

Notice of Proposed Rulemaking and Notice of Public Hearing

Section 467 Rental Agreements

IA-292-84

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the treatment of rent and interest under certain agreements for the lease of tangible property. The proposed regulations apply to certain rental agreements that provide increasing or decreasing rents, or deferred or prepaid rent. This document also provides notice of a public hearing on these regulations.

DATES: Written comments, requests to appear and outlines of topics to be discussed at the public hearing scheduled for September 25, 1996, must be received by September 3, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (IA-292-84), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (IA-292-84), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. The public hearing will be held in the Commissioner's Conference Room, 3rd Floor, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Forest Boone of the Office of Assistant Chief Counsel (Income Tax and Accounting) at (202) 622-4960; concerning submissions and the public hearing, Mike Slaughter at (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regula-

tions (26 CFR part 1) relating to section 467 of the Internal Revenue Code (Code). This section was added by the Tax Reform Act of 1984. In general, section 467 requires parties to certain rental agreements to accrue rent and interest in accordance with the rules specified in section 467. These proposed regulations provide guidance regarding the applicability of section 467, and the amount of rent and interest required to be accrued under section 467. No inference should be drawn from any provision in the proposed regulations concerning whether an arrangement constitutes a lease for Federal income tax purposes.

Explanation of Provisions

1. Section 467 rental agreements

Section 467(a) provides that, if a rental agreement is a section 467 rental agreement, the lessor and lessee must take into account for a taxable year the section 467 rent and the section 467 interest for that year. A section 467 rental agreement is a rental agreement that has increasing or decreasing rents, or prepaid or deferred rents. A rental agreement has increasing or decreasing rents if the annualized fixed rent allocated to any rental period exceeds the annualized fixed rent allocated to any other rental period in the lease term. The proposed regulations provide that a rent holiday at the beginning of the lease term is disregarded in determining whether the rental agreement has increasing or decreasing rent if the rent holiday period is three months or less.

In addition, the proposed regulations provide that a rental agreement has increasing or decreasing rent if it requires (or may require) the payment of contingent rent, other than contingent rent that is contingent due to (a) a provision computing rent based on a percentage of the lessee's gross or net receipts (but only if the percentage does not vary throughout the term of the lease); (b) adjustments based on a reasonable price index; or (c) a provision requiring the lessee to pay real estate taxes, insurance premiums, maintenance costs, or any other cost (other than a debt service cost) that relates to the leased property and is not within

the control of the lessor or lessee or a person related to the lessor or lessee.

Section 467(d)(1)(A) provides that a rental agreement has deferred rent if rent allocated to a calendar year is payable after the close of the succeeding calendar year. The proposed regulations provide that there is prepaid rent if rent allocated to a calendar year is payable prior to the beginning of the prior calendar year.

Section 467(d)(2) provides that section 467 does not apply to a rental agreement if the aggregate rental payments and other consideration to be received for the use of the property do not exceed \$250,000.

2. Section 467 rent

Under the proposed regulations, the section 467 rent for a taxable year is the sum of the fixed rent for any rental periods that begin and end in the taxable year, a ratable portion of the fixed rent for other rental periods beginning or ending in the taxable year, and any contingent rent that accrues in the taxable year. In general, the proposed regulations provide that rental periods may be of any length as long as (a) the rental periods are one year or less, cover the entire lease term, and do not overlap, and (b) each scheduled payment under the rental agreement occurs within 30 days of the beginning or end of a rental period. The amount of fixed rent for a rental period depends on the terms of the rental agreement.

A. Disqualified leaseback or long-term agreement

Section 467 provides that if the section 467 rental agreement is a leaseback or long-term agreement and has increasing or decreasing rents a principal purpose of which is tax avoidance (a disqualified leaseback or long-term agreement), the fixed rent for each rental period is the constant rental amount. The proposed regulations provide that (a) the Commissioner, rather than the parties to the rental agreement, will determine whether a rental agreement is a disqualified leaseback or long-term agreement and (b) a rental agreement will not be disqualified unless it requires more than \$2,000,000

in rental payments and other consideration. The proposed regulations also provide that, if either the lessor or the lessee is not subject to Federal income tax on its income or is a tax-exempt entity (within the meaning of section 168(h)(2)), the rental agreement will be closely scrutinized, and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent.

Section 467(b)(5) provides that regulations should set forth circumstances under which section 467 rental agreements will not be treated as disqualified leasebacks or long-term agreements, including circumstances relating to the use of price indices, percentage rents, reasonable rent holidays, or changes in amounts paid to third parties. In addition to these safe harbors, which have been included in the proposed regulations, the Conference Committee Report stated that the Committee anticipated that regulations under section 467 would adopt standards under which leases providing for fluctuations in rents by no more than a reasonable percentage above or below the average rent over the term of the lease will be deemed not motivated by tax avoidance. The report cited the standards for advance rulings on leveraged lease transactions set forth in Rev. Proc. 75-21 (1975-1 C.B. 715), and stated that such standards may not be appropriate for real estate leases. H.R. Rep. No. 861, 98th Cong., 2d Sess. 893 (1984).

The proposed regulations contain a safe harbor providing that tax avoidance will not be considered to be a principal purpose for providing increasing or decreasing rents if the rents allocable to each calendar year of the lease do not vary from the average annual rents over the entire lease term by more than 10 percent. This safe harbor is based on, but is not identical to, the safe harbor contained in Rev. Proc. 75-21. The proposed regulations do not provide a safe harbor specifically applicable to real estate leases. The IRS and the Treasury Department invite comments regarding the nature and extent of a safe harbor for such leases, as well as comments on whether additional safe harbors are appropriate either generally or for particular industries.

Section 467(e)(1) provides that the constant rental amount is the amount

that, if paid at the end of each rental period, would result in a present value equal to the present value of all amounts payable under the disqualified leaseback or long-term agreement. If constant rental accrual is required, all rental periods must be equal in length except for an initial or final short rental period.

B. Agreements without adequate interest

If the section 467 rental agreement is not a disqualified leaseback or long-term agreement and does not provide adequate interest for prepaid or deferred rent, the proposed regulations provide that the fixed rent for each rental period is the proportional rental amount. The proportional rental amount is the fixed rent allocated to the rental period under the rental agreement multiplied by a fraction, the numerator of which is the present value of the amounts payable as fixed rent and interest on fixed rent under the rental agreement and the denominator of which is the present value of the fixed rent allocated to each rental period under the rental agreement. Under the proposed regulations, a rental agreement provides adequate interest if (a) no deferred or prepaid rent is required under the agreement, (b) there is deferred or prepaid rent but the agreement requires the payment of interest at an adequate single fixed rate, or (c) there is deferred or prepaid rent but the present values of rent payments and rent accruals meet certain tests set forth in the proposed regulations.

C. Rental agreement accrual

The proposed regulations provide that if neither the constant rental amount nor the proportional rental amount is required to be accrued, the fixed rent for a rental period is the fixed rent allocated to that rental period in accordance with the section 467 rental agreement. The amount of fixed rent allocated to a rental period by the rental agreement depends on whether the agreement provides a specific allocation of fixed rent. The proposed regulations provide that if a rental agreement provides a specific allocation of fixed rent, the amount of fixed rent allocated to each rental period during the lease term is the amount of rent allocated to that period by the

agreement. For this purpose, a rental agreement that allocates rent to a period is treated as allocating rent ratably within that period. Thus, if a rental agreement provides that \$120,000 is allocated to each calendar year in the lease term, \$10,000 of rent is allocated to each calendar month. In general, under the proposed regulations, a rental agreement specifically allocates fixed rent if the agreement unambiguously specifies, for periods of no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during that period.

If a section 467 rental agreement does not provide a specific allocation of fixed rent, the amount of fixed rent allocated to a rental period is the amount of fixed rent payable during that rental period.

3. Section 467 interest

The section 467 interest for a taxable year is the sum of the interest on fixed rent for any rental period that begins and ends in the taxable year, a ratable portion of the interest on fixed rent for any other rental period beginning or ending in the taxable year, and any interest that accrues on contingent rent during the taxable year. If a section 467 rental agreement provides an adequate stated rate of interest, the interest on fixed rent for a rental period is the interest provided in the agreement for that period. If no adequate stated rate of interest is provided, the interest on fixed rent for a rental period is determined under the section 467 loan rules.

Under the proposed regulations, there is a deemed loan (a section 467 loan) in a rental period if, at the beginning of that period, there is a difference between the amount of fixed rent payable under the section 467 rental agreement and the amount of fixed rent required to be accrued under the proposed regulations. For rental periods in which there is a section 467 loan, the interest for the rental period is equal to the product of the principal balance of the section 467 loan at the beginning of the rental period and the yield of the section 467 loan.

In general, the principal balance of a section 467 loan as of the beginning of any rental period is the difference between the cumulative amount of accrued fixed rent and interest and the

cumulative amount of fixed rent and interest payable under the section 467 rental agreement. The yield of a section 467 loan is the discount rate at which the sum of the present values of all amounts payable by the lessee as fixed rent and interest on fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest on prepaid fixed rent, equals the sum of the present values of the fixed rent allocated to the rental periods.

The amount constituting a section 467 loan may be either positive or negative. For purposes of applying any aspect of the proposed regulations relating to a section 467 loan, the principal balance of the loan should be clearly identified as either positive or negative. For example, if the principal balance of a loan at the beginning of a rental period is a negative number, the interest on the loan for that period will also be a negative number.

4. *Rental agreements with variable rates of interest*

The proposed regulations provide rules for section 467 rental agreements that provide for certain types of variable rates of interest. The rules in the proposed regulations are similar to the rules provided in §1.1275-5 for the computation of original issue discount (OID) for variable rate debt instruments providing for interest at qualified floating rates. Under the proposed regulations, a rental agreement provides variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that meet the requirements of §1.1275-5(a)(3)(i)(A) or (B) and §1.1275-5(a)(4). If a rental agreement provides for fluctuations in interest other than pursuant to one or more qualified floating rates the interest will be subject to the rules for contingent payments.

Under the proposed regulations, if a section 467 rental agreement provides variable interest, the fixed rate substitutes (determined in the same manner as under §1.1275-5(e) treating the agreement date as the issue date) for the variable rates of interest called for by the agreement must be used in computing the proportional rental amount, the constant rental amount, the principal balance of a section 467 loan, and the yield of a section 467 loan.

Further, in determining the interest on fixed rent for any rental period, the variable interest adjustment amount must be taken into account. The variable interest adjustment amount for a rental period is the difference between (a) the amount of interest that would have accrued during the rental period under the terms of the rental agreement, and (b) the amount of interest that would have accrued during the rental period under the terms of the agreement using the fixed rate substitutes.

5. *Rental agreements with contingent payments*

The proposed regulations reserve on the issue of the section 467 treatment of contingent rent. The IRS and the Treasury Department anticipate that regulations addressing this issue will provide rules for contingent rent similar to those provided for computing OID for contingent payment debt instruments in §1.1275-4. The IRS and the Treasury Department invite comments regarding the application of the §1.1275-4 rules to section 467 rental agreements.

6. *Recapture*

Section 467(c) provides that if a section 467 rental agreement is a leaseback or long-term agreement providing for increasing rent but is not subject to constant rental accrual, and the property subject to the agreement is disposed of, a portion of the gain realized on the disposition is required to be recaptured by the lessor as ordinary income. Accordingly, a leaseback or long-term agreement could be subject to section 467(c) even though it does not require more than \$2,000,000 in rental payments and other consideration and is thus not subject to constant rental accrual.

The recapture amount is equal to the lesser of the prior understated inclusions or the section 467 gain. The prior understated inclusions are the excess of (a) the aggregate amount of section 467 rent and section 467 interest for the period during which the lessor held the property, determined as if the section 467 rental agreement were a disqualified leaseback or long-term agreement, over (b) the aggregate amount of section 467 rent and section 467 interest accrued by the lessor during

that period. The section 467 gain is the excess of (a) the amount realized from the disposition, over (b) the sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income under any provision of subtitle A of the Code other than section 467(c) (e.g., section 1245 or 1250).

