Effective Date: November 6, 1995

COORDINATED ISSUE
RETAIL INDUSTRY
TENANT'S RENT LEVELING
IRC SECTION 467 LEASE AGREEMENTS

FACTS:

Company R, an accrual basis retailer, is the lessee of nonresidential real property under several leases, each entered into after 06-08-84. Company R is not leasing back property in which it previously had an interest. Company R has entered into three categories of leases, which are described as follows:

1. Leases which are for a period of 14 years or less. Taxpayer's total rent obligation exceeds $250,000. Under the terms of the leases, R is required to pay a specified amount of rent per year, with the first 12 months of the lease being "rent free." The annual rent is $50,000 in years 2-6 and $100,000 in years 7-14 according to the rent payment schedules attached to the lease.

2. Leases which are generally for a period of 20 years and the lease terms all exceed 75 percent of the statutory recovery period for the property. Taxpayer's total rent obligation under each of the leases exceeds $250,000. According to the terms of these leases, the taxpayer is required to pay a specified amount of rent each year, with the annual amount of rent increasing at periodic intervals. One-twelfth of each year's total lease payment is due and payable in equal installments on the first of each month. The rent increases reflect current market conditions and common business practice. A review of all relevant facts and circumstances fails to demonstrate that a principal purpose for providing the increasing rents was the avoidance of income tax.

3. Leases which are for a period of 14 years or less. Taxpayer's total rent obligation is less than $250,000. Under the terms of the leases R is required to pay a specified amount of rent per year, with either the first 12 months of the lease being "rent free" or the lessee being required to pay a specified amount of rent per year, with the annual amount of rent increasing at periodic intervals. One-twelfth of each year's total lease payment is due and payable in equal installments on the first of each month.

ISSUE:

Is Company R, for all leases described, allowed to accrue as an annual deduction the annual amount due under a lease agreement or a constant rental amount as defined

by section 467(e)?

The following questions regarding "section 467 agreements" must be answered to resolve this issue:

1. Are the payment schedules allocations of rent for purposes of section 467(b)(1)(A) of the Internal Revenue Code?

2. Is it necessary to determine, based on all the facts and circumstances, that a principal purpose for providing increasing rents is the avoidance of tax for a lease agreement to be classified as a disqualified long-term agreement under section 467(b)(4)?

3. Do the lease agreements require rent to be paid after the period to which it is allocated for purposes of section 467(b)(1)(B)?

INTRODUCTION:

Section 467 of the Internal Revenue Code applies to most leases entered into after June 8, 1984, which require payments of more than $250,000. For example, section 467 applies to any such lease that involves increases in rent over its term. Normally, rents under a section 467 lease are to be reported in accordance with the allocations in the lease. We believe that payment schedules can be allocations for this purpose. Thus, in most cases, both the lessor and the lessee should report rent in accordance with the rent payment schedule, whether they are on accrual or cash method.

Section 467 leases may be subject to rent leveling in certain limited circumstances. Rent leveling (the requirement that both the lessor and the lessee report a constant rental amount) is applicable when there are no allocations of rent under the lease or, in certain circumstances, where the Service finds that the principal purpose for increasing rents under the lease is tax avoidance.

Section 467 of the Code was enacted to end mismatching between lessors and lessees in the reporting of rents. However, the statute is being used to continue mismatching. For example, a lessee may claim that the lease is subject to rent leveling while the lessor claims that the rent should be reported in accordance with the agreement. This could happen if the lessee does not treat the rent payment schedule as an allocation of rent, while the lessor does.

LAW:

Section 467(a)(1) provides that both the lessor or lessee, under any section 467 rental agreement, will take into account the amount of the rent that accrues during the taxable year as determined under section 467(b).

Under section 467(d)(1), the term "section 467 rental agreements" means any rental agreement for the use of tangible property under which, (A) there is at least one amount allocable to the use of property during a calendar year which is to be paid after the close of the calendar year following the calendar year in which the use occurs, or (B) there are increases in the amount to be paid as rent under the agreement.

Under section 467(d)(2)(A), section 467 does not apply to agreements involving payments of $250,000 or less.

Section 467(b)(1) states that, except as provided in section 467(b)(2), the determination of the amount of the rent under any section 467 rental agreement which accrues during any taxable year shall be made (A) by allocating rents in accordance with the agreement, and (B) by taking into account any rent to be paid after the close of the period in an amount based on present value concepts to be determined under regulations.

