Comments of the
Semiconductor Industry Association (SIA)
on
"Guidance Related to the Foreign Tax Credit; Clarification of Foreign-Derived Intangible Income"

85 Fed. Reg. 72078 (Nov. 12, 2020)

[REG-101657-20]

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The Semiconductor Industry Association (SIA) appreciates the opportunity to submit the following comments to the Internal Revenue Service (IRS) on proposed regulations entitled "Guidance Related to the Foreign Tax Credit; Clarification of Foreign-Derived Intangible Income." 85 Fed. Reg. 72078 (Nov. 12, 2020).

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 is pleased to provide comments on the following sections of the proposed regulations.

I. Creditability of Foreign Taxes – Treatment of Refundable Amounts and Credits (Prop. Reg. § 1.901-2(e)(2)(ii))

The proposed regulations provide that a foreign tax is not considered paid if it is reduced by a tax credit regardless of whether the credit is refundable in cash, overturning decades of law and practice. We respectfully request that current law be retained, in line with emerging international tax standards developed by the United States and its trading partners in this area.

Federal, state, and foreign governments commonly implement non-tax incentive programs through the tax system for administrative ease, including by requiring the incentive to first offset any income tax due before becoming payable in cash, in order to ease the burden and potential fraud associated with administering the payments. Such regimes typically include refundable tax credits that are determined by reference to the gross amount of qualifying expenditures incurred in a narrowly defined activity, such as R&D or investment in qualifying property (expenditure-based credits). Governments adopt such regimes to incentivize businesses to engage in the subsidized activity in the jurisdiction. The decision to make the credit refundable reflects a policy determination that the incentive should apply equally to businesses that do not owe current tax, for example, due to losses. Because refundable expenditure-based credits do not depend on any measure of net income or tax liability, such incentives are properly viewed as akin to governmental grants that are separate and apart from the income tax system.

The nature of refundable expenditure-based credits is recognized under the longstanding foreign tax credit rules. Under current law, an amount paid to a foreign country is not a tax "to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven." Treas. Reg. § 1.901-2(e)(2)(i). Under this longstanding standard, a tax credit that can only be claimed against an income tax liability is treated as reducing the amount of tax paid, while a tax credit that is refundable without regard to any income tax liability (e.g., refundable in cash) is treated as a payment of any income tax offset, rather than a reduction of such income tax.[1]

The Preamble provides two reasons for this change: (1) challenges with administering the current rules, which distinguish tax credits that are refundable under foreign law from those that are not, (2) concerns that foreign countries wishing to reduce the tax burden on taxpayers could substitute non-refundable tax credits rather than reduce the rate of foreign tax, achieving similar economic results at the expense of the U.S. fisc.

While we welcome efforts to reduce administrative burden and achieve more consistent results, we are concerned that the IRS and Treasury have not fully considered the range of data available to assist in the administration of the current rules, as well as other relevant international tax policy developments. For example, the OECD routinely publishes data and analyses on expenditure-based R&D tax incentives and direct government funding of R&D.[2] These reports provide objective information on the structure of governmental incentive programs, and include detailed country profiles for over 30 of the U.S.'s largest trading partners. Given the advances in information technology and transparency since the IRS developed the existing policies in the 1980s, the current rules are much less burdensome to apply and administer today than they were when the current regulations were adopted 40 years ago.

More importantly, the distinction drawn under current law – between refundable tax credits and non-refundable tax credits – has a strong policy basis. While an expenditure-based credit that can be recovered only against a local income tax liability is properly treated as a reduction of that liability, a government grant that can be used by the taxpayer to pay any expense, including its local income tax liability, is not. A credit that is likely to be refunded regardless of a taxpayer's

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[1] Rev. Rul. 86-134, 1986-2 C.B. 104; GCM 39617 (March 17, 1987); Tech. Adv. Mem. 200146001 (Nov. 16, 2001).

[2] *See, e.g.*, the reports linked at http://www.oecd.org/sti/rd-tax-stats.htm.

local income tax liability is more like a government grant than a reduction in income tax because the taxpayer is assured of receiving the benefit no matter its income tax liability (if any). Such refundable credits and government grants are not economically similar to reductions in foreign tax rates because they can benefit categories of businesses that do not typically have income tax liabilities, such as taxpayers that have losses, are in a start-up mode, or are growing rapidly.

