U.S. Multinationals & Assembling the U.S. Tax Provision

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Current Issues In Assembling The U.S. Tax Provision

Agenda

- Introduction
  - The Backdrop of Corporate Governance
  - Recent Corporate Governance Developments
- ETR Forecasting & Interim Reporting
  - General Rules
  - Sarbox Disclosure Concerns
- Favorable Tax Attributes & Positions-FIN 48
- Adjusting Foreign Books to U.S. GAAP
- Presenting the Tax Footnote
  - General Overview
  - Case Study
- Other Points of Note

Corporate Governance Defined

- The Establishment of Rules and Procedures For Making Decisions on Corporate Affairs
- The Establishment of a Structure Through Which Company Objectives Are Set
- The Establishment of Means to Attain and Monitor the Performance of These Objectives

Parties to Corporate Governance

- CEO, COO, Board of Directors
- Investors or Shareholders
- Vendors, Customers,
- Creditors
- Regulatory Agencies Worldwide
- Community at Large

Corporate Governance Principles

- Rights & Equitable Treatment of Shareholders & Investors
- Interests of All Parties to Corporate Governance
- Role & Responsibilities of Senior Management and the BOD
- Corporate Ethics
- Disclosure & Transparency

Issues Addressed by Corporate Governance Principles

- Oversight & Preparation of Financials
- Internal Controls and Auditor Independence
- Review of Compensation of Sr. Mgmt
- Procedures for Nomination to BOD
- Resources Provided to BOD to Carry Out Responsibilities
- Risk Management & Oversight
- Dividend/Distribution Policy

Internal Corporate Governance Controls To Accomplish Organizational Goals

- BOD Monitoring
  - Relationship with Sr. Mgmt.
  - Independent Directors
- Performance Based Remuneration
- Audit Committees
- Ad Hoc Committees

External Corporate Governance Controls Imposed by External Stakeholders

- Debt Covenants
- External Auditors
- Government Regulations
- Media Pressure
- Takeovers
- Competition
- Labor Market

Corporate Governance Issues

- Quality and Quantity of Accounting Information
- Demand for Information
- Monitoring Corporate Governance Costs
- Defining the Role of the Accountant and Accounting Firm

Corporate Governance Regulation

- Self Regulation
  - Principles
  - Rules
  - Enforcement
- External Regulation
  - SARBOX
  - International Legal Systems
    - Tax
    - Commercial

Assembling the Tax Provision
SEC Comments

- Focus Points
  - Tax Contingencies
  - APB 23 Disclosures
  - Deferred Tax Assets/Valuation Allowances
  - Tax Planning Transactions

Assembling the U.S. Tax Provision

SEC Comment Letter Requests

- Clarify the Nature of the IRS Examination Reserves
- Explain the Validity of DTA’s In Light of NOL’s
- Specific Discussion of Evidence Used to Initially Set Up a Valuation Allowance and Why that Evidence No Longer Exists
- Discussion of Tax Reserves and Rationale for Reversal
- Indication of Reporting a IRS Tax Shelter Transaction
- Disclosure of Each Material Amount of Deferred Taxes
- APB 23 Rationale for Indefinite Postponement of Earnings Repatriations

Forecasting The Effective Tax Rate & Interim Reporting

APB 28

"…the enterprise shall make its best estimate of the effective tax rate expected for the full fiscal year. The rate so determined should be used in providing for income taxes on a current year to date basis. …in arriving at this effective tax rate no effect shall be included for the tax related to significant unusual, or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period.

Fin 18 (Discrete Items)

"…it would be rare that timing, direction, and magnitude of future exchange rate changes and the enterprise's financial position at the time of an expected future exchange rate could each be reasonably estimated…the tax/(benefit) applicable to an item that cannot be estimated shall be reported in the interim period in which the item is reported."

Forecasting the Effective Tax Rate & Interim Reporting

APB 28 GENERAL RULES

- ESTIMATE ANNUAL EFFECTIVE TAX RATE ON ESTIMATED ANNUAL BOOK PRETAX INCOME
  - USE OF BUSINESS FORECASTS & BEST INFO AVAILABLE
    - SITE P&L'S, OVERHEAD ALLOCATIONS, INTEREST INC/EXP.
  - CURRENT TAX RATES IN EFFECT IN VARIOUS JURISDICTIONS
  - FORECAST PERMANENT DIFFERENCES & GENERATION & UTILIZATION OF TAX ATTRIBUTES-CREDITS, DTA'S ETC.
- APPLY ESTIMATED TAX RATE TO YEAR TO DATE INCOME
  - CURRENT QUARTER EXPENSE REFLECTS ANY CUMULATIVE CATCH UP ADJUSTMENTS
- CHANGES IN TAX LAW OR RATE
  - CURRENT TAX-CALCULATE NEW RATE, APPLY NEW RATE TO YEAR TO DATE INCOME AND MAKE CUMULATIVE CATCH UP ADJUSTMENT
  - DEFERRED TAX-APPLY CHANGES OR NEW RATE TO DEFERRED TAX ACCOUNTS AND REFLECT INPACT IN QUARTER OF CHANGE

