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DEPARTMENT OF THE TREASURY

Internal Revenue Service

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[TD 8820]

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Section 467 Rental Agreements; Treatment of Rent and Interest Under Certain Agreements for the Lease of Tangible Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the treatment of rent and interest under certain agreements for the lease of tangible property. The regulations apply to certain rental agreements that provide increasing or decreasing rents, or deferred or prepaid rent, and provide guidance for lessees and lessors of tangible property.

DATES: Effective Date: These regulations are effective on May 18, 1999.

Applicability Date: For dates of applicability of these regulations, see Effective Dates under SUPPLEMENTARY INFORMATION.

FOR FURTHER INFORMATION CONTACT: Forest Boone of the Office of Assistant Chief Counsel (Income Tax and Accounting) at (202) 622-4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

Section 467 was added to the Internal Revenue Code by section 92(a) of the Tax Reform Act of 1984 (Public Law 98-369 (98 Stat. 609)). On June 3, 1996, the IRS and Treasury Department issued a notice of proposed rulemaking (61 FR 27834 [IA-292-84, 1996-2 C.B. 462]) relating to section 467. The proposed regulations provide guidance regarding the applicability of section 467, and the amount of rent and interest required to be accrued under section 467. Comments responding to the notice were received, and a public hearing was held on September 25, 1996.

The IRS and Treasury Department issued interim guidance in Notice 97-72 (1997-2 C.B. 334), which informed taxpayers of certain conditions under which a refinancing of indebtedness incurred by a lessor to acquire property that is the subject of a rental agreement will not be considered a substantial modification of that agreement for purposes of section 467. After considering the comments that were received in response to the notice of proposed rulemaking and the statements made at the public hearing, the proposed regulations are adopted as revised by this Treasury decision. The significant comments and revisions are discussed below.

**Explanation of Provisions**

1. Section 467 Rental Agreements

Under the proposed and final regulations, section 467 applies to any rental agreement with increasing or decreasing rent and aggregate rental payments or other consideration of more than \$250,000. 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.

In determining whether a rental agreement has increasing or decreasing rent, the proposed regulations provide that a rent holiday at the beginning of the lease term is disregarded if the rent holiday period is three months or less. Several commentators requested that the rent holiday period be lengthened, arguing that it should be the same as the rent holiday period permitted for determining whether a leaseback or long-term agreement has tax-motivated increasing rents (the lesser of 24 months or 10 percent of the lease term). The final regulations do not adopt this suggestion.

Section 467(d)(1)(B) provides that a rental agreement will be treated as a section 467 rental agreement if there are increases in the amount to be paid as rent under the agreement. Except for the \$250,000 de minimis exception set forth in section 467(d)(2), section 467 does not contain any exceptions to the rule that rental agreements with increasing rent are section 467 rental agreements. The three-month rent holiday exception was added in the proposed regulations to prevent relatively insubstantial rent holidays from causing a rental agreement to be

treated as a section 467 rental agreement. Accordingly, the three-month rent holiday exception is intended merely as a de minimis exception and a rule of administrative convenience. In contrast, Congress specifically directed that a rent holiday safe harbor should be provided for normal commercial practices in determining whether a leaseback or long-term agreement has tax-motivated increasing rents. Thus, since the policies that support a rent holiday exception for disqualified leasebacks and long-term agreements are clearly not the same as the policies that support a rent holiday exception for whether an agreement has increasing rent and is therefore a section 467 rental agreement, the IRS and Treasury Department do not believe the rent holiday periods should be the same.

The proposed regulations also 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. Several commentators

requested additional exceptions for other types of payments, as well as an expansion of the existing exceptions.

The final regulations provide several additional types of contingent payments that will not be taken into account in determining whether a rental agreement has increasing or decreasing rent. Because of the relationship between these contingent rent provisions and the contingent rent provisions that are disregarded in determining whether an agreement is a disqualified leaseback or long-term agreement, the new contingent rent exceptions will be discussed below in connection with the discussion of disqualified leasebacks and long-term agreements.

2. Section 467 Rent

Under the proposed and final 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. The amount of fixed rent for a rental period depends on the terms of the rental agreement and, under the regulations, will be either the amount of fixed rent allocated to the period under the agreement, the constant rental amount, or the proportional rental amount.

A. Disqualified leaseback or long-term agreement

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 a disqualified leaseback or long-term agreement 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. The proposed regulations include as safe harbors only the provisions set forth in section 467(b)(5) and an uneven rent test based on Rev. Proc. 75-21 (1975-1 C.B. 715). Other factors that would be considered as evidence of tax avoidance were not provided.

Several commentators requested additional safe harbors for other types of payments, as well as an expansion of the existing safe harbors. In response to these comments, several changes have been made in the final regulations to the tax avoidance and safe harbor provisions.

(i) Determining tax avoidance

The proposed regulations do not provide any substantive rules for determining tax avoidance because a leaseback or long-term agreement will not be treated as disqualified in the absence of an affirmative determination by the Commissioner. As a result, the objective of consistency of treatment between the lessee and lessor would have been met without the need to

promulgate factors or other rules that taxpayers could use to determine whether tax avoidance was present. While the final regulations retain the rule that only the Commissioner may make a tax avoidance determination, the IRS and Treasury Department believe that the combination of substantive guidance on tax avoidance and additional safe harbors will permit taxpayers to determine more readily whether their leasebacks or long-term agreements will be determined to be disqualified by the Commissioner. Accordingly, substantive provisions have been added to the final regulations prescribing the circumstances in which Federal income tax avoidance will be treated as a principal purpose for providing increasing or decreasing rent.

The final regulations provide that, if a significant difference between the marginal Federal income tax rates of the lessor and lessee can reasonably be expected at some time during the lease term, 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. The regulations provide rules to determine when there is a significant difference in marginal tax rates of the lessor and lessee. Under these rules, the marginal tax rates are determined not only by reference to the Federal income tax status of the taxpayer (for example, as a corporation, partnership, or individual), but also to the specific circumstances of the taxpayer. Thus, if a corporation either is subject to the alternative minimum tax or has available net

operating losses or credits to carry forward from an earlier taxable year, the corporation's marginal tax rate will differ from other corporations not subject to the alternative minimum tax and not having available net operating losses or credits. Further, in the case of an S corporation or partnership, the marginal tax rate will be determined by taking into account the amounts of income or deduction allocable to its shareholders or partners, respectively, and the marginal tax rates of the shareholders or partners.

Finally, as noted above, the final regulations retain the rule of the proposed regulations that only the Commissioner may determine that a section 467 rental agreement should be treated as a disqualified leaseback or long-term agreement. The final regulations also provide that such determination may be made either on a case-by-case basis or in regulations or other guidance published by the Commissioner providing that a certain type or class of leaseback or long-term agreement will be treated as disqualified and subject to constant rental accrual.

(ii) Safe harbors

In response to comments, the final regulations include several safe harbor provisions not included in the proposed regulations. The new safe harbors are intended to cover a variety of payments that could be made under the terms of a rental agreement. Under the final regulations, tax avoidance is not considered a principal purpose for providing increasing or decreasing rent if the increase or decrease in rent is described

in one of the contingent rent safe harbor provisions. The IRS and Treasury Department believe that these additional safe harbors and the expansion of the existing safe harbors appropriately balance the need to provide a degree of certainty for taxpayers with the need to limit the potential for tax avoidance.

The final regulations add several safe harbors for various types of contingent payments that either are intended to compensate the lessor for costs unrelated to the lessor's continuing investment in the leased property or are so contingent that they should not be taken into account for purposes of section 467 until the liability for such payment becomes fixed. Accordingly, subject to the limitations in the regulations, safe harbors are provided for payments required to be made by the lessee: in the event of damage, destruction, or loss of the leased property; in the case of a qualified motor vehicle operating agreement within the meaning of section 7701(h)(2)(A), for the failure of the property to maintain a specified residual value; for the failure of the property to be returned to the lessor at the end of the lease term in the condition specified in the agreement; or for the failure of the lessor to obtain the income tax benefits contemplated by the agreement. In addition, a provision requiring late payment charges is also not taken into account in determining whether tax avoidance is present in a leaseback or long-term agreement. Limitations on the scope of these safe harbors are provided in order to ensure that these

provisions are included in the agreement for a valid business purpose and that the provisions are not used to achieve tax avoidance.

Several commentators suggested that rent adjustments based on the lessor's indebtedness, which itself bears interest at a variable rate, are not tax motivated. In response, a safe harbor has also been added for certain variable interest rate provisions. Under this safe harbor, a rent adjustment provision will be disregarded if it is based solely on the dollar amount of changes in the lessor's interest costs, and only if the lessor and the lender are not related and the indebtedness is evidenced by a variable rate debt instrument (within the meaning of §1.1275-5(a)(1)). However, no inference may be drawn from this safe harbor (or any other provision of the regulations relating to a variable interest rate adjustment) concerning the effect of such an adjustment on the classification of the rental agreement as a lease for Federal income tax purposes.

In addition, the final regulations expand the scope of the safe harbors provided in the proposed regulations relating to percentage rents, inflation adjustments, and reasonable rent holidays. A provision in a lease will not fail to qualify for the percentage rent safe harbor because, for example, it applies to receipts or sales after making certain limited deductions, it applies different percentages to different departments or floors, or it applies to receipts or sales in excess of a determinable amount. In addition, a provision will not fail to qualify as an

increase based on a reasonable price index because it may limit the adjustment to a fixed percentage in some years. However, this inflation adjustment safe harbor will not apply if the limitation in the rental agreement represents, in substance, a series of fixed increases in rent. For example, if the limitation on an annual inflation adjustment is substantially below the level of inflation reasonably expected during the lease term, the limitation is, in substance, a series of fixed increases in rent.

The proposed regulations include a rent holiday safe harbor for the determination of tax avoidance, which provision applies only if there is a substantial business purpose for the rent holiday. Commentators objected to this requirement because the requirement of a business purpose was not set forth in the legislative history accompanying the enactment of section 467. The final regulations delete the requirement that there be a substantial business purpose for the rent holiday, but add the requirement that was set forth in the legislative history. H.R. Conf. Rep. No. 861, 98<sup>th</sup> Cong., 2d Sess. 893 (1984). Under the additional rule in the final regulations, the reasonableness of the rent holiday is determined by reference to the commercial practice (as of the agreement date) in the locality where the use of the property occurs. This commercial reasonableness requirement does not apply, however, in the case of a rent holiday of three months or less at the beginning of the lease term.

The proposed regulations also limit the rent holiday safe harbor to rent holidays at the beginning of the lease term. The final regulations remove this limitation and permit one consecutive period at any point during the lease term to qualify for the rent holiday safe harbor if the commercial reasonableness requirement is satisfied and the rent holiday period does not exceed the lesser of 24 months or 10 percent of the lease term.

Finally, except in the case of the rent holiday safe harbor, the safe harbor provisions discussed above also apply in determining whether a rental agreement has increasing or decreasing rent and is thus subject to section 467. Accordingly, if a type of contingent rent in a rental agreement meets the requirements of the applicable safe harbor provision, it is not taken into account in determining whether the agreement has increasing or decreasing rent for purposes of both the application of section 467 and the determination of whether the agreement is a disqualified leaseback or long-term agreement.

(iii) Uneven rent test

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 "uneven rent test" is derived from the Conference Committee Report, which 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 to be motivated by tax avoidance. The report cited the standards for advance rulings on leveraged lease transactions in Rev. Proc. 75-21, and stated that such standards may not be appropriate for real estate leases. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 893 (1984). The proposed regulations do not provide a safe harbor specifically applicable to real estate leases but comments were requested on whether a different uneven rent test should be established for real estate leases.

Commentators requested that the basic "90-110" test in Rev. Proc. 75-21 be adopted without modification. The principal modification to the basic 90-110 test in the proposed regulations identified by the commentators was the use of the calendar year rather than the lease year to test for uneven rents. These commentators also requested that the alternate uneven rent test (sometimes referred to as the "2/3-1/3" test) be adopted as an additional safe harbor. Finally, these commentators requested clarification of the application of these uneven rent tests in certain circumstances.

In response to these comments, the final regulations expand and clarify the scope of the uneven rent test in the proposed regulations. First, the final regulations allow a rent holiday period at the beginning of the lease term to be ignored in applying the uneven rent test if its duration is not more than

three months. Further, all but two of the contingent rent provisions ignored for purposes of determining tax avoidance are also disregarded in applying the uneven rent test. Rules are also provided to assist taxpayers in applying the uneven rent test if the rental agreement contains a variable rent provision.

For long-term leases of real estate, the final regulations provide a modified uneven rent test. Under the final regulations, all of the rules relating to the uneven rent test will be applied to long-term leases of real estate, except that a 15 percent variance will be permitted in lieu of the 10 percent variance (the "85-115" test) and a rent holiday will be disregarded if it is commercially reasonable and its duration does not exceed the lesser of 24 months or 10 percent of the lease term.

The final regulations do not adopt the suggestion that the alternative  $\frac{2}{3}$ - $\frac{1}{3}$  test also be made available as an additional safe harbor. Section 467 evidences recognition that tax avoidance may result from the use of either increasing or decreasing rents in a section 467 rental agreement, depending on the circumstances of the lessor and lessee in the particular transaction. The IRS and Treasury Department believe that the use of the  $\frac{2}{3}$ - $\frac{1}{3}$  test may, in some cases, result in substantial decreases in rent. Thus, the  $\frac{2}{3}$ - $\frac{1}{3}$  test is not included in the final regulations.

Furthermore, the final regulations retain the use of the calendar year as the basis for applying the uneven rent test.

The IRS and Treasury Department believe that use of the calendar year is most consistent with the structure of section 467, which provides the calendar year as the basis for determining whether rent is deferred.

Some commentators requested additional safe harbors and other special rules for leases of real estate, including the allowance of fixed increases that approximate the parties' expectations of general price increases during the lease term. The final regulations do not provide any additional provisions relating to real estate leases except for the modified 85-115 uneven rent test and the expanded rent holiday safe harbor. The IRS and Treasury Department believe that any fixed increases in a real estate lease that exceed the permitted variance under the relaxed safe harbor should be tested for tax avoidance under the general standards.

(iv) The \$2,000,000 limitation

The proposed regulations provide that, among other limitations, a rental agreement will not be treated as a disqualified leaseback or long-term agreement unless it requires more than \$2,000,000 in rental payments and other consideration.

Although the \$2,000,000 limitation has been retained in the final regulations, the IRS and Treasury no longer believe such a limitation is appropriate. Accordingly, the IRS and Treasury are issuing proposed regulations that would eliminate the \$2,000,000 limitation on a prospective basis.

B. Rental agreement accrual

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

The proposed regulations provide that, in the absence of a specific allocation of fixed rent, the amount of rent allocated to each rental period during the lease term is the amount of fixed rent payable during that rental period. A number of commentators requested that the rule for allocating rent in the absence of a specific allocation of fixed rent be amended. The commentators stated that, if a rental agreement contains only a rent payment schedule without a separate rent allocation schedule, the agreement should be treated as one that does not provide for an allocation of rents. In these circumstances, the

commentators contend that the agreement should be subject to constant rental accrual under section 467(b)(3)(B).

The final regulations do not adopt this suggestion. Instead, the final regulations, like the proposed regulations, provide that, in the absence of 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. The IRS and Treasury Department believe that it is inappropriate to apply the constant rental accrual rules solely because a rental agreement does not include a specific allocation of fixed rent, whether as a result of inadvertence, failure to obtain professional tax advice, or otherwise. Further, while the constant rental accrual method is not available unless the Commissioner makes a tax avoidance determination, parties wishing to accrue rent in accordance with the constant rental accrual method may provide for an allocation schedule in their rental agreement with tax consequences that approximate the use of the constant rental accrual method.