In the case of any section 467 rental agreement to which section 467(b)(2) applies, the portion of the rent which accrues during any taxable year shall be that portion of the constant rental amount with respect to the agreement which is allocable to the taxable year.

Under section 467(b)(3), section 467(b)(2) applies to any rental payment agreement if (A) the agreement is a disqualified leaseback or long-term agreement, or (B) the agreement does not provide for the allocation referred to in section 467(b)(1)(A).

Section 467(b)(4) defines "disqualified leaseback or long-term agreement" to mean any section 467 rental agreement if (A) the agreement is part of a leaseback transaction or the agreement is for a term in excess of 75 percent of the statutory recovery period for the property, and (B) a principal purpose for providing increasing rents under the agreement is the avoidance of income tax.

Section 467(b)(5) allows exceptions to disqualification in certain cases. It states that the Secretary shall prescribe regulations setting forth circumstances under which agreements will not be treated as disqualified leaseback or long-term agreements, including circumstances relating to (A) changes in amounts paid determined by reference to price indices, (B) rents based on a fixed percentage of lessee receipts or similar amounts, (C) reasonable rent holidays, or (D) changes in amounts paid to unrelated third parties.

Section 467(e)(1) defines the term "constant rental amount" to mean, with respect to any section 467 rental agreement, the amount which, if paid as of the close of each lease period under the agreement, would result in an aggregate present value equal to the present value of the aggregate payments required under the agreement.

Under section 467(e)(3)(A), the statutory recovery period for nonresidential real property is 19 years.

Non-section 467 agreements: Section 461(a) of the Code provides that "any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income. For an accrual basis taxpayer, a deduction or credit is allowable in the year all events have occurred which determine the fact of liability and the amount of the liability can be determined with reasonable accuracy."

Section 446(a) of the Code states that taxable income is computed under the method of accounting the taxpayer regularly uses in computing income for his books. The Code, under section 446(b), provides for an exception to this general rule. If the method used does not clearly reflect income the taxable income, will be computed under a method which the Secretary determines to clearly reflect income.

DISCUSSION:

SITUATIONS 1 AND 2 (SECTION 467 AGREEMENTS)

Question 1:
Are the payment schedules allocations of rent for purposes of section 467(b)(1)(A) of the Internal Revenue Code?

The lease agreements outlined in factual situations (1) and (2) include provisions regarding the payment of rent, generally at regular yearly intervals, over the term of the lease. Therefore under section 467 of the Code, the constant rental accrual requirement is not applicable.

Company R states that section 467(b)(3)(B) applies to these rental agreements because the payment schedules are not allocations of rent under section 467(b)(1)(A) and, therefore, the rent accrual is made in accordance with section 467(b)(2). Company R argues that a payment schedule cannot be an allocation because section 467(b)(1)(B) and its legislative history demonstrate that the allocation of rent can be different than the payment of rent and Congress intended that for purposes of accruing rental deductions, a separate provision must be specified in the lease agreement stating that the parties have agreed on how to accrue the rental deductions over the

term of the lease.

Company R's position is based on the following statement: "The rent allocable to a taxable year will be determined from the terms of the lease. If the lease specifies amounts that are allocable to particular periods but these amounts are not paid until more than one year after the year to which they relate, the amount of rent to be accrued for each period will be an amount determined in accordance with Treasury regulations based on present value concepts..." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 892 (1984). R argues that if the payment schedule is treated as an allocation of rent there will be no rental agreements that do not allocate rents and this will have the effect of nullifying 467(b)(3)(B).

The intention of section 467 was to eliminate mismatching, for example, where an accrual basis lessee may accrue a deduction and a cash basis lessor may defer income inclusion. The method selected in most instances to eliminate the mismatch of income and deductions between lessee and lessor is reporting income and deductions in accordance with the lease. The lessee and lessor are required to deduct and report the same amount of rent regardless of their methods of accounting.

