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Tales from The Crypt: Is Taxing Book Income Back?

The Democratic nominee for President, former Vice President Joe Biden, has released a number of tax proposals, including increasing the corporate tax rate from 21 percent to 28 percent and doubling the tax rate on global intangible low-taxed income from 10.5 percent to 21 percent. The former Vice President is also proposing a 15 percent minimum tax on a company's global book income for companies with income exceeding $100 million. Like most campaign tax proposals, there are very few details on the mechanics of these proposals, although the Tax Policy Center has analyzed the proposals and written that, under the global minimum tax, a credit will be provided for foreign income taxes and losses may be carried forward to offset income in future years. The tax may be structured as an alternative minimum tax ("AMT").

The Organisation for Economic Co-operation and Development ("OECD"), as part of its Inclusive Framework on BEPS, also is focusing on taxing book income. The OECD has developed two pillars to address the tax challenges arising from the digitalization of the economy. *See Tax Notes and Developments, "Blueprints of Two Pillars on Which the Future of International Taxation Balances."* Under Pillar One, part of the residual profits of a multinational may be reallocated from the multinational's home country to the market country where the users or consumers reside, irrespective of physical presence (referred to as Amount A). In addition, an amount is allocated for baseline distribution and marketing functions that take place in the market jurisdiction (referred to as Amount B). Under Pillar Two, a global minimum tax would be imposed on corporate profits (referred to as Global Anti-Base Erosion or "GloBE"). Under both pillars, the focus on profits would initially be determined using book income (referred to as consolidated financial accounts) with certain approved adjustments.

The United States has, for much of its recent history, rejected the idea of taxing a company's book income. Part of that rejection can be attributed to the differing purposes of the tax laws and financial accounting. The Supreme Court, in a much-cited opinion from 1979, wrote in *Thor Power Tool v Commissioner,* 439 U.S. 522 (1979):

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement, rather than overstatement, of net income and net assets." In view of the Treasury's

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> markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

During enactment of the Tax Reform Act of 1986, the Senate Finance Committee proposed an adjustment to the corporate AMT. The adjustment, called the business untaxed reported profit ("BURP"), would have increased the corporate minimum tax base equal to fifty percent of the amount by which a corporation's book income exceeded its alternative minimum taxable income.

In proposing the BURP adjustment, the Senate Finance Committee wrote:

> The minimum tax cannot successfully address concerns of both real and apparent fairness unless there is certainty that whenever a company publicly reports substantial earnings (either pursuant to public reporting requirements, or through voluntary disclosure for substantial non-tax reasons), that company will pay some tax (unless it has sufficient net operating losses to offset its income for the year).
>
> Thus, the committee believes that it is important to provide that the alternative minimum taxable income of a corporation will be increased when book income for the year exceeds alternative minimum taxable income. Such a provision will increase both the real and the perceived fairness of the tax system, eliminate the highly publicized instances in which corporations with substantial book income have paid no tax, and further broaden the minimum tax base to approach economic income more closely.

The idea of taxing a corporation's book income through the BURP adjustment generally has been credited to Professor Michael Graetz, who advocated for such an approach in the early 1980s. Professors Boris Bittker and James Eustice described the BURP adjustment to the corporate minimum tax base as "dramatic, novel and intricate," while poking fun at Professor Graetz in a footnote in their treatise writing, "When Big Mike [Graetz] BURPS, Wall Street trembles."

The House Ways and Means Committee opposed the BURP adjustment to the corporate AMT believing that book income could be manipulated. The compromise between the House and the Senate was that the BURP adjustment would apply for only three years, 1987 to 1989, and would then be replaced by the adjusted current earnings ("ACE") adjustment in 1990. BURP's replacement, ACE, was a hybrid of traditional earnings and profits and taxable income. Under the ACE adjustment, the minimum tax base was increased (or decreased) by seventy-five percent of the difference between a corporation's ACE and its alternative minimum taxable income. As part of the Tax Cuts and Jobs Act of

2017, Congress repealed the corporate AMT, which included the ACE adjustment.

