REPORT #893

TAX SECTION

New York State Bar Association

Report on Regulations Proposed under Section 467 of the Code

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TAX SECTION
New York State Bar Association

February 14, 1997

Hon. Donald C. Lubick
Acting Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Regulations under IRC § 467 (IA-292-84)

Dear Secretary Lubick and Commissioner Richardson:

I enclose our report commenting on the pro-posed regulations issued under section 467 of the Internal Revenue Code. The preparation of the report was coordinated by Joel Scharfstein.

The report makes a number of comments and suggestions concerning the proposed regulations. We also suggest consideration of a legislative change. Our comments and suggestions are summarized on pages 11 through 15 of the report.

We would be pleased to assist in finalizing the proposed regulations.

Respectfully submitted,

Richard L. Reinhold

[Enclosure]

NEW YORK STATE BAR ASSOCIATION

TAX SECTION[1]

Report on Regulations Proposed under Section 467 of the Code

This report comments on proposed regulations (the "Proposed Regulations") under Section 467 of the Internal Revenue Code of 1986, as amended (the "Code") relating to tax accounting for rental payments that were issued on May 31, 1996.[2]

INTRODUCTION

The Statutory Scheme

Section 467 was added to the Code by the Deficit Reduction Act of 1984 (the "1984 Act"). In general, that Section provides rules for the treatment by lessees and lessors of agreements for the use of tangible property in cases where the lease provides for either (i) the deferral of any payment for the use of the property during a period beyond the end of the calendar year following the calendar year in which such use occurs, or (ii) increases, between periods, in the rental

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[1] This report was prepared jointly by an ad hoc committee (the "Committee") of the New York State Bar Association Tax Section comprised of Kimberly S. Blanchard, William C. Bowers, Andrew T. Chalnick, Patricia Geoghegan, Michael Hirschfeld, Carol Quinn, Richard L. Reinhold, and Joel Scharfstein. Helpful comments were received from Carolyn Joy Lee, Stephen B. Land and Richard O. Loengard. The views expressed herein do not in all cases reflect the views of all members of the Committee.

[2] 61 Fed. Reg. 27,834(1996).

amount.[3] The statute provides for comparable rules to be applied under regulations to be prescribed by the Treasury.[4] Leases involving total payments of less than $250,000 are not subject to the rules of Section 467.[5]

The basic statutory scheme is as follows: First, if a lease is subject to the statute (a "Section 467 rental agreement") both the lessee and lessor, regardless of their usual method of accounting, must take into account rent under the lease (and interest with respect to any rent the payment of which is deferred beyond the taxable year of accrual) on an accrual basis.[6] Second, except in the case of a "disqualified leaseback or long-term agreement," the determination of the amount of rent that accrues in any period is made by allocating rents in accordance with the terms of the lease, and taking into account any amounts allocable to a period but paid after the end of such period on a present value basis in a manner prescribed by regulations.[7] Third, if a lease is a disqualified leaseback or long-term agreement, accrual of rent under the lease is leveled to equal, for each period, the "constant rental amount."[8] The constant rental amount is the amount, which if paid at the close of each lease period would result in an aggregate present value equal to the present value of the aggregate payments required

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[3] Section 467(d)(1). Except as otherwise indicated herein, all references to "§" or "Section" are to sections of the Code and all "Reg. §" references are to the regulations promulgated there-under.

[4] Section 467(f).

[5] Section 467(d)(2) and Prop. Reg. § 1.467-1(a)(2).

[6] Section 467(a) and Prop. Reg. § 1.467-1(a)(1).

[7] Section 467(b)(1).

[8] Section 467(b)(2) and (3)

under the lease.[9] Present values for this purpose are computed using a discount rate equal to 110% of the applicable federal rate ("AFR") compounded semi-annually in effect with respect to debt instruments having a maturity equal to the term of the rental agreement.[10] Fourth, the parties to a Section 467 rental agreement must treat the difference between the total amount of rent accrued and the total amount of rent paid as a loan and accrues annually stated or imputed interest on such loan, whether the rents are allocated in accordance with the lease or under constant rental accrual.[11]

A rental agreement is disqualified if the agreement (i) provides for increases in rent and a principal purpose of such rent structure is the avoidance of tax and (ii) is either a "leaseback transaction" (as defined[12]) or a long-term lease (i.e., a lease for a term in excess of 75% of the statutory recovery period for the leased property).[13] For this purpose, the statutory recovery period for real estate (including land) is 19 years.[14]

The statute provides that the Secretary of Treasury will prescribe regulations setting forth circumstances under which increases in rents will not be considered motivated by tax avoidance, including circumstances relating to changes in rents determined by reference to price indices, rents based on a fixed percentage of lessee receipts or similar amounts, and rents

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9 Section 467(e)(1).

10 Section 467(e)(4).

11 Section 467(a) and (b).

12 Section 467(e)(2).

13 Section 467(b)(4).

14 Section 467(e)(3).

based on amounts paid by the lessor to unrelated third parties.[15] The statute further provides a safe harbor for reasonable rent holidays.[16]

The Conference Report with respect to the 1984 Act states that with respect to adjustments for price indices, the conferees intend that the regulations will provide a safe harbor for rents that increase at a variable rate equal to the rate of increase in the CPI (or other appropriate index) and that such increases may be capped and may also be aggregated and made in intervals of five years or less.[17] The Conference Report indicates that the permissible third party costs of the lessor include costs such as real estate taxes, insurance, maintenance and similar costs.[18] A footnote with respect to third party costs states that the conferees intend “no inference” as to the effect of a lease clause requiring the lessee to assume the burden of an increase in the lessor's debt service on the property.[19] With respect to rent holidays, the Conference Report states that the conferees intend that a safe harbor will be provided for leases for which no rent (or reduced rent) is payable for a reasonable time after inception of the lease, such reasonableness to be determined by commercial practice in the locality where the use

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15 Section 467(b)(5)(A),(B) and (D).

16 Section 467(b)(5)(C).

17 H.R. Conf. Rep. No. 861. 98th Cong., 2d. Sess. at 893 (1984) (the “Conference Report”).

18 Id.

19 Id. note 5.

of the property will occur at the time the lease is entered into, and that, in general, a rent holiday may not exceed 12 months and in no event shall exceed 24 months.[20] The Conference Report also states that the conferees anticipate that the regulations will adopt a safe harbor protecting leases with fluctuations in rent by no more than a reasonable percentage above or below the average rent payable over the term of the lease.[21] In this regard the conferees noted that although the Service, in Rev. Proc. 75-21, 1975-1 C.B. 715, has taken the position that a 10% fluctuation in rent is permissible for personal property leases, this standard may be inappropriate for real estate leases and that regulations may provide less restrictive standards for such leases.[22] Additionally, the Joint Committee explanation with respect to the 1984 Act states that Congress intended that a lease will be exempt from section 467 if it provides for reasonable increases in rent that are wholly contingent and cannot be reasonably ascertained at the time the lease is executed, provided all rents are payable by the end of the period to which they relate or become fixed, or within reasonable time thereafter.[23]

The Statute also provides “recapture rules” requiring that any excess of the aggregate amount of rent that would be accrued on a constant rental basis with respect to the lease lease over the aggregate amount of rent accrued under the Section 467 rules, be accounted for as ordinary-income upon disposition

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[20] Id.

[21] Id.

[22] Id.

[23] Joint. Comm. on Taxation, 98th Cong., 2d. Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 291 (1984) (hereinafter, the “Blue Book”), citing floor statement of Senator Dole, 130 Cong. Rec. §. 8884 (June 29, 1984).

by a lessor of its position in a long-term agreement or leaseback which is not a disqualified agreement.[24]

The Proposed Regulations

The Proposed Regulations provide detailed technical rules implementing the statutory scheme. In addition, they extend the statutory scheme relating to increasing rents and deferred payments to decreasing rents and prepayments, in a generally symmetric fashion.[25] Perhaps most importantly from an industry perspective, the Proposed Regulations provide the safe harbors referenced in the statute and in the Conference Report under which certain increases or decreases in rent will not be considered to have a principal purpose of tax avoidance for purposes of determining whether a lease is a disqualified leaseback or disqualified long-term agreement.[26] They also contain rules excluding certain contingent payments, and a limited rent holiday, from consideration in determining whether a lease is a Section 467 rental agreement as a result of increasing or decreasing rents.[27] Additionally, they provide rules relating

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[24] Section 467(c).

[25] Prop. Reg. § 1.467-1(c).

