OVERVIEW OF TAX POLICY ISSUES
RELATED TO THE
AIR TRANSPORTATION INDUSTRY
AND DESCRIPTION OF H.R. 2354

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT

of the

HOUSE COMMITTEE ON WAYS AND MEANS

on October 24, 1989

Prepared by the Staff

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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a hearing for October 24, 1989, to review the tax policy aspects of recent merger, acquisition, and leveraged buyout transactions in the air transportation industry.

This document,[1] prepared by the staff of the Joint Committee on Taxation in connection with the Subcommittee hearing, provides an overview of certain tax policy issues related to the air transportation industry, and a description of H.R. 2354 (introduced by Mr. Dorgan).

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[1] This document may be cited as follows: Joint Committee on Taxation, Overview of Tax Policy Issues Related to the Air Transportation Industry and Description of H.R. 2354 (JCX-67-89), October 23, 1989.

I. BRIEF HISTORY OF THE AIRLINE INDUSTRY[2]

The regulated era

Prior to the Airline Deregulation Act of 1978, the airline industry was highly regulated by the Civil Aeronautics Board (CAB). The CAB regulated the routes that an airline was permitted (and required) to fly as well as the fares that could be charged. The number of large interstate carriers was limited and entry of new carriers was closely regulated.

In this period, fares generally were set so that revenues from long-haul markets subsidized short-haul markets. Carriers were required to provide service on certain low-density short-haul routes even though the service was not profitable. On longer, more profitable routes airlines often competed, not through price, but through the frequency of service and quality of service amenities provided. The regulated environment with the restrictions on price competition may also have permitted the level of wages in the airline industry to exceed what would have prevailed under more competitive conditions.

Beginning in 1977, the CAB provided airlines greater latitude to discount domestic fares. As fares declined and air travel and industry profits rose, Congress enacted the Airline Deregulation Act of 1978, which phased out the CAB's authority over rates and routes.[3] Aside from safety and airway system responsibilities retained by the Federal Aviation Administration (FAA), the remaining responsibilities for consumer protection and merger regulation were eventually transferred to the Department of Transportation.

Entry of new airlines

Beginning in 1979, airlines such as World, Pacific Southwest, and Midway entered the scheduled interstate air passenger market. The entry of new carriers was slowed by the deep recession in the airline industry in the early 1980s, but resumed apace with the entry of numerous airlines such as America West and People Express.

These new airlines typically had lower overhead and

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[2] See Congressional Budget Office, Policies for the Deregulated Airline Industry, July 1988, for a more detailed discussion.

[3] Because the marginal cost of transporting a passenger in what would otherwise be an empty seat is small, increased load factors permitted airlines simultaneously to reduce fares and increase profits.

labor costs than existing airlines. The new entrants would offer lower fares than the existing airlines, and the incumbents' higher costs often meant that the existing carriers were unprofitable when they tried to match the lower fares.

Existing airlines attempted to reduce costs and restructure operations with varying degrees of success. Braniff and Continental filed for bankruptcy, although Continental was able to abrogate its labor contracts in bankruptcy. Many incumbent airlines renegotiated labor contracts, such as American; suffered strikes due to an attempt to reduce wage levels, such as Eastern; or both, in the case of TWA. Operations were reformed and aircraft more suitable to new route structures obtained.

Airlines dramatically changed their route structure in the deregulated environment. Hub-and-spoke route systems, where numerous routes feed into a single hub, permitted air carriers to deploy aircraft more efficiently and provide service to a greater number of cities. By flying aircraft from numerous cities into one airport and transferring passengers and baggage to departing aircraft, a wider number of city-to-city connections could be economically offered with one-stop service than could be served with a more disperse route structure.

Consolidation

By 1986, the era of rapid new airline formation seemed over. The market share of the new entrants declined annually after 1985. Many of the entrant airlines failed or were acquired.

The remaining major carriers continued to expand the hub-and-spoke route systems. It also has been suggested that other practices, such as the development of sophisticated and complex pricing methods, frequent-flyer programs, and the use of computerized reservation systems have been important for the success of the large carriers.

Starting in 1985 and continuing through the end of 1988 the Department of Transportation was responsible for approving mergers and consolidations of airlines. Twenty-seven approvals or exemptions were granted in that period, although not all resulted in an eventual merger or involved major airlines.[4]

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4 General Accounting Office, Airline Competition: DOT's Implementation of Airline Regulatory Authority, June 1989. Several major mergers or acquisitions occurred during this period including TWA-Ozark, Northwest-Republic,

(Footnote continued)

By 1987, the market share held by the largest carriers in the domestic airline industry exceeded the level before deregulation.[5] Concern has been expressed also about the predominance of certain airlines in specific hub airports. On average, however, the number of airlines serving various city markets has actually increased since 1983. This seemingly contradictory pattern of concentration is due to the growth of large hub-and-spoke route systems by several carriers that can serve a wide range of cities with one-stop service.