C. Other applicable limitations

Some commentators suggested that the final regulations provide that rental agreements will be closely scrutinized for substantial economic effect in appropriate cases. For example, a rental agreement may provide a specific allocation of fixed rent (or no specific allocation of fixed rent) that, under the regulations, would result in significant back-loaded or front-loaded rent, but would not be subject to constant rental accrual

because it is not a leaseback or long-term agreement. In general, the rules of section 467 represent exceptions to the general rules of tax accounting applicable to income and expense associated with rental agreements. However, the IRS and Treasury Department do not believe that section 467 and the regulations thereunder override other principles of Federal tax law in the case of income and expense associated with rental agreements. Thus, the final regulations explicitly provide that the Commissioner may apply authorities other than section 467 and the regulations thereunder, such as section 446(b) clear-reflection-of-income principles, section 482, and the substance-over-form doctrine, to determine the income and expense from a rental agreement (including the proper allocation of fixed rent under a rental agreement).

### 3. Rental Agreements with Contingent Payments

The proposed regulations reserve guidance on the section 467 treatment of contingent rent, indicating that regulations addressing this issue would provide rules for contingent rent similar to those provided for computing original issue discount for contingent payment debt instruments in §1.1275-4. The final regulations continue to reserve on the section 467 treatment of contingent payments. The IRS and Treasury Department expect that regulations under §1.467-6 will be separately proposed, and continue to invite comments regarding the treatment of contingent rent and the application of the §1.1275-4 rules to section 467 rental agreements.

4. Recapture on Sale or Other Disposition of Property

Some commentators requested certain modifications and further clarification of the recapture rules under section 467(c) in the case of dispositions by gift, transfers at death, and certain tax-free transactions. In response to these comments, additional rules and examples illustrating those rules are provided in the final regulations.

The purpose of the additional rules is to place the transferee in the same tax position upon the subsequent disposition of the leased property as the transferor would have been in if the transferor had not transferred the property to the transferee. For example, if property subject to a section 467 rental agreement is transferred in a transaction subject to section 351, and if the transferor would have recognized section 467(c) recapture upon a taxable disposition of the property, the transferee may be subject to recapture upon a subsequent taxable disposition of the property. The amount of the recapture upon the subsequent taxable disposition will be determined by taking into account the section 467 rent and section 467 interest relating to the period of the transferor's ownership of the property. Thus, if a leaseback or long-term agreement provides for increasing rent but is not a disqualified leaseback or long-term agreement, a taxable disposition of the property by the transferee on or after the expiration of the lease term will not be subject to section 467(c) recapture. Alternatively, a taxable disposition of the property by the transferee before the

expiration of the lease term will be subject to the same amount of section 467(c) recapture that would have applied if the transferor had continued to own the property.

5. Other Disposition Rules

The proposed regulations reserve guidance on 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. The IRS and Treasury Department believe, however, that special rules are not necessary in the case of nonrecognition transactions. As a general matter, because a section 467 loan is treated as indebtedness for all purposes of the Internal Revenue Code, the rules that apply to each of the nonrecognition provisions in cases where the property transferred is encumbered by indebtedness will apply to the transfer of property or a leasehold interest subject to a section 467 loan. Further, if the section 467 loan represents an additional asset of the transferor, it is unlikely that any gain will be realized by the transferor because, in most cases, the basis of the loan will be equal to the sum of the principal amount of the loan and the accrued interest thereon. Thus, the provisions of the proposed regulations relating to special rules for transfers in nonrecognition transactions have been deleted.

6. Treatment of Modifications

The proposed regulations provide that, if the lessor and lessee agree to a substantial modification of the terms of an existing lease, the modified lease is generally treated as a new

rental agreement for purposes of section 467. Thus, if the modified lease provides for increasing or decreasing rent, or deferred or prepaid rent, and the rent exceeds \$250,000, it is treated under the proposed regulations as a section 467 rental agreement, even if the pre-modification lease was not a section 467 rental agreement.

Some commentators requested additional guidance regarding whether a substantial modification of a lease has occurred, in view of the significant potential consequences of such a modification. In addition, the commentators suggested several types of modifications that, in their view, should not be treated as a substantial modification.

Other commentators indicated that the proposed regulations did not clarify whether only the remaining portion of the modified lease is to be taken into account for purposes of determining the section 467 rent and interest for rental periods following the modification.

The final regulations retain the general rule of the proposed regulations under which a rental agreement would be treated as a new lease for purposes of section 467 if the parties agreed to a substantial modification. Under the final regulations, if a substantial modification of a rental agreement occurs after June 3, 1996, the post-modification agreement is treated as a new agreement for purposes of determining whether the agreement is a section 467 rental agreement or a disqualified leaseback or long-term agreement and for purposes of applying the

effective date provisions of the section 467 regulations. These rules do not apply, however, to a modification occurring on or before May 18, 1999, unless the rental agreement being modified is a post-June 3, 1996, disqualified leaseback or long-term agreement or the post-modification agreement is a disqualified leaseback or long-term agreement.

In general, in determining whether a modified agreement is a section 467 rental agreement, or a disqualified leaseback or long-term agreement, the modified agreement is considered to consist only of the terms that relate to post-modification items (as described below). However, if a principal purpose of the modification is to avoid the purpose or intent of section 467 or the regulations thereunder, the Commissioner may treat the entire agreement (as modified) as a single agreement for purposes of section 467. The final regulations also provide that the post-modification agreement, notwithstanding its treatment as a new agreement, will be characterized, in certain cases, in the same manner as the agreement in effect before the modification. For example, if an agreement was a leaseback or was subject to constant rental accrual before its modification, the post-modification agreement will generally be treated as a leaseback or as subject to constant rental accrual. Similarly, if the agreement was a long-term agreement before its modification and the entire agreement (as modified) is a long-term agreement, the post-modification agreement will be treated as a long-term agreement.

The final regulations also provide rules for accounting for the effects of modifications occurring after May 18, 1999. In the case of a substantial modification, the lessor and lessee must take pre-modification items (generally, rent for periods before the modification, interest thereon, and payments allocable thereto (whether made before or after the modification)) into account under the method of accounting used before the modification. In computing section 467 rent, section 467 interest, and the amount of the section 467 loan with respect to post-modification items, only post-modification items are taken into account. In addition, the parties to the agreement are required to take into account adjustments necessary to prevent duplications and omissions resulting from the modification.

In the case of a modification that is not substantial, section 467 rent and interest for periods affected by the modification are determined under the terms of the entire agreement (as modified). In addition, the parties to the agreement are required to recompute the balance of the section 467 loan under the new terms and to take into account (as either additional rent or a reduction in rent previously taken into account) the change in the loan balance resulting from the modification. They are also required to take into account any amount necessary to prevent duplications or omissions resulting from the modification.

The final regulations also provide additional guidance for determining whether a substantial modification of a lease has

occurred, adopting some of the principles applicable to the modification of debt instruments under §1.1001-3. Under the final regulations, all of the facts and circumstances will be examined to determine whether a substantial modification has occurred. Because this determination is inherently factual, the regulations do not provide more specific criteria for making this determination. However, in order to ensure that relatively insubstantial changes to the terms of a lease agreement and changes that do not implicate the policies of section 467 are not treated as substantial modifications under this rule, safe harbor provisions have been added.

In general, the modifications that are likely to affect the character of a rental agreement for purposes of section 467 are those that change the amount or timing of rent allocated or rent payable for the use of the property, or the identity of the taxpayer taking those amounts into account. Thus, a substantial modification will not result from changes in any provision for the payment of third-party costs or any other provision that is ignored for purposes of determining whether the agreement provides for contingent rents. In addition, the refinancing of a lessor's indebtedness on a leveraged lease will generally not be treated as a substantial modification of the lease, subject to compliance with certain conditions and limitations. These conditions and limitations are intended to permit refinancings to avoid classification as a substantial modification in

circumstances where the primary objective of the lessee is to take advantage of favorable changes in interest rates.

In the case of a transfer of leased property by a lessor or a substitution of a lessee, the final regulations provide that the transfer or substitution will be treated as a substantial modification only if a principal purpose of the transaction is the avoidance of Federal income tax. In determining whether a transfer or substitution should be treated as a substantial modification, the safe harbors and other principles that generally apply in tax avoidance determinations are taken into account and the Commissioner may treat the post-modification agreement as a new agreement or treat the entire agreement (as modified) as a single agreement.

7. Definition of Lease Term

The proposed regulations provide that an option period, whether exercisable by the lessor or the lessee, is included in the lease term only if it is reasonably expected, as of the agreement date, that the option will be exercised. In contrast, Rev. Proc. 75-21 provides a comparable rule only for options that are exercisable by the lessee, while including the duration of all lessor renewal options in the lease term. The IRS and Treasury Department believe that nothing in section 467 justifies a deviation from the rule of Rev. Proc. 75-21 in this instance. Accordingly, for purposes of determining the term of a lease, the final regulations retain the rule of the proposed regulations

only for lessee options, and treat all lessor options as if they had been exercised.

8. Effective Dates

The regulations are applicable for (1) disqualified leasebacks and long-term agreements entered into after June 3, 1996, and (2) other rental agreements entered into after May 18, 1999. No inference should be drawn 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.

Some commentators requested that the effective date for disqualified leasebacks and long-term agreements be deferred so that the regulations would apply only to agreements entered into after the date on which final regulations are published in the **Federal Register**. The final regulations do not adopt this suggestion. The IRS and Treasury Department believe that the additional safe harbors provided in these regulations will prevent leasebacks and long-term agreements entered into after June 3, 1996, and on or before May 18, 1999 (the interim period), from being inappropriately disqualified in cases where the increasing or decreasing rents have not been motivated by tax avoidance. Some of these commentators also requested that the regulations not be applied to rental agreements entered into pursuant to a contract that was binding on the applicable

effective date. The effective dates have been clarified in response to these comments.

Other commentators requested that taxpayers be permitted to rely on the provisions of the proposed regulations in the case of leasebacks and long-term agreements entered into during the interim period. According to these commentators, the terms of certain leasebacks and long-term agreements entered into during the interim period were structured so as to comply with the safe harbors and other provisions of the proposed regulations in order to ensure that these agreements would not be treated as disqualified leasebacks or long-term agreements. In the absence of a provision permitting taxpayers to rely on the provisions of the proposed regulations in these cases, these agreements might lose their safe-harbor protection because of changes made in the final regulations. Accordingly, the final regulations permit taxpayers to rely on the provisions of the proposed regulations in the case of any leaseback or long-term agreement entered into during the interim period. No specific election is required in the case of an agreement subject to this provision.

9. Special Transitional Rule

Although the regulations do not apply to any rental agreement entered into on or before June 3, 1996, and do not apply to any rental agreement other than a disqualified leaseback or long-term agreement entered into on or before May 18, 1999, some commentators requested that they be allowed to change their method of accounting to the constant rental accrual method for

rental agreements involving certain types of property financed by tax-exempt bonds where the agreements were entered into prior to the issuance of the section 467 regulations. The special rule was requested because, prior to the issuance of regulations, lessees had entered into rental agreements providing for disproportionately large payments of rent in the later years of the lease term, but without specific allocations of rents. In the view of the commentators, the circumstances in which a schedule of rent payments would be treated as a rent allocation schedule were not fully addressed by the legislative history.

In response to the comments, the final regulations contain a special transitional rule under which lessees may change their method of accounting for certain agreements to the constant rental accrual method. With respect to this special transitional rule, a lessee's change in its method of accounting for a rental agreement does not affect the method of accounting used by the lessor for the same agreement. In the case of similar rental agreements entered into after May 18, 1999, lessees will be able to obtain results comparable to the constant rental accrual method only by providing a specific allocation schedule that differs from the rent payment schedule.

10. Issues Not Addressed

The final regulations do not address the application of section 467 to payments for services. With respect to the possible application of section 467 to transactions sometimes referred to as "lease strips" or "stripping transactions", as

described in Notice 95-53 (1995-2 C.B. 334), regulations under section 7701(l) were proposed after the issuance of the proposed regulations under section 467 setting forth the treatment of such transactions. Consequently, the IRS and Treasury Department believe that no specific guidance on the treatment of such transactions under section 467 is necessary.

The final regulations also do not provide guidance concerning the applicability of penalties or additions to tax when the Commissioner determines that a section 467 rental agreement should be treated as a disqualified leaseback or long-term agreement. No inference should be drawn from the failure to address the issue in these regulations concerning the Commissioner's authority to impose applicable penalties and additions to tax in such circumstances.

### **Special Analyses**

It has been determined that this Treasury decision 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) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel

for Advocacy of the Small Business Administration for comment on their impact on small businesses.

**Drafting Information**

The principal author of these 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.

**List of Subjects in 26 CFR part 1**

Income taxes, Reporting and recordkeeping requirements.

**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is 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, in part, as follows:

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

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

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

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

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

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

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

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

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

§1.467-9 is also issued under 26 U.S.C. 467. \* \* \*

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. \* \* \*

\* \* \* \* \*

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

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

\* \* \* \* \*

(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 (See §601.601(b)(2) of this chapter), 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.

\* \* \* \* \*

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

1. 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 two sentences at the end of the introductory text of paragraph (d)(7).

The 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).

\* \* \* \* \*

(7) \* \* \* Assume further that the examples do not involve section 467 rental agreements and, therefore, section 467 is not applicable. The examples are as follows:

\* \* \* \* \*

Par. 6. Sections 1.467-0 through 1.467-9 are added to read as follows:

§1.467-0 Table of contents.

This section lists the captions that appear in §§1.467-1 through 1.467-9.

§1.467-1 Treatment of lessors and lessees generally.

- (a) Overview.
  - (1) In general.
  - (2) Cases in which rules are inapplicable.
  - (3) Summary of rules.
    - (i) Basic rules.
    - (ii) Special rules.
  - (4) Scope of rules.
  - (5) Application of other authorities.
- (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) of this section.
- (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) Substantial modification of a rental agreement.
  - (1) Treatment as new agreement.
    - (i) In general.
    - (ii) Limitation.
      - (2) Post-modification agreement; in general.
      - (3) Other effects of a modification.
      - (4) Special rules.
        - (i) Carryover of character; leasebacks.
        - (ii) Carryover of character; long-term agreements.
        - (iii) Carryover of character; disqualified agreements.
        - (iv) Allocation of rent.
  - (v) Difference between aggregate rent and interest and aggregate payments.
    - (A) In general.
    - (B) Constant rental accrual prior to the modification.
    - (C) Agreements described in this paragraph (f)(4)(v)(C).
- (vi) Principal purpose of tax avoidance.
  - (5) Definitions.
  - (6) Safe harbors.
  - (7) Special rules for certain transfers.
    - (i) In general.
    - (ii) Exception.
- (g) Treatment of amounts payable by lessor 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 agreements 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 rental agreements relating to properties having different statutory recovery periods.
  - (c) Tax avoidance as principal purpose for increasing or decreasing rent.
    - (1) In general.
    - (2) Tax avoidance.
      - (i) In general.
      - (ii) Significant difference in tax rates.
      - (iii) Special circumstances.
        - (3) Safe harbors.
        - (4) Uneven rent test.
          - (i) In general.
          - (ii) Special rule for real estate.
          - (iii) Operating rules.
    - (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) Examples.

§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), (f), or (g).
- (b) Principal balance.
  - (1) In general.
  - (2) Section 467 rental agreements that provide for prepaid fixed rent and adequate 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) Yield for purposes of applying paragraph (a)(4) of this section.
  - (4) 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) Positive or negative 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 and modifications.

- (a) Section 467 recapture.
- (b) Recapture amount.
  - (1) In general.
  - (2) Prior understated inclusion.
  - (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.
  - (A) In general.
  - (B) Transfers to certain tax-exempt organizations.
- (4) Dispositions by transferee.
- (5) Like-kind exchanges and involuntary conversions.
- (6) Installment sales.
- (7) Dispositions covered by section 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) [Reserved]
  - (4) Examples.
- (f) Treatment of assignments by lessee and lessee-financed renewals.
  - (1) Substitute lessee use.
  - (2) Treatment of section 467 loan.
  - (3) Lessor use.
  - (4) Examples.
- (g) Application of section 467 following a rental agreement modification.
  - (1) Substantial modifications.
    - (i) Treatment of pre-modification items.
    - (ii) Computations with respect to post-modification items.
    - (iii) Adjustments.
      - (A) Adjustment relating to certain prepayments.
      - (B) Adjustment relating to retroactive beginning of lease term.
    - (iv) Coordination with rules relating to dispositions and assignments.
      - (A) Dispositions.
      - (B) Assignments.
  - (2) Other modifications.
    - (i) Computation of section 467 loan for modified agreement.
    - (ii) Change in balance of section 467 loan.
    - (iii) Section 467 rent and interest after the modification.
    - (iv) Applicable Federal rate.

