

# US tax reform and the telecommunications industry

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## Post-election: the political landscape

On January 3, 2017, the 115th Congress was sworn in, capping a surprising sweep by Republicans of the House, Senate and White House. Before, during and following the campaigns, President Trump, House Speaker Ryan and Senate Majority Leader McConnell each signaled that comprehensive tax reform was a high priority. This unanimity of purpose among Republicans – coupled, now, with their ability to drive the legislative agenda – dramatically elevates the prospects for broad-based tax reform.

At this point, the overall process for tax reform in 2017 has not taken shape, nor has any detailed legislative proposal been made public. President Trump's Treasury nominee, Steven Mnuchin, will lead the Administration's tax overhaul efforts. Nevertheless, House leadership has met with the Ways and Means Committee, and it is aggressively moving forward with its efforts to develop legislative language for tax reform. The centerpiece of this legislation will undoubtedly be a broad-based reduction in tax rates – an important policy objective shared both by House Republicans and President Trump.

Although a detailed legislative proposal has not yet been made public, it is reasonable to expect that the public process for tax reform will pick up momentum now that President Trump's inauguration has taken place. In anticipation of what the House Ways and Means Committee is presently drafting as legislative proposals, it is appropriate for telecommunications professionals to carefully review and consider prior iterations of tax legislation, since they are a likely and readily available source for current proposals.

## The House Republican Blueprint for tax reform

Many expect the House Republican tax reform Blueprint (the Blueprint) will be a starting point for tax reform legislative language. While not a legislative draft, the Blueprint, which was released in June of 2016, outlines a revenue-neutral approach to tax reform that is intended to spur economic growth. Not surprisingly, the most significant aspect of the Blueprint is a broad-based reduction in tax rates. The Blueprint pays for this rate reduction by eliminating special-interest deductions and credits.

Existing provisions	Blueprint proposal
Top corporate tax rate (now 35%)	20%, corporate AMT eliminated
Top pass-through rate (now 39.6%)	25%
Taxation of future foreign earnings	Territorial; 100% exemption for dividends paid from foreign subs.; border adjustment
Mandatory tax, untaxed accumulated foreign earnings	8.75% for cash or cash equivalents, 3.5% otherwise, payable over eight years
Cost recovery	100% expensing: tangible, intangible assets
Interest	No current deduction will be allowed for net interest expense
Other business provisions	Calls for them to generally be eliminated, except for R&D credit and LIFO
Individual rates (now 10%, 15%, 25%, 28%, 33%, 35%, 39.6%)	12%, 25%, 33%
Capital gains and dividends	50% deduction for capital gains, dividends, and interest
Carried interest	(Not addressed)
Estate tax (now 40% rate, \$5.45 million exemption)	Repealed
State tax deduction	Eliminated
Charitable contribution deduction	Retained, but could be modified
Mortgage interest deduction	Retained, but could be modified

Broadly speaking, the Blueprint calls for a reduction in the top corporate tax rate from 35% to 20%. Individuals will also see a significant reduction in rates. Under the Blueprint, individuals would be subject to a tax rate of 12%, 25% and 33%, depending on their income level. Active income received from pass-through vehicles and sole proprietorships would be subject to a 25% tax rate. Passive investment income (e.g., net capital gains, dividends and interest) would qualify for a 50% exclusion, meaning that individuals would be taxed on such income at graduated tax rates of 6%, 12.5% and 16.5%.

The changes proposed by the Blueprint go beyond just tax rates. Of particular import, the Blueprint calls for a potentially significant tax benefit in the form of full and immediate expensing of investments in all tangible, intangible and real property (other than land). At the same time, the Blueprint proposes to eliminate deductibility of net interest expense, which would constitute a repeal of a very significant business tax benefit. The Blueprint also contains other noteworthy proposals that should be monitored. For example, the Blueprint proposes to eliminate AMT for corporations (as well as for individuals) and contains a proposal that would allow net operating losses to be carried forward indefinitely (subject to certain adjustments and limitations). Finally, the Blueprint proposes repeal of all of the tax increases that were part of the Affordable Care Act, such as the 3.8% tax on net investment income, the 0.9% payroll tax, the medical device excise tax and other industry-specific tax increases.