Because the distinction between refundable and non-refundable tax credits has a strong policy basis, it is incorporated in basic U.S. tax law, and is being incorporated into international tax standards being developed by the United States and its trading partners. Section 118(b) requires government grants to be included in income, rather than treating such grants as non-taxable contributions to capital. Absent a specific rule, such amounts, including presumably refundable credits that are economically similar to government grants, are treated as income and not reductions to tax expense. Section 6401(b), which provides that refundable credits provided under certain sections of Federal income tax law be treated as overpayments of income tax, does not apply to credits provided by states or foreign jurisdictions. U.S. corporate taxpayers that receive grants or refundable credits from foreign jurisdictions presumably would follow basic U.S. income tax principles and account for such items as gross income, rather than reduction in tax expense. Pursuant to Treas. Reg. § 1.952-2(a), that is the case for controlled foreign corporations as well. The proposed regulations run counter to these basic tax principles.

In addition, the OECD as part of its work on the Pillar 2 global minimum tax is facing policy issues similar to those noted in the proposed regulations in the context of determining the amount of covered income tax paid and is developing standards consistent with longstanding U.S. law (and not the proposed regulations). Under the Pillar 2 Blueprint issued in October 2020, consistent with financial accounting standards on which Pillar 2 is based, non-refundable tax credits are treated as reductions in tax, while government grants are not. Refundable tax credits are generally treated as not reducing tax, subject to safeguards to ensure that governments do not design nominally "refundable" tax credit regimes that circumvent the general rules.[3] We note that the governmental misbehavior of concern to the OECD – governments designing nominally refundable tax credits that in practice can only be recovered against local income tax, thereby having the effect of overstating actual tax paid – tracks the concern expressed by the IRS and Treasury in the Preamble. Rather than abandon the correct policy, however, the OECD has proposed to design reasonable safeguards to ensure that only true refundable tax credit regimes are treated consistently with government grant programs. Finally, we note that U.S. taxpayers' ability to utilize foreign tax credits following the 2017 changes to the U.S. international tax rules have been significantly constrained, further reducing the risk that foreign governments will design tax incentive regimes with an eye toward creditability under U.S. rules.

For these reasons, changing longstanding U.S. law is not necessary to reduce administrative complexity or prevent foreign governments from adopting tax systems intended to harm U.S. interests. Further, such a change would likely place U.S. multinationals at a competitive disadvantage when compared to foreign multinationals making similar investments abroad.

[3] OECD (2020), Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Part 3.3.7.

Recommendation: We respectfully request that the IRS and Treasury not finalize Prop. Reg. § 1.901-2(e)(2)(ii) and instead preserve the longstanding law, under which credits that are likely to be refunded regardless of tax liability do not reduce foreign income taxes paid.

II. Creditability of Foreign Taxes – Net Gain Requirement and New Jurisdictional Nexus Requirement (Prop. Reg. § 901-2(b) and -2(c))

The proposed regulations provide that a foreign tax satisfies the net gain requirement, and therefore is considered an income tax, only if it satisfies each of the realization, gross receipts, and net income requirements with rigid reference to U.S. tax rules. The proposed regulations also provide a new jurisdictional nexus requirement, providing that a foreign tax is not considered an income tax unless it is imposed on a jurisdictional basis identical to the imposition of U.S. taxes. Together, these changes would increase compliance costs as taxpayers would be required to evaluate foreign tax regimes against ever-evolving U.S. tax standards on a real-time basis and would dramatically limit foreign taxes that can be credited against U.S. tax on foreign source income. We do not believe that the policy concerns expressed by the IRS and Treasury in the Preamble justify such fundamental changes to longstanding law. We respectfully request that current law be retained. If the IRS and Treasury believe that a jurisdictional nexus requirement is appropriate, we urge the IRS and Treasury consider re-proposing regulations that provide that a foreign jurisdiction's imposition of a charge based on the generation of income sourced in that jurisdiction, including based on the location of customers, users, or similar destination based criteria, would be sufficient to deem the charge an income tax in the U.S. sense for purposes of section 901.