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[4] (continued)
USAir-Piedmont, Texas Air with Eastern and People Express, and the United acquisition of the Pan Am Pacific division.

[5] CBO, supra n.2, p. 15.

II. CERTAIN PRESENT-LAW RULES RELEVANT TO THE TAXATION OF AIRLINES

A. Debt and Equity

In general

Corporations and their investors generally are separate taxable entities.[6] The tax treatment of the corporation and the investor varies depending upon whether the investor's interest in the corporation is considered debt or equity.

In general, there is a corporate tax advantage to capitalizing a corporation with debt rather than equity because interest paid to debt investors is deductible to the corporation, while dividends paid to equity investors are not. If the investor is taxable, it generally must include the full amount of interest received or accrued in its taxable income. A U.S. tax-exempt investor is not generally taxable on interest income unless it has borrowed in connection with its debt ownership. A foreign person is not generally subject to U.S. tax on interest from a U.S. corporate debt investment.

U.S. individual investors generally are fully taxable on dividend income. However, U.S. corporate investors may deduct from income 70 percent of amounts received or accrued as dividends (an 80 percent or 100 percent deduction is available if the corporate investor owns sufficient stock in the issuer). If an issuing corporation does not expect to be able to utilize an interest deduction (for example, because it already has sufficient available loss carryforwards to offset its income for the foreseeable future), there may be a tax advantage to issuing stock rather than debt where the earnings used to pay the dividends are not taxed to the issuing corporation (due to the availability of losses to offset the income that produces the earnings) and are taxed at no more than a 10.2 percent rate to the recipient corporation (30 percent of the 34 percent maximum corporate tax rate).[7]

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[6] Corporations that are taxed at the corporate level are frequently referred to as "C corporations" because the tax treatment of such corporations is governed by Subchapter C of the Code.

[7] Provisions currently pending would modify the ability to obtain this result in certain circumstances involving dividends paid by members of a group of corporations filing a consolidated return. See the Revenue Reconciliation Act of 1989 (H.R. 3299) as passed by the House and amended by the
(Footnote continued)

U.S. tax-exempt investors generally are not taxed on dividend income from corporate stock investments unless they have borrowed in connection with their stock ownership. Foreign investors are generally subject to a maximum 30-percent gross withholding tax on dividends, but this rate is often reduced under a tax treaty between the U.S. and the shareholder's country of residence. No treaty reduces the rate to zero.

<u>Distinguishing debt from equity</u>

The characterization of an investment in a corporation as debt or equity for Federal income tax purposes is generally determined by the economic substance of the investor's interest in the corporation. The form of the instrument representing the investment and the taxpayer's characterization of the interest as debt or equity is not necessarily controlling. However, taxpayers have considerable latitude in structuring the terms of an instrument so that an interest in a corporation will be considered to be debt or equity, as so desired.

There is presently no definition in the Code or the regulations that can be used to determine whether an interest in a corporation constitutes debt or equity for tax purposes. Such a determination must be made under principles developed in case law. Courts have approached the issue of distinguishing debt and equity by trying to determine whether the particular investment at issue in each case more closely resembles a pure debt interest or a pure equity interest. It is generally understood that a pure debt instrument is ordinarily represented by a written, unconditional promise to pay a principal sum certain, on demand or before a fixed maturity date not unreasonably far in the future, with interest payable in all events and not later than maturity.[8] Conversely, a pure equity interest is generally understood as an investment that places the funds contributed by the investor at the risk of the enterprise, provides a share of any future profits, and carries with it rights to control or manage the enterprise.

The determination of whether an interest constitutes debt or equity is generally made by analyzing and weighing the relevant facts and circumstances of each case.[9] Some interests in a corporation can clearly be characterized, on

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[7](continued)
Senate, sec. 11201 of the House bill and sec. 6201 of the Senate amendment.

[8] <u>See</u>, e.g., <u>Farley Realty Corp.</u> v. <u>Comm'r</u>, 279 F.2d 701 (2d Cir. 1960), and B. Bittker & J. Eustice, <u>Federal Income Taxation of Corporations and Shareholders</u>, para. 4.03 (1979).

their face, as either debt or equity. However, other interests may have features common to both debt and equity (known as "hybrid securities"), or underlying facts and circumstances may indicate that an interest has been inappropriately characterized as debt or equity (such as when purported debt is held by the corporation's shareholders on a pro rata basis, or when debt is held in a thinly capitalized corporation).

