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ON CHIPS AND TAXES

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Can the CHIPS and Science Act bolster the U.S. semiconductor industry? 2

In August, President Biden signed the Creating Helpful Incentives to Produce Semiconductors (CHIPS) and Science Act into law. The legislation aims to support semiconductor manufacturing in the U.S., yet the bill will unlikely reduce total U.S. reliance on foreign chip manufacturers.

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Investors exposed to tech and parts of the Health Care sector may have breathed a sigh of relief with exclusion of the global minimum tax (GMT) from the Inflation Reduction Act. Still unclear, however, is the impact on two of our favored sectors if the GMT ultimately is implemented.

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On August 16, President Biden signed into law the Inflation Reduction Act, which includes two key corporate tax features: alternative minimum tax and excise tax on stock repurchases. Although the legislation is expected to increase tax revenues, the reforms are unlikely to affect most companies.

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Can the CHIPS and Science Act bolster the U.S. semiconductor industry?

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A step in the right direction

In August, President Biden signed the Creating Helpful Incentives to Produce Semiconductors (CHIPS) and Science Act into law. The legislation aims to support semiconductor manufacturing in the U.S. and reduce reliance on overseas manufacturers. U.S. semiconductor manufacturing has been heavily outsourced in the past three decades. According to the Congressional Research Service, the U.S. has capacity to fabricate 12% of global supply, and an even smaller share of advanced chips. Supply-chain issues from COVID-19 lockdowns exposed the risk of relying on overseas suppliers, as vehicles and other goods needing chips became increasingly scarce.

Although the CHIPS and Science Act is a step in the right direction, we do not believe it will significantly reduce the U.S.'s reliance on offshore suppliers.

Between 1990 and 2020, U.S. fabrication capacity of semiconductors decreased from 40% of worldwide capacity to 12%.

Source: Congressional Research Service, January 13, 2022

Highlights of the CHIPS Act

The CHIPS legislation allocates $54.2 billion to bolster U.S. semiconductor manufacturing. $39 billion is allotted for subsidies between fiscal years 2022 and 2026. Congress included a provision for a 25% tax credit for capital expenses related to advanced-chip manufacturing. $11 billion is earmarked for research and workforce development. $2 billion is allocated to onshoring semiconductor technologies. $1.5 billion is allocated to funding wireless technologies. The remaining $0.7 billion is allocated to produce chips essential for national security and infrastructure and to reinforce cooperation among global suppliers.[1]

Three weeks after passing the legislation, President Biden signed an executive order to facilitate its execution. Implementation priorities included protecting taxpayer dollars, ensuring long-term U.S. sector leadership, developing economies of scale, encouraging private-sector investments, and generating stakeholder benefits.[2]

Given long lead times, new U.S. semiconductor manufacturing will likely not be available for full production for 18 months to two years.

U.S. reliance on overseas chipmakers persists

The U.S. joined several other countries aiming to bolster their semiconductor supply chains with similar onshore incentives. Besides the U.S., countries that have passed legislation to encourage localized semiconductor manufacturing include the European Union, India, South Korea, and Japan. Although the CHIPS legislation is designed to support the U.S. semiconductor industry, in our view, it will not be enough to decouple from overseas suppliers.

According to SEMI, the global semiconductor industry association, global investment in semiconductor manufacturing will lead to roughly 86 new plants between 2020 and 2024 (13 in the Americas), which we view as a long-term positive for capital-equipment companies.[3]

1. CHIPS and Science Act Fact Sheet, House Committee on Science, Space, and Technology, July 27, 2022
2. White House Briefing Room, August 25, 2022
3. www.semi.org

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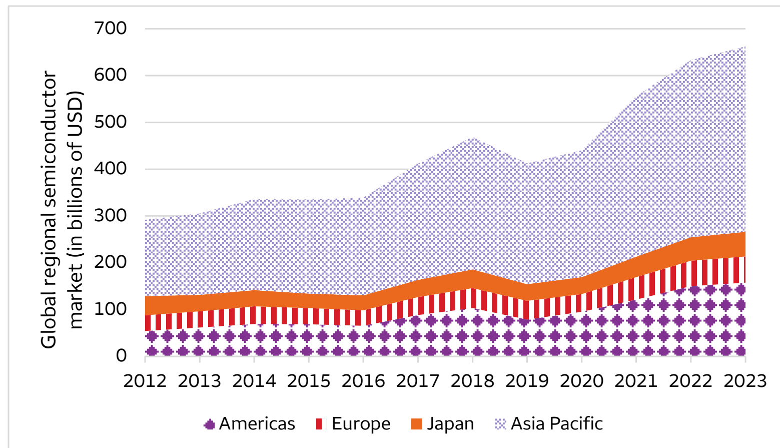
Worldwide investment in the sector is likely to eclipse new U.S. investment in chip manufacturing. A single manufacturing facility can cost between $10 billion and $15 billion to build. In comparison, Taiwan's largest foundry plans to invest $100 billion in semiconductor initiatives over the next three years.[4] The relatively modest funding in the CHIPS bill is unlikely to significantly reduce U.S. reliance on global suppliers.