In the case of a disposition that is not a sale, exchange, or involuntary conversion, the section 467 gain is the excess of (a) the fair market value of the property on the date of disposition, over (b) the sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income under Code provisions other than section 467(c). The regulations provide exceptions to this recapture rule for dispositions by gift, transfers at death, and certain tax-free transactions.

7. *Other disposition rules*

Under the proposed regulations, if property subject to a section 467 rental agreement is sold, exchanged, or otherwise disposed of, the section 467 rent for a period is taken into account by the owner of the property during the period. The lessee, however, must continue to take section 467 rent and section 467 interest into account without regard to the change of ownership.

Further, if there is a sale, exchange or other disposition of property subject to a section 467 rental agreement, the beginning balance of the transferor's section 467 loan after the transfer equals the net present value at the time of the transfer of all amounts subsequently payable as fixed rent and interest on fixed rent to the transferor and all amounts subsequently payable as interest on prepaid fixed rent by the transferor. The transferor must continue to take into account interest on the transferor's section 467 loan balance after the transfer. The beginning balance of the transferee's section 467 loan is equal to the principal balance of the section 467 loan immediately before the transfer reduced by the beginning balance of the transferor's section 467 loan after the transfer. Amounts payable to the transferor after the transfer are not taken into account in adjusting the transferee's section 467 loan balance.

Finally, under the proposed regulations, if there is a disposition of

property subject to a section 467 rental agreement, the transferor and transferee must treat the beginning balance of the transferee's section 467 loan as a liability that is either assumed in connection with the transfer of the property or secured by the property acquired subject to the liability (if negative) and as a reduction in the consideration for the transfer of the property (if positive). In the case of a positive section 467 loan balance, a reduction in the consideration for the transfer of the property is appropriate because the transferee will also be deemed to have acquired an asset other than the property itself, i.e., the loan, and a portion of the total consideration should be allocated to the loan balance. Similar rules apply to transfers of leasehold interests under section 467 rental agreements.

In order to account for any timing differences that may exist between a schedule of payments under a section 467 rental agreement and a separate schedule providing an allocation of rent, it will be necessary, in appropriate cases, to determine the amount of a section 467 loan balance even if the rental agreement does not have either deferred or prepaid rent or if the rental agreement has deferred or prepaid rent but provides adequate stated interest. The proposed regulations provide that the section 467 loan rules apply to rental agreements described in the preceding sentence, but only for purposes of the rules relating to dispositions of property subject to a section 467 rental agreement and the rules relating to transfers of leasehold interests under a section 467 rental agreement.

Although the proposed regulations contain rules applicable to all dispositions of property subject to a section 467 rental agreement and all transfers of leasehold interests under a section 467 rental agreement, the regulations reserve guidance on the question of whether special rules should be provided for transfers of property and leasehold interests in transactions in which gain or loss is not recognized in whole or in part. Examples of these transactions would include transfers between a partnership and one or more of its partners, transfers to a controlled corporation under section 351, transfers pursuant to a reorganization described in section 368(a), like-kind exchanges subject to section 1031, and transfers

by gift or upon the death of the owner of the property or the holder of the leasehold interest. The IRS and Treasury Department invite comments on whether special rules should be provided for any of these transactions.

8. Proposed effective date

The regulations are proposed to be effective for (1) rental agreements entered into after the date that final regulations under section 467 are published and (2) disqualified leasebacks and long-term agreements entered into after June 3, 1996. No inference should be drawn from the proposed effective date concerning the treatment of rental agreements entered into before the regulations are applicable. Moreover, the IRS will, in appropriate circumstances, apply the provisions of section 467 requiring constant rental accrual to rental agreements entered into on or before June 3, 1996.

9. Issues not addressed

The proposed regulations do not address the application of section 467 to payments for services. The IRS and the Treasury Department invite comments on the appropriate scope of rules under section 467 for transactions involving deferred payments for services in light of the scope of section 404. In addition, the IRS and the Treasury Department invite comments on whether rules should be provided for transactions involving prepayments for services.

The proposed regulations do not address the application of section 467 to transactions sometimes referred to as "lease strips" or "stripping transactions", as described in Notice 95-53 (1995-44 I.R.B. 21). Notice 95-53 provides that regulations will be issued pursuant to section 7701(l) (and, as appropriate, other sections of the Code) recharacterizing stripping transactions. The IRS and the Treasury Department invite comments on whether rules should be provided that would apply section 467 to such transactions.

The proposed regulations do not provide for an adjustment to section 467 rent and interest where a section 467 rental agreement is modified. The IRS and the Treasury Department invite comments on the appropriate treatment of the lessor and lessee in these cases.

The proposed regulations do not provide rules addressing the treatment of payments by the lessor to induce a lessee to enter into a rental agreement.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these proposed regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 25, 1996 at 10 a.m. in the Commissioner's Conference Room, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and submit an outline of the topics to be discussed and the time to be devoted to each topic by September 3, 1996. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Forest Boone of

the Office of Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.467-1 is also issued under 26 U.S.C. 467.

Section 1.467-2 is also issued under 26 U.S.C. 467.

Section 1.467-3 is also issued under 26 U.S.C. 467.

Section 1.467-4 is also issued under 26 U.S.C. 467.

Section 1.467-5 is also issued under 26 U.S.C. 467.

Section 1.467-6 is also issued under 26 U.S.C. 467.

Section 1.467-7 is also issued under 26 U.S.C. 467.

Section 1.467-8 is also issued under 26 U.S.C. 467.

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Par. 2. In §1.61-8, the first sentence of paragraph (b) is revised to read as follows:

§1.61-8 Rents and royalties.

* * * * *

(b) * * * Except as provided in section 467 and the regulations thereunder, gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. * * *

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Par. 3. In §1.451-1, paragraph (g) is added to read as follows:

§1.451-1 General rule for taxable year of inclusion.

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(g) *Timing of income from section 467 rental agreements.* For the timing of income with respect to section 467 rental agreements, see section 467 and the regulations thereunder.

Par. 4. Section 1.461-1 is amended by:

1. Adding a sentence at the end of paragraph (a)(1).

2. Adding paragraph (a)(2)(iii)(E).

The additions read as follows:

§1.461-1. General rule for taxable year of deduction.

(a) * * * (1) * * * See section 467 and the regulations thereunder for rules under which a liability arising out of the use of property pursuant to a section 467 rental agreement is taken into account.

(2) * * *

(iii) * * *

(E) Except as otherwise provided by regulations or other published guidance issued by the Commissioner, in the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, the all events test (including economic performance) is considered met in the taxable year in which the liability is to be taken into account under section 467 and the regulations thereunder.

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Par. 5. Section 1.461-4 is amended by:

1. Revising the heading of paragraph (d)(3)(ii).

2. Redesignating the text of paragraph (d)(3)(ii) following the heading as paragraph (d)(3)(ii)(A) and adding a heading for newly designated paragraph (d)(3)(ii)(A).

2. Adding paragraph (d)(3)(ii)(B).

3. Adding sentence at the end of the introductory text of paragraph (d)(7).

The revisions and additions read as follows:

§1.461-4 Economic performance.

* * * * *

(d) * * *

(3) * * *

(ii) *Exceptions—(A) Volume, frequency of use, or income.* * * *

(B) *Section 467 rental agreements.* In the case of a liability arising out of the use of property pursuant to a

section 467 rental agreement, economic performance occurs as provided in §1.461-1(a)(2)(iii)(E).

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(7) * * * Assume further that the examples do not involve section 467 rental agreements and, therefore, section 467 is not applicable.

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Par. 6. Sections 1.467-0 through 1.467-8 are added to read as follows:

§1.467-0 Table of contents.

This section lists the major captions that appear in §§1.467-1 through 1.467-8.

§1.467-1 Treatment of lessors and lessees generally.

- (a) Overview.
 - (1) In general.
 - (2) Cases in which rules are inapplicable.
 - (3) Limited effect for rental agreements with total rents between \$250,000 and \$2,000,000.
 - (4) Summary of rules.
 - (i) Basic rules.
 - (ii) Special rules.
- (b) Method of accounting for section 467 rental agreements.
- (c) Section 467 rental agreements.
 - (1) In general.
 - (2) Increasing or decreasing rent.
 - (i) Fixed rent.
 - (A) In general.
 - (B) Certain rent holidays disregarded.
 - (ii) Fixed rent allocated to a rental period.
 - (A) Specific allocation.
 - (1) In general.
 - (2) Rental agreements specifically allocating fixed rent.
 - (B) No specific allocation.
 - (iii) Contingent rent.
 - (A) In general.
 - (B) Certain contingent rent disregarded.
- (3) Deferred or prepaid rent.
 - (i) Deferred rent.
 - (ii) Prepaid rent.
 - (iii) Rent allocated to a calendar year.

- (iv) Examples.
 - (4) Rental agreements involving total payments of \$250,000 or less.
 - (i) In general.
 - (ii) Special rules in computing amount described in paragraph (c)(4)(i).
 - (d) Section 467 rent.
 - (1) In general.
 - (2) Fixed rent for a rental period.
 - (i) Constant rental accrual.
 - (ii) Proportional rental accrual.
 - (iii) Section 467 rental agreement accrual.
 - (e) Section 467 interest.
 - (1) In general.
 - (2) Interest on fixed rent for a rental period.
 - (i) In general.
 - (ii) Section 467 rental agreements with adequate interest.
 - (3) Treatment of interest.
 - (f) Modification of a rental agreement.
 - (g) Treatment of amounts payable by essor to lessee.
 - (1) Interest.
 - (2) Other amounts. [Reserved]
 - (h) Meaning of terms.
 - (i) [Reserved]
 - (j) Computational rules.
 - (1) Counting conventions.
 - (2) Conventions regarding timing of rent and payments.
 - (i) In general.
 - (ii) Time amount is payable.
 - (3) Annualized fixed rent.
 - (4) Allocation of fixed rent within a period.
 - (5) Rental period length.
- §1.467-2 Rent accrual for section 467 rental agreements without adequate interest.*
- (a) Section 467 rental agreement for which proportional rental accrual is required.
 - (b) Adequate interest on fixed rent.
 - (1) In general.
 - (2) Section 467 rental agreements that provide for a variable rate of interest.
 - (c) Computation of proportional rental amount.
 - (1) In general.
 - (2) Section 467 rental agreements that provide for a variable rate of interest.
 - (d) Present value.
- (e) Applicable Federal rate.
 - (1) In general.
 - (2) Source of applicable Federal rates.
 - (3) 110 percent of applicable Federal rate.
 - (4) Term of the section 467 rental agreement.
 - (i) In general.
 - (ii) Section 467 rental agreements with variable interest.
 - (f) Examples.

§1.467-3 Disqualified leasebacks and long-term agreements.

 - (a) General rule.
 - (b) Disqualified leaseback or long-term agreement.
 - (1) In general.
 - (2) Leaseback.
 - (3) Long-term agreement.
 - (i) In general.
 - (ii) Statutory recovery period.
 - (A) In general.
 - (B) Special rule for leases of properties having different statutory recovery periods.
 - (c) Tax avoidance as principal purpose for increasing or decreasing rent.
 - (1) In general.
 - (2) Safe harbors.
 - (d) Calculating constant rental amount.
 - (1) In general.
 - (2) Initial or final short periods.
 - (3) Method to determine constant rental amount; no short periods.
 - (i) Step 1.
 - (ii) Step 2.
 - (iii) Step 3.
 - (e) Example.

§1.467-4 Section 467 loan.