[26] Prop. Reg. § 1.467-3(c)(2).

[27] Prop. Reg. § 1.467-1(c)(2)(i)(B) (excluding from consideration a rent holiday at the beginning of a lease not exceeding months) and (iii)(B) (disregarding contingent rent to the extent (a) the rent is contingent solely as a result of a provision under which the lessor receives a fixed percentage of a lessee's gross or net receipts, (b) the rent is contingent solely as a result of an adjustment based on a reasonable price index or (c) the rent is contingent solely as a result of a provision requiring a lessee to pay third party costs, as defined in Prop. Reg. § 1.467-1 (h)(9)). In view of the wording of this provision u is not clear whether these three exclusions can be combined; although the description of the provision in the Preamble to the Proposed Regulations, 1996-28 I.R.B. 38 (hereinafter, the “Preamble”), supports the view that they can be combined. See Section 3.1 of this report, infra.

to the statutory exclusions of leases involving total payments of $250,000 or less from treatment as a Section 467 rental agreement and a rule excluding leases involving total payments of $2 million or less from treatment as disqualified long-term agreements or leasebacks.[28] The regulations are proposed to be effective for rental agreements entered into after the date of publication of final regulations in Federal Register and disqualified leaseback and long-term agreements entered into after June 3, 1996.[29]

In the case of Section 467 rental agreements which are not disqualified leasebacks or long-term agreements, the Proposed Regulations provide that the fixed rent that accrues for any rental period (i) is the amount allocated to that period under the rental agreement ii the agreement has no deferred or prepaid rent[30] or provides for "adequate interest"[31] on deferred or

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[28] Prop. Reg. § 1.467-1(a)(2), (3), -1(c)(4) & -3(b)(1)(i). For these purposes all contingent rent is taken into account on a "reasonably expected" basis, other than contingent rent which is a pass through of third-party costs (as defined), or based on a price index adjustment.

[29] Prop. Reg. § 1.467-8. The Preamble cautions, however, that the Service will, in appropriate circumstances, apply the provisions of Section 467 requiring constant rental accrual to rental agreements entered into on or before June 3, 1996.

[30] Rent is deferred for this purpose if it is payable after the period to which it is allocated. Analogously, rent is considered prepaid if it is payable prior to a period to which it is allocated.

[31] A rental agreement which provides for deferred or prepaid rent has adequate interest, if disregarding any contingent rent, the rental agreement provides for interest on deferrals and prepayments at a single fixed rate, compounded at least annually, which is no lower than 110% of the AFR. Prop. Reg. § 1.467- 2(b)(1)(ii). In addition, a rental agreement which has deferred rent and no prepaid rent will be deemed to have adequate interest if the present value of the rental stream of payments required by the lessee (including interest) is greater than or equal to the present value of the stream of the rent allocations under the lease. Prop. Reg. § 1.467-2(b)(1)(iii). A mirror image rule applies to agreements with prepaid rents but no deferred rent. Prop. Reg. § 1.467-2(b)(1)(iv).

prepaid rent[32] and otherwise is (ii) the "proportional rental amount,"[33] which is a uniform percentage of the rent allocated to that period. In the case of disqualified leasebacks or long-term agreements, the fixed rent that accrues for any rental period is the constant rental amount.[34]

If a rental agreement provides for deferred or prepaid rent and does not provide for adequate stated interest at a single fixed rate, or is subject to constant rental accrual, the Proposed Regulations treat the excess of the cumulative accruals of fixed rent (and interest on fixed rent includible in the income of the lessor) for prior periods over the cumulative amounts payable as fixed rent (or interest thereon) on or before the first day of the current rental period, as a loan by the lessor to the lessee, or by the lessee to the lessor, as appropriate.[35] Such loans with respect to agreements for which

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[32] Prop. Reg. § 1.467-1(d)(2)(iii).

[33] The proportional rental amount for a rental period is the amount of fixed rent allocated to the rental period under the rental agreement multiplied by a fraction, the numerator of which is the present values of the stream of payments of fixed rent and interest thereon required under the lease and the denominator of which is the present value of all fixed rents allocated under the lease. Prop. Reg. § 1.467-2(c). Present value for this purpose is determined using a discount rate equal to 110% of the AFR. Prop Reg. $ 1.467-2(d). See note 50, infra, for an example demonstrating calculation of the proportional rental amount.

[34] Prop. Reg. § 1.467(d)(2)(i).

[35] Prop. Reg. §§ 1.467-4(a),(b). The loan amount is also adjusted for interest on prepaid fixed rent payable by the lessor and interest on prepaid fixed rent includible in the gross income of the lessee. Prop. Reg. § 1.467-4(b)(1). Loan amounts may be positive or negative (generally in the case of prepayments). Prop. Reg. § 1.467-4(a)(1).

accruals are determined on a proportional rental basis[36] or under constant accrual, are deemed to bear interest at a rate of 110% of the AFR.[37] In other cases, the loans are deemed to bear interest at the discount rate implicit in the agreement.[38] Lessees and lessors under a Section 467 rental agreement are required to account for interest with respect to such loans on an accrual basis.[39]

The Proposed Regulations generally reserve on the treatment of contingent payments and the amount of contingent rent considered to accrue in any year.[40] Contingent rent is defined as any rent which is not fixed (i.e., any rent to the

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[36] That is, because they do not provide for adequate stated interest at a single fixed rate.

[37] Prop. Reg. § 1.467-4(c)(2).

[38] That is, the discount rate at which the present value of the stream of amounts payable by the lessee as fixed rent and interest on fixed rent, plus amounts payable by the lessor as interest on fixed rent, equals the present value of the fixed rental accruals under the agreement. Prop. Reg. § 1.467-4(c)(1).

[39] Prop. Reg. § 1.467-4(f), Examples 1 and 2. The interest for a rental period equals the principal balance of the loan at the beginning of the rental period times the applicable interest rate. It a lease, not sublet to constant rental accrual, provides for deferrals or prepayments and tor adequate stated interest thereon at a single fixed rate, the interest on fixed rent for a rental period is the amount of interest provided in the rental agreement for the period. Prop. Reg. § 1.467-1(e)(2).

[40] Prop. Reg. § 1.467-6. Note that Prop. Reg. § 1.467-1(d) provides that the Section 467 rent for a taxable year includes “the contingent rent that accrues for such year as provided in Reg. 1.467-6.” However, as indicated above, contingent rent is addressed in some contexts, including rules (i) ignoring certain types of contingent rent (e.g., reasonable price index adjustments) in determining whether an agreement has increasing or decreasing rent and (ii) requiring that contingent rent (other than price index adjustments and pass through of third party costs) be taken into account in determining eligibility for the $250,000 dc minimis exclusion from Section 467, and the $2 million dc minimis exclusion from disqualified leaseback or long-term agreement treatment.

extent that either the amount or the time of payment are not fixed and determinable as of the lease date).[41]

The Proposed Regulations provide two safe harbors under which long-term agreements or leasebacks, with increasing or decreasing rents, will not be considered disqualified[42] -- the so-called “90/110 Safe Harbor”, and a second set of safe harbors (the “Disqualified Lease Safe Harbors”). These are discussed in detail in Section 2.2, infra. Finally, the Proposed Regulations provide that only the Commissioner may determine that a long-term agreement or leaseback is disqualified, and thus subject to rent leveling.[43]

SUMMARY OF COMMENTS

Following is a summary of the major comments, suggestions and recommendations contained in this report in the order discussed:

1. General Anti-Abuse Rule. Treasury and the Service may wish to consider adopting an anti-abuse rule pursuant to which allocations of rent would not be respected it they do not have real economic significance and are tax motivated. Consideration might also be given to a legislative initiative to make the Section 467 rules more analogous to those under the original issue discount (“OID”) regulations.

2. Additional Presumption of No Tax Avoidance. For purposes of determining whether a long-term agreement or leaseback is disqualified, the final regulations should include a presumption of no tax avoidance motive if both the lessor and lessee are in the same federal income tax position and are reasonably expected to be in the same federal income tax position throughout the lease term.

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41 Prop. Reg. § 1.467-1(h)(2).

42 That is, the increasing or decreasing rent will not be considered to have a principal purpose of tax avoidance.

43 Prop. Reg. § 1.467-3(b)(1)(iii).

3. Examples of Non-Tax Motivated Agreements. The final regulations (or perhaps concurrently issued revenue rulings) should provide examples of commercial arrangements for increasing or decreasing rents which would not generally be considered to be motivated by tax avoidance tor purposes of determining whether a long-term agreement or leaseback is disqualified.

