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The Honorable David J. Kautter
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The Honorable David J. Kautter
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Internal Revenue Service
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May 31, 2018

Re: Comments Requested in Notice 2018-28

Dear Sirs:

Sempra Energy is pleased to present its comments on guidance under Section 163(j) of the Internal Revenue Code¹ as requested by the Department of Treasury (“**Treasury**”) and the Internal Revenue Service (the “**IRS**”) in Notice 2018-28. In particular, these comments focus on the appropriate scope of the exception to the application of the Section 163(j) limits on interest deductibility that is contained in Section 163(j)(7)(A)(iv) relating to certain statutorily specified regulated utility businesses (the “**Utilities Exception**”).

Section 163(j) generally imposes a limit on the deductibility in any taxable year of “business interest” to 30 percent of adjusted taxable income (as defined). “Business interest” is in turn defined under Section 163(j)(5) as “any interest paid or accrued on indebtedness properly allocable to a trade or business.” The various industry exceptions from Section 163(j), including the exception for certain real estate businesses and the Utilities Exception, are implemented statutorily through an exclusion from the universe of activities that qualify as a “trade or business” under Section 163(j)(7). Specifically, Section 163(j)(7)(A) provides that the “term ‘trade or business’ shall not include:

(iv) the trade or business of the furnishing or sale of—

(I) electrical energy, water, or sewage disposal services,

¹ All references to Sections are to sections of the Internal Revenue Code of 1986 as amended by Public Law 115-97 (2017-101242), as amended (the “**Act**”). All references to Treasury Regulation Sections are to the Treasury Regulations promulgated thereunder.

(II) gas or steam through a local distribution system, or

(III) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or a public utility commission or other similar body of any state or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.”

The central technical issue with respect to the Utilities Exception can be viewed as how to determine whether indebtedness is “properly allocable” to a trade or business that is not excepted from “trade or business” treatment by the Utilities Exception. Alternatively, the question can be viewed as whether indebtedness is “properly allocable” to an activity described in the Utilities Exception; to the extent such indebtedness is properly allocable to activities in the Utilities Exception, such indebtedness will not be properly allocable to a “trade or business” and interest thereon will thus not be subject to the limitations of Section 163(j).

Sempra Energy believes that in the context of the Utilities Exception an apportionment rule is necessary under which a portion of holding company indebtedness is apportioned to the regulated utilities businesses conducted by subsidiaries. We believe that an income (or adjusted income) based approach is the most rational such approach with respect to Section 163(j), but that an asset based approach would also be acceptable. A more detailed discussion of possible approaches to apportionment is provided below.

In addition to this basic apportionment approach for holding company indebtedness, Sempra Energy believes three additional basic rules should be adopted. First, indebtedness incurred at the level of a corporate subsidiary or partnership affiliate predominantly engaged in the conduct of a regulated utilities business should be directly allocated to that business for purposes of application of the Utilities Exception. Second, for purposes of allocation of indebtedness, a corporate member of a consolidated group that has a substantial interest in a partnership predominantly engaged in the conduct of a regulated utilities business should be viewed as conducting the regulated utility business activities of such partnership for all purposes of application of the Utilities Exception; in other words, the regulated utilities activity of the partnership should be imputed to the corporate member that is a partner, at least with respect to substantial interests in partnerships. Third, under a limited tracing rule, indebtedness incurred at the holding company level to acquire Section 1504 control of a corporate subsidiary conducting directly a regulated utilities business, or via ownership of a significant interest in a partnership conducting such a business, should be viewed as incurred in the regulated utilities business; and a corresponding rule should apply with respect to indebtedness incurred to purchase directly or indirectly interests in corporations or partnerships that are not conducting businesses described in the Utilities Exception. The reasons we believe these rules should be adopted are also discussed further below.

We believe that, taken together, these core rules fit the businesses covered by the Utilities Exception in a broad range of the most likely fact situations, while accommodating the reasonable policy concerns of the government. It is possible, however, that some

additional auxiliary rules may be necessary to address less common fact situations, as discussed further below.

In the context of the different basic rules we are advocating, we believe it is appropriate for the government to consider promulgating a general anti-abuse rule potentially applicable with respect to any of these rules. In the discussion below, we give some examples of cases to which such a rule may be applicable.