If Congress considers enacting a book income tax base, many of the issues that arose in the past may arise again. Those issues would need to be addressed and weighed against the possible real and perceived fairness of taxing such a base. For example, if Congress adopts a book income tax base, it is ceding some of its taxing jurisdiction to the Financial Accounting Standards Board ("FASB"), which is responsible for setting accounting standards for companies in the United States. Any changes to the book income base made by FASB would impact the taxes owed by a company subject to tax on such a base.

Some members of Congress or the Treasury and IRS may be concerned that book income is too subjective, while others may find book income's imprecision unattractive as the foundation for a tax system. As noted by the Supreme Court in *Thor Power Tool*, "Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be."

In addition, any adjustments to book income in determining the tax base could lead to increased complexity by creating a new base of taxation. It would in essence be a third base of income – along with book income and taxable income. If the adjustments to the book income base are significant, then in addition to creating complexity, it seems that such adjustments would defeat the purpose of utilizing book income as a base of taxation. If, however, the adjustments to book income are minimal, such an approach, while eliminating complexity, would also eliminate the tax benefits associated with a number of tax incentives that Congress has enacted, such as expensing of capital equipment.

As described above, there are several hurdles that Congress and the OECD will need to consider as they evaluate whether to use book income as a tax base. Given the US's political process and our history with BURP, we are more confident that these hurdles will be discussed and evaluated in a transparent fashion and that taxpayers will have the opportunity to share their concerns with Congress and a potential future Biden administration before any legislative changes are made. However, the OECD is much further along in its deliberations, and taxpayers will need to submit written comments before December 14, 2020.

By: Christopher H. Hanna, Dallas, Joshua D. Odintz and Alexandra Minkovich, Washington, DC

Final Regulations Issued for Dispositions by Foreign Persons of Interests in Partnerships that Conduct a US Trade or Business

On September 21, 2020, Treasury and the IRS finalized regulations under Code Section 864(c)(8) (the “Final Regulations”), generally retaining the basic approach and structure of the proposed regulations issued on December 20, 2018 (REG-113604-18) (the “Proposed Regulations”).

Section 864(c)(8), which was added to the Code by the Tax Cuts and Jobs Act in 2017, generally provides that if a nonresident alien individual or foreign corporation owns an interest in a partnership that is engaged in a US trade or business, gain or loss on the sale or exchange of the partnership interest by the foreign person is taxable in the US - *i.e.*, the gain or loss is treated as effectively connected with the conduct of a trade or business within the US (‘‘effectively connected gain’’ or ‘‘effectively connected loss’’). However, this treatment applies only to the extent that the foreign person would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value as of the date of the sale or exchange (the “deemed sale limitation”). This rule generally overturns the result of *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017), *aff’d,* 926 F.3d 819 (D.C. Cir. 2019), which held that gain or loss on the sale or exchange by a foreign person of an interest in a partnership that was engaged in a US trade or business was foreign-source and was not taxable as effectively connected income in the US.

Determining Deemed Sale Effectively Connected Gain or Loss

Consistent with the Proposed Regulations, the Final Regulations illustrate how to determine the deemed sale limitation through a three-step process:
(1) determine the amount of gain or loss from each partnership asset as if the partnership conducted a deemed sale of *all* of its assets on the date of transfer;
(2) determine the amount of such deemed sale gain or loss that would be treated as *effectively connected gain or loss* with respect to each asset; and
(3) determine the foreign transferor’s *distributive share* of the deemed sale effectively connected gain or loss amounts from step two.