 - (a) In general.
 - (1) Overview.
 - (2) No section 467 loan in the case of certain section 467 rental agreements.
 - (3) Rental agreements subject to constant rental accrual.
 - (4) Special rule in applying the provisions of §1.467-7(e) or §1.467-7(f).
 - (b) Principal balance.
 - (1) In general.
 - (2) Section 467 rental agreements that provide for prepaid fixed rent and adequate stated interest.
 - (3) Timing of payments.
 - (c) Yield.
 - (1) In general.
 - (i) Method of determining yield.
 - (ii) Method of stating yield.
 - (iii) Rounding adjustments.
 - (2) Yield of section 467 rental agreements for which constant rental amount or proportional rental amount is computed.
 - (3) Determination of present values.
 - (d) Contingent payments.
 - (e) Section 467 rental agreements that call for payments before or after the lease term.
 - (f) Examples.

§1.467-5 Section 467 rental agreements with variable interest.

 - (a) Variable interest on deferred or prepaid rent.
 - (1) In general.
 - (2) Exceptions.
 - (b) Variable rate treated as fixed.
 - (1) In general.
 - (2) Variable interest adjustment amount.
 - (i) In general.
 - (ii) Sign of adjustment.
 - (3) Section 467 loan balance.
 - (c) Examples.

§1.467-6 Section 467 rental agreements with contingent payments. [Reserved]

§1.467-7 Section 467 recapture and other rules relating to dispositions.

 - (a) Section 467 recapture.
 - (b) Recapture amount.
 - (1) In general.
 - (2) Prior understated inclusions.
 - (i) In general.
 - (ii) Partial rental periods.
 - (3) Section 467 gain.
 - (i) In general.
 - (ii) Certain dispositions.
 - (c) Special rules.
 - (1) Gifts.
 - (2) Dispositions at death.
 - (3) Certain tax-free exchanges.
 - (i) In general.
 - (ii) Dispositions covered.

- (4) Dispositions by transferee.
- (5) Like-kind exchanges and involuntary conversions.
- (6) Installment sales.
- (7) Dispositions covered by sections 170(e), 341(e)(12), or 751(c).
- (d) Examples.
- (e) Other rules relating to dispositions.
 - (1) In general.
 - (2) Treatment of section 467 loan.
 - (3) Special rules for transfers in certain nonrecognition transactions. [Reserved]
- (f) Treatment of assignments by lessee and lessee-financed renewals.
 - (1) Substitute lessee use.
 - (2) Lessor use.
 - (3) Special rules for transfers in certain nonrecognition transactions. [Reserved]

§1.467-8 Effective date.

§1.467-1 Treatment of lessors and lessees generally.

(a) *Overview*—(1) *In general.* When applicable, section 467 requires a lessor and lessee of tangible property to treat rents consistently and to use the accrual method of accounting regardless of their overall method of accounting. In addition, in certain cases involving tax avoidance, the lessor and lessee must take rent and stated or imputed interest into account under a constant rental method, pursuant to which time value of money principles are applied to treat the rent as having accrued ratably over the entire lease term.

(2) *Cases in which rules are inapplicable.* Section 467 applies only to leases (or other similar arrangements) that constitute section 467 rental agreements as defined in paragraph (c) of this section. For example, a rental agreement is not a section 467 rental agreement, and, therefore, is not subject to the provisions of this section and §§1.467-2 through 1.467-8 (the section 467 regulations), if it specifies equal amounts of rent for each month (or other similar period) throughout the lease term and all payments of rent are due in the year to which the rent relates (or in the preceding or succeeding year). In addition, the section 467 regulations do not apply to a rental agreement that requires total rents of

\$250,000 or less determined, for this purpose, by disregarding any adjustments based on a reasonable price index and the amount of any rent resulting from the lessee's obligation to pay certain third-party expenses of the lessor.

(3) *Limited effect for rental agreements with total rents between \$250,000 and \$2,000,000.* A rental agreement is a section 467 rental agreement, and, therefore, the section 467 regulations generally apply, if the agreement requires total rents of more than \$250,000 and does not specify equal amounts of rent for each month (or other similar period) throughout the lease term. If, however, the rental agreement requires total rents of \$2,000,000 or less (determined by disregarding adjustments and excluding the same types of rent that are disregarded or excluded for purposes of the \$250,000 threshold requirement) and all payments of rent are due in the year to which the rent relates (or in the preceding or succeeding year), the only effect of the section 467 regulations is to require the lessor and lessee to take rent into account in the year to which the rent relates.

(4) *Summary of rules*—(i) *Basic rules.* Paragraph (c) of this section provides rules for determining whether a rental agreement is a section 467 rental agreement. Paragraphs (d) and (e) of this section provide rules for determining the amount of rent and interest, respectively, required to be taken into account by a lessor and lessee under a section 467 rental agreement. Paragraphs (f) through (h) and (j) of this section provide various definitions and special rules relating to the application of the section 467 regulations.

(ii) *Special rules.* Section 1.467-2 provides rules for section 467 rental agreements that have deferred or prepaid rents without providing for adequate interest. Section 1.467-3 provides rules for application of the constant rental accrual requirement, including criteria for determining whether an agreement is subject to this requirement. Section 1.467-4 provides rules for establishing and adjusting a section 467 loan, the amount that a lessor is deemed to have loaned to the lessee, or vice versa, pursuant to the application of the section 467 regulations. Sections 1.467-5 and 1.467-6 provide rules for applying the section 467 regulations

where a rental agreement requires variable interest or certain contingent payments. Section 1.467-7 provides rules for the treatment of dispositions by a lessor of property subject to a section 467 rental agreement and the treatment of assignments by lessees and certain lessee-financed renewals of a section 467 rental agreement. Finally, §1.467-8 provides the effective date rules for the section 467 regulations.

(b) *Method of accounting for section 467 rental agreements.* If a rental agreement is a section 467 rental agreement, as described in paragraph (c) of this section, the lessor and lessee must each take into account for any taxable year—

(1) The section 467 rent for the taxable year (as defined in paragraph (d) of this section); and

(2) The section 467 interest for the taxable year (as defined in paragraph (e) of this section).

(c) *Section 467 rental agreements*—

(1) *In general.* Except as otherwise provided in paragraph (c)(4) of this section, the term *section 467 rental agreement* means a rental agreement, as defined in paragraph (h) of this section, that has increasing or decreasing rents (as described in paragraph (c)(2) of this section), or prepaid or deferred rents (as described in paragraph (c)(3) of this section).

(2) *Increasing or decreasing rent*—(i) *Fixed rent*—(A) *In general.* A rental agreement has increasing or decreasing rent if the annualized fixed rent, as described in paragraph (j)(3) of this section, allocated to any rental period exceeds the annualized fixed rent allocated to any other rental period in the lease term.

(B) *Certain rent holidays disregarded.* Notwithstanding the provisions of paragraph (c)(2)(i)(A) of this section, a rental agreement does not have increasing or decreasing rent if the increasing or decreasing rent is solely attributable to a rent holiday provision allowing reduced rent (including no rent) for a period at the beginning of the lease term, but only if the duration of the rent holiday does not exceed three months.

(ii) *Fixed rent allocated to a rental period*—(A) *Specific allocation*—(1) *In general.* If a rental agreement provides a specific allocation of fixed rent, as described in paragraph (c)(2)(ii)(A)(2) of this section, the amount of fixed rent

allocated to each rental period during the lease term is the amount of fixed rent allocated to that period by the rental agreement.

(2) *Rental agreements specifically allocating fixed rent.* A rental agreement specifically allocates fixed rent if the rental agreement unambiguously specifies, for periods no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during that period, and the total amount of fixed rent specified is equal to the total amount of fixed rent payable under the lease. For example, a rental agreement providing that rent is \$100,000 per calendar year, and that provides for total payments of fixed rent equal to the total amount specified, specifically allocates rent. Similarly, a rental agreement that states the amount of rent accruing each month or the amount of rent allocated to each year contains a specific allocation if the total payments of fixed rent equal the total amount specified. A rental agreement stating only when rent is payable does not specifically allocate rent.

(B) *No specific allocation.* If a rental agreement does not provide a specific allocation of fixed rent (for example, because the total amount of fixed rent specified is not equal to the total amount of fixed rent payable under the lease), the amount of fixed rent allocated to a rental period is the amount of fixed rent payable during that rental period. If an amount of fixed rent is payable before the beginning of the lease term, it is allocated to the first rental period in the lease term. If an amount of fixed rent is payable after the end of the lease term, it is allocated to the last rental period in the lease term.

(iii) *Contingent rent*—(A) *In general.* A rental agreement has increasing or decreasing rent if it requires (or may require) the payment of contingent rent (as defined in paragraph (h) of this section), other than contingent rent described in paragraph (c)(2)(iii)(B) of this section.

(B) *Certain contingent rent disregarded.* Contingent rent is disregarded for purposes of this paragraph (c)(2)(iii) to the extent—

(1) The rent is contingent solely as the result of a provision pursuant to which the rent is equal to a percentage of the lessee's receipts (gross or net), but only if the percentage does not vary throughout the term of the lease;

(2) The rent is contingent solely as the result of an adjustment based on a reasonable price index, as defined in paragraph (h) of this section; or

(3) The rent is contingent solely as the result of a provision requiring the lessee to pay third-party costs, as defined in paragraph (h) of this section.

(3) *Deferred or prepaid rent*—(i) *Deferred rent.* A rental agreement has deferred rent under this paragraph (c)(3) if the amount of rent allocated to a calendar year (determined under paragraph (c)(3)(iii) of this section), when added to the rent allocated to all preceding calendar years, exceeds the cumulative amount of rent payable as of the close of the succeeding calendar year.

(ii) *Prepaid rent.* A rental agreement has prepaid rent under this paragraph (c)(3) if the amount of rent allocated to a calendar year (determined under paragraph (c)(3)(iii) of this section), when added to the rent allocated to all preceding calendar years, is less than the cumulative amount of rent payable before the beginning of the preceding calendar year.

(iii) *Rent allocated to a calendar year.* For purposes of this paragraph (c)(3), the rent allocated to a calendar year is the sum of—

(A) The fixed rent allocated to any rental period (determined under paragraph (c)(2)(ii) of this section) that begins and ends in the calendar year;

(B) A ratable portion of the fixed rent allocated to any other rental period that begins or ends in the calendar year; and (C) Any contingent rent that accrues during the calendar year as provided in §1.467-6.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(3):

Example 1. (i) A and B enter into a rental agreement that provides for the lease of property to begin on January 1, 1997, and end on December 31, 2000. The rental agreement provides that rent of \$100,000 accrues during each year of the lease term. Under the rental agreement, no rent is payable during calendar year 1997, a payment of \$100,000 is to be made on December 31, 1998, and December 31, 1999, and a payment of \$200,000 is to be made on December 31, 2000. A and B both select the calendar year as their rental period. Thus, under paragraph (c)(3)(iii) of this section, the amount of rent allocated to each rental period under paragraph (c)(2)(ii) of this section is \$100,000. Therefore, the rental agreement does not have increasing or decreasing rent as described in paragraph (c)(2)(i) of this section.

(ii) Under paragraph (c)(3)(i) of this section, a rental agreement has deferred rent if, at the close of a calendar year, the cumulative amount of rent allocated under paragraph (c)(3)(iii) of this section exceeds the cumulative amount of rent payable as of the close of the succeeding year. In this example, there is no deferred rent: the rent allocated to 1997 (\$100,000) does not exceed the cumulative rent payable as of December 31, 1998 (\$100,000); the rent allocated to 1998 and preceding years (\$200,000) does not exceed the cumulative rent payable as of December 31, 1999 (\$200,000); the rent allocated to 1999 and preceding years (\$300,000) does not exceed the cumulative rent payable as of December 31, 2000 (\$400,000); and the rent allocated to 2000 and preceding years (\$400,000) does not exceed the cumulative rent payable as of December 31, 2001 (\$400,000). Therefore, because the rental agreement does not have increasing or decreasing rent and does not have prepaid or deferred rent, the rental agreement is not a section 467 rental agreement.

Example 2. (i) A and B enter into a rental agreement that provides for the lease of personal property for ten years, beginning on January 1, 1997, and ending on December 31, 2006. The rental agreement provides for accruals of rent of \$10,000 during each month of the lease term. Under paragraph (c)(3)(iii) of this section, \$120,000 is allocated to each calendar year. The rental agreement provides for a \$1,200,000 payment on December 31, 1997.