4. Commissioner Determines Disqualification. The final regulations should clarify that, in the absence of an express determination by the Commissioner, taxpayers may not take the position that a rental agreement is disqualified. In this regard, it may be appropriate to provide taxpayers with some comfort (through a Notice, IRS manual rule, or otherwise) that the Service will generally not assert that a lease is disqualified in cases where the relevant returns of the party whose income tax liability would be lowered by reason of the lease being disqualified have closed, but the other party's years remain open.

5. Rent Equal to Percentage of Lessee's Receipts. For purposes of the exclusion for rents "equal to a percentage of the lessee's receipts (gross or net)" the final regulations should clarify (a) that only lessee receipts from the leased property or that bear a reasonable relationship to the leased property are within the scope of exclusion, (b) the meaning of the parenthetical phrase "gross or net" modifying the term receipts and (c) whether contingent rent equal to a fixed percentage of lessee receipts over a fixed base qualifies for the exclusion.

6. Reasonable Price Index. The definition of a "reasonable price index" should be clarified to permit taxpayers to use not only indices, such as CPI, which measure overall inflation or deflation, but also indices (or sub-indices) which measure components of inflation or deflation, provided such indices are generally recognized and bear a substantial commercial relationship to the leased property or relevant industry (e.g., real estate). In addition, if generally recognized regional, state or locally based inflation indices exist, their use should be permitted for leases within the region, state or locality, as appropriate. In addition, the safe harbor in the final regulations should allow (a) a "cap" and/or a "floor" on the increases to specified maximums and minimums and (b) increases to be aggregated and made in intervals of five years or less.

7. Third Party Costs. The final regulations should (a) clarify when a "third-party cost" will not be considered within the control of a lessor, lessee or related person, and should consider providing that a cost will not be so considered if the amount and timing of the cost is not subject to manipulation by those persons and (b) confirm that amounts paid by a lessee in respect of general or tax indemnities will generally be considered third- party costs, to the extent made to reimburse the lessor for additional tax liability and accounting, legal and other out of pocket costs related thereto.

8. Lessor-Provided Services. The final regulations should provide that amounts paid for services provided by a lessor under a lease agreement that are separately identified under a lease agreement as payments for lessor provided services and represent fair market

value payments for such services will not be considered rent for purposes of Section 467, whether or not characterized as additional or supplement rent under the agreement (with the burden of proof on the taxpayer to prove that the payments for the services are at fair market value).

9. Reasonable Rent Holiday. If the requirement that a rent holiday have a substantial business purpose standard is retained, consideration should be given to adding a sentence to the effect that generally a substantial business purpose for a rent holiday will be considered to exist if similar rent holidays are reasonably consistent with common commercial practice.

10. 90/110 Safe Harbor. Assuming that the regulations to be issued regarding the treatment of contingent rent will provide for treatment of contingencies in a manner similar to that provided in the Section 1275 regulations concerning contingent interest, we suggest that contingent rent be taken into account in testing qualification under the 90/110 Safe Harbor on a projected basis. Alternatively, consideration should be given to providing in the final regulations that contingent rent (not otherwise qualifying as third party costs) is not taken into account in determining qualification under the safe harbor provided that no principal purpose for the contingent rent arrangement is tax avoidance. Either approach should permit the 90/110 Safe Harbor to apply in the case of rents that vary in accordance with floating-rate debt, provided the floating rate is a qualified floating rate.

11. Calendar Year. For purposes of the 90/110 Safe Harbor, consideration should be given to permitting taxpayers to use any fiscal year (or alternatively, the fiscal year of the lessee or lessor) in testing qualification under the 90/110 Safe Harbor; provided that if rent varies within rental periods within such year, taxpayers would not be permitted to use the 90/110 Safe Harbor if tax avoidance is a principal purpose of such variance. Alternatively, the 90/110 Safe Harbor should be based not on years, but on rental periods, and annualized rent allocated to each rental period should be tested against the average annualized rent allocated to all rental periods. If it is determined that a calendar year is to be used in testing the 90/110 Safe Harbor, the final regulations should clarify how the rent allocated to the short initial or final partial years is taken into account in computing the average rent.

12. Real Estate Safe Harbor. We believe it would be appropriate for the final regulations to contain a special safe harbor for real estate leases which allows the parties to periodically increase the rent allocated under a rental agreement by a fixed percentage based on the average (or some fraction thereof) of an appropriate index over some period prior to the date the lease is entered into. The parties should also be allowed to adjust the rent in such manner less frequently than annually, say every five years. Taxpayers should not be permitted to use this safe harbor in conjunction with the 90/110 Safe Harbor, or with a CPI price index adjustment, although it may be appropriate in this context to allow the safe harbor to be used in conjunction with other safe harbors, as discussed below. Consideration might also be given to amending Section 467 to reflect the longer recovery periods applicable to real property under current law. Also, consideration might be given to expanding the 90/110 Safe Harbor in the

case of real estate leases to say, an 80/120 Safe Harbor, although this formulation does not seem particularly helpful.

Further, we suggest that the final regulations provide that a real estate lease will not be subject to disqualification unless the total amount payable under the lease exceeds some amount that is a function of the lease term, for example, $300,000 per year.

13. Contingent Rents. The report discusses, as summarized below, certain types of contingent rent which we do not believe present a meaningful opportunity for tax avoidance, and which are common in the leveraged-lease and equipment leasing industry. The categories of contingent rents which are ignored for purposes of determining whether a rental agreement has increasing or decreasing rent, and for purposes of determining whether a rental agreement qualifies under the Disqualified Lease Safe Harbors, should be expanded to include these types of rent. Also, the final regulations should provide that a rental agreement which contains the described contingent rents can qualify for the 90/110 Safe Harbor.

The final regulations should ignore for the relevant testing purposes rental adjustments based on changes in a qualified floating rate as applied to a debt repayment schedule fixed at the inception of a lease agreement, whether the debt repayment schedule reflects actual costs of a lessor or is a notional schedule. For this purpose, a rate described in Reg. § 1.1275-5(b) should be considered a qualified floating rate. The final regulations should also be dratted to accommodate refinancing resets and adjustments to rent to reflect a change in the credit rating of a lessee or lessor.

Further, the final regulations should ignore for the relevant testing purposes adjustments in rent based on the occurrence of remote or incidental contingencies. In particular, a provision in a leveraged-lease agreement to cover actual costs of a lessor or lender under credit agreement provisions for withholding tax gross ups, “increased costs” and other indemnifications of the lenders for the range of costs covered by a typical indemnity should be ignored, if, as is typically the case, the likelihood of such indemnities being triggered is remote.

Further, the final regulations should generally provide that fluctuations in rent occasioned by reason of rent being denominated in a foreign currency are ignored for the relevant testing purposes.

Finally, the final regulations should provide that a “terminal rental adjustment clause” (a “TRAC” provision) is ignored for the relevant testing purposes provided that the TRAC amount is based on a reasonable expectation of actual selling prices based on an objective standard, such as the N.A.D.A. Official Commercial Truck Guide.

14. Options to Extend Term. As discussed below, the parties to a lease with a renewal term cannot be certain whether a renewal term will be taken into account in determining whether a lease is a long-term agreement, or in applying the 90/110 Sale Harbor. The final regulations should address this issue. One approach would be to respect a taxpayer's determination as to projected fair market value, provided it is not unreasonable, and provided appropriate documentation is maintained.

15. Alternative Payment Schedules. The final regulations should provide rules dealing with options to prepay and defer rent and alternative payment schedules. In this regard, consideration might be given to promulgating rules analogous to those used in the OID regulations.

16. Effective Date Issues. Consideration should be given to permitting taxpayers to choose voluntarily to apply the mechanical rules of the Proposed Regulations to any rental agreement that is a long-term agreement or leaseback entered into after promulgation of the Proposed Regulations and prior to promulgation of final regulations.

SPECIFIC COMMENTS

1. General Observations ("Allocation" Rules)

The basic statutory scheme, as extended by the Proposed Regulations to prepayments, provides significant opportunities for tax planning in cases where the rent leveling provisions are not applicable, that is, in all cases not involving a leaseback or long-term agreement. In such cases, for federal income tax purposes, the lessor and lessee take into account rent under the agreement, regardless of the actual payment schedule, in accordance with the allocations of rent as set forth in the rental agreement, adjusted in the case of deferred payments[44] for present values.[45] Present values are generally determined using a

[44] Without adequate stated interest at a single fixed rate.

