

- (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.

[T.D. 8820, 64 FR 26851, May 18, 1999, as amended by T.D. 8917, 66 FR 1039, Jan. 5, 2001]

**§ 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 de-

scribed 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 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 pro-

vides 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 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 pay-

ments 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.

(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 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.

(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.

[T.D. 8820, 64 FR 26853, May 18, 1999, as amended by T.D. 8917, 66 FR 1039, Jan. 5, 2001]

**§ 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).

(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