In order to determine whether the gain or loss from step one is properly characterized as effectively connected gain or loss in step two, the step one gain or loss must be analyzed with respect to each partnership asset. Sourcing rules in the Code and regulations are generally fact-specific. For instance, the “US office rule” in sections 865(e)(2)(A) and (e)(3) depends upon factual determinations made regarding the underlying sale — whether the sale is attributable to an office or other fixed place of business in the US, and, with respect to inventory property, whether the property is sold for use, disposition, or

consumption outside the US and whether an office or other fixed place of business maintained by the taxpayer in the foreign country materially participated in the sale. However, such facts are not determinable in a deemed sale because no sale has actually occurred.

To address this disconnect, the Final Regulations retain the basic framework of the Proposed Regulations, providing rules that serve as a proxy for the factual determinations that apply for purposes of sourcing deemed sale gain and loss and, in turn, for determining deemed sale effectively connected gain and loss. More specifically, for purposes of the US office rule, the Final Regulations generally treat all deemed sale gain and loss as attributable to an office or other fixed place of business maintained by the partnership in the US, and do not treat inventory property as sold for use, disposition, or consumption outside the US in a sale in which an office or other fixed place of business maintained by the partnership in a foreign country materially participates ("US office attribution rule"). However, if the partnership does not maintain an office or other fixed place of business in the US, such office attribution does not apply.

The Final Regulations also retain a "ten-year exception" intended to remove assets that have no nexus to the US from the deemed sale effectively connected gain and loss determination. Under this exception, if during the ten-year period ending on the date of transfer, (i) an asset produced no income or gain that was taxable as income that was effectively connected with the conduct of a trade or business within the US by the partnership (or a predecessor), and (ii) the asset has not been used, or held for use, in the conduct of a trade or business within the US by the partnership (or a predecessor), gain or loss from the deemed sale of the asset is not treated as effectively connected gain or loss under step two. The Final Regulations modify the relevant testing period for the ten-year exception to account for a partnership (including a predecessor of the partnership) that has not existed for at least ten years, or that has not held an asset for at least ten years, by shortening the relevant testing period to the lesser of the ten-year period ending on the date of the transfer or the period during which the partnership (and a predecessor of the partnership) held the asset.

In response to comments that the simplifying factual assumptions described above may overstate the amount of effectively connected gain or loss on a deemed sale of the partnership's assets (as compared to an actual asset sale), the Final Regulations provide additional sourcing rules for determining the foreign source portion of deemed sale gain and loss attributable to specific assets (inventory, intangibles, and depreciable personal property). Like the US office attribution rule, these rules do not apply if the partnership does not maintain an office or other fixed place of business in the US. The asset-specific rules utilize available historic facts as a proxy for the sourcing results, and the attendant effectively connected determinations, that would occur in an actual sale by the partnership of inventory, intangibles, or depreciable personal property. Although generally intended to be taxpayer favorable, these rules require complex calculations and significant historical data.

Treaty Coordination

As discussed above, the Final Regulations clarify that the US office attribution rule does not apply unless the partnership maintains an office or other fixed place of business in the US. A partnership without a US office or other fixed place of business will also generally not have a permanent establishment in the US. The treaty coordination rule of the Final Regulations takes into account an applicable treaty when computing the amount of a foreign transferor's distributive share of deemed sale effectively connected gain and loss (step three). As a result, for purposes of step three, gain or loss derived by the foreign transferor attributable to assets deemed sold that would be exempt from tax under an applicable US income tax treaty if disposed of by the partnership are not taken into account.

The Final Regulations retain the general rule that prevents taxation of gain on assets that do not form part of a permanent establishment, but also address certain gains that may be taxed without regard to whether there is a permanent establishment. For example, if the only gains or losses that would be taken into account are gains or losses attributable to US real property interests after applying treaty benefits, the foreign transferor determines its effectively connected gain and effectively connected loss pursuant to the FIRPTA rules of section 897 and not under section 864(c)(8).

Partner-Specific Exclusions, Exceptions, and Basis Considerations

The Final Regulations provide that a foreign transferor's distributive share of deemed sale effectively connected gain or loss (step three) does not include any amount that is excluded from the foreign transferor's gross income or otherwise exempt from US federal income tax by reason of an applicable provision of the Code. Similarly, a foreign transferor's step three amount does not include any amount to which an exception under FIRPTA applies.