Section 467 of the Code and its legislative history give no clear guidance on what is meant by an "allocation." However, a common understanding of rent payment schedules is that they allocate rent to a particular period of time. Although the statute and the legislative history indicate that the payment of rent can differ from its allocation, it also suggests that they can be the same, "...the amount of rent allocable to a lease period under a section 467 rental agreement is the amount specified as due or payable with respect to the period, whether or not payable currently." Joint Committee on Taxation Staff, General Explanation of Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong. 287 (1984). There is no evidence that Congress intended rental agreements routinely to contain rent allocation schedules separate from the rent payment schedule in order to avoid constant rent accrual under section 467(b)(3)(B). Leases not providing for increasing rents are considered section 467 rental agreements if they provide for deferred payments. A deferred payment is an amount payable for the use of property in one year that is due after the end of the year following the year of use. The leases in Situation (1) provide for deferred payment as the rent holidays are a deferred payment.

The existence of a rent holiday as part of the lease, for a reasonable period, does not cause the rental agreement to fail to provide for the allocation of rent. A provision abating rents allocates zero rent to the period. Section 467(b)(5)(C) of the Code provides that reasonable rent holidays are not circumstances that would be treated as disqualified leasebacks or long-term leases. The legislative history states in its discussion of rent holidays that, "Whether the length of a "rent holiday" is reasonable will be determined by commercial practice in the locality where the use of the property

will occur at the time the lease is entered into. The conferees expect that, in general, this rent holiday will not exceed twelve months, and in no event shall exceed twenty-four months." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 893 (1984).

Answer 1:
The payment schedules provided in the lease agreements are allocations of rent for purposes of section 467(b)(1)(A) and the leases are not subject to rent leveling under section 467(b)(2). The rent described in the payment schedules as payable each year is the amount required to be reported by both the lessor and the lessee under section 467(b)(1).

Question 2:
May the taxpayer determine, based on all the facts and circumstances, that a principal purpose for providing increasing rents is the avoidance of tax for a lease agreement in order to classify it as a disqualified long-term agreement under section 467(b)(4)?

Company R also states that the leases described in situation (2) are disqualified long-term agreements under section 467(b)(3)(A) because the leases are long-term agreements and the increases in R's leases are not described in section 467(b)(5).

The issue of whether to allocate rent according to the constant rental accrual requirement of section 467(b)(2), or to allocate it in accordance with the lease agreement, depends in this circumstance on whether (1) the principal purpose of providing increasing rents is tax avoidance and (2) whether the agreements are leasebacks or long-term leases. All the leases under situation (2) are long-term leases as provided by section 467(b)(4)(A). However, for a lease to be classified as a disqualified long-term agreement, section 467(b)(4)(B) requires that a principal purpose for providing the increasing rents is income tax avoidance.

Section 467(b)(5) authorizes the Secretary to issue regulations setting forth circumstances under which agreements will not be treated as a disqualified leaseback or long-term lease.

The legislative history states that "the determination of the existence of a tax avoidance purpose will be made on the basis of all the relevant facts and circumstances." H.R. Conf. Rep. No. 861, at 893. Some of the factors to consider include the tax brackets of the lessor and lessee at the beginning the lease and their expected tax brackets, the motives of the parties in increasing rents, the business reasons for the increases, etc.
An agreement between lessee and lessor in the same tax bracket would not normally have tax avoidance as its principal purpose, while on the contrary, agreements

between low bracket lessees and high bracket lessors require close scrutiny. However, the fact that the parties are in significantly different tax brackets should not be the only factor in determining tax avoidance. The reason for increasing rents over the term of the agreement may be for sound business reasons, such as the need to provide for increasing operating costs over the life of the lease.

Answer 2:

We believe that only the Service can assert that the taxpayer had a tax avoidance purpose. It is necessary to determine, based on all the facts and circumstances, that a principal purpose for providing increasing rents is the avoidance of tax for a lease to be classified as a disqualified long-term agreement. There is no evidence that a principal purpose for providing the rent increases was tax avoidance. A "principal purpose" is not implied simply because the increases in rent are not described in section 467(b)(5).

Question 3:
Do the lease agreements require rent to be paid after the period to which it is allocated for purposes of section 467(b)(1)(B)?

Section 467(b)(1) of the Code provides that the amount of rent that accrues under any section 467 rental agreement, except for the constant rent accruals of section 467(b)(2), during any year is, (A) the amount allocated to the year under the terms of the agreement, and (B) in applicable agreements, an amount determined by taking into account any rent to be paid after the close of the period in an amount determined by regulations based on a present value basis.