The Affiliated Group Perspective

A substantial portion of the taxpayers to which the Utilities Exception is potentially applicable are affiliated groups filing consolidated returns for U.S. federal income tax purposes. Consistent with the legislative history of the Act, Notice 2018-28 states the intention of Treasury and the IRS to issue regulations relating to Section 163(j) that apply the statute on a consolidated basis with respect to affiliated groups filing consolidated returns. The notice states that taxable income for purposes of computing adjusted taxable income under Section 163(j) will be determined on a consolidated basis. In addition, the notice specifically states that, among other things, the regulations will address the application of Section 163(j) “to a consolidated group with one or more members that conduct a trade or business described in section 163(j)(7)(A)(ii), (iii), or (iv), as amended by the Act, or whose members hold an interest in a non-corporate entity such as a partnership that conducts such a trade or business.”

Thus, Notice 2018-28 reflects the fact that groups conducting utility and energy-services businesses often conduct their regulated businesses through multiple types of entities and potentially incur indebtedness relating to such businesses at different levels in the ownership structure. The regulated utility businesses may be conducted in one or more subsidiary corporations, through a partnership or, in some cases, directly at the level of the common parent holding company. Many groups conducting regulated utilities businesses described in the Utilities Exception also have subsidiaries directly or indirectly engaged in related activities that are not regulated utilities covered by the Utilities Exception. While a significant amount of the indebtedness relating to the regulated utilities businesses of such a group may be incurred at the operating entity directly conducting the regulated businesses, such as a subsidiary member of the consolidated group or a partnership of which a group member is a partner, a significant amount of indebtedness may be incurred at the common parent holding company level. Debt financing is often incurred at the common parent holding company level because of the efficiency of raising capital at that level or, in some cases, as a result of regulatory standards or direction. The proceeds of some of this indebtedness may be directly traceable to the acquisition of an entity conducting a regulated utilities business; in other cases the proceeds may be used for general operating expenses or ongoing capital expenditures of the operating corporate and partnership affiliates. An appropriate regime for application of the Utilities Exception must reflect these multifarious ways of conducting regulated utilities businesses and raising debt capital with respect to such businesses.

Sempra Energy's Structure

The Sempra Energy group's ownership structure and operations generally reflect this common fact pattern. Sempra Energy is a publicly traded Fortune 500 energy-services holding company based in San Diego, California. Sempra Energy's operating units (i) provide electric and gas services to customers within the United States and South America and (ii) invest in, develop and operate energy infrastructure in the United States, Mexico and South America.

Within the United States, the Sempra Energy group conducts its regulated utility activities through three legal entities: (1) San Diego Gas & Electric Company ("**SDGE**"); (2) Southern California Gas Company ("**SoCal Gas**"); and (3) Oncor Electric Delivery Company, LLC ("**Oncor**"), which constitutes a partnership for U.S. federal income tax purposes. Both SDGE and SoCal Gas are wholly-owned subsidiaries of the parent holding company Sempra Energy and are included in the Sempra Energy consolidated return. Oncor is slightly more than 80 percent owned by Sempra Texas Holdings Corp. ("**Texas Holdings**"), which is for tax purposes a wholly-owned subsidiary of Sempra Energy.² All the income of Oncor allocable to Texas Holdings is thus included in the Sempra Energy consolidated return. The business activities of all three entities are among those described in the Utilities Exception, and the assets used in such businesses would thus not be eligible for 100 percent bonus depreciation. *See* Section 168(k)(9).

The acquisition of Oncor by Sempra Energy was consummated in the first quarter of 2018 through Sempra Energy holding company's purchase for cash of the stock of Texas Holdings.³ A substantial portion of the cash purchase price of such acquisition was financed by the incurrence of debt at the common parent (holding company) level. The Public Utility Commission of Texas approved Sempra Energy's and Oncor's joint change-in control application after the Bankruptcy Court for the District of Delaware had provided its final approval a month earlier. The Oncor acquisition represents the expansion of the Sempra Energy group's United States regulated utilities business outside of California.

