Tax reform: How will it impact the tech sector?

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Hanish Patel: One of the most transformative changes to the Corporate US tax code in decades, the Tax Cuts and Jobs Act was signed into law on December 22, 2017. A reduction in tax rates, a one-time tax on earnings currently held overseas, and a shift away from deferred taxation are all likely to result in an influx of cash back to US corporate headquarters. These changes have implications for technology, media, and telecom companies that extend far beyond their financial results. In fact, we may soon witness a tectonic shift in how US and non-US headquartered companies build value chains, decide where to do R&D, and where and how to invest.

In this episode of User Friendly, we'll explore these and other implications of the new tax code and discuss what tech, media, and telecom companies should be thinking about as they approach these changes. My guests today from Deloitte are Brian Pinto, Janet Moran, and Jim Nason, tax leaders from our Tech, Media, and Entertainment and Telecom industry sectors, respectively. Brian, Janet, Jim, welcome to the show.

Brian Pinto: Glad to be here.

Janet Moran: Thank you.

James Nason: Thank you for having us.

Hanish Patel: So let's set the stage. I want to quickly ask each of you to summarize what elements of the new tax rules will have the biggest impacts on your industry sector. Brian, let's start with you. What parts of the tax law will specifically impact tech companies?

Brian Pinto: I'd start with the headline rate reduction—going from 35 percent to 21 percent is a significant change that will impact some of the decisions that our tech clients make around where they put value. Another change that impacts a lot of our tech clients is the move from a deferral regime where earnings were deferred from US tax until repatriated to what is effectively a full inclusion regime. So, other than a small part of the earnings, all the earnings will be subject immediately to US tax—a minimum tax.

Hanish Patel: And Janet, are there any parts of these changes that will uniquely impact the media and entertainment sector?

Janet Moran: Oh, absolutely. I mean, Brian has clearly stated the biggest one is the reduction in the tax rate. Now media companies historically have actually paid in some of the higher effective tax rates, you know higher 20s, mid-30s. So to go from, say, 35 percent down to 21 percent—40 percent reduction is a huge benefit for them. If you think about the media companies in the last few years, it's been challenging. They have a lot of fierce competition coming out of Silicon Valley and Seattle, so it's kind of been a difficult time with declining advertising revenues and cord-cutting happening and declining pay TV subscriptions. So, I think we'll see, with the influx of cash, the repatriation that's going to take place. There were a lot of companies parking foreign earnings overseas, and I think they'll bring that back; we'll get to see some M&A activity from that. We'll get to see some R&D spending and hopefully some really cool content development being done with the dollars that come back, paying down debt, giving out bonuses. So, really, lots of good things for the industry, I think, coming out of this. Also for the media and entertainment industry there is a new limitation on disallowance entertainment expenditures as a deduction. So that's a real "bah humbug" part of the legislation. Also no more tax-free, like-kind exchanges-in, unless you are in the real estate industry. In media, we've seen like-kind exchanges used for sports contracts, for SCC licenses. But other than that, I think the rate reduction and having that cash—access to all that cash that was overseas—and being able to use that for great things like M&A and investment in R&D.

Hanish Patel: No doubt. Now, I'm going to touch upon some of the upside later as well, and clearly it's a real shame for those Hollywood parties that you've mentioned. But yeah, clearly some challenges ahead for media and entertainment. And then, Jim, same view in terms of telcos—what are they going to be keeping their eye on?

James Nason For telecom, specifically, first and foremost, who doesn't love a rate cut? Love a rate cut! There is angst and consternation, but it's really over the implementation and the intricacies of what it means to implement this tax change. But first and foremost, hello 21 percent! Now when that euphoria dies down, a couple of areas come into focus that are more telecom related, and first is telco—above almost all others—is hugely capital intensive. It's a business that's been built on building out networks and built by mergers and acquisitions. So, the good with the bad. Immediate expensing is monster great for the CapEx that the telcos put into play. And we've had that CapEx forever. But even more so today with the advent, the growth, and a rollout of 5G. And fifth-generation wireless is BIG, BIG, BIG—all caps, all underlined, all in bold!

