Sempra Energy – April 2015

<u>Comments on Certain International Tax Provisions for Consideration by the International Tax Working Group of the United States Senate Committee on Finance</u>

Sempra Energy ("Sempra"), a U.S.-based energy company with domestic and international operations, supports a lower tax rate on foreign earnings as proposed by a number of participants in tax reform discussions. Sempra appreciates the opportunity to provide its comments to the International Tax Working Group and looks forward to discussing them with policymakers in greater detail.

I. Background

The underpinning concepts of the U.S. tax rules governing international operations were developed more than 50 years ago – when effectively all products were manufactured, transported, sold, and physically delivered. Since that time, international commerce has greatly changed and today many companies' most valuable assets are not fixed, which makes it difficult to establish how and when to value intangibles such as corporate reputation and technical know-how.

A. Worldwide Taxation with Deferral

As a general premise, the U.S. taxes income earned by U.S.-based companies on their worldwide operations. However, tax is not due on certain foreign business income until that income is repatriated, which may be many years in the future. This delay in taxation in the U.S. is commonly referred to as deferral. Upon repatriation, such foreign earnings are added to taxable income – although additional U.S. tax rules apply to prevent those earnings from being subject to double taxation (i.e., taxation in both the foreign jurisdiction and the U.S. on the same dollar of earnings). Specifically, the U.S. tax rules permit U.S.-based companies to: (1) offset their U.S. tax liabilities with credits for foreign taxes paid, and (2) deduct U.S. expenses allocable to foreign earnings (although in many cases the U.S. expenses reduce the foreign tax credits that can be used).

In pure economic terms, the current U.S. system of deferral has a significant impact on the value the U.S. government realizes in taxing the foreign operations of U.S. based companies. For example, the present value cost to a U.S. based company for a U.S. tax liability that is deferred over a long period of time is practically zero. To illustrate this point, a U.S. based company that can earn a 10% rate of return on its capital will owe just one penny for every dollar of U.S. tax that it would otherwise currently owe if that dollar of U.S. tax can be deferred for 50 years. Thus, the current U.S. system of deferral incentivizes U.S. based companies to accumulate foreign earnings outside the U.S., rather than repatriate those earnings. Importantly, there is no supportable policy reason to defer U.S. tax on foreign earnings while currently taxing domestic earnings.

B. Territorial Taxation

If the U.S. abandons its current system of worldwide taxation with deferral in favor of a territorial system of taxation, foreign earnings of U.S. based companies would be exempt from U.S. taxation. Adoption of a territorial system would align the U.S. with most OECD countries, which already employ such a system. It is important to note, however, that no country has enacted a pure territorial system, and virtually all large industrialized countries utilizing a form of territorial system impose important limitations on that system. For example, some countries, such as France, reduce the deduction for expenses attributable to foreign source earnings. Other countries, such as Germany, reduce the exemption amount in lieu of carving back the expense deduction. Further, most countries that follow a territorial system have enacted anti-abuse or "base erosion" provisions in order to prevent companies from recharacterizing local earnings as foreign earnings.

II. Untaxed Accumulated Foreign Earnings of U.S. Based Companies

In order to successfully transition the U.S. to a new and more competitive system of taxation on foreign earnings, Sempra supports tax reform that requires all prior untaxed foreign earnings to be taxed immediately at a rate that is significantly lower than the current 35% rate. However, Sempra believes that the foreign tax credit reduction contained in several tax reform proposals must be eliminated in order to minimize the significant economic disparity that the reform would otherwise create between U.S.-based companies that have paid a reasonable foreign tax on their earnings and U.S.-based companies that have structured their foreign operations to eliminate or greatly reduce their foreign tax liabilities.

By way of example, the Treasury Department's 2016 Green Book, also known as the *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, and the President's *Fiscal Year 2016 Budget* (the "2016 Treasury Proposal") proposes a 14% tax immediately on all previously untaxed foreign income. For companies that already paid tax in another country, it would offset that U.S. tax with a foreign tax credit, but that credit would only amount to 40% of the taxes that company actually paid. While this approach may be relatively simple and straight forward, the proposed reduction in the foreign tax credit disproportionately impacts taxpayers who have paid a reasonable foreign tax on their foreign earnings and favors taxpayers that have paid little, if any, foreign tax on their foreign earnings.

