

Internal Revenue Service, Treasury

§ 1.467-7

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:

	Accrued interest under rental agreement	Accrued interest using fixed rate substitutes
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.

	Proportional rent	Accrued interest	Projected payment	Cumulative loan
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).

[T.D. 8820, 64 FR 26865, May 18, 1999]

§ 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—

(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:

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

(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:

(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). How-

ever, 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:

	Allocation	Payment
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:

	Section 467 rent	Section 467 interest
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:

	Allocation	Payment
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:

	Section 467 rent	Section 467 interest
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 × \$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 × \$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:

Calendar year	Payment	Section 467 interest	Section 467 rent	Section 467 loan balance
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

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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:

Calendar year	Payment	Section 467 interest	Section 467 rent	Section 467 loan balance
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

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:

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:

Calendar year	Payment	Section 467 interest	Section 467 loan balance
Beginning			\$1,136,271.41
2002	\$0	\$124,989.85	1,261,261.26

Calendar year	Payment	Section 467 interest	Section 467 loan balance
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:

Calendar year	Rent	Payments
2000	\$200,000	\$400,000
2001	200,000	300,000
2002	200,000	200,000
2003	200,000	100,000

Calendar year	Rent	Payments
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:

Calendar year	Payment	Section 467 interest	Section 467 rent	Section 467 loan balance
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.

(vii) 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

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meaning of §1.467-3(b), and has the following allocation schedule and payment schedule:

Year	Allocation	Payment
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) be-

Year	Rent	Interest	Loan balance
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

cause 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:

(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):

Year	Allocation	Payment
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:

Year	Rent	Interest	Loan balance
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:

Calendar year	Rent	Payments
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:

Calendar Year	Section 467 rent	Section 467 interest	Payments	Section 467 loan balance
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)

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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:

Calendar	Section 467 rent	Section 467 interest	Payments	Section 467 loan balance
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.

[T.D. 8820, 64 FR 26867, May 18, 1999]

§ 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