(ii) The rental agreement does not have increasing or decreasing rent as described in paragraph (c)(2)(i) of this section. The rental agreement provides prepaid rent under paragraph (c)(3)(ii) of this section because an amount of rent allocated to a calendar year, when added to the rent allocated to all preceding calendar years, is less than the cumulative amount of rent payable before the beginning of the preceding calendar year. For example, the rent allocated to 1999 and preceding calendar years (\$360,000) is less than the cumulative amount of rent payable before the beginning of the preceding calendar year (\$1,200,000 is payable on December 31, 1997). Accordingly, the rental agreement is a section 467 rental agreement.

(4) *Rental agreements involving total payments of \$250,000 or less*—(i) *In general.* A rental agreement is not a section 467 rental agreement if, taking into account any payments of contingent rent, and any other contingent consideration, the sum of the aggregate amount of rental payments under the rental agreement and the aggregate value of other consideration to be received for the use of property is not reasonably expected, as of the agreement date (as defined in paragraph (h) of this section), to exceed \$250,000.

(ii) *Special rules in computing amount described in paragraph (c)(4)(i).* The following rules apply in determining the amount described in paragraph (c)(4)(i) of this section—

(A) Stated interest on deferred rent is not taken into account. However, the Commissioner may recharacterize a

portion of stated interest as additional rent if a rental agreement provides for interest on deferred rent at a rate that, in light of all of the facts and circumstances, is clearly greater than the arm's-length rate of interest that would have been charged in a lending transaction between the lessor and lessee.

(B) Consideration that does not involve a cash payment is taken into account at its fair market value. A liability that is either assumed or secured by property acquired subject to the liability is taken into account at its remaining principal amount or, in the case of an obligation originally issued at a discount, at its adjusted issue price.

(C) All leases that are part of the same transaction or a series of related transactions are treated as a single lease. Whether two or more leases are part of the same transaction or a series of related transactions depends on all the facts and circumstances.

(D) Any increase or decrease in rent payable solely as a result of an adjustment based on a reasonable price index is not taken into account.

(E) Contingent rent described in paragraph (c)(2)(iii)(B)(3) of this section is not taken into account.

(d) *Section 467 rent*—(1) *In general.* The section 467 rent for a taxable year is the sum of—

(i) The fixed rent for any rental period (determined under paragraph (d)(2) of this section) that begins and ends in the taxable year;

(ii) A ratable portion of the fixed rent for any other rental period beginning or ending in the taxable year; and

(iii) In the case of a section 467 rental agreement that provides for contingent rent, the contingent rent that accrues during the taxable year as provided in §1.467-6.

(2) *Fixed rent for a rental period*—(i) *Constant rental accrual.* In the case of a section 467 rental agreement that is a disqualified leaseback or long-term agreement (as described in §1.467-3(b)), the fixed rent for a rental period is the constant rental amount (as determined under §1.467-3(d)).

(ii) *Proportional rental accrual.* In the case of a section 467 rental agreement that is not described in paragraph (d)(2)(i) of this section, and does not provide adequate interest on fixed rent (as determined under §1.467-2(b)), the fixed rent for a rental

period is the proportional rental amount (as determined under §1.467-2(c)).

(iii) *Section 467 rental agreement accrual.* In the case of a section 467 rental agreement that is not described in paragraph (d)(2)(i) or (ii) of this section, the fixed rent for a rental period is the amount of fixed rent allocated to the rental period under the rental agreement, as determined under paragraph (c)(2)(ii) of this section.

(e) *Section 467 interest*—(1) *In general.* The section 467 interest for a taxable year is the sum of—

(i) The interest on fixed rent for any rental period that begins and ends in the taxable year;

(ii) A ratable portion of the interest on fixed rent for any other rental period beginning or ending in the taxable year; and

(iii) In the case of a section 467 rental agreement that provides for contingent rent, any interest that accrues on the contingent rent during the taxable year as provided in §1.467-6.

(2) *Interest on fixed rent for a rental period*—(i) *In general.* Except as provided in paragraph (e)(2)(ii) of this section and §1.467-5(b)(1)(ii), the interest on fixed rent for a rental period is equal to the product of—

(A) The principal balance of the section 467 loan (as described in §1.467-4(b)) at the beginning of the rental period; and

(B) The yield of the section 467 loan (as described in §1.467-4(c)).

(ii) *Section 467 rental agreements with adequate interest.* Except in the case of a section 467 rental agreement that is a disqualified leaseback or long-term agreement, if a section 467 rental agreement provides adequate interest under §1.467-2(b)(1)(i) (agreements with no deferred or prepaid rent) or §1.467-2(b)(1)(ii) (agreements with adequate stated interest at a single fixed rate), the interest on fixed rent for a rental period is the amount of interest provided in the rental agreement for the period.

(3) *Treatment of interest.* If the section 467 interest for a rental period is a positive amount, the lessor has interest income and the lessee has an interest expense. If the section 467 interest for a rental period is a negative amount, the lessee has interest income and the lessor has an interest expense.

(f) *Modification of a rental agreement.* If, after the lease date, the lessor

and lessee agree to a substantial modification of the terms of a lease, the modified lease is treated, except as provided in this paragraph (f), as a new rental agreement for purposes of this section and §§1.467-2 through 1.467-8. If a principal purpose of such a modification is to avoid the purpose or intent of section 467, the Commissioner may treat the original and modified lease as a single rental agreement for purposes of this section and §§1.467-2 through 1.467-8.

(g) *Treatment of amounts payable by lessor to lessee*—(1) *Interest.* For purposes of determining present value, any amounts payable by the lessor to the lessee as interest on prepaid rent are treated as negative amounts.

(2) *Other amounts.* [Reserved]

(h) *Meaning of terms.* The following meanings apply for purposes of this section and §§1.467-2 through 1.467-8—

(1) *Agreement date* means the earlier of the lease date or the first date on which there is a binding written contract that substantially sets forth the terms under which the property will be leased.

(2) *Contingent rent* means any rent that is not fixed rent, including any amount reflecting an adjustment based on a reasonable price index.

(3) *Fixed rent* means any rent to the extent its amount and the time at which it will be paid are fixed and determinable under the terms of the section 467 rental agreement as of the lease date, as defined in paragraph (h)(4) of this section. For this purpose, the possibility of a breach or other early termination of the rental agreement and any provision that makes adjustments based on a reasonable price index are disregarded in determining whether amounts specified in the agreement are fixed rent.

(4) *Lease date* means the date on which the lessee first has the right to use property that is the subject of the section 467 rental agreement.

(5) *Lease term* means the period during which the lessee has the use of property subject to the section 467 rental agreement. An option period is included in the lease term only if it is expected, as of the agreement date, that the option will be exercised by either the lessor or the lessee. For this purpose, a lessor is generally expected to exercise an option if, for example, as of the agreement date, the rent in effect

for the option period exceeds the expected market rental for the property during such period. Similarly, a lessee is generally expected to exercise an option if, for example, as of the agreement date, the rent for the option period is less than the expected market rental for such period. The lessor's or lessee's determination that an option period is either included in or excluded from the lease term is not binding on the Commissioner. If the lessee (or a related person) agrees that one or both of them will or could be obligated to make payments in the nature of rent (within the meaning of §1.168(i)-2(b)-(2)) for a period when another lessee (the substitute lessee) or the lessor will have use of the property subject to the rental agreement, the Commissioner may, in appropriate cases, treat the period when the substitute lessee or lessor will have use of the property as part of the lease term. See paragraph §1.467-7(f) for special rules applicable to the lessee, substitute lessee, and lessor.

(6) An adjustment is based on a reasonable price index if the adjustment reflects inflation or deflation occurring over a period during the lease term and is determined consistently under any generally recognized index for measuring inflation or deflation.

(7) Except as otherwise provided in this paragraph (h)(7), two persons are related persons if they either have a relationship to each other that is specified in section 267(b) or section 707(b)(1) or are related entities within the meaning of sections 168(h)(4)(A), (B), or (C). For purposes of determining whether a section 467 rental agreement is a leaseback within the meaning of §1.467-3(b)(2), two persons are related persons if they are related persons within the meaning of section 465(b)(3)(C).

(8) *Rental agreement* includes any agreement, whether written or oral, that provides for the use of tangible property and is treated as a lease for Federal income tax purposes.

(9) *Third-party costs* include any real estate taxes, insurance premiums, maintenance costs, or any other cost (other than a debt service cost) that relates to the leased property and is not within the control of the lessor or lessee or any related person.

(i) [Reserved].

(j) *Computational rules.* For purposes of this section and §§1.467-2

through 1.467-8, the following rules apply—

(1) *Counting conventions.* Any reasonable counting convention may be used (e.g., 30 days per month/360 days per year) to determine the length of a rental period or to perform any computation. Rental periods of the same descriptive length, for example annual, semiannual, quarterly, or monthly, may be treated as being of equal length.

(2) *Conventions regarding timing of rent and payments—*(i) *In general.* For purposes of determining present values and yield—

(A) Except as otherwise provided in this section and §§1.467-2 through 1.467-7, the rent allocated to a rental period is taken into account on the last day of the rental period;

(B) Any amount payable during the first half of the first rental period is treated as payable on the first day of that rental period;

(C) Any amount payable during the first half of any other rental period is treated as payable on the last day of the preceding rental period; and

(D) Any amount payable during the second half of a rental period is treated as payable on the last day of the rental period.

(ii) *Time amount is payable.* For purposes of this paragraph (j)(2), an amount is payable on the last day for timely payment (that is, the last day such amount may be paid without incurring interest, computed at an arm's-length rate, or a substantial penalty charge) and an amount payable at the midpoint of a rental period is treated as payable during the first half of the rental period.

(3) *Annualized fixed rent.* Annualized fixed rent is determined by multiplying the fixed rent allocated to the rental period under paragraph (c)(2)(ii) of this section by a number that represents the ratio of one year to the length of the rental period. Thus, if the fixed rent allocated to a rental period is \$100,000 and the rental period is one month, the annualized fixed rent allocated to the rental period is \$1,200,000.

(4) *Allocation of fixed rent within a period.* A rental agreement that allocates fixed rent to any period is treated as allocating fixed rent ratably within that period. Thus, if a rental agreement provides that \$120,000 is allocated to each calendar year in the lease term,

\$10,000 of rent is allocated to each calendar month.

(5) *Rental period length.* Except as provided in §1.467-3(d)(1) (relating to agreements for which constant rental accrual is required), rental periods may be of any length and may vary in length as long as—

(i) The rental periods are one year or less, cover the entire lease term, and do not overlap;

(ii) Each scheduled payment under the rental agreement (other than a payment scheduled to occur before or after the lease term) occurs within 30 days of the beginning or end of a rental period; and

(iii) In the case of a rental agreement that does not provide a specific allocation of fixed rent, the rental periods selected do not cause the agreement to be treated as a section 467 rental agreement unless all alternative rental period schedules would result in such treatment.

§1.467-2 Rent accrual for section 467 rental agreements without adequate interest.

(a) *Section 467 rental agreement for which proportional rental accrual is required.* Under §1.467-1(d)(2)(ii), the fixed rent for each rental period is the proportional rental amount, defined under paragraph (c) of this section, if—

(1) The section 467 rental agreement is not a disqualified leaseback or long-term agreement under §1.467-3(b); and

(2) The section 467 rental agreement does not provide adequate interest on fixed rent under paragraph (b) of this section.

