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THE IMPACT OF THE TAX REFORM ACT OF 1986 ON THE AVIATION INDUSTRY

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I. INTRODUCTION

IN AUGUST 1981, President Reagan signed into law the Economic Recovery Tax Act of 1981 (ERTA). ERTA provided for rapid depreciation and was dedicated to the preservation of the investment tax credit. Congress decided the law prior to 1981 did not provide the investment stimulus essential for economic expansion. High inflation rates had diminished the real value of depreciation deductions. This reduction discouraged replacing old equipment with more modern technology. To provide this stimulus, Congress believed that more rapid cost recovery allowances and maintaining or increasing the investment tax credit would be an effective way to stimulate capital formation, increase productivity, and improve the nation’s competitiveness in international trade.


2 ERTA created the Accelerated Cost Recovery System (ACRS) now contained in I.R.C. § 168 (CCH 1985) to allow taxpayers more rapid depreciation allowances. This section defines recovery property to be tangible property used in a trade or business or for the production of income subject to the allowance for depreciation used in a trade or business or for the production of income. Id. As a general rule, ACRS allowed assets to be depreciated over a much shorter time period than was previously allowed.


4 Id. Congress was also sympathetic to numerous complaints that the rules under the prior law were too complex. See id.

5 Id. This conclusion was based on the testimony of numerous witnesses and
Less than four years after ERTA became law, President Reagan sent a proposal to Congress "to change our present tax system into a model of fairness, simplicity, efficiency, and compassion, to remove the obstacles to growth and unlock the door to a future of unparalleled innovation and achievement." For some reason, the President now viewed the changes he had proposed four years earlier as unfair. There are two possible explanations for this change. First, in low inflationary periods, capital investment was being undertaxed. The ERTA changes were intended only to prevent overtaxation of capital investment. Second, capital investment was being determined by the tax incentives rather than for economic reasons. This was viewed as preventing the market from allocating resources efficiently. Therefore, the President proposed that the investment tax credit be repealed and cost recovery altered in order to provide incentives that protect the taxation of capital investment from inflation and allocate capital investment more efficiently.

Responding to the President's proposal, Congress embarked on the most comprehensive tax reform in thirty years. The process culminated with both the House and the Senate approving the Tax Reform Act of 1986.
(the "Act") by overwhelming majorities. Passage of the Act has been described as "a very bright day indeed for the American people." On the other hand, the Act has been described as "unfair, unsimple and a gamble with our economy." One of the nation's accounting firms summarized the bill as follows: "The President recommended a new tax law founded on fairness, growth, and simplicity. The Act is not fair, probably does not encourage growth, and certainly is not simple." Another accounting firm points out that the bill is full of anomalies and complications that will produce tax hikes and paperwork burdens as opposed to the tax cuts and simplifications legislators had promised. The conflicting viewpoints and poignant criticisms can be attributed to the secrecy employed in preparing the Act and the speed with which it was run through Congress.


Id. at col. 3-4 (statement of Rep. Bill Archer).

PANNELL KERR FORSTER, EXPLANATION OF THE TAX REFORM (?) ACT OF 1986 1 (August 1986). The criticisms are that the Act represents incomplete reform because many tax preferences are included in modified form. Furthermore, the bill is seen as recessionary and as increasing the budget deficit setting the stage for a return of inflation. The added complexities are due to the numerous effective dates, transition rules, grandfather clauses, and technical rule changes. See id. at 2.

5 Tax Mgmt. Weekly Rep. (BNA) 1044 (Aug. 25, 1986) (statements of Gerald Padwe, national director of tax practice for Touche Ross & Co.). One area with which Padwe is especially concerned is that the changes to employee benefit plans will cause every private sector employer to redraft their plans. See id.

The conference report was filed on September 18, 1986. Tax Reform Act of 1986, H.R. Conf. Rep. No. 841, 99th Cong. 1 (1986) [hereinafter TRA of 1986]. The report is in two volumes. Volume 1 is 925 pages long and contains the text of the Act (this volume is subdivided into sections and will be cited by such). Volume 2 is 886 pages long and contains the Statement of the Managers, a joint statement to the House and Senate explaining the effect of the Act (this volume is subdivided by pages and will be cited by such; page numbers are prefaced with "II"). This massive Act was voted on in the House just one week after being filed. See supra note 10. The Senate voted on the Act only nine days after filing. See supra note 11. The Congressional Record is full of complaints of congressmen who did not have a chance to read, much less understand, the Act prior to voting. E.g., 132 CONG. REC. H8365 (daily ed. Sept. 25, 1986) (statement of Rep. Archer); id. at H8398 (statement of Rep. Parris); id. at S13,890 (daily ed. Sept. 27, 1986) (statement of Sen. Metzenbaum regarding the secrecy employed by Rep. Rostenkowski and Sen. Packwood in determining transition rules).
With all its imperfections, anomalies, and complications, tax reform is here and we will all have to learn to work within the framework of this massive bill.\(^{17}\) The first section of this article discusses the three provisions of the Act that will have the greatest impact on commercial aviation: the changes to the Accelerated Cost Recovery System (ACRS),\(^{18}\) the repeal of the investment tax credit (ITC),\(^{19}\) and the changes made regarding deductibility of purchased net operating losses (NOLs).\(^{20}\) While the focus is primarily on the major air carriers, some mention will be made of important provisions affecting smaller carriers and individuals that may own and operate aircraft.\(^{21}\) The second section of the paper will illustrate the effect of these changes using data in the annual reports of various airlines.\(^{22}\) These illustrations will show the tremendous impact the Act will have on the aviation industry.

II. THE TAX REFORM ACT OF 1986

A. Accelerated Cost Recovery System Changes

Section 167 was enacted to allow taxpayers a depreciation deduction in the form of a reasonable allowance for the exhaustion, wear, and tear of business property held for the production of income.\(^{23}\) In 1981, the allowance was substantially changed when ACRS was codified in Section 168 of the Internal Revenue Code (the "Code").\(^{24}\)

\(^{17}\) On October 16, 1986, the Senate attempted to correct some of the Act's shortcomings by passing an enrollment resolution. Dallas Morning News, Oct. 17, 1986, at 5A, col. 1. This would have corrected more than 250 errors in the bill and also would have provided about $50 million of additional transition rules. Id. However, the bill also needed House approval and the 99th Congress adjourned before the House could consider the bill. Id.

