Potential U.S. tax implications of proposed Bermuda corporate income tax

The government of Bermuda, on August 8, 2023, released a public consultation describing a potential new corporate tax regime (Bermuda CIT), effective for tax years beginning on or after January 1, 2025. The Bermuda CIT is being contemplated as a response to the adoption of the base erosion and profit shifting (BEPS) Pillar Two global minimum tax (GloBE) rules in many jurisdictions.[1] The potential U.S. tax implications arising from the differing options implicit in the consultation generally highlight the considerations that so-called "investment hub" jurisdictions are weighing in crafting their responses to the GloBE rules.

The consultation describes the potential approach as a corporate income tax (CIT) applicable to multinational enterprises (MNE Groups) with revenues of €750 million or more, including Bermuda tax resident entities and nonresident entities with a Bermuda permanent establishment (PE) that is a constituent entity (CE), notwithstanding certain exceptions. Although the tax rate applicable in calculating Bermuda CIT has not been determined, it is expected to be between 9-15% and is unlikely to result in an overall effective tax rate (ETR) on Bermuda profits in excess of 15%. It is also anticipated that the Bermuda CIT will not be a qualified domestic minimum top-up tax (QDMTT) but would, nonetheless, qualify as a "covered tax" for purposes of the GloBE rules. The Bermuda CIT would, therefore, reduce the amount of top-up tax payable to other jurisdictions under an income inclusion rule (IIR) or undertaxed profits rule (UTPR) with respect to Bermuda profits. While the proposed Bermuda CIT is silent as to the substance-based income exclusion in Article 5.3 of the GloBE Model Rules, it is anticipated that it would include the International Shipping Income Exclusion in Article 3.3, presumably including the strategic or commercial management substance requirement in Article 3.3.6. The Bermuda CIT would also take into account foreign taxes paid with respect to Bermuda income, including income taxes, withholding taxes, and U.S. federal excise tax (USFET)[2] paid with respect to Bermuda profits by allowing a credit against the Bermuda CIT. A credit may be permitted for controlled foreign corporation (CFC) taxes paid by a direct or indirect

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[1] *See* OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris (GloBE Model Rules), https://www.oecd.org/tax/beps/tax-challengesarising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf; *see also* OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*, OECD, Paris (GloBE Commentary), https://www.oecd.org/tax/beps/tax-challenges-arisingfrom-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf.

[2] The U.S. federal excise tax (FET) is a 4% excise tax payable on premiums paid to non-US insurance companies for casualty insurance or indemnity bonds, and 1% on the premiums for life, sickness or accident insurance, annuity contracts, and reinsurance.

shareholder under a CFC regime, including U.S. Federal income tax (USFIT) on global intangible low-taxed income (GILTI) and subpart F income.

Foreign (U.S.) taxes paid on Bermuda profits

How USFIT is ultimately taken into account by the Bermuda CIT will inevitably have consequences for U.S. MNE Groups, including whether the Bermuda CIT is treated as a covered tax (taken into account in the numerator of the GloBE Jurisdictional ETR calculation) or a QDMTT that provides a credit against top-up tax owed under an IIR or UTPR (or shuts off an IIR or UTPR if the QDMTT qualifies for the QDMTT safe harbor contained in the July administrative guidance). If USFIT on GILTI and subpart F income that directly or indirectly relates to Bermuda income is allowed as a credit against the Bermuda CIT, this will reduce the amount of tax paid under the Bermuda CIT. By comparison, a QDMTT would not take into account any USFIT paid by reason of GILTI or subpart F and would, therefore, result in a higher amount of tax in Bermuda.[3] For example, assume USP owns a Bermuda CFC with $100 profit, all of which is subpart F income. Assume further that USP pays $21 of pre-credit USFIT and credits $6 in foreign taxes (credited foreign taxes, or FTCs),[4] such that $15 of USFIT is pushed down for purposes of calculating the Bermuda GloBE Jurisdictional ETR. If the Bermuda CIT allows for the USFIT on the subpart F income to be credited against the CIT in a manner that follows Article 4.3.2(c) of the Model Rules, that would result in an effective tax rate (pre-Bermuda CIT) of 15% ($15/$100), and presumably no tax would be collected under the Bermuda CIT. Whereas, if the Bermuda CIT were a QDMTT, no allocation of USFIT would be permitted under the GloBE rules and $15 would be collected in Bermuda, in addition to USFIT paid under the subpart F or GILTI regimes.

The consultation states that tax paid under a CFC regime may be permitted as a credit, but it does not describe how to determine the Bermuda-related portion of USFIT on GILTI and subpart F income if such taxes are ultimately allowed as a credit against the Bermuda CIT. If Bermuda adopts the approach of the GloBE rules, the mechanism would be different for each of subpart F and GILTI taxes. Article 4.3.2(c) of the GloBE Model Rules provides that, if a CE's income is taxed under an owner jurisdiction's "CFC tax regime," such taxes are reallocated from the owner jurisdiction to the CE jurisdiction for purposes of determining covered taxes. The GloBE Commentary clarifies that the general process for allocating CFC taxes follows the three-step approach in Article 4.3.2(a), dealing with PEs.[5] As applicable for USFIT on subpart F income of a U.S. shareholder, the first step is to determine the amount of a CFC's subpart F income that is included in the U.S. shareholder's taxable income for USFIT under section 951(a). Second, the U.S. shareholder's tax liability from such income is determined by multiplying that income by 21%, the applicable U.S. corporate tax rate. And, finally, the third step is to determine the FTCs, if any, allowed under section 960 with respect to the taxes paid by the CFC (which may include foreign taxes paid in respect of other income because the U.S. FTC rules allow for cross-crediting of foreign taxes within the same FTC category). The amount of the covered taxes allocated to the CFC is the excess of the subpart F tax liability over the allowed FTCs utilized against USFIT otherwise paid on such income. In a simplified example, assume a U.S. shareholder has an inclusion of $100 for the subpart F income of its wholly owned CFC located in country X. Assume, further, that country X imposes a 12% regular

[3] *See* Feb. 2023 AG, at 118.30.