On the international front, the Blueprint would move to a territorial tax system and provide a 100% exemption for dividends paid from the future active earnings of foreign subsidiaries. An 8.75% tax rate would be imposed on previously untaxed accumulated foreign cash or cash-equivalent earnings and a 3.5% tax rate would apply to all other accumulated foreign earnings, payable over eight years. The Blueprint also outlines a destination-basis system in which export sales would be exempt from tax and imported "inputs" would not be deductible.

While many countries use border adjustments in connection with their value added taxes, the World Trade Organization prohibits such adjustments as part of an income tax regime; meaning, if enacted, this proposal could be subject to challenge.

Under a rule passed in the 114th Congress by House Republicans, the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) must use a process known as dynamic scoring when quantifying the impact of significant tax legislation. In essence, this means that the macroeconomic effects of such legislation, such as the effect of tax changes on jobs, wages, investment, federal revenue, and the overall size of the economy, must be taken into account as part of the estimate, and that a macroeconomic revenue score must be provided for major legislation that changes federal mandatory spending levels.

No revenue estimates were included with the Blueprint. It is, however, intended to be both pro-growth and revenue-neutral (i.e., not increase the budget deficit). To arrive at this position, the Blueprint relies on several key revenue assumptions in measuring the overall neutrality of the tax reform legislation.

- ▶ Current policy revenue baseline: in measuring the revenue neutrality of comprehensive tax reform legislation, it is necessary for some type of reference baseline to be used (or made reference to as part of the process). The House Blueprint uses a "current policy" baseline, which assumes Congress will continue to extend current tax policies, and that temporary tax expenditures will be permanently extended. Thus, when the 2015 tax extenders legislation was signed into law last year by President Obama, which made permanent a number of business and individual tax provisions, and temporarily extended other provisions, there was an

accompanying reduction in federal revenue over a 10-year budget window. Under a current policy baseline, this revenue effect gets incorporated into CBO's future budget projections, and may reduce the base broadening that is needed to achieve revenue neutrality.

- ▶ The Blueprint also includes positive revenue effects that its drafters assume will arise from the economic growth they expect from this change in tax policy.

## The Camp Plan: a precursor to the Blueprint

In February 2014, then-House Ways and Means Committee Chairman Dave Camp released as a discussion draft a comprehensive proposal for tax reform (the Camp Plan). When it was issued, the Camp Plan was the product of three-plus years of work from the Chairman and his staff and, like the Blueprint, embraced the many trade-offs necessary to significantly lower tax rates, a critical component of realizing economic growth associated with tax reform. Given the similarity of their policy objectives, many believe the Camp Plan to be a precursor of the Blueprint and a ready source of potential tax reform legislative language.

As with the Blueprint, tax rate reduction is the cornerstone of the Camp Plan, along with the curtailment or outright repeal of tax deductions and credits. Under the Camp Plan, the top corporate tax rate would have been reduced from 35% to 25%, with this rate reduction being phased in over a five-year period. The Camp Plan would repeal the corporate AMT while also providing a limited refund opportunity for pre-existing AMT credits.

Individuals would have also seen a reduction in tax rates under the Camp Plan. Had it been enacted, individuals under the Camp Plan would have seen lower rates that included 10% and 25% brackets. High-income earners would have been subject to an additional 10% surtax. Although capital gains and dividends received by individuals would have been taxed at ordinary income rates under the Camp Plan, the plan did exclude 40% of capital gains and dividends from taxation (with the exclusion applying to all rates, including the 10% surtax). On the individual front, the Camp Plan did not stop at rates. It also proposed significant changes to the calculation of an individual's adjusted gross income, made changes to the standard deductions and the types and amount of expenses that could be itemized. Like corporations, individuals would have been freed from AMT under the Camp Plan, which provided for its repeal. Individuals would, however, continue to be subject to the 3.8% Medicare surtax.