The Revenue Reconciliation bill of 1989 (H.R. 3299) as passed by the House would recharacterize as equity certain long-term, high yield debt instruments that do not pay interest currently. (House bill section 11202). The bill as amended by the Senate would not recharacterize such instruments but would deny the issuer a deduction until the interest is paid (Senate bill section 6202).

B. Limitations on Use of Net Operating Loss Carryforwards Following Corporate Ownership Change

The use of corporate net operating loss carryforwards is limited following a corporate ownership change. In general, an ownership change occurs if the percentage of stock (by value) owned by one or more 5 percent shareholders has increased more than 50 percentage points within a three-year period. Certain groups of less than 5 percent shareholders are treated as a single shareholder for this purpose.

Following an ownership change, the use of pre-ownership change net operating loss carryforwards (NOLs) is limited to an amount of income based on the value of the equity of the corporation immediately before the ownership change. After the ownership change, pre-change NOLS may be used against an annual amount of income equal to the value of the corporation immediately before the change, times the applicable long-term tax-exempt rate in effect at the time of the ownership change.

In addition, pre-change NOLs may be used without limitation against pre-change built-in gains that are recognized following the ownership change, provided that at the time of the ownership change net built-in gains exceeded 25 percent of the asset value of the corporation. To the extent an election is made under section 338 to treat a stock acquisition as an asset acquisition, all built-in gains recognized in the deemed asset sale may be offset by pre-change losses (even if such gains do not exceed 25

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[9] In John Kelley Co. v. Comm'r, 326 U.S. 489 (1943), the Supreme Court stated that "[t]here is no one characteristic, not even the exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts."

percent of the asset value.)

Pre-change built-in losses recognized after the ownership change (for example, losses that are attributable to a decline in the value of property that occurred before the ownership change, but that are recognized when the property is sold after the change) are subject to limitation in the same manner as pre-change NOLS. However, built-in losses are not subject to limitation if net built-in losses do not exceed 25 percent of the value of the assets immediately before the ownership change.[10]

Special rules apply to certain ownership changes resulting from a bankruptcy proceeding. If old shareholders and creditors own at least 50 percent of the stock of a corporation emerging from bankruptcy, then the special loss limitations do not apply. However, the corporation must reduce its net operating loss carryforwards by 50 percent of the excess of any debt cancelled in the proceeding over the value of the stock received by creditors in the proceeding for such debt. In addition, the corporation is denied an interest deduction for interest on such cancelled debt in the prior three years. If a second ownership change occurs within 2 years, the use of NOLs that arose before the first ownership change is eliminated.

A corporation emerging from bankruptcy that does not meet the 50-percent ownership requirements of the foregoing provision, or that elects not to use that provision because it does not wish to experience the NOL and interest deduction reductions or the second ownership change rule that attend that provision, is generally subject to the basic loss limitation rules. However, the value of the corporation immediately before the ownership change is determined on the basis of the value as increased by the cancellation of any creditors' claims in the proceeding.

Rules similar to the rules limiting NOLs also apply to limit the use of tax credit carryforwards following an ownership change.

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[10] Revenue Reconciliation provisions currently pending in H.R. 3299 would modify the 25-percent threshold. Section 11205 of the House bill would lower the threshold to the lesser of 15 percent of value of the assets or $10 million. Section 6205 of the Senate amendment would lower the threshold to the lesser of 15 percent of the value of the assets or $25 million.

C. Depreciation and Leasing

Depreciation of airline property

The amount of the depreciation deduction allowed with respect to any tangible property is determined under the accelerated cost recovery system as modified by the Tax Reform Act of 1986 ("MACRS"). Under MACRS, the depreciation deduction for any depreciable property is determined by using (1) the applicable recovery period, (2) the applicable depreciation method, and (3) the applicable convention.

The applicable recovery period generally is based on the class life of the property under the asset depreciation range ("ADR") system under the law in effect before 1981. Under the ADR system, property used in commercial air transportation generally is assigned a class life of 12 years. Under MACRS, property with a class life of 10 or more years but less than 16 years is treated as 7-year property. Consequently, the applicable recovery period for property used in commercial air transportation generally is 7 years.

The applicable depreciation method for 7-year property generally is the 200-percent declining balance method switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized. Finally, the applicable convention generally is the half-year convention, which treats property placed in service or disposed of during any taxable year as placed in service or disposed of on the mid-point of the taxable year.