Immediate expensing also creates a new lens, as Janet was pointing out, for M&A. So M&A models for large asset buys that are out there—this changes the way we look at an M&A deal. Companies in the telco space, along with media and along with technology—they're trying to figure out what their sweet spot is. And they're going to need to fill out kind of their vertical and horizontal paths to market by adding different segments to their business, and I think that's going to come through M&A. So, at the same time as issues associated with immediate expensing, those very same M&A models are going to be significantly impacted by interest limitations. Highly leveraged telecommunications companies that are out there with big debt on their books are going to be facing what the impact of that is—to have that on their books, to reduce those expenses that are deductible. And then, at the same time, as they look to take on new companies through an M&A strategy—what will that mean if they have to take out debt to accomplish that M&A? So if I were to predict forward—boy, if I were focused on what to do in this marketplace—it would be M&A modeling, which I think is really the next big thing to watch in this combined TMT industry.

Hanish Patel: Thank you, Jim and Janet and Brian, for setting that stage. I want to springboard right off exactly where you went, in terms of just some of that impact for the companies that you talked about. And clearly all three of you touched upon that quite dramatic drop from 35 percent to 21 percent. Janet, that lower corporate tax rate—what does that mean for you, I, the rest of the audience, as consumers? How is that going to permeate through? What are we going to see differently because of that tax rate?

Janet Moran: Well, let's just take a step back. We do have what seems to be a very dramatic drop in that federal corporate rate; however, we have 50 states in the United States alone and at least 47 of them have a corporate income tax rate. So, we're going to have to model out what happens in the states and how much taxes are paid in the states. We also have foreign jurisdictions, that, you know, who knows—maybe some foreign jurisdictions will want to compete with the US now, and maybe they want to keep their foreign companies back home and they'll try to put out some preferential tax treatment.

So, we really have to do a lot of modeling to see at the end of the day and taking into consideration some of these parts of the tax reform. So don't get too excited until we know all of the details. But that being said, I think we'll see companies using that money to pay off debt, to maybe give dividends, share buybacks, and hopefully, as I said, to really increase R&D. Now, this is where I think the consumers could get a little excited. Think about all the cool things that could be done now with this money in terms of R&D—all of the development. You could venture into AR and VR and all kinds of ways of using Internet of Things to get your media and your communications to consumers faster. You know, do I think that things are going to get cheaper? I think they are going to get *cooler*. And that's exciting. And then just on another side—a lot of people are getting money back from the IRS this year, and that's going to be exciting because when a 20-something-year-old has a couple extra hundred bucks, what do you think they do with it? They probably go to the movies, they probably buy movies, they probably increase their subscriptions, and they probably do media and entertainment types of things with that. So when you think about the overall effect of the tax legislation, both from a corporate and the individual perspective, I think TMT is going to have a really good couple of years.

Hanish Patel: Some of those benefits of that tax law are clearly going to be beneficial to a number of people. But there are definitely a lot of challenges ahead. Brian, tell me some more about some of those biggest challenges that the tech companies will specifically face in response to the new law.

Brian Pinto: When I think about the challenges my clients in the tech industry are facing, they are mostly centered around their value chain. Historically, a lot of our tech companies have put their intellectual property offshore—at least the foreign rights to those intangibles—and exploited those in their system outside the US. And on a go-forward basis—because those offshore earnings will be subject to a minimum tax, or what we call the GILTI provisions, as well as some of our outbound R&D payments to support the R&D services, which will be captured by our "base erosion and anti-abuse tax" [BEAT]—it's forcing a look at our value chains and an analysis as to whether we put value in new places like the US.