R argues that its lease agreements are subject to section 467(b)(1)(B), which requires rent to be paid after the close of the period to be taken into account in an amount to be determined under regulations, which shall be based on present value concepts. The "period" referred to is the period to which the rent is allocated under section 467(b)(1)(A).

Answer 3:
The rent payment schedule is an allocation of rent for purposes of section 467(b)(1)(A) and the leases in situations (1) and (2) do not require rent to be paid after the close of the period to which the rent is allocated. Therefore, section 467(b)(1)(B) is inapplicable.

SITUATION 3 (NON-SECTION 467 AGREEMENTS)

Section 461(a) of the Code and the Regulations at 1.461-1(a)(2) provide that an expense is deductible for the year in which all events have occurred to fix the fact of liability and the amounts can be determined with reasonable accuracy.

A deduction under the accrual method also requires economic performance under section 461(h). In this instance, economic performance occurs as the property is supplied to the lessee. Section 461(h)(2)(A)(i); Treas. Reg. § 1.461-4(d)(3). The amount accruable is the amount which meets both the all events test and economic performance.

Under the accrual method, an expense is generally deductible when the liability is fixed even though payment is not made until a subsequent period. See United States v. Hughes Properties, Inc., 476 U.S. 593 (1986); Burnham Corp. v. Commissioner, 90 T.C. 953 (1988), aff'd, 878 F.2d 86 (2d Cir. 1989). Thus, a lessee can accrue rent during a year that it is obligated to pay for the use of the property during that year, whether or not payment is yet required. Rev. Rul. 70-119, 1970-1 C.B. 120. See also Grand Ave. Motor Co. v. United States, 124 F. Supp. 423 (D. Minn. 1954).

Thus, Company R may be able to deduct some amount of rent during the rent holiday. Logically, if both parties agreed to terminate a lease 6 months into a year-long rental holiday, the lessee may owe some rent for those six months. This obligation may arise under the lease or under applicable state law. To the extent that the taxpayer is liable for a fixed and determinable amount for a period of occupancy (whether or not the lease has terminated), the taxpayer has met the all events test and economic performance in regard to the amount of rent attributable to the period of use. A lessee cannot level rents due under a lease without meeting both of these tests for the deduction.

Company R's method of accounting must also meet the clear reflection standard under section 446(b) of the Code. There may be some circumstances when a significant rental payment, to be made some years after the period to which it is attributable, would raise a question about its current deductibility under the clear reflection standard. See Ford Motor Co. v. Commissioner, 102 T.C. 87 (1994), appeal docketed, No. 9401956 (6th Cir. August 29, 1994).

However, the rent holiday described, which involves a one-year delay in accrual, is not a situation in which the Service could successfully argue that the taxpayer's accrual method does not clearly reflect income. See Ford Motor, 102 T.C. at 96-98. The accrual of rental expense as the leased property is used reflects the "true income for the year" since the rent is "attributable to the production of that income during the year." See Hughes Properties, 476 U.S. at 606, quoting United States v. Anderson,

269 U.S. 422 (1926).

These same principles would be applicable to the other leases described, where rent increases over the term of the lease. Thus, when there are rent increases and an amount is payable each year for use of the property during the tax year, that amount would generally be the proper amount to accrue for the applicable tax year.

CONCLUSIONS:

The leases outlined in situation (1) which require payments of over $250,000 and allow for rent holidays during the first 12 months of the lease are "section 467 rental agreements." The payment schedules are allocations of rent under section 467(b)(1)(A) and are not subject to section 467(b)(1)(B). The rent described in the payment schedule is the amount to be accrued under section 467(b)(1), including zero rent during the rent holiday period.

The long-term leases described in situation (2) are not disqualified long-term agreements under section 467(b)(4). The long-term lease agreements provide for the allocation of rent, and tax avoidance is not inferred as the principal purpose of the increasing rents simply because the increase is not described in section 467(b)(5). In addition, the payment schedules are allocations of rent under section 467(b)(1)(A), and therefore, Company R would accrue rent as provided for in the terms of the long-term leases.

For the leases described in situation (3), which are not subject to section 467, the lessee may accrue the amount of rent for each period that meets both the all events test and economic performance. Company R will not otherwise be able to level rents under the agreement. A successful challenge of Company R's accrual of rent under the clear reflection standard is unlikely.