In the case of tangible property that during any taxable year is used predominantly outside the United States, the depreciation deduction is required to be determined under the alternative depreciation system. The amount of the depreciation deduction allowed under the alternative depreciation system generally is determined by using (1) a recovery period equal to the ADR class life, (2) the straight-line method, and (3) the applicable convention. Consequently, if an aircraft is used predominantly outside the United States, the depreciation deduction with respect to the aircraft is determined by using a 12-year recovery period, the straight-line method, and the applicable convention.

For purposes of this provision, an aircraft is not used predominantly outside the United States if the aircraft is registered by the Administrator of the Federal Aviation Administration and is operated to and from the United States or is operated under contract with the United States.

Leasing of airline property

Frequently, an airline will lease an aircraft from another person in lieu of purchasing the aircraft and financing such purchase through a loan from the seller or a third party. An airline will often lease an aircraft if the airline is unable to obtain a full tax benefit from ownership of the aircraft. For example, an airline that is subject to the alternative minimum tax may often achieve more favorable Federal income tax treatment by leasing an aircraft instead of purchasing it. This result occurs because a portion of the depreciation deduction allowed for regular tax purposes is treated as a preference for purposes of the alternative minimum tax whereas the rental payments under a lease are not treated as a preference for alternative minimum tax purposes.

In a typical aircraft leasing transaction, the airline as lessee is required to pay all taxes, insurance premiums, maintenance costs, and other expenses relating to the aircraft during the lease term (a "net lease"). In addition, because the aircraft is in the possession of the airline, the lease agreement will usually provide that the airline bears all risk of loss or damage with respect to the aircraft. Finally, the airline is often provided with an option to purchase the aircraft for its fair market value at the end of the lease term.

For Federal income tax purposes, the owner of property is entitled to the depreciation deductions with respect to such property. The determination of the owner of property for Federal income tax purposes is based on rules developed through a series of court cases and administrative pronouncements of the Internal Revenue Service.

For example, in determining whether a transaction is a lease, the courts and the Internal Revenue Service attempt to consider whether there is a bona fide business purpose for the structure of the transaction and also whether the nominal lessor has retained sufficient benefits and burdens of ownership with respect to the property. A nominal lessor generally is not considered to have retained sufficient benefits and burdens of ownership if the user of the property has an option to obtain title to the property at the end of the lease term for a price that is either nominal in relation to the value of the property at the time that the option may be exercised or that is relatively small compared to the total payments required to be made. Furthermore, if the nominal lessor may force the nominal lessee to purchase the property at the end of the lease term, the nominal lessor also may not have retained sufficient benefits and burdens of ownership because the risk that there would be no market for the property at the end of the lease term would be eliminated.

D. Treatment of Transactions Involving Qualified Pension Plans and Employee Stock Ownership Plans (ESOPs)

Background

If a pension, profit-sharing, or stock bonus plan qualifies under the Internal Revenue Code ("qualified pension plan"), then (1) a trust under the plan generally is exempt from income tax, and (2) employers generally are allowed deductions (within limits) for contributions to the trust for the year for which the contributions are made. The participants in the plan, however, are not taxed on plan benefits until the benefits are actually distributed.

A defined benefit pension plan is a type of qualified pension plan under which an employee accrues a specified retirement benefit set forth in the plan that is not related to the amount of assets held by the plan or any account balance maintained for the employee.

An employee stock ownership plan (ESOP) is a type of qualified pension plan that is designed to invest primarily in securities of the employer maintaining the plan and that satisfies certain specific requirements set forth in the Code and Treasury regulations. If employer securities are acquired for an ESOP with borrowed funds the ESOP is referred to as a leveraged ESOP.

Certain present-law rules affect the investment of qualified pension plan assets in leveraged buyouts and the role of pension plans and ESOPs in leveraged buyouts. These rules include (1) the special fiduciary requirements applicable to pension plans, (2) the funding requirements applicable to qualified defined benefit pension plans and their impact on overfunded defined benefit pension plans, and (3) the special rules relating to the ESOPs.

Fiduciary requirements applicable to pension plans

The Employee Retirement Income Security Act of 1974 (ERISA) contains rules governing the conduct of fiduciaries of employee benefit plans. ERISA has general rules relating to the standard of conduct of plan fiduciaries that require that a plan fiduciary discharge his or her duties solely in the interest of plan participants and beneficiaries and in a prudent manner. ERISA also contains rules prohibiting certain transactions between a plan and parties in interest with respect to the plan, such as a plan fiduciary, which are designed to prevent self-dealing.

The Code does not contain extensive fiduciary rules. However, in order for a plan to be qualified under the Code, a plan is required to provide that the assets of the plan be used for the exclusive benefit of employees and their beneficiaries. In addition, the Code contains rules prohibiting transactions between a plan and disqualified persons with respect to a plan that are similar to the prohibited transaction rules under ERISA.