(b) *Adequate interest on fixed rent—*

(1) *In general.* A section 467 rental agreement provides adequate interest on fixed rent if, disregarding any contingent rent—

(i) The rental agreement has no prepaid or deferred rent as described in §1.467-1(c)(3);

(ii) The rental agreement has prepaid or deferred rent, and—

(A) The rental agreement provides interest (the stated rate of interest) on deferred or prepaid fixed rent at a single fixed rate (as defined in §1.1273-1(c)(1)(iii));

(B) The stated rate of interest on fixed rent is no lower than 110 percent of the applicable Federal rate (as

defined in paragraph (e)(3) of this section);

(C) The amount of deferred or prepaid fixed rent on which interest is charged is adjusted at least annually to reflect the amount of deferred or prepaid fixed rent as of a date no earlier than the date of the preceding adjustment and no later than the date of the succeeding adjustment; and

(D) The rental agreement requires interest to be paid or compounded at least annually;

(iii) The rental agreement provides for deferred rent but no prepaid rent, and the sum of the present values of all amounts payable by the lessee as fixed rent (and interest, if any, thereon) is equal to or greater than the sum of the present values of the fixed rent allocated to each rental period; or

(iv) The rental agreement provides for prepaid rent but no deferred rent, and the sum of the present values of all amounts payable by the lessee as fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest, if any, on prepaid fixed rent, is equal to or less than the sum of the present values of the fixed rent allocated to each rental period.

(2) *Section 467 rental agreements that provide for a variable rate of interest.* For purposes of the adequate interest test under paragraph (b)(1) of this section, if a section 467 rental agreement provides for variable interest, the rental agreement is treated as providing for fixed rates of interest on deferred or prepaid fixed rent equal to the fixed rate substitutes (determined in the same manner as under §1.1275-5(e) treating the agreement date as the issue date) for the variable rates called for by the rental agreement. For purposes of this section, a rental agreement provides for variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that meet the requirements of §1.1275-5(a)(3)(i)(A) or (B) and §1.1275-5(a)(4).

(c) *Computation of proportional rental amount—(1) In general.* The proportional rental amount for a rental period is the amount of fixed rent allocated to the rental period under §1.467-1(c)(2)(ii), multiplied by a fraction. The numerator of the fraction is the sum of the present values of the amounts payable under the terms of the section 467 rental agreement as fixed

rent and interest thereon. The denominator of the fraction is the sum of the present values of the fixed rent allocated to each rental period under the rental agreement.

(2) *Section 467 rental agreements that provide for a variable rate of interest.* To calculate the proportional rental amount for a section 467 rental agreement that provides for a variable rate of interest, see §1.467-5.

(d) *Present value.* For purposes of determining adequate interest under paragraph (b) of this section or the proportional rental amount under paragraph (c) of this section, present values are determined as of the first day a fixed rent payment is called for by the section 467 rental agreement if the rental agreement calls for payments of fixed rent prior to the lease term. Otherwise, present values are determined as of the first day of the first rental period in the lease term. The present value of any amount is determined using a discount rate equal to 110 percent of the applicable Federal rate. For purposes of the present value determination under paragraph (b)(1)-(iv) of this section, the fixed rent allocated to a rental period must be discounted from the first day of the rental period. For other conventions and rules relating to the determination of present value, see §1.467-1(g) and (j).

(e) *Applicable Federal rate—(1) In general.* The applicable Federal rate for a section 467 rental agreement is the applicable Federal rate in effect on the agreement date. Except as otherwise provided in this section, the *applicable Federal rate* for a rental agreement means—

(i) The Federal short-term rate if the term of the rental agreement is not over 3 years;

(ii) The Federal mid-term rate if the term of the rental agreement is over 3 years but not over 9 years; and

(iii) The Federal long-term rate if the term of the rental agreement is over 9 years.

(2) *Source of applicable Federal rates.* The Internal Revenue Service publishes the applicable Federal rates, based on annual, semiannual, quarterly, and monthly compounding, each month in the Internal Revenue Bulletin (see §601.601(d) of this chapter. However, the applicable Federal rates may be based on any compounding assumption.

To convert a rate based on one compounding assumption to an equivalent rate based on a different compounding assumption, see §1.1272-1(j), *Example 1*.

(3) *110 percent of applicable Federal rate.* For purposes of §1.467-1, this section and §§1.467-3 through 1.467-8, 110 percent of the applicable Federal rate means 110 percent of the applicable Federal rate based on semi-annual compounding, or any rate based on a different compounding assumption that is equivalent to 110 percent of the applicable Federal rate based on semi-annual compounding.

(4) *Term of the section 467 rental agreement—(i) In general.* For purposes of determining 110 percent of the applicable Federal rate under this paragraph (e), the term of the section 467 rental agreement includes the lease term, any period before the lease term beginning with the first day an amount of fixed rent is payable under the terms of the rental agreement, and any period after the lease term ending with the last day an amount of fixed rent or interest thereon is payable under the rental agreement.

(ii) *Section 467 rental agreements with variable interest.* If a section 467 rental agreement provides variable interest on prepaid or deferred fixed rent, the term of the rental agreement for purposes of calculating 110 percent of the applicable Federal rate is determined in accordance with paragraph (e)(4)(i) of this section by substituting for the term of the rental agreement, the longest period between interest rate adjustment dates, or, if the rental agreement provides an initial fixed rate of interest on prepaid or deferred fixed rent, the period between the agreement date and the last day the fixed rate applies, if this period is longer. If, as described in §1.1274-4(c)(2)(ii), the rental agreement provides for a qualified floating rate (as defined in §1.1275-5(b)) that in substance resembles a fixed rate, 110 percent of the applicable Federal rate is determined by reference to the lease term.

(f) *Examples.* The following examples illustrate the application of this section. In each of these examples it is assumed that constant rental accrual does not apply:

Example 1. (i) C agrees to lease property from D for five years beginning on January 1, 1998, and ending on December 31, 2002. The section

467 rental agreement provides that rent of \$100,000 accrues in each calendar year in the lease term and that rent of \$500,000 plus \$120,000 of interest is payable on December 31, 2002. Assume that the parties select the calendar year as the rental period and that 110 percent of the applicable Federal rate based on annual compounding is 10 percent.

(ii) The rental agreement has deferred rent under §1.467-1(c)(3)(i) because the fixed rent allocated to calendar years 1998, 1999, and 2000 is not paid until 2002. In addition, because the rental agreement does not state an interest rate, the rental agreement does not satisfy the requirements of paragraph (b)(1)(ii) of this section. Thus, the adequacy of interest must be determined under paragraph (b)(1)(iii) of this section.

(iii)(A) Because the rental agreement has deferred fixed rent and no prepaid rent, the agreement has adequate interest only if the present value rules provided in paragraph (b)(1)(iii) are met. The present value of all fixed rent and interest payable under the rental agreement is \$384,971.22, determined as follows: $\$384,971.22 = \$620,000 / (1.10)^5$. The present value of all fixed rent allocated under the rental agreement (discounting the amount of fixed rent allocated to a rental period from the last day of the rental period) is \$379,078.68, determined as follows:

$$\$379,078.78 = \$1000,000 \times \frac{1 - (1.10)^5}{.10}$$

(B) Accordingly, the sum of the present values of amounts payable exceeds the sum of the present values of fixed rent allocated. The rental agreement provides adequate interest on fixed rent.

(iv) For an example illustrating the computation of the yield on the rental agreement and the allocation of the interest and rent provided for under the rental agreement, see §1.467-4(f), *Example 2*.

Example 2. (i) E and F enter into a section 467 rental agreement for the lease of equipment beginning on January 1, 1998, and ending on December 31, 2002. The rental agreement provides that rent of \$100,000 accrues for each calendar month during the lease term. All rent is payable on December 31, 2002, together with interest on accrued rent at a qualified floating rate set at a current value (as defined in §1.1275-5(a)(4)) that is compounded at the end of each calendar month and adjusted at the beginning of each calendar month throughout the lease term. Therefore, the rental agreement provides for variable interest within the meaning of paragraph (b)(2) of this section.

(ii) On the agreement date the qualified floating rate is 7.5 percent, and 110 percent of the applicable Federal rate, as defined in paragraph (e)(3) of this section, based on monthly compounding, is 7 percent. Under paragraph (b)(2) of this section, the fixed rate substitute for the qualified floating rate is 7.5 percent and the agreement is treated as providing for interest at this fixed rate for purposes of determining whether adequate interest is provided under paragraph (b) of this section. Accordingly, the requirements of paragraph (b)(1)(ii) of this section are satisfied, and the rental agreement has adequate interest.

Example 3. (i) X and Y enter into a section 467 rental agreement for the lease of real

property beginning on January 1, 1998, and ending on December 31, 2000. The rental agreement provides that rent of \$80,000 is allocable to 1998, \$100,000 is allocable to 1999, and \$120,000 is allocable to 2000. Under the rental agreement, Y must make a \$300,000 payment on December 31, 2000. Assume that both X and Y choose the calendar year as the rental period, X and Y are calendar year taxpayers, and 110 percent of the applicable Federal rate is 8.5 percent compounded annually. Assume further that the rental agreement fails to provide adequate interest under paragraph (b)(1) of this section. Therefore, under §1.467-1(d)-(2)(ii), the fixed rent for each rental period is the proportional rental amount.

(ii)(A) The proportional rental amount is computed under paragraph (c) of this section. Because the rental agreement does not call for any fixed rent payments prior to the lease term, under paragraph (d) of this section, present value is determined as of the first day of the first rental period in the lease term. The sum of the present values of the amounts payable by the lessee under the rental agreement is computed as follows:

$$\$234,872.43 = \frac{\$300,000}{(1 + .085)^3}$$

(B) The sum of the present values of the fixed rent allocated to each rental period (discounting the fixed rent allocated to a rental period from the last day of such rental period) is computed as follows:

$$\$252,627.22 = \frac{\$80,000}{(1 + .085)} + \frac{\$100,000}{(1 + .085)^2} + \frac{\$120,000}{(1 + .085)^3}$$

(C) Thus, the fraction for determining the proportional rental amount is $.9297194$ ($\$234,872.43 / \$252,627.22$). The section 467 fixed rents for the taxable years within the lease term are:

Taxable year	Section 467 rent
1998	\$ 74,377.55 (\$ 80,000 × .9297194)
1999	92,971.94 (\$100,000 × .9297194)
2000	111,566.33 (\$120,000 × .9297194)

§1.467-3 Disqualified leasebacks and long-term agreements.

(a) *General rule.* Under §1.467-1(d)(2)(i), constant rental accrual (as described under paragraph (d) of this section) must be used to determine the fixed rent for each rental period in the lease term if the section 467 rental agreement is a disqualified leaseback or long-term agreement within the meaning of paragraph (b) of this section.

(b) *Disqualified leaseback or long-term agreement—(1) In general.* A leaseback (as defined in paragraph (b)(2) of this section) or a long-term agreement (as defined in paragraph (b)(3) of this section) is disqualified only if—

(i) The amount determined with respect to the section 467 rental agreement under §1.467-1(c)(4) (relating to the exception for rental agreements involving total payments of \$250,000 or less) exceeds \$2,000,000;

(ii) A principal purpose for providing increasing or decreasing rent is the avoidance of Federal income tax (as described in paragraph (c) of this section); and

(iii) The Commissioner determines that it is appropriate to treat the section 467 rental agreement as a disqualified leaseback or long-term agreement.

(2) *Leaseback.* A section 467 rental agreement is a leaseback if the lessee (or a related person) had any interest (other than a de minimis interest) in the property at any time during the two-year period ending on the agreement date. For this purpose, interests in property include options and agreements to purchase the property (whether or not the lessee or related person was considered the owner of the property for Federal income tax purposes) and, in the case of subleased property, any interest as a sublessor.

(3) *Long-term agreement—(i) In general.* A section 467 rental agreement is a long-term agreement if the lease term exceeds 75 percent of the statutory recovery period for the property.

(ii) *Statutory recovery period—(A) In general.* The term *statutory recovery period* means—

(1) In the case of property depreciable under section 168, the applicable period determined under section 467(e)(3)(A);

(2) In the case of land, 19 years; and

(3) In the case of any other tangible property, the period that would apply under section 467(e)(3)(A) if the property were property to which section 168 applied.