\(^{18}\) See infra notes 24-63 and accompanying text.

\(^{19}\) See infra notes 64-87 and accompanying text.

\(^{20}\) See infra notes 88-111 and accompanying text.

\(^{21}\) See, e.g., TRA of 1986, supra note 16, § 511 (adding I.R.C. § 163(h) which disallows deductions for personal interest); see also infra notes 112-118 and accompanying text.

\(^{22}\) See infra notes 119-153 and accompanying text for examples of the economic impact of the Act.

\(^{23}\) See I.R.C. § 167 (CCH 1985).

\(^{24}\) See id. § 168.
Under this system, depreciable assets were assigned to one of five recovery periods ranging from three to nineteen years. The vast majority of tangible personal property, including aircraft, was assigned a five year recovery period. The deduction allowable for the tax year was then determined by multiplying the unadjusted basis of the property by the applicable percentage. The percentages for the five year class were based on the 150% declining balance method changing to straight-line when this amount would exceed the declining balance amount. In addition, the Code allowed taxpayers to elect to recover the cost of assets by the straight-line method. The Code, however, mandated that the taxpayer choose one of three available straight-line recovery periods. The Act modifies ACRS for property placed in service after December 31, 1986. The depreciation deduction will now be determined by using “(1) the applicable depreciation method, (2) the applicable recovery period, and (3) the applicable convention.”

Under the Act, the taxpayer must first determine the applicable depreciation method. For most tangible personal property, this is defined as the 200-percent declin-

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25 Id. The five classes are: 3 year property, 5 year property, 10 year property, 15 year public utility property, and 19 year real property. Id.
26 Id. § 168(c)(2)(B). The five year category was a catch all for property that did not meet the definition for the other classes. Id.
27 Id. § 168(b).
28 TRA of 1986, supra note 16, at II-38. In a pure declining balance method, the depreciation is calculated using the undepreciated cost of the asset. Therefore, a point is eventually reached where the straight-line depreciation amount will exceed the declining balance method amount.
29 I.R.C. § 168(b)(3) (CCH 1985). This election was mainly beneficial to depreciable realty as recapture only includes the excess over straight line. Id. § 1250. Section 1250 requires that the gain on disposal of depreciable realty be ordinary income to the extent depreciation taken exceeds the depreciation that would have been taken had the asset been depreciated on the straight-line method. Therefore, the cost could be recovered over the same time period but gain on disposition would all be capital gain and taxed at the lower capital gain rates.
30 Id. § 168(b)(3).
31 TRA of 1986, supra note 16, § 203. In addition, the taxpayer can elect to have the new provisions apply to any property placed in service between July 1, 1986, and December 31, 1986. Id.
32 TRA of 1986, supra note 16, § 201 (to be codified at I.R.C. § 168(a)).
ing balance method switching to the straight-line method "for the [first] taxable year for which using the straight line method with respect to the adjusted basis as of the beginning of such year will yield a larger allowance." This method differs from original ACRS only by using the more rapid declining balance rate. For certain classes of property, the applicable depreciation method will be determined by substituting 150-percent for 200-percent. For real property, the applicable method will be the straight-line method.

Next, the taxpayer must determine the applicable recovery period. The Act replaces the current system of five recovery periods with a system of eight recovery periods. The recovery periods will now range from three to thirty-one and one-half years. The proper recovery period will be determined by reference to the Class Life Asset Depreciation Range (CLADR) midpoints used for property placed in service prior to January 1, 1981. In the case of aircraft used in air transportation, the CLADR midpoint is twelve years. This class life will place air-

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53 Id. (to be codified at I.R.C. § 168(b)(1)).
54 Id. (to be codified at I.R.C. § 168(b)(2)). The property that must use the 150-percent method will be property that is in the 15 and 20 year classes.
55 Id. (to be codified at I.R.C. § 168(b)(3)).
56 Id. (to be codified at I.R.C. § 168(c)).
57 Id. The classes are 3 year, 5 year, 7 year, 10 year, 15 year, 20 year, 27.5 year, and 31.5 year property. Id.
58 Id. (to be codified at I.R.C. § 168(j)). See Rev. Proc. 83-35, 1983-1 C.B. 745 (latest list of CLADR depreciation ranges). The CLADR system allowed taxpayers to depreciate property used in a trade or business over the asset's economic useful life. To lessen taxpayer arguments as to the useful life of an asset, the Treasury periodically issued Revenue Proclamations that listed various ranges over which the depreciation deduction could be taken. The range would be expressed as a quantity of years and the CLADR midpoint is the midpoint of this range. For example, the range for commercial aircraft is from 9.5 to 14.5 years. Id. Therefore, as long as the asset was being depreciated over a period of 9.5 years to 14.5 years, the IRS would not challenge the useful life used by the taxpayer. The midpoint for commercial aircraft is the point half-way between 9.5 and 14.5, 12 years. Id.
59 Rev. Proc. 83-35, 1983-1 C.B. 745, 758. Aircraft not used in commercial aviation have a CLADR mid-point of six years so they will remain five year property. Id. at 746.
craft within the definition of seven year property. This longer recovery period will result in smaller depreciation deductions even though the method used is at a greater accelerated percentage.

The final step in this process is to determine the appropriate convention. The general rule is that all property placed in service during any taxable year will be treated as if it were placed in service on the midpoint of such year. The Act provides a special rule whereby a mid-quarter convention must be used instead of the half-year convention. The mid-quarter convention must be used whenever the aggregate bases of property placed in service during the last quarter of the taxable year exceed forty percent of the aggregate bases of all property placed in service during the year. It should be noted that the mid-quarter convention must be applied to all property placed in service during the year, not just the property placed in service during the last quarter.