Neither the Code nor ERISA contains a specific prohibition on the use of pension plan assets in leveraged buyouts or other corporate transactions. However, the use of pension plan assets in a leveraged buyout could be a violation of ERISA's fiduciary rules if, for example, the investment does not satisfy the prudence standard.

Rules relating to overfunded pension plans

Under present law, if a company terminates a defined benefit pension plan, any assets in excess of the assets necessary to provide for employees' accrued benefits may be returned to the employer if the plan has provided for such reversion for 5 years before the reversion. In general, any such reversion is includible in the income of the employer and is subject to a 15-percent nondeductible excise tax payable by the employer. There are no restrictions on the employer's use of the excess assets after the termination of the plan.

Pension Benefit Guaranty Corporation

As part of ERISA, Congress established the Pension Benefit Guaranty Corporation (PBGC), a Federal corporation within the Department of Labor, to insure the pension benefits of employees when defined benefit pension plans terminate with assets insufficient to satisfy the plan's liability to provide benefits to participants.

Employee stock ownership plans

An ESOP is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan which is designed to be invested primarily in employer securities and which may be utilized as a technique of corporate finance. Under an ESOP, employer stock is acquired for the benefit of employees. ESOPs are accorded preferential tax treatment under the Code as an incentive for corporations to finance their capital requirements or their transfers of ownership in such a way that employees have an opportunity to gain an equity interest in their employer. Thus, ESOPs are exempt from tax under the rules generally applicable to qualified pension plans and, subject to statutory limitations, employer contributions to an ESOP are tax deductible. Further, special tax rules apply to leveraged ESOPs that are not available to other types of qualified pension plans.[11]

Under the Code and ERISA, ESOPs have the unique ability (unavailable to any other type of qualified pension plan) to borrow from the employer to acquire employer securities, or to acquire employer securities with a loan guaranteed by the employer. This feature makes ESOPs particularly attractive as a technique of corporate finance.

Leveraged ESOPs

Under a leveraged ESOP, the employer makes contributions to repay the acquisition loan and to pay interest on the loan. An employer may deduct the full amount of any contribution to a leveraged ESOP that is used by the ESOP to pay interest on a loan to purchase employer securities and may deduct amounts used to repay loan principal in amounts up to 25 percent of payroll costs. The employer securities acquired by the ESOP are held in a suspense account and are allocated over time as the acquisition loan is repaid.

E. Treatment of Certain Expenditures Incurred in Connection with Acquisitions and Similar Transactions

The Federal income tax treatment of expenditures incurred in connection with certain transactions that may alter the ownership or control of a business depends upon whether the expenditures are characterized as ordinary and necessary business expenses or as capital expenditures. Ordinary and necessary business expenses are allowed as a deduction for the year in which paid or incurred. Capital expenditures are not immediately deductible but must be capitalized. Amounts that are capitalized generally may be recovered through amortization or depreciation but only over the period to which they relate, and only if that period is reasonably determinable. Under these standards, expenditures to acquire equity or to acquire the stock of another corporation are generally capitalized and not deductible. Expenditures to obtain debt financing are generally capitalized and may generally be recovered over the period of the debt financing to which they relate.

In National Starch and Chemical Corp. v. Commissioner[12]

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[11] For example, a financial institution that lends to an ESOP may exclude from income 50 percent of the interest received with respect to the loan (sec. 133), and the employer maintaining the ESOP may deduct dividends on employer securities held by the ESOP if certain requirements are satisfied (sec. 404(k)). Provisions currently pending would modify the ability to obtain the section 133 exclusion. See the Revenue Reconciliation Act of 1989 (H.R. 3299) as passed by the House and amended by the Senate (sec. 11311 of the House bill and sec. 6311 of the Senate amendment). In addition, section 11312 of the House bill would also modify section 404(k).

the Tax Court addressed the treatment of expenditures paid by a corporation in connection with the exploration and consummation of its friendly acquisition by another corporation. The taxpayer deducted the expenditures as ordinary and necessary business expenses, contending that the expenditures did not relate to the acquisition of a specific and identifiable asset. However, the Tax Court held that the expenditures were nondeductible capital expenditures because the taxpayer's board of directors determined it would be in the taxpayer's long term interest to transfer ownership of the stock to the acquiror and expenditures relating to a taxpayer's permanent betterment are capital in nature.