Sempra Energy conducts its energy infrastructure operations primarily through five legal entities: (1) Sempra LNG; (2) Sempra Midstream, Inc.; (3) Sempra Pipelines & Storage Corp.; (4) SEI Storage Corp.; and (5) Sempra Renewables, LLC. Sempra directly or indirectly owns 100 percent of these five legal entities. A significant portion of the business activities conducted indirectly by these entities are through partnerships owning project-specific assets in which these Sempra entities or the subsidiaries thereof have substantial interests. The activities conducted directly or indirectly by these entities are not described in the Utilities Exception, and assets acquired in such businesses are thus potentially eligible for 100 percent bonus depreciation. All five entities are brother-sister affiliates of the three Sempra Energy entities engaged in regulated utilities businesses, and the entities conducting

² Sempra Energy owns 100 percent of Texas Holdings through Sempra Texas Bidco, a disregarded entity for tax purposes that holds a 100 percent interest in Texas Holdings. Texas Holdings in turn owns a 80.25 percent interest in Oncor through Sempra Texas Intermediate Holding Company, a disregarded entity, which owns 100 percent of Oncor Electric Delivery Holdings Company, LLC, a disregarded entity, which in turn owns the 80.25 percent interest in Oncor.

³ At the time of the acquisition the name of Texas Holdings was Energy Future Holdings Corp.

the regulated businesses do not control or have significant interests in entities conducting unregulated businesses that are not eligible for the Utilities Exception.

Outside of the United States, the Sempra Energy group conducts its regulated activities and other energy operations through controlled foreign corporations for U.S. federal income tax purposes ("CFCs"). These CFCs are tax residents of the Netherlands, Mexico, Peru and Chile.

Necessity of Multifaceted Approach

In the context of complex holding company structures like that of Sempra Energy and other energy services and utility groups, Sempra Energy believes Treasury and the IRS should adopt a flexible multifaceted approach to the determination of whether indebtedness is "properly allocable" to activities described in the Utilities Exception and those which are not. In particular, we believe it is appropriate to provide elements of tracing, imputation and apportionment, as described further below. This is consistent with the flexible approach taken in other areas. *See, e.g.*, Notice 89-35, 1989-1 C.B. 675 (multiple alternative methods permitted with respect to allocation of interest relating to passthroughs for purposes of passive loss limitations and nonbusiness interest limitations). However, we believe, as noted earlier, that Treasury and the IRS should consider adding a general anti-abuse rule to the specifically described methods of allocation.

We will divide our discussion into three parts dealing with (1) indebtedness issued directly by the regulated operating entity, whether a corporation or partnership; (2) indebtedness issued by the corporate member of the consolidated group that is a partner in a partnership conducting a business described in the Utilities Exception; and (3) indebtedness issued at the holding company level.

Indebtedness Issued Directly by the Regulated Operating Entity

The first step in the application of the Utilities Exception should be to apply it with respect to interest on indebtedness directly issued by an entity, such as, for example, a corporate member of a consolidated group that is predominately engaged directly in a qualified regulated utilities business, or a partnership predominantly engaged in such a business, a substantial interest in which is owned by a corporate member of the group. Public utility commissions and other utility regulators often require an entity conducting a regulated utility business to directly issue debt to fund a portion of its capital improvements, and this indebtedness will be reflected on the balance sheet for such utility business.

This approach to the treatment of indebtedness directly issued by the entity conducting a regulated utilities business is consistent with direct allocation of interest expense under a number of Code sections. *See, e.g.*, Section 246A(d)(3)(A), in which portfolio indebtedness is defined to mean any indebtedness "directly attributable to the investment in the portfolio stock." *See* Rev. Rul. 88-66, 1988-2 C.B. 34. *Cf.* Rev. Proc. 72-18, Sec. 3, 1972-1 C.B. 740 relating to Section 265 (application of Section 265(a)(2) where proceeds are directly used to purchase tax-exempt bonds).

We understand that this approach to allocation of the indebtedness directly issued by the operating entity is conceptually inconsistent with a pure “single entity” approach to consolidated returns, under which the separate identities of corporate members are ignored.⁴ However, the consolidated return rules have always reflected a mixture of single entity and separate entity concepts, depending on the underlying policy objective.⁵ Thus, we believe the direct allocation proposed in this context is conceptually appropriate from a consolidated return perspective.