Chart 1. Regional markets for semiconductors continue to grow particularly in Asia



Sources: World Semiconductor Trade Statistics and Wells Fargo Investment Institute, September 9, 2022, data as of August 2022. The 2022 and 2023 numbers are predictions from World Semiconductor Trade Statistics.

We expect global incentives to spur semiconductor initiatives to expand supply but not stimulate demand. The current semiconductor cycle is starting to trend lower, driven by demand weakness in computers, low- and mid-range smartphones, and gaming and could potentially spread to other semiconductor end markets as aggressive Federal Reserve rate hikes aim to cool demand and contain inflation. Moreover, new U.S. manufacturing supply will likely not be available for full production for 18 months to two years, which may or may not coincide with a cyclical upturn in the semiconductor cycle needed to drive demand to support capacity coming online.

Spurred by the CHIPS legislation, several big tech companies pledged $50 billion in investments in semiconductor initiatives.[5] This may benefit near-term investor sentiment toward the Information Technology (IT) sector. Tactically, we are favorable on the sector. The CHIPS Act is expected to directly benefit semiconductor companies that own their own manufacturing facilities, as well as semiconductor capital-equipment companies that supply leading-edge equipment to them.

Given the lengthy lead times to construct manufacturing facilities, we expect the legislation to create longer-term opportunities in the IT sector. Taiwan's largest foundry plans to use subsidies to fund an advanced five-nanometer manufacturing facility in Phoenix, Arizona.[6] With Taiwan's proximity to China, the CHIPS Act could be a first step toward strengthening the U.S.'s semiconductor supply chain. This may help alleviate risks associated with future pandemics and U.S. reliance on production in Asia given U.S.-China tensions over Taiwan's sovereignty.

Key takeaways

- The CHIPS and Science Act allocates $54.2 billion to bolster U.S. semiconductor manufacturing.

  Source: CHIPS and Science Act Fact Sheet, House Committee on Science, Space, and Technology, July 27, 2022

- The act is unlikely to significantly reduce U.S. reliance on global suppliers.

- Announcements of semiconductor initiatives from big tech firms may benefit the Information Technology (IT) sector in the near term. Tactically, we favor the sector and expect the legislation to create longer-term opportunities for investors.

4. "Inside TSMC, the Taiwanese chipmaking giant that's building a new plant in Phoenix," CNBC.com, March 23, 2022
5. FACT SHEET: CHIPS and Science Act Will Lower Costs, Create Jobs, Strengthen Supply Chains, and Counter China, The White House, August 9, 2022
6. "Inside TSMC, the Taiwanese chipmaking giant that's building a new plant in Phoenix," CNBC.com, March 23, 2022

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The global minimum tax: Orphaned by tax reform

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U.S. multinationals prepare for life without a global minimum tax

A global minimum tax (GMT) agreement signed last year by 137 countries was conspicuous by its absence from the newly minted Inflation Reduction Act signed into law by the president. Lack of U.S. support risks undercutting momentum for last year's agreement upending a century of international tax principles. However, at least five major eurozone countries have vowed to implement the new law beginning next year, perhaps pressuring other signatories — including the U.S. — ultimately to implement the agreement's two key pillars, or features of the legislation:

Driving the global minimum tax debate is the estimated $240 billion in lost tax revenues globally, according to OECD estimates.

1. Pillar One would tax 25% of an estimated $125 billion in global multinationals' profits based on where the revenues are generated rather than where the business is headquartered. It would apply to companies with global sales of about $20 billion and on earnings with margins above 10%. This feature is scheduled for mid-2023.[7]

2. An even more far-reaching Pillar Two establishes a 15% global minimum tax not expected to be implemented before 2024. The tax on companies with revenues of at least $750 billion would generate an estimated $150 billion in additional corporate tax revenue worldwide.[8]

The Joint Committee on Taxation in late July estimated that failing to adopt the global minimum tax would cost the U.S. Treasury $318.7 billion in forgone revenues over 10 years.