Hanish Patel: Got it, and I'd actually like to kind of dig a bit deeper on that overseas side. So Jim, what are the potential wins and losses for these TMT companies as they face the result of that transition tax on existing overseas profits?

James Nason: So, Hanish, if you look at this "glass half full" view, you could have paid 35 percent to bring these dollars back. But the clients that I'm talking to are not looking at the glass as half full; they are looking at the glass as mainly empty in the fact that they need to put 10 percent in terms of a penalty to get this money back into the United States. And I think the tax guys that are looking into their pockets aren't necessarily getting filled with those dollars. It's more an issue that they have to comply with this, document this, fill this out, figure out what it is, so that the company can inure to these benefits. There is an opportunity to bring some cash back based on that foreign investment and to bring that back into the US. But I think Janet already asked the big question, which is: "What are they going to do with that newfound money?" I know that several of the major companies that are our clients across the TMT space have announced employee bonuses or some humanitarian gestures with this cash, based on overall tax reform. But the question is going to be, "Where will those big bucks go?" And there has been a ton of public discussion on this. If I think of the telco space—could they further invest in the network, that would be awesome.

I think the reduction of debt—because that's got the double whammy by keeping debt alive on the books and not being able to deduct the interest payments as helpfully as in the past—[it] could be a possibility. I think you hear a lot of rumors of stock buybacks by a lot of these companies to, again, "tidy up" the balance sheet. So, from a telecom perspective, as I look at this, I would say the bigger question for me is what is the right move with the cash? How do you react to this based on a little bit of uncertainty on the horizon, depending on how [midterm] elections go, from a blue and red perspective?

Hanish Patel: Thank you, Jim. And actually, just thinking about, like you say, how to use that cash. Brian, a thought around that and specifically to that point—when we think about these US-based multinational tech companies, where do you think they will choose to repatriate that cash and use that cash?

Brain Pinto: The first place I'd start is M&A. We see no slowdown in the M&A market, and, in fact, it's projected over the next 18 months to be at record levels. I've had a lot of my tech clients that are not historic acquirers—they want to talk about M&A, they want to talk about the impact of reform on M&A. And so there are more and more discussions with both tax and corporate development around strategies to deploy M&A. So, I think that is number one. Janet talked about another one with R&D. I think companies are going to be looking to deploy new technologies and invest in new technologies and make acquisitions around technologies and look for new opportunities to move into new markets—so, building factories in new markets or building infrastructure in particular markets. So, I think, that's where I think a lot of the cash flow will find a home.

Hanish Patel: All three of you talked about M&A and clearly there are a lot of deals happening across tech, media, and telecom right now. So Janet, can you give us an example of how TMT companies should rethink how they restructure and structure their M&A deals?

Janet Moran: Well, Jim alluded to this before. I think we probably can expect to see more asset deals because you'll get a stepped-up basis in your assets if you do an asset deal. And then, of course, with these new provisions you can immediately spend some of that. So, I think we will see some more asset deals. But it depends on what a buyer and a seller are looking to do. If you are a seller, and you want to get rid of all your liabilities, you are going to want to sell your stock. If you are a buyer, and you are hoping to avail yourself of some pre–tax reform NOLs, you might want to do a stock deal as well. So it really depends on what buyers and sellers are looking to accomplish. And certainly I don't think the tax tail will wag the dog in a business deal. But I do think tax will have a bigger seat at the table. I mean the tax ramifications of deals are going to be important, especially with this new interest expense limitation. I think you'll see more deals being done with cash, and you've got all the strategic buyers now that are going to repatriate cash from overseas and they are going to have this money on hand—they might not have to do borrowings to do a deal. So, we might see an advantage for strategic buyers over the old general PE type of buyers.

So, there could be some real activity going on in the M&A market. I think there will be, and I think tax will have a much bigger seat at the table than they used to.