[45] The statute and the examples in the Proposed Regulations indicate that for this purpose a payment is considered deferred if it payable after the close of the period to which it is allocated (and similar rules apply to prepayments). Section 467(b)(1)(B); Prop. Reg. § 1.467-2(f), Example 3. However, the Proposed Regulations do not contain a specific definition of deferred or prepaid rent for this purpose. See, e.g., Prop. Reg. § 1.467-2(b)(1)(ii), (iii) and (iv). The regulations do contain a specific and conceptually different definition of when an agreement has deferred or prepaid rent for the purpose of determining whether an agreement is a Section 467 rental agreement. See Prop. Reg. § 1.467-1(c)(3).

discount rate of 110% of the AFR.[46] Under these rules, rent under a multi-year rental agreement can all be allocated to the first year, allowing the lessee to deduct the entire amount, as adjusted for present values, in that year;[47] conversely, the entire amount can be allocated to the last year of the lease, allowing the lessor to defer income recognition to that year, even if rent is paid evenly over the lease term through "prepayments."[48]

Example. Assume X, a taxable individual, leases a building to Y, a corporation with large net operating loss carry-forwards, for a term of 12 years for $1,000,000 per year. The lease is neither a leaseback nor a long-term agreement. Assume also that X and Y both are on calendar years. The rental agreement provides that (i) $12,000,000 of rent is allocated to the 12th year and zero rent is allocated to years 1 through 11 and (ii) $1,000,000 of rent is to be prepaid at the end of each of years 1 through 11. Assume 110% of AFR is 10%.

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[46] Prop. Reg. § 1.467-2(d). Note the discount rate for this purpose is not specifically mandated by the statute (as it is for purposes of computing the constant rental amount), but it would generally make little sense to use a different rate.

[47] Sir Prop. Reg. § 1.461-1(a)(2)(iii)(E) (providing that "in the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, the all events test (including economic performance) is considered met in the taxable year in which the liability is taken into account under section 467 and the regulations there-under").

[48] See Prop. Reg. § 1.61-8 ("Except provided in section 467 and the regulations there-under, gross income includes advance rentals ...") (emphasis added) and Prop. Reg. § 1.451-1 (deferring to Section 467 with respect to the timing of income in connection with Section rental agreements).

Under the Proposed Regulations, X achieves significant tax advantages. First, X has no income until year 12,[49] at which time X recognizes $21,384,000 of rental income representing the "proportional rental amount". Additionally, X has $9,384,000 of interest deductions over the term of the lease on loans that Y is deemed to have made to A' (representing the excess of $21,384,000 over $12,000,000).[50] Y's rental deduction of $21,384,000 is similarly deferred, and Y has $9,384,000 of interest income over the term of the lease; but Y may be indifferent to these tax consequences due to its NOL.

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[49] The Proposed Regulations make it clear that the prepayments are treated as loans by the lessee to the lessor. Prop. Reg. § 1.467-4 (negative loans).

[50] On these facts, the net present value of payments equals $6,814,000, the net present value of the rental accrual equals 53,824,000 and the proportional rental fraction is approximately 1.78202 (6.814 over 3,824). The proportional rental amounts and interest consequences to the parties (000's omitted) are summarized below:

Year	Accrual	Payment	Proportional Rental Amount	Loan Balance	Interest Income of Lessee
1	0	1,000	0	0	0
2	0	1,000	0	-1,000	100
3	0	1,000	0	-2,100	210
4	0	1,000	0	-3,310	331
5	0	1,000	0	-4,641	464
6	0	1,000	0	-6,105	611
7	0	1,000	0	-7,716	772
8	0	1,000	0	-9,487	949
9	0	1,000	0	-11,436	1,144
10	0	1,000	0	-13,579	1,358
11	0	1,000	0	-15,937	1,594
12	12,000	1,000	21,384	-18,531	1,853
Total	$12.000	$12.000	$21,384	:	$9,384

These rules, and the above example, place significant pressure on the economic relevance of the "allocation" of rents under an agreement. As previously explained, the allocation and payment schedules do not have to correspond. Mandated payment schedules which do not correspond to the allocation of rent will generally give rise to prepaid or deferred rent,[51] but will not affect the basic allocation of rent under a Section 467 rental agreement.[52] In general, under the Proposed Regulations there are no restrictions on the manner in which the parties may allocate fixed rent among rental periods[53] as long as (i) the amount of rent allocated to a rental period is the fixed amount for which the lessee becomes liable on account of the use of the property during that period and (ii) the sum of the amounts allocated to all rental periods equals the total amount of fixed rent payable under the lease.[54] In light of the standard laid down by the regulations, the economic relevance of the allocation of rent is that the lessee must become liable for the allocated amount for that period. While the artificial skewing of such liability can have significant consequences in certain contexts, such as, for example, bankruptcy, casualty and condemnation, query whether the economic risks of tax driven allocations could be avoided in many

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[51] The treatment of options to prepay or defer rent and alternative payment schedules under the Proposed Regulations is unclear. It appears that any rent with respect to which an option to prepay or defer exists will not be considered fixed rent. See Section 4.2, infra.

[52] Although the allocated amounts may be multiplied by the proportional rental factor.

[53] Rental periods must be no longer than one year.

[54] Prop. Reg. § 1.467-1(c)(2)(ii)(A)(2).

cases through the use of bankruptcy proof entities and other stratagems.[55] The Proposed Regulations do not contain an analog of the "substantiality" requirement applicable to partnership allocations under Section 704(b) of the Code,[56] i.e., there is no requirement that the economic effect of an allocation be substantial in order for the allocation to be respected. Stated differently, the permissive de-linking of payment and allocation schedules creates the potential for rental allocations that have no significant economic effect.

To address these concerns, the Treasury and the Service may wish to consider whether it would be possible and appropriate to adopt an anti-abuse rule under which allocations will not be respected if the stated allocations of rent diverge too markedly from a bona fide allocation and are tax motivated.[57] At a minimum, it may make sense for the final regulations to provide that allocation schedules will be closely scrutinized tor substantial economic effect where there are significant scheduled prepaid or deterred amounts relative to the allocation schedule. Some members of the Committee also believe that Treasury should consider a legislative initiative to make the Section 467 rules more analogous to those under the original issue discount ("OID") regulations. A possible approach would be to provide a broader de

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55 For example, consider the effect of an early termination clause which substantively protects the lessor's overall return, or a put/call arrangement with respect to the property (or other property) to provide the lessor the same protection.

56 Sec Reg. § 1.704-1(b)(2)(i),(iii). To be respected under the § 704(b) regulations, an allocation must have economic effect and the economic effect of the allocation must be substantial.

57 We note that the Conference Report provided that "[t]he conferees emphasize that no inference is intended as to the ability of the Internal Revenue Service to challenge the form of an agreement involving deferred or stepped rents under general accrual or clear reflection of income principles, on the basis that a purported lease constitutes a mere financing transaction, or on other grounds."

minimis rule but otherwise to subject all leases to rent leveling.[58]

2. Leasebacks and Long-Term Agreements

2.1. General Anti-Avoidance Standard

2.1.1. Generally

Section 467(b)(2) provides for rent leveling in the case of a leaseback or long-term agreement that contains increasing or decreasing rent if a principal purpose of providing for such increasing or decreasing rent under the agreement is the avoidance of federal income tax. The Proposed Regulations provide that whether tax avoidance is a principal purpose for providing increasing or decreasing rent is based on all of the facts and circumstances, and that if either the lessee or the lessor is not subject to federal income tax on its income, or is a tax-exempt entity, 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.[59]

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[58] Note, however. Prop. Reg. § 1.467-1(c)(2)(ii)(2)(B) which provides that if a rental agreement does not provide a specific allocation of rent, the amount of rent allocated to a rental period is the amount payable during that rental period. While this rule appears to produce a reasonable result, it seems inconsistent with the statute, which specifically provides tor rent leveling in all cases where there is no allocation of rent. Section 467(b)(3)(B).

[59] Prop. Reg. § 1.467-3(c)(1).

The Conference Report stated that a major factor under the facts and circumstances test is whether, and to what extent, the tax brackets of the lessor and the lessee differ at the time the lease is entered into, and the parties' reasonable expectations as to their relative tax brackets over the term of the lease.[60] It states that where a lessor is "in a higher marginal tax bracket than a lessee (e.g., where the lessee is a tax-exempt entity or has substantial NOLs or is otherwise in a low marginal bracket)" the motives of the parties will be closely scrutinized and taxpayers held to a higher standard of proof. On the other hand, the legislative history indicates that the abuses to which this provision is addressed would generally not be present in the case of lessees and lessors in the same tax positions.[61]

We believe that it would be useful for the final regulations to include a presumption[62] of no tax avoidance motive if both the lessor and lessee are in the same federal income tax position and are reasonably expected to be in the same federal

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60 Conference Report at 893.