- (v) Modification effective within a rental period.
- (vi) Other adjustments.
- (vii) Coordination with rules relating to dispositions and assignments.
- (viii) Exception for agreements entered into prior to effective date of section 467.
- (3) Adjustment by Commissioner.
- (4) Effective date of modification.
- (5) Examples.
- (h) Omissions or duplications.
- (1) In general.
- (2) Example.

§1.467-8 Automatic consent to change to constant rental accrual for certain rental agreements.

- (a) General rule.
- (b) Agreements to which automatic consent applies.

§1.467-9 Effective dates and automatic method changes for certain agreements.

- (a) In general.
- (b) Automatic consent for certain rental agreements.
- (c) Application of regulation project IA-292-84 to certain leasebacks and long-term agreements.
- (d) Entered into.
- (e) Change in method of accounting.
- (1) In general.
- (2) Application of regulation project IA-292-84.
- (3) Automatic change procedures.

§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 (and time value of money principles) 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 accrual method, pursuant to which the rent is treated as accruing 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 1.467-9 (the section 467 regulations), if it specifies equal amounts of rent for each month throughout the lease term and all payments of rent are due in the calendar year to which the rent relates (or in the preceding or succeeding calendar year). In addition, the section 467 regulations do not apply to a rental agreement that requires total rents of \$250,000 or less. For purposes of determining whether the agreement has total rents of \$250,000 or less, certain specified contingent rent is disregarded.

(3) 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. Paragraph (i) of this section is reserved.

(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 method, including criteria for determining whether an agreement is subject to this method. 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). Section 1.467-5 provides rules for applying the section 467 regulations where a rental agreement requires payments of interest at a variable rate. Section 1.467-6, relating to the treatment of certain section 467 rental agreements with contingent payments, is reserved. 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. Section 1.467-7 also provides rules for the treatment of modified rental agreements. Section 1.467-8 provides special transitional rules relating to the method of accounting for certain rental agreements entered into on or before May 18, 1999. Finally, §1.467-9 provides the effective date rules for the section 467 regulations.

(4) Scope of rules. No inference should be drawn from any provision of this section or §§1.467-2 through 1.467-9 concerning whether--

(i) For Federal tax purposes, an arrangement constitutes a lease; or

(ii) For Federal tax purposes, any obligation of the lessee under a rental agreement is treated as rent.

(5) Application of other authorities. Notwithstanding section 467 and the regulations thereunder, other authorities such as section 446(b) clear-reflection-of-income principles, section 482, and the substance-over-form doctrine, may be applied by the Commissioner to determine the income and expense from a rental agreement (including the proper allocation of fixed rent under a rental agreement).

(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 the sum of--

(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)(12) of this section, that has increasing or decreasing rents (as described in paragraph (c)(2) of this section), or deferred or prepaid 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 (or no rent) for a period of three months or less at the beginning of the lease term.

(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 providing for total payments of fixed rent equal to the

total amount specified, specifically allocates rent. 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)(2) of this section), other than contingent rent described in paragraph (c)(2)(iii)(B) of this section.

(B) Certain contingent rent disregarded. For purposes of this paragraph (c)(2)(iii), rent is disregarded to the extent it is contingent as the result of one or more of the following provisions--

(1) A qualified percentage rents provision, as defined in paragraph (h)(8) of this section;

(2) An adjustment based on a reasonable price index, as defined in paragraph (h)(10) of this section;

(3) A provision requiring the lessee to pay third-party costs, as defined in paragraph (h)(15) of this section;

(4) A provision requiring the payment of late payment charges, as defined in paragraph (h)(4) of this section;

(5) A loss payment provision, as defined in paragraph (h)(7) of this section;

(6) A qualified TRAC provision, as defined in paragraph (h)(9) of this section;

(7) A residual condition provision, as defined in paragraph (h)(13) of this section;

(8) A tax indemnity provision, as defined in paragraph (h)(14) of this section;

(9) A variable interest rate provision, as defined in paragraph (h)(16) of this section; or

(10) Any other provision provided in regulations or other published guidance issued by the Commissioner, but only if the provision is designated as contingent rent to be disregarded for purposes of this paragraph (c)(2)(iii).

(3) Deferred or prepaid rent--(i) Deferred rent. A rental agreement has deferred rent under this paragraph (c)(3) if the cumulative amount of rent allocated as of the close of a calendar year (determined under paragraph (c)(3)(iii) of this section) 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 cumulative amount of rent

payable as of the close of a calendar year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year (determined under paragraph (c)(3)(iii) of this section).

(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.

(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, 2000, and end on December 31, 2003. 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 2000, a payment of \$100,000 is to be made on December 31, 2001, and December 31, 2002, and a payment of \$200,000 is to be made on December 31, 2003. A and B both select the calendar year as their rental period. Thus, 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 2000 (\$100,000)

does not exceed the cumulative rent payable as of December 31, 2001 (\$100,000); the rent allocated to 2001 and preceding years (\$200,000) does not exceed the cumulative rent payable as of December 31, 2002 (\$200,000); the rent allocated to 2002 and preceding years (\$300,000) does not exceed the cumulative rent payable as of December 31, 2003 (\$400,000); and the rent allocated to 2003 and preceding years (\$400,000) does not exceed the cumulative rent payable as of December 31, 2004 (\$400,000). Therefore, because the rental agreement does not have increasing or decreasing rent and does not have deferred or prepaid 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 a 10-year lease of personal property, beginning on January 1, 2000, and ending on December 31, 2009. 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, 2000.

(ii) The rental agreement does not have increasing or decreasing rent as described in paragraph (c)(2)(i) of this section. The rental agreement, however, provides prepaid rent under paragraph (c)(3)(ii) of this section because the cumulative amount of rent payable as of the close of a calendar year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year. For example, the cumulative amount of rent payable as of the close of 2000 (\$1,200,000 is payable on December 31, 2000) exceeds the cumulative amount of rent allocated as of the close of 2001, the succeeding calendar year (\$240,000). 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, as of the agreement date (as defined in paragraph (h)(1) of this section), it is not reasonably expected that the sum of the aggregate amount of rental payments under the rental agreement and the aggregate value of all other consideration to be received for the use of property (taking into account any payments of contingent rent, and any other contingent consideration) will exceed \$250,000.

(ii) Special rules in computing amount described in paragraph (c)(4)(i) of this section. 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 the sum of its remaining principal amount and accrued interest (if any) thereon or, in the case of an obligation originally issued at a discount, at the sum of its adjusted issue price and accrued qualified stated interest (if any), within the meaning of §1.1273-1(c)(1).

(C) All rental agreements that are part of the same transaction or a series of related transactions involving the same lessee (or any related person) and the same lessor (or any related person) are treated as a single rental agreement. Whether two or more rental agreements are part of the same transaction or a series of related transactions depends on all the facts and circumstances.

(D) If an agreement includes a provision increasing or decreasing rent payable solely as a result of an adjustment based on a reasonable price index, the amount described in paragraph (c)(4)(i) of this section must be determined as if the applicable price index did not change during the lease term.

(E) If an agreement includes a variable interest rate provision (as defined in paragraph (h)(16) of this section), the amount described in paragraph (c)(4)(i) of this section must be determined by using 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 applicable to the lessor's indebtedness.

(F) Contingent rent described in paragraphs (c)(2)(iii)(B)(3) through (8) 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.

(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 either 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.

(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 interest stated 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.

Section 467 interest is treated as interest for all purposes of the Internal Revenue Code.

(f) Substantial modification of a rental agreement--(1) Treatment as new agreement--(i) In general. If a substantial modification of a rental agreement occurs after June 3, 1996, the post-modification agreement is treated as a new agreement and the date on which the modification occurs is treated as the agreement date in applying section 467 and the regulations thereunder to the post-modification agreement. Thus, for example, the post-modification agreement is treated as a new agreement entered into on the date the modification occurs for purposes of determining whether it is a section 467 rental agreement under this section, whether it is a disqualified leaseback or long-term agreement under §1.467-3, and whether it is entered into after the applicable effective date in §1.467-9.

(ii) Limitation. In the case of a substantial modification of a rental agreement occurring on or before May 18, 1999, this paragraph (f) applies only if--

(A) The rental agreement was a disqualified leaseback or long-term agreement before the modification and the agreement date, determined without regard to the modification, is after June 3, 1996; or

(B) The post-modification agreement would, after application of the rules in this paragraph (f) (other than the special rule for disqualified agreements in paragraph (f)(4)(iii) of this section), be a disqualified leaseback or long-term agreement.

(2) Post-modification agreement; in general. For purposes of determining whether a post-modification agreement is a section 467 rental agreement or a disqualified leaseback or long-term agreement under paragraph (f)(1) of this section, the terms of the post-modification agreement are, except as provided in paragraph (f)(4) of this section, only those terms that provide for rights and obligations relating to post-modification items (within the meaning of paragraph (f)(5)(iv) of this section).

(3) Other effects of a modification. For rules relating to amounts that must be taken into account following certain modifications, see §1.467-7(g).

(4) Special rules--(i) Carryover of character; leasebacks. If an agreement is a leaseback prior to its modification and the lessee prior to the modification (or a related person) is the lessee after the modification, the post-modification agreement is a leaseback even if the post-modification lessee did not have an interest in the property at any time during the two-year period ending on the date on which the modification occurs.

(ii) Carryover of character; long-term agreements. If an agreement is a long-term agreement prior to its modification and the entire agreement (as modified) would be a long-term agreement, the post-modification agreement is a long-term agreement.

(iii) Carryover of character; disqualified agreements. If an agreement (as in effect before its modification) is a disqualified leaseback or long-term agreement as the result of a

determination (whether occurring before or after the modification) under §1.467-3(b)(1)(ii) and the post-modification agreement is a section 467 rental agreement (or the entire agreement (as modified) would be a section 467 rental agreement), the post-modification agreement will, notwithstanding its treatment as a new agreement under paragraph (f)(1)(i) of this section, be subject to constant rental accrual unless the Commissioner determines that, because of the absence of tax avoidance potential, the post-modification agreement should not be treated as a disqualified leaseback or long-term agreement.

(iv) Allocation of rent. If the entire agreement (as modified) provides a specific allocation of fixed rent, as described in paragraph (c)(2)(ii)(A)(2) of this section, the post-modification agreement is treated as an agreement that provides a specific allocation of fixed rent. If the entire agreement (as modified) does not provide a specific allocation of fixed rent, the fixed rent allocated to rental periods during the lease term of the post-modification agreement is determined by applying the rules of paragraph (c)(2)(ii)(B) of this section to the entire agreement (as modified).

(v) Difference between aggregate rent and interest and aggregate payments--(A) In general. Except as provided in paragraph (f)(4)(v)(B) of this section, a post-modification agreement described in paragraph (f)(4)(v)(C) of this section is treated as a section 467 rental agreement subject to proportional rental accrual (determined under §1.467-2(c)).

(B) Constant rental accrual prior to the modification. A post-modification agreement described in paragraph (f)(4)(v)(C) of this section is treated as a section 467 rental agreement subject to constant rental accrual if--

(1) Constant rental accrual is required under paragraph (f)(4)(iii) of this section; or

(2) The post-modification agreement involves total payments of more than \$250,000 (as described in paragraph (c)(4) of this section), and the Commissioner determines that the post-modification agreement is a disqualified leaseback or long-term agreement.

(C) Agreements described in this paragraph (f)(4)(v)(C). A post-modification agreement is described in this paragraph (f)(4)(v)(C) if the aggregate amount of fixed rent and stated interest treated as post-modification items does not equal the aggregate amount of payments treated as post-modification items.

(vi) Principal purpose of tax avoidance. If a principal purpose of a substantial modification is to avoid the purpose or intent of section 467 or the regulations thereunder, the Commissioner may treat the entire agreement (as modified) as a single agreement for purposes of section 467 and the regulations thereunder.

(5) Definitions. The following definitions apply for purposes of this paragraph (f) and §1.467-7(g):

(i) A modification of a rental agreement is any alteration, including any deletion or addition, in whole or in part, of a

legal right or obligation of the lessor or lessee thereunder, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

(ii) A modification is substantial only if, based on all of the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically substantial. A modification of a rental agreement will not be treated as substantial solely because it is not described in paragraph (f)(6) of this section.

(iii) A modification occurs on the earlier of the first date on which there is a binding contract that substantially sets forth the terms of the modification or the date on which agreement to such terms is otherwise evidenced.

(iv) Post-modification items with respect to any modification of a rental agreement are all items (other than pre-modification items) provided under the terms of the entire agreement (as modified).

(v) Pre-modification items with respect to any modification of a rental agreement are pre-modification rent, interest thereon, and payments allocable thereto (whether payable before or after the modification.) For this purpose--

(A) Pre-modification rent is rent allocable to periods before the effective date of the modification, but only to the extent such rent is payable under the entire agreement (as modified) at the time such rent was due under the agreement in effect before the modification; and

(B) Pre-modification items are identified by applying payments, in the order payable under the entire agreement (as modified) unless the agreement specifies otherwise, to rent and interest thereon in the order in which amounts accrue.

(vi) The entire agreement (as modified) with respect to any modification is the agreement consisting of pre-modification terms providing for rights and obligations that are not affected by the modification and post-modification terms providing for rights and obligations that differ from the rights and obligations under the agreement in effect before the modification. For example, if a 10-year rental agreement that provides for rent of \$25,000 per year is modified at the end of the 5th year to provide for rent of \$30,000 per year in subsequent years, the entire agreement (as modified) provides for a 10-year lease term and provides for rent of \$25,000 per year in years 1 through 5 and rent of \$30,000 per year in years 6 through 10. The result would be the same if the modification provided for both the increase in rent and the substitution of a new lessee.

(6) Safe harbors. Notwithstanding the provisions of paragraph (f)(5) of this section, a modification of a rental agreement is not a substantial modification if the modification occurs solely as the result of one or more of the following--

(i) The refinancing of any indebtedness incurred by the lessor to acquire the property subject to the rental agreement

and secured by such property (or any refinancing thereof) but only if all of the following conditions are met--

(A) Neither the amount, nor the time for payment, of the principal amount of the new indebtedness differs from the amount and time for payment of the remaining principal amount of the refinanced indebtedness, except for de minimis changes;

(B) For each of the remaining rental periods, the rent allocation schedule, the payments of rent and interest, and the amount accrued under section 467 are changed only to the extent necessary to take into account the change in financing costs, and such changes are made pursuant to the terms of the rental agreement in effect before the modification;

(C) The lessor and the lessee are not related persons to each other or to any lender to the lessor with respect to the property (whether under the refinanced indebtedness or the new indebtedness); and

(D) With respect to the indebtedness being refinanced, the lessor was granted a unilateral option (within the meaning of §1.1001-3(c)(3)) by the creditor to repay the refinanced indebtedness, exercisable with or without the lessee's consent;

(ii) A change in the obligation of the lessee to make any of the contingent payments described in paragraphs (c)(2)(iii)(B)(3) through (8) of this section; or

(iii) A change in the amount of fixed rent allocated to a rental period that, when combined with all previous changes in the amount of fixed rent allocated to the rental period, does not

exceed one percent of the fixed rent allocated to that rental period prior to the modification.