As under prior law, the taxpayer can elect to use the straight-line method. The Act refers to this as the alternative depreciation system. This straight-line election differs substantially from the prior law as the taxpayer is not given a choice among three recovery periods; the pe...
period is determined by the statute.\textsuperscript{47} Except for real property and property which has no class life, the recovery period under the alternative depreciation system will be the class life.\textsuperscript{48} Therefore, a taxpayer electing the straight-line method must now depreciate the asset over a longer period whereas before the asset could be depreciated over the recovery period.

As for the aviation industry, the effects of the revised ACRS will not be seen immediately as several transition rules will delay the enactment of the provisions to aircraft. The general transition rule provides that the changes will not apply to property acquired pursuant to a written contract which was binding on March 1, 1986.\textsuperscript{49} The rule further requires that the property be placed in service before January 1, 1989.\textsuperscript{50} The Statement of Managers further explains that the contract must be binding as of March 1, 1986, and at all times thereafter.\textsuperscript{51} If the contract is substantially modified after that date, it will not be considered as binding at all times.\textsuperscript{52} Commercial passenger airliners are granted a one year extension of this transition rule. The contract will still have to be dated prior to March 31, 1986, but the aircraft does not have to be placed in service until January 1, 1990.\textsuperscript{53}

The other transition rule for aircraft is found in section 204(a)(11) of the Act. This exception applies to any new

\textsuperscript{47} Id.

\textsuperscript{48} Id. If the property has no CLADR life, the straight-line recovery period is 12 years. In the case of real property, the recovery period is 40 years. Id. Any tangible property used predominantly outside the United States must use the alternative depreciation system. Id. For this purpose, any satellite or spacecraft held by a United States person launched from within the United States is not deemed to be property used outside of the United States. Id.

\textsuperscript{49} Id. § 203(b)(1).

\textsuperscript{50} Id. § 203(b)(2).

\textsuperscript{51} Id. at II-54, 55.

\textsuperscript{52} Id. Design changes made for reasons of economic or technical efficiencies that cause insignificant changes in the original price will not be deemed substantial modifications. Id.

\textsuperscript{53} Id. § 204(c)(3). This extension only applies to new commercial aircraft used by a domestic airline. Id. There is also a transition rule exempting any satellite subject to a binding contract as of January 28, 1986, for which there was an agreement to launch in existence at that date. Id. § 204(a)(12).
aircraft with nineteen or fewer passenger seats that is manufactured in Florida, Georgia, Kansas, or Texas.\(^5\) Furthermore, the aircraft must have been in inventory or in the planned production schedule of the final assembly manufacturer with orders placed for the engines on or before August 16, 1986.\(^5\) The final requirement for this exception is that the aircraft must be purchased or subject to a binding contract by December 31, 1986, and placed in service by July 1, 1987.\(^5\) This particular rule stirred some controversy on the floor of the Senate as Senator Metzenbaum felt the purpose of transition rules was to protect someone who had proceeded under the former tax law and was adversely affected by the change.\(^5\) He pointed out that not only did the rule provide special treatment for aircraft that did not yet exist, the rule was discriminatory in that it did not apply to aircraft companies in Delaware and Arkansas.\(^5\) Senator Packwood's reply highlights the confusion that accompanied passage of the bill:

This is a rule asked for, I think, by the majority leader; I am not sure. We were under the impression [the rule] covered all the domestic plane manufacturers in the United States. General aviation manufacturers in this country are in desperate shape. We intended that any planes that were ordered by the end of this year and placed in service by July 1 next year be entitled to the investment tax credit.

When we put the rule in we were told it was all the domestic manufacturers. Subsequently, one of the Senators from Arkansas has told me about their problem with the Falcon jet, which is a plane that is partially manufactured in France and brought to Arkansas for further as-

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\(^5\) Id. § 204(a)(11). For this purpose, an aircraft is considered manufactured at the point of its final assembly. Id.

\(^5\) Id.

\(^5\) Id.

\(^5\) Id.


\(^5\) Id. These companies are identified by Sen. Metzenbaum as Falcon Jet and West Wind. Id.
In summary, under the revised ACRS, aircraft will be depreciated over a seven year period using the double declining balance method switching to straight-line in the year in which this amount exceeds the declining balance amount. A half-year convention must be used in both the year of acquisition and disposition. Alternatively, a twelve year life using the straight-line method may be elected. These rules apply to all property placed in service after December 31, 1986, unless one of the transition rules apply.

B. Repeal of the Investment Tax Credit

The ITC is a device used by Congress in recent years to stimulate the economy by providing taxpayers an incentive to purchase new equipment. The original version of the ITC was introduced in 1962 and repealed seven years later. Two years later, Congress restored the credit due to the lagging economy. In 1975, 1978, and 1981, Congress further liberalized the credit in response to economic concerns present at those times. In some years, Congress has required concurrent reductions in the de-

59 Id. at $13,891. Sen. Packwood's comments indicate they did not want to cover Falcon Jet as it was partially manufactured in France. However, the transition rule states that place of manufacture is to be the place of final assembly which is Arkansas for the Falcon Jet. See supra note 54.
60 See supra notes 33-40 and accompanying text for the discussion of determining the proper method and life.
61See supra notes 41-44 and accompanying text for the discussion of determining the proper convention.
62 See supra notes 45-48 and accompanying text for the discussion of the alternative depreciation system.
63 See supra notes 49-59 and accompanying text for a discussion of the transition rules.
65 Freeland, supra note 64, at 785.
66 Id.
67 Id. For example, ERTA expanded the categories of assets eligible for ITC to include certain petroleum storage facilities and railroad rolling stock. Joint
preciable basis of investment credit property. When no basis reduction is required, the credit works as a subsidy, not merely a reflection of a cost of producing income.

In its present form, taxpayers are allowed a credit equal to ten percent of their qualified investment in property. In the case of recovery property other than three year property, the qualified investment is equal to the cost of the property. For three year recovery property, the qualified investment is sixty percent of the cost. In addition, the taxpayer must reduce the depreciable basis in investment credit property by fifty percent of the credit. If the taxpayer elects, he can take a reduced credit, determined by subtracting two percentage points from the regular percentage, in lieu of reducing the basis in the asset.