More important, such an approach is advantageous from the point of view of ease of administration of these rules. The three Sempra Energy entities conducting the regulated utilities business – SDGE, SoCal Gas and Oncor – conduct only regulated utility business activities eligible for the Utilities Exception, and we believe that this compartmentalization of regulated activities in legal entities is generally common in the industry. Taking into account the fact that these activities are regulated, the indebtedness directly incurred by those entities is, as a general rule, very likely to be clearly attributable to businesses eligible for the Utilities Exception.⁶ Moreover, in our experience, such regulated entities usually do not own equity interests in entities conducting unregulated businesses. Imposing a more general group-wide allocation rule with respect to the indebtedness of such entities would thus not be likely to lead to a result as accurate as the simple separate entity approach we are advocating.

Assuming a direct allocation rule of the type advocated here with regard to indebtedness properly allocable to activities described in the Utilities Exception, the same general standard should apply with respect to indebtedness incurred directly in a corporate subsidiary or other affiliated entity such as a partnership that is conducting a nonregulated business and thus not eligible for the Utilities Exception. For example, interest on indebtedness directly incurred by those Sempra Energy corporate subsidiaries and partnership affiliates conducting a renewable energy business as described above would generally not be described in the Utilities Exception and would therefore be subject to Section 163(j).

We understand that there are at least some cases in which a single legal entity such as a corporate entity will be engaged in both a significant regulated business described in the Utilities Exception and a significant business that is not described in the Utilities Exception. With respect to such subsidiaries an apportionment rule of the type discussed below may be appropriate.

It is also possible that, in rare cases, financing transactions that could be viewed as abusive would be engaged in by a subsidiary otherwise only engaged in a business described in the Utilities Exception. For example, indebtedness could be incurred by the regulated subsidiary and secured by its assets, but the proceeds distributed up to the holding company

⁴ See Report on Section 163(j), New York State Bar Association Tax Section (March 28, 2018) (“**NYSBA Section 163(j) Report**”), p. 25.

⁵ See Dubroff and Broadbent, “Consolidated Returns: Evolving Single and Separate Entity Themes,” 72 *Taxes* 743 (December 1994).

⁶ Although the three Sempra Energy affiliates conducting regulated utilities businesses have not historically engaged in activities as to which market-based pricing is permitted by the regulators, we understand that the regulated affiliates of some groups do engage in some such activities. We believe such ancillary activities should also be viewed as within the scope of the Utilities Exception.

and then deployed in an unregulated business. We believe as a practical matter that such a transaction is unlikely to be undertaken in this context. But if it were undertaken, a general anti-abuse rule or other more specific rule could be made applicable.

Indebtedness Issued by a Corporate
Member of the Group Owning an Interest in a Partnership Conducting
A Regulated Utilities Business

A second issue raised in this context is the treatment of indebtedness incurred directly by a corporate partner in a partnership conducting a regulated utilities business in the case in which the partner is a member of an affiliated group engaged directly or indirectly in regulated utilities businesses described in the Utilities Exception. As discussed above, Notice 2018-28 specifically contemplates that activities conducted through partnerships would be subject to the Section 163(j)(7)(A) exceptions in the context of consolidated groups with members owning such interests. We understand that myriad complex technical issues under Section 163(j) are raised in the context of partnerships. *See generally* Section 163(j)(4).

We treat here, however, a narrow case: the case in which a corporate member of a consolidated group owns a partnership interest in a partnership predominantly engaged in the conduct of a regulated utilities business described in the Utilities Exception, and all the income of the member from such partnership is included in the relevant consolidated return. In such a case, all the indebtedness incurred by such corporate partner allocable to the partnership interest should be treated as properly allocable to the regulated utilities business. If substantially all the assets of such corporate partner (for example, assets other than routine bank accounts) is an interest in a partnership conducting such a business, which will in this context often be the case, all the indebtedness of such corporate member of the group should be viewed as allocable to the business conducted by the partnership for purposes of applying the Utilities Exception.

One question that arises in this regard is how large an interest in the partnership should be required for an imputation rule of the type proposed here to be applicable. In the case of Sempra Energy, the principal case in which such rule would be applied is with respect to the more than 80 percent interest of Texas Holdings in Oncor, which as noted above is a partnership for tax purposes. As a conceptual matter, however, we believe the largest minimum percentage interest that should be required for imputation is 20 percent, and we believe that it can reasonably be argued that no minimum ownership requirement should be required for the imputation rule to be applicable.