61 The Conference Report states that "[w]here their tax brackets are roughly equal, a natural tension will normally exist between the lessor and lessee since the lessor will defer recognition of income at the cost to the lessee of a deduction to which it would otherwise be entitled." The Blue Book further states that "Congress believed" that where the parties arc in approximately the same marginal tax brackets (and reasonably expect to be so during the entire term of the lease), such that their aggregate tax liability will not be materially reduced by the stepping of rents, no tax avoidance motive generally should be found." As an example, the Blue Book states that no significant reduction of the parties' combined taxes would occur if the lessor is a partnership composed of 50-percent-bracket individuals and the lessee is a 46-percent-bracket corporation. Blue Book at 288, n. 24. We note that the Joint Committee on Taxation warned, however, that "even where the parties are in substantially the same tax bracket, other circumstances might establish a tax avoidance purpose." Id.

62 Although it is not apparent to us the circumstances which could establish a tax avoidance purpose where parties are in the same tax position, consideration could be given to making any such positive presumption explicitly rebuttable if this is a concern.

income tax position throughout the lease term, i.e., if the net present value of any federal income tax benefit to the lessor or lessee, as the case may be, as a result of uneven rent is reasonably expected to equal the net present value of the federal income tax detriment to the other party.[63] Such a presumption would provide taxpayers in the same federal income tax position with more confidence that providing for increasing or decreasing rents will not subject their rent structures to scrutiny. Although inclusion of such a presumption will perhaps not be helpful to many large taxpayers who might be expected to be alternative minimum taxpayers at some point during a lease term (and therefore would not be able to avail themselves of the presumption unless the other party to the lease were similarly situated), its inclusion could, we believe, reduce the burden imposed by Section 467 on smaller taxpayers who enter into long-term leases which provide for increasing and decreasing rents for economic and not tax avoidance purposes.[64]

We also believe that it would be helpful for the regulations (or perhaps concurrently issued revenue rulings) to provide examples of commercial arrangements for increasing or decreasing rents that would not generally be considered to be motivated by tax avoidance. Such examples would cover cases which are too fact driven to be covered by a blanket safe harbor, but

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[63] A similar rule is employed in the partnership allocation regulations in determining whether an allocation has substantial economic effect. See Reg. §§ 1.704-1(b)(2)(iii)(a) & -1(b)(5), Example 5.

[64] Although only rental agreements with total payments in excess of $2,000,000 are potentially subject to rent leveling under the Proposed Regulations, smaller taxpayers can readily exceed this threshold, especially in the case of long term leases of real property.

still as a general matter merit exclusion from disqualified lease treatment. For example, leases of power plants often provide for rents based in pan on constant coverage ratios and an example indicating that such arrangements would generally not be considered tax motivated would be appropriate.[65]

2.1.2. Commissioner-Determination

The Proposed Regulations provide that one of the conditions for a leaseback or long-term agreement to be disqualified is that "[t]he Commissioner determines that it is appropriate to treat the section 467 rental agreements as a disqualified leaseback or long-term agreement."[66] This condition is non-statutory, but represents a reasonable mechanism to ensure that the tax positions of lessees and lessors are consistent. While a careful reading of the Proposed Regulations makes clear that the Commissioner's determination is a prerequisite to such treatment, the final regulations could usefully clarify that, in

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[65] Example: A acquires and leases a cogeneration plant to B, a special purpose corporation or partnership. B has entered into long-term contacts with third parties for the sale of electricity and other useful energy and the purchase and transportation of fuel. Based on the terms of these contracts, reasonable projections of the output, fuel efficiency and other performance of the plant, and reasonable estimates of other operating expenses, A and B have projected B's net operating revenues from the plant for each year during the term of the lease. A and B have negotiated a fixed rent schedule under the lease such that for each year of the lease term, the ratio of (a) the mandatory rent that accrues during such year to (b) the projected net operating revenue ("PNOR") of the plant during such year is "X". Thus, if in year 3 the PNOR is M, the fixed rent for that year would be the product of M and X. and if in year 7 if the PNOR is N, the fixed rent for that year would be the product of N and X. This "constant coverage" methodology is common in the project financing arena, and, like contingent rents that fluctuate with actual receipts. It is driven by cash availability, the earning power of the leased asset and business needs.

[66] Prop. Reg. § 1.467-3(b)(iii).

the absence of an express determination by the Commissioner, taxpayers may not take the position that a rental agreement is disqualified.[67]

2.2. Safe Harbors to the Anti-Avoidance Standard

2.2.1. Generally

Section 467(a)(5) provides that the Secretary shall prescribe regulations setting forth circumstances under which agreements will not be considered disqualified leasebacks or long-term agreements, including circumstances relating to changes in amounts paid determined by reference to price indices, rents based on a fixed percentage of lessee receipts or similar amounts, reasonable rent holidays, or changes in amounts paid to unrelated third parties. The Proposed Regulations include two safe harbors covering certain provisions for increasing or decreasing rent which will not be considered to have a principal purpose of tax avoidance -- the Disqualified Lease Sate Harbor and the 90/110 Safe Harbor. The Disqualified Lease Safe Harbor, contained in Prop. Reg. § 1.467-3(c)(2)(ii), is really a set of safe harbors.[68] It covers increases or decreases in rent if all[69]

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[67] In this regard, we note that taxpayers that want constant rental accrual can generally achieve it bv providing for level rent allocations in their lease agreements. Note also that it may be appropriate to provide taxpayers with some comfort (through a Notice, IRS manual rule, or otherwise) that the Service will generally not exercise its discretion in this regard where the relevant returns of the party whose income tax liability would be lowered by reason of the lease being disqualified have closed, but the other party's years remain open.

[68] The safe harbors contained in the Disqualified Lease Safe Harbor, other than the rent holiday safe harbor, parallel those contained in Prop. Reg. § 1.467-1(c)(2)(ii), which excepts certain contingent rent from treatment as increasing or decreasing rent, and the recommendations below apply equally to the provisions of Prop. Reg. § 1.467-1(c)(2)(ii).

[69] Thus, this safe harbor cannot be combined with the 90/110 Safe Harbor.

increases or decreases are attributable to one or more[70] of the following: (i) a provision requiring a lessee to pay additional rent based on a fixed percentage of the lessee's receipts, (ii) a provision requiring an adjustment based on a reasonable price index (as defined),[71] (iii) a provision requiring the lessee to pay third-party costs (as defined),[72] or (iv) a rent holiday at the beginning of the lease term that does not exceed 24 months or 10% of the lease term and for which there is a “substantial business purpose.” The 90/110 Safe Harbor covers cases where the rent allocated to each calendar year of the lease (ignoring only third-party costs within the meaning of Prop. Reg. § 1.467-1(h) passed through to the lessee) does not vary by more than 10% above or below the average rent for all calendar years of the lease.[73]

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[70] Thus, for example, a CPI adjustment can be combined with a pass-through of increases in third-party costs. Allowing all three types of adjustments to be combined would seem to be a liberal rule.

[71] Sec Prop. Reg. § 1.467-1(h)(6). An adjustment is based on a reasonable price index if the adjustment reflects inflation or deflation occurring over a period during the lease term and is determined consistently under any generally recognized index for measuring inflation or deflation.

[72] Sir Prop. Reg. § 1.467-1(h)(9). Third-parts costs include “any real estate taxes, insurance premiums, maintenance costs, or any other costs (other than debt service cost) that relates to the leased property and is not within the control of the lessor or lessee or any related person.”

[73] Prop. Reg. § 1.467-3(c)(2)(i)

2.2.2. Comments on Disqualified Lease Safe Harbors

Fixed Percentage of Lessee Receipts. The Proposed Regulations cover increases in rent pursuant to a provision requiring an increase in rent "equal to a percentage of the lessee's receipts (gross or net) if the percentage does not vary during the lease term."[74] As drafted, the Proposed Regulations seem to require that rents in this category be a percentage of a lessee's entire receipts, rather than just receipts allocable to the leased property. This result seems unintended as it makes little sense to base this category on a lessee's entire receipts where a lessee may engage in activities unrelated to the leased properties. We suggest, therefore, that the final regulations clarify that only lessee receipts from the leased property or that bear a reasonable relation to the leased property are within the scope of this exclusion.

