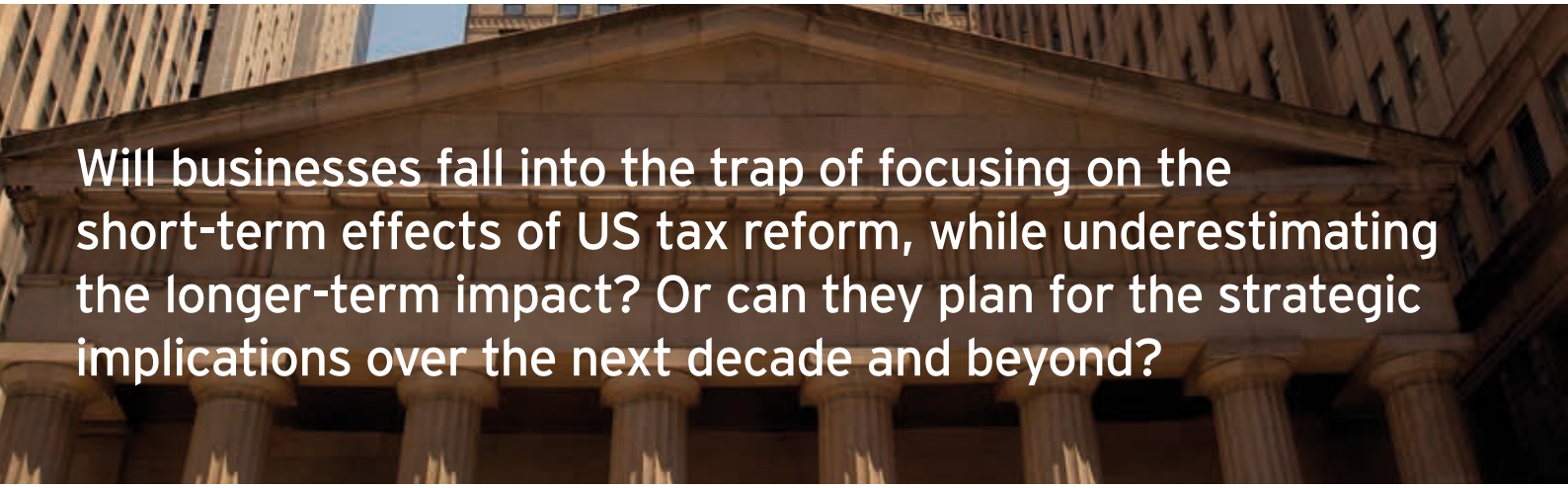
US Tax Reforms

The long-term considerations for financial institutions

April 2018

EY

Building a better working world



Will businesses fall into the trap of focusing on the short-term effects of US tax reform, while underestimating the longer-term impact? Or can they plan for the strategic implications over the next decade and beyond?

At a stroke, the US has changed the tax landscape for both domestic and foreign businesses. The immediate headline provisions of the US tax reform package are clear: a permanent reduction in the corporate tax rate to 21% and new measures to use the tax system to bring capital and jobs back to the US, reflecting commitments made during the campaign for the 2016 election.

Multinational groups have been scrambling to adjust to the complex new provisions, many of which target companies generating significant profits overseas. These groups are revising their tax accounting calculations and attempting to understand the immediate impact of the legislation on their financial statements. The result: a series of very large balance sheet adjustments affecting retained earnings and capital.

However, the broader impacts of the reforms have been less clear, particularly for global financial institutions. Indeed, much long-term planning has been temporarily sidelined as businesses adjust to the new provisions. But, now that year-end accounting activity is drawing to a close, the focus will inevitably shift to the reactions of global businesses over the longer term. As it does so, one thing is certain: every multinational financial institution will be impacted to some extent by this overhaul of the US tax system.

The reforms: "America first"

The President has been clear that the aim of these tax reforms is to revitalize the US economy by eliminating what he perceived to be anti-competitive elements in US tax law and preventing the ease with which companies were able to erode the US tax base. To that end, the provisions create several new incentives and deterrents. However, their complexity means they affect each industry in unpredictable and potentially distorting ways.

On the one hand, rules offering preferential rates for moving intellectual property back to the US will likely have little impact on financial services, but could have a significant effect on manufacturing and technology. On the other hand, provisions like "BEAT" (the base erosion and anti-abuse tax) and "GILTI" (global intangible low-taxed income) are expected to have a major impact on financial services, where they could well erode the benefit of the lower corporate tax rate.

Reforms at a glance

- Headline corporate tax rate reduced from 35% to 21% from 1 January 2018.
- Creation of a broader tax base which, among other things, limits net interest deductions to 30% of EBITDA (restricted to EBIT beginning 2022) applying to both related and unrelated party debt.
- One-time transition tax charge arising in the 2017 tax year on historic earnings that have not previously been taxed, payable over eight years.
- Participation exemption granted for dividends received from 10%-owned non-US subsidiaries, facilitating the efficient movement of funds back to US owners.
- Base erosion and anti-avoidance tax (BEAT), liability for which is determined on a tax base that does not allow a US deduction on foreign related-party payments, with potential long-term effects on supply chains, booking models, and inter-group service arrangements.
- Global intangible low-taxed income (GILTI), which taxes a US parent immediately on non-US subsidiary profits not associated with a routine return on tangible fixed assets – expected to disproportionately affect industries with low levels of tangible assets (such as financial services).
- Foreign derived intangible income (FDII), which taxes export income not associated with tangible assets at a beneficial tax rate, incentivizing the export of services from the US (note that financial services income is excluded).

