

§ 1.467-3

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

Taxable year	Section 467 rent
2000	\$743,775.52 (\$ 800,000×.9297194).
2001	929,719.40 (\$1,000,000×.9297194).
2002	1,115,663.28 (\$1,200,000×.9297194).

[T.D. 8820, 64 FR 26859, May 18, 1999, as amended by T.D. 8917, 66 FR 1040, Jan. 5, 2001]

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

(a) *General rule.* Under § 1.467-1(d)(2)(i), constant rental accrual (as described under paragraph (d) of this section) must be used to determine the fixed rent for each rental period in the lease term if the section 467 rental agreement is a disqualified leaseback or long-term agreement within the meaning of paragraph (b) of this section. Constant rental accrual may not be used in the absence of a determination by the Commissioner, pursuant to paragraph (b)(1)(ii) of this section, that the rental agreement is disqualified. Such determination may be made either on a case-by-case basis or in regulations or other guidance published by the Commissioner (see § 601.601(d)(2) of this chapter) providing that a certain type or class of leaseback or long-term agreement will be treated as disqualified and subject to constant rental accrual.

(b) *Disqualified leaseback or long-term agreement—(1) In general.* A leaseback (as defined in paragraph (b)(2) of this section) or a long-term agreement (as defined in paragraph (b)(3) of this section) is disqualified only if—

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

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

(iii) For section 467 rental agreements entered into before July 19, 1999, the amount determined with respect to the rental agreement under § 1.467-1(c)(4) (relating to the exception for rental agreements involving total payments of \$250,000 or less) exceeds \$2,000,000.

(2) *Leaseback.* A section 467 rental agreement is a leaseback if the lessee (or a related person) had any interest (other than a de minimis interest) in the property at any time during the two-year period ending on the agreement date. For this purpose, interests in property include options and agreements to purchase the property (whether or not the lessee or related person was considered the owner of the property for Federal income tax purposes) and, in the case of subleased property, any interest as a sublessor.

(3) *Long-term agreement—(i) In general.* A section 467 rental agreement is a long-term agreement if the lease term exceeds 75 percent of the property's statutory recovery period.

(ii) *Statutory recovery period—(A) In general.* The term statutory recovery period means—

(1) In the case of property depreciable under section 168, the applicable period determined under section 467(e)(3)(A);

(2) In the case of land, 19 years; and

(3) In the case of any other tangible property, the period that would apply under section 467(e)(3)(A) if the property were property to which section 168 applied.

(B) *Special rule for rental agreements relating to properties having different statutory recovery periods.* In the case of a rental agreement relating to two or more related properties that have different statutory recovery periods, the statutory recovery period for purposes of paragraph (b)(3)(ii)(A) of this section is the weighted average, based on the fair market values of the properties on the agreement date, of the statutory recovery periods of each of the properties.

(c) *Tax avoidance as principal purpose for increasing or decreasing rent—(1) In general.* In determining whether a principal purpose for providing increasing or decreasing rent is the avoidance of Federal income tax, all relevant facts

and circumstances are taken into account. However, an agreement will not be treated as a disqualified leaseback or long-term agreement if either of the safe harbors set forth in paragraph (c)(3) of this section is met. The mere failure of a leaseback or long-term agreement to meet one of these safe harbors will not, by itself, cause the agreement to be treated as one in which tax avoidance was a principal purpose for providing increasing or decreasing rent.

(2) *Tax avoidance*—(i) *In general.* If, as of the agreement date, a significant difference between the marginal tax rates of the lessor and lessee can reasonably be expected at some time during the lease term, the agreement will be closely scrutinized and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent. The term “marginal tax rate” means the percentage determined by dividing one dollar into the amount of the increase or decrease in the Federal income tax liability of the taxpayer that would result from an additional dollar of rental income or deduction.

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

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

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

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

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

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

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

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

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

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

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

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

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

consists of real property (as defined in § 1.856-3(d)).

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

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

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

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

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

(1) The period does not exceed the lesser of 24 months or 10 percent of the lease term (determined before the ap-

plication of this paragraph (c)(4)(iii)(D)).

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

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

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

(d) *Calculating constant rental amount*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, the constant rental amount is the amount that, if paid at the end of each rental period, would result in a present value equal to the present value of all amounts payable under the disqualified leaseback or long-term agreement as rent and interest. In computing the constant rental amount, the rules for determining present value are the same as those provided in § 1.467-2(d) for computing the proportional rental amount. If constant rental accrual is required, all rental periods (other than an initial or final short period of not more than one month) must be equal in length and satisfy the requirements of § 1.467-1(j)(5).

(2) *Initial or final short periods.* If a disqualified leaseback or long-term agreement has an initial or final short rental period, the constant rental amount for the initial or final short period may be determined under any reasonable method. However, the sum of the present values of all the constant rental amounts must equal the present values of all amounts payable under the disqualified leaseback or long-term agreement as rent and interest. Any

adjustment necessary to eliminate the section 467 loan balance because of the method used to determine the constant rental amount for short periods must be taken into account as section 467 rent for the final rental period.

(3) *Method to determine constant rental amount; no short periods*—(i) *Step 1.* Determine the present value of amounts payable under the disqualified lease-back or long-term agreement as rent or interest.

(ii) *Step 2.* Determine the present value of \$1 to be received at the end of each rental period during the lease term as of the first day of the first rental period during the lease term (or, if earlier, the first day a rent payment is required under the rental agreement).

(iii) *Step 3.* Divide the amount determined in paragraph (d)(3)(i) of this section (Step 1) by the number of dollars determined in paragraph (d)(3)(ii) of this section (Step 2).