The Code also imposes limitations on the amount of used property that can qualify for the credit. There are also limitations on the amount of tax liability that can be offset by the ITC and provisions allowing unused credits to be carried back three years or carried forward fifteen.

The Act repeals the ITC for property placed in service
after December 31, 1985. This particular provision of the Act was controversial in the House not only because of its potentially harmful effect on the economy, but also because of its retroactive nature. In addition, any unexpired ITC carryforwards must be reduced by thirty-five percent before they can be used to offset tax liabilities for tax years beginning after July 1, 1987. For tax years beginning before and ending after July 1, 1987, the thirty-five percent reduction is prorated based on the number of months in the tax year after June 30, 1987.

For the most part, the same property exempted from the ACRS changes is eligible for ITC. The main difference between the eligible properties is that the written contract must be binding as of December 31, 1985, for the ITC property rather than March 1, 1986. However, the credit earned on this property must also be reduced the same way any credit carryforward is reduced regards-

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79 132 CONG. REC. H8,399 (daily ed. Sept. 25, 1986) (statement of Rep. Frenzel). It is extremely unlikely that a taxpayer could mount a successful due process challenge to the retroactive nature of the ITC repeal and the reduction in ITC carryforwards. The Supreme Court has consistently held that “application of an income tax statute to the entire calendar year in which enactment took place does not per se violate the Due Process Clause of the Fifth Amendment.” United States v. Darusmont, 449 U.S. 292, 297 (1981) (challenge to the 1976 amendments to the minimum tax provisions of I.R.C. §§ 56, 57); see also Ivey v. Commissioner, 46 T.C.M. (CCH) 172, 175 (1983) (retroactive changes to minimum tax are not so harsh and oppressive to be a denial of due process).

80 TRA of 1986, supra note 16, § 211 (to be codified at I.R.C. § 49(c)(2)). This reduction is to maintain a consistency between the amount of the credit taken and the top corporate tax rate. However, a 35% reduction in the rate would have been a top corporate rate of 30% not the 34% enacted. Therefore, it appears Congress reduced the ITC carryforwards more than was necessary.

81 Id. For example, a calendar year taxpayer would have to reduce his ITC carryforward by 6/12ths, a taxpayer with a September 30 year end will have to reduce his credit by 3/12ths.

82 Id. § 211 (to be codified at I.R.C. § 49(e)); see supra notes 49-59 and accompanying text for discussion of the transition rules.

83 TRA of 1986, supra note 16, § 211 (to be codified at I.R.C. § 49(c)(3)). The date change is necessary due to the fact that the ITC repeal is effective prior to the ACRS changes.
less of the year generated.\textsuperscript{84} One potential trap is that the basis reduction for transition property will be all of the credit taken not just half.\textsuperscript{85} Therefore, if a taxpayer elected to take the full ITC on transition property, his recovery basis would only be ninety percent of the cost as opposed to the current ninety-five percent.\textsuperscript{86} The Act also changes the amount of tax which can be offset by the general business credit to the first $25,000 of tax plus seventy-five percent of the tax liability in excess of $25,000.\textsuperscript{87}

C. Limitations on Purchased Net Operating Losses

When a corporation's allowable deductions exceed its gross income, the result is a net operating loss (NOL).\textsuperscript{88} These NOLs can be carried back and offset against taxable income in any of the three previous years or carried forward and offset against taxable income in any of the subsequent fifteen years.\textsuperscript{89} Prior to the Act, when a corporation with an NOL was purchased, NOL carryforwards were eliminated in different degrees and subject to different requirements, depending on whether the transaction took the form of a taxable purchase or a tax-free reorganization.\textsuperscript{90} If the change in ownership was a taxable

\textsuperscript{84} Id. That is, the reduction mentioned at notes 80-81 and accompanying text, is to be applied to all credits regardless of the year generated. Transition property, therefore, really does not qualify for a full 10\% credit because it must be reduced by the applicable percentage before it can be used to offset the tax liability.

\textsuperscript{85} Id. (to be codified at I.R.C. § 49(d)). This reduction is mandatory as the Act removes the election to take a reduced credit in lieu of basis adjustment. Id.; see supra note 74 and accompanying text.

\textsuperscript{86} This basis reduction is required by section 48(q)(1) of the Internal Revenue Code. The current basis reduction is one-half of the credit taken (5 percent of cost). The Act requires the basis be reduced by the entire credit taken (10 percent of the cost).

\textsuperscript{87} TRA of 1986, supra note 16, § 221 (amending I.R.C. § 38(c)(1)(B)); see supra note 76 and accompanying text.

\textsuperscript{88} I.R.C. § 172(c) (CCH 1985). There are certain modifications that have to be made to convert the excess deductions to the NOL, however, explanation of these modifications is beyond the scope of this paper. See id. § 172(d).

\textsuperscript{89} Id. § 172(b).

\textsuperscript{90} See generally B. BITTKER & J. EUSTICE, FUNDAMENTALS OF FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §§ 16.22-.23 (P. Joseph ed. 1980).
purchase, an NOL deduction could not be carried forward if one or more of the corporation's ten principal shareholders increased their ownership by at least fifty percentage points through taxable purchases and the corporation ceased conducting the trade or business of the loss corporation.\textsuperscript{91} In the case of a tax-free reorganization, the NOL deduction was reduced if the shareholders of the loss corporation received less than twenty percent of the stock of the merged entity.\textsuperscript{92} This reduction was equal to five percent for each percentage point below twenty received by these shareholders.\textsuperscript{93}

The Act provides that the amount of the NOL carryforward that may be used to offset taxable income in any post-change year shall not exceed the value of the old loss corporation multiplied by the long-term tax-exempt rate.\textsuperscript{94} Furthermore, if the new corporation does not continue the business enterprise of the old loss corporation at all times during the two year period beginning on the change date, no NOL deduction will be allowed.\textsuperscript{95} The statute defines the value of the old loss corporation as "the value of the stock of such corporation . . . immediately before the ownership change."\textsuperscript{96} The Statement of Managers states that this value is to be fair market value and that the price at which the loss corporation's stock changes hands in an arms-length transaction will be evidence, but not conclusive evidence, of fair market value.\textsuperscript{97}