(7) Special rules for certain transfers--(i) In general. For purposes of this paragraph (f), a substitution of a new lessee or a sale, exchange, or other disposition by a lessor of property subject to a rental agreement will not, by itself, be treated as a substantial modification unless a principal purpose of the transaction giving rise to the modification is the avoidance of Federal income tax. In determining whether a principal purpose of the transaction giving rise to the modification is the avoidance of Federal income tax--

(A) The safe harbors and other principles of §1.467-3(c) are taken into account; and

(B) The Commissioner may treat the post-modification agreement as a new agreement or treat the entire agreement (as modified) as a single agreement.

(ii) Exception. Notwithstanding the provisions of paragraph (f)(7)(i) of this section, the continuing lessor and the new lessee (in the case of a substitution of a new lessee) or the new lessor and the continuing lessee (in the case of a sale, exchange, or other disposition by a lessor of property subject to a rental agreement) may, in appropriate cases, request the Commissioner to treat the transaction as if it were a substantial modification in order to have the provisions of paragraph (f)(4)(iii) of this section and §1.467-7(g)(1) apply to the transaction.

(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 1.467-9:

(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 (as defined in paragraph (h)(10) of this section) or a variable interest rate provision (as defined in paragraph (h)(16) of this section).

(3) Fixed rent means any rent to the extent its amount and the time at which it is required to be paid are fixed and determinable under the terms of the rental agreement as of the lease date. The following rules apply for the purpose of determining the extent to which rent is fixed rent:

(i) The possibility of a breach, default, or other early termination of the rental agreement and any adjustments based on a reasonable price index or a variable interest rate provision are disregarded.

(ii) Rent will not fail to be treated as fixed rent merely because of the possibility of impairment by insolvency, bankruptcy, or other similar circumstances.

(iii) If the lease term (as defined in paragraph (h)(6) of this section) includes one or more periods as to which either the lessor or the lessee has an option to renew or extend the term of the agreement, rent will not fail to be treated as fixed rent merely because the option has not been exercised.

(iv) If the lease term includes one or more periods during which a substitute lessee or lessor may have use of the property, rent will not fail to be treated as fixed rent merely because the contingencies relating to the obligation of the lessee (or a related person) to make payments in the nature of rent have not occurred.

(v) If either the lessor or the lessee has an unconditional option or options, exercisable on one or more dates during the lease term, that, if exercised, require payments of rent to be made under an alternative payment schedule or schedules, the amount of fixed rent and the dates on which such rent is required to be paid are determined on the basis of the payment schedule that, as of the agreement date, is most likely to occur. If payments of rent are made under an alternative payment schedule that differs from the payment schedule assumed in applying the preceding sentence, then, for purposes of paragraph (f) of this section, the rental agreement is treated as having been modified

at the time the option to make payments on such alternative schedule is exercised.

(4) Late payment charge means any amount required to be paid by the lessee to the lessor as additional compensation for the lessee's failure to make any payment of rent under a rental agreement when due.

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

(6) Lease term means the period during which the lessee has use of the property subject to the rental agreement, including any option to renew or extend the term of the agreement other than an option, exercisable by the lessee, as to which it is reasonably expected, as of the agreement date, that the option will not be exercised. 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 §1.467-7(f) for special rules applicable to the lessee, substitute lessee, and lessor.

(7) A loss payment provision means a provision that requires the lessee to pay the lessor a sum of money (which may be either a stipulated amount or an amount determined by reference to a formula or other objective measure) if the property subject to the rental agreement is lost, stolen, damaged or destroyed, or otherwise rendered unsuitable for any use (other than for scrap purposes).

(8) A qualified percentage rents provision means a provision pursuant to which the rent is equal to a fixed percentage of the lessee's receipts or sales (whether or not receipts or sales are adjusted for returned merchandise or Federal, state, or local sales taxes), but only if the percentage does not vary throughout the lease term. A provision will not fail to be treated as a qualified percentage rents provision solely by reason of one or more of the following additional terms:

(i) Differing percentages of receipts or sales apply to different departments or separate floors of a retail store, but only if the percentage applicable to a particular department or floor does not vary throughout the lease term.

(ii) The percentage is applied to receipts or sales in excess of determinable dollar amounts, but only if the determinable dollar amounts are fixed and do not vary throughout the lease term.

(9) A qualified TRAC provision means a terminal rental adjustment clause (as defined in section 7701(h)(3)) contained in

a qualified motor vehicle operating agreement (as defined in section 7701(h)(2)), but only if the adjustment to the rental price is based on a reasonable estimate, determined as of any date between the agreement date and the lease date (or, in the event the agreement date is the same as or later than the lease date, determined as of the agreement date), of the fair market value of the motor vehicle (including any trailer) at the end of the lease term.

(10) 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 a generally recognized index for measuring inflation or deflation (for example, the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U), which is published by the Bureau of Labor Statistics of the Department of Labor). An adjustment will not fail to be treated as one that is based on a reasonable price index merely because the adjustment may be limited to a fixed percentage, but only if the parties reasonably expect, as of any date between the agreement date and the lease date (or, in the event the agreement date is the same as the lease date, as of such date), that the fixed percentage will actually limit the amount of the rent payable during less than 50 percent of the lease term.

(11) 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). In all other cases, 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).

(12) 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.

(13) A residual condition provision means a provision in a rental agreement that requires a payment to be made by either the lessor or the lessee to the other party based on the difference between the actual condition of the property subject to the agreement, determined as of the expiration of the lease term, and the expected condition of the property at the expiration of the lease term, as set forth in the rental agreement. The amount of any such payment may be determined by reference to any objective measure relating to the use or condition of the property, such as miles, hours or other duration of use, units of production, or similar measure. A provision will be treated as a residual condition provision only if the payment represents compensation for the use of, or wear and tear on, the property in excess of, or below, a standard set forth in the rental agreement, and the standard is reasonably expected, as of any date between the agreement date and the lease date (or, in the event the agreement date is the same as or later than the lease date, as of the agreement date), to be met at the expiration of the lease term.

(14) A tax indemnity provision means a provision in a rental agreement that may require the lessee to make one or more payments to the lessor in the event that the Federal, foreign, state, or local income tax consequences actually realized by a lessor from owning the property subject to the rental agreement and leasing it to the lessee differ from the consequences reasonably expected by the lessor, but only if the differences in such consequences result from a misrepresentation, act, or failure to act on the part of the lessee, or any other factor not within the control of the lessor or any related person.

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

(16) A variable interest rate provision means a provision in a rental agreement that requires the rent payable by the lessee to the lessor to be adjusted by the dollar amount of changes in the amount of interest payable by the lessor on any indebtedness that was incurred to acquire the property subject to the rental agreement (or any refinancing thereof), but--

(i) Only to the extent the changes are attributable to changes in the interest rate; and

(ii) Only if the indebtedness provides for interest at one or more qualified floating rates (within the meaning of §1.1275-

5(b)), or the changes are attributable to a refinancing at a fixed rate or one or more qualified floating rates.

(i) [Reserved].

(j) Computational rules. For purposes of this section and §§1.467-2 through 1.467-9, the following rules apply--

(1) Counting conventions. Any reasonable counting convention may be used (for example, 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 only, except as otherwise provided in this section and §§1.467-2 through 1.467-8--

(A) 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;

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

(E) Any amount payable at the midpoint of a rental period is treated, in applying this paragraph (j)(2), as an amount payable during the first half 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, a substantial penalty, or other substantial detriment (such as giving the lessor the right to terminate the agreement, bring an action to enforce payment, or exercise other similar remedies under the terms of the agreement or applicable law)).

(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 the number of periods of the rental period's length in a calendar year. Thus, if the fixed rent allocated to a rental period is \$10,000 and the rental period is one month, the annualized fixed rent for that rental period is \$120,000 (\$10,000 times 12).

(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, may vary in length, and may be different as between the lessor and the lessee 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 agreements 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, computed 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 deferred or prepaid rent as described in §1.467-1(c)(3);

(ii) The rental agreement has deferred or prepaid 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 (within the meaning of paragraph (d) of this section) 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 all stated interest provided by the agreement 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 (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, the present value of any amount is determined using a discount rate equal to 110 percent of the applicable Federal rate. In general, present values are determined as of the first day of the first rental period in the lease term. However, if a section 467 rental agreement calls for payments of fixed rent prior to the lease term, present values are determined as of the first day a fixed rent payment is called for by the agreement. 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. 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 1.467-9, 110 percent of the applicable Federal rate means 110 percent of the applicable Federal rate based on semiannual compounding or any rate based on a different compounding assumption that is equivalent to 110 percent of the applicable Federal rate based on semiannual compounding. The Internal Revenue Service publishes 110 percent of the applicable Federal rates, based on annual, semiannual, quarterly, and monthly compounding, each month in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(4) Term of the section 467 rental agreement--(i) In general. For purposes of determining 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 deferred or prepaid fixed rent, the term of the rental agreement for purposes of calculating the applicable Federal rate is the longest period between interest rate adjustment dates, or, if the rental agreement provides an initial fixed rate of interest on deferred or prepaid 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, 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 the rental agreement is not a disqualified leaseback or long-term agreement subject to constant rental accrual. The examples are as follows:

Example 1. (i) C agrees to lease property from D for five years beginning on January 1, 2000, and ending on December 31, 2004. 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, 2004. Assume that the parties select the calendar year as the rental period and that 110 percent of the applicable Federal rate is 10 percent, compounded annually.

(ii) The rental agreement has deferred rent under §1.467-1(c)(3)(i) because the fixed rent allocated to calendar years 2000, 2001, and 2002 is not paid until 2004. 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.

(iii)(A) Because the rental agreement has deferred fixed rent and no prepaid rent, the agreement has adequate interest only if the present value test provided in paragraph (b)(1)(iii) of this section is met. The present value of all fixed rent and interest payable under the rental agreement is \$384,971.22, determined as follows:  $\$620,000/(1.10)^5 = \$384,971.22$ . 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:

$$\$379,078.68 = \$100,000 \times \frac{1-(1.10)^{-5}}{.10}$$

(B) The rental agreement provides adequate interest on fixed rent because the present value of the single amount payable under the section 467 rental agreement exceeds the sum of the present values of fixed rent allocated.

(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, 2000, and ending on December 31, 2004. 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, 2004, 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, 2000, and ending on December 31, 2002. The rental agreement provides that rent of \$800,000 is allocable to 2000, \$1,000,000 is allocable to 2001, and \$1,200,000 is allocable to 2002. Under the rental agreement, Y must make a \$3,000,000 payment on December 31, 2002. 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.

(ii) 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.

(iii)(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, the present value is determined as of the first day of the first rental period in the lease term. The present value of the single amount payable by the lessee under the rental agreement is computed as follows:

$$\$2,348,724.30 = \frac{\$3,000,000}{(1 + .085)^3}$$

(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:

$$\$2,526,272.20 = \frac{\$800,000}{(1 + .085)} + \frac{\$1,000,000}{(1 + .085)^2} + \frac{\$1,200,000}{(1 + .085)^3}$$

(C) Thus, the fraction for determining the proportional rental amount is .9297194 ( $\$2,348,724.30/\$2,526,272.20$ ). The section 467 interest for each of the taxable years within the lease term is computed and taken into account as provided in §1.467-4. The section 467 rent for each of the taxable years within the lease term is as follows:

<u>Taxable year</u>	<u>Section 467 rent</u>
2000	\$ 743,775.52 (\$ 800,000 x .9297194)
2001	929,719.40 (\$1,000,000 x .9297194)
2002	1,115,663.28 (\$1,200,000 x .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. Constant rental accrual may not be used in the absence of a determination by the Commissioner, pursuant to paragraph (b)(1)(ii) of this section, that the rental agreement is disqualified. Such determination may be made either on a case-by-case basis or in regulations or other guidance published by the Commissioner (see §601.601(d)(2) of this chapter) providing that a certain type or class of leaseback or long-term agreement will be treated as disqualified and subject to constant rental accrual.

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

(ii) The Commissioner determines that, because of the tax avoidance purpose, the agreement should be treated as a disqualified leaseback or long-term agreement; and

(iii) 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.

(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 property's statutory recovery period.

(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 rental agreements relating to properties having different statutory recovery periods. In the case of a rental agreement relating to 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 agreement 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. In determining whether a principal purpose for providing increasing or decreasing rent is the avoidance of Federal income tax, all relevant facts and circumstances are taken into account. However, an agreement will not be treated as a disqualified leaseback or long-term agreement if either of the safe harbors set forth in paragraph (c)(3) of this section is met. The mere failure of a leaseback or long-term agreement to meet one of these safe harbors will not, by itself, cause the agreement to be treated as one in which tax avoidance was a principal purpose for providing increasing or decreasing rent.

(2) Tax avoidance--(i) In general. If, as of the agreement date, a significant difference between the marginal tax rates of the lessor and lessee can reasonably be expected at some

time during the lease term, 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. The term "marginal tax rate" means the percentage determined by dividing one dollar into the amount of the increase or decrease in the Federal income tax liability of the taxpayer that would result from an additional dollar of rental income or deduction.

(ii) Significant difference in tax rates. A significant difference between the marginal tax rates of the lessor and lessee is reasonably expected if--

(A) The rental agreement has increasing rents and the lessor's marginal tax rate is reasonably expected to exceed the lessee's marginal tax rate by more than 10 percentage points during any rental period to which the rental agreement allocates annualized fixed rent that is less than the average rent allocated to all calendar years (determined by taking into account the rules set forth in paragraph (c)(4)(iii) of this section); or

(B) The rental agreement has decreasing rents and the lessee's marginal tax rate is reasonably expected to exceed the lessor's marginal tax rate by more than 10 percentage points during any rental period to which the rental agreement allocates annualized fixed rent that is greater than the average rent allocated to all calendar years (determined by taking into

account the rules set forth in paragraph (c)(4)(iii) of this section).

(iii) Special circumstances. In determining the expected marginal tax rates of the lessor and lessee, net operating loss and credit carryovers and any other attributes or special circumstances reasonably expected to affect the Federal income tax liability of the taxpayer (including the alternative minimum tax) are taken into account. For example, in the case of a partnership or S corporation, the amount of rental income or deduction that would be allocable to the partners or shareholders, respectively, is taken into account.

(3) Safe harbors. Tax avoidance will not be considered a principal purpose for providing increasing or decreasing rent if--

(i) The uneven rent test (as defined in paragraph (c)(4) of this section) is met; or

(ii) The increase or decrease in rent is wholly attributable to one or more of the following provisions--

(A) A contingent rent provision set forth in §1.467-1(c)(2)(iii)(B); or

(B) A single rent holiday provision allowing reduced rent (or no rent) for one consecutive period during the lease term, but only if--

(1) The rent holiday is for a period of three months or less at the beginning of the lease term and for no other period; or

(2) The duration of the rent holiday is reasonable,

determined by reference to commercial practice (as of the agreement date) in the locality where the use of the property occurs, and does not exceed the lesser of 24 months or 10 percent of the lease term.

(4) Uneven rent test--(i) In general. The uneven rent test is met if the rent allocated to each calendar year does not vary from the average rent allocated to all calendar years (determined in accordance with the rules set forth in paragraph (c)(4)(iii) of this section) by more than 10 percent.

(ii) Special rule for real estate. Paragraph (c)(4)(i) of this section is applied by substituting "15 percent" for "10 percent" if the rental agreement is a long-term agreement and at least 90 percent of the property subject to the agreement (determined on the basis of fair market value as of the agreement date) consists of real property (as defined in §1.856-3(d)).

(iii) Operating rules. In determining whether the uneven rent test has been met, the following rules apply:

(A) Any contingent rent attributable to a provision set forth in §1.467-1(c)(2)(iii)(B)(3) through (9) is disregarded.

(B) If the lease term includes one or more partial calendar years (a period less than a complete calendar year), the average rent allocated to each calendar year is the total rent allocated under the rental agreement, divided by the actual length (in years) of the lease term. The rent allocated to a partial calendar year is annualized by multiplying the allocated rent by the number of periods of the partial calendar year's length in a

full calendar year and the annualized rent is treated as the amount of rent allocated to that year in determining whether the uneven rent test is met.