In the case of a nonresident alien individual or foreign corporation that purchased an interest in a partnership (engaged in a US trade or business within the US) with a section 754 election in place, the inside basis of the partnership's assets would have been adjusted to fair market value with respect to the foreign partner to reflect its initial outside basis in the partnership. This step-up in basis could impact the amount of the foreign partner's gain or loss under section 864(c)(8) upon a later sale or exchange of its partnership interest because of the deemed sale limitation, *i.e.*, the partnership's deemed sale of all of its assets would result in a smaller amount of gain if a section 754 election were in place upon the foreign transferor's initial purchase of the partnership interest. Therefore, the importance of whether an election under section 754 is available to a prospective foreign partner is highlighted in this context.

Applicability Dates

The Final Regulations generally apply to transfers occurring on or after December 26, 2018.

By: Steven Schneider, Washington, DC, Leah Gruen, Chicago, and Murtuza Hussain, Houston

Updates on US's Competent Authority Arrangements for the Automatic Exchange of Country-by-Country Reports

The main objective of OECD base erosion and profit shifting ("BEPS") Action Item 13 (Transfer Pricing Documentation and Country-by-Country Reporting ("CbC Reports")) is to standardize the information provided to tax authorities in order to increase transparency and combat transfer pricing and base erosion risks. One key tool contained in Action 13 to meet this objective is the framework for government-to-government mechanisms to exchange CbC Reports. The framework provides that CbC Reports are automatically exchanged where the relevant jurisdictions execute bilateral competent authority arrangements ("CAAs").

The automatic exchange of CbC Reports is intended to increase international tax transparency and improves the access of tax authorities to information regarding the global allocation of the income and taxes paid by multinational enterprises ("MNEs").

On September 24, 2020, the OECD released the third peer review report on Action 13 CbC Reports, which found that 40 of the 131 reviewed countries have yet to finalize a domestic legal or administrative framework for CbC reporting. In the United States, the first filing obligation for CbC Reports applies to fiscal years commencing on or after July 1, 2016. The United States also allows MNE groups to file CbC Reports voluntarily for fiscal years beginning between January 1, 2016, and June 30, 2016.

The OECD's report recommended that the United States should continue to work actively towards signing bilateral CAAs with jurisdictions of the Inclusive Framework that meet the confidentiality, consistency, and appropriate use conditions, and with which the United States has an agreement in effect that allows for the automatic exchange of information. The United States has concluded CAAs with more than 40 jurisdictions, adding Curaçao to the list earlier this year. The United States is also continuing negotiations with several others jurisdictions, including Cyprus, France, and Germany.

On September 4, 2020, the Cyprus Tax Department issued a statement to clarify that the CAA for the automatic exchange of CbC Reports with the United States,

which is still under negotiation, is expected to be effective for fiscal years starting on or after January 1, 2020. The delayed effective would give rise to a local filing obligation in Cyprus for US-based MNEs for fiscal years prior to January 1, 2020. This arises because, under the OECD's model legislation, local report filing is required for US-based MNEs in cases where there is no CAA between the United States and the relevant jurisdictions, but there is still an international agreement that forms the legal basis for automatic exchange of information between the two jurisdictions (such as a bilateral income tax treaty).

Joint statements have also been issued by the Competent Authorities of the United States and France and by the Competent Authorities of the United States and Germany expressing the intention to spontaneously exchange CbC Reports for fiscal years of MNE groups commencing on or after January 1, 2016 and before January 1, 2019, while bilateral CAAs are being negotiated.

On December 5, 2019, the United States and French governments, in a joint statement, announced that while the countries are continuing their negotiation to conclude a CAA, the Competent Authorities will, pursuant to Article 27 of the US-France Tax Treaty (authorizing exchange of information for tax purposes), engage in spontaneous exchange of CbC Reports for fiscal year 2018.

