Section 467 Rental Agreements
January 21 2011
ABA Tax Section – Capital Recovery and Leasing
ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.
Section 467 rental agreements defined as:
- Agreements, written or oral, which provide for the use of tangible property and are treated as leases for Federal income tax purposes that have:
  - Aggregate rent in excess of $250,000, AND EITHER
  - Deferred or prepaid rents, OR
  - Increasing or decreasing rents
- Note that any rental agreement that requires (or may require) contingent payments are generally deemed to have increasing or decreasing rents (subject to certain exceptions)
Section 467
Three Accrual Methods

- Basic Method – Just Follow the Lease Provisions
- Proportional rental accrual
- Constant rental accrual
Section 467 Method #1
Follow Lease Provisions

◆ Follow lease provisions if:
  - Lease is *neither* a disqualified leaseback *nor* a disqualified long-term lease agreement, *and*
  - Lease provides for “adequate interest on fixed rent”

◆ Lease provides for “adequate interest on fixed rent” if:
  - Lease has no deferred or prepaid rent, *or*
  - Lease has deferred or prepaid rent and provides for interest on deferred or prepaid rent at single fixed rate, no lower than 110% of AFR, and paid or compounded at least annually, with deferred or prepaid rent adjusted at least annually to reflect correct amount
Section 467 Method #1
Follow Lease Provisions

Payment schedules are generally allocations of rent for section 467 purposes
  - Use rent payment schedule if no separate rent allocation schedule
    - For example – rent holiday in payment schedule and no separate rent allocation schedule
      - Zero rent allocated to rent holiday period
      - Generally does not cause rental agreement to fail to allocate rent
Section 467
Proportional Rental Accrual

◆ Apply proportional rental accrual if:
  - Lease does not provide for “adequate interest on fixed rent” (i.e. prepaid of deferred rent and no adequate interest required), and
  - Lease is not a disqualified leaseback or disqualified long-term lease agreement
◆ Portion of each rental payment will be recharacterized as interest
◆ Interest for all purposes of the code (e.g., passive loss rules, limits on interest deductions, withholding tax etc.)
Section 467
What is Prepaid or Deferred Rent?

Lease will have section allocating rent charge for each year AND another section specifying when rent is payable

- Rent is **prepaid** if cumulative rent payable through close of any year exceeds cumulative rent allocated to all periods through the close of succeeding year
- Rent is **deferred** if cumulative rent allocated to all periods through close of any year exceeds cumulative rent payable as of end of succeeding year
- Effectively, rent may be deferred or prepaid for one year without lease being a Section 467 rental agreement
**Deferred Rent vs. Prepaid Rent**

<table>
<thead>
<tr>
<th>Year</th>
<th>Rent Allocated</th>
<th>Rent Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$20</td>
<td>$0</td>
</tr>
<tr>
<td>2</td>
<td>$20</td>
<td>$15</td>
</tr>
<tr>
<td>3</td>
<td>$20</td>
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<td>$20</td>
<td>$30</td>
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<tr>
<td>5</td>
<td>$20</td>
<td>$35</td>
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<table>
<thead>
<tr>
<th>Year</th>
<th>Rent Allocated</th>
<th>Rent Payable</th>
</tr>
</thead>
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<tr>
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<td>$45</td>
</tr>
<tr>
<td>2</td>
<td>$20</td>
<td>$25</td>
</tr>
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<td>3</td>
<td>$20</td>
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<td>$20</td>
<td>$10</td>
</tr>
<tr>
<td>5</td>
<td>$20</td>
<td>$10</td>
</tr>
</tbody>
</table>
Prepaid Rent Example – Proportional Rent Calculation

- One Payment in Year 1 = $1,800,000
- Allocated $510,000 yr1; 600,000 yr2; 690,000 yr3
- PV of Payment @10% = $1,800,000
- PV @ 10% of allocations = $1,477,911
- Divide PV of payments by PV of allocations = 1.217935
# Prepaid Rent Example – Total Section 467 Rent and Interest

<table>
<thead>
<tr>
<th>Year</th>
<th>Rent Allocated per Lease</th>
<th>Sec. 467 Prop. Rent Amount</th>
<th>Sec. 467 Interest</th>
<th>Net 467 Rent and Interest</th>
<th>Rent payments</th>
<th>Sec. 467 Loan Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>510,000</td>
<td>621,147</td>
<td>(180,000)</td>
<td>441,147</td>
<td>1,800,000</td>
<td>(1,800,000)</td>
</tr>
<tr>
<td>2</td>
<td>600,000</td>
<td>730,761</td>
<td>(135,885)</td>
<td>594,876</td>
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<td>(1,358,853)</td>
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<tr>
<td>3</td>
<td>690,000</td>
<td>840,375</td>
<td>(76,399)</td>
<td>763,976</td>
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<td>(763,997)</td>
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<tr>
<td>Total</td>
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<td>2,192,283</td>
<td>(392,284)</td>
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<td>1,800,000</td>
<td>1,800,000</td>
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</tbody>
</table>
Deferred Rent Example – Proportional Rent Calculation

- One Payment in Year 3 = $1,800,000
- Allocated $510,000 yr1; 600,000 yr2; 690,000 yr3
- PV of Payment @10% = $1,352,366
- PV @ 10% of allocations = $1, 477,911
- Divide PV of payments by PV of allocations = 0.915053
## Deferred Rent Example – Total Section 467 Rent and Interest