Prior to this decision, an Internal Revenue Service technical advice memorandum had concluded that expenditures incurred to ward off a hostile takeover were immediately deductible.[13] However, it has been reported that this technical advice memorandum was withdrawn following the decision in the <u>National Starch and Chemical Corp.</u> case.[14]

The Internal Revenue Service has ruled that expenses incurred to wage a proxy fight for control of the board of directors, relating to issues of corporate policy, are deductible as ordinary and necessary business expenses. <u>See</u>, Rev. Rul. 67-1, 1967-1 C.B. 28, acquiescing in and following <u>Locke Manufacturing Cos.</u> v. <u>U.S.</u>, 237 F. Supp. 80 (D.Conn. 1965); <u>see also Central Foundry Co. v. Commissioner</u>, 49 T.C. 234 (1967).

F. Excise Taxes for the Airport and Airway Trust Fund

Excise taxes are imposed on air transportation and some fuels in order to finance aviation-related expenditures from the Airport and Airway Trust Fund (AATF).

The excise taxes which are transferred to the AATF are (1) an 8-percent tax on air passenger transportation, (2) a 5-percent tax on air freight, (3) a $3 per passenger international departure tax, (4) a 12 cents-per-gallon tax on gasoline used in noncommercial aviation, and (5) a tax of 14 cents-per-gallon on jet fuel used in noncommercial aviation. These taxes are in effect through December 31, 1990.

Expenditures may be made from the AATF only for purposes which are specified in the AATF statute in the Internal Revenue Code. In fiscal year 1988, expenditures were made

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[12] 93 T.C. No. 7 (July 24, 1989).
[13] TAM 8927005

[14] <u>Wall Street Journal</u> p. 1 (Tax Report), September 20, 1989.

from the Trust Fund for Federal Aviation Administration (FAA) operations, grants-in-aid for airport construction and improvement, air navigation facilities and equipment, and research, engineering, and development, and NOAA weather services.

Under present law, the excise taxes, other than the international departure tax, will be reduced by 50 percent on January 1, 1990, because appropriations for fiscal years 1988 and 1989 for airport improvement and construction, facilities and equipment, and research, engineering, and development were less than 85 percent of the authorized levels of spending.[15]

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15 In the Revenue Reconciliation bill (H.R. 3299), as passed by the House, there is a provision to suspend the reduction in aviation-related excise taxes for one year to January 1, 1991. The Transportation appropriation bill for fiscal year 1990 (H.R. 3015) provides funds for increased levels of airport improvement and construction, facilities and equipment, and research, engineering, and development, as well as some increase in FAA operations outlays.

In the Senate amendment to H.R. 3299, the automatic reduction in AATF excise taxes is deferred until October 1, 1990, and it will go into effect if the relevant appropriations accounts provide less than 85 percent of the authorizations for those accounts for fiscal years 1989 and 1990.

III. TAX ISSUES RELATING TO THE AIRLINE INDUSTRY

A. Airline Mergers

Merger and leveraged buyout activity in the economy accelerated contemporaneously with the increase of mergers in the airline industry. Most observers believe, however, that the spate of mergers, acquisitions, and buyouts in the airline industry is in response to deregulation and the resulting significant changes in the structure of the industry, and is not motivated primarily by tax considerations.

The transformation from a highly regulated industry to a deregulated one involved significant changes in the size and operations of individual carriers. Several of the existing airlines merged in an attempt to form a more competitive route structure, reduce costs, or avoid bankruptcy. In addition, many of the new entrants, failed or were acquired (often as an alternative to bankruptcy).

There is much debate regarding the motivation and benefits of the most recent round of airline mergers.[16] Supporters argue that consolidation permits more efficient route structures. In particular, efficient hub-and-spoke route networks permit airlines to transport a larger number of passengers from a wider range of cities more efficiently than would otherwise be possible. Under this view, it is necessary to have a route structure of sufficient scale and scope to generate the full efficiencies from the hub-and-spoke structure and to permit airlines to compete effectively. In addition, consolidation may reduce costs by eliminating duplicative resources.

Others argue that consolidation reduces competition in the airline industry. The creation of large hubs at certain airports may create a "fortress airport" from which the carrier is relatively secure from competition from other carriers. This may permit the carrier to charge above competitive prices for certain flights to and from the hub. Some are also concerned that large carriers, through the use of frequent flyer programs and computerized reservation services, may encourage mergers of smaller airlines so that they are able to compete effectively against the large carriers. Lastly, some argue that competition for limited

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[16] See, for example, Michael E. Levine, "Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy," Yale J. of Regulation, v. 4, no. 2, Spring 1987, and Steven A. Morrison and Clifford Winston, "Enhancing the Performance of the Deregulated Air Transportation System," Brookings Papers on Economic Activity, Microeconomics, 1989.

airport gate space, landing slots, and planes may motivate the acquisition of certain airlines in order to gain access to these resources.

