

## Treasury Issues Proposed Guidance on CHIPS Act Investment Tax Credit

Tax Alert

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On March 23, 2023, the U.S. Departments of the Treasury (Treasury) and [Commerce](#) (Commerce) issued proposed guidance on incentives for domestic semiconductor manufacturing enacted in the [Creating Helpful Incentives to Produce Semiconductors \(CHIPS\) Act](#). Treasury and the IRS issued [proposed regulations](#) to implement the section 48D advanced manufacturing investment credit established by the CHIPS Act of 2022 to incentivize semiconductor manufacturing in the U.S. (Proposed Treasury Regulations). The Proposed Treasury Regulations provide guidance on critical definitions in the statute, provide for the treatment of investments that stretch past the termination of the credit, and elaborate on provisions meant to discourage investments in semiconductor manufacturing capacity in China.

### Key Definitions

The Proposed Treasury Regulations elaborate on several definitions that are key to determining whether a taxpayer has made investments eligible for the credit. Section 48D(a) allows a credit equal to 25 percent of a "qualified investment" made in a taxable year with respect to any "advanced manufacturing facility." A "qualified investment" with respect to an "advanced manufacturing facility" means "the basis of any qualified property placed in service by the taxpayer during such taxable year which is part of an advanced manufacturing facility." "Qualified property" generally means tangible property:

- For which depreciation (or amortization in lieu of depreciation) is allowed
- That is either constructed, reconstructed, or erected by the taxpayer, or acquired by the taxpayer so long as the property has not previously been used
- Which is integral to the operation of the advanced manufacturing facility

An "advanced manufacturing facility" is defined as "a facility for which the primary purpose is the manufacturing of semiconductors or semiconductor manufacturing equipment."

### Qualified Property

First, the Proposed Treasury Regulations provide guidance on the elements of "qualified property" in section 48D(b)(2). Of note are the definitions of "original use" and "integral to the operation of an advanced manufacturing facility." The Proposed Treasury Regulations define "original use" as "the first use to which the property is put by any taxpayer in connection with a trade or business or for the production of income." Prop. Treas. Reg. § 1.48D-3(e)(1). While the acquisition cost of property reconditioned or rebuilt by another taxpayer does not satisfy the "original use" requirement, additional costs incurred to recondition or rebuild property acquired or owned by the taxpayer may be included in its creditable basis in property. *Id.* The fact that a taxpayer or another person held property in inventory prior to the taxpayer placing the property in service will not prevent property from meeting the "original use" requirement. Prop. Treas. Reg. § 1.48D-3(e)(2).

The Proposed Treasury Regulations explain that property is "integral to the operation of an advanced manufacturing facility" if it "is used directly in the manufacturing operation, is essential to the completeness of the manufacturing operation, and is not transformed in any way as a result of the manufacturing operation." Prop. Treas. Reg. § 1.48D-3(f). They give several examples of property that is normally treated as integral or not integral to the operation of an advanced manufacturing facility. Research and storage facilities may be integral if it is used in connection with the manufacturing of semiconductors or semiconductor manufacturing equipment, for example in the case of a research facility that manufactures prototypes.

## Advanced Manufacturing Facility

The Proposed Treasury Regulations define an "advanced manufacturing facility" as a facility "for which the primary purpose . . . is the manufacturing of finished semiconductors . . . or the manufacturing of finished semiconductor manufacturing equipment." Prop. Treas. Reg. § 1.48D-4(b). They define "semiconductor" as "an integrated electronic device or system commonly manufactured using materials such as, but not limited to, silicon, silicon carbide, or III-V compounds, and processes such as, but not limited to, lithography, depositions, and etching." Prop. Treas. Reg. § 1.48D-2(k). They also define "semiconductor manufacturing" to include semiconductor fabrication and packaging. Prop. Treas. Reg. § 1.48D-2(l).

Whether the primary purpose of a facility is to manufacture finished semiconductors or semiconductor manufacturing equipment is determined based on all facts and circumstances. Prop. Treas. Reg. § 1.48D-4(c)(1). However, a facility that "manufactures, produces, grows or extracts materials or chemicals" that are used by an advanced manufacturing facility as components in manufacturing semiconductors or semiconductor equipment will not have a primary purpose of manufacturing finished semiconductors or semiconductor manufacturing equipment. Prop. Treas. Reg. § 1.48D-4(c)(2). The Proposed Treasury Regulations provide an illustrative example in which the primary purpose requirement is satisfied if 75 percent of property placed in service is dedicated to manufacturing semiconductors or semiconductor manufacturing equipment. Prop. Treas. Reg. § 1.48D-4(c)(3).

