

§ 1.467-5 Section 467 rental agreements with variable interest.

(a) *Variable interest on deferred or prepaid rent*—(1) *In general.* This section provides rules for computing section 467 rent and interest in the case of section 467 rental agreements providing variable interest. For purposes of this section, a rental agreement provides for variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that meet the requirements of § 1.1275-5(a)(3)(i)(A) or (B) and (a)(4). If a section 467 rental agreement provides for interest that is neither variable interest nor fixed interest, the agreement provides for contingent payments.

(2) *Exceptions.* This section is not applicable to section 467 rental agreements that provide adequate interest under § 1.467-2(b)(1)(i) (agreements with no deferred or prepaid rent) or (b)(1)(ii) (rental agreements with stated interest at a single fixed rate). The exceptions in this paragraph (a)(2) do not apply to rental agreements subject to constant rental accrual under § 1.467-3.

(b) *Variable rate treated as fixed*—(1) *In general.* If a section 467 rental agreement provides variable interest—

(i) The fixed rate substitutes (determined in the same manner as under § 1.1275-5(e), treating the agreement date as the issue date) for the variable rates of interest on deferred or prepaid fixed rent provided by the rental agreement must be used in computing the proportional rental amount under § 1.467-2(c), the constant rental amount under § 1.467-3(d), the principal balance of a section 467 loan under § 1.467-4(b), and the yield of a section 467 loan under § 1.467-4(c); and

(ii) The interest on fixed rent for any rental period is equal to the amount that would be determined under § 1.467-1(e)(2) if the section 467 rental agreement did not provide variable interest, using the fixed rate substitutes determined under paragraph (b)(1)(i) of this section in place of the variable rates called for by the rental agreement, plus the variable interest adjustment amount provided in paragraph (b)(2) of this section.

(2) *Variable interest adjustment amount*—(i) *In general.* The variable in-

terest adjustment amount for a rental period equals the difference between—

(A) The amount of interest that, without regard to section 467, would have accrued during the rental period under the terms of the section 467 rental agreement; and

(B) The amount of interest that, without regard to section 467, would have accrued during the rental period under the terms of the section 467 rental agreement using the fixed rate substitutes determined under paragraph (b)(1)(i) of this section in place of the variable interest rates called for by the rental agreement.

(ii) *Positive or negative adjustment.* If the amount determined under paragraph (b)(2)(i)(A) of this section is greater than the amount determined under paragraph (b)(2)(i)(B) of this section, the variable interest adjustment amount is positive. If the amount determined under paragraph (b)(2)(i)(A) of this section is less than the amount determined under paragraph (b)(2)(i)(B) of this section, the variable interest adjustment amount is negative.

(3) *Section 467 loan balance.* The variable interest adjustment amount is not taken into account in determining the principal balance of a section 467 loan under § 1.467-4(b). Instead, the section 467 loan balance is computed as if all amounts payable under the section 467 rental agreement were based on the fixed rate substitutes determined under paragraph (b)(1)(i) of this section.

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

Example 1. (i) X and Y enter into a section 467 rental agreement for the lease of personal property beginning on January 1, 2000, and ending on December 31, 2002. The rental agreement allocates \$100,000 of rent to 2000, \$200,000 to 2001, and \$100,000 to 2002, and requires the lessee to pay all \$400,000 of rent on December 31, 2002. The rental agreement requires the accrual of interest on unpaid accrued rent at two different qualified floating rates (as defined in § 1.1275-5(b)), one for 2001 and the other for 2002, such interest to be paid on December 31 of the year it accrues. The rental agreement provides that the qualified floating rate is set at a current value within the meaning of § 1.1275-5(a)(4). Assume that on the agreement date, 110 percent of the applicable Federal rate is 10 percent, compounded annually. Assume also that the agreement is not a leaseback or

§ 1.467-5

26 CFR Ch. I (4-1-01 Edition)

long-term agreement and, therefore, is not subject to constant rental accrual.

(i) To determine if the section 467 rental agreement provides for adequate interest under § 1.467-2(b), § 1.467-2(b)(2) requires the use of fixed rate substitutes (in this example determined in the same manner as under § 1.1275-5(e)(3)(i) treating the agreement date as the issue date) in place of the variable rates called for by the rental agreement. Assume that on the agreement date the qualified floating rates, and therefore the fixed rate substitutes, relating to 2001 and 2002 are 10 and 15 percent compounded annually. Taking into account the fixed rate substitutes, the sum of the present values of all amounts payable by the lessee as fixed rent and interest thereon is greater than the sum of the present values of the fixed rent allocated to each rental period. Accordingly, the rental agreement provides adequate interest under § 1.467-2(b)(1)(iii) and the fixed rent accruing

in each calendar year during the rental agreement is the fixed rent allocated under the rental agreement.

(iii) Because the section 467 rental agreement provides for variable interest on unpaid accrued fixed rent at qualified floating rates and the qualified floating rates are set at a current value, the requirements of § 1.1275-5(a)(3)(i)(A) and (4) are met and the rental agreement provides for variable interest within the meaning of paragraph (a)(1) of this section. Therefore, under paragraph (b)(1)(i) of this section, the yield of the section 467 loan is computed based on the fixed rate substitutes. Under § 1.467-4(c), the constant yield (rounded to two decimal places) equals 13.63 percent compounded annually. Based on the fixed rate substitutes, the fixed rent, interest on fixed rent, and the principal balance of the section 467 loan, for each calendar year during the lease term, are as follows:

	Accrued rent	Accrued interest	Projected payment	Cumulative loan
2000	\$100,000	\$0	\$0	\$100,000
2001	200,000	13,630	(10,000)	303,630
2002	100,000	41,370	(445,000)	0

(iv) To compute the actual reported interest on fixed rent for each calendar year, the variable interest adjustment amount, as described in paragraph (b)(2) of this section, must be added to the accrued interest determined in paragraph (iii) of this *Example 1*. Assume that the variable rates for 2001 and 2002 are actually 11 and 14 percent, respectively. Without regard to section 467, the interest that would have accrued during each calendar year under the terms of the section 467 rental agreement, and the interest that 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 ap-

plicable 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.

(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:

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

(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:

	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—

(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 disquali-

fied 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