Forecasting the Effective Tax Rate-APB 28 Issues

Sarbanes-Oxley Disclosure Considerations

- FIN 48 Uncertain Tax Positions Requirements
- Rule 408(h) of Regulation S-X and FAS 109 Rate Rec. Requirement
- APB 20 Requirement to Disclose Significant Changes in Estimate
- SOP 94-6 Requirement for “Early Warning” for Change in Accounting Estimate
- ETR as a Material Accounting Policy
- Disclosure of “Off Balance Sheet Arrangements”
  - Under MD&A Standards Re: Current or Future Effect on Registrant’s Financial Condition, Expenses, Revenues, Etc.
  - Certain Guarantee Contracts; Interests in Assets Transferred to a Non-Consolidated Entity (FIN 46)

Forecasting the Effective Tax Rate & Interim Reporting-Recent Tax Legislation

Qualified Production Activities Income

- Reduced U.S. Tax Rate on Income As Calculated
- QPA Gross Receipts Less Sum of
  - Cost of Goods Allocable to QPA Gross Receipts
  - Other Deductions Directly Allocable to QPA Gross Receipts
  - A Ratable Portion of Other Deductions Not Directly Allocable To QPA Gross Receipts
    - Section 1.861-8 Concepts For Statutory Class Of Income
- Deduction for QPAI (Subject to Limitations) Results in Reduced U.S. Tax Rate
  - 2005-2006; 3% to 33.95%
  - 2007-2009; 6% to 32.9%
  - 2010 forward; 9% to 31.85%

Forecasting the Effective Tax Rate & Interim Reporting

Booking the QPAI Deduction

- Treated as a Special Deduction
  - Tax Benefit Accounted For in Year Taken on Tax Return
  - Include the Impact in APB 28 Forecasting
  - Tax Reserves Issue
  - Disclosure in Rate Reconciliation & MD&A
  - DTA's & DTL's Still Booked at 35% Statutory
    - Valuation Allowances Subject to Graduated Rates

Forecasting the Effective Tax Rate & Interim Reporting

Share Based Payments

- FAS 123 r Recordation of Equity Compensation in Financials
- Creation of Temporary Differences As Opposed to Prior Current Tax Provision Benefit Offset In Equity
- Will Entail Comparison of Actual Tax Return (Current) Benefit to Anticipated Tax Benefit (DTA)
  - Book Expense Determined by FAS 123 r Option Valuation, Say Black Scholes, Initial and Updated Valuation.
  - Tax Expense Determined by FMV of Stock over Strike Price at Date of Exercise

Forecasting the Effective Tax Rate FAS 123 r Current Tax to DTA Comparison

- Book Expense in Excess of Tax Deduction
  - If the tax deduction reported on the tax return is less than the cumulative compensation expense reported through the P&L, the tax benefit of the tax deduction should be recorded through the P&L (FAS 123 Par 44)
- Tax Expense In Excess of Book Expense
  - If the tax deduction reported on the tax return is more than the cumulative compensation expense recorded through the P&L, the tax benefit of the excess deduction over the compensation expense should be to paid in capital (FAS 123 Par 44)

Forecasting the Effective Tax Rate-APB 28 Issues

Specific FAS 109 Provisions

- Paragraph 26-Change in Valuation Allowance
  - Effect of Change in a BOY VA Resulting from Change in Circumstances Affecting Judgment on Realizability Is Reflected in Continued Ops
  - Paragraph 30 Exception for Reversals of VA's Set Up for DTA's in Business Combinations, That is Credit Goes to:
    - Goodwill to Zero
    - Other Non-Current Intangibles to Zero
    - Income Tax Expense
  - Paragraph 36 Exception for Items Booked In Equity
    - FAS 52 CTA
    - FAS 12 Changes in Marketable Securities
    - Changes to Contributed Capital
    - Stock Option Expenses with Different Book & Tax Treatment

