

T.D. 8917

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

**Section 467 Rental Agreements
Involving Payments of
\$2,000,000 or Less**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning section 467 rental agreements. The regulations provide amendments to the regulations under section 467, including the removal of the exception to constant rental accrual for rental agreements involving payments of \$2,000,000 or less. The regulations affect taxpayers that are parties to a section 467 rental agreement.

DATES: *Effective Date:* These regulations are effective January 5, 2001.

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

FOR FURTHER INFORMATION CONTACT: Forest Boone, (202) 622-4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR Part 1 under section 467 of the Internal Revenue Code (Code). Section 467 was added to the Code by section 92(a) of the Tax Reform Act of 1984 (Public Law 98-369; 98 Stat. 609).

On May 18, 1999, a notice of proposed rulemaking (REG-103694-99, 1999-1, C.B. 49) under section 467 was published in the **Federal Register** (64 F.R. 26924). The notice proposed to amend the section 467 regulations relating to constant rental accrual by treating section 467 rental agreements involving payments of \$2,000,000 or less in the same manner as agreements involving payments of more than \$2,000,000. Although comments and requests for a public hearing were solicited, no comments were received and no public hearing was requested or held. Accordingly, the amendment to the constant rental accrual rules called for by the proposed regulations is adopted without revision.

In addition, the IRS and Treasury Department have identified three provi-

sions in the section 467 regulations (T.D. 8820, 1999–1 C.B. 1209), published on May 18, 1999, at 64 F.R. 26845, that require clarification. Accordingly, these final regulations also provide clarifying amendments to the section 467 regulations.

Explanation of Provisions

A. Removal of the \$2,000,000 Constant Rental Accrual Exception

Section 467 includes an anti-abuse rule applicable to certain section 467 rental agreements. Under this rule, a constant rental amount must be taken into account by a lessor and lessee for each rental period during the lease term. 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 agreement.

Constant rental accrual applies only with respect to leasebacks and long-term agreements that provide for increasing or decreasing rent and only if the Commissioner determines that the agreement is disqualified because tax avoidance is a principal purpose for providing increasing or decreasing rent. In addition, however, the regulations provide that a rental agreement will not be disqualified and, consequently, will not be subject to constant rental accrual unless it requires more than \$2,000,000 in rental payments and other consideration.

These final regulations remove the \$2,000,000 exception from constant rental accrual for section 467 rental agreements entered into on or after July 19, 1999. Consequently, for section 467 rental agreements entered into on or after July 19, 1999, the Commissioner may determine that the agreement is a disqualified leaseback or long-term agreement subject to constant rental accrual, even if the agreement requires \$2,000,000 or less in rental payments and other consideration.

B. Definition of Lease Term

Section 1.467–1(h)(6) defines lease term to mean “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, exercis-*

able by the lessee, as to which it is reasonably expected, as of the agreement date, that the option will not be exercised.” [Emphasis added]. By contrast, the proposed regulations preceding the section 467 final regulations stated that an option period, whether exercisable by the lessor or lessee, is included in the lease term only if it is expected, as of the agreement date, that the option will be exercised. The purpose of the broader rule in the final regulations was to include all lessor option periods in the lease term. The IRS and Treasury Department recognize, however, that the broader rule has caused some uncertainty as to whether a change in the treatment of lessee options, particularly those exercisable at fair market value rental, was also intended. These regulations clarify that a change in the treatment of lessee options was not intended. They provide, in language similar to that of the proposed section 467 regulations, that lessee options are to be included in the lease term only if it is expected, as of the agreement date, that the option will be exercised. For this purpose, a lessee is generally expected to exercise an option if, for example, as of the agreement date the rent for the option period is less than the expected fair market value rental for such period. It should be noted, however, that factors other than the relationship between rent and expected fair market value rental for the option period may be relevant in determining whether it is expected that a lessee option will be exercised. Thus, even in the case of a lessee option exercisable at fair market value rental, it may, on account of such other relevant factors, be expected that the option will be exercised.

C. When an Amount is Considered Payable

Section 1.467–1(j)(2)(ii) provides that, for purposes of determining present value and yield under the regulations, an amount is payable on the last day for timely payment (the last day for timely payment rule). The last day for timely payment 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).

The IRS and Treasury Department believe that the last day for timely payment rule, applicable to the computation of present value and yield, should also apply to other cases in which the date on which an amount is payable is relevant for purposes of section 467. Accordingly, the section 467 regulations have been amended to provide that, for purposes of applying all of the section 467 rules, not just those dealing with present value and yield, an amount is payable on the last day for timely payment.