Regarding the new jurisdictional nexus requirement in particular, the Preamble to the proposed regulations notes that "Treasury and the IRS have determined that it is necessary and appropriate to require that a foreign tax conform to traditional international norms of taxing jurisdiction as reflected in the Internal Revenue Code…to qualify as an income tax in the U.S. sense." To wit, the proposed regulations introduce a new concept of jurisdictional nexus to aid in the determination of whether a foreign tax is an income tax in the U.S. sense by limiting acceptable jurisdictional nexus to that arising due to physical presence, the application of a local country's sourcing rules (as long as they are "reasonably similar" to those that are in effect in the U.S.), and situs of property.[4] The proposed regulations expressly reject jurisdictional nexus arising solely from "the location of customers, users, or any other similar destination-based criterion."[5]

The Preamble also notes that prior iterations of the section 901 regulations had some form of a jurisdictional nexus requirement,[6] and points to requests for guidance that Treasury has received "recommending that the regulations adopt a rule requiring that income subject to foreign tax bear an appropriate connection to a foreign country for a foreign tax to be eligible for the foreign tax credit." What the Preamble fails to acknowledge is that at least one request for guidance urged the inclusion of a jurisdictional nexus requirement that was flexible enough to

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[4] Prop. Treas. Reg. § 1.901-2(c)(1)(i) – (iii).

[5] Prop. Treas. Reg. § 1.901-2(c)(1)(i).

[6] Temp. Treas. Reg. § 4.901-2(a)(1)(iii), 45 Fed. Reg. 75647 (1980) (articulating one prong of the test to determine whether a foreign charge is an income tax in the U.S. sense to be whether "…the charge follows reasonable rules of taxing jurisdiction.")

ensure creditability of most foreign taxes imposed, notwithstanding the fact that the imposition of those taxes might be based on jurisdictional nexus concepts that represent departures from "traditional norms of taxing jurisdiction."[7]

Section 901 provides for a credit for foreign income taxes. Nothing in the language of the statute, or its history, suggests that the term "income tax" for this purpose incorporates principles of tax nexus reflected in the current U.S. income tax. Indeed, the history and structure of the foreign tax credit rules strongly militate against such a conclusion. While the predecessor to section 901(a) initially provided a foreign tax credit for taxes imposed by a foreign country "upon income derived from sources therein,"[8] this requirement was removed in 1921 in favor of the predecessor to the section 904 limitation.[9] This basic structure remains in place today – section 901 provides a credit for foreign income taxes paid, and section 904 ensures that this credit is limited so that the U.S. tax on U.S. source income is preserved. Nothing in the statute or its history suggests that section 901 itself imposes an independent nexus requirement that tests whether the taxpayer has nexus to the foreign country imposing the tax consistent with current U.S. nexus rules.

If the IRS and Treasury believe that a jurisdictional nexus requirement is appropriate, we urge that any such requirement recognize that evolving standards for jurisdictional nexus are manifold, and that the U.S. determination of creditability should be based on whether nexus to a foreign jurisdiction arises because of domicile or residence, physical presence, or realization from income from sources within a country from the perspective of that country. In particular, the concept should be expansive enough to include circumstances in which tax might be imposed on income sourced to a jurisdiction by operation of rules attributing source based on the situs of users or customers, or those in which activities might rise to the level of a physical presence when taxpayers access the jurisdiction remotely.[10] In taking a more flexible view of jurisdictional nexus, Treasury would achieve its aim of ensuring that the foreign tax credit alleviates double taxation arising from a taxpayer's activities or investment outside the United States, while also recognizing the historical and evolving landscape in which U.S. multinationals are operating abroad. While the Preamble references novel extraterritorial taxes, many countries have long imposed taxes on technical and other service fees provided to local customers. Such a proposal would also address questions by government officials in public comments regarding taxes that have no nexus whatsoever to a jurisdiction, which we concede would not properly be considered taxes. To proceed with the narrow definition of jurisdictional

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[7] *See* New York State Bar Association, Tax Section, *Report on Issues Relating to the Definition of a Creditable Tax for Purposes of Sections 901 and 903 of the Code*, November 24, 2015*, available at* https://archive.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2015/Tax_Section_Report_1332.html.

[8] *See* Revenue Act of 1918, §§ 222(a)(1) and 238(a) (1919).

[9] *See* Revenue Act of 1921, §§ 222(a)(5) and 238(a).

[10] *See* New York State Bar Association, Tax Section, Report on Issues Relating to the Definition of a Creditable Tax for Purposes of Sections 901 and 903 of the Code at 20 – 21 (explicitly referencing what Treasury calls "novel extraterritorial taxes," or those imposed on profits arising from taxpayers' sales to or advertising revenue generated by customers resident in a jurisdiction absent a physical presence, as taxes that would qualify as income taxes in the U.S. sense for purposes of section 901).

nexus as proposed would force US taxpayers to bear the brunt of international tax policy shifts and face unmitigated double taxation in a manner that is inconsistent with the statutory scheme.