The Camp Plan proposed changes to the manner in which businesses recover the cost of investments in business assets. Unlike the Blueprint, the Camp Plan proposed to repeal and replace the modified accelerated depreciation rules by or with rules substantially similar to the alternative depreciation system. Thus, in general, class lives would have matched more closely the true economic useful life of assets, and depreciation deductions would have been determined under a straight-line method. In addition, a taxpayer could have elected to take an additional depreciation deduction to account for

the effects of inflation on depreciable personal property, calculated by multiplying the year-end adjusted basis in the property (determined without regard to inflation deductions) by the chained CPI rate for the year.<sup>1</sup> In addition, the provision required the Treasury Department to reexamine the class lives of depreciable assets, focusing on the economic life of the assets, and revise IRS guidance. According to the summary prepared by the Ways & Means tax staff, such an update had not been published since 1987, and the nature of the asset classes had changed dramatically in the previous 26 years.<sup>2</sup> Other key components of the Camp Plan that potentially impacted telecom included the following:

- ▶ Amortization of research and experimental expenditures. The Camp Plan would have required that all R&E expenditures be amortized over a five-year period beginning with the midpoint of the tax year in which the expenditure is paid or incurred. The five-year period would have continued even in the event any property with respect to which amortization deductions were made was retired or abandoned.
- ▶ Expenditures incurred for the development of software would have been treated as R&E expenditures. [Note: the Camp Bill would have also made permanent the then-temporary section 41 tax credit; as part of this proposal, the general 20% credit would have been repealed and replaced with a 15% credit of the qualified research expenses that exceed 50% of the average basic research payments for the three tax years preceding the tax year for which the credit is determined (thus making the Alternative Simplified Credit permanent); but, amounts paid for supplies or with respect to computer software would no longer have qualified as qualified research expenses - a potentially significant exclusion for software-enabled telecommunication networks and associated taxpayer credit claims.]
- ▶ Revised Section 179 expensing for smaller taxpayers. Under the Camp Plan, taxpayers would have been able to expense up to \$250,000 of investments in new equipment and property per year, with the deduction phased out for investments exceeding \$800,000. Among other things, the provision would have also restored and made permanent rules allowing computer software to qualify for section 179 expensing.
- ▶ Amortization of goodwill and certain other intangibles. Under the Camp Plan, the amortization period for acquired intangible assets would have been extended to 20 years. This would have included, for example, goodwill, going concern value, licenses, permits, or other rights granted by governmental units, customer- and supplier-based intangibles, i.e., all other section 197 intangibles.
- ▶ Section 199. The Camp Plan would have phased out the deduction under code section 199 for domestic production activities.

The Camp Plan also contained a number of proposals that would have

affected partnerships and flow-through entities. For instance, under the Camp Plan, certain partnership interests held in connection with the performance of services (i.e., carried interests) would have been subject to a rule that characterizes a portion of any capital gains as ordinary income. The rules applicable to carried interests would have also applied to partnership distributions and dispositions of such interests. Real property partnerships would have been carved out of the rule. In addition to this rule affecting carried interests, the Camp Plan proposed a number of changes to partnerships that would have impacted guaranteed payments and liquidating distributions, caused basis adjustments to be mandatory in certain instances, made changes to the rules governing unrealized receivables and inventory items and limited the exception for publicly traded partnerships to mining and natural resource partnerships. The Camp Plan also contained a number of REIT proposals, many of which were already enacted as part of the PATH Act legislation that was passed at the end of 2015.