The Competent Authorities of the United States and France acknowledged in the statement that assessing high-level transfer pricing risks and other base erosion and profit shifting risks, as well as economic and statistical analysis, where appropriate, are critical objectives of exchanging CbC Reports that should not be postponed. Similar statements were released for fiscal years 2016 and 2017.

The United States and German governments released similar statements authorizing the spontaneous exchange of CbC Reports for the same years pursuant to Article 26 of the US-Germany Tax Treaty.

By: Sahar Zomorodi, New York

Canada: New Trust Reporting and Disclosure Rules Are Coming into Force in 2021

New Canadian trust reporting and disclosure rules will come into effect in 2021. In brief, the new rules will impose a filing obligation on certain trusts which currently do not have a filing requirement. They apply to non-resident trusts that currently have to file a T3 return and certain trusts that are resident in Canada. Such trusts will be required to report the identity of all trustees, beneficiaries and settlors of the trust, as well as anyone with the ability to exert control or override trustee decisions over the appointment of income or capital of the trust (e.g., a protector).

Background

The new rules were introduced in the 2018 federal budget with the aim to improve the collection of beneficial ownership information in relation to trusts and to help the Canada Revenue Agency assess the tax liability for trusts and its beneficiaries.

Currently, a trust generally is required to file an annual income tax return - T3 Trust Income Tax and Information Return ("T3 return") - if the trust has tax payable or distributed any of its income or capital to its beneficiaries. A trust that has no activity during the year and no tax payable generally is not required to file a T3 return.

The New Rules

Starting from the 2021 taxation year, the new rules will require non-resident trusts that currently are required to file a T3 return and certain express trusts (generally a trust created with the settlor's express intent) that are resident in Canada, to file a T3 return to provide additional information, including the name, address, date of birth (for individuals), jurisdiction of residence and taxpayer identification number ("TIN") of the following:

- the settlor of the trust;
- each of the trustees;
- each of the beneficiaries; and
- anyone with the ability to exert control or override trustee decisions over the appointment of income or capital of the trust (e.g., a protector).

The required information is required to be filed as a new schedule along with the T3 return. It cannot be filed on its own.

The following trusts may be exempt from the new disclosure obligations:

- mutual fund trusts, segregated funds and master trusts;
- trusts governed by registered plans (e.g., registered pension plans, registered retirement savings plans, tax free savings accounts, etc.);
- lawyers' general trust accounts;
- graduated rate estates and qualified disability trusts;
- trusts that qualify as non-profit organizations or registered charities;
- trusts that have been in existence for less than three months; and
- trusts that hold less than C$50,000 in assets (limited to deposits, government debt obligations and listed securities) throughout the taxation year.

Failure to file the T3 return including the new schedule could result in penalty of C$25 per day of delinquency (with a minimum penalty of C$100 and maximum

penalty of C$2,500). If such failure is made knowingly, or if there is gross negligence, an additional penalty of 5% of the maximum fair market value of the trust's assets (with a minimum penalty of C$2,500) could be imposed. Existing penalties in relation to the T3 return will continue to apply.

Takeaway

As a result of the new trust reporting and disclosure rules, trusts that had no reporting and disclosure obligations on the basis that they had no tax payable and no activity during the year will soon be caught under the new rules and required to file a T3 return. Trustees should be prepared for the new rules with a full understanding of the scope and reporting obligations. These new additional reporting requirements should also be taken into account in determining whether and how a new trust should be set up as well as any variation of an existing trust from a Canadian perspective. Finally, the penalty of 5% of the value of the trust's assets for deliberate failure or grossly negligent failure to disclose is significant. Trustees would be well advised to take appropriate steps to ensure that this penalty does not apply to any trusts under their administration.