James Nason: Well, I don't know that I could agree more with you here, Janet—and I'm really liking the idea of the tax guys getting that bigger seat at the table. What I think traditionally has happened from an M&A perspective is the tax model is kind of that "last hour in a day" when we're determining whether or not we are going to go through with this deal. I think it is such an impactful piece to the puzzle, and if you squeeze the balloon here it's going to pop up somewhere else. Again, I stress the point that I think strategic modeling that includes the tax impacts of how the deal gets accomplished in each step.

Hanish Patel: Going back to something that was mentioned earlier, and about—you are looking at this tax rate cut, but what it is going to mean at a corporate level and what that means across the various states. The way I see it, not every state will adopt the federal tax provisions, and weighing the trade-offs between reduced tax revenues and attracting corporate players to their specific jurisdictions—Jim, what adjustments do you think they'll really make around that?

James Nason: Hanish, you hit the nail right on the head there. Janet mentioned it and I know everyone is aware that it's out there, but while this is a biggie, this is a biggie. State conformity, or lack thereof, is going to be huge with what the impact will have on companies when all the dust settles. Watching this unfold is quite the nail-biter for many of my clients, because depending on what a state—that you have a huge presence in and a huge liability in—that could only get bigger, or in a situation where you don't have a huge liability and all of a sudden based on a tweak here or tweak there your liability grows significantly. This has state windfall written all over it, and in case you haven't been watching, states are broke. Whether it's a loss of federal funding or it's huge pension liabilities, states are operating in the red. So, this could be a huge play for states.

If you look at some of the biggies that we've already talked about—you look at full expensing—yes, the states don't care for that one very much; so that's likely to be a definite adjustment that you're going to see—and a majority of the states, if I were predicting. Dividends received varies widely amongst the states, so that will play out on its own. The interesting one—I just realized, pardon that pun—the interesting one is, in fact, the interest limitation. States really like the idea of limiting the interest that you can deduct, but the taxpayers really need to pay attention to this one because they need to watch how states implement this—because at the federal level, it's one thing to disallow interest, but states who have varying filing methods could limit the interest deduction at an entity level, or some different kind of level, and this could make a huge, huge dollar difference in terms of what the taxes are in an "add 'em up" environment, in a separate state environment, to all the play. Because there is a lot of debt that occurs not just to the outside but internally in and around the corporate group.

Hanish Patel: You talked about some of those challenges there for the state. You've all talked [about] some of the challenges for the companies within each one of your sectors. I'm going to give each of you 30 seconds to tell us what part of tax code offers the biggest growth or transformation opportunity within the sector, and I'm going to crack the whip on this one and keep you really close to those 30 seconds. So Brian, starting with you, tell us what provision would generate the most growth opportunities for tech companies? Away you go.

Brain Pinto: I'm going to take the 100 percent dividends received deduction and repatriation provision. So, again, we're going to unlock what was cited as possibly trillions of dollars of cash and having that available and accessible to our US multinationals who can then deploy that through M&A and R&D. So, I think that is the provision I would point to, citing this huge opportunity to take advances with M&A.

Hanish Patel: Brilliant, thanks, Brian. Janet, over to you. What element of the tax reform presents the biggest growth opportunities in media and entertainment companies? And your clock starts now.

Janet Moran: Well, I hate to be a copycat, but I have to say having the ability to tap into all that overseas cash and get it back here and use it for R&D and, as I said before, really create some additional original content. I mean, consumers—we finally figured out how to get to the consumer through technology, and now we've got this monster that's been created and we've got to feed the monster 24/7, and the monster wants everything, and they want original stuff. So, I think using that money to create new content continually, and more and cooler content, and interactive content, and accessible anywhere, anytime—I think that's what these media companies need to do with that money, and I think that will be a differentiator for them. The people that own that will last, and the people that don't will go away quickly.

Hanish Patel: Janet, I have to say you ran long there, but because you're talking about cool content, I just got so excited about what could be coming down the pipe for me to consume, so I let you go with that! Jim, I'm going to give you your 30 seconds, unless you can excite me even more about what it means for telco companies with the tax cut.