### Deferred Rent Proportional Method

<table>
<thead>
<tr>
<th>Year</th>
<th>Rent Allocated per Lease</th>
<th>Sec. 467 Prop. Rent Amount</th>
<th>Sec. 467 Interest</th>
<th>Net 467 Rent and Interest</th>
<th>Rent payments</th>
<th>Sec. 467 Loan Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
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<td>466,677</td>
<td></td>
<td>466,677</td>
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<td>600,000</td>
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<td>46,667</td>
<td>595,698</td>
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<td>466,676</td>
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<tr>
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<td>1,062,374</td>
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<tr>
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<td>1,647,094</td>
<td>152,904</td>
<td>1,800,000</td>
<td>1,800,000</td>
<td>1,800,000</td>
</tr>
</tbody>
</table>
Disqualified Leasebacks and Long-term Lease Agreements

❖ **Leaseback**
  - If tenant had an interest within 2 years of leasing from landlord

❖ **Long-Term Lease Agreement**
  - Lease term exceeds 75% of statutory recovery period of property; e.g.,
    - Specified statutory recovery period, *not* depreciable life of asset
    - For real property, statutory recovery period is 19 years

❖ **Leaseback or Long-Term Lease Agreement is disqualified if:**
  - A principal purpose for providing increasing or decreasing rents is the avoidance of Federal income tax, **and**
  - IRS decides to treat agreement as disqualified
Deferred Rent Example – Constant Rental Calculation

- One Payment in Year 3 = $1,800,000
- PV of Payment @10% = $1,352,366
- PV @ 10% of $1 assumed to be payable on the last day of each accrual period = $2.486852
- Divide PV of payments by PV of $1 =
- Constant Rental Factor of $543,806
## Deferred Rent Example – Total Section 467 Rent and Interest

<table>
<thead>
<tr>
<th>Year</th>
<th>Rent Allocated per Lease</th>
<th>Sec. 467 Constant Rent Amount</th>
<th>Sec. 467 Interest</th>
<th>Net 467 Rent and Interest</th>
<th>Rent payments</th>
<th>Sec. 467 Loan Balance</th>
</tr>
</thead>
<tbody>
<tr>
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<td>543,806</td>
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<tr>
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<td>54,381</td>
<td>598,187</td>
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<td>543,806</td>
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<tr>
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<td>114,200</td>
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<td>1,141,993</td>
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<td>Total</td>
<td>1,800,000</td>
<td>1,631,418</td>
<td>168,581</td>
<td>1,800,000</td>
<td>1,800,000</td>
<td>1,800,000</td>
</tr>
</tbody>
</table>
“A” (not THE) Principal Purpose to Avoid Tax

- Constant rental accrual does not apply unless rental agreement is disqualified
- To be disqualified, agreement must have a principal purpose of tax avoidance
- How is the principal purpose test applied?
  - Agreement will be “closely scrutinized” if reasonable to expect “significant” difference between marginal tax rate of lessor and lessee at some point during lease term.
    - Greater than 10% is significant, taking into account NOLs, credit carryovers, AMT and partnership allocations.
Safe Harbors to Avoid Constant Rental Accrual Treatment

- Increasing or decreasing rent is not considered to be motivated by tax avoidance where, inter alia:
  - Rent allocated for each year is within 10% of average annual rent
  - Where the rental agreement is a long-term agreement and at least 90% of property subject to agreement is real property, 15% variation allowed
  - If 10% test applies, eliminate free rent period < 3 months in making calculation if concession is at start of lease
  - If 15% test applies, eliminate free rent period up to 24 months or 10% of the lease term if commercially reasonable
  - Increase or decrease in rent attributable to a single rent holiday for one consecutive period if rent holiday is for 3 months or less at beginning of lease term, or does not exceed 24 months and is commercially reasonable in locality of use of property
Safe Harbors to Avoid Constant Rental Accrual Treatment

Safe Harbors (continued):

- Increase or decrease in rent attributable to a specified contingent rent provision, including:
  - A qualified percentage rents provision (rent equal to fixed percentage of lessee’s sales receipts or sales)
  - An adjustment based on a reasonable price index
  - A provision requiring lessee to pay costs to a third party
  - A provision requiring payment of late payment charges
  - A tax indemnity provision
  - A variable interest rate provision
Section 467 and Lease Modifications

If a lease is “substantially modified,” it is treated as a new agreement made on the date of modification
  - New determination must be made as to whether lease is a Section 467 rental agreement, and whether proportional rental accrual or constant rental accrual apply

Safe harbors – not a substantial modification if:
  - Change in rent solely result of lessor refinancing debt incurred to acquire property,
  - Change in rent in any rental period does not vary by more than 1% from original rent in that period, or
  - Change in rent due to lessee’s obligations to pay third-party costs and certain other types of contingent payments
  - Change in lessor or lessee generally not a substantial modification
Section 467 Recapture

If a lessor transfer property subject to a leaseback or long-term agreement (not disqualified) and the lease has some amount of back-loaded rent,” the lessor must recapture as ordinary income an amount of gain on the sale equal to the income it would have received if the lease had been subject to constant rental accrual over the income it actually reported.
Section 467 Method Changes

- **Automatic consent generally available for change to use rent allocation method**
  - Not applicable to taxpayers required to use constant rental accrual method or proportional rental accrual method
  - Must attach to Form 3115 copy of one of section 467 rental agreements to be covered by change (or at least rent allocation pages)
  - No audit protection if IRS determines section 467 rental agreement is disqualified leaseback or long-term agreement
Section 467 Method Changes

- **Automatic consent (cont.)**
  - Generally see when taxpayers have been inadvertently following book
    - Taxpayer recognizes deferred rent on straight-line basis over term of rental agreement even though required to use rent allocation method under section 467

- **All other changes generally non-automatic**
  - Rev. Proc. 97-27

- **Section 481(a) adjustment spread period**
  - Unfavorable (positive) adjustment – 4 years
  - Favorable (negative) adjustment – 1 year
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