Forecasting the Effective Tax Rate-APB 28 Issues

Specific FAS 109 Provisions

- Paragraph 28 Changes in Tax Status of an Enterprise
  - Taxable to Non-Taxable Or Non-Taxable to Taxable
    - E.G. Corporation to Pass-Through Entities and Visa Versa
    - Deferred tax asset or liability is recognized with respect to the entity on the day of its change in tax status.
      - Set up on day status changes from non-taxable to taxable
      - Eliminated on the day status changes from taxable to non-taxable
  - What is Taxable????
    - Reporting Entity relationship with a Taxing Jurisdiction
  - Applies to Elective Changes of Tax Status
    - Recognized on Approval Date or Filing Date if No Approval Necessary
  - Applies to Changes Due to Tax Law Provisions
    - Recognized on the Enactment Date

Forecasting the Effective Tax Rate-APB 28 Issues

Specific FAS 109 Provisions

- Paragraph 27 Enacted Changes in Tax Laws or Rates
  - Deferred Tax Assets and Liabilities Shall Be Adjusted for the Effects of a Change in Tax Law or Rates.
  - The Effect Shall Be Included in Income From Continuing Operations For the Period That Includes The Enactment Date.

Forecasting the Effective Tax Rate Intra-period Tax Allocation

FAS 109 Paragraph 35 General Rules

- Four categories: Continuing Operations; Discontinued Operations; Extraordinary Items; Items Reflected in Shareholders Equity
- Continued Operations Allocations Equals Tax Effect on Pretax Income
  - Plus/Minus Changes in Deferred Tax Assets per Paragraph 26.
  - Plus/Minus Changes in Tax Laws or Rates per Paragraph 27.
  - Plus/Minus Changes in Tax Status Per Paragraph 26.
  - Plus/Minus Tax Deductible Dividends to Shareholders.

Forecasting The Effective Tax Rate Intra-Period Allocation Example

FAS 109 Paragraphs 273-275

- Assume Book Pretax Equals Tax Pretax
  - Book Pretax From Continuing Operations Equals (500)
  - Book Pretax From Extraordinary Item Cap Gain Equals 900
  - Tax Rates-40-% On Continuing Operations, 30% on Capital Gain
  - (500) Loss Of Continuing Operations Partially Offsets 900 Capital Gain
- Overall Tax Provision Calculated As Follows:
  - Book Pretax 400
  - Current Tax Provision (120) @ 30% Capital Gains Rate
- Allocated Current Tax Provision As Follows:
  - To Continuing Ops (30% Benefit of Cap Gain Offset) 150
  - To Extraordinary (30% Cap Gains Rate) (270)
  - Total Current Tax Provision (120)

Forecasting the Effective Tax Rate-Intra-Period Allocation Example

FAS 109 Paragraphs 273-275

- Assume Book Pretax Equals Tax Pretax
  - Book Pretax From Continuing Operations Equals 300
  - Book Pretax From Extraordinary Gain Equals 400
  - Tax Rate is 40%; Tax Credits of 330 Are Generated
- Overall Tax Provision Calculated As Follows;

Book Pretax		700
Tax @ 40%	(280)	
Less Tax Credits	<u>(330)</u>	
Tax Benefit (DTA)		(50)

Forecasting the Effective Tax Rate Intra-Period Allocation Example

FAS 109 Paragraph 276 Continued

- Allocation of (50) Tax Benefit

Tax Before Tax Credits on 300 of Continuing Operations	120	
Less Tax Credits	(330)	
Tax Expense to Continuing Ops		(210)
Tax Expense on Extraordinary Gain Of 400 at 40%		160
Tax Provision		(50)

Forecasting The Effective Tax Rate Intra-Period Tax Allocation

FAS 109 Paragraph 38 - Allocation To Other Than Continuing Ops.

- Total Tax Provision Minus Continued Operations Allocated
  - If Only One Item Solely to That Item.
  - If More Than One Than Allocated in Proportion to the Item's Effects on the Tax Provision.
- If There is a Mismatch Of Separate Allocations To Tax Provision
  - Determine Benefit of The Total Net Loss for Loss Items.
  - Apportion This Tax Benefit Ratably to Each Loss Item.
  - Determine Any Residual Tax Provision Other Than To Continuing Ops.
  - Apportion This Residual Ratably to Any Gain Items.