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

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

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

(ii) As described in paragraph (c)(2) of this section, as of the agreement date, a significant difference between the marginal tax rates of the lessor and lessee can reasonably be expected at some time during the lease

term. First, the rental agreement has increasing rents. Second, the lessor's marginal tax rate exceeds the lessee's marginal tax rate by more than 10 percentage points during a rental period to which the rental agreement allocates less than a ratable portion of the aggregate amount of rent payable under the agreement. For example, for the year 2000, the lessor's expected marginal tax rate is 35 percent, the percentage determined by dividing the increase in the Federal income tax liability of K that would result from an additional dollar of rental income (\$.35) by \$1. Because the lessee is subject to the alternative minimum tax, the lessee's expected marginal tax rate for 2000 is 20 percent, the percentage determined by dividing the decrease in the Federal income tax liability (taking into account both the decrease in the lessee's regular tax and the increase in the lessee's alternative minimum tax) that would result from an additional dollar of rental deduction (\$.20) by \$1. Further, for the year 2000, the rent allocated in accordance with the rental agreement is \$427,500, which is less than a ratable portion of the aggregate amount of rental payments, \$495,000, determined by dividing the total rents payable under the agreement (\$4,950,000) by the number of years in the lease term (10). Thus, because a significant difference between the marginal tax rates of the lessor and lessee can reasonably be expected during the lease term, the agreement will be closely scrutinized and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing rent.

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

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

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

\$900,000. The test is met for 2005 because the annualized rent for that year is \$1,100,000. The test is met for each of the years 2001 through 2004 because the rent for each of these years is not less than \$900,000 and not more than \$1,100,000. Accordingly, because the uneven rent test of paragraph (c)(4)(i) of this section is met, the long-term agreement will not be treated as disqualified.

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

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

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

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

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

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

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

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

(ii) The adjustment provision produces a schedule of rent payments that is virtually identical to the schedule that would have resulted if G had actually borrowed money in an amount and on terms identical to the terms used in determining interest on the notional principal amount and the adjustment were based on that indebtedness. An adjustment based on actual indebtedness of the lessor would have been a variable interest rate provision eligible for a safe harbor

under paragraph (c)(3)(ii)(A) of this section. Accordingly, based on all the facts and circumstances, the adjustment provision did not have as one of its principal purposes the avoidance of Federal income tax, and thus the long-term agreement will not be treated as disqualified.

Example 6. (i) X and Y enter into a leaseback for a 5-year lease of personal property beginning on January 1, 1998, and ending on December 31, 2002. The rental agreement provides that \$0 of rent is allocated to years 1998, 1999, and 2000, and that rent of \$17,500,000 is allocated to years 2001 and 2002. The rental agreement provides that the rent allocated to each year is payable on December 31 of that year. Assume all rental periods are the calendar year. Assume also that 110 percent of the applicable Federal rate based on annual compounding is 12 percent.

(ii)(A) If the Commissioner determines that the leaseback is disqualified, the constant rental amount is computed as follows:

(B) Step 1 in calculating the constant rental amount is to determine the present value of the two payments due under the rental agreement as follows:

$$\$21,051,536 = \frac{\$17,500,000}{(1.12)^4} + \frac{\$17,500,000}{(1.12)^5}$$

(iii) Because no amounts of rent are payable before the lease term, Step 2 in calculating the constant rental amount is to determine the present value as of the first day of the lease term of \$1 to be received at the end of each rental period during the lease term. This results in a present value of \$3.6047762. In Step 3 the amount determined in Step 1 is divided by the number of dollars determined in Step 2. Thus, the constant rental amount is \$5,839,901 for each calendar year during the lease term computed as follows:

$$\$5,839,901 = \frac{\$21,051,536}{3.6047762}$$

[T.D. 8820, 64 FR 26860, May 18, 1999, as amended by T.D. 8917, 66 FR 1040, Jan. 5, 2001]

§ 1.467-4 Section 467 loan.

(a) *In general*—(1) *Overview.* Except as provided in paragraph (a)(2) of this section, the section 467 loan rules of this section apply to a section 467 rental agreement if, as of the first day of a rental period, there is a difference between the amount of fixed rent payable under the rental agreement on or before the first day and the amount of fixed rent required to be accrued in accordance with § 1.467-1(d)(2) before the first day. Paragraph (b) of this section

provides rules for computing the principal balance of a section 467 loan at the beginning of any rental period. The principal balance of a section 467 loan may be positive or negative. For Federal tax purposes, if the principal balance is positive, the amount represents a loan from the lessor to the lessee, and if the principal balance is negative, the amount represents a loan from the lessee to the lessor.

(2) *No section 467 loan in the case of certain section 467 rental agreements.* Except as provided in paragraphs (a)(3) and (4) of this section, this section does not apply to section 467 rental agreements that provide adequate interest under § 1.467-2(b)(1)(i) (agreements with no deferred or prepaid rent) or § 1.467-2(b)(1)(ii) (agreements with deferred or prepaid rent that provide adequate stated interest at a single fixed rate).

(3) *Rental agreements subject to constant rental accrual.* Notwithstanding the provisions of paragraph (a)(2) of this section, this section applies to rental agreements subject to constant rental accrual under § 1.467-3 (relating to disqualified leasebacks or long-term agreements).

(4) *Special rule in applying the provisions of § 1.467-7(e), (f), or (g).* Notwithstanding the provisions of paragraph (a)(2) of this section, section 467 loan balances must be computed for section 467 rental agreements that are not subject to constant rental accrual under § 1.467-3 and that provide adequate interest under § 1.467-2(b)(1)(i) or (ii), but only for purposes of applying the provisions of § 1.467-7(e) (relating to dispositions of property subject to a section 467 rental agreement), § 1.467-7(f) (relating to assignments by lessees and lessee-financed renewals), and § 1.467-7(g) (relating to modifications of rental agreements).

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

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

(ii) Increased by the sum of—

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