(B) *Special rule for leases of properties having different statutory recovery periods.* In the case of a lease of two or more related properties that have different statutory recovery periods, the statutory recovery period for purposes of paragraph (b)(3)(ii)(A) of this section is the weighted average, based on the fair market values of the properties on the lease date, of the statutory recovery periods of each of the properties.

(c) *Tax avoidance as principal purpose for increasing or decreasing*

rent—(1) *In general.* Whether tax avoidance is a principal purpose for providing increasing or decreasing rent in a leaseback or long-term agreement is based on all of the facts and circumstances. However, if either the lessee or the lessor is not subject to Federal income tax on its income or is a tax-exempt entity (within the meaning of section 168(h)(2)), the agreement will be closely scrutinized and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent.

(2) *Safe harbors.* Tax avoidance is not considered to be a principal purpose for providing increasing or decreasing rent if—

(i) The rent allocated to each calendar year (determined without regard to any increase or decrease attributable to a provision described in paragraph (c)(2)(ii)(C) of this section) does not vary from the average rent allocated to all calendar years by more than 10 percent (for this purpose, the rent allocated to a partial calendar year is adjusted by multiplying the rent by the number of partial years in a full calendar year); or

(ii) All of the increases and decreases in rent are attributable to one or more of the following provisions—

(A) A provision requiring an increase in rent equal to a percentage of the lessee's receipts (gross or net) if the percentage does not vary throughout the term of the lease;

(B) A provision requiring an adjustment based on a reasonable price index as described in §1.467-1(h);

(C) A provision requiring the lessee to pay third-party costs as described in §1.467-1(h); or

(D) A rent holiday provision allowing reduced rent (including no rent) for an interim period at the beginning of the lease term, but only if the duration of the rent holiday does not exceed the lesser of 24 months or 10 percent of the lease term and there is a substantial business purpose for the rent holiday provision.

(d) *Calculating constant rental amount*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, the constant rental amount is the amount that, if paid at the end of each rental period, would result in a present value equal to the present value of all amounts payable under the dis-

qualified leaseback or long-term agreement as rent and interest. In computing the constant rental amount, the rules for determining present value are the same as those provided in §1.467-2(d) for computing the proportional rental amount. If constant rental accrual is required, all rental periods (other than an initial or final short period of not more than one month) must be equal in length and satisfy the requirements of §1.467-1(j)(5).

(2) *Initial or final short periods.* If a disqualified leaseback or long-term agreement has an initial or final short rental period, the constant rental amount for the initial or final short period may be determined under any reasonable method. However, the sum of the present values of all the constant rental amounts must equal the present values of all amounts payable under the disqualified leaseback or long-term agreement as rent and interest. Any adjustment necessary to eliminate the section 467 loan balance because of the method used to determine the constant rental amount for short periods must be taken into account as section 467 rent for the final rental period.

(3) *Method to determine constant rental amount; no short periods*—(i) *Step 1.* Determine the present value of amounts payable under the disqualified leaseback or long-term agreement as rent or interest.

(ii) *Step 2.* Determine the present value of \$1 to be received at the end of each rental period during the lease term as of the first day of the first rental period during the lease term (or, if earlier, the first day a rent payment is required under the rental agreement).

(iii) *Step 3.* Divide the amount determined in paragraph (d)(3)(i) of this section (Step 1) by the number of dollars determined in paragraph (d)(3)(ii) of this section (Step 2).

(e) *Example.* The following example illustrates the application of paragraph (d) of this section:

Example. (i) X and Y enter into a disqualified leaseback for a 5-year lease of personal property beginning on January 1, 1998, and ending on December 31, 2002. The rental agreement provides that \$0 of rent is allocated to years 1998, 1999, and 2000, and that rent of \$17,500,000 is allocated to years 2001 and 2002. The rental agreement provides that the rent allocated to each year is payable on December 31 of that year. Assume all rental periods are the calendar year. Assume also that 110 percent of the applicable Federal rate based on annual compounding is 12 percent.

(ii) Step 1 in calculating the constant rental amount is to determine the present value of the two payments due under the rental agreement as follows:

$$\$21,051,536 = \frac{\$17,500,000}{(1.12)^4} + \frac{\$17,500,000}{(1.12)^5}$$

(iii) Because no amounts of rent are payable before the lease term, Step 2 in calculating the constant rental amount is to determine the present value as of the first day of the lease term of \$1 to be received at the end of each rental period during the lease term. This results in a present value of \$3.6047762. In Step 3 the amount determined in Step 1 is divided by the number of dollars determined in Step 2. Thus, the constant rental amount is \$5,839,901 for each calendar year during the lease term computed as follows:

$$\$5,839,901 = \frac{\$21,051,536}{3.6047762}$$

§1.467-4 Section 467 loan.

(a) *In general*—(1) *Overview.* Except as provided in paragraph (a)(2) of this section, the section 467 loan rules of this section apply to a section 467 rental agreement if, as of the first day of that period, there is a difference between the amount of fixed rent payable under the rental agreement on or before the first day and the amount of fixed rent required to be accrued in accordance with §1.467-1(d)(2) before the first day. Paragraph (b) of this section provides rules for computing the principal balance of a section 467 loan at the beginning of any rental period. The principal balance of a section 467 loan may be positive or negative. For purposes of the Code, if the principal balance is positive, the amount represents a loan from the lessor to the lessee and, if the principal balance is negative, the amount represents a loan from the lessee to the lessor.

(2) *No section 467 loan in the case of certain section 467 rental agreements.* Except as provided in paragraph (a)(3) and (4) of this section, this section does not apply to section 467 rental agreements that provide adequate interest under §1.467-2(b)(1)(i) (agreements with no deferred or prepaid rent) or §1.467-2(b)(1)(ii) (agreements with deferred or prepaid rent that provide adequate stated interest at a single fixed rate).

(3) *Rental agreements subject to constant rental accrual.* Notwithstanding the provisions of paragraph (a)(2) of this section, this section applies to

rental agreements subject to constant rental accrual under §1.467-3.

(4) *Special rule in applying the provisions of §1.467-7(e) or (f).* Notwithstanding the provisions of paragraph (a)(2) of this section, this section applies to rental agreements that provide adequate interest under §1.467-2(b)(1)(i) or (ii), but only for purposes of applying the provisions of §1.467-7(e) (relating to dispositions of property subject to a section 467 rental agreement) or §1.467-7(f) (relating to assignments by lessees and lessee-financed renewals) to a transaction described therein. Further, for section 467 rental agreements that provide adequate interest under §1.467-2(b)(1)(i) or (ii), the section 467 interest that accrues on the section 467 loan balance after the sale, exchange, or other disposition under §1.467-7(e) or the assignment or renewal under §1.467-7(f) is the section 467 interest that accrues under the terms of the rental agreement (if any).

(b) *Principal balance—(1) In general.* Except as provided in paragraph (b)(2) of this section or in §1.467-7(e) or (f), the principal balance of the section 467 loan at the beginning of a rental period equals the fixed rent accrued in preceding rental periods—

(i) Increased by the interest on fixed rent includible in the gross income of the lessor for preceding rental periods and any amount payable by the lessor on or before the first day of the rental period as interest on prepaid fixed rent; and

(ii) Decreased by the interest on prepaid fixed rent includible in the gross income of the lessee for preceding rental periods and any amount payable by the lessee on or before the first day of the rental period as fixed rent or interest thereon.

(2) *Section 467 rental agreements that provide for prepaid fixed rent and adequate stated interest.* If a section 467 rental agreement calls for prepaid fixed rent and provides adequate interest under §1.467-2(b)(1)(iv), the principal balance of the section 467 loan at the beginning of a rental period equals the principal balance determined under paragraph (b)(1) of this section, plus the fixed rent accrued for that rental period.

(3) *Timing of payments.* For purposes of this paragraph (b), the day on which an amount is payable is determined under the rules of §1.467-1(j)(2).

(c) *Yield—(1) In general—(i) Method of determining yield.* Except as provided in paragraph (c)(2) of this section, the yield of a section 467 loan is the discount rate at which the sum of the present values of all amounts payable by the lessee as fixed rent and interest on fixed rent, plus the sum of the present values of all amounts payable by the lessor as interest on prepaid fixed rent, equals the sum of the present values of the fixed rent that accrues in accordance with §1.467-1(d)(2). The yield must be constant over the term of the section 467 rental agreement, and, when expressed as a percentage, must be calculated to at least two decimal places.

(ii) *Method of stating yield.* In determining the section 467 interest for a rental period, the yield of the section 467 loan must be stated appropriately by taking into account the length of the rental period. Section 1.1272-1(j) *Example 1* provides a formula for converting a yield based on a period of one length to an equivalent yield based on a period of a different length.

(iii) *Rounding adjustments.* Any adjustment necessary to eliminate the section 467 loan because of rounding the yield to two or more decimal places must be taken into account as section 467 interest for the final rental period determined as provided in paragraph (e) of this section.

(2) *Yield of section 467 rental agreements for which constant rental amount or proportional rental amount is computed.* In the case of a section 467 rental agreement to which §1.467-1(d)(2)(i) or (ii) applies, the yield of the section 467 loan equals 110 percent of the applicable Federal rate (based on a compounding period equal to the rental period).

(3) *Determination of present values.* The rules for determining present value in computing the yield of a section 467 loan are the same as those provided in §1.467-2(d) for computing the proportional rental amount.

(d) *Contingent payments.* Except as otherwise required under §1.467-6, contingent payments are not taken into account in calculating either the yield or the principal balance of a section 467 loan.

(e) *Section 467 rental agreements that call for payments before or after the lease term.* If a section 467 rental agreement calls for the payment of fixed rent or interest thereon before the

beginning of the lease term, this section must be applied by treating the period beginning on the first day an amount is payable and ending on the day before the beginning of the first rental period of the lease term as one or more rental periods. If a rental agreement calls for the payment of fixed rent or interest thereon after the end of the lease term, this section must be applied by treating the period beginning on the day after the end of the last rental period of the lease term and ending on the last day an amount of fixed rent or interest thereon is payable as one or more rental periods. Rental period length for the period before the lease term or after the lease term is determined in accordance with the rules of §1.467-1(j)(5).

(f) *Examples.* The following examples illustrate the application of this section:

Example. (i)(A) A leases property to B for a three-year period beginning on January 1, 1998, and ending on December 31, 2000. The section 467 rental agreement has the following rent allocation schedule and payment schedule:

	<i>Rent Allocation</i>	<i>Payment</i>
1998	\$400,000	
1999	600,000	
2000	800,000	\$1,800,000

(B) The rental agreement requires a \$1.8 million payment to be made on December 31, 2000, but does not provide for interest on deferred rent. Assume A and B choose the calendar year as the rental period length. Assume further that 110 percent of the applicable Federal rate based on annual compounding is 10 percent.

(ii) The rental agreement is not a disqualified leaseback or long-term agreement because it does not provide for the payment of more than \$2,000,000 in rent (determined pursuant to §1.467-3(b)(1)(i)). Because the section 467 rental agreement does not provide adequate interest under §1.467-2(b) and is not subject to constant rental accrual, the fixed rent that accrues during each rental period is the proportional rental amount as described in §1.467-2(c). The proportional rental amounts for each rental period are as follows:

1998	\$370,370.37
1999	555,555.56
2000	740,740.74

(iii) A section 467 loan arises at the beginning of the second rental period because the rent payable on or before that day (zero) is less than the fixed rent accrued under §1.467-1(d)(2) in all preceding rental periods (\$370,370.37). Under paragraph (c)(2) of this section, the yield of the loan is equal to 110 percent of the applicable Federal rate (10 percent compounded annually). Because no payments are treated as made on or before the first day of the second rental period,

the principal balance of the loan at the beginning of the second rental period is \$370,370.37. The interest for the second rental period on fixed rent is \$37,037.04 (.10 × \$370,370.37) and, under §1.467-1(e)(3), is treated as interest income of the lessor and as an interest expense of the lessee.