By: Peter Clark and Josephine Chuk, Toronto

The African Continental Free Trade Area: A Great Opportunity with a Tough Balancing Act

The African Continental Free Trade Area (the "AfCFTA") is one of the largest trading blocs in the world. The agreement establishing the AfCFTA (the "CFTA Agreement") has been signed by 54 out of the 55 member states of the African Union ("AU"), and ratified by at least 30 of them with 28 having deposited their instrument of ratification as of the date of this writing. The AfCFTA's initial objective is to foster intra-African trade by improving market access through the phasing out of tariffs, removal of trade barriers, harmonization of customs laws and practices, and enhancing cooperation and capability building. The AU is aiming for a gradual liberalization that would eventually pave the way for a customs union and regional integration fostering the free movement of people and capital. For large businesses that are already established in Africa or looking to enter the market, the AfCFTA provides a tremendous opportunity for optimizing their operational structure.

The CFTA Agreement, together with its protocols and annexes, creates a framework that provides ground rules for cross-border trade and tariffs, investment, intellectual property rights, disputes resolution and competition policy. As of this writing, only the Trade in Goods Protocol, Trade in Services Protocol and Rules and Procedures on the Settlement of Disputes have been finalized and adopted. Negotiations are ongoing with respect to the remaining protocols, and there is a fast-tracked protocol on e-commerce that is expected to

be finalized in early 2021. Trading under the AfCFTA will officially commence on January 1, 2021 for the member states that have ratified it (referred to as "State Parties" under the CFTA Agreement). Among other things, State Parties will commit to phase out tariffs on 90% of tariff lines within 5 years (10 or 15 years in certain cases), followed by another phase-out period for 7% of tariff lines. The remaining 3%, not exceeding 10% of the value of imports, can be excluded from liberalization entirely.

The AfCFTA has been lauded for the flexibility that it affords State Parties to make offers to each other, and tailor their preferential trade arrangements based on the specific commitments that they make with respect to goods and services. The agreed-upon items will be enumerated in schedules that will be appended to the CFTA Agreement or its protocols. The trading agreements that emerge from these negotiations should open up new markets for African products at a time when demand has slowed down for exports due to the pandemic, and many African countries are feeling the pressure of economic slowdowns, rising unemployment and foreign exchange shortages. Import substitution also is a driver for the AfCFTA's success as African countries continue to import consumables and other basic necessities from outside the continent for which comparable regional supplies are available.

The CFTA Agreement prescribes numerous exceptions and carve-outs to address adverse consequences that may arise from a liberalized trade regime. By way of example, Part VIII of the Trade in Goods Protocol gives State Parties wide latitude to take all kinds of measures to protect their social, economic and security interests, unless such measures constitute an arbitrary or unjustifiable discrimination between State Parties, or a disguised restriction on international trade. As the State Parties are at different stages of development and some are more dominant than others, one such measure that could slow down the liberalization process relates to trade imbalances. Under Article 28 of the Protocol, a State Party that experiences balance of payment difficulties can take restrictive measures for a duration necessary to remedy the situation. The significant variations in how the obligations of State Parties play out from jurisdiction to jurisdiction could take a toll on the compliance systems of businesses.

The AfCFTA is intended to co-exist with the numerous preferential trade arrangements to which its signatories belong until such arrangements are phased out over time. Within Africa alone, there are eight regional economic communities ("RECs") that are recognized by the African Union, which include the Arab Maghreb Union ("AMU"), the Economic Community of West African States ("ECOWAS"), the East African Community ("EAC"), the Intergovernmental Authority on Development ("IGAD"), the Southern African Development Community ("SADC"), the Common Market for Eastern and Southern Africa ("COMESA"), the Economic Community of Central African States ("ECCAS"), and the Community of Sahel-Saharan States ("CEN-SAD"). Under Article 5 of the CFTA Agreement, the RECs are treated as the building blocks of the AfCFTA.