\textsuperscript{91} I.R.C. § 382(a) (CCH 1985). The term loss corporation refers to the acquired corporation which has a NOL carryforward.
\textsuperscript{92} Id. § 382(b).
\textsuperscript{93} Id.
\textsuperscript{94} TRA of 1986, supra note 16, § 621 (to be codified at I.R.C. § 382)). Old loss corporation refers to the acquired entity with an NOL carryforward.
\textsuperscript{95} Id. This provision was also in the prior law. I.R.C. § 382(a)(1)(C) (CCH 1985). Whether there is a change of business is a question of fact and the relevant factors include changes in the corporation's employees, plant, equipment, product, location, and customers. B. Britker & J. Eustice, supra note 90, § 16.22. Discontinuance of more than a "minor portion" of a corporation's business may constitute a change of business. Id. Generally, the courts have been fairly liberal in construing this provision. Id.
\textsuperscript{96} TRA of 1986, supra note 16, § 621 (to be codified at I.R.C. § 382(e)).
\textsuperscript{97} Id. at II-187.
The long-term tax-exempt rate will be computed as the yield on a diversified pool of prime, general obligation tax-exempt bonds with remaining periods to maturity of more than nine years. The rate used will be the highest Federal long-term rate in effect for any month in the quarter in which the change occurs. The rate is to be adjusted for differences between rates on long-term taxable and tax-exempt obligations. The conferees intend for the Treasury Department to publish the long-term rate in revenue rulings within thirty days of enactment and monthly thereafter. The long-term tax-exempt rate should normally fall between sixty-six percent and 100 percent of the long-term Federal rate. These limitations apply to NOL carryforwards arising in taxable years ending prior to the change date as well as to a pro rata share of the losses of the current year prior to the change.

For the purposes of these limitations, a change in ownership occurs in two ways. The first is when the percentage of stock ownership in the new corporation by one or more five percent shareholders has increased by more than fifty percentage points over the lowest percentage of ownership such shareholders held in the old loss corporation at any time during the previous three years. In this regard, to determine if a change in ownership has oc-

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98 Id. at II-187-88.
99 Id. § 621 (to be codified at I.R.C. § 382(f)).
100 Id.
101 Id. at II-188. The use of a rate lower than the long-term Federal rate is necessary to ensure that the value of NOL carryforwards to the buying corporation is not more than their value to the loss corporation. Otherwise, there would be a tax incentive for acquiring loss corporations. Id.
102 Id. This range is due to the top corporate tax rate of 34%. Id.
103 Id. § 621 (to be codified at I.R.C. § 382(d)). In addition, the section 382 limitation must be further modified for "built-in gains." Id. (to be codified at I.R.C. § 382(h)). This means that if the fair market value of the assets of the old loss corporation exceeds the basis in the assets, the limitation will be increased by any gains recognized on the disposition of these assets during the five year period beginning on the date of the ownership change. Id. This adjustment is not necessary if the amount by which the fair market value exceeds adjusted basis is less than or equal to 25% of the fair market value. Id.
104 Id. (to be codified at I.R.C. § 382(g)).
curred, all stock owned by shareholders who are not five percent shareholders shall be aggregated and treated as if it belonged to one five percent shareholder.\textsuperscript{105} Second, a change in ownership occurs in the event of an equity structure shift.\textsuperscript{106} The Act defines an equity structure shift as any tax-free reorganization within the meaning of Code section 368 except for a mere change in identity.\textsuperscript{107} The Act also specifically includes taxable reorganization-type transactions and public offerings as equity structure shifts.\textsuperscript{108} The Act specifically exempts corporations that are under the jurisdiction of a court in a Title 11 or similar case from the NOL limitations if a petition was filed with the court before August 14, 1986.\textsuperscript{109} Thereafter, all other Title 11 or similar cases will be subject to a more lenient version of the NOL limitations.\textsuperscript{110} These new provisions apply to any ownership change occurring after December 31, 1986.\textsuperscript{111}

D. Miscellaneous Provisions

There are some other provisions which will have an impact on all corporations. First, the corporate tax rate is changed.\textsuperscript{112} Effective with tax years beginning on or after

\textsuperscript{105} Id.
\textsuperscript{106} Id.
\textsuperscript{107} Id. Section 368 defines a reorganization as: a statutory reorganization, an acquisition accomplished by a stock for stock exchange, an acquisition accomplished by a stock for property exchange, a transfer of assets to another corporation if one or more of the transferor's shareholders are in control of the transferee immediately after the transfer, a recapitalization, a mere change in identity, or a transfer of assets in a Title 11 case. I.R.C. § 368(a)(1) (CCH 1985).
\textsuperscript{108} Id. Section 368 defines a reorganization as: a statutory reorganization, an acquisition accomplished by a stock for stock exchange, an acquisition accomplished by a stock for property exchange, a transfer of assets to another corporation if one or more of the transferor's shareholders are in control of the transferee immediately after the transfer, a recapitalization, a mere change in identity, or a transfer of assets in a Title 11 case. I.R.C. § 368(a)(1) (CCH 1985).
\textsuperscript{109} TRA of 1986, supra note 16, § 621 (to be codified at I.R.C. § 382(g)(3)(B)).
\textsuperscript{110} Id. § 621(f)(5) (section dealing with effective dates).
\textsuperscript{111} See id. § 621(a) (to be codified at I.R.C. § 382(l)(5)). Certain ownership conditions must be met and the taxpayer can even waive this lenient treatment. Id.
\textsuperscript{112} Id. § 621(f). These limitations on NOL carryforwards also apply to any unused general business credit the old loss corporation may have. Id. § 621(a) (to be codified at I.R.C. § 383). The NOL provisions were amended in 1976 and these changes were to take effect as of January 1, 1986. Id. at II-195. The Act repeals the 1976 amendments. Id. There is a transition rule to exclude the Eastern Air Line, Inc. - Texas Air Corporation merger as long as it is completed by March 31, 1987. Id. § 621(f)(7). This is a classic example of a transition rule situation since the merger plan commenced prior to passing the Act.
\textsuperscript{113} Id. § 601 (to be codified at I.R.C. § 11).
July 1, 1987, the first $50,000 of taxable income is taxed at fifteen percent, the next $25,000 at twenty-five percent, and the amount over $75,000 is taxed at thirty-four percent.\(^{113}\) Under the previous tax law, the top corporate rate was forty-six percent.\(^{114}\) The two lower tax rates are phased out for corporations with taxable income over $100,000 so that corporations with income in excess of $335,000 will pay a flat rate of thirty-four percent.\(^{115}\) Second, the corporate dividends received deduction is reduced from eighty-five percent to eighty percent of dividends received from domestic corporations.\(^{116}\) Finally, corporations will now be taxed on the difference between the fair market value and the adjusted basis of appreciated property distributed to shareholders as a dividend\(^{117}\) or in a complete liquidation of the corporation.\(^{118}\)