(C) In the case of a rental agreement not described in paragraph (c)(4)(ii) of this section, an initial rent holiday period and any rent allocated to such period are disregarded for purposes of this paragraph (c)(4) if taking such period and rent into account would cause the agreement to fail to meet the uneven rent test. For purposes of this paragraph (c)(4), an initial rent holiday period is any period of three months or less at the beginning of the lease term during which annualized fixed rent (determined by treating such period as a rental period for purposes of §1.467-1(j)(3)) is less than the average rent allocated to all calendar years (determined before the application of this paragraph (c)(4)(iii)(C)).

(D) In the case of a rental agreement described in paragraph (c)(4)(ii) of this section, one qualified rent holiday period and any rent allocated to such period are disregarded for purposes of this paragraph (c)(4) if taking such period and rent into account would cause the agreement to fail the uneven rent test. For this purpose, a qualified rent holiday period is a consecutive period that is an initial rent holiday period or that meets the following conditions:

(1) The period does not exceed the lesser of 24 months or 10 percent of the lease term (determined before the application of this paragraph (c)(4)(iii)(D)).

(2) Annualized fixed rent during the period (determined by treating the period as a rental period for purposes of §1.467-1(j)(3)) is less than the average rent allocated to all calendar years (determined before the application of this paragraph (c)(4) (iii)(D)).

(3) Providing less than average rent for the period is reasonable, determined by reference to commercial practice (as of the agreement date) in the locality where the use of the property occurs.

(E) If the rental agreement contains a variable interest rate provision, the uneven rent test is applied by treating the rent as having been fixed under the terms of the rental agreement for the entire lease term using fixed rate substitutes (determined in the same manner as §1.1275-5(e), treating the agreement date as the issue date) for the variable rates of interest provided under the terms of the lessor's indebtedness.

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

Example 1. (i) K, lessor, and L, lessee, enter into a long-term agreement for a 10-year lease of personal property beginning on January 1, 2000. K and L are C corporations that use the calendar year as their taxable year. K does not have any unused losses or credits from taxable years preceding 2000. In addition, as of the agreement date, K expects that it will be subject to the maximum rate of tax imposed by section 11 in 2000 and that it will not be limited in its ability to use any losses or credits. As of the agreement date, L expects that it will be subject to the alternative minimum tax imposed by section 55 in 2000. The rental agreement provides for rent allocations in each year of the lease term, as follows:

<u>Year</u>	<u>Amount</u>
2000	\$427,500
2001	442,500
2002	457,500
2003	472,500
2004	487,500
2005	502,500
2006	517,500
2007	532,500
2008	547,500
2009	562,500

(ii) As described in paragraph (c)(2) of this section, as of the agreement date, a significant difference between the marginal tax rates of the lessor and lessee can reasonably be expected at some time during the lease term. First, the rental agreement has increasing rents. Second, the lessor's marginal tax rate exceeds the lessee's marginal tax rate by more than 10 percentage points during a rental period to which the rental agreement allocates less than a ratable portion of the aggregate amount of rent payable under the agreement. For example, for the year 2000, the lessor's expected marginal tax rate is 35 percent, the percentage determined by dividing the increase in the Federal income tax liability of K that would result from an additional dollar of rental income (\$.35) by \$1. Because the lessee is subject to the alternative minimum tax, the lessee's expected marginal tax rate for 2000 is 20 percent, the percentage determined by dividing the decrease in the Federal income tax liability (taking into account both the decrease in the lessee's regular tax and the increase in the lessee's alternative minimum tax) that would result from an additional dollar of rental deduction (\$.20) by \$1. Further, for the year 2000, the rent allocated in accordance with the rental agreement is \$427,500, which is less than a ratable portion of the aggregate amount of

rental payments, \$495,000, determined by dividing the total rents payable under the agreement (\$4,950,000) by the number of years in the lease term (10). Thus, because a significant difference between the marginal tax rates of the lessor and lessee can reasonably be expected during the lease term, 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 rent.

Example 2. (i) A and B enter into a long-term agreement for a 5-year lease of personal property beginning on July 1, 2000, and ending on June 30, 2005. The rental agreement provides that the rent is allocated to the calendar years in the lease term in accordance with the following schedule and is paid at successive six-month intervals (on December 31 and June 30) during the lease term:

<u>Year</u>	<u>Amount</u>
2000	\$450,000
2001	900,000
2002	900,000
2003	1,100,000
2004	1,100,000
2005	550,000

(ii) In determining whether the uneven rent test described in paragraph (c)(4)(i) of this section is met, the total amount of rent allocated under the rental agreement is \$5,000,000, and the lease term is five years. The average rent for each year is \$1,000,000 (see paragraph (c)(4)(iii)(B) of this section), and the uneven rent test is met if the rent for each year is not less than \$900,000 and not more than \$1,100,000. The test is met for 2000 because the annualized rent for that year is \$900,000. The test is met for 2005 because the annualized rent for that year is \$1,100,000. The test is met for each of the years 2001 through 2004 because the rent for each of these years is not less than \$900,000 and not more than \$1,100,000. Accordingly, because the uneven rent test of paragraph (c)(4)(i) of this section is met, the long-term agreement will not be treated as disqualified.

Example 3. (i) C and D enter into a long-term agreement for a lease of personal property beginning on October 1, 1999, and ending on December 31, 2005. The rental agreement provides that the rent is allocated to the calendar years in the lease term in accordance with the following schedule and is paid at successive six-month intervals (on December 31 and June 30) during the lease term:

<u>Year</u>	<u>Amount</u>
1999	\$ 0
2000	900,000
2001	900,000
2002	900,000
2003	1,100,000
2004	1,100,000
2005	1,100,000

(ii) The three-month rent holiday period at the beginning of the lease term is an initial rent holiday within the meaning of paragraph (c)(4)(iii)(C) of this section. Moreover, the agreement would fail the uneven rent test if the rent holiday period and the rent allocated to the period were taken into account. Thus, under paragraph (c)(4)(iii)(C) of this section, the period and the rent allocated to the period are disregarded for purposes of applying the uneven rent test. In that case, the lease term is six years, and the uneven rent test is met because the average rent for each year in the lease term is \$1,000,000 and the rent for each calendar year in the lease term is not less than \$900,000 nor more than \$1,100,000. Accordingly, the long-term agreement will not be treated as disqualified.

Example 4. (i) E and F enter into a long-term agreement for a 6-year lease of personal property beginning on January 1, 2000, and ending on December 31, 2005. The rental agreement provides that the rent allocated to the calendar years in the lease term and paid at successive six-month intervals (on June 30 and December 31) during the lease term is the sum of the interest on the lessor's indebtedness, in the amount of \$4,637,577, and an amount determined in accordance with the following schedule:

<u>Year</u>	<u>Amount</u>
2000	\$ 539,574
2001	583,603
2002	631,225
2003	886,733
2004	959,090
2005	1,037,352

(ii) Assume further that the lessor's indebtedness bears interest at the rate of 2 percent in excess of the 6-month London Interbank Offered Rate (LIBOR) in effect on the first day of the 6-month period for each rental period and that, on the agreement date, the interest rate under this formula would be 8 percent. If the interest rate remained fixed during the entire lease term, the formula for determining the rent payable by the lessee would result in payments of rent in the amount of \$450,000 for each six-month period in 2000, 2001, and 2002, and \$550,000 for each six-month period in 2003, 2004, and 2005.

(iii) Under paragraph (c)(4)(iii)(E) of this section, the fixed rate substitute for the variable interest rate provision produces a schedule of fixed rents that meets the uneven rent test of paragraph (c)(4)(i) of this section. Thus, even if the actual rents payable under the rental agreement do not meet the uneven rent test because of fluctuations in the 6-month LIBOR, the uneven rent test will be treated as having been met, and the long-term agreement will not be treated as disqualified.

Example 5. (i) G and H enter into a long-term agreement for a 5-year lease of personal property beginning on January 1, 2000, and ending on December 31, 2004. The rental agreement provides that the rent is payable to G at the rate of \$40,000 per month in arrears, subject to an adjustment based on changes in prevailing interest rates during the lease term. Under this adjustment, the lessor is entitled to receive an amount equal to the sum of a specified dollar amount, which increases each month as payments of rent are made, and interest on a notional principal amount (as defined in §1.446-3(c)(3)) at a qualified floating rate (as defined in §1.1275-5(b)). The notional principal amount is initially established at 80 percent of the cost of the property. As each payment of rent is made, the notional principal amount is reduced (but not below zero) to an amount that would represent the outstanding principal balance of a loan the payments on which are equal to the monthly payments of rent. As of the agreement date, the value of the qualified floating rate is 9 percent. Although G did not incur indebtedness specifically for the purpose of acquiring the property, the parties agreed to the adjustment provisions in order to compensate G for its general costs of borrowing.

(ii) The adjustment provision produces a schedule of rent payments that is virtually identical to the schedule that would have resulted if G had actually borrowed money in an amount and on terms identical to the terms used in determining interest on the notional principal amount and the adjustment were based on that indebtedness. An adjustment based on actual indebtedness of the lessor would have been a variable interest rate provision eligible for a safe harbor under paragraph (c)(3)(ii)(A) of this section. Accordingly, based on all the facts and circumstances, the adjustment provision did not have as one of its principal purposes the avoidance of Federal income tax, and thus the long-term agreement will not be treated as disqualified.

Example 6. (i) X and Y enter into a 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)(A) If the Commissioner determines that the leaseback is disqualified, the constant rental amount is computed as follows:

(B) 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 a rental 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 Federal tax purposes, 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 paragraphs (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 (relating to disqualified leasebacks or long-term agreements).

(4) Special rule in applying the provisions of §1.467-7(e), (f), or (g). Notwithstanding the provisions of paragraph (a)(2) of this section, section 467 loan balances must be computed for section 467 rental agreements that are not subject to constant rental accrual under §1.467-3 and 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), §1.467-7(f) (relating to assignments by lessees and lessee-financed renewals), and §1.467-7(g) (relating to modifications of rental agreements).

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

(i) The fixed rent accrued in preceding rental periods;

(ii) Increased by the sum of--

(A) The interest on fixed rent includible in the gross income of the lessor for preceding rental periods; and

(B) Any amount payable by the lessor on or before the first day of the rental period as interest on prepaid fixed rent; and

(iii) Decreased by the sum of--

(A) The interest on prepaid fixed rent includible in the gross income of the lessee for preceding rental periods; and

(B) 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 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)(i)(B) through (E) and §1.467-1(j)(2)(ii).

(c) Yield--(1) In general--(i) Method of determining yield. Except as provided in paragraphs (c)(2) and (3) 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 an adjustment to the 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 length of the rental period).

(3) Yield for purposes of applying paragraph (a)(4) of this section. For purposes of applying paragraph (a)(4) of this section, the yield of the section 467 loan balance of any party, or prior party, to a section 467 rental agreement for a period is the same for all parties and is the yield that results in the net accrual of positive or negative interest for that period equal to the amount of such interest that accrues under the terms of the rental agreement for that period. For example, if property subject to a section 467 rental agreement is sold (transferred) and the beginning section 467 loan balance of the transferor (as described in §1.467-7(e)(2)(i)) is positive and the beginning section 467 loan balance of the transferee (as described in §1.467-7(e)(2)(ii)) is negative, the yield on each of these loan balances for any period is the same for all parties and is the yield that results in the net accrual of positive or negative interest, taking into account the aggregate positive or negative interest on the section 467 loan balances of both the transferor and transferee, equal to the amount of such interest that accrues under the terms of the rental agreement for that period.

(4) 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, 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 is 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 is 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 1. (i)(A) A leases property to B for a three-year period beginning on January 1, 2000, and ending on December 31, 2002. The section 467 rental agreement has the following rent allocation schedule and payment schedule:

	<u>Rent Allocation</u>	<u>Payment</u>
2000	\$400,000	
2001	600,000	
2002	800,000	\$1,800,000

(B) The rental agreement requires a \$1.8 million payment to be made on December 31, 2002, but does not provide for interest on deferred rent. Assume A and B choose the calendar year as the rental period length and that 110 percent of the applicable Federal rate based on annual compounding is 10 percent. Assume also that the agreement is not a leaseback or long-term agreement and, therefore, is not subject to constant rental accrual.

(ii) 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:

2000	\$370,370.37
2001	555,555.56
2002	740,740.73

(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 x \$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 x \$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, \$740,740.73 + \$96,296.30, equals \$1,800,000). B takes the amounts of interest and rent into account as interest and rent expense, respectively, and A takes such amounts into account as interest and rent income, respectively, for the calendar years identified above, regardless of their respective overall methods of accounting.

Example 2. (i) The facts are the same as in Example 1, §1.467-2(f). C agrees to lease property from D for five years beginning on January 1, 2000, and ending on December 31, 2004. 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, 2004. The parties select the calendar year as the rental period, and 110 percent of the applicable Federal rate is 10 percent, compounded annually. The rental agreement has deferred rent but provides adequate interest on fixed rent.

(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 2004, 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:

<u>Calendar Year</u>	<u>Section 467 Interest</u>	<u>Section 467 Rent</u>	<u>Section 467 Loan Balance</u>
2000	\$ 0	\$100,000.00	\$100,000.00
2001	10,775.08	100,000.00	210,775.08
2002	22,711.18	100,000.00	333,486.26
2003	35,933.41	100,000.00	469,419.67
2004	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 overall 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 (a)(4). If a section 467

rental agreement provides for interest that is neither variable interest nor fixed interest, the agreement provides for contingent payments.

(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 (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 deferred or prepaid 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) Positive or negative 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, 2000, and ending on December 31, 2002. The rental agreement allocates \$100,000 of rent to 2000, \$200,000 to 2001, and \$100,000 to 2002, and requires the lessee to pay all \$400,000 of rent on December 31, 2002. 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 2001 and the other for 2002, 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. Assume also that the agreement is not a leaseback or long-term agreement and, therefore, is not subject to constant rental accrual.

(ii) 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 2001 and 2002 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:

	<u>Accrued Rent</u>	<u>Accrued Interest</u>	<u>Projected Payment</u>	<u>Cumulative Loan</u>
2000	\$100,000	\$ 0	\$ 0	\$100,000
2001	200,000	13,630	( 10,000)	303,630
2002	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 2001 and 2002 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) of this section are as follows:

	<u>Accrued Interest Under Rental Agreement</u>	<u>Accrued Interest Using Fixed Rate Substitutes</u>
2000	\$ 0	\$ 0
2001	11,000	10,000
2002	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 2001 and is -\$3,000 (\$42,000 - \$45,000) for 2002. Thus, under paragraph (b)(1)(ii) of this section, the actual interest on fixed rent for 2001 is \$14,630 (\$13,630 + \$1,000) and for 2002 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:

$$\begin{aligned} \$ 10,000/(1.15)^2 &= \$ 7,561.44 \\ 445,000/(1.15)^3 &= \underline{292,594.72} \\ &= \underline{\underline{\$300,156.16}} \end{aligned}$$

(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:

	<u>Proportional Rent</u>	<u>Accrued Interest</u>	<u>Projected Payment</u>	<u>Cumulative Loan</u>
2000	\$ 98,756.09	\$ 0.00	\$ 0	\$ 98,756.09
2001	197,512.18	14,813.41	( 10,000)	301,081.68
2002	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 2001 is \$15,813.41 (\$14,813.41 + \$1,000) and for 2002 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 and modifications.

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

paragraph (a) 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 amount--(1) In general. The recapture amount for a disposition is the lesser of--

- (i) The prior understated inclusion (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 inclusion. The prior understated inclusion is the excess (if any) of--

- (i) 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 subject to constant rental accrual under §1.467-3; over
- (ii) The aggregate amount of section 467 rent and section 467 interest accrued by the lessor during that period.

(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 Internal Revenue Code other than section 467(c) (for example, section 1245 or 1250).