On the international front, the Camp Plan proposed a number of substantive changes to the international tax regime. Many of these proposals mirrored those in Camp's October 2011 international tax draft. Like the Blueprint, the Camp Plan contained provisions that focused on the foreign earnings of US companies. Specifically, the Camp Plan proposed all US shareholders that owned a 10% interest in a foreign corporation be subject to a one-time transitional tax on its pro rata share of the foreign corporation's post-1986 tax-deferred earnings. This tax could have been paid over an eight-year period and would have been determined using an 8.75% tax rate in the case of accumulated earnings held in cash, cash equivalents or certain other short-term assets, or 3.5% in the case of accumulated earnings invested in property, plant and equipment. An affected US shareholder with a 10%-or-greater stake in a foreign corporation with a post-1986 accumulated deficit would have been able to offset the deficit ratably against tax-deferred earnings of other foreign corporations. The Camp Plan also contained a proposal that would have exempted 95% of the foreign-source portion of dividends received by a US corporation from a foreign corporation in which the US corporation owned at least a 10% stake. No exemption was provided for income of foreign branches. The Camp Plan also had a number of other international proposals, ranging from new anti-base erosion provisions to changes to the existing foreign tax credit and sub-part F regimes, as well as changes to the international thin-capitalization provisions.

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<sup>1</sup> Committee on Ways and Means, Tax Reform Act of 2014, Discussion Draft, Section by Section Summary, as prepared by the Ways and Means Committee Majority Tax Staff

<sup>2</sup> See above.

## Cost recovery reform and interest expense: open debate on simplification and reform

As noted above, the Blueprint calls for a potentially significant corporate tax benefit in the form of full and immediate expensing of investments in all tangible, intangible, and real property (other than land). At the same time, the Blueprint proposes to eliminate deductibility of net interest expense which would constitute a repeal of a very significant business tax benefit. As also noted above, the Blueprint does not presently include any revenue estimates as part of its proposals. It is within this “scoring” ambiguity that one can also find clarity – as a result of their impact to US Treasury tax revenues lost and raised – these two particular provisions within the Blueprint are quite possibly inextricably linked. In other words, due to its deficit impacts, capital expensing may not happen without eliminating deductibility of net interest expense and most probably vice-versa. Without a Joint Committee on Taxation revenue estimate, the magnitude of impact for either proposal is currently unclear.

However, it should be noted that there are less dramatic ways to simplify and reform cost recovery and interest expense while also maintaining revenue neutrality over a 10-year budget window. These considerations, both specific to the telecom industry and generally, are addressed in the following paragraphs.

The last major chapter in today’s depreciation rules and guidance was last written nearly 30 years ago. According to the Congressional Budget Office (CBO), outdated depreciation lives are one of the main drivers of the tax code bias between investments in different industries.<sup>3</sup> One could take these CBO comments a step further and comment that Internal Revenue Service (IRS) Revenue Procedure 87-56 not only biases those in different industries, but due to industry convergence occurring within the last 30 years, also promotes tax code bias with competitors in the **same** industries such as with telecom carriers and cable television companies. We expect some forthcoming parity to be achieved through an announced Revenue Procedure<sup>4</sup> project purportedly designed to recognize the fact that telecom carriers and cable operators are direct competitors within the same industry and thus remove certain asset class life biases between the two. However, we further expect that the guidance will fall far short in reforming and simplifying cost recovery rules for the telecom industry in comparison with other industries. It is in this regard that

we further consider the CBO’s estimates that the effective marginal tax rate on investments in computers and software is nearly 40%, while the rate on railroad track and mining structures is about 15%.

With expectations that telecom network operators will have software controlling 75% of their networks by 2020, it is clear that a continued bias across industries fails to account for and thus disadvantages new technologies and a modern economy. We further note this disparity in IRS-issued Revenue Procedures, inclusive of the recently issued Revenue Procedure 2017-22, that provides for a safe harbor under section 118(a) of the Code (which generally provides that corporations are not subject to immediate federal tax upon the receipt of capital contributions). The recently issued Revenue Procedure, similar to other prior section 118(a) revenue procedures as applicable to prior grant programs, allows for corporate taxpayers to not include in gross income the amounts received under the particular governmental grants as long as the corporation properly reduces the basis of its property under Code section 362(c)(2) and the regulations thereunder. It should be noted that no such safe harbor guidance has been issued with respect to the Federal Communications Commission (FCC)’s Connect America Fund (CAF)<sup>5</sup>, and thus telecom operators continue to be disadvantaged by a lack of IRS guidance that could eliminate uncertainty surrounding the appropriate tax treatment. The issue of the application of Code section 118 to the receipt of broadband infrastructure grant payments presents a very unique fact pattern specific to the telecommunications industry, but guiding principles taken from the above mentioned revenue procedures and other cases can be applied. A newly appointed FCC chairman may provide more impetus to receiving parity with other industries that receive governmental grants, as discussed further below in the context of President Trump’s plans for spending on infrastructure.