In the context of a consolidated return, an imputation rule with respect to partnership interests would enable a rational computation of the Section 163(j) limitation. Because, under Section 163(j)(4)(A)(i), Section 163(j) is in the first instance applied at the partnership level, the income of a partnership engaged in a regulated utilities business described in the Utilities Exception would generally technically not give rise to income from a “trade or business” under Section 163(j) and thus would generally not be viewed as giving rise to adjusted taxable income (or excess taxable income derived therefrom). Consequently, the income from such utilities business conducted by the partnership would not support a deduction under Section 163(j) for business interest incurred at the level of the corporate member holding a partnership interest. Thus, the interest on indebtedness clearly directly

related to the holding of the partnership interest should be viewed, for purposes of, Section 163(j), as tested against such income and also treated as technically not from a “trade or business.” Any contrary conclusion would render the value and income associated with the net equity investment of such a partnership meaningless from the perspective of Section 163(j), a result directly contrary to the inarguable economic relationship of the parties and their lenders.

The treatment of the corporate member as engaged in the regulated utilities business of a partnership in which it has a substantial partnership interest is consistent with standards under the Code and developed by Treasury and the IRS in other areas. *See, e.g.*, Section 875 (non-US person that is a partner in a partnership engaged in a U.S. trade or business is treated as engaged in such trade or business); Treas. Reg. Sec. 1.175-3 (“A taxpayer is engaged in the business of farming if he is a member of a partnership engaged in the business of farming.”) *See also* Treas. Reg. Section 1.368-1(d)(4)(iii) (each partner in a partnership treated as owning certain assets of the partnership in accordance with its interest in the partnership, and members of a qualified group treated as conducting a business of the partnership if in aggregate such partners own a “significant interest”); Treas. Reg. Sec. 1.368-1(d)(5) Example 11 (33⅓ percent interest viewed as significant); and Rev. Rul. 2007-42 (active trade or business requirement of Section 355 met by partner with 33⅓ percent interest in partnership conducting an active trade or business even if partner did not manage partnership).

Other commentators have supported such a rule with respect to the Section 163(j) exceptions. For example, the New York State Bar Association Tax Section concluded: “In a case where a partner incurs debt which is allocable to its interest in a partnership that conducts an exempt business, guidance should provide that interest on the partner-level debt is exempt from Section 163(j).” NYSBA Section 163(j) Report, p. 44. It may be noted that the New York State Bar Association Tax Section is not proposing that such a rule apply only with respect to partners owning a specified minimum percentage interest.⁷

In sum, assuming that the corporate member of a consolidated group owns a substantial interest in a partnership conducting a utilities business described in the Utilities Exception, the corporate member should in effect be viewed as conducting the partnership’s qualified business. Thus, debt incurred at the level of such a corporate member allocable to such partnership interest should be viewed as properly allocable to a regulated utilities business conducted by the partnership. Moreover, as discussed further below, consistent with imputation of the regulated utility business to the corporate member partner with a substantial interest in the partnership, the acquisition by the common parent holding company of stock in such a corporate member should be viewed as, in effect, the purchase by the group of the business conducted by a partnership in which the corporate partner has a significant interest.

This approach to the treatment of corporate member owners of interests in partnerships is generally consistent with the rules that would be applicable to corporate members of utility and energy services groups owning interests in partnerships conducting businesses that are not described in the Utilities Exception. The treatment of the

⁷ *See also* Rubinger and LePree, “The (Unintended) Consequences of Tax Reform on Inbound Financings,” 158 *Tax Notes* 1511, at pp. 1515-1516 (March 12, 2018).

indebtedness of such corporate partners would be governed by the detailed rules of Section 163(j)(4). Under those rules, “excess taxable income” attributable to the partnership’s business (i.e. income in excess of that necessary to support deductions for interest on the partnership debt) would flow up to the corporate partner and potentially be available to cover interest on indebtedness at the partner level.⁸

It might be necessary for the government to develop an auxiliary rule to this basic rule to address how indebtedness at the level of the corporate partner is allocated to the partnership interest owned by such partner when the corporate partner owns other significant assets. In the case of Texas Holdings, the corporate member of the Sempra Energy group that owns the partnership interest in Oncor for tax purposes, the interest in the partnership conducting the regulated utilities business is the only significant asset, and we believe that such a fact situation will be the most common case. In some cases, however, it may be necessary to apply rules similar to the apportionment and limited tracing rules described below to allocate the debt incurred at the corporate partner level.

