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Subject: Section 467 analysis

This addresses the question of whether a rental agreement contains a specific allocation of rent for purposes of § 467.

Issue:

Does a taxpayer's § 467 rental agreement provide a specific allocation of fixed rent if it includes a provision stating that the § 467 loan balance is reduced to zero upon any termination of the lease?

Discussion:

Taxpayers subject to § 467 of the Internal Revenue Code must account for fixed rent using one of the methods prescribed in the regulations under § 467. Unless a taxpayer is required to use constant rental accrual or proportional rental accrual, the taxpayer must take fixed rent into account in accordance with the manner in which rent is allocated in the rental agreement. If a taxpayer has a specific allocation of fixed rent in its rental agreement that meets the requirements of § 1.467-1(c)(2)(ii)(A)(2), the taxpayer's rent allocation schedule is used to determine the rent allocated under the rental agreement (i.e., the rent the taxpayer takes into account for a taxable year). If there is no specific allocation of rent, the taxpayer uses the payment schedule to account for rent.

Section 1.467-1(c)(2)(ii)(A)(2) provides as follows:

> [A] rental agreement specifically allocates fixed rent if the rental agreement unambiguously specifies, for periods no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during that period, and the total amount of fixed rent specified is equal to the total amount of fixed rent payable under the lease. A rental agreement stating only when rent is payable does not specifically allocate rent.

Thus, under §1.467-1(c)(2)(ii)(A)(2), the rent allocation must be meaningful – it must actually represent the amount of rent for which the lessee is liable for using the property. The allocation does not meet the requirements of § 1.467-1(c)(2)(ii)(A)(2) if its sole purpose is to dictate the tax consequences to the lessee and lessor. If the rental agreement provides that the rent allocation exists only for tax purposes, it does not meet the requirements of § 1.467-1(c)(2)(ii)(A)(2) because it does not represent amounts for which the lessee becomes liable on account of the use of the property during that period.

A rental agreement provides the following term: Upon any termination of this lease, the balance of the section 467 Loan is reduced to zero and is fully discharged for all purposes. In our view, this provision means that the allocation schedule fails to represent the amount of rent for which the lessee becomes liable on account of the use of the property. Thus the allocation schedule does not meet the requirements of § 1.467-1(c)(2)(ii)(A)(2).

Under § 1.467-4, a taxpayer has a § 467 loan under certain circumstances. The taxpayer's § 467 loan is equal to the difference between the payments under the rental agreement and the allocations under the agreement. If the payments are more than the allocations, the lessee is considered to have made a loan to the lessor. If the allocations exceed the payments, the lessor has made a loan to the lessee. If the loan balance is reduced to zero and fully discharged upon termination of the lease, the payment schedule and not the allocation schedule represents the amount of rent for which the lessee becomes liable on account of the use of the property. Consequently, if a rental agreement includes a provision stating that the balance of the loan is reduced to zero and fully discharged for all purposes upon any termination of the lease, the allocation schedule does not meet the requirements of § 1.467-1(c)(2)(ii)(A)(2). In that case, the taxpayer should be accounting for its rents in accordance with the rent payment schedule in the rental agreement.