At first sight, the reforms could well achieve the President's ambitions of favoring doing business in the US, but only up to a point. For example, an entirely domestic US enterprise might receive the full benefit of the lower corporation tax rate, while avoiding the more punitive measures like BEAT. However, global businesses, and particularly global financial institutions, will always want to retain a global presence. They cannot therefore avoid grappling with the complexities and potential inefficiencies of the longer-term impact of the reforms.

So, what might the consequences be for financial institutions? There are three key questions:

Will global financial institutions increase investment in the US?

With the cut in the headline rate of corporate tax, one of the major hurdles to greater investment in the US has been removed. Many global financial institutions will now be asking if they should move more of their activity to the US, especially given the challenges faced by European institutions. With Brexit already forcing those institutions to revisit their global footprints, the US has made itself a more attractive location for new investment and capital deployment at an auspicious time.

That said, digging deeper into the reforms reveals a series of other incentives and restrictions that will mean financial institutions might struggle to achieve the full benefit of the lower tax rate. In particular, the BEAT means that multinational financial institutions operating in the US must review their intra-group arrangements to remain competitive in the US market.

What is the likely impact on capital and corporate structures?

Previous US tax rules imposed a heavy cost on the repatriation of profits, meaning US financial institutions often "permanently reinvested" their profits in offshore jurisdictions. By some estimates this was collectively up to $3 trillion despite executives, shareholders and analysts frequently asking whether this was the most efficient use of capital. Under the new rules, the position is completely different – US financial institutions will no longer have a meaningful tax incentive to leave funds offshore.

There is also likely to be an increase in business disposals and acquisitions as corporations position themselves to benefit from the lower US tax rate. Acquisition targets in the US will be more attractive than they were, although the BEAT could deter institutions from holding US-based businesses from abroad. Nevertheless, the reforms should provide a higher return on capital for financial institutions.

Looking further ahead, corporate structures, regulatory capital and intra-group flows will likely need a fundamental rethink. Multinationals have spent the past 30 years designing their corporate structures and operating models to balance tax costs with the evolving requirements of global regulatory frameworks. The US tax reform package turns these calculations on their heads and will favor growth and investment in US-based operations for all businesses.

Are we in for a tax trade war?

The US tax reform package is designed to increase the competitive advantage of US-headquartered businesses. But it has also advertized to the world that the US is a premier location for multinationals and an ideal place to grow and develop a global business. That has given the country a first-mover advantage. But will it be permanent? Or will other jurisdictions follow suit?

Measures like the BEAT are different in many respects from existing international tax rules and will be evaluated by the OECD at the request of the EU. In general, the BEAT would deny a deduction for certain amounts paid to foreign related parties in certain circumstances without regard to existing tax rules like transfer pricing requirements, for instance. Finance ministers from Western European countries have already requested a rethink because the BEAT "may lead to significant tax charges and may harmfully distort international financial markets."

Could this be the opening salvo in a trade war conducted through tax legislation? Perhaps. At the very least, other countries will likely now reassess their own corporate tax rates. China, Australia, Israel and Canada have already announced reviews of their tax regimes. The EU is gathering views from its multinationals and may seek to respond by taxing technology giants more heavily. International tax experts are getting increasingly nervous about these kinds of retaliatory threats and potential distortions in world trade.

In summary

The US reforms, and particularly the unprecedented overnight 14% reduction in the US corporate tax rate, will have both an immediate effect and a longer-term dynamic impact. They will create significant upsides for many US businesses and, more broadly, on the global stage, there is likely to be a strategic rethink of capital deployment to and from businesses in the US. An uplift in M&A activity is also likely over the short and long term. But, looking further ahead, the reforms could significantly distort some industries, and may have a myriad of unintended consequences. Business models, funding and corporate structures will all need to be re-examined to reflect changes in supply chains, transfer pricing arrangements, booking models and capital funding flows.

Contacts

Tax Banking and Capital Markets

Ralf Eckert
Partner, Ernst & Young AG

T: +41 58 286 3559
E: ralf.eckert@ch.ey.com

Tax Insurance

Thomas Brotzer
Partner, Ernst & Young AG

T: +41 58 286 3412
E: thomas.brotzer@ch.ey.com

Tax Wealth and Asset Management

Linda Henry
Partner, Ernst & Young LLP

T: +44 20 7951 8618
E: lhenry@uk.ey.com

For more information and an approach tailored to your needs, please contact our team.

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Building a better working world
At EY Financial Services, we share a single focus — to build a better financial services industry, not just for now, but for the future.

We train and nurture our inclusive teams to develop minds that can transform, shape and innovate financial services.

It's because we have minds made for financial services that we ask better questions. Better questions lead to better answers that benefit our people, our clients and our communities. It's how we play our part in building a better working world.

EYG No. 02011-184GBL

EY-000058809.indd (UK) 04/18.
Artwork by Creative Services Group London.

ED None

In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

ey.com/FSminds