To illustrate this point, assume Company A has operations in Country X that imposes a 20% tax rate while Company B structured its foreign operations so that it was not subject to foreign tax (i.e., had a 0% foreign tax rate). Assuming a 14% U.S. tax rate on accumulated foreign earnings and only a partial foreign tax credit (e.g., 40% of foreign tax), the total tax burden on the accumulated foreign earnings for these two companies is computed as follows –

	Company A	Company B
Foreign Taxable Income	100	100
Tax Rate	20%	0%
Foreign Tax Paid	20	0
14% U.S. Tax	14	14
Foreign Tax Credit	8	0
Net U.S. Tax	6	14
Total Tax	26	14

The disparity between the total taxes paid by Company A and Company B is significant (26% for Company A and 14% for Company B). This disparity is due to the reduction in the amount of foreign tax credits allowed. To illustrate this point, consider the U.S. tax owed by Company A and Company B under the following three scenarios: (1) the 2016 Treasury Proposal, (2) the 2016 Treasury Proposal with no reduction in foreign tax credits, and (3) the current tax system.

	Company A	Company B
U.S. Tax - Credits As Proposed	$ 6	$14
U.S. Tax - No Reduction in Credits	$ 0	$14
U.S. Tax - Current Tax System	$15	$35

When compared against current tax system, the 2016 Treasury Proposal reduces Company A's U.S. tax obligation by $9 while reducing Company B's obligation by $21. Sempra does not believe there is a strong policy reason to treat companies differently based on the amount of foreign taxes paid. By modifying the 2016 Treasury Proposal to provide a full credit for foreign taxes paid, Company A's U.S. tax obligation is reduced by $15 when compared to current law, while Company B's obligation is reduced by $21. While Company B continues to receive better treatment than Company A, the gap is significantly smaller when the foreign tax credit is not reduced.[1] Therefore, Sempra

[1] The foreign tax credit reduction is also included in the Ways and Means Committee's tax reform discussion draft introduced in the 113th Congress by former House Ways and Means Committee Chairman Dave Camp (R-MI) as the Tax Reform Act of 2014 (H.R. 1).

believes the better view is that there should not be a reduction to the foreign tax credit, even if it is necessary to increase the proposed tax rate on accumulated foreign earnings.

III. Current Foreign Earnings of U.S. Based Companies

A. Sempra's Proposed Hybrid Approach

As a perennially desired destination for multinational companies, the U.S. is capable of embracing an international tax system that is fair and promotes economic growth without engaging in harmful tax competition with other countries. Therefore, Sempra's proposes a new hybrid system of international taxation that incorporates the most desirable components of both the worldwide system of taxation and the territorial system. This system would permit a full exemption for the foreign earnings of U.S. companies from active business enterprises in certain countries. Specifically, the full exemption would be available for active business activities in countries: (1) where the U.S. has a tax treaty, or (2) which are designated as a cooperative non-haven country. Further, to reduce the incentives U.S. based companies currently have to shift manufacturing away from the U.S. the proposed exemption would be reduced for any goods and services that are produced overseas and consumed within the U.S. (non-exempt foreign earnings). For foreign income that would not be eligible for the exemption, a full credit would be allowed for foreign taxes incurred.

Additionally, to prevent U.S. taxpayers from subsidizing foreign operations that directly compete with U.S. based operations, Sempra's proposed new system would disallow U.S. expenses that are, directly or indirectly, attributable to non-exempt foreign earnings. The proposal would also support U.S. job growth by permitting a full deduction for U.S. expenses that are attributable to exempt foreign earnings. As mentioned above, this approach – which combines: (1) a foreign earnings exemption for active business enterprises, (2) the elimination of deferral on foreign earnings, and (3) the elimination of U.S. tax deductions for U.S. expenses allocable to non-active and non-exempt foreign earnings – merges the best aspects of the worldwide system of taxation and the territorial system.

B. Tax Credits for Tax Equivalency

Sempra's proposed hybrid approach, the 2016 Treasury Proposal and the Ways & Means Committee's tax reform discussion draft (hereinafter, the "Ways & Means Discussion Draft")[2] all permit foreign tax credits to prevent double taxation. Sempra believes that such credits are necessary for the U.S. to stay competitive with foreign jurisdictions.

[2] The Ways and Means Discussion Draft was introduced in the 113th Congress by former House Ways and Means Committee Chairman Dave Camp (R-MI) as the Tax Reform Act of 2014 (H.R. 1).

However, a foreign levy can be direct or indirect. For example, foreign governments occasionally offer Sempra, as well as other infrastructure-based multinationals, incentives during the bid process on large scale infrastructure projects. These incentives are designed to reduce the overall cost of capital that is necessary to build the project. Examples of such projects include building renewable energy facilities and/or power plants in areas of a country that lack adequate resources.