III. IMPACT OF THE ACT

One thing that is overwhelmingly clear from the Act is that capital intensive industries, such as commercial avia-
A study conducted by Tax Analysts of Arlington, Virginia, showed that the airlines will see their effective tax rates increase from twenty percent to almost twenty-four percent once the Act is fully implemented. This is a combination of many changes, but is mainly due to the repeal of the ITC. Specific airlines will see an increase of as much as nine percent in their effective tax rate.

A few examples will help illustrate the impact of some of these changes. For the sake of simplicity and illustration, the examples will assume that no transition rules apply in order to see the impact the Act will have once fully implemented. The numbers used are the 1985 amounts shown in the annual reports of the various airlines.

A. ACRS and the ITC Repeal

The first example illustrates the ACRS changes and the ITC repeal. In 1985, AMR Corporation had additions to capital assets in excess of $1.2 billion. Assuming these are all new items of five year recovery property that qualify for ITC (such as airplanes), the depreciation allowance under the present law will be roughly $171.2 million in the year of acquisition. If these assets were placed in service during 1987, the depreciation allowance would be roughly $171.7 million. While this first appears immaterial, actually producing a tax savings of roughly

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120 Id. at col. 3. This study was based on computing tax rates according to present law and under the Act based on 1985 financial data on file with the Securities and Exchange Commission. Id.
121 Id. at 2H, col. 3. The study shows that AMR Corporation will watch its effective tax rate increase from 19.4% to 28.6%. The study assumes full implementation of the bill and ignores any transition rules. Id.
123 The calculation is: (0.95 x $1.2 billion) x 15%, where 0.95 equals depreciable basis after ITC is taken and 15% is the first year ACRS percentage.
124 This calculation is: $1.2 billion / 7 (the recovery period). Technically, this figure is then multiplied by two, since double declining balance is the appropriate method, then divided by two, since the half-year convention is used.
$170,000,\textsuperscript{125} it must be remembered that the ITC is no longer available to the company. This will cost AMR roughly $120 million in taxes.\textsuperscript{126} So, taken by themselves, the ACRS changes do not have a great effect as they only spread the depreciation deductions over two more years. However, when viewed in light of the repeal of ITC, the changes are significant.\textsuperscript{127}

Assuming that AMR Corporation elects to take the reduced credit rather than reduce the depreciable basis in these assets changes the example. Choosing this method would yield a first year depreciation deduction of roughly $180.3 million,\textsuperscript{128} an increased depreciation deduction of $8.6 million in the year of acquisition when compared to the revised ACRS.\textsuperscript{129} At the revised top corporate rate, this would cost AMR Corporation an additional $2.9 million in tax.\textsuperscript{130} When added to the loss of over $96 million in ITC,\textsuperscript{131} a significant increase in tax is seen under both scenarios.

B. Reductions in ITC Carryforwards

The second example illustrates the impact of the reductions in ITC carryforwards. The annual reports of most of the major airlines reveal significant amounts of ITC carryforwards that are available to years ending in 1986 and beyond. Delta Air Lines, Inc. has tax credit carryforwards of $74.7 million scheduled to expire in the year

\begin{itemize}
\item \textsuperscript{125} This calculation is simply the difference in the depreciation figures multiplied by the tax rate: $(171.7 \text{ million} - 171.2 \text{ million}) \times 34\%$.
\item \textsuperscript{126} This calculation is the asset cost multiplied by the ITC percentage: $1.2 \text{ billion} \times 10\%$.
\item \textsuperscript{127} The change does become significant if the corporation wants to elect the straight-line method. Under prior law a five year life could be elected which would result in first year depreciation of $114.2 \text{ million} \textsuperscript{(a half year convention must be used). Under the Act, a 12 year life must be used resulting in first year depreciation of $50.1 \text{ million}}$.
\item \textsuperscript{128} This is the cost of the assets multiplied by the statutory rate: $1.2 \text{ billion} \times 15\%$.
\item \textsuperscript{129} $180.3 \text{ million} - 171.7 \text{ million} \textsuperscript{(the difference in the depreciation under the reduced basis and the reduced credit methods)}$.
\item \textsuperscript{130} $8.6 \text{ million} \times 34\% \textsuperscript{(the increased depreciation multiplied by the tax rate)}$.
\item \textsuperscript{131} $1.2 \text{ billion} \times 8\% \textsuperscript{(reduced credit rate in lieu of reduction in basis)}$.
\end{itemize}
The $150.1 million of ITC carryforwards of Eastern Air Lines, Inc. begin to expire in 1995. The airline with the most at stake is Pan Am Corporation whose annual report reveals $361 million in credit carryforwards scheduled to expire between 1990 and 2000. The changes will also have a significant impact on the regional carriers as illustrated by Southwest Airlines, Inc.'s $20 million in ITC carryforwards. Another commercial air carrier that will be affected by the reductions in ITC carryforwards will be Western Air Lines, Inc. with $62.8 million scheduled to expire from 1992 to 2000. The significance of this change and its retroactive nature are highlighted when these five companies have earned, in the aggregate, over $668 million in credits which will now be subject to reduction. Assuming these corporations all report on the calendar year, these credits must be reduced by seventeen and one-half percent before applying them to the 1987 tax liability. This would mean that $116.9 million in credits that the companies earned is no longer available to offset their tax liability. In 1988, the credits would be reduced by an additional $234.0 million. These five companies will lose over $350 million in credits they earned by relying on and complying with the tax law existing when they decided to purchase these assets. Although this is the worst possible case, it is not totally unrealistic given the fact that most of these compa-