James Nason: Yeah, I can't touch that. She's got media, that's the easy one. My biggie, because of the CapEx that's involved in building out the networks, is immediate expensing of asset purchases. I mean that is a game changer, and the impact that it's going to have is really related to the timing. It's the timing of—right now, the big thing—there is network maintenance that goes on regularly, but 5G is huge. The move to 5G is exponential as far as the capabilities. To enhance all those cool gadgets that Janet is talking about—she needs 5G. And the cost to implement that is exceptionally high. Being able to expense that is going to have companies work that much faster to get in there. The sooner we get 5G, the sooner all the cool stuff is going to work even better.

Hanish Patel: Thanks, Jim. And I know you played upon the fact that I'm always excited with cool gadgets to get you a few extra seconds there. So nice touch on that one. But no, thank you to all of you for kind of painting the picture of what that real upside is. Let's all take a step back and look at that slightly bigger picture. Even beyond what we talked about earlier, some of those M&A opportunities around R&D and what we're thinking about it in a broad sense. A lot of people are wondering if the TMT industry, frankly, is going to sink or swim in the wake of these changes. And I'd love to hear from each of you on what your overall outlook is for each one of your industry sectors.

Brain Pinto: So, I'll start on technology. I'd say the future is very bright. As companies look to move into new technologies—across industries by the way—but looking to put in place digital transformation, put in AI and blockchain and other transformative technologies, they're going to be looking to the tech industry to provide those products and services. So I think reform gives those companies a platform to drive change throughout their organization. Jim talked about 100 percent bonus depreciation—that will help our clients in the tech industry as the suppliers of those products. So again, I think again the future is very bright.

Janet Moran: From my perspective, since I went long last time I'll go short here. I think media companies have been treading water a bit in recent years, and I don't think they are going to be treading water anymore. I think they are going to be swimming—and not just swimming, but swimming *laps*, you know. I think that this cash is going to create a lot of great development and exciting things for the industry. And I think we're going to see some foreign companies that were hesitant to come into the US—they wanted our customers, but they did want to have a presence here—I think we are going to see some of them coming in to our US soil. And so, you know, we're going see more investment in the US, and I think the media companies are really going to be beneficiaries of this new tax reform, I have to say.

James Nason: From my perspective, I don't know that I could be more bullish. TMT are literally changing the world and definitely making it smaller. If I think of every industry out there, every single one of them, I think of them as a spoke on a wheel. TMT is the hub of how that wheel goes around. And I think for all of the things that both Janet and Brian spoke of, I think TMT is huge going forward. Now my only caveat to my wildly bullish outlook is around categorization and how we keep score, which is always the way. How tech, media or telecom companies exist today is likely to be very different in the not-so-distant future as we get into their business, they get into our business, other industries get into our business, and it starts to be confused [about] what tech is or what media is or what telecom is. So, I want to throw that proviso out there that as convergence lays down and changes our—what our—perspective of what these various industries are, could change the overall scorekeeping. But overall TMT is a rock-solid way into the future.

Hanish Patel: This is great stuff, and it sounds like, yes, there is little doubt that digesting these tax cuts, the Jobs Act—it's going to be challenging—state level, enterprise level. But it's clearly full of potential. I mean these provisions are complex and the implications for tech, media, and telecom companies are clearly far-reaching. That positive outlook is really exciting for [not just] everybody in the corporate space but all of us as consumers. So thank you, Brian Pinto, Janet Moran, and Jim Nason, for joining us today to discuss these implications and sharing valuable insights for businesses as they start preparing for that new tax law. So Brian, Janet, Jim—thanks for being on the show.

Janet Moran: Thank you.

Brian Pinto: Thank you.

Hanish Patel: Thanks for tuning in to this week's episode of User Friendly. Tune back in in two weeks for another exciting topic. See you then.

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