits). A low minimum tax is critical for SIA companies to be competitive in foreign markets where we compete against foreign corporations subject to a territorial system with no minimum tax.

Rules for a transition to a territorial system, including a tax on historical CFC earnings that have not been repatriated to the U.S. parent, are another critical issue for the U.S. semiconductor industry. SIA believes that any transition tax must impose a lower rate on earnings that have been invested into plant and equipment than the rate imposed on cash and equivalents. This is of particular concern because semiconductor manufacturing is a capital-intensive industry where companies may have reinvested a significant portion of those earnings in high-cost capital equipment. Companies that have invested in capital assets outside the United States to address the needs of a global marketplace and the cost of capital advantages associated with offshore investment could face a significant tax liability without any corresponding increased cash flow to pay the tax. Companies must be allowed to pay this tax liability over several years, but any transition tax would still impose additional costs and financial statement liability on U.S. companies while their competitors would face no comparable burden during the same period. This may lead to foreign acquisitions of U.S. companies and mergers of U.S. and foreign companies resulting in more offshore headquarters. Neither the rate on cash and equivalents nor the rate on earnings that have been invested in plant and equipment should exceed 10 percent. Finally, SIA believes that any mandatory or deemed repatriation should only be considered as a transition to a territorial system in the context of tax reform.

Round Tripping and Subpart F

In our electronic age, semiconductors are integrated into almost every part of our daily lives. They are critical component parts in millions of products, including any device with an on/off switch. Nearly all of the industry's revenue is derived from sales of semiconductors that become components of other property, and more than 80% of industry sales are made outside the United States. SIA would strongly oppose any proposal to impose an additional level of Subpart F tax on income derived from the sale of products outside the U.S. that ultimately become components of final goods that are imported into the U.S. – also known as round-tripping. Such a tax would move the U.S. further away from a territorial system, and potentially capture a large and unquantifiable amount of industry sales.

For example, take the case where a semiconductor is sold by a CFC of a U.S. company operating in Singapore to a company in China, which manufactures sound systems for cars.

That Chinese company sells its sound systems to car manufacturers in Germany, Japan and Mexico. Those car manufacturers sell some of their cars in the U.S. A round-tripping proposal would attempt to impose additional U.S. tax on the Singapore CFC profits from semiconductors that end up in cars sold in the U.S. – even when the CFC’s sale may be several transactions removed from the product actually imported into the United States. This would present two significant problems. First, the additional tax burden raises costs on the U.S. company’s CFC operations that a foreign-owned competitor located right across the street with the same product flow would not have. Such a provision would subject U.S.-based semiconductor manufacturers – and only U.S.-based semiconductor manufacturers – to significantly higher taxes on a substantial amount of revenue, even when those semiconductors are not sold in the U.S.

Second, this would impose a potentially crippling compliance burden for U.S. semiconductor companies by requiring them to track the ultimate destination of semiconductors that are inserted into the finished product of an unrelated independent customer. U.S. chip-makers have very little ability to track the final destination of the products in which their chips are components when they are sold to unrelated third party entities, especially when the third party’s products are incorporated into another entity’s end products.

U.S. semiconductor companies are the first link in the global electronics supply chain. We locate manufacturing facilities in foreign locations via CFCs to be close to our customers – foreign companies that use semiconductors as components in their products – since more than 80 percent of industry sales are outside the United States. As noted earlier, our industry employs 250,000 Americans and semiconductors have been the United States’ number two manufactured export from 2008 through 2012. Such a proposal would be overbroad and overreaching by attempting to levy additional U.S. tax on components produced and sold abroad to unrelated foreign customers that manufacture abroad. It would run counter to needed reforms moving the U.S. toward a territorial system and would make U.S. semiconductor companies less competitive relative to their foreign peers by seeking to levy additional taxes on income from transactions that do not remotely touch the U.S. market. A semiconductor manufacturer’s transaction ends when it makes a sale to an unrelated party. The semiconductor manufacturer cannot and should not have to track where an unrelated party ultimately sells its finished products.

At a minimum, any such proposal should include specific language clarifying that the round tripping provisions and higher levels of tax will not apply if the product undergoes substantial transformation by an unrelated entity before it is resold as a final product. Substantial transformation is a term that has been defined in the Rules of Origin, Title 19, Part 102, Code of Federal Regulations (19 CFR 102). In general, the country of origin for a good is the country in which the good is manufactured, produced or grown. Further work or material added to the good of another country must affect "substantial transformation" of the good in order to change the good’s country of origin. 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 way of example, a semiconductor is 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. Under this suggested change, it would therefore be considered substantially transformed and not subject to the higher “round tripping” tax.

Conclusion

A strong U.S. semiconductor industry plays an important role in the American economy. Our member companies engage in a wide range of government policy issues all over the world, including tax policy. We would be pleased to assist the Working Group as it continues in its efforts to improve our tax system.