## Effective Dates and the Beginning of Construction

The credit sunsets on December 31, 2026 and is not available with respect "to property the construction of which begins after" that date. The Proposed Treasury Regulations set out the following two tests that taxpayers may use to determine the beginning of construction: (1) the physical work test and (2) the five percent safe harbor. Prop. Treas. Reg. § 1.48D-5(b)(1). The physical work test is satisfied when physical work of a significant nature occurs on construction of an item of property. Prop. Treas. Reg. § 1.48D-5(c). Work may be performed by a third party if it is done so under a binding contract. The five percent safe harbor is satisfied when the taxpayer has paid or incurred five percent of the total cost of the property. Prop. Treas. Reg. § 1.48D-5(d). The Proposed Treasury Regulations allow taxpayers to choose the test by which they determine when construction begins for purposes of section 48D. Prop. Treas. Reg. § 1.48D-5(b)(1).

Both the physical work test and the five percent safe harbor include a continuity requirement. Generally, the continuity requirement is satisfied if a taxpayer can show, based on the relevant facts and circumstances, "continuous construction or continuous efforts." Prop. Treas. Reg. § 1.48D-5(b)(2). Under a safe harbor, a taxpayer will be deemed to have met the continuity requirement if it places property in service within ten years of the date on which construction began on the property.

Solely for purposes of determining the beginning of construction, the Proposed Treasury Regulations allow taxpayers to treat multiple items of qualified property as a single manufacturing facility project, provided that the facts and circumstances support such a determination. Prop. Treas. Reg. § 1.48D-5(a)(3). They offer a non-exhaustive list of factors that could support a finding that multiple properties are operated as a part of a single advanced manufacturing facility project. Aggregating multiple buildings into one single advanced manufacturing facility project could allow taxpayers to claim a credit with respect to construction on components of a project that begins after December 31, 2026, provided that all other requirements are met. The Proposed Treasury Regulations also provide a disaggregation rule that would allow a single advanced manufacturing facility project to be broken up into its individual components for purposes of determining which of the projects is eligible for the credit in instances where some of the projects are not placed in service within the ten-year continuity safe harbor period. Prop. Treas. Reg. § 1.48D-5(a)(3)(iv).

## Recapture Provisions

The Proposed Treasury Regulations elaborate significantly on the credit recapture provisions under section 50(a) whereby a taxpayer that benefits from the section 48D credit must recapture the credits if it engages in an "applicable transaction" during the 10-year period after it places in service property that is eligible for the section 48D credit. The credit recapture provisions relate to

certain expansions of semiconductor manufacturing capacity in a "foreign country of concern," *e.g.*, China, and include exceptions for certain transactions involving legacy semiconductor manufacturing. The preamble to the Proposed Treasury Regulations states that they were intended to "align and harmonize" the credit recapture provisions with standards set forth in proposed rules issued by Commerce on the same day.

The Proposed Treasury Regulations define "applicable transaction" as "any significant transaction involving a material expansion of semiconductor manufacturing capacity in any foreign country of concern." Prop. Treas. Reg. § 1.50-2(b)(3). A "significant transaction" means any transaction (or series of transactions) in which a taxpayer makes a proposed, pending, or completed investment valued at \$100,000 or more. Prop. Treas. Reg. § 1.50-2(b)(10). (This is the same threshold amount set forth in the proposed Commerce regulations.) A "material expansion" means any addition of physical space or equipment intended to or resulting in an expansion of semiconductor manufacturing capacity of five percent. Prop. Treas. Reg. § 1.50-2(b)(7).

The Proposed Treasury Regulations include an exception to the recapture provisions for transactions that expand the manufacturing capacity for certain legacy semiconductors. A transaction that primarily involves the expansion of capacity to manufacture legacy semiconductors is not an applicable transaction, provided that (1) at least 85 percent of the output of the facility at issue is incorporated into finished products used or consumed in the market of a foreign country of concern, or (2) the transaction is an expansion of an existing facility and does not increase manufacturing capacity at that facility by more than 10 percent. Prop. Treas. Reg. § 1.50-2(c).

## Observations

Taxpayers in the industry should carefully evaluate the new guidance for determining eligibility for the advanced manufacturing credit and the provisions requiring recapture of the credit because of future investment in China. While the Proposed Treasury Regulations allow taxpayers to begin to plan whether and how the credit will apply to their planned investments, open questions remain, including those regarding the direct pay election in section 48D(d).

Treasury and the IRS requested comments on several specific areas. Importantly, the preamble to the Proposed Treasury Regulations solicits comments from taxpayers regarding the definition of "semiconductor," specifically whether it should be expanded to include "semiconductive substances – materials with electronic properties controllable by the addition of, typically small, quantities of specific elements or dopants – on which an electronic device or system is manufactured, such as, but not limited to, polysilicon and compound semiconductor wafers." Treasury and the IRS also requested comments on the proposed information reporting requirements related to planned significant transactions that could potentially trigger the recapture provision and procedural and registration requirements for the direct pay election. Comments on the Proposed Treasury Regulations are due May 22, 2023.

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