Tax policy

The general tax policy issues surrounding mergers apply with equal force to the air transportation industry. To the extent there are tax policy problems highlighted by airline mergers, these issues could be addressed in general terms that would affect all industries. If perceived problems in the airline industries are due to conditions specific to the airline industry, then a more targeted change may be desired. Unless the specific issues relevant to the airline industry stem from problems with existing tax rules, changes other than to tax rules, perhaps to antitrust or transportation regulatory policy, may be desired.

B. Airline Debt

In general

The average level of debt, by some measures, has increased in the capital structure of nonfinancial corporations in the economy between 1980 and 1987.[17] Although there are numerous reasons and methods for changing levels of debt, the increased use of debt commonly is associated with merger activity. Leveraged buyouts may represent the most dramatic manifestation of the use of corporate debt.

A great deal of attention has been focussed on the level and use of corporate debt generally. Concern has been expressed regarding the potential risks that may be imposed on investors, issuers, employees and the economy from increased debt levels. The role of debt in mergers and the role of tax policy in encouraging the use of debt has been the focus of scrutiny.

Sources of risk in airline debt

The general issues regarding the role of debt and the tax incentives for debt apply equally to the airline industry. Certain issues, however, may be particularly relevant to the airline industry.

The demand for air passenger travel generally is sensitive to the condition of the economy and, thus, the

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17 Joint Committee on Taxation, Federal Income Tax Aspects of Corporate Financial Structures, (JCS-1-89), January 1989, contains an extensive discussion of issues associated with debt and equity.

fortunes of the airline industry depend on the state of the business cycle. Corporations in cyclical industries are generally viewed as riskier than corporations in more stable industries and, thus, the debt of cyclical firms may be riskier than corporate debt in more stable industries at the same level of debt. This effect may be most important in the case of a leveraged buyout where fluctuations in the cash flow of the firm is most likely to affect the firm's ability to meet interest payments. Thus, high levels of debt, and leveraged buyouts in particular, in the airline industry may be viewed as riskier than similar debt in more stable industries.

Other attributes of the airline industry may make debt less risky than would otherwise be the case. A major portion of the assets of air carriers consists of airplanes and airport leases. These assets, particularly airplanes, are readily marketable and have economic value independent of the performance of the airline that owns them. Lenders may be willing to lend to a degree they would not otherwise if the airplanes are used as security. The lender's ability to readily sell aircraft in case of loan default make these loans less risky than they otherwise would be. In general, it is reported that airline lending following deregulation is dominated by loans secured by the airline's assets.[18]

Leasing and debt

A sale and leaseback of airline assets may permit airlines to obtain funds in a manner similar to a financing arrangement. The sale of aircraft may generate cash that could be used to pare down other debt. Depending on the accounting treatment of a particular sale and leaseback transition and the level of debt attributable to the aircraft prior to the sale, the transaction may serve to reduce the reported debt-equity ratio of the airline without a significant change in the airline's economic situation. In addition, because a portion of accelerated depreciation is treated as a preference item, a sale and leaseback that transfers ownership for tax purposes also may be advantageous to firms which are on the alternative minimum tax system.

Effect of debt levels on air safety

It has been argued that air carriers with high levels of debt may scrimp on maintenance and safety expenditures in order to meet interest payments. Maintenance is an expenditure with little immediate visible impact but low levels of maintenance may increase the risk of accidents. More generally, some argue that the competitive, deregulated environment puts pressure on airlines to reduce maintenance

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18 Levine, <u>supra,</u> p. 436.

and safety efforts.

The evidence in support of this view is limited. The accident rate has continued to decline at a rate similar to the rate that preceded deregulation. Also, passengers may respond to air accidents by avoiding the airline following a crash which could impose a substantial economic cost on the carrier.

Of course, an airline near bankruptcy may not respond to market outcomes and may risk reducing maintenance efforts for short-term survival. This problem, although potentially important in leveraged buyout situations, would be relevant for any airline in financial distress regardless of the cause. Thus, regulatory oversight by the Federal Aviation Administration may be a more appropriate response to any safety problem than a specific new tax disincentive for debt. In addition, the FAA has authority to provide for safety related expenditures at least partially funded through the Airport and Airway Trust Fund.

C. Pensions and ESOPs in Mergers and Buyouts

The general pension and ESOP issues relating to mergers and acquisitions apply equally to the airline industry. These issues are discussed below.

<u>Excess pension assets</u>

Because excess assets are a ready source of cash, the existence of excess assets in a defined benefit pension plan may make a company attractive as a target, and some transactions have involved the termination of a defined benefit pension plan in order to help finance the acquisition. In addition, existing management may terminate a plan and recover the excess assets as part of takeover activity, for example, in order to make the company a less attractive target or to use the funds in its own takeover initiatives.