Forecasting the Effective Tax Rate- APB 28 Issues

FAS 109 Paragraph 276 –Foreign Subsidiary FAS 52 Allocation To Shareholders Equity

	FC	FX	$US
BOY Ret Earnings	1000	1.2	1,200
Current Yr. P&L	600	1.1	660
EOY Ret Earnings	1600	1.0	1,600

No APB 23 Deferral Elected-DTL Required

20% Net U.S. Tax After FTC

Forecasting the Effective Tax Rate-APB 28 Issues

FAS 52 Allocation Continued

- FAS 52 Gross Adjustment Equals 260
  - 1,200 BOE Ret. Earnings times .2 Plus 660 Current P&L times .1
- FAS 52 Deferred Taxes Allocated to Equity
  - 20% times 260 Equals 52
- FAS 109 P&L Deferred Tax Liability Account
  - BOE 1,200 times 20% Equals 240
  - Current P&L 660 times 20% Equals 132
  - EOY B/S Deferred Tax Liability 372

Booking Favorable Tax Attributes

FAS 109 Paragraphs 21 Through 25

- Keys Into Valuation Allowance Issues
- Defined As Deductible Temporary Differences or Credit Carryovers
  - U.S. Federal and State NOL's
  - U.S. General Business Credits
  - U.S. Alternative Minimum Tax Credits
  - Alternative Minimum Tax Credits (?)
  - Foreign Jurisdiction Loss Carryovers
- Dependent on Sources of Taxable Income

Booking Favorable Tax Attributes

Sources of Taxable Income (FAS 109 Par. 21)

- Future Reversals of Existing Taxable Temporary Differences
- Future Taxable Income Exclusive of Reversing Temporary Differences and Carryforwards
- Taxable Income In Prior Carryback Year
- Tax Planning Strategies
  - Acceleration of Taxable Income
  - Changing The Character of Taxable Income
  - Switching From Tax-Exempt to Taxable Investments

Booking Favorable Tax Attributes

Booking Tax Benefits for Carrybacks-FAS 109 Par. 240

- A Tax Receivable is Recognized For the Amount of Taxes Paid in a Prior Year That is Refundable by Carryback of an Operating Loss or Unused Tax Credits for the Current Year.

Booking Favorable Tax Attributes

Booking Tax Benefits for Carryforwards-FAS 109 Par 241-245

- Consider Provisions of Tax Law Limiting Utilization of Carryforward
- Determined by the Source of Income in the Current Year Which Utilizes the Loss Carryforward, Not The Source of the Income Which Generated The Loss
  - E.G. Allocated to Continuing Operations If It Offsets Income From Continuing Operations
  - E.G. Allocated to Extraordinary Gain If It Offsets Income From Extraordinary Gain
- Allocated to Continuing Operations If Resulting From a Change In Circumstance Causing a Change in Judgment Regarding Future Tax Benefit
- Tax Benefit Always Allocated To Continuing Operations If
  - Occurred In Current Year
  - Carried Back
  - Expected In Future Year

Booking Favorable Tax Attributes

Tax Planning Strategies -FAS 109 Par 246-251

- Do Not Include Actions Taken In the Ordinary Course of Business
- Action Not Usually Taken But For Realization of Tax Benefit
  - Prudent and Feasible
  - To Utilize an Expiring NOL or Tax Credit
  - Would Result In the Realization of a Deferred Tax Asset
- Includes Action to Shift Timing of Anticipated Future Taxable Income
- Includes Action to Shift Pattern of Reversing Future Temporary Differences

The Income Tax Provision – GAAP Reserve

- FIN 48 – Accounting for Uncertain Tax Positions:
  - Mandates a two-step process in accounting for uncertainty in income taxes:
    - First determine whether benefit should be recognized;
    - If recognition threshold is met, determine measurement of benefit;
  - FIN 48 differs in key respects from the Exposure Draft and existing accounting policies of many companies;
  - Effective as of the beginning of the first annual period beginning after December 15, 2006.

The Income Tax Provision – GAAP Reserve

- FIN 48 Scope – “Tax Positions” accounted for under FAS 109:
- The term “Tax Position” encompasses individual tax return filing positions and expected filing positions, including:
  - A decision not to file a tax return;
  - An allocation or a shift of income between jurisdictions;
  - The characterization of income or a decision to exclude reporting taxable income in the tax return;
  - A decision to classify a transaction, entity, or other position in a tax return as tax-exempt.

The Income Tax Provision – GAAP Reserve

- FIN 48 – Initial Recognition:
  - Benefits associated with the tax position must be "More-Likely-Than-Not" of being sustained;
  - Based solely on the technical merits of the tax position:
    - **"Audit risk" cannot be considered;**
    - **Must assume the taxing authority will have full knowledge of relevant information;**
  - Tax planning strategies must meet the MLTN threshold to be considered in supporting the realizability of DTAs;
  - MLTN is a lower threshold than past practices of "Probable."