[4] In this example, assume the $6 FTCs were paid in respect of other income of USP in the same FTC category as the Bermuda subpart F income and applied against the $21 of pre-credit USFIT under the tax allocation rules contained in Article 4.3.2(c) of the Model Rules (described below).

[5] GloBE Commentary, at 46-54, 58.

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corporate income tax on the CFC's income, including its subpart F income, that such U.S. shareholder has no other FTCs, and that such country X taxes are fully creditable for USFIT. The U.S. shareholder pays $21 ($100 x 21%) of tax on the subpart F income of the CFC (ignoring expense allocation) and claims a $12 FTC, for an actual tax liability with respect to the CFC's subpart F income of $9, which is reallocated to the CFC under Article 4.3.2(c) for purposes of applying any GloBE top-up tax to the country X GloBE income under an IIR or UTPR.

For GILTI, because it is a so-called "blended CFC tax regime," administrative guidance[6] released in February 2023 provides a transitional simplified allocation method whereby the portion of USFIT paid under the GILTI regime that is allocated to a CE (which may be a CFC or a tested unit of a CFC, such as a branch that operates in a jurisdiction other than that of the CFC) is calculated using a formula that considers both (1) the quantum of income in a jurisdiction as calculated under the CFC tax regime (i.e., the CFC's tested income rather than its GloBE income) and (2) the degree to which the GloBE ETR in the jurisdiction falls below the "applicable rate," which is the rate at which foreign taxes would fully offset tax due under the CFC regime (i.e., 13.125% for GILTI).[7]

For example, consider a US shareholder that owns two CFCs in different jurisdictions with equal tested income, where the first CFC pays foreign tax at a 12% rate and the second CFC pays tax at a 15% rate. Because the second CFC's GloBE Jurisdictional ETR exceeds 13.125%, all the GILTI tax will be allocated to the first CFC even though some of it likely results from shareholder expenses allocable to the second CFC. By contrast, if both CFCs had GloBE Jurisdictional ETRs exceeding 13.125%, both would have blended CFC allocation keys of 0 such that none of the allocable blended CFC tax would be allocated. Although not explicitly provided, presumably in this case the allocable blended CFC tax would remain a covered tax of the U.S. shareholder as it is included in the U.S. shareholder's financial accounts that is not allocated to any other jurisdiction and therefore would be taken into account for purposes of determining any GloBE top-up tax due on U.S. GloBE income.

U.S. FTC considerations for Bermuda CIT

Whether the Bermuda CIT is a QDMTT or not may affect the ability of a U.S. Shareholder to claim FTCs with respect to any tax paid in Bermuda. If the Bermuda CIT is a QDMTT, it is expected that it would be creditable for USFIT under section 901 (although future Treasury Regulations may clarify this treatment). This may not actually provide a tax benefit, however, particularly for GILTI taxes, because many MNEs are excess credit in the GILTI basket under section 904.

Alternatively, if the Bermuda CIT is not a QDMTT because the calculation takes into account the pushdown of USFIT for GILTI and subpart F income inclusions in respect of the Bermuda CFC's income for purposes of calculating the amount owing under the Bermuda CIT, the allowance of a FTC for the Bermuda CIT against USFIT imposed on the Bermuda CFC's income would make the calculation of the Bermuda CIT iterative and may ultimately lead to no USFIT on the Bermuda CFC's income in certain fact patterns. For example, assume a U.S. shareholder wholly owns one CFC that is located in Bermuda and Bermuda's CIT includes a 15% tax rate

[6] OECD (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), OECD/G20 Inclusive Framework on BEPS*, OECD, Paris (Feb. 2023 AG), https://www.oecd.org/tax/beps/agreed-administrative-guidance-for-the-pillar-two-globe-rules.pdf.
[7] Feb. 2023 AG, at 2.10.

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with a credit determined under the pushdown mechanism described above that is contained in Article 4.3.2(c) of the Model Rules. Assume that the GloBE jurisdictional ETR is less than 13.125% because the amount of Bermuda CIT is less than 13.125% when the credit for U CFC tax is taken into account. Assume further that the CFC has $100 of tested income under section 951A(c)(2)(A) and the U.S. shareholder has no other CFCs. The U.S. shareholder has an initial GILTI tax liability of $10.5 ($100 x 10.5%), assuming a 50% section 250 deduction and 0 FTCs before the Bermuda CIT is determined. Bermuda would then initially impose a tax of $4.5 ($100 x 15% - $10.5), taking into account the GILTI pushdown. If $3.6 of the Bermuda tax (i.e., net of 20% haircut) is creditable for USFIT, and assuming the FTC limitation in the GILTI basket is not lower than $3.6, the U.S. shareholder's GILTI tax liability is then reduced to $6.9, which presumably would cause a recalculation of the tax owed in Bermuda to $8.1 and the iteration would continue. Given this result, it is unclear how Treasury will ultimately view this iterative aspect of a non-QDMTT.

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