Whether the employees benefit or are hurt by a plan termination depends on what type of plan, if any, the employer maintains following the termination.

<u>Leveraged buyouts and plan solvency</u>

Leveraged buyout transactions may affect the solvency of defined benefit pension plans and increase the risk to the Pension Benefit Guaranty Corporation (PBGC) and plan participants. A company that has undergone a leveraged buyout may experience cash flow difficulties and therefore may have difficulty satisfying its funding obligation with respect to the plan, with the result that the plan becomes underfunded. To the extent that a leveraged buyout or acquisition improves the financial position of a firm that is failing, however, the transaction may result in increased funding of the pension plan due to the improved performance of the company.

If a company with an underfunded pension plan is in financial distress, the company may terminate the plan, and the PBGC pays guaranteed benefits to plan participants to the extent such benefits cannot be paid from plan assets. The PBGC attempts to recoup at least a portion of its benefit payments from the company. If a company is highly leveraged, the assets of the company may be depleted to the point that there are insufficient assets to pay all creditors. In that case, the PBGC will generally not be able to recoup its benefit payments and will suffer a loss that is borne by the Federal government.

To the extent that airline companies are highly leveraged, the issue of potential increased risk to the PBGC may arise.

Role of leveraged ESOPs in corporate finance

Because leveraged ESOPs provide a source of cash to the sponsoring corporation, they may be advantageous in a variety of situations. For example, a leveraged ESOP may be used not only to provide the company with working capital, but also to finance an acquisition of the assets or stock of another corporation, including a leveraged buyout. A leveraged ESOP may also be used defensively to prevent a hostile takeover, to take a company private, or as part of a friendly leveraged buyout. The establishment of an ESOP may also involve the termination of an overfunded defined benefit pension plan because the excess assets may be used to acquire employer securities for the ESOP.

Because of the tax advantages of ESOP leveraging, use of an ESOP may result in a lower cost of borrowing than if traditional financing were used. Moreover, because of the rules relating to the voting of stock held by an ESOP, a sale of stock to the ESOP will not necessarily dilute management's control of the company to the same degree as a sale to outside parties.

The proposed United Airline buyout led by management and the pilots' union, for example, involves a leveraged ESOP.

D. Frequent Flyer Programs

It is believed by some that frequent flyer programs provide a competitive advantage to large airlines with extensive route networks because travelers may accumulate awards more easily on an airline with a large number of flights and city connections. In addition, large airlines may fly to more distant and exotic locales, which may be desirable destinations for some travelers. Travelers may be more attracted to large airlines with frequent flyer programs that permit the utilization of frequent flyer awards for travel to such locales. Consequently, frequent flyer programs may induce more brand loyalty to a large airline than a small one. Thus, frequent flyer programs may give larger airlines a competitive advantage over smaller ones, all else being equal. It is also believed that the competitive advantage afforded by a large frequent flyer program may provide an incentive for airline consolidation.[19] To the extent that income tax is collected on certain frequent flyer benefits, frequent flyer programs may become less attractive and therefore the incentive for airline consolidation may be reduced.

Others believe that all airlines are able to offer frequent flyer programs and can design award structures that are as attractive to potential passengers as those offered by larger airlines. Some smaller airlines, for example, offer frequent flyer programs in conjunction with large foreign airlines, which enables the smaller airlines to include in their programs some distant and exotic locales that are not offered by large domestic airlines.

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19 Morrison and Winston, supra.

IV. DESCRIPTION OF H.R. 2354

Explanation of the Bill

H.R. 2354, introduced by Mr. Dorgan and others on May 16, 1989, would deny the deduction for interest payments on debt used in certain takeovers in the airline industry. Specifically, the interest deduction would be disallowed in cases where debt exceeding $100 million is incurred to acquire more than 50 percent of the stock of a "major airline", if (1) a significant portion of the acquisition is pursuant to a hostile offer, (2) the debt consists of junk bonds, or (3) the debt-equity ratio of the issuing corporation immediately after the acquisition is greater than 1 to 1 and increased by at least 50 percent as a result of the acquisition.

For these purposes, a junk bond is defined as a bond that (1) is subordinated either to the claims of trade creditors or to a substantial amount of the corporation's unsecured debt, (2) has a yield to maturity in excess of 135 percent of the applicable federal rate, (3) has a below-investment-grade rating from a nationally recognized rating agency, or (4) has other equity features. A major airline is any corporation so treated by the Department of Transportation and any corporation which is a member of an affiliated group (as defined in sec. 1504) which includes a major airline (as defined by the Department of Transportation).

Effective Date

The provisions of the bill would apply to indebtedness incurred after May 16, 1989.