(ii) Certain dispositions. In the case of a disposition that is not a sale or exchange, 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. If a disposition is in part a sale or exchange and in part a gift, paragraph (a) of this section applies to the disposition but the prior understated inclusion is determined by taking into account only section 467 rent and section 467 interest properly allocable to the portion of the property not disposed of by gift.

(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). This paragraph (c)(2) does not apply to property which constitutes a right to receive an item of income in respect of a decedent. See sections 691 and 1014(c).

(3) Certain tax-free exchanges--(i) 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 Internal Revenue Code other than section 467(c). However, see paragraph (c)(4) of this section for dispositions by transferees.

(ii) Dispositions covered--(A) In general. Except as provided in paragraph (c)(3)(ii)(B) of this section, 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.

(B) Transfers to certain tax-exempt organizations. This paragraph (c)(3) does not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from tax imposed by chapter 1, subtitle A of the Internal Revenue Code (a tax-exempt entity) except to the extent the property is used in an activity the income from which is subject to tax under section 511(a) (a section 511(a) activity). However, if assets used to any extent in a section 511(a) activity are disposed of by the tax-exempt entity, then, notwithstanding any other provision of law (except section 1031

or section 1033) the recapture amount with respect to such disposition, to the extent attributable under paragraph (c)(4) of this section to the period of the transferor's ownership of the property prior to the first disposition, shall be included in the tax-exempt entity's unrelated business taxable income. To the extent that the tax-exempt entity ceases to use the property in a section 511(a) activity, the entity will be treated for purposes of this paragraph (c)(3) and paragraph (c)(4) of this section as having disposed of the property to such extent on the date of the cessation.

(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 paragraph (a) of this section applies, the prior understated inclusion determined under paragraph (b)(2) of this section is computed by taking into account the amounts attributable to the period of the transferor's ownership of the property prior to the first disposition. Thus, for example, the section 467 rent and section 467 interest that would have been taken into account by the transferee if the section 467 rental agreement were a disqualified leaseback or long-term agreement subject to constant rental accrual include the amounts that would have been taken into account by the transferor, and the aggregate amount of section 467 rent and section 467 interest accrued by the transferee includes the aggregate amount of section 467 rent

and section 467 interest that was taken into account by the transferor. The prior understated inclusion determined under this paragraph (c)(4) must be reduced by any recapture amount taken into account under paragraph (a) of this section by the transferor.

(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); and

(ii) The fair market value of property acquired that is not subject to the same 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 is reported under the installment method of accounting if and to the extent that method is otherwise available under section 453.

(7) Dispositions covered by section 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 paragraphs (a), (b), and (c) of this section. In each of these examples the transferor of property subject to a section 467 rental agreement is entitled to the rent for the day of the disposition. The examples are as follows:

Example 1. (i)(A) X and Y enter into a section 467 rental agreement for a 5-year lease of personal property beginning on January 1, 2000, and ending on December 31, 2004. The rental agreement provides that the calendar year will be the rental period and that rents accrue and are paid in the following pattern:

	<u>Allocation</u>	<u>Payment</u>
2000	\$ 0	\$ 0
2001	87,500	0
2002	87,500	175,000
2003	87,500	175,000
2004	87,500	0

(B) 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 also that the rental agreement is a long-term agreement (as defined in §1.467-3(b)(3)), but it is not a disqualified leaseback or long-term agreement. Further, because the agreement does not provide prepaid or deferred rent, proportional rental accrual is not applicable. (See §1.467-2(b)(1)(i)). Therefore, the rent taken into account under §1.467-1(d)(2) is the fixed rent allocated to the rental periods under §1.467-1(c)(2)(ii).

(ii) On December 31, 2000, X sells the property subject to the section 467 rental agreement to an unrelated person for \$575,000. At the time of the sale, X's adjusted basis in the property is \$175,000. Thus, X's gain on the sale of the property is \$400,000. Assume that \$175,000 of this gain would be treated as ordinary income under provisions 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 inclusion or the section 467 gain.

(iii)(A) In computing the prior understated inclusion under paragraph (b)(2) of this section, 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:

	<u>Section 467 Rent</u>	<u>Section 467 Interest</u>
2000	\$65,812.55	\$ 0
2001	65,812.55	7,239.38
2002	65,812.55	15,275.09
2003	65,812.55	4,944.73
2004	65,812.55	(6,521.95)

(B) The total amount of section 467 rent and section 467 interest for 2000, based on constant rental accrual, is \$65,812.55. Since X did not take any section 467 rent or section 467 interest into account in 2000, the prior understated inclusion is also \$65,812.55. X's section 467 gain is \$225,000, which is the excess of the gain realized (\$400,000) over the amount of that gain treated as ordinary income under non-section 467 provisions (\$175,000). Accordingly, the recapture amount (the lesser of the prior understated inclusion or the section 467 gain) treated as ordinary income is \$65,812.55.

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:

	<u>Allocation</u>	<u>Payment</u>
2000	\$60,000	\$ 0
2001	65,000	0
2002	70,000	175,000
2003	75,000	175,000
2004	80,000	0

(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). Under §1.467-2(c), the following amounts would be required to be taken into account:

	<u>Section 467 Rent</u>	<u>Section 467 Interest</u>
2000	\$57,260.43	\$ 0
2001	62,032.13	6,298.65
2002	66,803.83	13,815.03
2003	71,575.53	3,433.11
2004	76,347.23	(7,565.94)

(B) The amount of section 467 rent and section 467 interest taken into account by X for 2000 is \$57,260.43. Thus, the prior understated inclusion is \$8,552.12 (the excess of the amount of section 467 rent and section 467 interest based on constant rental accrual for 2000, \$65,812.55, over the amount of section 467 rent and section 467 interest actually taken into account, \$57,260.43). Since the prior understated inclusion is less than the section 467 gain (\$225,000, as determined in Example 1(iii)(B)), the recapture amount treated as ordinary income is also \$8,552.12.

Example 3. (i) The facts are the same as in Example 1, except that, instead of selling the property, X transfers the property to S on December 31, 2002, in exchange for stock of S in a transaction that meets the requirements of section 351(a). Under paragraph (c)(3) of this section, because of the application of section 351, X is not required to take into account any section 467 recapture.

(ii) On December 31, 2003, S sells the property subject to the section 467 rental agreement to an unrelated person for \$450,000. At the time of the sale, S's adjusted basis in the property is \$105,000. Thus, S's gain on the sale of the property is \$345,000. Assume that \$245,000 of this gain would be treated as ordinary income under provisions of the Internal Revenue Code other than section 467(c). Under paragraph (a) of this section, S is required to take the recapture amount into account as ordinary income which, under paragraph (b) of this section, is the lesser of the prior understated inclusion or the section 467 gain.

(iii) S owned the property in 2003 and, under paragraph (c)(4) of this section, for purposes of determining S's prior understated inclusion, S is treated as if it had owned the property during the years 2000 through 2002. In computing S's prior understated inclusion under paragraph (b)(2) of this section, the section 467 rent and section 467 interest based on constant rental accrual are the same as the amounts set forth in the schedule in Example 1(iii)(A). Thus, the constant rental amount for 2000, 2001, 2002, and 2003 is \$290,709.40 ((4 x \$65,812.55) + \$7,239.38 + \$15,275.09 + \$4,944.73). The section 467 rent and section 467 interest actually taken into account prior to the disposition is \$262,500. Thus, S's prior understated inclusion is \$28,209.40 (\$290,709.40 minus \$262,500

(3 x \$87,500)). S's section 467 gain is \$100,000, the difference between the gain realized on the disposition (\$345,000) and the amount of gain that is treated as ordinary income under non-section 467 Code provisions (\$245,000). Accordingly, S's recapture amount, the lesser of the prior understated inclusion or the section 467 gain, is \$28,209.40.

(e) Other rules relating to dispositions--(1) In general.

If there is a sale, exchange, or other disposition of property subject to a section 467 rental agreement (the transfer), the section 467 rent and, if applicable, section 467 interest for a period are taken into account by the owner of the property during the period. The following rules apply in determining the section 467 rent and section 467 interest for the portion of the rental period ending immediately prior to the transfer:

(i) The section 467 rent and section 467 interest for the portion of the rental period ending immediately prior to the transfer are a pro rata portion of the section 467 rent and the section 467 interest, respectively, for the rental period. Such amounts are also taken into account in determining the transferor's section 467 loan balance, prior to any adjustment thereof that may be required under paragraph (h) of this section, immediately before the transfer.

(ii) If the transferor of the property is entitled to the rent for the day of transfer, the transfer is treated as occurring at the end of the day of the transfer.

(iii) If the transferee of the property is entitled to the rent for the day of transfer, the transfer is treated as occurring at the beginning of the day of the transfer.

(2) Treatment of section 467 loan. If there is a transfer described in paragraph (e)(1) of this section, the following rules apply in determining the transferor's and the transferee's section 467 loans 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 (but after giving effect to 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 transferor's 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) [Reserved].

(4) Examples. The following examples illustrate the application of this paragraph (e). In each of these examples the transferor of property subject to a section 467 rental agreement is entitled to the rent for the day of the transfer. The examples are as follows:

Example 1. (i) Q and R enter into a section 467 rental agreement for a 5-year lease of personal property beginning on January 1, 2000, and ending on December 31, 2004. The rental agreement provides that \$0 of rent is allocated to 2000, 2001, and 2002, and \$1,750,000 is allocated to each of the years 2003 and 2004. 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 Q and R 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 disqualified long-term agreement (as defined in §1.467-3(b)(3)) and that the section 467 rent, the section 467 interest, and the section 467 loan balance would be the following amounts:

<u>Calendar Year</u>	<u>Payment</u>	<u>Section 467 Interest</u>	<u>Section 467 Rent</u>	<u>Section 467 Loan Balance</u>
2000	\$ 0	\$ 0	\$592,905.87	\$ 592,905.87
2001	0	65,219.65	592,905.87	1,251,031.39
2002	0	137,613.45	592,905.87	1,981,550.71
2003	1,750,000.00	217,970.58	592,905.87	1,042,427.16
2004	1,750,000.00	114,666.97	592,905.87	0

(ii) On December 31, 2002, Q sells the property subject to the section 467 rental agreement to P, an unrelated person, for \$3,000,000. Q does not retain the right to receive any amounts payable by R under the rental agreement after the date of sale, but the agreement is not otherwise modified. At the time of the sale, Q's adjusted basis in the property is \$975,000. Assume that, under §1.467-1(f)(7), the disposition is not a substantial modification. Further, the Commissioner does not determine that the treatment of the agreement as a disqualified long-term agreement should be changed and, under §1.467-1(f)(4)(iii), the agreement remains subject to constant rental accrual. Thus, under paragraph (g)(2)(iii) of this section, section 467 rent and section 467 interest for periods after the disposition will be taken into account on the basis of constant rental accrual applied to the terms of the entire agreement (as modified).

(iii) Under paragraph (e)(2)(ii) of this section, the beginning balance of P's section 467 loan is \$1,981,550.71. P's section 467 loan balance is computed by reducing the balance of the section 467 loan immediately before the transfer (\$1,981,550.71) by the beginning balance of the transferor's section 467 loan (\$0 because Q does not retain the right to receive any amounts payable under the rental agreement subsequent to the transfer).

(iv) Q will be treated as if it had received \$1,981,550.71 from the disposition of the section 467 loan and \$1,018,449.29 from the sale of the property subject to the rental agreement. Thus, Q's gain on the sale of the property is \$43,449.29 (\$1,018,449.29 amount realized less \$975,000 adjusted basis). Q's gain is not subject to the recapture provisions of section 467(c) and paragraph (a) of this section because the rental agreement was disqualified under §1.467-3(b)(1) and, thus, the requirement of paragraph (a)(2) of this section is not met. Q recognizes no gain on the disposition of the section 467 loan because Q's basis in the loan equals the amount considered received for the loan. Further, Q does not take into account any of the section 467 rent or section 467 interest attributable to periods after the transfer of the property.

(v) P is treated as if it had acquired the property and the positive balance in the transferee's section 467 loan. P's cost basis in the property is \$1,018,449.29, and its cost basis in the

section 467 loan immediately following the transfer is \$1,981,550.71. P takes section 467 rent and section 467 interest into account for the calendar years 2002 and 2003 under the constant rental accrual method and, accordingly, treats payments received under the rental agreement as recoveries of the principal balance of the section 467 loan (as adjusted from time to time).

Example 2. (i) The facts are the same as Example 1, except that on December 31, 2002, Q transfers the property to P in exchange for stock of P having a fair market value of \$3,000,000 and the transaction meets the requirements of section 351(a).

(ii) Q is treated as having transferred two assets to P, the property subject to the rental agreement and the positive balance of the section 467 loan. Under section 351(a), because only stock of P is received by Q, Q does not recognize any of the gain realized on the transaction. Pursuant to section 358(a), the basis of Q in the P stock received in the exchange is the same as the aggregate basis of the property exchanged, or \$2,956,550.71 (the sum of the balance of the section 467 loan, \$1,981,550.71, and the adjusted basis of the property, \$975,000). Q does not take into account any of the section 467 rent or section 467 interest attributable to periods after the transfer of the property.

(iii) P is treated as if it had acquired the property and the positive balance in the transferee's section 467 loan in the transaction. Pursuant to section 362(a), P's basis in each asset is the same as the basis of Q immediately preceding the transfer. Thus, the basis of P in the property subject to the rental agreement is \$975,000, and the basis of P in the section 467 loan immediately following the transfer is \$1,981,550.71. P takes section 467 rent and section 467 interest into account for the calendar years 2003 and 2004 under the constant rental accrual method and, accordingly, treats payments received under the rental agreement as recoveries of the principal balance of the section 467 loan (as adjusted from time to time).

(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 if a period when a substitute lessee has the use of property subject to a section 467 rental agreement is otherwise included in the lease term under §1.467-1(h)(6), the section 467 rent for a period is taken into account by the person having the

use of the property during the period. The following rules apply in determining the section 467 rent and section 467 interest for the portion of the rental period ending immediately prior to the assignment:

(i) The section 467 rent and section 467 interest for the portion of the rental period ending immediately prior to the assignment are a pro rata portion of the section 467 rent and the section 467 interest, respectively, for the rental period. Such amounts are also taken into account in determining the lessee's section 467 loan balance, prior to any adjustment thereof that may be required under paragraph (h) of this section, immediately before the substitute lessee first has use of the property.

(ii) If the lessee is liable for the rent for the day that the substitute lessee first has use of the property, the substitute lessee's use shall be treated as beginning at the end of that day.

(iii) If the substitute lessee is liable for the rent for the day that the substitute lessee first has use of the property, the substitute lessee's use shall be treated as beginning at the beginning of that day.

(2) Treatment of section 467 loan. If, as described in paragraph (f)(1) of this section, 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 section 467 rental agreement is otherwise included in the lease term under §1.467-1(h)(6), the following rules apply in

determining the amount of the lessee's and the substitute lessee's section 467 loans 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 time the substitute lessee first has use of the property (but after giving effect to the transfer of the right to use 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 is not 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 lessee's 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 receipts 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, the following rules apply:

(A) If the principal balance of the lessee's section 467 loan immediately before the substitute lessee first has use of the property was negative, any consideration paid by the substitute lessee to the lessee in conjunction with the transfer of the use of the property shall be treated as a nontaxable return of capital to the lessee to the extent that--

(1) The consideration does not exceed the amount owed to the lessee under the lessee's section 467 loan balance immediately before the substitute lessee first has use of the property; and

(2) The lessee has basis in the principal balance of the lessee's section 467 loan immediately before the substitute lessee first has use of the property.

(B) Except as provided in paragraph (f)(2)(iv)(D) of this section, the excess, if any, of the beginning balance of the amount owed to the substitute lessee under the section 467 loan, over any consideration paid by the substitute lessee to the lessee in conjunction with the transfer of the use of the property, is treated as an amount incurred by the lessee for the taxable year in which the substitute lessee first has use of the property.