The Income Tax Provision – GAAP Reserve

- FIN 48 – Initial Recognition (continued):
  - Examples of evidence to support MLTN status:
    - Unambiguous tax law;
    - Unqualified tax opinion from a qualified expert;
    - Analysis prepared by management that considers all relevant facts, circumstances, and regulations;
    - Similar positions accepted or not challenged by the taxing authority in prior examinations (as long as they were considered);
    - Legal precedent from similar positions taken by other taxpayers.

The Income Tax Provision – GAAP Reserve

- FIN 48 – Subsequent Recognition:
  - If MLTN threshold is not initially met, recognition of the benefit of a tax position occurs in the first interim period that:
    - MLTN threshold is subsequently met;
    - The tax position is ultimately settled with the tax authority; or
    - The statute of limitations has expired.

The Income Tax Provision – GAAP Reserve

- FIN 48 – Derecognition:
  - After initial recognition, if the position no longer meets the MLTN threshold based on its technical merits, the benefit of the tax position is derecognized (i.e., reversed):
  - Use of a Valuation Allowance is not a permitted substitute for the derecognition of a tax benefit.

The Income Tax Provision – GAAP Reserve

- FIN 48 – Measurement:
  - Two-Step Model:
    - First, determine that the recognition threshold (MLTN) is met; then if met;
    - Recognize the largest benefit that is greater than 50% likely of being ultimately realized upon settlement assuming the taxing authority has full knowledge of all relevant information.

The Income Tax Provision – GAAP Reserve

- FIN 48 – Measurement Example:
  - A position is MLTN to be sustained. Management believes that there are three possible outcomes in a tax authority examination:

Probability of Outcome	Benefit
30%	$100
30%	$80
40%	$0

- In this case, $80 should be recognized as there is a 60% chance that at least that amount will be realized.

The Income Tax Provision – GAAP Reserve

- FIN 48 – Measurement – Changes in Judgment:
  - A change in judgment that results in subsequent recognition, derecognition, or remeasurement of tax positions taken in prior annual periods should be recognized entirely in the interim period in which the change in judgment occurs;
  - The impact of such a change is not reflected in the estimated annual effective tax rate (i.e., it is a "discreet item");
  - Changes to positions taken in an earlier interim period within the same annual period are reflected in the annual effective tax rate.

The Income Tax Provision – GAAP Reserve

- FIN 48 – Subsequent Events:
  - Only information that is available at the reporting date should be considered;
  - This is different from the typical analysis under AU 550
  - The subsequent information may require disclosure if the impact on subsequent periods is expected to be significant.

The Income Tax Provision – GAAP Reserve

- FIN 48 – Classification:
  - The difference between the tax benefit recognized in the financial statements and the amount reflected in the tax return:
    - Is recorded as an increase in taxes payable or receivable; or
    - Is recorded as an increase in a DTL or DTA if the position impacts a temporary difference or tax carryforward item;
  - Classification of the resulting exposure liability is based on the expected timing of settlement (current if payment expected within one year).

The Income Tax Provision – GAAP Reserve

- FIN 48 – Classification – Timing Differences:
  - FIN 48 may also impact the measurement of deferred taxes;
  - DTAs and DTLs should be recognized based on the difference between:
    - Financial statement carrying amount; and
    - Tax basis as determined under FIN 48.

The Income Tax Provision – GAAP Reserve

- FIN 48 – Disclosures:
  - Rollforward of unrecognized tax benefits (on a worldwide aggregate basis), including (at a minimum):
    - The gross amounts of increases and decreases in unrecognized tax benefits for tax positions taken during a previous annual period;
    - The gross amounts of increases and decreases in unrecognized tax benefits for tax positions taken during the current annual period;
    - Decreases in unrecognized tax benefits related to settlements;
    - Reductions in unrecognized tax benefits due to lapse of the statute of limitations;
  - Disclosure of the amount of unrecognized tax benefits that, if recognized, would impact the effective tax rate.

The Income Tax Provision – GAAP Reserve

- FIN 48 – Disclosures (continued):
  - Other annual disclosure requirements:
    - Classification of interest and penalties as well as the amount of interest and penalties in the income statement and accrued on the balance sheet;
    - If changes to an estimate are reasonably possible in the next 12 months, a discussion of:
      - Nature of the uncertainty;
      - Nature of the event that could cause the change;
      - An estimate of the range of possible change or a statement that estimates cannot be made.
    - Description of open tax years by major jurisdiction.