137 See supra notes 80-81 and accompanying text for explanation of the reductions in ITC carryforwards.
139 See supra note 81 and accompanying text for a discussion of the required reductions in ITC carryforwards.
140 See supra note 81 and accompanying text. In 1988, the unused ITC carryforward must be "grossed up" for the prior year limitation even though the amount excluded in the prior year is not available as a credit in 1988. Id.
nies also have large NOL carryforwards that must be used before any ITC carryforwards can be used. This makes it very possible for the ITC carryforwards to be subject to the entire reduction described above.

C. Limitations on Purchased NOLs

The limitations on NOL deductions are best illustrated by the recent merger of Texas Air Corporation and Eastern Air Lines, Inc. The abundance of mergers and acquisitions in the industry makes the limitations on purchased NOL's extremely important. On February 24, 1986, Eastern Air Lines, Inc. (Eastern) and Texas Air Corporation (Texas Air) entered into an Agreement and Plan of Merger whereby Eastern will become a wholly-owned subsidiary of Texas Air. As of March 25, 1986, Texas Air had acquired approximately forty-seven percent of the outstanding common stock of Eastern. Assuming Texas Air acquires this majority interest, this merger will clearly meet the fifty percent change in ownership requirement making the NOLs of Eastern subject to the new limitations. Pursuant to the merger plan, Texas Air paid ten dollars per share for the Eastern stock. Assuming this amount meets the burden of proof as to the value of the old loss corporation, this figure will be used as the value of the old loss corporation in computing the

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141 E.g., Western Air Lines, Inc., 1985 Annual Report 17 (1986) (NOL carryforwards of $78 million). The NOL deduction must be used before any credits can be applied. See I.R.C. § 63(a) (CCH 1985) (taxable income is gross income less allowed deductions).
142 E.g., infra note 144 and accompanying text (Eastern and Texas Air merger); Dallas Morning News, Sept. 10, 1986, at 1D, col. 3 (Delta and Western merger).
143 See supra notes 88-111 and accompanying text for a discussion of the NOL limitations.
144 Eastern Air Lines, Inc., supra note 133, at 22.
145 Id. The Plan provides that Texas Air may increase its total beneficial interest up to 51% through open market purchases before the merger is effected. Id.
146 See supra notes 88-111 and accompanying text defining when a change in ownership occurs.
limitation. The next variable in the equation is the Federal long-term rate which is 7.42 percent as of this writing. Assuming the long-term tax-exempt rate will be sixty-six percent of this rate, a rate of 4.90 percent will be used for illustration. As of December 31, 1985, Eastern had 60,747,648 shares of common stock outstanding. At ten dollars per share, the value of the old loss corporation is $607.5 million. Multiplying this by the adjusted Federal long-term tax-exempt rate, the limitation on Eastern's NOL carryforward is $29.8 million. However, as of December 31, 1985, Eastern had NOL carryforwards of $777.0 million. Therefore, the maximum amount of Eastern's NOL carryforward that Texas Air could use in the first post merger year is the $29.8 million. The remaining $747.2 million will then be carried to the next year and once again be subject to the same limitations. Note that in these subsequent years, the only change in the limitation calculation will be fluctuations in the Federal long-term tax-exempt rate. One final warning regarding these provisions: Texas Air must continue the business enterprise of Eastern at all times during the first two years after merger or Eastern's NOL carryforwards will be disallowed. This would cost Texas Air over $700 million in deductions.

IV. CONCLUSION

This paper discussed only three of the major changes

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149 This is the Federal long-term rate adjusted to approximate the tax-exempt rate by taking the top corporate tax rate of 34% and subtracting this from 100%.

150 EASTERN AIR LINES, INC., supra note 133, at 12. The calculation should also include all preferred stock outstanding at the change date as well. TRA of 1986, supra note 16, § 621 (to be codified at I.R.C. § 382(e)). For ease of illustration, the value of the preferred stock is omitted and it is assumed there is no change in stock outstanding between year end and change date.

151 $607.5 million x 0.0490.

152 EASTERN AIR LINES, INC., supra note 133, at 18.

153 See supra note 95 and accompanying text.
made by the Tax Reform Act of 1986: ACRS changes, ITC repeal, and limitations on purchased NOLs. These three changes, however, will have a dramatic impact on the industry. As illustrated above, AMR would lose $120 million in ITC on only one year’s asset additions,\footnote{See supra note 126 and accompanying text showing AMR’s ITC reduction.} the industry would lose over $350 million in ITC carryforwards,\footnote{See supra notes 140-141 and accompanying text for calculation of industry wide ITC carryforward losses.} and Texas Air’s deductions of NOLs purchased from Eastern are greatly reduced.\footnote{See supra notes 151-153 and accompanying text for illustration of the NOL carryforward limitation.} Time and practicality do not permit the entire scope of the Act to be explored. This discussion, however, indicates the enormous impact this Act will have. Because of the vast scope of areas changed by this bill, no one can say with certainty what effect it will have. The Congressional record is full of statements of the doom the Act will cause as well as statements about the wonders it will work.\footnote{E.g., 132 Cong. Rec. H8358, H8365, H8366, H8385, H8399 (daily ed. Sept. 25, 1986) (statements of Reps. Rostenkowski, Archer, Gradison, Armey, and Frenzel).} However, a few interesting observations seem appropriate.