Higher taxes, lost revenues. An important driver of global tax reform has been the estimated $240 billion in revenues lost annually by multinationals shifting to low-tax locations, according to Organisation for Economic Co-operation and Development (OECD) estimates.[9] One deal-breaker in the U.S. was opposition by moderate Democratic Senator Manchin and Republicans to a change in tax law, critical to achieving a required two-thirds majority vote in the Senate. Another is the failure to align corporate tax rules with those stipulated in the global minimum tax draft.

A "fiscal fail-safe" feature of the GMT is designed to encourage compliance by allowing authorities to top up revenues on subsidiary income taxed at less than 15% in their headquartered country.[10] The Joint Committee on Taxation has estimated U.S. forgone tax revenues at nearly $319 billion over 10 years by eschewing the GMT and this topping-up provision. U.S. multinationals risk paying a higher tax bill if the U.S. stays out of the agreement than if the U.S. joins. Digital services taxes already imposed in Europe on mostly American social media and other internet companies act as a lever to encourage the U.S. to pass the GMT agreement. France has taken the lead with a 3% tax on income from targeted ads and the sale of data for companies with at least $750 million in global revenue and digital sales of $25 million or more in France.[11]

7. Daniel Bunn and Sean Bray, "The Latest on the Global Tax Agreement," The Tax Foundation, September 7, 2022
8. Ibid.
9. "U.S. Risks Losing Billions in Taxes as Congress Spurns Global Deal," Bloomberg L.P., July 27, 2022
10. Rob Garver, "U.S. Failure to Implement Global Minimum Tax Could Be Costly," VOA News, July 28, 2022
11. "Plans for a Global Minimum Tax Revolution, Explained," Bloomberg L.P., August 5, 2021

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What does it mean for investors? On the face of it, we believe mega-cap companies (companies with market capitalizations in excess of $200 billion) with sizable foreign income from intangible (and geographically mobile) assets have the greatest exposure if momentum in the U.S. GMT debate again shifts toward passage. By the numbers, our favored large-cap Information Technology and Health Care sectors are potentially most at risk (the latter because of pharmaceuticals with sizable intellectual property on the industry's balance sheet). More than half of the nearly 30 listed companies surveyed with foreign income exposure of at least 50% and a foreign effective tax rate of less than 15% are in the tech sector, according to a study last year by Goldman Sachs, Inc., including more than half of those in the semiconductor industry.[12]

However, we believe more than foreign exposure and effective tax rates will determine the ultimate impact of any future GMT on industry earnings and stock performance. First, our view is that U.S. implementation of the GMT likely is several years away, at the earliest, given opposition from Senator Manchin and Republicans. The prospects for a split government after the midterm elections only increase the likelihood of delay. Needed U.S. support by other signatories to the 2021 agreement likely will delay further global implementation despite the decision by core eurozone countries to press ahead with adoption of the new tax law. Second, company financial innovation historically has been effective in minimizing the impact of tax changes. Their subdued reaction to the tax debate, thus far, could suggest confidence in their ability to do so this time. Lastly, GMT skeptics argue that subsidies, grants, property-tax relief, and other incentives could offset the leveling effect of the minimum tax rate, despite the risk of running afoul of rules set by the World Trade Organization.

Key takeaways

- On the face of it, we believe exposure to the GMT is greatest among Information Technology and parts of the Health Care sector.
- We believe the ultimate impact on investment performance will depend less on the GMT debate than on whether and when the new law is implemented, the company response to it, and policy actions to mitigate the tax law's impact.

12. "What a 15% Global Minimum Corporate Tax Rate Means for the Stock Market," Barron's, June 9, 2021, https://www.barrons.com/articles/global-minimum-corporate-tax-rate-51623186979

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Corporate tax features of the Inflation Reduction Act

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Corporate tax hikes

On August 16, 2022, President Biden signed into law the Inflation Reduction Act of 2022, a sweeping bill with significant tax, energy, and health care implications. Two key corporate tax aspects of the act include the following:

1. 15% minimum tax on corporate book income (less corporate alternative minimum tax) for corporations with profits over $1 billion, effective in 2023.