Fin 48 Pressure Points

- Quantitative
  - # of Tax-Paying Jurisdictions
  - # of Non-Recurring Tax Transactions
  - # of Legal Entities
  - # of Intercompany Transactions
  - # of Personnel-Tax, Accounting, Business
  - Business Plan Data

Fin 48 Pressure Points

- Qualitative
  - Internal Controls
  - Existing Audit Experience
  - Existing Cushion Components
  - ETR Materiality
  - Financial Expertise
  - DTA’s and Permanent Items
  - Documentation Procedures

Assembling The Effective Tax Rate Adjusting Foreign Books to U.S. GAAP

- Confirm Start-Off Point
  - Statutory Accounts
  - Management Accounts
- Confirm Information Flow or Mapping
  - General Ledger Interfaces
  - Web Based Interfaces
  - Year-End Accounting/Tax Packages
  - Transparency Issues
- Determine Push-Down Accounting Issues
- Analyze Consolidating Entries
- Determine Host Country Tax Profile and Attributes
- Compute Foreign Tax Provision

Assembling The Effective Tax Rate Adjusting Foreign Books to GAAP

Examples of Best Practices

- Non-U.S. Tax Provision
  - Income Tax Accrual Workbook
  - Tax Accrual Guidance and Procedures
- Non-U.S. Beginning Balance Validation (Cumulative Balances)
  - Non-U.S. Income Tax Payable Workbook and Guidance Material
  - Non-U.S. Tax Basis Balance Sheet/Deferred Tax Workbook and Guidance Material
  - Non-U.S. NOL and Carryforward Tax Attributes Workbook and Guidance Material

Assembling the Effective Tax Rate Adjusting Foreign Books to U.S. GAAP

Documentation Issues-Auditor Concerns & Questions

- Support Foreign DT by Tax Balance Sheets
- Support Activity in Foreign Current Payable
- Support Foreign Permanent Differences
- Support Foreign Provision to Return True Up
- Support Foreign NOL DTA's
- Support Foreign Reserves-Book on Foreign Accounts
- Support APB 23 and FTC Positions

Assembling The U.S. Tax Provision-Presenting The Tax Footnote

BALANCE SHEET DISCLOSURE

- CURRENT AND NON-CURRENT
  - DETERMINED BY RELATED ASSET
  - DETERMINED BY EXPECTED REVERSAL

- NET BY TAX PAYING ENTITY AND JURISDICTION

Assembling The U.S. Tax Provision- Presenting the Tax Footnote

FOOTNOTE DISCLOSURE REQUIREMENTS

- COMPONENTS OF INCOME TAX EXPENSE
- DESCRIPTION OF TEMPORARY DIFFERENCES AND CARRYFORWARDS
- RECONCILIATION OF INCOME TAX EXPENSE TO STATUTORY RATE
- TOTAL DEFERRED TAX ASSETS AND LIABILITIES
- TOTAL VALUATION ALLOWANCE AND NET CHANGE

Assembling The U.S. Tax Provision- Presenting the Tax Footnote

COMPONENTS OF INCOME TAX EXPENSE

- CURRENT EXPENSE/(BENEFIT)
- DEFERRED EXPENSE/(BENEFIT)
- CURRENT AND DEFERRED AMOUNTS CONSIST OF
  - FEDERAL
  - STATE
  - FOREIGN
- AMOUNTS SHOULD BE SEPARATELY STATED FOR EACH MAJOR COMPONENT
  - NOT REQ'D IF LESS THAN 5% OF TOTAL TAX EXPENSE

Assembling The U.S. Tax Provision-
Presenting The Tax Footnote

COMPONENTS OF DEFERRED TAXES

- INVENTORY OF DEFERRED TAX ITEMS
- TOTAL OF ALL DEFERRED TAX LIABILITIES
- VALUATION ALLOWANCE RECOGNIZED FOR DEFERRED TAX ASSETS

Assembling The U.S. Tax Provision-Presenting The Tax Footnote

NOL'S AND TAX CREDITS

- AMOUNTS
- EXPIRATION DATES
- APPLICABLE LIMITATIONS
  - SRLY'S
  - CARRYOVER PERIODS

Assembling The U.S. Tax Provision- Presenting The Tax Footnote

- DISCLOSURE OF BOTH U.S. AND FOREIGN PRETAX INCOME OR LOSS IS REQUIRED WHERE FOREIGN PRETAX EXCEEDS 5% OF PRETAX INCOME OR LOSS
- DISCLOSURE OF AUDIT ISSUES AND RESOLUTIONS