However, Article 19, Section 1, states that if there are conflicts or inconsistencies between the CFTA Agreement and the legal instruments of the RECs, the former will supersede the latter “to the extent of the specific inconsistency.” A notable exception under Section 2 states that where a State Party belongs to a regional economic community that has attained a higher level of regional integration than under the AfCFTA, those State Parties “shall maintain such higher levels among themselves.” Applying this to an actual situation, the East African Community (“EAC”) is a customs union between six countries, which makes it more integrated than the AfCFTA. Section 2 would apply to Kenya, Rwanda and Uganda, the three countries that belong to both the EAC and the AfCFTA.

Under Article 18 of the CFTA Agreement as well as Article 4 of each of the Trade in Goods Protocol and Trade in Services Protocol, State Parties are expected to extend most-favored-nation (“MFN”) treatment to each other on a reciprocal basis. This essentially means that the best trade terms under their respective third-party agreements will apply between them. The wholesale extension of MFN status to 30 countries is likely to be unworkable, especially for the more developed economies on the continent that have various global and regional trade agreements in effect. To account for this, the Trade in Services Protocol provides some relief by allowing State Parties to include exceptions from MFN status on an exemption list that will be attached as a schedule to the Protocol.

A bigger challenge looms with the interplay between the AfCFTA and the domestic laws of State Parties, and the administration and enforcement of what could be inconsistent mandates. Subject to a few exceptions, the AfCFTA affords State Parties maximum flexibility to apply their own laws. Laws vary from country to country, and some countries have more stringent requirements concerning foreign investments, business and occupational licenses and registrations, and tax and legal compliance. These considerations make the determination of host jurisdictions, choice of entity and other local arrangements of paramount importance to the establishment of optimized business operations within the bloc.

Where the service provider is a legal entity, Article 24 of the Trade in Services Protocol should be kept in mind, which allows a State Party to deny the benefits of the Protocol to a service supplier of another State Party where the service is supplied by a legal entity of a non-State Party that lacks a “real and continuous link with the economy” of the other State Party or has “negligible or no business operations” with any State Party. Moreover, caution should be exercised to not gloss over critical service sector considerations, such as how a particular service is classified and licensed. Article 10, paragraph 1, of the Protocol provides for a State Party to recognize the credentials, licenses and certifications secured by a service supplier from another State Party. However, license requirements vary widely and the legal definition of “service” may not include a proposed activity. If the services involved are in a learned field, verification of educational credentials and equivalency determinations could get cumbersome without readily available school rankings information or established procedures for credentialing agencies to handle the verification process. The Schedule of Specific Commitments to the

Protocol may cover agreed-upon conditions and qualifications, but it is unlikely that those would be the only requirements that would apply.

Another nettlesome area is the imposition of direct taxes on nonresident service suppliers. Article 20 of the Trade in Services Protocol requires "national treatment", which essentially prohibits the imposition of discriminatory taxes on services suppliers of one State Party providing services in the territory or to consumers of another State Party. Nevertheless, under Article 15, inconsistent national treatment is permitted if the divergence is aimed at ensuring equitable or effective imposition or collection of direct taxes in respect of the service suppliers of other State Parties. There currently are various proposals globally for taxing remote service providers, with no consensus on what constitutes equitable taxation, which makes the identification of a discriminatory tax challenging at best. Perhaps, the AfCFTA protocol on e-commerce would provide additional guidelines that can be applied fairly and consistently by members of the bloc. It is worth noting that the parties to the CFTA Agreement are governments and the complaining party under the disputes resolution protocol is a State Party that initiates a dispute settlement procedure, which means that private parties aggrieved by a discriminatory tax would have to find a remedy indirectly through the State Party that has jurisdiction over them.