Indebtedness Incurred at the Common Parent Holding Company Level

The third context in which the question of the proper allocation of indebtedness with respect to the Utilities Exemption is raised is with respect to indebtedness incurred at the level of the common parent of a utility holding company or energy services holding company like that of Sempra Energy. As noted above, either for financial efficiency or regulatory reasons, it is possible that a significant amount of indebtedness relating to a regulated utilities business will be incurred at the parent holding company level. The parent is often the most creditworthy entity in the group. Moreover, in some cases, utility regulators will not permit all the relevant debt to be issued by the entity conducting the regulated utility business and to burden directly the assets of that business. Thus, it is imperative that, depending on the facts, at least a portion of common parent holding company debt be viewed as “properly allocable” to the regulated utility businesses conducted by one or more of the operating subsidiaries held below the parent holding company in the affiliated group.

One way to think about this point is in relation to a group that only conducts regulated utilities businesses through its subsidiaries, and that has a common parent holding company that conducts no business and solely owns stock in the operating subsidiaries and issues stock and indebtedness to investors and lenders. Assuming the Utilities Exception applied to the businesses conducted by the subsidiaries, none of the income attributable to such businesses would give rise to “adjusted taxable income” that could serve as a basis for taking a deduction under Section 163(j). See Section 163(j)(8)(A) (adjusted taxable income computed without regard to “any item of income, gain, deduction, or loss which is not properly allocable to a trade or business”). Thus, if the indebtedness incurred at the parent holding company level were not viewed as allocable to such exempt business and the interest thereon were thus viewed as “business interest” because interest on corporate indebtedness is

⁸ As noted by the New York State Bar Association Tax Section, treatment of partner level indebtedness allocable to the holding of a partnership interest as exempt if the partnership is engaged in an exempt activity is “conceptually similar to the approach taken in the statute with respect to excess taxable income.” See NYSBA Section 163(j) Report, p. 44.

generally treated as business interest, no interest deductions would be allowed under Section 163(j) with respect to the parent holding company indebtedness, even if its taxable income for purposes of computing adjusted taxable income were computed on a consolidated basis as described in Notice 2018-28. This result obviously cannot be rationally supported.

Assuming that parent holding company indebtedness should, on some basis, potentially be viewed as “properly allocable” to regulated utility activities conducted by direct or indirect subsidiaries, there are two possible approaches that could be adopted, tracing and apportionment. We believe either approach should be viewed as reasonable to apply for these purposes under particular facts. We acknowledge that, in the context of the Utilities Exception, tracing should have a relatively circumscribed role. However, we believe that at least the narrow tracing rule advocated here is fully justified.

1. Tracing of Indebtedness Incurred to Purchase Subsidiaries.

Tracing with respect to interest allocation generally involves one of two situations: (a) incurrence of indebtedness to make a purchase of an interest in an entity, as, for example, interest on indebtedness incurred to purchase a partnership interest; or (b) indebtedness incurred to make a capital contribution in, or loan to, another entity such as a partnership or corporate subsidiary.

We understand that an unlimited tracing rule can give rise to distortive results, both in the application of the Utilities Exception and with respect to the other exceptions, such as the elective exception to Section 163(j) applicable with respect to real estate. For example, a common parent holding company regularly raising equity and debt capital could claim that all its contributions down to the operating subsidiaries conducting the regulated utilities business are sourced from the debt financing and the contributions to the subsidiaries conducting the businesses not described in the Utilities Exception are sourced from the equity financing. Similar issues are raised when the source of the investments by the common parent holding company are partly retained earnings held at the common parent holding company level.

In the context of the Utilities Exception, however, we believe a particularly strong case can be made for a narrowly crafted rule permitting tracing of the debt of a common parent holding company when the proceeds of the debt are used to purchase, directly or indirectly, from unrelated parties a major ownership interest in an entity conducting a regulated utility business described in the Utilities Exception. Because as noted above the common parent of a utility holding company or energy-services holding company is frequently particularly creditworthy, the holding company will often incur the indebtedness to purchase, directly or indirectly a new subsidiary conducting a regulated utilities business. In some cases the relevant regulator will not permit all or even a portion of such indebtedness to be “pushed down” to the actual entity conducting the business. Sempra Energy believes that such acquisition indebtedness should be viewed as “properly allocable” to the business of the acquired entity and thus potentially subject to the Utilities Exception.