A. Impact of the Act on the Aviation Industry

As far as the airline industry is concerned, the Act is likely to accelerate consolidations in the industry through mergers, acquisitions, and bankruptcies.\footnote{Tax Reform Seen Favoring Retailing, Service Industries, J. Acct., October 1986, at 18, 24.} It appears these mergers and acquisitions, however, will be more on the order of forced sales. Given the limitations on purchased NOLs, a struggling carrier is not as attractive of a purchase as it once was. The struggling carrier will have to be content with a lower purchase price since the purchaser is no longer willing to pay for tax benefits it can not reap. However, this may cause a streamlining of the industry that will benefit investors. According to George W. James, president, Airline Economics, Inc., “[T]he tax
legislation could have a bright side for investors. Not only will it enhance the status of well-positioned carriers, but it will probably lower excess capacity in the industry and strengthen prices over time. A reduction in personal and corporate tax rates will probably increase spending on air travel."159 This observation may be premature, however. While it is true rates are lowered, unreimbursed employee travel is no longer a deduction for determining adjusted gross income. The Act requires such deductions to be a miscellaneous itemized deduction subject to a floor of two percent of adjusted gross income.160 Therefore, to get a deduction, the employee must first be able to itemize.

B. General Observations of the Act

One truly unfortunate aspect of the Act is that it evidently is not the tax reform to end all tax reform. In presenting the Act to the House, Rep. Rostenkowski stated he was quite certain the House would have to pass a rate increase next year to bring down the deficit.161 However, his Senate counterpart, Sen. Packwood, disagrees and declares that "we ought to have this code the way it is, including the rates, for a number of years."162 Furthermore, Sen. Packwood has stated that any changes within the next year will only be technical corrections and not substantive changes.163 Majority Leader Dole, however, has indicated substantive changes will be made as well as rate increases.164 A more pragmatic approach was taken by Sen. Long. He declared that Congress is not smart enough to avoid a recession and when it occurs,
“Congress will restore the investment tax credit, special low rates for capital gains, and possibly more liberal write-offs for plant and equipment to get the economy going again.”

This Act started out with very lofty goals of fairness, simplicity, and growth. In some areas it achieved these goals. It reduces the permanent tax brackets for individuals from fifteen to two. It eliminates more than six million working poor from the tax rolls, probably the Act’s greatest achievement. The ability to use real estate as an abusive tax shelter through passive losses culminating in capital gains is removed. Therefore, the Act must be given a certain amount of credit for what it does accomplish. Furthermore, Rep. Rostenkowski and Sen. Packwood are to be commended for their drive and dedication at completing this monumental task. However, overall, the Act falls short of its goal and the benefits mentioned above are outweighed by the shortcomings.

The Act is not fair. The most obvious example is the repeal of ITC. How can it be fair for taxpayers to proceed in compliance with the law and then be told they will lose over fifty percent of the credits they generated by relying on the law? There are other provisions that have a similar retroactive impact. Taxpayers who sold a capital asset under an installment sale relied on the law that the maximum tax on the installments would be twenty percent are now faced with a maximum rate of twenty-eight percent.

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165 Id. at 1132.
166 See supra note 6 and accompanying text.
168 Id.
169 TRA of 1986, supra note 16, § 501 (to be codified at I.R.C. § 469). This new section limits the ability to deduct passive losses only to the extent of passive gains and specifically identifies rental activity as passive. Id.
170 See supra notes 132-141 and accompanying text.
171 TRA of 1986, supra note 16, §§ 301, 302 (repealing I.R.C. § 1202 (providing deduction for long-term capital gains) and adding I.R.C. § 1(j) (providing maximum rate of 28% on long-term capital gains)).
The Act does not encourage growth. This test is subjective, but most economists judged the House version of the Act to cost about one percent growth over the first three years.\textsuperscript{172} This cost is from a decline in manufacturing jobs that is predicted to occur in the first five years of the Act.\textsuperscript{173} The Senate version was viewed to cost only half as much.\textsuperscript{174} The final version is said to be somewhere between these two.\textsuperscript{175} This translates into several hundred thousand jobs that will not be created that would have been under the present tax code.\textsuperscript{176} These same economists predict growth beginning in year five.\textsuperscript{177} However, five years tends to dull the economists' crystal ball. Given Congress' track record, it is hard to imagine five years going by without Congress passing some substantial changes in the tax law.

Finally, this Act is far from simple. One need only pick up the 925 pages of the Act to see it fails this test. Proponents refer to the fact that there are only two individual brackets. By now we have all heard of the "phantom" thirty-three percent bracket used to phase-out the standard deduction and personal exemption for "wealthy taxpayers".\textsuperscript{178} ACRS is certainly not simplified, especially considering the provisions for using a mid-quarter convention if more than forty percent of acquisitions occur in the fourth quarter.\textsuperscript{179} Just on first blush, the purchased NOL provisions are not simple as a section two pages long is replaced with one twelve pages long.\textsuperscript{180} As illustrated, this section involves many more calculations on an

\textsuperscript{173} Id.  
\textsuperscript{174} Id.  
\textsuperscript{175} Id.  
\textsuperscript{176} Id.  
\textsuperscript{177} Id.  
\textsuperscript{178} See supra notes 42-43 and accompanying text.  
\textsuperscript{179} See supra notes 88-111 and accompanying text.  
\textsuperscript{180} See supra note 16, § 101 (amending I.R.C. § 1 (relating to tax imposed on individuals)). The phase out begins at taxable income of $71,900 for married individuals filing jointly and $43,150 for unmarried individuals. Id.  
\textsuperscript{180} See supra notes 88-111 and accompanying text.
ongoing basis than was previously required.\textsuperscript{181}

Regardless of these complications, retroactive sections, and sections that discourage capital investment and growth, President Reagan signed the Act on October 22, 1986, and it is now the Internal Revenue Code of 1986.\textsuperscript{182} The impact the Act will have on the economy and on specific industries will be interesting to watch. Although it does not improve our system of taxation, the best that can be hoped for at this point is that Congress will resist the temptation to change the law. This will at least allow every taxpayer to function with some degree of certainty and stability. The predictability this would provide investors and businesses would probably do more to encourage growth than any substantive changes Congress could enact.

\textsuperscript{181} Id.

\textsuperscript{182} TRA of 1986, \textit{supra} note 16, § 2.