Assembling The U.S. Tax Provision Case Study -Sempra Energy 12/31/05

Note 7 Income Taxes

The reconciliation of the statutory federal income tax rate to the effective income tax rate is as follows:

	2005	2004	2003
Statutory federal income tax rate	35.0%	35.0%	35.0%
Utility Depreciation	5	4	7
State Income Taxes-Net	3	4	8
Tax Credits	(14)	(14)	(24)
Foreign Sub Inc. Activity	(3)	(3)	(1)
Settlement of IRS Audit	(7)	---	(12)
Reversal of State Accruals	(6)	(3)	---
Interest Rate Reduction	--	(2)	---
Utility Repair Allowance	(2)		(1)
Return to Provision Adj	(3)	(1)	(5)
Other Net	(3)	(2)	(---)
Effective Tax Rate	5%	18%	7%

Assembling the U.S. Tax Provision
Case Study - Sempra Energy 12/31/05

The components of total income (loss) from operations (including continuing extraordinary items) before income taxes are as follows:

	2005	2004	2003
(dollars in millions)			
Domestic	$748	$796	$551
Foreign	$168	$251	$129
Total Income Before Taxes	$916	$1,051	$680

Assembling the U.S. Tax Provision Case Study -Sempra Energy 12/31/05

The Components of Income Tax Expense Are As Follows:

(dollars in millions)	2005	2004	2003
Current:			
Federal	$306	$120	$80
State	8	21	74
Foreign	11	39	11
Total	325	180	165
Deferred:			
Federal	(195)	17	(126)
State	(76)	(24)	(4)
Foreign	(6)	26	18
Total	(277)	19	(112)
Deferred Investment Credits	(6)	(6)	(6)
Total Income Tax Expense	$42	$193	$47

Assembling The U.S. Tax Provision Case Study- Sempra Energy 12/31/05

Accumulated deferred income taxes at December 31 relate to the following:

(dollars in millions)	2005	2004
Deferred tax liabilities		
Differences in financial and tax basis of PP&E	$ 900	$ 861
Balancing Accounts & Regulatory Assets	192	124
Partnership Income	59	56
Unrealized Revenue	39	79
Loss on Reacquired Debt	29	38
Property Taxes	23	25
Equity Units	5	21
Other	2	11
Total Deferred Tax Liabilities	1,249	1,215

Assembling The U.S. Tax Provision Case Study-Sempra Energy 12/31/05

Deferred Tax Assets (dollars in millions)	2005	2004
Investment Tax Credits	50	55
General Business Tax Credit Carryforward	236	193
Alternative Minimum Tax Credits	143	111
Net Operating Losses of Foreign Entities	86	104
Postretirement Benefits	44	51
Other Deferred Liabilities	42	29
Compensation Related Items	171	173
Bad Debt Allowance	8	18
State Income Taxes	39	48
Other Accruals	291	35
Other	44	32
Total Deferred Tax Assets	1154	849
Net Deferred Tax Liability Before Valuation Allowance	95	366
Valuation Allowance	18	39
Net Deferred Tax Liability	113	405

Assembling The U.S. Tax Provision Case Study-Sempra Energy 12/31/05

(dollars in millions)	2005	2004
Total Deferred Tax Liabilities	1,249	1,215
Total Deferred Tax Assets	(1136)	(810)
Net Deferred Tax Liability	113	405

The net deferred tax liability is recorded on the Consolidated Balance Sheet at

December 31 (dollars in millions)	2005	2004
Current (asset)/liability	(132)	(15)
Noncurrent liability	245	420
Total	113	405

Assembling The U.S. Tax Provision Case Study-Sempra Energy 12/31/05

In connection with its affordable housing investments the company has $236 million of unused general business tax credits in varying amounts dating back to 1999. The ability to offset these credits against future taxable income will expire between the years 2019 and 2025. The company expects to utilize the credits prior to expiration. In addition, the company has $143 million of alternative minimum tax credits with no expiration date. All of these credits have been included in the company's calculation of income tax expense in the year they arose.

Foreign subsidiaries have $348 million in unused foreign net operating losses available to reduce future income taxes, primarily in Mexico, Canada and the United Kingdom. Significant amounts of these losses become unavailable to reduce future income taxes beginning in 2009. Financial statement benefits have been recorded on all but $37 Million of these losses, primarily by offsetting them against deferred tax liabilities with the same expiration pattern and country of jurisdiction. No benefits have been recorded on $37 Million of the losses because they have been incurred in jurisdictions where utilization is sufficiently in doubt.

