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	Rent allocation	Payment
2002	800,000	\$1,800,000

(B) The rental agreement requires a \$1.8 million payment to be made on December 31, 2002, but does not provide for interest on deferred rent. Assume A and B choose the calendar year as the rental period length and that 110 percent of the applicable Federal rate based on annual compounding is 10 percent. Assume also that the agreement is not a leaseback or long-term agreement and, therefore, is not subject to constant rental accrual.

(i) Because the section 467 rental agreement does not provide adequate interest under § 1.467-2(b) and is not subject to constant rental accrual, the fixed rent that accrues during each rental period is the proportional rental amount as described in § 1.467-2(c). The proportional rental amounts for each rental period are as follows:

2000	\$370,370.37
2001	555,555.56
2002	740,740.73

(iii) A section 467 loan arises at the beginning of the second rental period because the rent payable on or before that day (zero) is less than the fixed rent accrued under § 1.467-1(d)(2) in all preceding rental periods (\$370,370.37). Under paragraph (c)(2) of this section, the yield of the loan is equal to 110 percent of the applicable Federal rate (10 percent compounded annually). Because no payments are treated as made on or before the first day of the second rental period, the principal balance of the loan at the beginning of the second rental period is \$370,370.37. The interest for the second rental period on fixed rent is \$37,037.04 (.10 × \$370,370.37) and, under § 1.467-1(e)(3), is treated as interest income of the lessor and as an interest expense of the lessee.

(iv) Because no payments are made on or before the first day of the third rental period, the principal balance of the loan at the beginning of the third rental period is equal

to the fixed rent accrued during the first and second rental periods plus the lessor's interest income on fixed rent for the second rental period (\$962,962.97 = \$370,370.37 + \$555,555.56 + \$37,037.04). The interest for the third rental period on fixed rent is \$96,296.30 (.10 × \$962,962.97). Thus, the sum of the fixed rent and interest on fixed rent for the three rental periods is equal to the total amount paid over the lease term (first year fixed rent accrual, \$370,370.37, plus second year fixed rent and interest accrual, \$555,555.56 + \$37,037.04, plus third year fixed rent and interest accrual, \$740,740.73 + \$96,296.30, equals \$1,800,000). B takes the amounts of interest and rent into account as interest and rent expense, respectively, and A takes such amounts into account as interest and rent income, respectively, for the calendar years identified above, regardless of their respective overall methods of accounting.

Example 2. (i) The facts are the same as in *Example 1*, § 1.467-2(f). C agrees to lease property from D for five years beginning on January 1, 2000, and ending on December 31, 2004. The section 467 rental agreement provides that rent of \$100,000 accrues in each calendar year in the lease term and that rent of \$500,000 plus \$120,000 of interest is payable on December 31, 2004. The parties select the calendar year as the rental period, and 110 percent of the applicable Federal rate is 10 percent, compounded annually. The rental agreement has deferred rent but provides adequate interest on fixed rent.

(ii)(A) Pursuant to paragraph (c)(1) of this section, the yield of the section 467 loan is 10.775078%, compounded annually. The following is a schedule of the rent allocable to each rental period during the lease term, the balance of the section 467 loan as of the end of each rental period (determined, in the case of the calendar year 2004, without regard to the single payment of rent and interest in the amount of \$620,000 payable on the last day of the lease term), and the interest on the section 467 loan allocable to each rental period:

Calendar year	Section 467 interest	Section 467 rent	Section 467 loan balance
2000	\$0	\$100,000.00	\$100,000.00
2001	10,775.08	100,000.00	210,775.08
2002	22,711.18	100,000.00	333,486.26
2003	35,933.41	100,000.00	469,419.67
2004	50,580.33	100,000.00	620,000.00

(B) C takes the amounts of interest and rent into account as expense and D takes such amounts into account as income for the calendar years identified above, regardless of their respective overall methods of accounting.

§ 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

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

(ii) 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

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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:

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

(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

	Proportional rent	Accrued interest	Projected payment	Cumulative loan
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 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) or section 1022. However, see paragraph (c)(4) of this section for dispositions of property subject to section 1022 by transferees. This paragraph (c)(2) does not apply to property that constitutes a right to receive an item of income in respect of a decedent. See sections 691, 1014(c), and 1022(f).

(3) *Certain tax-free exchanges—(i) In general.* The recapture amount in the case of a disposition to which this