It remains to be seen whether or not corporate tax reform will also remove unnecessary complexity, uncertainty and bias from today’s depreciation rules. However, there is certainly growing awareness as to inequities, including details on potential revenue estimates on achieving simplification as evidenced by the tax reform groundwork that was being laid out through legislative text in 2016.<sup>6</sup> As competing proposals move forward towards corporate tax reform consideration by the Joint Committee on Taxation (JCT), there is little doubt that the cost recovery developments will be well worth the attention of telecom operators.

Similarly, the tax code’s bias in favor of debt financing rather than with equity has also been a topic of Congressional hearings in 2016, and thus also worthy of acknowledgment by taxpayers. It has been

<sup>3</sup> Congress of the United States, Joint Committee on Taxation, April 18, 2016.

<sup>4</sup> IRS Revenue Procedure 2015-12, provides several safe harbor methods of accounting for certain property costs paid or incurred by cable system operators. Further noteworthy for telecom operators, the IRS addresses primary-use classifications of cable distribution network assets performing one-way and two-way communication services for purposes of determining the appropriate depreciation class life for such assets (expanding applicability of similar tests provided in Rev. Proc. 2003-63). The IRS indicates in the background section that it anticipates providing a safe harbor similar to the safe harbor for cable operators for a wireline telecommunications service provider to determine the primary use of assets used to provide video, high-speed internet, and voice communications services.

<sup>5</sup> The Connect America Fund (CAF) – also known as the universal service High-Cost program – is the FCC’s program to expand access to voice and broadband services for areas where they are unavailable.

<sup>6</sup> A proposed “Mass Asset Cost Recovery and Reinvestment System” discussion draft released by Senate Finance Committee Ranking Member Ron Wyden (D-Oregon), seeking to replace the current Modified Accelerated Cost Recovery System (MACRS) and Alternative Depreciation System (ADS) with a simplified pooled depreciation system under which assets would be assigned to pools based on their current MACRS property class assignments.

noted in hearings that business and economic sectors that are over-leveraged are, broadly speaking, more vulnerable to losses in the event of an economic downturn. This puts consumers at greater risk for things like higher interest rates due to bankruptcies, taxpayer bailouts, and the like. Our current corporate tax system, which puts a premium on debt in the form of a tax preference, adds to these risks. For example, President Obama's Updated Framework for Business Tax Reform, makes this observation: "[T]he current corporate tax code encourages corporations to finance themselves with debt rather than with equity. Specifically, under the current tax code, corporate dividends are not deductible in computing corporate taxable income, but interest payments are. This disparity creates a sizable wedge in the effective tax rates applied to return from investments financed with equity versus debt." The Congressional Budget Office and the Joint Committee on Taxation, along with Treasury Departments of past administrations, agree. The George W. Bush Administration's Mack-Breaux tax reform panel and the Obama Administration's Volcker tax reform panel came to the same conclusion: our tax code's bias in favor of debt financing causes significant distortions in the economy.<sup>7</sup>

However, given the substantial burdens our corporate tax system already imposes on US businesses, newly proposed provisions that create disincentives for businesses to invest in the US, such as elimination of the tax benefits received from debt-financed acquisitions and capital expansions, may be looked at skeptically as to whether or not these provisions move forward through the entire legislative process and as part of corporate tax reform.

The complexity of the impacts from such provisions could be overwhelming. Taxpayers may further look to recent legislative initiatives from the prior administration's issuance of proposed Section 385 regulations. These regulations were initially promulgated to prevent corporate inversions, but involved complicated definitions around the use of financing instruments that would or would not be regarded as debt by the IRS and thus initially contained a much broader scope in its proposed form. However, in its final form and after much commentary from the business community, the section 385 regulations curtailed much of the complicated and concerning provisions of equity over debt characterization, ostensibly for the benefit of US taxpayers.