We believe that this rule can be crafted as a narrow one, limited to indebtedness, secured or unsecured, that is clearly attributable to the direct or indirect acquisition of either control (for Section 1504 affiliation purposes) of a corporate subsidiary predominantly engaged in a regulated utilities business covered by the Utilities Exception or a 50 percent or

more interest in the capital or profits⁹ of a partnership predominantly engaged in such a business covered by the Utilities Exception. In some cases, the indebtedness incurred at the common parent holding company level will be accompanied by an immediate on-lending of the loan proceeds to an affiliate lower in the corporate structure, which will in turn make the acquisition, directly or indirectly, of a new subsidiary or substantial partnership interest. The same narrow direct tracing rule should apply with respect to indebtedness incurred to acquire a nonregulated business that is not eligible for the Utilities Exception.

For purposes of application of this tracing rule, regulations could require that relevant documentation be kept and maintained by the common parent of the affiliated group to establish the acquisition purpose of the indebtedness incurred at the holding company level. Relevant documentation could also include board minutes and filings with the SEC or other regulatory body.

This type of narrow tracing rule could apply to a number of different situations. For example, it would apply to a case in which the common parent holding company incurred indebtedness to fund, or to on-lend to an affiliate to fund, part of the purchase price of the acquisition of all or a Section 1504 controlling interest in a corporation engaged in a regulated utilities business, which would become a member of the consolidated group after its purchase. Similarly, it would apply to the purchase by either the common parent holding company or a lower level affiliate of a more than 50 percent interest in a partnership conducting a business described in the Utilities Exception. It should also apply to a case like Sempra Energy's acquisition of Oncor in which the interest in the utilities business is acquired through the purchase of control of the stock of a corporation that itself owns for tax purposes a significant (80.25 percent of the profits) interest in a partnership conducting a regulated utilities business. These cases represent in effect major expansions of the regulated utilities business conducted by a group.

In our view, the potential for abuse of this narrowly circumscribed tracing rule is quite limited. By definition, the applicability of each rule is limited in amount to the acquisition price of the corporate stock or partnership interest acquired. Moreover, the entity the interest in which is acquired must, by definition, be engaged in a regulated business. Finally, the interest must be acquired from an unrelated party or parties, unlike the capital contribution case described above exemplifying the potential distortions of an unlimited tracing rule. Although we believe it is unlikely that a pattern of abuse would arise with respect to such a rule in the context of an acquisition of such a substantial interest in regulated business, the government could apply a general anti-abuse rule to the rare case in which unrelated parties were in effect used as agents to make discrete investments in assets that do not represent the significant expansion of a regulated business contemplated by the proposed tracing rule.

We understand that other types of exceptions to general apportionment may be proposed in other contexts. For example, tracing with respect to nonrecourse secured financing of significant assets could make sense in some contexts. *See, e.g.* Treas. Reg. Sec. 1.861-10T(b)(2). However, we believe the limited tracing rule we are proposing here is of more central importance in the context of the Utilities Exception.

⁹ Cf. Section 708(b)(2)(A).

2. Apportionment.

To the extent common parent holding company indebtedness is not allocable to regulated utilities businesses described in the Utilities Exception or to ineligible businesses under the narrow tracing rule we have advocated for acquisitions of corporate subsidiaries or interests in partnerships, we believe that such indebtedness should be apportioned to the businesses conducted by the operating subsidiaries based on either of two approaches, an income-based approach or an asset based approach.

a. Alternative 1: Income Based Approach.

Although Section 864(e) prohibits allocation based on gross income for purposes of subchapter N of the Internal Revenue relating to source of income, Sempra Energy believes that in the context of Section 163(j) an income based approach is particularly appropriate. The policy issues addressed under Section 864(e) are significantly different than those at issue here. An income based approach is consistent with the limitation imposed under Section 163(j) based on adjusted taxable income. This type of limitation is particularly appropriate because debt capacity is often determined by lenders using income-based metrics, including for example, earnings before interest, taxes, depreciation and amortization (“**EBITDA**”). The credit rating methodology used by Standard & Poor’s, for example, recognizes that “[t]he pattern of cash flow generation, current and future, in relation to cash obligations is often the best indicator of a company’s financial risk.”¹⁰ This is consistent with the acknowledgement in the OECD Base Erosion and Profit Sharing (“**BEPS**”) Proposal recommending a Section 163(j)-like limit on interest deductibility that a group’s interest expense “is spread around the group in accordance with EBITDA.”¹¹