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The company has not provided for U.S. income taxes on foreign subsidiaries undistributed earnings ($767 Million at December 31, 2005), since they are expected to be reinvested indefinitely outside the U.S. It is not possible to predict the amount of U.S. income taxes that might be payable if these earnings were eventually repatriated.

Assembling the U.S. Tax Provision Case Study-Sempra Energy 12/31/05

The company believes it has adequately provided for income tax issues not yet resolved with federal, state, and foreign tax authorities. At December 31, 2004, $51 Million was accrued for such matters. Although not probable, the most adverse resolutions of these issues could result in additional charges to earnings in future periods. Based upon a consideration of all relevant facts and circumstances, the company does not believe the ultimate resolution of tax issues for all open tax periods will have a materially adverse effect upon its results of operations or financial condition.

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The new American Jobs Creation Act enabled companies to repatriate monies earned outside the U.S. an income tax cost of only 15% of the normal rate, if the repatriation occurred by the end of 2005. The company decided not to repatriate any foreign earnings pursuant to that act's repatriation provisions.

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Section 29 Income Tax Credits

On July 1, 2004, Sempra Financial sold its investment in an enterprise that earns Section 29 Income Tax Credits. That investment comprised one-third of Sempra Energy's Section 29 participation and was sold because of company's alternative minimum tax position defers utilization of the credits in the determination of income taxes currently payable. The transaction has been accounted for under the cost-recovery method, whereby future proceeds in excess of the carrying value of the investment will be recorded as income as received. As a result of this sale, Sempra Financial will not be receiving Section 29 income tax credits in the future. Sempra Commodities continues its operations related to Section 29 income tax credits.

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The IRS has conducted various examinations of the partnerships associated with the Section 29 income tax credits covering various years as recent as 2000, depending on the partnership. It has reported no change in the credits. From acquisition of the facilities in 1998, the company has generated Section 29 income tax credits of $434 Million through December 31, 2005 of which $85 Million were recorded for the year ended December 31, 2005.

In the next two years, if the annual average wellhead price per barrel of oil reaches a certain price, the phase-out of Section 29 credits will begin. Those prices are $53.21, for 2006 and $54,27 for 2007.

Assembling The U.S. Tax Provision Case Study-Sempra Energy 12/31/05

Pacific Enterprises Quasi-Reorganization

Effective 12/31/92 PE effected a quasi-reorganization for financial reporting purposes. The reorganization resulted in a restatement of the company's assets and liabilities to their estimated fair market value at December 31, 1992 and the elimination of PE's retained earnings deficit. Since the reorganization was for financial purposes and not a taxable transaction, the company established deferred taxes relative to the book and tax bases differences.

During 2004, the company completed an extensive analysis of PE's deferred tax accounts. The analysis resulted in a $72 Million reduction of the deferred tax liabilities and an offsetting credit to equity. The credit was recorded in equity because the balances related to the tax effects of transactions prior to the quasi reorganization. In 2004 the company also concluded its outstanding IRS examinations and appeals related to PE and its subsidiaries. As of December 31, 2005, the company's balance sheet includes a net deferred tax asset of $11 Million related to remaining reserves arising from the quasi-reorganization.

Assembling the U.S. Tax Provision Other Points of Note

Relation of Schedule M-3 to The Tax Provision

- Transparency With Underlying Financial Statements
- Documentation of Tax Planning and Compliance
- Schedule M-3 As Start Off Point For Section 404 Internal Controls Procedures
- M-3 Line Items Versus Accounting System Chart of Accounts
- Reflection of Permanent and Temporary Differences
- Push Down Accounting & Consolidated Adjustment Issues

Assembling the U.S. Tax Provision Other Points of Note

Internal Revenue Manual Part 4 Chapter 10 Section 20

- Deals With Requesting Audit, Tax Accrual or Tax Reconciliation Workpapers.
- Audit Workpapers Are Those Created By or For the Independent Auditor.
- Tax Accrual Workpapers Are Those Audit Workpapers That Relate To The Tax Reserve for Current, Deferred, Or Contingent Liabilities Including Footnote Disclosures.
- Tax Reconciliation Workpapers Are Used In Assembling & Compiling Financial Data In Preparation for Reporting The Information on The Tax Return.
- Requests for Audit & Accrual Workpapers Subject to “Unusual Circumstances” Standard
  - Collateral Source For Factual Data
  - Listed Transactions Protocol
- Requests for Tax Reconciliation Workpapers Requested As a Routine Matter