D. Adequate Interest for Agreements With Both Deferred and Prepaid Rent

Under the section 467 regulations, the fixed rent for each rental period is the proportional rental amount if the section 467 rental agreement is not a disqualified leaseback or long-term agreement and if the agreement does not provide adequate interest on fixed rent. The regulations set forth rules for determining whether an agreement has adequate interest on fixed rent. These regulations clarify how these rules apply in the case of agreements with both deferred and prepaid rent.

E. Effective Dates

The removal of the exception from constant rental accrual for rental agreements involving payments of \$2,000,000 or less is applicable for section 467 rental agreements entered into on or after July 19, 1999. The other amendments in these regulations are applicable to rental agreements entered into after March 6, 2001. However, taxpayers may choose to apply these amendments to rental agreements entered into on or before March 6, 2001.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also 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 these 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 its impact on small business.

Drafting Information

The principal author of the regulations is Forest Boone, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in the development of the regulations.

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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 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * * *

Par 2. Section 1.467-0 is amended by adding an entry for §1.467-2(b)(3) to read as follows:

§1.467-0 Table of contents.

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

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(b) * * *

(3) Agreements with both deferred and prepaid rent.

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Par 3. Section 1.467-1 is amended by revising paragraphs (h)(6) and (j)(2)(ii) to read as follows:

§1.467-1 Treatment of lessors and lessees generally.

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(h) * * *

(6) *Lease term* means the period during which the lessee has use of the property subject to the rental agreement, including any option of the lessor to renew or extend the term of the agreement. An option of the lessee to renew or extend the

term of the agreement is included in the lease term only if it is expected, as of the agreement date, that the option will be exercised. For this purpose, a lessee is generally expected to exercise an option if, for example, as of the agreement date the rent for the option period is less than the expected fair market value rental for such period. The lessor's or lessee's determination that an option period is either included in or excluded from the lease term is not binding on the Commissioner. If the lessee (or a related person) agrees that one or both of them will or could be obligated to make payments in the nature of rent (within the meaning of §1.168(i)-2(b)(2)) for a period when another lessee (the substitute lessee) or the lessor will have use of the property subject to the rental agreement, the Commissioner may, in appropriate cases, treat the period when the substitute lessee or lessor will have use of the property as part of the lease term. See §1.467-7(f) for special rules applicable to the lessee, substitute lessee, and lessor. This paragraph (h)(6) applies to section 467 rental agreements entered into after March 6, 2001. However, taxpayers may choose to apply this paragraph (h)(6) to any rental agreement that is described in §1.467-9(a) and is entered into on or before March 6, 2001.

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(j) * * *

(2) * * *

(ii) *Time amount is payable.* For purposes of this section and §§1.467-2 through 1.467-9, 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)). This paragraph (j)(2)(ii) applies to section 467 rental agreements entered into after March 6, 2001. However, taxpayers may choose to apply this paragraph (j)(2)(ii) to any rental agreement that is described in §1.467-9(a) and is entered into on or before March 6, 2001.

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Par 4. In §1.467-2, paragraph (b)(3) is added to read as follows:

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

* * * * *

(b) * * *

(3) *Agreements with both deferred and prepaid rent.* If an agreement has both deferred and prepaid rent, the agreement provides adequate interest under paragraph (b)(1) of this section if the conditions set forth in paragraph (b)(1)(ii)(A) through (D) of this section are met for both the prepaid and the deferred rent. For purposes of this paragraph (b)(3), an agreement will be considered to meet the condition set forth in paragraph (b)(1)(ii)(A) of this section if the agreement provides a single fixed rate of interest on the deferred rent and a single fixed rate of interest on the prepaid rent, even if those rates are not the same. This paragraph (b)(3) applies to section 467 rental agreements entered into after March 6, 2001. However, taxpayers may choose to apply this paragraph (b)(3) to any rental agreement that is described in §1.467-9(a) and is entered into on or before March 6, 2001.

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Par 5. In §1.467-3, paragraph (b)(1)(iii) is revised to read as follows:

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

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(b) * * * (1) * * *

(iii) For section 467 rental agreements entered into before July 19, 1999, the amount determined with respect to the 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.

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Robert E. Wenzel,
*Deputy Commissioner
of Internal Revenue.*

Approved December 12, 2000.

Jonathan Talisman,
*Acting Assistant Secretary of
the Treasury.*