If an income (or EBITDA) based apportionment approach is utilized for allocating the indebtedness incurred at the common parent holding company level, adjustment must be made to reflect the indebtedness incurred below the holding company level. One possible way to make such an adjustment if allocations were based on relative taxable income adjusted in the same manner as under Section 163(j) would be to back out an amount equal to 3 1/3 times the interest on the indebtedness incurred below the holding company for purposes of making the apportionment. Thus, taxable income (as adjusted) would be allocated to indebtedness incurred below the holding company level in a manner consistent with the structure of Section 163(j).¹²

b. Alternative 2: Asset Based Approach.

In the alternative, Sempra Energy believes that it would be acceptable for Treasury and the IRS to consider an asset-based apportionment methodology based on the relative basis of assets employed in each trade or business conducted by the operating subsidiaries. In

¹⁰ Standard & Poor’s Ratings Services, *How Standard & Poor’s Rates Nonfinancial Corporate Entities*, at 6 (Feb. 24, 2014).

¹¹ OECD/G20 Base Erosion and Profit Sharing Project, *Action 4-2015 Final Report*, at 21 (2015).

¹² As a technical matter, the definition of adjusted taxable income under Section 163(j) could not be used because only income from a “trade or business” as technically defined is taken into account under the Section 163(j) definition.

this connection, we believe that the basis of assets for purposes of this apportionment should be modified to utilize the tax basis determinable by use of the alternative depreciation system (“ADS”). Adjustments for lower tier indebtedness should be made by netting against such bases the allocable indebtedness.

In a world in which expensing applies with respect to a significant number of assets, a tax book value approach incorporating basis determined under the ADS system is appropriate. We note in this regard that Congress used such an approach in the Act for purposes of computing asset bases under the Global Intangible Low-Taxed Income (“GILTI”) rules. *See* Section 951A(d)(3)(A). A similar approach to determination of tax book value has been permitted in other contexts. *See* Treas. Reg. Sec. 1.861-9 (i)(l)(i) (alternative tax book value method “determined as though such property were subject to the alternative depreciation system set forth in section 168(g).”). *See also* Section 312(k)(3)(A) (earnings and profits determined under ADS system for tangible property).

Once the valuation method is determined, debt should be apportioned according to the net adjusted basis of the assets of each trade or business, including any trade or business subject to the Utilities Exception, according to the apportionment fractions which are computed as if all such trades or businesses were a single taxpayer with certain adjustments:

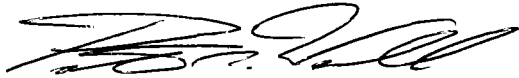
- i. For example, inter-group stock holdings and loans would not be considered assets in either the numerators or denominators of the allocation fractions.
- ii. Similarly, interest on debt between members of an affiliated group should be ignored in determining the amount of debt that must be allocated, consistent with the approach taken in Notice 2018-28 with respect to consolidated groups.
- iii. Trust assets that are set aside to fund specific liabilities such as pension trusts and plant decommissioning trusts should be excluded from the formula.
- iv. Construction-work-in-progress should be excluded.

Conclusion

In sum, in the context of multiple entity holding company structures conducting utility and other energy services businesses that include consolidated groups, Sempra Energy supports a multifaceted approach to determining the activities to which indebtedness should be viewed as “properly allocable.” Indebtedness directly incurred by an entity predominantly engaged in a business described in the Utilities Exception or a business not eligible for the exception should be viewed as “properly allocable” to the subsidiary member or partnership conducting each such business. The business of a partnership eligible for the Utilities Exception should be imputed to a corporate member of the group owning an interest in the partnership, at least with respect to substantial interests in partnerships. Indebtedness incurred at the common parent holding company level attributable to the direct or indirect purchase of control of a corporate subsidiary member or a 50 percent interest in the capital or profits of a partnership should be viewed as directly allocable to the business activities conducted by such acquired corporate member or partnership. Finally, remaining common

parent holding company indebtedness should be apportioned according to either an income based (or, alternatively) asset based methodology.

Very truly yours,

A handwritten signature in black ink, appearing to read 'P. Wall', written in a cursive style.

Peter Wall
Vice President, Controller
& Chief Accounting Officer
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