(iv) Because no payments are made on or before the first day of the third rental period, the principal balance of the loan at the beginning of the third rental period is equal to the fixed rent accrued during the first and second rental periods plus the lessor's interest income on fixed rent for the second rental period (\$962,962.97 = \$370,370.37 + \$555,555.56 + \$37,037.04). The interest for the third rental period on fixed rent is \$96,296.30 (.10 × \$962,962.97). Thus, the sum of the fixed rent and interest on fixed rent for the three rental periods is equal to the total amount paid over the lease term (first year fixed rent accrual, \$370,370.37, plus second year fixed rent and interest accrual, \$555,555.56 + \$37,037.04, plus third year fixed rent and interest accrual, \$740,740.74 + \$96,296.30, equals \$1,800,000). B takes the amounts of interest and rent into account as expense and A takes such amounts into account as income for the calendar years identified above, regardless of their respective methods of accounting.

Example 2. (i) The facts are the same as in *Example 1*, §1.467-2(f).

(ii)(A) Pursuant to paragraph (c)(1) of this section, the yield of the section 467 loan is 10.775078%, compounded annually. The following is a schedule of the rent allocable to each rental period during the lease term, the balance of the section 467 loan as of the end of each rental period (determined, in the case of the calendar year 2002, without regard to the single payment of rent and interest in the amount of \$620,000 payable on the last day of the lease term), and the interest on the section 467 loan allocable to each rental period:

Calendar Year	Section 467 Interest	Section 467 Rent	Section 467 Loan Balance
1988	\$ 0	\$100,000.00	\$100,000.00
1999	10,775.08	100,000.00	210,775.08
2000	22,711.18	100,000.00	333,486.26
2001	35,933.41	100,000.00	469,419.67
2002	50,580.33	100,000.00	620,000.00

(B) C takes the amounts of interest and rent into account as expense and D takes such amounts into account as income for the calendar years identified above, regardless of their respective methods of accounting.

§1.467-5 Section 467 rental agreements with variable interest.

(a) *Variable interest on deferred or prepaid rent*—(1) *In general.* This section provides rules for computing section 467 rent and interest in the case of section 467 rental agreements providing variable interest. For purposes of this section, a rental agreement provides for variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that

meet the requirements of §1.1275-5(a)-(3)(i)(A) or (B) and §1.1275-5(a)(4). If a section 467 rental agreement provides for interest that is neither variable interest nor determined by reference to a fixed rate, the amount of any interest will be treated as a contingent payment subject to §1.467-6.

(2) *Exceptions.* This section is not applicable to section 467 rental agreements that provide adequate interest under §1.467-2(b)(1)(i) (agreements with no deferred or prepaid rent) or §1.467-2(b)(1)(ii) (rental agreements with stated interest at a single fixed rate). The exceptions in this paragraph (a)(2) do not apply to rental agreements subject to constant rental accrual under §1.467-3.

(b) *Variable rate treated as fixed*—(1) *In general.* If a section 467 rental agreement provides variable interest—

(i) The fixed rate substitutes (determined in the same manner as under §1.1275-5(e) treating the agreement date as the issue date) for the variable rates of interest on prepaid or deferred fixed rent provided by the rental agreement must be used in computing the proportional rental amount under §1.467-2(c), the constant rental amount under §1.467-3(d), the principal balance of a section 467 loan under §1.467-4(b), and the yield of a section 467 loan under §1.467-4(c); and

(ii) The interest on fixed rent for any rental period is equal to the amount that would be determined under §1.467-1(e)(2) if the section 467 rental agreement did not provide variable interest, using the fixed rate substitutes determined under paragraph (b)(1)(i) of this section in place of the variable rates called for by the rental agreement, plus the variable interest adjustment amount provided in paragraph (b)(2) of this section.

(2) *Variable interest adjustment amount*—(i) *In general.* The variable interest adjustment amount for a rental period equals the difference between—

(A) The amount of interest that, without regard to section 467, would have accrued during the rental period under the terms of the section 467 rental agreement; and

(B) The amount of interest that, without regard to section 467, would have accrued during the rental period under the terms of the section 467 rental agreement using the fixed rate substitutes determined under paragraph

(b)(1)(i) of this section in place of the variable interest rates called for by the rental agreement.

(ii) *Sign of adjustment.* If the amount determined under paragraph (b)(2)(i)-(A) of this section is greater than the amount determined under paragraph (b)(2)(i)(B) of this section, the variable interest adjustment amount is positive. If the amount determined under paragraph (b)(2)(i)(A) of this section is less than the amount determined under paragraph (b)(2)(i)(B) of this section, the variable interest adjustment amount is negative.

(3) *Section 467 loan balance.* The variable interest adjustment amount is not taken into account in determining the principal balance of a section 467 loan under §1.467-4(b). Instead, the section 467 loan balance is computed as if all amounts payable under the section 467 rental agreement were based on the fixed rate substitutes determined under paragraph (b)(1)(i) of this section.

(c) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) X and Y enter into a section 467 rental agreement for the lease of personal property beginning on January 1, 1998, and ending on December 31, 2000. It allocates \$100,000 of rent to 1998, \$200,000 to 1999, and \$100,000 to 2000, and requires the lessee to pay all \$400,000 of rent on December 31, 2000. The rental agreement requires the accrual of interest on unpaid accrued rent at two different qualified floating rates (as defined in §1.1275-5(b)), one for 1999 and the other for 2000, such interest to be paid on December 31 of the year it accrues. The rental agreement provides that the qualified floating rate is set at a current value within the meaning of §1.1275-5(a)(4). Assume that on the agreement date, 110 percent of the applicable Federal rate is 10 percent, compounded annually.

(ii) The rental agreement is not a disqualified leaseback or long-term agreement because it does not provide for the payment of more than \$2,000,000 in rent (determined pursuant to §1.467-3(b)(1)(i)). To determine if the section 467 rental agreement provides for adequate interest under §1.467-2(b), §1.467-2(b)(2) requires the use of fixed rate substitutes (in this example determined in the same manner as under §1.1275-5(e)(3)(i) treating the agreement date as the issue date) in place of the variable rates called for by the rental agreement. Assume that on the agreement date the qualified floating rates, and therefore the fixed rate substitutes, relating to 1999 and 2000 are 10 and 15 percent compounded annually. Taking into account the fixed rate substitutes, the sum of the present values of all amounts payable by the lessee as fixed rent and interest thereon is greater than the sum of the present values of the fixed rent allocated to each rental period. Accordingly, the rental agreement provides adequate interest under §1.467-2(b)(1)(iii) and the fixed rent accruing in

each calendar year during the rental agreement is the fixed rent allocated under the rental agreement.

(iii) Because the section 467 rental agreement provides for variable interest on unpaid accrued fixed rent at qualified floating rates and the qualified floating rates are set at a current value, the requirements of §1.1275-5(a)(3)(i)(A) and (4) are met and the rental agreement provides for variable interest within the meaning of paragraph (a)(1) of this section. Therefore, under paragraph (b)(1)(i) of this section, the yield of the section 467 loan is computed based on the fixed rate substitutes. Under §1.467-4(c), the constant yield (rounded to two decimal places) equals 13.63 percent compounded annually. Based on the fixed rate substitutes, the fixed rent, interest on fixed rent, and the principal balance of the section 467 loan, for each calendar year during the lease term, are as follows:

	Accrued Rent	Accrued Interest	Projected Payment	Cumulative Loan
1998	\$100,000	\$ 0	\$ 0	\$100,000
1999	200,000	13,630	(10,000)	303,630
2000	100,000	41,370	(445,000)	0

(iv) To compute the actual reported interest on fixed rent for each calendar year, the variable interest adjustment amount, as described in paragraph (b)(2) of this section, must be added to the accrued interest determined in paragraph (iii) of this Example 1. Assume that the variable rates for 1999 and 2000 are actually 11 and 14 percent, respectively. Without regard to section 467, the interest that would have accrued during each calendar year under the terms of the section 467 rental agreement, and the interest that would have accrued under the terms of the rental agreement using the fixed rate substitutes determined under paragraph (b)(1)(i) are as follows:

	Accrued Interest Under Rental Agreement	Accrued Interest Using Fixed Rate Substitutes
1998	\$ 0	\$ 0
1999	11,000	10,000
2000	42,000	45,000

(v) Under paragraph (b)(2) of this section, the variable interest adjustment amount is \$1,000 (\$11,000 - \$10,000) for 1999 and is -\$3,000 (\$42,000 - \$45,000) for 2000. Thus, under paragraph (b)(1)(ii) of this section, the actual interest on fixed rent for 1999 is \$14,630 (\$13,630 + \$1,000) and for 2000 is \$38,370 (\$41,370 - \$3,000).

Example 2. (i) The facts are the same as in Example 1 except that 110 percent of the applicable Federal rate is 15 percent compounded annually and the section 467 rental agreement does not provide adequate interest under §1.467-2(b). Consequently, the fixed rent for each calendar year during the lease is the proportional rental amount.

(ii) The sum of the present values of the fixed rent provided for each calendar year during the lease term, discounted at 15 percent compounded annually, equals \$303,936.87.

(iii)(A) Paragraph (b)(1)(i) of this section requires the proportional rental amount to be computed based on the assumption that interest will accrue and be paid based on the fixed rate substitutes. Thus, the sum of the present values of the projected payments under the section 467

rental agreement equals \$300,156.16, computed as follows:

$$\begin{aligned} \$ 10,000/(1.15)^2 &= \$ 7,561.44 \\ 445,000/(1.15)^3 &= \$300,156.16 \end{aligned}$$

(B) The fraction for computing the proportional rental amount equals .9875609 (\$300,156.16/\$303,936.87).

(iv) Based on the fixed rate substitutes, the fixed rent, interest on fixed rent, and the balance of the section 467 loan for each calendar year during the lease term are as follows:

	Propor- tional Rent	Accrued Interest	Projected Payment	Cumulative Loan
1998	\$ 98,756.09	\$ 0.00	\$ 0	\$ 98,756.09
1999	197,512.18	14,813.41	(10,000)	301,081.68
2000	98,756.09	45,162.23	(445,000)	0.00

(v) The variable interest adjustment amount in this example is the same as in Example 1. Under paragraph (b)(1)(ii) of this section, the actual interest on fixed rent for 1999 is \$15,813.41 (\$14,813.41 + \$1,000) and for 2000 is \$42,162.23 (\$45,162.23 - \$3,000).

§1.467-6 Section 467 rental agreements with contingent payments.
[Reserved]

§1.467-7 Section 467 recapture and other rules relating to dispositions.

(a) *Section 467 recapture.* Notwithstanding any other provision of the Code, except as provided in paragraph (c) of this section, a lessor disposing of property in a transaction to which this section applies must recognize the recapture amount (determined under paragraph (b) of this section) and treat that amount as ordinary income. This section applies to any disposition of property subject to a section 467 rental agreement that—

(1) Is a leaseback (as defined in §1.467-3(b)(2)) or a long-term agreement (as defined in §1.467-3(b)(3));

(2) Is not disqualified under §1.467-3(b)(1); and

(3) Allocates to any rental period fixed rent that, when annualized, exceeds the annualized fixed rent allocated to any preceding rental period.

(b) *Recapture Recapture amount—*
(1) *In general.* The recapture amount for a disposition is the lesser of—

(i) The prior understated inclusions (determined under paragraph (b)(2) of this section); or

(ii) The section 467 gain (determined under paragraph (b)(3) of this section).

(2) *Prior understated inclusions—*
In general. The prior understated inclusions are the excess (if any) of—

(A) The aggregate amount of section 467 rent and section 467 interest for the period during which the lessor held the property, determined as if the section 467 rental agreement were a disqualified leaseback or long-term agreement; over

(B) The aggregate amount of section 467 rent and section 467 interest accrued by the lessor during that period.

(ii) *Partial rental periods.* For purposes of this paragraph (b)(2), the aggregate amounts described in paragraph (b)(2)(i)(A) and (B) of this section include a ratable portion of the section 467 rent and section 467 interest for any partial rental period during which the lessor held the property.