Recommendation: We respectfully request that current law regarding the net gain requirement be retained, and that the IRS and Treasury abandon the proposed jurisdictional nexus requirement. To the extent that a jurisdictional nexus requirement is deemed necessary for inclusion in the regulations, we urge the IRS and Treasury to consider adopting, in re-proposed regulations, a much more expansive nexus standard, such that a foreign country's imposition of a charge based on the generation of income sourced in that country from its perspective, including based on the location of customers, users, or similar destination based criteria, would be sufficient to deem the charge an income tax in the U.S. sense for purposes of section 901.

III. Creditability of Foreign Taxes – Contested Tax Liability Amounts (Prop. Treas. Reg. § 1.905-1(d)(4))

As a general rule, Prop. Treas. Reg. § 1.905-1(d)(4) provides that taxpayers may elect to claim a provisional foreign tax credit for foreign taxes arising from a contested tax liability that are remitted before the contest is finally resolved. If the taxpayer so elects, it must comply with certain requirements, including filing an amended return for the taxable years to which the contested liability relates and filing a statement that includes, *inter alia*, an agreement to extend the statute of limitations for three years from the later of the filing date or the due date of the return for the taxable year in which the taxpayer notifies the Internal Revenue Service of the final resolution of the contest. In addition, taxpayers are required to file an annual certification up to and including the year in the contest is finally resolved. Failure to comply with the administrative requirements of the provisional foreign tax credit election will result in either disallowance of the provisional foreign tax credit or treating the taxpayer as if they received a refund of the contested tax liability amount, thereby triggering the foreign tax redetermination rules under Treas. Reg. § 1.905-3(b).

Given the ever-increasing complexity, volume, and duration of foreign tax audits and tax disputes, the proposed annual certification requirement substantially increases taxpayers' administrative burden, directly impacting their ability to claim foreign tax credits and mitigate double taxation on a timely basis. The regulatory guidance to section 905 already requires taxpayers to file an amended return to claim foreign tax credits for foreign taxes that were not captured on originally filed local tax returns. While we recognize the need to notify the Internal Revenue Service upon resolution of the contest and understand the policy reasons to extend the statute of limitations in these circumstances, both aims can be achieved without imposing the burden of annual certifications on taxpayers. Further, the failure to file penalties are unduly harsh; by extending the statute of limitations, the Internal Revenue Service has the ability to challenge taxpayers' elections to claim provisional tax credits on substantive grounds.

Recommendation: We respectfully recommend that no annual certification be required for contested liabilities if the taxpayer elects to claim the provisional foreign tax credit. The taxpayer should notify the IRS by filing an amended tax return for the taxable year to which the contested liability relates and at the time of resolution. At a minimum, in the event the IRS and Treasury determine that an annual certification is required for the efficient administration of the provisional foreign tax credit to be administered effectively, a taxpayer's failure to file should not result in a deemed refund of the contested tax liability.

IV. Allocation and Apportionment of Foreign Taxes (Prop. Treas. Reg. § 1.861-20)

Prop. Treas. Reg. § 1.861-20 re-proposes rules for allocating and apportioning foreign income taxes that originally were proposed in 2019 to provide “more detailed and comprehensive guidance.” Among other changes, Prop. Treas. Reg. § 1.861-20(d)(3)(v) introduces the concept of the “taxable unit” in an effort to harmonize the assignation to a statutory or residual grouping an item of foreign gross income the taxpayer includes by reason of the receipt of a disregarded payment, with reference to recently finalized regulatory guidance relating to the GILTI high tax exclusion under section 954 and the separate limitation category rules under section 904. The concepts introduced under these rules are complex and represent a novel approach to allocating and apportioning foreign taxes. Under the proposed approach, taxpayers would be required to perform extensive analysis on foreign taxes paid not only at a CFC and QBU levels, but also at the level of the taxable unit.

We believe that requiring taxpayers to perform more extensive analysis on foreign taxes paid at multiple entity levels is unduly complex, unnecessary, and burdensome.

Recommendation: We respectfully request that foreign taxes paid should be allocated and apportioned on a QBU by QBU basis, and then aggregated at the U.S. shareholder level. Moreover, given the extensive changes made by the 2020 Proposed Regulations to various important disregarded payment rules, we respectfully request that Prop. Treas. Reg. § 1.861-20 be applicable to taxable years beginning after the date the Final Regulations are filed in the Federal Register.

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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.