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<sup>7</sup> Public discussion and remarks attributable to Senate Finance Committee Chairman Orrin Hatch, United States Senate Committee on Finance Hearings on Corporate Integration, May 24, 2016.

## The Trump Tax Plan: an evolving perspective

Over the course of the 2016 presidential campaign, Trump the candidate offered a skeletal perspective on what tax reform might look like if he were to become President (the Trump Plan). From a high-level policy perspective, the Trump Plan is consistent with the Blueprint and the Camp Plan insofar as the most significant aspect of the Trump Plan is a reduction in tax rates coupled with the elimination of special-interest deductions and credits. Under the Trump Plan, individual income tax rates would be 12%, 25%, and 33%, the same as those proposed by the Blueprint.

The Trump plan differs from the Blueprint, however, with respect to the tax rate applicable to corporations and on income from pass-through entities. In each such instance, The Trump Plan calls for a 15% tax rate, which is lower than the rate proposed under the Blueprint or the Camp Plan. The Trump Plan also calls for an elimination of AMT for corporations. Although the Trump Plan calls for the repeal of the estate tax, Trump has proposed that unrealized capital gains in excess of \$10 million that are held at death will be subject to immediate income tax at the time of death without a step-up in tax basis.

With respect to immediate expensing for investment in business assets and interest deductibility, the Trump position is less well defined. Initially, Trump the candidate indicated his support for immediate expensing by manufacturers of their new business investments, a view that seemed comparable to the approach taken in the Blueprint. In a subsequent speech, however, Trump clarified his position and indicated that immediate expensing should be limited to only manufacturers – and for those manufacturers who make this election, the deduction for corporate interest expense will be lost. In terms of changes to the international tax regime, the Trump Plan is similarly vague. Trump and his staff have expressed support for a 10% tax rate on the deemed repatriation of previously untaxed foreign earnings of US companies, but the campaign never made clear whether they still support repeal of deferral in a new international tax system going forward.



## Considerations and questions for telecom

President Trump is widely expected to significantly depart from the priorities of the Obama Administration by pursuing a regulatory agenda that is generally friendlier to telecom. The Republican (GOP) majorities in the House and Senate have a similar agenda, and Democrats in Congress are expected to mobilize in opposition – in particular by leveraging their power in the Senate to filibuster legislation – and publicly highlight the potential impacts of the Trump Administration's policies on innovation and competitiveness.

## FCC transition and regulatory policy; impact on sector M&A

With Trump's election as President, FCC Chairman Tom Wheeler indicated on December 15, 2016, that he would resign. His departure means that Donald Trump's administration will start with a 2-1 Republican majority within the 5-commissioner member FCC, with two empty seats as the Senate in the lame duck session of Congress had previously failed to approve FCC Democrat Jessica Rosenworcel for a new term. Thus, with the appointment of a Republican chairman and the filling of an additional seat by a Democrat in order to fill out the 5-commissioner member FCC, this potentially allows the new Republican majority to immediately begin dismantling largely Democratic-led policies around open internet, privacy and merger reviews.<sup>8</sup>

While President Trump's positions on significant telecommunications policy issues are not yet clear, he has made comments about the "detrimental impact of the current stifling regulatory environment on the American economy" and has called for the elimination of two regulations for every new one created. This would portend a "lighter touch" regulatory environment for the sector.

### Open Internet Order (net neutrality)

Net neutrality is the idea that all traffic on the internet should be treated equally, and that broadband providers cannot block or slow down services or applications used over the Web. The FCC's 2015 Open Internet Order reclassified Internet service providers as "common carriers" under the Telecommunications Act (Act), with the effect that internet providers were prohibited from treating data differently based on its source or content – in other words, treating all web traffic equally as part of a shared infrastructure whereby broadband providers (fixed and mobile) are prevented from blocking or degrading internet traffic. This classification of broadband access under the Act subjects it to a wider range of rules and makes it much easier to regulate. Embraced

by President Obama and upheld by a District of Columbia DC Appeals Court, the classification of broadband access as a Title II service (telecommunications service) under the Act is currently being appealed to the Supreme Court by the telecom industry.