The final regulations should also clarify the meaning of the parenthetical phrase "gross or net" modifying the term receipts. We assume that this phrasing is intended to convey that receipts for this purpose may be adjusted for returned merchandise, or state and local sales taxes.[75] If so, the regulations should so clarify. Further, the final regulations should clarify that the same percentage need not apply to different types of receipts, as long as the percentage applicable

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[74] Prop. Reg. § 1.467-3(c)(2)(ii)(A).

[75] The regulations promulgated under Section 856, concerning real estate investment trusts, utilize a similar concept. Sec Reg. § 1.856-4(b)(3) (providing that amounts received from a lessee shall not be excluded as "rents from real property" solely by reason of being based on a fixed percentage of receipts or sales, -whether or not receipts or sales arc adjusted for returned merchandise, or Federal, State or local sales taxes).

to each type of receipt is fixed.[76] The final regulations should also clarify whether contingent rent equal to a fixed percentage of lessee receipts over a fixed base qualifies. Such escalation clauses are common in the real estate context; but the language of the Proposed Regulations suggests that it would not qualify since the safe harbor requires contingent rent to be equal to a percentage of a lessee's receipts.[77]

In addition, the reference in the safe harbor to an increase in the lessee's rents suggests that the safe harbor applies only where the rent moves up and not down. We so no reason for this lack of symmetry and suggest that the safe harbor be modified to apply also to decreases in rent that are based on the specified fixed percentage of the lessee's receipts.

Moreover, it may be appropriate to expand the safe harbor to apply to rents that are based on the lessee's usage of the leased property. Such rents are common, for example, in many aircraft leases and car rental leases which provide for “power-by-the-hour” rent based on the lessee's actual usage of the leased property. Alternatively, that case might be covered by an example under the general anti-avoidance standard as discussed in Section 2.1.1, supra.

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[76] Cf. Reg. § 1.856-4(b)(3) (for REIT purposes, rents from real property “would include rents where the lease provides for differing percentages of receipts or sales from different departments or from separate floors of a retail store so long as each percentage is fixed at the lime of entering into the lease. . .”)

[77] Compare with Section 856(d)(2)(A) (exclusion for rents “based” on a fixed percentage of less receipts) and Reg. § 1.856-4(b)(3), example (sanctioning a case where rent is a fixed percentage of lessee receipts over a base).

Finally, with respect to the percentage rent safe harbor, consideration should be given to adding an anti-avoidance rule under which the safe harbor would not be available in cases where the lessee is also a sub-lessor and its payments under the primary lease are based in whole or in part on its receipts under the sub-lease, if a principal purpose of such arrangement is tax avoidance.[78] For instance, tax avoidance could be achieved if the lessee/sub-lessor is an NOL company which enters into (i) a sub-lease that provides for highly stepped rental payments and (ii) a lease that provides for a complete pass-through of its receipts, i.e., the stepped rental payments under the sub-lease.

Reasonable Price Index Adjustment. Prop. Reg. § 1.467-3(c)(2)(ii)(B) covers adjustments in rents that are based on a "reasonable price index" as defined in Prop. Reg. § 1.467-1(h)(6). That section defines a reasonable price index to include "any generally recognized index for measuring inflation or deflation." We suggest that this definition be clarified to permit taxpayers to use not only indices, such as CPI, which measure overall inflation or deflation but also indices (or sub indices) which measure components of inflation or deflation, provided such indices are generally recognized and bear a substantial commercial relationship to the leased property or relevant industry (e.g., real estate).[79] In addition, if

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[78] Cf. Reg. § 1.856-4(b)(6)(i) (rents received from lessee are disqualified for REIT purposes it based on receipts from sub-lessee where the sub-lessee's rents are based on its net income or profits).

[79] This suggestion is based on the assumption that the CPI exclusion is intended to permit stepped rents to reflect inflation and not merely as a backstop to the third party cost exclusion to cover increased costs.

generally recognized regional, state or locally based inflation indices exist, their use should be permitted for leases within the region, state or locality, as appropriate.[80]

In addition, the Conference Report expressly indicates that this safe harbor may include a "cap" on the increases to a specified maximum percentage, and that any increases based on this safe harbor may be aggregated and made in intervals of five years or less. Permitting such additional flexibility would not seem to present any substantial opportunity for tax avoidance, and we suggest that the safe harbor be modified in the final regulations in a manner consistent with the legislative history. Consistent with the application of the regulations to leases with decreasing rents, any such modification should allow a "floor" as well.

Third-Party Costs. Prop. Reg. § 1.467-3(c)(2)(ii)(C) covers the obligation of the lessee to pay "third-party costs." as defined in Prop. Reg. § 1.467-1(h)(5). That regulation defines such costs to include "any real estate taxes, insurance premiums, maintenance costs, or any other cost (other than debt service costs) that relates to the leased property and is not within the control of the lessor or lessee or any related party."

First, we suggest that the final regulations clarify when a third-party cost will not be considered within the control of a lessor, lessee or related person. The Conference Report observed that third-party costs are "generally not subject to manipulation," and we suggest that, consistent with the Conference Report, consideration be given to providing in the

[80] A possible approach would be to adopt a standard that an index is "a generally recognized index for measuring inflation or deflation" if it is recognized as such by the general public within the relevant area, or by a substantial part of the relevant industry.

final regulations that a cost will not be considered within the control of a lessee, lessor or related party if the amount and timing of the cost is not subject to manipulation by those persons.

Second, the final regulations should expressly confirm that amounts paid by a lessee in respect of a general or tax indemnity will generally be considered third-party costs, to the extent made to reimburse the lessor for additional tax liability and accounting, legal and other out of pocket costs related thereto.[81] Availability of the exception might appropriately be limited to cases where the likelihood of indemnity payments is remote at the inception of the lease. Although this result seems relatively clear under the Proposed Regulations, specific clarification in the final regulations is warranted in view of the presence of such indemnities in almost all leveraged leases.[82]

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[81] A general indemnity would typically cover any losses or expenses arising from the leased property itself, from the use of such property during the lease, from the income from such property, from the financing of such property or from the lease agreement itself (e.g., stamp taxes, filing fees, etc.). A tax indemnity would typically cover any arising out of the same matters that are covered by the general indemnity and would include, for example, sales taxes on rents, property taxes on the leased property, incremental state or foreign income taxes incurred by the lessor as a result of the use of the property in specified jurisdictions, and taxes that could be payable by the lessor it the leased property does not have the federal income tax characteristics intended by the parties.

[82] Such a provision would not be required to the extent such payments are ignored (and are not considered to result in increasing or decreasing rent) under a general provision dealing with contingent rent. Note in this regard that the Disqualified Lease Safe Harbors only apply it all increases or decreases in rent are attributable to items listed in clauses (A) through (D) of Prop. Reg. § 1.467-3(c)(2)(ii).

Third, the Committee believes that the concept of third-party costs should be expanded to include payments to the lessor (or a related party) for services provided on an arm's length basis. While at first blush this might appear inappropriate since payments for such services are within the control of the parties and are subject to manipulation, we note that lessor services could be provided for in ancillary agreements separate from the rental agreement,[83] and that if such agreements have arm's length terms, payments under such agreements would seem not to be vulnerable to re-characterization as disguised rental payments under the lease. We also note that is common commercial practice to provide for certain lessor provided services under leases, and requiring the use of separate documents would seem a trap for the unwary. Therefore, consideration should be given to providing in the final regulations that if amounts paid for services provided by a lessor under a lease agreement (i) are separately identified under the agreement as payments for lessor provided services and (ii) represent fair market value payments for such services, such payments would not be considered rent for purposes of Section 467, whether or not characterized as additional or supplement rent under the agreement.[84] The burden of proof as to whether the payments for services are at fair market value should be on the taxpayer.

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[83] The Proposed Regulations apply only to payments under a "rental agreement," which is defined to include "any agreement that provides for the use of tangible property and is treated as a lease for federal income tax purposes." Prop. Reg. § 1.467-1(h)(8). The Proposed Regulations do not contain a specific provision expanding the definition of a lease to include all agreements among the parties concerning the leased property. Cf. Reg. § 1.704-1(b)(2)(ii)(h) (defining partnership agreement to include all agreements among the partners concerning affairs of the partnership whether or not embodied in a document referred to by the partners as the partnership agreement).

[84] Cf. Section 856(d)(1)(B) (which provides that for REIT qualification purposes, rents include charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated).