(C) To the extent the beginning balance of the amount owed to the substitute lessee under the section 467 loan exceeds any consideration paid by the substitute lessee to the lessee in conjunction with the transfer of the use of the property, repayments of the beginning balance are items of gross income of the substitute lessee in the taxable year in which repayment occurs (determined by applying any repayment first to the beginning balance of the substitute lessee's section 467 loan).

(D) Any amount incurred by the lessee under paragraph (f)(2)(iv)(B) of this section with respect to a transfer of the use of property (the current transfer) shall be reduced (but not below zero) to the extent that the lessee, in its capacity, if any, as a substitute lessee with respect to an earlier transfer of the use of the property would have recognized additional gross income under paragraph (f)(2)(iv)(C) of this section if the current transfer had not occurred.

(v) For purposes of paragraph (f)(2)(iv)(C) of this section, repayments occur as the negative balance is amortized through the net accrual of rent and negative interest.

(3) 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)(6), the section 467 rent for the period is not taken into account and the lessor is treated as a substitute lessee for purposes of this paragraph (f).

(4) Examples. The following examples illustrate the application of this paragraph (f). In each of these examples, the substitute lessee is liable for the rent for the day on which the substitute lessee first has use of the property subject to the section 467 rental agreement. Further, assume that in each example the lessee assignment is not a substantial modification under §1.467-1(f). The examples are as follows:

Example 1. (i) The facts are the same as in Example 1 of paragraph (e)(4) of this section, except that on December 31, 2001, R, the lessee, contracts to assign its entire remaining interest in the leasehold to S, a calendar year taxpayer. The assignment becomes effective at the beginning of January 1, 2002. Pursuant to the terms of the assignment, R agrees with S that R will make \$1,400,000 of the \$1,750,000 rental payment required on December 31, 2003.

(ii) Under paragraph (f)(2)(i) of this section, R's section 467 loan balance as of the beginning of January 1, 2002, the time S first has use of the property, is \$1,136,271.41 ( $\$1,400,000/(1.11)^2$ ). Under paragraph (f)(2)(ii) of this section, S's section 467 loan balance as of the beginning of January 1, 2002, is \$114,759.98 (the principal balance of R's section 467 loan immediately before S has use of the property (\$1,251,031.39), less R's section 467 loan balance at the beginning of January 1, 2002 (\$1,136,271.41)).

(iii) Because S's \$114,759.98 section 467 loan balance is positive, under paragraph (f)(2)(iii)(A) of this section, such amount is treated as gross receipts of R for 2002, R's taxable

year in which S first has use of the property. R will treat the \$114,759.98 as an amount received in exchange for the transfer of the leasehold interest. Under paragraph (f)(2)(iii)(B) of this section, S will treat that amount as a liability assumed in acquiring the leasehold interest. Thus, S's cost basis in the leasehold interest is \$114,759.98.

(iv) Under paragraph (f)(1) of this section, S takes the section 467 rent attributable to the property into account for the period beginning on January 1, 2002. For 2002, S takes section 467 interest into account based on S's section 467 loan balance at the beginning of 2002. S's amounts payable, section 467 rent, section 467 interest, and end-of-year section 467 loan balances for calendar years 2002 through 2004 are as follows:

<u>Calendar Year</u>	<u>Payment</u>	<u>Section 467 Interest</u>	<u>Section 467 Rent</u>	<u>Section 467 Loan Balance</u>
Beginning				\$ 114,759.98
2002	\$ 0	\$ 12,623.60	\$592,905.87	720,289.45
2003	350,000.00	79,231.83	592,905.87	1,042,427.15
2004	1,750,000.00	114,666.98	592,905.87	0

(v) Under paragraph (f)(2)(i) of this section, R must continue to take into account section 467 interest on R's section 467 loan balance after S first has use of the property. R's section 467 loan balance beginning when S first has use of the property is \$1,136,271.41. R's section 467 interest and end-of-year section 467 loan balances for calendar years 2002 through 2003 are as follows:

<u>Calendar Year</u>	<u>Payment</u>	<u>Section 467 Interest</u>	<u>Section 467 Loan Balance</u>
Beginning			\$1,136,271.41
2002	\$ 0	\$ 124,989.85	1,261,261.26
2003	1,400,000.00	138,738.74	0

Example 2. (i) On January 1, 2000, B leases tangible personal property from C for a period of five years. The rental agreement provides that the rental period is the calendar year and that rent payments are due at the end of the calendar year. The rental agreement does not provide for interest on prepaid rent. Assume that B and C are both calendar year taxpayers and that 110 percent of the applicable Federal rate is 10 percent, compounded annually. The rental agreement allocates rents and provides for payments of rent as follows:

<u>Calendar Year</u>	<u>Rent</u>	<u>Payments</u>
2000	\$200,000	\$400,000
2001	200,000	300,000
2002	200,000	200,000
2003	200,000	100,000
2004	200,000	0

(ii) The rental agreement has prepaid rent within the meaning of §1.467-1(c)(3)(ii) because the cumulative amount of rent payable through the end of 2001 (\$700,000) exceeds the cumulative amount of rent allocated to calendar years 2000 through 2002 (\$600,000). Because the rental agreement does not provide for adequate interest on prepaid fixed rent, the rent for each calendar year during the lease term is the proportional rental amount, as described in §1.467-2(c). The amounts payable, section 467 rent, section 467 interest, and end-of-year section 467 loan balances for each calendar year are as follows:

<u>Calendar Year</u>	<u>Payment</u>	<u>Section 467 Interest</u>	<u>Section 467 Rent</u>	<u>Section 467 Loan Balance</u>
2000	\$ 400,000	\$ 0	\$ 218,987.40	(\$181,012.60)
2001	300,000	(18,101.26)	218,987.40	( 280,126.46)
2002	200,000	(28,012.64)	218,987.40	( 289,151.70)
2003	100,000	(28,915.17)	218,987.40	( 199,079.47)
2004	0	(19,907.93)	218,987.40	0

(iii) On December 31, 2001, B contracts to assign its entire remaining interest in the leasehold to D, a calendar year taxpayer. The assignment becomes effective at the beginning of January 1, 2002. D pays B \$278,000 on January 1, 2002, in conjunction with the assignment of the leasehold interest. Under the terms of the assignment, B is not obligated to make any rental payments due after the assignment.

(iv) Under paragraph (f)(2)(i) of this section, B's section 467 loan balance as of the beginning of January 1, 2002, the time D first has use of the property, is zero because D is obligated to make all rent payments due after the assignment of the leasehold interest. Under paragraph (f)(2)(ii) of this section, D's section 467 loan balance as of the beginning of January 1, 2002, is negative \$280,126.46 (the principal balance of B's section 467 loan immediately before D has use of the property (negative \$280,126.46), less B's section 467 loan balance when D first has use of the property (zero)). Because D's beginning section 467 loan balance is negative, paragraph (f)(2)(iv) of this section applies.

(v) Because B's \$280,126.46 section 467 loan balance at the end of 2001 (that is, immediately before D has use of the

property) is negative, paragraph (f)(2)(iv)(A) of this section applies. B's loan balance is the amount owed to B under the section 467 loan and consists of the excess of B's payments to C over the net amount of rent and negative interest B has taken into account through the end of 2001. Thus, B's basis in the negative section 467 loan balance at the end of 2001 is \$280,126.46. Because the \$278,000 paid by D to B in conjunction with the transfer of the leasehold interest does not exceed the amount owed to B under the section 467 loan at the end of 2001, and does not exceed B's basis in that loan balance, under paragraph (f)(2)(iv)(A) of this section B treats the \$278,000 payment from D as a nontaxable return of capital.

(vi) The beginning balance of the amount owed to D under the section 467 loan (\$280,126.46) exceeds by \$2,126.46 the \$278,000 paid by D to B in conjunction with the transfer of the leasehold interest. Paragraph (f)(2)(iv)(B) of this section treats the \$2,126.46 as an amount incurred by B in 2002, B's taxable year in which D first has use of the property. Paragraph (f)(2)(iv)(D) of this section does not apply to reduce the amount incurred by B because B is the original lessee under the section 467 rental agreement.

(vii) Under paragraph (f)(1) of this section, D takes the section 467 rent into account for the period beginning when D first has use of the property. D takes section 467 interest into account based on a beginning section 467 loan balance of negative \$280,126.46.

(viii) The beginning balance of the amount owed to D under the section 467 loan (\$280,126.46) exceeds by \$2,126.46 the \$278,000 paid by D to B in conjunction with the transfer of the leasehold interest. Under paragraph (f)(2)(iv)(C) of this section, D must include this amount in gross income in 2002, the year in which this amount of D's beginning section 467 loan balance is paid through the net accrual of rent and negative interest. This inclusion in gross income ensures that the reductions in D's taxable income attributable to the section 467 rental agreement will not exceed the actual amount of D's expenditures.

(g) Application of section 467 following a rental agreement modification--(1) Substantial modifications. The following rules apply to any substantial modification of a rental agreement occurring after May 18, 1999, unless the entire agreement (as modified) is treated as a single agreement under §1.467-

1(f)(4)(vi):

(i) Treatment of pre-modification items. The lessor and lessee must take pre-modification items (within the meaning of §1.467-1(f)(5)(v)) into account under their method of accounting used before the modification to report income and expense attributable to the rental agreement.

(ii) Computations with respect to post-modification items. In computing section 467 rent, section 467 interest, and the amount of the section 467 loan with respect to post-modification items--

(A) Post-modification items are treated as provided under a rental agreement (the post-modification agreement) separate from the agreement under which pre-modification items are provided;

(B) The lease term of the post-modification agreement begins at the beginning of the first period for which rent other than pre-modification rent is provided; and

(C) The applicable Federal rate for the post-modification agreement is the applicable Federal rate in effect on the day on which the modification occurs.

(iii) Adjustments--(A) Adjustment relating to certain prepayments. If any payments before the beginning of the lease term of the post-modification agreement are post-modification items, the lessor and lessee must take into account, in the taxable year in which the modification occurs, any adjustment necessary to prevent duplication with respect to such payments or the omission of interest thereon for periods before the beginning of the lease term.

(B) Adjustment relating to retroactive beginning of lease term. If the lease term of a post-modification agreement begins before the date on which the modification occurs, the lessor and lessee must take into account in the taxable year in which the modification occurs any amount necessary to prevent the duplication or omission of rent or interest for the period after the beginning of the lease term of the post-modification agreement and before the beginning of the taxable year in which the modification occurs. For this purpose, the amount necessary to prevent duplication or omission is determined after taking into account any adjustments required by the Commissioner for taxable years ending prior to the beginning of the taxable year in which the modification occurs. In determining any adjustments required by the Commissioner for taxable years ending prior to the beginning of the taxable year in which the modification occurs, the Commissioner will disregard the modification.

(iv) Coordination with rules relating to dispositions and assignments--(A) Dispositions. If the modification involves a sale, exchange, or other disposition of the property subject to the rental agreement--

(1) Adjustments required under this paragraph (g) are taken into account before applying paragraphs (a), (b), (c), and (e) of this section;

(2) The prior understated inclusion for purposes of paragraph (b) of this section is the sum of the prior understated inclusion with respect to pre-modification items and the prior

understated inclusion with respect to post-modification items;  
and

(3) Paragraph (e) of this section applies separately with respect to pre-modification items and post-modification items.

(B) Assignments. If the modification involves an assignment of the lessee's interest in the rental agreement to a substitute lessee or a substitute lessee having use of the property during a period otherwise included in the lease term--

(1) Adjustments required under this paragraph (g) are taken into account before applying paragraph (f) of this section; and

(2) Paragraph (f) of this section applies separately with respect to pre-modification items and post-modification items.

(2) Other modifications. The following rules apply to a modification (other than a substantial modification) of a rental agreement occurring after May 18, 1999:

(i) Computation of section 467 loan for modified agreement. The amount of the section 467 loan relating to the agreement is computed as of the effective date of the modification. The section 467 rent and section 467 interest for periods before the effective date of the modification are determined, solely for purposes of computing the amount of the section 467 loan, under the terms of the entire agreement (as modified).

(ii) Change in balance of section 467 loan. (A) If the balance of the section 467 loan determined under paragraph (g)(2)(i) of this section is greater than the balance of the section 467 loan immediately before the effective date of the

modification, the difference is taken into account, in the taxable year in which the modification occurs, as additional rent.

(B) If the balance of the section 467 loan determined under paragraph (g)(2)(i) of this section is less than the balance of the section 467 loan immediately before the effective date of the modification, the difference is taken into account, in the taxable year in which the modification occurs, as a reduction of the rent previously taken into account by the lessor and lessee.

(C) For purposes of this paragraph (g)(2)(ii), a negative balance is less than a positive balance, a zero balance, or any other negative balance that is closer to a zero balance.

(iii) Section 467 rent and interest after the modification. The section 467 rent and section 467 interest for periods after the effective date of the modification are determined under the terms of the entire agreement (as modified).

(iv) Applicable Federal rate. The applicable Federal rate for the agreement does not change as a result of the modification.

(v) Modification effective within a rental period. If the effective date of a modification does not coincide with the beginning or end of a rental period under the agreement in effect before the modification, the section 467 rent and section 467 interest for the portion of the rental period ending immediately prior to the effective date of the modification are a pro rata portion of the section 467 rent and the section 467 interest,

respectively, for the rental period. Such amounts are also taken into account in determining the section 467 loan balance, prior to any adjustment thereof that may be required under paragraph (h) of this section, immediately before the effective date of the modification. Similar rules apply with respect to the section 467 rent and section 467 interest determined under the terms of the entire agreement (as modified) for purposes of computing the amount of the section 467 loan under paragraph (g)(2)(i) of this section and the section 467 rent and section 467 interest for a partial rental period beginning on the effective date of the modification.

(vi) Other adjustments. The lessor and lessee must take into account, in the taxable year in which a retroactive modification occurs, any amount necessary to prevent the duplication or omission of rent or interest for the period before the beginning of the taxable year in which the modification occurs.

(vii) Coordination with rules relating to dispositions and assignments. If the modification involves a sale, exchange, or other disposition of the property subject to the rental agreement, an assignment of the lessee's interest in the rental agreement to a substitute lessee or a substitute lessee having use of the property during a period otherwise included in the lease term, adjustments required under this paragraph (g) are taken into account before applying paragraphs (a), (b), (c), (e), and (f) of this section.

(viii) Exception for agreements entered into prior to effective date of section 467. This paragraph (g)(2) does not apply to a modification of a rental agreement that is not subject to section 467 because of the effective date provisions of section 92(c) of the Tax Reform Act of 1984 (Public Law 98-369 (98 Stat. 612)).

(3) Adjustment by Commissioner. If the entire agreement (as modified) is treated as a single agreement under §1.467-1(f)(4)(vi), the Commissioner may require adjustments to taxable income to reflect the effect of the modification, including adjustments that are similar to those required under paragraph (g)(2) of this section.

(4) Effective date of modification. The effective date of a modification of a rental agreement occurs at the earliest of--

(i) The date on which the modification occurs;

(ii) The beginning of the first period for which the amount of rent or interest provided under the entire agreement (as modified) differs from the amount of rent or interest provided under the agreement in effect before the modification;

(iii) The due date of the first payment, under either the entire agreement (as modified) or the agreement in effect before the modification, that is not identical, in due date and amount, under both such agreements;

(iv) The date, in the case of a modification involving the substitution of a new lessor, on which the property subject to the rental agreement is transferred; or

(v) The date, in the case of a modification involving the substitution of a new lessee, on which the substitute lessee first has use of the property subject to the rental agreement.

(5) Examples. The following examples illustrate the application of this paragraph (g):

Example 1. (i) F, a cash method lessor, and G, an accrual method lessee, agree to a 7-year lease of tangible personal property for the period beginning on January 1, 1998, and ending on December 31, 2004. The rental agreement allocates \$100,000 of rent to each calendar year during the lease term, such rent to be paid December 31 following the close of the calendar year to which it is allocated. Because the rental agreement does not provide for increasing rent, or deferred rent within the meaning of section 467(d)(1)(A), section 467 does not apply to the rental agreement.