Under a new FCC chairman, it is possible for the agency to revert to its prior interpretation that considered internet service providers to be "information services" (a change in classification from a Title II telecommunications service to a Title I information service). Such change would generally make it more difficult for the government to regulate matters such as pricing or privacy matters.

While President Trump's specific intentions around net neutrality have yet to be clearly articulated, in 2014, he tweeted: "Obama's attack on the Internet is another top down power grab. Net neutrality is the Fairness Doctrine. Will target conservative media."

### Internet service provider (ISP) broadband privacy rules (limits on how ISPs can use/sell customer data)

Also swept up in the net neutrality regulatory landscape is the concept of consumer privacy policies related to the internet. Any concerted effort by President Trump, House and Senate Republicans to dismantle the former will likely impact the latter. In general, the current privacy regime imposes upon internet providers certain requirements around the use and sharing of behavioral data collected from internet use of their customers.

Last year, the House of Representatives unanimously passed the Email Privacy Act (H.R. 699), which generally would require law enforcement officials to obtain a warrant issued upon a showing of probable cause before compelling third-party service providers from divulging users' private information, such as stored emails and backup files. It is possible that Congress could act on this bill in 2017.

### M&A/consolidations within the industry

Global M&A activity reflects the ongoing transformation in the telecom sector. In the face of increasing competitive intensity, evolving consumer behaviors and disruption from over-the-top (OTT) players (i.e., audio, video or other media delivered over the internet without the involvement of a multiple system operator in the control or distribution of the content), operators look to transactions to expand their value proposition.

Deals combining wireline, wireless and pay-TV assets have been key as operators look to build compelling multi-play bundles, target cross-screen opportunities and garner more customer wallet share.

A steady flow of cross-sector transactions, comprising 50% of deals in the last three years, reflect operator moves to diversify revenue

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<sup>8</sup> On January 23, President Trump selected Ajit Pai to serve as the next chairman of the FCC.



streams and target emergent digital opportunities. Telcos are building out their service portfolios by acquiring new capabilities in key segments, including OTT video, IT services, digital advertising, programming content and the Internet of Things (IoT). Tapping opportunities in key industry verticals is a focus, with sectors including financial services, transportation and health care driving cross-sector deals. These major changes in telecom will continue to evolve over the coming years, which will put the FCC's position in the spotlight.

Although President Trump, during his campaign, was a vocal opponent of consolidation and market power in the communications industry, a Trump-led FCC could provide a more supportive environment for consolidation within the industry and foster an environment that revisit synergies around potential transactions.

## Infrastructure

President Trump has proposed a \$1 trillion infrastructure plan (over a 10-year period) that would rely heavily on private-public partnerships by providing a tax credit to encourage private investors to fund projects overseen by states and municipalities. As conceived by Trump's advisors, the tax credit would apply to infrastructure projects with a dedicated source of revenue, such as toll roads, airports or utilities financed at least in part by fees paid by users. Decisions on which projects to fund would generally be left to the states.

It is unclear how the additional spending would be financed or whether this measure would be part of tax reform, or advanced separately.

Telecom industry leaders made the case that under this proposal, the build-out of networks, and fiber investments, should receive the same priority as building new bridges and highways, with the strong underlying policy of ensuring that Americans have access to high-speed mobile broadband in rural and urban areas alike.

These type of initiatives are consistent with existing FCC reforms surrounding its universal service program for rural telephone service in order to more effectively support networks delivering both broadband and voice. The FCC's initiatives are further supported by the Connect America Fund (CAF), which was established to act as an amplifier for broadband access buildouts across the US. An FCC Commissioner, Ajit Pai, has been an outspoken proponent of increasing the requirements for broadband speed that would be established for rural America as part of the buildout. It is quite possible that the existing funding levels of the \$10 billion CAF grant program could be enhanced as part of President Trump's infrastructure focus. Similarly, a new FCC Republican majority and chairman may revisit the telecom operator work requirements of the carriers providing upgraded broadband speeds "to be the best in the world," but also addressing the uncertainty surrounding the tax treatment of these grants under Internal Revenue Code section 118(a).