The incentives offered may be in the form of income tax credits or reduced tax rates. Ultimately, the reduced costs to build a project are passed on to the local customers in the way of lower energy or electricity rates. Sempra believes that for U.S. foreign tax credit purposes, a foreign tax "equivalent" should be allowed. For example, if the statutory rate is 30% but the effective tax rate is 15% as a result of the local tax credit incentive, the U.S. based company should be allowed to include the tax equivalent of a 30% tax rate for purposes of calculating its U.S. foreign tax credit. Sempra believes this system would be somewhat equivalent to how U.S. energy producers receive incentives (e.g., production tax credit) and how the benefits or tax savings are ultimately passed on to the customer in lower rates.

C. Related Party Expenses

As discussed above, Sempra believes that U.S. expenses attributable to non-exempt foreign earnings, whether directly or indirectly, should be disallowed in order to prevent U.S. taxpayers from subsidizing foreign operations that directly compete with U.S. based operations. Sempra further believes that in order to support U.S. job growth, U.S. expenses that are attributable to exempt foreign earnings should be fully deductible. In both instances, related party expenses, such as interest expense, should be fully taken into account in this determination.

As an example, the Ways & Means Discussion Draft addressing thin capitalization limits on interest deductibility only takes third party debt into account in determining whether U.S. interest expense should be deductible. However, failure to take into account related party cross border debt distorts the treatment of expenses. To illustrate, if the U.S. parent company borrows $100 and on-lends $25 to a CFC on similar terms, the $25 CFC debt should be netted against the $100 U.S. parent company debt such that the U.S. parent company is treated as having $75 of debt and the CFC is treated as having $25 of debt. Exhibit 1 (attached hereto) provides a numerical example illustrating both the distortion and the elimination of that distortion when related party debt is taken into account.

D. Simplification

While there is a clear trade-off between simplicity and the potential for disparate treatment between similarly situated taxpayers, Sempra favors simplicity. Sempra's proposal to eliminate deferral and limit what qualifies as exempt income is a relatively simple approach. This proposal also mitigates the complexities of base erosion – a concern shared by almost all policy makers. Further, Sempra believes that a complex approach to reforming the U.S. international tax rules will lead to loopholes and potential abuse — which will require further governmental action and add additional complexity. Additional complexity, in turn, dramatically increases compliance costs and also leads to unintended consequences. These unintended consequences may have harmful effects on U.S. multinationals, such as: (1) the inability to efficiently restructure to meet business needs, (2) the inability to submit competitive bids, and (3) the inability to form strategic alliances. Therefore, Sempra believes the benefits of simplicity outweigh the disparate treatment that some companies may experience.

IV. Conclusion

Sempra appreciates the opportunity to submit these observations and proposals for consideration and would be happy to develop them further if that would be of interest.

Exhibit 1

Camp Discussion Draft - base erosion - thin capitalization - interest expense deduction limitation examples

In all three examples, the U.S. company that has a debt equity ratio of 1:1 and a worldwide ratio of 1:1, so no distortion. Example assumes interest rate of 5%. Under the current Discussion Draft, the taxpayer is penalized when the debt equity ratio is achieved with related party debt (see example 2a). By recognizing the related party debt in calculating the excess U.S. debt ratio, this penalty is eliminated (see example 2b).

example 1 ***200 US third party debt, 200 foreign third party debt and no related party debt between US and foreign***

	Debt	Assets	Debt Ratio		
U.S. debt level	200	400	0.500		
Worldwide debt level	400	800	0.500	0.550	110% of worldwide debt
				-0.050	***No excess U.S. debt ratio***
				10.000	US interest expense
				0.000	Nondeductible interest expense
				10.000	US deductible interest expense

example 2a ***250 US third party debt, 150 foreign third party debt and 50 related party debt between US and foreign***

	Debt	Assets	Debt Ratio		
U.S. debt level	250	400	0.625		
Worldwide debt level	400	800	0.500	0.550	110% of worldwide debt
				0.075	***Excess U.S. debt ratio***
				12.500	US interest expense
				0.937	Nondeductible interest expense
				11.563	US deductible interest expense

example 2b ***Same as example 2a except 50 related party debt taken into account in the rule (i.e., included in U.S. and worldwide debt amounts)***

	Debt	Assets	Debt Ratio		
U.S. debt level	200	400	0.500		
Worldwide debt level	400	800	0.500	0.550	110% of worldwide debt
				-0.050	***No excess U.S. debt ratio***
				10.000	US interest expense
				0.000	Nondeductible interest expense
				10.000	US deductible interest expense