(3) *Section 467 gain—*
(i) *In general.* Except as otherwise provided in paragraph (b)(3)(ii) of this section, the section 467 gain is the excess (if any) of—

(A) The amount realized from the disposition; over

(B) The sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income under any provision of subtitle A of the Code other than section 467(c) (e.g., section 1245 or 1250).

(ii) *Certain dispositions.* In the case of a disposition that is not a sale, exchange, or involuntary conversion, the section 467 gain is the excess (if any) of the fair market value of the property on the date of disposition over the amount determined under paragraph (b)(3)(i)(B) of this section.

(c) *Special rules—*
(1) *Gifts.* Paragraph (a) of this section does not apply to a disposition by gift. However, see paragraph (c)(4) of this section for dispositions by transferees.

(2) *Dispositions at death.* Paragraph (a) of this section does not apply to a disposition if the basis of the property in the hands of the transferee is determined under section 1014(a). In the case of items constituting income in respect of a decedent, see section 691.

(3) *Certain tax-free exchanges—*
In general. The recapture amount in the case of a disposition to which this paragraph (c)(3) applies is limited to the amount of gain recognized to the transferor (determined without regard to paragraph (a) of this section), reduced by the amount of any gain from the disposition that is treated as ordinary income under any provision of

subtitle A of the Code other than section 467(c).

(ii) *Dispositions covered.* This paragraph (c)(3) applies to a disposition of property if the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 721, or 731.

(4) *Dispositions by transferee.* If the recapture amount with respect to a disposition of property (the first disposition) is limited under paragraph (c)(1) or (3) of this section and the transferee subsequently disposes of the property in a transaction to which this section applies, the amount described in paragraph (b)(2)(i)(A) of this section must be increased for purposes of determining the recapture amount for such subsequent disposition by the excess (if any) of—

(i) The recapture amount on the first disposition, determined without regard to the limitations of paragraphs (c)(1) and (3) of this section; over

(ii) The recapture amount on the first disposition determined after application of such limitations.

(5) *Like-kind exchanges and involuntary conversions.* If property is disposed of or converted and, before the application of paragraph (a) of this section, gain is not recognized in whole or in part under section 1031 or 1033, then the amount of section 467 gain taken into account by the lessor is limited to the sum of—

(i) The amount of gain recognized on the disposition or conversion of the property (determined without regard to paragraph (a) of this section); plus

(ii) The fair market value of property acquired that is not subject to a section 467 rental agreement and that is not taken into account under paragraph (c)(5)(i) of this section.

(6) *Installment sales.* In the case of an installment sale of property to which paragraph (a) of this section applies—

(i) The recapture amount is recognized and treated as ordinary income in the year of the disposition; and

(ii) Any gain in excess of the recapture amount shall be reported under the installment method of accounting if and to the extent that method is otherwise available under section 453.

(7) *Dispositions covered by sections 170(e), 341(e)(12), or 751(c).* For purposes of sections 170(e), 341(e)(12),

and 751(c), amounts treated as ordinary income under paragraph (a) of this section must be treated in the same manner as amounts treated as ordinary income under section 1245 or 1250.

(d) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) X and Y enter into a section 467 rental agreement for a 5-year lease of personal property beginning on January 1, 1997, and ending on December 31, 2001. The rental agreement provides that \$0 of rent is allocated to 1997, 1998, and 1999, and \$175,000 is allocated to each of the years 2000 and 2001. The rental agreement provides that the calendar year will be the rental period and that the rent allocated to each calendar year is payable on the last day of that calendar year. Assume that both X and Y are calendar year taxpayers and that 110 percent of the applicable Federal rate is 11 percent, compounded annually. Assume further that the rental agreement is a long-term agreement (as defined in §1.467-3(b)(3)). The rental agreement is not a disqualified leaseback or long-term agreement because it does not provide for the payment of more than \$2,000,000 in rent (determined pursuant to §1.467-3(b)(1)(i)). Therefore, the fixed rent allocated under §1.467-1(c)(2)(ii) is zero for the first three rental periods and \$175,000 for the fourth and fifth rental periods.

(ii) On December 31, 1999, X sells the property subject to the section 467 rental agreement to an unrelated person for \$990,000. At the time of the sale, X's adjusted basis in the property is \$550,000. Thus, X's gain on the sale of the property is \$440,000. Assume that none of this gain would be treated as ordinary income under any provision of the Internal Revenue Code other than section 467(c). Under paragraph (a) of this section, X is required to take the recapture amount into account as ordinary income. Under paragraph (b) of this section, the recapture amount is the lesser of the prior understated inclusions or the section 467 gain.

(iii)(A) In computing the prior understated inclusions under paragraph (b)(2), assume that the section 467 rent and section 467 interest (based on constant rental accrual) would be taken into account as follows if the section 467 rental agreement were a disqualified long-term agreement:

	Section 467 Rent	Section 467 Interest
1997	\$59,290.59	\$ 0
1998	59,290.59	6,521.96
1999	59,290.59	13,761.35
2000	59,290.59	21,797.06
2001	59,290.59	11,466.68

(B) The aggregate amount of the section 467 rent and section 467 interest (based on constant rental accrual) for 1997, 1998, and 1999 is \$198,155.08 ((3 × \$59,290.59) + \$6,521.96 + \$13,761.35). Since X did not take any section 467 rent or section 467 interest into account in 1997, 1998, and 1999, the prior understated inclusions are also \$198,155.08. Since none of the gain is treated as ordinary income under any provision of the Code other than section 467(c), the entire amount of gain (\$440,000) is section 467 gain. Accordingly, the recapture amount (, the lesser of the prior understated inclusions or the section 467 gain) treated as ordinary income is \$198,155.08.

Example 2. (i) The facts are the same as in *Example 1* except that the section 467 rental agreement specifies that rents accrue and are paid in the following pattern:

	Allocation	Payment
1997	\$60,000	\$ 0
1998	65,000	0
1999	70,000	0
2000	75,000	175,000
2001	80,000	175,000

(ii)(A) Assume the section 467 rental agreement does not provide for adequate interest under §1.467-2(b), and, therefore, the fixed rent for a rental period is the proportional rental amount. See §1.467-1(d)(2)(ii). Assume that, under §1.467-2(c), the following amounts would be required to be taken into account:

	Section 467 Rent	Section 467 Interest
1997	\$51,585.97	\$ 0
1998	55,884.80	5,674.46
1999	60,183.63	12,445.98
2000	64,482.46	20,435.23
2001	68,781.28	10,526.19

(B) The amount of section 467 rent and section 467 interest taken into account by A for 1997, 1998, and 1999 is \$185,774.84. Thus, the prior understated inclusions are \$12,380.24 (the excess of the aggregate amount of section 467 rent and section 467 interest, based on constant rental accrual, for these three years, \$198,155.08, over the aggregate amount of section 467 rent and section 467 interest actually taken into account, \$185,774.84). Since this amount is less than the section 467 gain, the recapture amount treated as ordinary income is also \$12,380.24.

(e) *Other rules relating to dispositions—(1) In general.* If property subject to a section 467 rental agreement is sold, exchanged, or otherwise disposed of, the section 467 rent for a period is taken into account by the owner of the property during the period. The lessee, however, must continue to take section 467 rent and section 467 interest into account without regard to the change of ownership.

(2) *Treatment of section 467 loan.* If there is a sale, exchange, or other disposition of property subject to a section 467 rental agreement (the transfer), the following rules apply in determining the amount of the section 467 loan for the period after the transfer, the amount realized by the transferor, and the transferee's basis in the property:

(i) The beginning balance of the transferor's section 467 loan is equal to the net present value at the time of the transfer of all subsequent amounts payable as fixed rent and interest on fixed rent to the transferor and all subsequent amounts payable as interest on prepaid fixed rent by the transferor.

The transferor must continue to take into account interest on the transferor's section 467 loan balance after the date of the transfer.

(ii) The beginning balance of the transferee's section 467 loan is equal to the principal balance of the section 467 loan immediately before the transfer reduced (below zero, if appropriate) by the beginning balance of the transferor's section 467 loan. Amounts payable to the transferor are not taken into account in adjusting the transferee's section 467 loan balance.

(iii) If the beginning balance of the transferee's section 467 loan is negative, the transferor and transferee must treat the balance as a liability that is either assumed in connection with the transfer of the property or secured by the property acquired subject to the liability. If the beginning balance of the transferee's section 467 loan is positive, the transferor and transferee must treat the balance as an additional asset acquired in connection with the transfer of the property. In the case of a positive beginning balance of the transferee's section 467 loan, the transferee will have an initial cost basis in the section 467 loan equal to the lesser of the beginning balance of the loan or the aggregate consideration for the transfer of the property subject to the section 467 rental agreement and the transfer of the transferor's interest in the section 467 loan.

(3) *Special rules for transfers in certain nonrecognition transactions.* [Reserved]

(f) *Treatment of assignments by lessee and lessee-financed renewals—*

(1) *Substitute lessee use.* If a lessee assigns its interest in a section 467 rental agreement to a substitute lessee or a period when a substitute lessee has the use of property subject to a rental agreement is otherwise included in the lease term under §1.467-1(h), the section 467 rent for a period is taken into account by the person having the use of the property during the period. In addition, the following rules apply in determining the amount of the section 467 loan for the period when the substitute lessee has use of the property and in computing the taxable income of the lessee and substitute lessee—

(i) The beginning balance of the lessee's section 467 loan is equal to the net present value, as of the date on which the substitute lessee first has use of the property, of all amounts subsequently payable by the lessee as fixed rent and interest on fixed rent and all

amounts subsequently payable as interest on prepaid fixed rent to the lessee. For purposes of this paragraph (f), any amount otherwise payable by the lessee shall not be treated as an amount subsequently payable by the lessee to the extent that such payment, if made by the lessee, would give rise to a right of contribution or other similar claim against the substitute lessee or any other person. The lessee must continue to take into account interest on the lessee's section 467 loan balance after the substitute lessee first has use of the property.

(ii) The beginning balance of the substitute lessee's section 467 loan is equal to the principal balance of the section 467 loan immediately before the substitute lessee first has use of the property reduced (below zero, if appropriate) by the beginning balance of the lessee's section 467 loan. Amounts payable by the lessee to any person other than the substitute lessee (or a related person) or payable to the lessee by any person other than the substitute lessee (or a related person) are not taken into account in adjusting the substitute lessee's section 467 loan balance.

(iii) If the beginning balance of the substitute lessee's section 467 loan is positive, the beginning balance is treated as— (A) Gross income of the lessee for the taxable year in which the substitute lessee first has use of the property; and

(B) A liability that is either assumed in connection with the transfer of the leasehold interest to the substitute lessee or secured by property acquired subject to the liability.

(iv) If the beginning balance of the substitute lessee's section 467 loan is negative—

(A) The beginning balance is treated as an amount incurred by the lessee for the taxable year in which the substitute lessee first has use of the property; and

(B) Repayments of the beginning balance are items of gross income of the substitute lessee in the taxable year in which the repayment occurs (determined by applying any repayment first to the beginning balance of the substitute lessee's section 467 loan).

(v) For purposes of paragraph (f)(1)(iv)(B) of this section, repayments occur as the negative balance is amortized through the net accrual of rent and negative interest.

(2) *Lessor use.* If a period when the lessor has the use of property subject to a section 467 rental agreement is

included in the lease term under §1.467-1(h), the section 467 rent for the period is not taken into account and the lessor is treated as a substitute lessee for purposes of paragraph (f)(1) of this section.

(3) *Special rules for transfers in certain nonrecognition transactions.* [Reserved]

§1.467-8 *Effective date.*

Sections 1.467-1 through 1.467-7 are effective for—

(a) Rental agreements entered into after the date these regulations are published as final regulations in the **Federal Register**; and

(b) Disqualified leasebacks and long-term agreements entered into after June 3, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

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