Finally, the Proposed Regulations do not include debt service costs as third- party costs.[85] The issue of the proper treatment of debt service costs for this purpose is complex. Relevant considerations include that debt service costs may reflect a schedule of built-in stepped costs and that prepayment and refinancing options are common. See Section 3, infra, for a discussion of certain rental adjustments with respect to debt service costs that we believe should be treated similarly to third-party costs, i.e., ignored for purposes of determining whether a lease has increasing or decreasing rents and for purposes of applying the various disqualified lease safe harbors discussed below.

Reasonable Rent Holiday. The Proposed Regulations cover a rent holiday at the beginning of the lease term allowing reduced or no rent, but only if there is a “substantial business purpose” tor the rent holiday, and the duration of the rent holiday is not greater than the lesser of 24 months or 10% of the lease term. The substantial business purpose requirement of the Proposed Regulations is more stringent and more subjective than the standard articulated in the Conference Report, which is that the rent holiday be reasonable in the context of “commercial practice in the locality where the use of the property will occur at the time the lease is entered into.” If the substantial business purpose standard is retained, consideration should be given to adding a sentence to the final regulations to the effect that generally a substantial business purpose for a rent holiday will be considered to exist if similar rent holidays represent

[85] The Conference Report states that “Congress intended no inference, however, as to the effect of a lease clause requiring the lessee to assume the burden of any increases in the lessor's debt service costs on the property (whether principal, interest, or both) including the effect of such a clause on the status of the lease as a true lease.” Conference Report at 893, note 5.

common commercial practice in the area in which the leased property is located.[86]

2.2.3. Comments with Respect to "90/110" Safe Harbor

As noted, the 90/110 Sate Harbor provides that tax avoidance will not be considered to be a principal purpose for increasing or decreasing rents if the rent allocated to each calendar year does not vary from the average rent allocated to all calendar years by more than 10%.[87] The 90/110 Safe Harbor cannot be used in conjunction with the other safe harbors contained in the Disqualified Lease Safe Harbor, other then the safe harbor tor third-party costs, which are ignored for this purpose.[88] For example, the 90/110 Safe Harbor cannot be used in conjunction with a rent holiday that qualifies under the safe harbor of Prop. Reg. § 1.4673(c)(2)(ii)(D).[89]

Unlike the other safe harbors, the 90/110 Safe Harbor is not specifically provided for under the statute. However, the Conference Report states that it is "anticipated that the Treasury Department will issue regulations adopting standards

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[86] The standard described in the Conference Report would provide more certainty to taxpayers than the standard contained in the Proposed Regulations. However, the concurrent commercial practice standard has uncertainties in its application as well (e.g., is a rent holiday concurrent commercial practice if 10% of relevant lease agreements contain a rent holiday. or is a 30% or 50% level required?).

[87] Rent allocated to a partial calendar year is annualized.

[88] The comments contained in Section 2.2.2, supra, with respect to costs which should be considered third-party costs are equally applicable here.

[89] As a result, in most cases a rent holiday would prevent an agreement from qualifying under the 90/110 Safe Harbor. Indeed, any rent holiday which provided for a zero rent allocation (or any other rent allocation reduced below 90% of the average rent) with respect to the period beginning on the lease commencement date and ending on or after the following December 31st, would be automatically disqualified.

under which leases providing for fluctuations in rents paid by no more than a reasonable percentage above or below the average rent payable over the term of the lease will be deemed not motivated by tax avoidance" and it goes on to note that the Internal Revenue Service has taken the position in Rev. Proc. 75-21[90] that "a 10% fluctuation above or below the average rent is permissible in the case of leases of personal property."[91] The Conference Report acknowledges that the Rev. Proc 75-21 standard may be inappropriate for real estate, and that it may be appropriate for the regulations to adopt a less restrictive standard for real estate.[92]

Treatment of Contingent Rent. If a rental agreement provides for contingent rent other than third-party costs (as defined), the effect of such contingent rent on the availability of the 90/110 Safe Harbor is unclear. Possibilities include (i) that the contingent rent is taken into account on projected basis,[93] or (ii) that the presence of any contingent rent (other than third-party costs) makes the safe harbor unavailable.

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90 Rev. Proc. 75-21, supra, sets forth guidelines for obtaining a ruling that a leveraged lease will be respected as a lease for tax purposes. Section 5 of that Revenue Procedure states that "[t]he Service ordinarily will not raise any question about prepaid or deferred rent it the annual rent for any year ... is not more than 10 percent above or below the amount calculated by dividing the total rent payable or the lease term by the number of years in such term. . .".

91 Conference Report at 893. It is our understanding that, in practice, many leases are specifically structured to provide stepped rents within the limits of the guidelines.

92 Id.

93 Thai is projected contingent rent would be taken into account to calculate both the rent allocated to each calendar year and the average rent allocated to all calendar years.

The approach of taking contingent rents into account on a projected basis in testing qualification under the 90/110 Safe Harbor appears to us to be a reasonable alternative, provided that such rents are otherwise required to be determined on a projected basis for determining rental accruals generally. This approach assumes that the regulations to be issued regarding treatment of contingent rent will provide for treatment of contingencies in a manner similar to that provided in the Section 1275 regulations concerning contingent interest.[94] As discussed in Section 3, infra, we believe that application of such rules would properly result in rental adjustments based on qualified floating rates, and rent payable only on remote contingencies or in incidental amounts, being ignored for purposes of testing the 90/110 Safe Harbor.

The alternative approach of making the 90/110 Safe Harbor unavailable if there is any contingent rent that is not a "third-party cost" will make the safe harbor unavailable in many commercial contexts, e.g., in the case of a leveraged lease with floating-rate interest. In such cases, notwithstanding that there may be a clear non-tax motivation for the contingent rent, parties to a rental agreement could not be completely comfortable that the rental schedule, taken as a whole, could not be shown to have a principal tax avoidance purpose. In this connection, see Sections 3.2 and 3.3, infra, on the treatment of floating rate debt and lender indemnities.

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[94] We note that Prop. Reg. § 1.467-6 reserved on the treatment of contingent rent, and that the Preamble solicited comments on whether the contingent interest rules should be extended to contingent rent.

If our suggestions in respect of contingent rent contained in Section 3 of this report are not adopted, one possibility for addressing contingencies under the 90/110 Safe Harbor in a manner that preserves the usefulness of the safe harbor would be to provide that contingent rent[95] (not otherwise qualifying as a third- party cost) is not taken into account in determining qualification under the safe harbor provided that no principal purpose for the contingent rent arrangement is tax avoidance.[96] If any provision for contingent rent (other than third-party costs) under the agreement has a principal purpose of tax avoidance, the safe harbor would be unavailable.[97] If this rule were adopted, there would be no absolute assurance that a rental agreement would qualify under the 90/10 Safe Harbor if any contingencies with respect to rent (other than a pass through of third-party costs) are provided for, but if the safe harbor would otherwise be available, and the contingent rent provided for has no tax avoidance motivation, it would remain available. While this rule might appear vague on the surface, we believe that tax practitioners would be comfortable in applying it.

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[95] Contingent rent for this purpose may be limited to rents the amount of which is subject to significant contingencies. Rents should not be considered contingent merely because the timing of their payment is not fixed, particularly if any deterred or prepaid amount bears adequate interest.

[96] Thus, if a rental agreement has both 90/110 increasing rents (which is tax motivated) and, for example, a commercially reasonable non-tax motivated CPI adjustment, the agreement would qualify for the safe harbor.

[97] Unless the amount of potential contingent rent is so small that even if taken into account when accrued in the numerator it does not disqualify the agreement under the safe harbor. Alternatively, minor amounts of contingent rent might be disregarded under the incidental prong of the "remote and incidental" contingency test that we suggest, infra. See Section 3.3 of the report.

In connection with this rule, the final regulations should provide that in determining whether an adjustment for contingent rent has a tax avoidance purpose, the fixed rent variations within the 90/110 Safe Harbor are not taken into account.[98] An alternative approach would be for the regulations to list specified forms of contingent rent that would generally be presumed not to have a tax avoidance purpose.[99]

Determination of Allocated Rents. Prop. Reg. § 1.467-3(c)(2)(i) does not specify how rents are allocated to calendar years for purposes of applying the 90/110 Safe Harbor.