## Other issues

In addition to the macro level issues mentioned above, there are a number of specific questions and issues relating to tax reform proposals that may be relevant to the telecom industry. A small sample of specific questions and considerations include the following:

- ▶ The telecom industry is a capital-intensive industry. Thus, the immediate expensing of capital equipment would be a significant benefit.
- ▶ Current tax proposals may reduce or eliminate deductions for interest, a very common deduction for almost all corporations. If deductions for interest are eliminated, corporations' capital structures will need to be re-evaluated, as the cost of debt financing/capital could significantly increase.
- ▶ Will the Trump Administration eliminate the R&D tax credit, or more likely the Section 199 manufacturing deduction, in favor of a lower corporate tax rate?
- ▶ Will the idea of a patent or innovation be revisited, whereby a lower rate is provided for income derived from intellectual property?
- ▶ Will a Trump Administration seek to reform the tax code to modernize the rules regarding data and the international transfer of software?
- ▶ Will the Trump Administration seek to reverse regulations such as the recently finalized Treasury regulations under Internal Revenue Code Section 385 that address whether certain instruments between related parties are treated as debt or equity?
- ▶ Will the Trump Administration take any action to reverse the permanent ban on state and local taxation of internet access and on multiple or discriminatory taxes on electronic commerce that was signed into law last year (the Internet Tax Freedom Act)?

Again, the foregoing list is a very small sample of some of the specific questions arising from the various tax reform proposals. That said, the answer to any of these questions will have significant impact on the telecom industry. As such, professionals in the telecom industry should be mindful of the various provisions and keep a close tab on developments as the legislative process moves forward.

## The legislative process and potential timing

The legislative process will begin with the House Ways and Means Committee producing a bill for consideration by the House. Once a bill is put forth, which may be as soon as the end of January, it will then have to be passed by the House before it can move on to the Senate and, ultimately, to the White House. At this point, perhaps the only thing about tax reform that is truly certain is that the bill that finally reaches the President's desk will be far different than any bill initially produced and passed by the House. In fact, many observers familiar with the legislative process believe that the final tax reform bill that will be signed by the President will, in fact, be written either in the Senate or in a Conference Committee following House and Senate

passage of their respective tax reform measures. It should come as no surprise that this entire process may take the better part of 2017, notwithstanding what appears to be a unanimous desire on the part of the Republicans for comprehensive tax reform.

The Republicans anticipate that they will receive little or no Democratic support on tax reform. Given the disparate views, many expect the Republicans to use the budget reconciliation process to pass tax reform legislation. Even using this process, 51 votes are required in the Senate in order to pass the bill (or 50 votes with Vice President Pence breaking the tie). In other words, Senate Majority Leader McConnell will press every Republican to support the Senate bill in order for it to pass. Whether Leader McConnell is able to deliver this majority – solely based on Republican support or with a handful of Democrats – will depend on his ability to make deals and achieve compromises with respect to a small number of limited issues. Expect Leader McConnell to make those deals once he sees that passing legislation that enacts comprehensive pro-growth tax reform is in reach.

## Conclusion

Ambitious tax rate reduction is the common objective of the Blueprint, the Camp Plan and the Trump Plan. This objective, coupled with House leadership's desire for deficit-neutral tax reform, make it highly likely that the House tax reform bill will aggressively broaden the tax base by eliminating or significantly curtailing credits, deductions and other preferences. Towards that end, it is reasonable to expect that the House bill will initially approach tax reform from an ideological vantage point. Beginning with the legislative process with the Ways and Means Committee and wary of negotiating with themselves, House leadership is expected to leave virtually no preference untouched, perhaps even going farther than the changes proposed in the Camp Plan.

Notwithstanding that the legislation will certainly evolve through compromise as it moves through the House, to the Senate and then to the White House, telecommunications companies and professionals should take pause now to identify and consider those tax reform proposals that may impact their businesses.



## Contacts

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