As a final note, care should be taken in the interpretation of the Rules of Origin guidelines contained in Annex 2, which limit preferential treatment to goods that have either originated from or have undergone substantial transformation within the AfCFTA. Annex 2 lists products that are deemed "wholly obtained" and provides guidelines for determining "sufficiently worked or processed" products. Where a group of materials or component parts have separate origins within and outside the AfCFTA and it would be impractical to physically separate them, financial accounting systems can be used to identify the incremental value upon which preferential treatment would be conferred. As has been witnessed in other parts of the world, when supply chains are geographically diversified, the origin analysis becomes intricate and compliance risks increase. Ultimately, State Parties must ensure that their administration and enforcement staff have the capabilities to meet the demands of operating in this space, including being in a position to issue advance rulings as part of the trade facilitation initiatives set forth in Annex 4.

The AfCFTA is expected to bring much-needed continental economic cooperation between African states for mutual benefit and development. Roadblocks to economic growth, such as foreign currency shortages, are already being addressed through the implementation of digital payment systems that enable settlement of transactions in local currencies. Once the outstanding protocols, annexes and schedules are finalized, there would be a plethora of rules and exceptions to navigate, and clear interpretation and efficient administration may take time to develop. In this regard, transparency and consistency in the overall regulatory framework would go a long way to alleviate

compliance burdens. As is typical of ambitious undertakings, it may be a while before the full benefit of the AfCFTA is realized.

***By: Pomy Ketema,* New York**

Breaking Down the Final 163(j) Regulations

Section 163(j), as rewritten under the Tax Cuts and Jobs Act, applies a business interest expense limitation equal the sum of business interest income (BIE), 30% of adjusted taxable income, and floor plan financing interest. BIE is interest paid or accrued on indebtedness that is properly allocable to a trade or business, with all BIE of a C corporation being properly allocable to a trade or business. The limitation generally applies to all businesses except small businesses that meet the gross receipts test, an electing real property trade or business, an electing farming business, certain regulated utilities, and certain employees performing services.

The Treasury and the IRS published voluminous final and proposed Section 163(j) regulations on September 14, 2020. The final regulations retain the structure of proposed regulations released in 2018 with several important changes. The individuals below reviewed the final regulations in an InsightPlus alert, "*Section 163(j) Regulations Are Finally Final*." See our InsightPlus platform to stay informed of Baker McKenzie's tax alerts in the jurisdictions of interest to you.

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Blueprints of Two Pillars on Which the Future of International Taxation Balances

On October 12, 2020, the OECD released highly-anticipated reports on the digital economy in the form of Blueprints on its Pillar One proposal regarding new nexus and profit allocation rules and its Pillar Two proposal regarding new global minimum tax rules. The OECD pushed the timeline for meeting a global consensus on the proposals to mid-2021 as political and technical issues, including model legislation, remain outstanding. In addition, the OECD requested comments on the Blueprints.

Members of our global tax team provide a summary of the proposals in Navigating the OECD Blueprints: "*Pillar One - Overview of 'the Blueprint'*" and "*Pillar Two - The New Normal for Effective Tax Rates*" available on InsightPlus.

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New York State Issues Personal Income Tax Sourcing Guidance for Nonresident Employees Telecommuting Due to COVID-19 Pandemic

Publishing long-awaited guidance on how existing state income tax sourcing rules will apply in light of the ongoing COVID-19 pandemic, the New York State Department of Taxation and Finance ("Department") recently advised that a nonresident's income will be sourced to New York State unless the nonresident's remote work location meets the "bona fide employer office" exception to the "convenience of the employer test." Specifically, the Department addressed a question in its FAQs regarding how to source income for Personal Income Tax purposes where a nonresident's primary office is in New York, but the nonresident is working remotely due to the COVID-19 pandemic, and essentially concluded that, to meet the exception to New York State sourcing, the employee's remote work situation must continue to meet the "bona fide employer office" test even during the pandemic. The Department's FAQs provide minimal reasoning for its position and we expect taxpayers to challenge it.

For more information on these and other recent state and local tax updates, please see "*New York State Issues Personal Income Tax Sourcing Guidance for Nonresident Employees Telecommuting Due to COVID-19 Pandemic*" on the SALT Savvy blog, available at www.saltsavvy.com.

By: Dmitrii Gabrielov, New York

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