Generally, this would apply to any large company, but not an S corporation, real estate investment trust, or regulated investment company whose average annual adjusted financial statement income exceeds $1 billion for three consecutive years. In the case of U.S. corporations that have foreign parents, it would apply only to income earned in the United States of $100 million or more. It would also apply to a new corporation in existence for less than three years based on the earnings in the years of existence.

2. 1% excise tax on the value of stock repurchases during the taxable year, net of new issuances of stock, effective for repurchases beginning in 2023.

This excise tax on stock repurchases, or "stock buybacks," of publicly traded companies provides that a covered corporation is subject to a tax equal to 1% of the fair market value of any stock of the corporation that is repurchased by such corporation during any taxable year. A "covered corporation" means a domestic U.S. corporation whose stock trades on an established securities market.

Excluded from the tax is stock contributed to retirement accounts, pensions, and employee stock ownership plans.

Book income versus taxable income

The key to understanding which companies may be burdened by the tax is to understand the differences between book income and taxable income. Under generally accepted accounting principles (GAAP) rules (book income), businesses must depreciate assets over time, but under the tax code (taxable income), businesses may either receive accelerated depreciation or full expensing in the case of equipment. This means that under the new law, book income temporarily may exceed taxable income, and as a result, some companies may be forced into the alternative minimum tax — as corporations will be paying the greater of their ordinary tax liability or 15% of their adjusted financial statement income. This could impact capital-intensive industries like manufacturing. More specifically, companies with heavy capital expenditures yet a low effective rate would be affected.

Another big issue is the treatment of stock-based compensation. GAAP rules require companies to deduct the costs when granted, but in the tax code, businesses may deduct those costs when they are exercised.

The nonpartisan Congress Joint Committee on Taxation found that 49% of the corporate minimum tax would fall on domestic manufacturers.

Source: "The Schumer-Manchin Tax Increase on Everyone," The Wall Street Journal, July 31, 2022

Twenty-seven mega-cap companies accounted for half of the dollar value of stock buybacks over the past year.

Source: "Stock-Buyback Tax Helps Offset Cost of Changes to Inflation Reduction Act," The Wall Street Journal, August 10, 2022

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What it means for investors

Implications of the book minimum tax: As a share of its income, the real estate and rental/leasing industry faces the heaviest burden of the book minimum tax, facing a net tax hike of 12.7% of its pretax book income, followed by mining, which faces a 4.6% tax hike.

The average effective tax rate under the corporate income tax rises from 18.7% to 19.3% in 2023. Manufacturing faces a somewhat higher effective tax rate, rising from 23.4% under current law to 23.8% from the minimum book tax. Also, the minimum book tax requires assets to be depreciated over a longer period of time, a negative for capital-intensive industries such as manufacturing. Mining closely follows with an effective tax rate of 23.6%, up from 22.6% under current law. Utilities and agriculture face the largest jump in the average effective tax rate, rising from 14.7% under current law to 23.3% if the minimum book tax comes into effect.

For perspective, there are some considerations that can help offset the overall impact. For example, some regular corporate income tax credits and deductions are still allowed under the minimum tax, including credits for foreign taxes paid. The carrying forward of prior-year losses to offset future income is also permitted, but only 80% can be applied to reducing taxable income. Credits for research and development expenses are allowable. In addition, the act preserves deductions on capital investments and allows companies to more quickly offset these expenses against tax bills. Finally, the U.S. Treasury finalizes rules and regulations under the new legislation, and this process will likely be intensely lobbied through 2023 and beyond, which may delay many of the negative implications for tax liability.

Excise tax on stock buybacks is effectively picking winners and losers: Companies with substantial equities-based compensation will more likely be subject to the book minimum tax, especially mega-cap companies and start-up companies, particularly in the tech sector. The 1% tax on share repurchases may trigger just a 1.5% increase in corporate dividend payouts, according to the Tax Policy Center.

Taking these factors and economic fundamentals into consideration, we remain neutral (and would have full market weight) in Utilities, Materials, and Industrials. We favor below-market-weight in Real Estate.

Key takeaways

- Corporate tax features of the Inflation Reduction Act include a new 15% corporate alternative minimum tax and the new 1% stock buyback excise tax.
- The new corporate taxes will likely have the greatest impact on capital-intensive industries such as manufacturing.
- Overall, the corporate tax hikes on corporate earnings or their share repurchase activities shouldn't affect most companies.

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