(ii) Prior to January 1, 2001, G timely makes the \$100,000 rental payments required as of December 31, 1999, and December 31, 2000. On January 1, 2001, F and G modify the rental agreement payment schedule to provide for a single final payment of \$500,000 on December 31, 2004. Assume that the change is a substantial modification within the meaning of §1.467-1(f)(5)(ii). Because the modification occurs after May 18, 1999, the post-modification agreement is treated, under §1.467-1(f)(1), as a new agreement for purposes of determining whether it is a section 467 rental agreement.

(iii) Under §1.467-1(f)(5)(v), the \$200,000 of rent allocated to calendar years 1998 and 1999 (periods prior to the modification) constitutes pre-modification rent, and the \$100,000 rent payments made on December 31, 1999, and December 31, 2000, constitute pre-modification payments. Although calendar year 2000 is also prior to the modification, the rent allocated to calendar year 2000 is not pre-modification rent and the related payment is not a pre-modification payment because the modification changed the time at which that rent is payable. See §1.467-1(f)(5)(v)(A).

(iv) Under paragraph (g)(1)(i) of this section, F and G take pre-modification rent and pre-modification payments into account under the method of accounting they used to report income and deductions attributable to the pre-modification agreement.

(v) Under §1.467-1(f)(1)(i), the post-modification agreement providing rent for the period beginning on January 1, 2000, and ending on December 31, 2004, is treated as a new rental agreement. This rental agreement allocates \$100,000 of rent to

each of the calendar years 2000 through 2004 and provides for a single rental payment of \$500,000 on December 31, 2004. Because the post-modification agreement provides for deferred rent under §1.467-1(c)(3)(i), section 467 applies. Further, the post-modification agreement does not provide for adequate interest on fixed rent, and therefore F and G must account for fixed rent and interest on fixed rent using proportional rental accrual. Under paragraph (g)(1)(iii) of this section, for their taxable years which include January 1, 2001, F and G must adjust reported rent for the difference between the rent taken into account for the calendar year 2000 under the unmodified agreement and the proportional rental amount for that year under the post-modification agreement.

Example 2. (i) On January 1, 2000, X, lessee, and Y, lessor, enter into a rental agreement for a 6-year lease of tangible personal property beginning January 1, 2000, and ending December 31, 2005. The agreement provides that the calendar year is the rental period and all rent payments are due on July 15 of all years in which a payment is required. Assume the agreement is not a disqualified leaseback or long-term agreement within the meaning of §1.467-3(b), and has the following allocation schedule and payment schedule:

<u>Year</u>	<u>Allocation</u>	<u>Payment</u>
2000	\$ 800,000	\$ 0
2001	900,000	0
2002	1,000,000	1,500,000
2003	1,000,000	1,500,000
2004	1,100,000	1,500,000
2005	1,200,000	1,500,000

(ii) The rental agreement has deferred rent within the meaning of §1.467-1(c)(3)(i) because the rent allocated to 2000 is not payable until 2002 and some of the rent allocable to 2001 is not payable until 2003. Further, the rental agreement does not provide adequate interest on fixed rent within the meaning of §1.467-2(b). Therefore, the rent amount to be accrued by X and Y for each rental period is the proportional rental amount, as described in §1.467-2(c). Assuming 110 percent of the applicable Federal rate is 10 percent compounded annually, the section 467 rent, interest, and loan balances are as follows:

<u>Year</u>	<u>Rent</u>	<u>Interest</u>	<u>Loan Balance</u>
2000	\$ 736,949.55	\$ 0	\$ 736,949.55
2001	829,068.24	73,694.96	1,639,712.75
2002	921,186.94	163,971.28	1,224,870.97
2003	921,186.94	122,487.10	768,545.01
2004	1,013,305.63	76,854.50	358,705.14
2005	1,105,424.33	35,870.53	0

(iii)(A) On January 1, 2004, X and Y agree that the \$1,500,000 payment scheduled for July 15, 2005, will be made in three equal installments on June 15, 2005, July 15, 2005, and August 15, 2005. Under §1.467-1(j)(2)(i)(C) (relating to timing conventions), the payment to be made on June 15, 2005, is treated as if it were payable on December 31, 2004, for purposes of determining present values and yield of the section 467 loan. Assume that this change, which results in the following allocation schedule and payment schedule, is not a substantial modification within the meaning of §1.467-1(f)(5)(ii):

<u>Year</u>	<u>Allocation</u>	<u>Payment</u>
2000	\$800,000	\$ 0
2001	900,000	0
2002	1,000,000	1,500,000
2003	1,000,000	1,500,000
2004	1,100,000	2,000,000
2005	1,200,000	1,000,000

(B) The agreement remains subject to proportional rental accrual after the modification because it has deferred rent and does not provide adequate interest on fixed rent within the meaning of §1.467-2(b).

(iv) Because the modification occurs after May 18, 1999, and is not substantial within the meaning of §1.467-1(f)(5)(ii), paragraph (g)(2) of this section applies. Under paragraph (g)(2)(i) of this section, the amount of the section 467 loan relating to the modified agreement is computed as of the effective date of the modification, and, solely for purposes of recomputing the amount of the section 467 loan, the section 467 rent and section 467 interest for periods before the modification are determined under the terms of the entire agreement (as modified). In addition, the applicable Federal rate does not change as a result of the modification. Thus, the recomputed section 467 rent, interest, and loan balances are as follows:

<u>Year</u>	<u>Rent</u>	<u>Interest</u>	<u>Loan Balance</u>
2000	\$ 742,242.59	\$ 0	\$ 742,242.59
2001	835,022.91	74,224.26	1,651,489.76
2002	927,803.24	165,148.98	1,244,441.98
2003	927,803.24	124,444.20	796,689.42
2004	1,020,583.56	79,668.94	(103,058.08)
2005	1,113,363.88	(10,305.80)	0

(v) Under paragraph (g)(2)(ii) of this section, the difference between the section 467 loan balance immediately before the effective date of the modification and the recomputed section 467 loan balance as of the effective date of the modification is taken into account. In this example, the loan

balance immediately before the effective date of the modification is \$768,545.01 and the recomputed loan balance as of the effective date of the modification is \$796,689.42. Thus, because the recomputed loan balance exceeds the original loan balance, the difference (\$28,144.41) is taken into account, in the taxable year in which the modification occurs, as additional rent. Beginning on January 1, 2004, section 467 rent and interest are taken into account by X and Y in accordance with the recomputed rent schedule set forth in paragraph (iv) of this example.

(h) Omissions or duplications--(1) In general. In applying the rules of this section in conjunction with the rules of §§1.467-1 through 1.467-5, adjustments must be made to the extent necessary to prevent the omission or duplication of items of income, deduction, gain, or loss. For example, if a transferee lessor acquires property subject to a section 467 rental agreement at other than the beginning or end of a rental period, and the transferee lessor's beginning section 467 loan balance differs from the transferor lessor's section 467 loan balance immediately prior to the transfer, it will be necessary to treat the rental period that includes the day of transfer as consisting of two rental periods, one beginning at the beginning of the rental period that includes the day of transfer and ending with or immediately prior to the transfer and one beginning with or immediately after the transfer and ending immediately prior to the beginning of the succeeding rental period. Because the substitution of two rental periods for one rental period may change the proportional rental amount or constant rental amount, the change in rental periods should be treated as a modification of the rental agreement that occurs immediately prior to the transfer. The change in rental periods, by itself, is not

treated as a substantial modification of the rental agreement although the substitution of a new lessor may constitute a substantial modification of the rental agreement. Likewise, §1.467-1(j)(2), which provides rules regarding when amounts are treated as payable, is designed to simplify calculations of present values, section 467 loan balances, and proportional and constant rental amounts. These simplifying conventions assume that there will be no change in the lessor or lessee under a section 467 rental agreement and that the terms of the section 467 rental agreement will not be modified. Therefore, as illustrated in the example in paragraph (h)(2) of this section, when actual events do not reflect these assumptions, it may be necessary to alter the application of these rules to properly reflect taxable income.

(2) Example. The following example illustrates an application of this paragraph (h):

Example. (i) J leases tangible personal property from K for five years beginning on January 1, 2000, and ending on December 31, 2004. Under the rental agreement, rent is payable on July 15 of the calendar year to which it is allocated. Both J and K treat the calendar year as the rental period. The allocation of rent and payments of rent required under the rental agreement are as follows:

<u>Calendar Year</u>	<u>Rent</u>	<u>Payments</u>
2000	\$200,000	\$450,000
2001	200,000	250,000
2002	200,000	200,000
2003	200,000	100,000
2004	200,000	0

(ii) The rental agreement does not provide for interest on prepaid rent. The rental agreement has prepaid rent under §1.467-1(c)(3)(ii) because the rent payable at the end of 2000 exceeds the cumulative amount of rent allocated to 2000 and 2001.

Therefore, J and K must take section 467 rent into account under the proportional rental method of §1.467-2(c). Assume that 110 percent of the applicable Federal rate is 10 percent, compounded annually. The section 467 rent, section 467 interest, amounts payable, and section 467 loan balances for each of the calendar years under the terms of the rental agreement are as follows:

<u>Calendar Year</u>	<u>Section 467 Rent</u>	<u>Section 467 Interest</u>	<u>Payments</u>	<u>Section 467 Loan Balance</u>
2000	\$ 220,077.48	\$ 0	\$450,000	\$ (229,922.52)
2001	220,077.48	(22,992.25)	250,000	(282,837.29)
2002	220,077.48	(28,283.73)	200,000	(291,043.54)
2003	220,077.48	(29,104.35)	100,000	(200,070.41)
2004	220,077.48	(20,007.07)	0	0

(iii) On January 1, 2002, J and K amend the terms of the rental agreement to advance the due date of the \$200,000 payment originally due on July 15, 2002, to June 15, 2002. This change in the payment schedule constitutes a modification of the terms of the rental agreement within the meaning of §1.467-1(f)(5)(i). Assume, however, that the change is not a substantial modification within the meaning of §1.467-1(f)(5)(ii). Because the modification occurs after May 18, 1999, and is not substantial, paragraph (g)(2) of this section applies. Thus, the section 467 loan balance at the beginning of 2002 must be recomputed as if the June 15, 2002, payment date had been included in the terms of the pre-modification rental agreement. If this had been the case, the section 467 rent, section 467 interest, amounts payable, and section 467 loan balances for each of the calendar years under the terms of the rental agreement would have been as follows:

<u>Calendar Year</u>	<u>Section 467 Rent</u>	<u>Section 467 Interest</u>	<u>Payments</u>	<u>Section 467 Loan Balance</u>
2000	\$ 224,041.38	\$ 0	\$450,000	\$ (225,958.62)
2001	224,041.38	(22,595.86)	450,000	(474,513.10)
2002	224,041.38	(47,451.31)	0	(297,923.03)
2003	224,041.38	(29,792.30)	100,000	(203,673.95)
2004	224,041.38	(20,367.43)	0	0

(iv) Section 1.467-4(b)(3) incorporates the conventions of §1.467-1(j)(2) in determining when amounts are treated as payable for purposes of determining the section 467 loan balance. Section 1.467-1(j)(2)(i)(C) treats amounts payable during the first half of any rental period except the first rental period as payable on the last day of the preceding rental period. Therefore, because June 15, 2002, occurs in the first half of 2002, in determining the section 467 loan balance at the beginning of 2002 under the amended terms of the rental

agreement, the \$200,000 payment due on June 15, 2002, is treated as payable on December 31, 2001.

(v) Under paragraph (g)(2)(ii)(B) of this section, if the recomputed section 467 loan balance is less than the section 467 loan balance immediately before the modification, the difference is taken into account as a reduction of the rent previously taken into account by the lessor and the lessee. In this example, the recomputed section 467 loan balance immediately after the modification is negative \$474,513.10 and the section 467 loan balance immediately before the modification is negative \$282,837.29. However, the section 467 loan balance immediately before the modification does not take into account the \$200,000 payment originally payable on July 15, 2002, whereas, under the conventions of §1.467-1(j)(2)(i)(C), the recomputed section 467 loan balance immediately after the modification takes into account that \$200,000 payment because it is now payable in the first half of the rental period (June 15). Under these circumstances, if the recomputed section 467 loan balance immediately after the modification is treated as negative \$474,513.10 for purposes of applying paragraph (g)(2)(ii)(B) of this section, K's gross income and J's deductions attributable to the section 467 rental agreement will be understated by \$200,000. Therefore, under paragraph (h)(1) of this section, only for purposes of applying paragraph (g)(2)(ii)(B) of this section, the \$200,000 payment due on June 15, 2002, should not be taken into account in determining the recomputed section 467 loan balance immediately after the modification.

§1.467-8 Automatic consent to change to constant rental accrual for certain rental agreements.

(a) General rule. For the first taxable year ending after May 18, 1999, a taxpayer may change to the constant rental accrual method, as described in §1.467-3, for all of its section 467 rental agreements described in paragraph (b) of this section. A change to the constant rental accrual method is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. A taxpayer changing its method of accounting in accordance with this section must follow the automatic change in accounting method provisions of

Rev. Proc. 98-60 (see §601.601(d)(2) of this chapter) except, for purposes of this paragraph (a), the scope limitations in section 4.02 of Rev. Proc. 98-60 are not applicable. Taxpayers changing their method of accounting in accordance with this section must do so for all of their section 467 rental agreements described in paragraph (b) of this section.

(b) Agreements to which automatic consent applies. A section 467 rental agreement is described in this paragraph (b) if-

(1) The property subject to the section 467 rental agreement is financed with an "exempt facility bond" within the meaning of section 142;

(2) The facility subject to the section 467 rental agreement is described in section 142(a)(1), (2), (3), or (12);

(3) The section 467 rental agreement does not include a specific allocation of fixed rent within the meaning of §1.467-1(c)(2)(ii)(A)(2); and

(4) The section 467 rental agreement was entered into on or before May 18, 1999.

§1.467-9 Effective dates and automatic method changes for certain agreements.

(a) In general. Sections 1.467-1 through 1.467-7 are applicable for--

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

(2) Rental agreements not described in paragraph (a)(1) of this section that are entered into after May 18, 1999.

(b) Automatic consent for certain rental agreements.  
Section 1.467-8 applies only to rental agreements described in §1.467-8.

(c) Application of regulation project IA-292-84 to certain leasebacks and long-term agreements. In the case of any leaseback or long-term agreement (other than a disqualified leaseback or long-term agreement) entered into after June 3, 1996, and on or before May 18, 1999, a taxpayer may choose to apply the provisions of regulation project IA-292-84 (1996-2 C.B. 462)(see §601.601(d)(2) of this chapter).

(d) Entered into. For purposes of this section and §1.467-8, a rental agreement is entered into on its agreement date (within the meaning of §1.467-1(h)(1) and, if applicable, §1.467-1(f)(1)(i)).

(e) Change in method of accounting--(1) In general. For the first taxable year ending after May 18, 1999, a taxpayer is granted consent of the Commissioner to change its method of accounting for rental agreements described in paragraph (a)(2) of this section to comply with the provisions of §§1.467-1 through 1.467-7.

(2) Application of regulation project IA-292-84. For the first taxable year ending after May 18, 1999, a taxpayer is granted consent of the Commissioner to change its method of accounting for any rental agreement described in paragraph (c)

of this section to comply with the provisions of regulation project IA-292-84 (1996-2 C.B. 462)(see §601.601(d)(2) of this chapter).

(3) Automatic change procedures. A taxpayer changing its method of accounting in accordance with this paragraph (e) must follow the automatic change in accounting method provisions of Rev. Proc. 98-60 (see §601.601(d)(2) of this chapter) except, for purposes of this paragraph (e), the scope limitations in section 4.02 of Rev.Proc. 98-60 are not applicable. A method change in accordance with paragraph (e)(1) of this section is made on a cut-off basis so no adjustment under section 481(a) is required.

Robert E. Wenzel

Deputy Commissioner of Internal Revenue

Approved: May 5, 1999

Donald C. Lubick

Assistant Secretary of the Treasury