Logically, it would seem that the rent that should be taken into account for this purpose is either the rent allocated under the rental agreement, or, in the case of a rental agreement which does not provide adequate stated interest on fixed rent, the proportional rental amount. However, since proportional rental amounts are, by definition, a fixed percentage of the rents allocated under a rental agreement, using proportional rental amounts in testing the 90/110 Safe Harbor will produce the same result as using the rent allocated under a rental agreement. For simplicity, we therefore suggest that the final regulations

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[98] In the absence of such a rule, the 90/110 rental schedule may taint an otherwise reasonable provision for contingent rent. That is, it could be argued that even if a CPI adjustment were completely non-tax motivated and commercially standard in a given locality, the CPI-based increases were tax-motivated when coupled with a 90/110 schedule.

[99] To be useful this list should include contingent rent based on rental adjustments described in Section 3 of this report (if not otherwise treated as third party costs), and rental adjustments of the types listed in the other Disqualified Lease Safe Harbors other than a rent holiday, and possibly other than adjustments based on a reasonable price index.

provide that rents are allocated for purposes of the 90/110 Safe Harbor as specified under a rental agreement.

Calendar Year. The Proposed Regulations require that in determining whether a rental agreement is within the scope of the 90/110 Safe Harbor, the average rent allocated under the agreement to all calendar years is compared to the rent allocated to each calendar year.[100]

The basis for requiring that the 90/110 Safe Harbor be tested against a calendar year is presumably to curb abuses associated with so-called “saw-tooth” payment schedules, under which a lease year is divided into two rental periods with the first period having zero (or low rent) and the second period high rent to make up for the zero (or low) rent in the first period. Such an arrangement could effectively allow a lessor[101] to defer including in income rent properly allocable to the initial rental

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[100] The use of the calendar year for this purpose is not mandated by the statute. The only place in the statute where a calendar year is mandated is for purposes of determining whether a rental agreement is a Section 467 rental agreement (because of deferred rent). In addition, Rev. Proc. 75-21, supra, does not call for use of a calendar year in testing qualification under the 90/110 test.

[101] Conversely, a lessee could accelerate deductions if the lease provided for high rent for the first period and zero or low rent for the second period.

period until the end of a lease.[102]

Under the Proposed Regulations, a calendar year lessor using a saw-tooth structure to so defer could not qualify for the 90/110 Safe Harbor as the rent allocated to the initial rental period (on an annualized basis)[103] would be less than 90% of the average rent allocated under the rental agreement.

The rule contained in the Proposed Regulations effectively eliminates the potential for such tax deferral in the case of calendar year lessors.[104] Fiscal year lessors, however, would still be able to use a saw-tooth structure to defer income,[105] regardless of tax motivation. This produces an unwarranted advantage for fiscal year lessors and raises the possibility that calendar year lessors could create special purpose wholly owned or controlled entities on a fiscal year to achieve tax deferral.

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[102] For example if a calendar year lessor entered into a long term lease beginning July 1st providing for $1.2 million of rent per year and was permitted to use a June 30th lease year for purposes of testing the 90/110 Safe Harbor, the parties could divide each lease year into two rental periods, the first of which ends December 31st and the second June 30th, and allocate zero rent to the first period and the full $1.2 million to the second. Under this arrangement, $600,000 of rent properly allocable to the initial rental period would effectively be deferred until the end of the lease. Note, the example provides for two six-month rental periods, rather than one annual rental period, as the Proposed Regulations provide that rent allocated to any rental period is treated as allocated ratably within that period. Prop. Reg. § 1.467-1(i)(4).

[103] For example, if the rent allocated to the initial period is zero, the annualized rent tor the first calendar year would also be zero.

[104] Or deduction acceleration in the case of calendar year lessees.

[105] A lessor with a June 30th fiscal year could use a calendar lease year with two periods, the first ending June 30th and the second ending December 31st, with zero (or low) rent for the first period and high rent for the second period.

In addition, the rule contained in the Proposed Regulations generally excludes from the 90/110 Safe Harbor leases with inter-year variations in lease rental allocations based on a non-calendar year business cycle of either the lessor, lessee or the property.[106] The parties could qualify for the safe harbor by allocating the rent uniformly within the lease year, but pay according to a saw-tooth schedule; however, providing for such allocation would presumably have non-tax legal consequences at variance with the economics of the business arrangement (for instance, under bankruptcy laws), in addition to accelerating income to a calendar year lessor. The non-tax concerns could generally not be addressed by specifying that each lease year contains only a single rental period if there are multiple payment dates specified within the period.[107]

In view of the foregoing, consideration should be given to permitting taxpayers to use any fiscal year (or alternatively any fiscal year of the lessee or lessor) in testing qualification under the 90/110 Safe Harbor; provided that if rent varies within rental periods within such year, taxpayers would not be permitted

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106 E.g., seasonal rentals of equipment. For example, if a lease of ski equipment is entered into in July with low payment and matching allocations for the period July through December, and high payments and matching allocations for the period January through July, the lease could not qualify for the safe harbor if the lease year is divided into two six month rental periods.

107 Reg. 1.467-1(j)(5) provides that rental periods may be of any length of one year or less as long as, among other things, each scheduled payment under the rental agreement (other than a payment scheduled to occur before or after the lease term) occurs within 30 days of the beginning or end of rental period. If zero rent (rather than low rent) is payable with respect to the first part of the year, having a single rental period covering the entire fiscal year would be permissible and permit qualification of a saw-tooth allocation schedule under the safe harbor. Rent in such a case would be allocated uniformly over the rental period. Prop. Reg. § 1.467-1(j)(4).

to use the 90/110 Safe Harbor if tax avoidance is a principal purpose of such variance.[108]

An alternative approach is to base the 90/110 Safe Harbor not on years, but on rental periods, and test the annualized rent allocated to each rental period under Prop. Reg. § 1.467-1(j)(3) against the average annualized rent allocated to all rental periods. This rule would prevent use of a saw-tooth lease structure, while leveling the playing field for calendar and fiscal year lessors. The downside to the proposed rule is that, as above, leases keyed to natural cycles within a year could not allocate rents in accordance with such cycles and be within the scope of the safe harbor.

If it is determined that a calendar year is to be used in testing the 90/110 Safe Harbor, the final regulations should clarify how the rent allocated to a short initial or final year is taken into account in computing the average rent.[109] Prop. Reg. § 1.467-3(c)(2)(i) currently provides in a parenthetical that "rent allocated to a partial calendar year is adjusted by multiplying the rent by the number of partial years in a full calendar year." It is clear that this rule is to be used in computing the rent allocated to a partial year for purposes of comparing that rent to the average rent. However, it is not clear whether this rule is to be used in determining average rent.

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[108] We note that this variation would inject some element of subjectivity into the salt-harbor which was not present in cases where a saw-tooth structure was used in conjunction with a calendar year based lease, but do not think this is of meaningful concern.

[109] A similar issue would arise if testing were permitted based on a fiscal year.

Alternatively, for example, average rent could be determined by dividing the total number of years in the lease term, without regard to whether that latter figure is a whole number or a fraction.[110] The final regulations should clarify whether the rule contained in Prop. Reg. § 1.467-3(c)(2)(i), or the alternative rule described in the preceding sentence, applies for purposes of determining average rent.

2.3. Special Safe Harbor under 90/110 Rule for Real Estate

The Conference Report noted that it may be appropriate in the regulations to provide less restrictive safe harbors in the case of real estate leases,[111] and the Preamble invites comments regarding the nature and extent of an appropriate safe harbor for such leases.[112] We believe that a special safe harbor for real estate leases is appropriate.

There are several justifications for providing a broader safe harbor for real estate leases. First, the requirement that real estate (including land) be treated as having a 19-year life for purposes of testing whether a real estate lease is a long-

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[110] The average rent will generally differ depending on which rule is chosen. For example, if a rental agreement with a two and one-half year term begins on July 1 and provides for rent of $45 during the first half year, rent of $100 during the second year and rent of $110 during the third year, the average rent computed under the rule contained in Prop. Reg. § 1.467-3(c)(2)(i) would be $100 ((45*2 + 100 + 110/3), while average rent computed under the alternative rule would be $100 ((45 + 100 + 110)/2.5).

[111] Conference Report at 893.

[112] The Preamble states that "[t]he proposed regulations do not provide a safe harbor specifically applicable to real estate leases. The IRS and the Treasury Department invite comments regarding the nature and extent of a safe harbor for such leases, as well as comments on whether additional safe harbors are appropriate either generally or for particular industries."

term agreement results in quite a large proportion of real estate leases being treated as long-term rental agreements. Real estate typically has a much longer economic useful life than 19 years and leases in excess of 14.25 years[113] are common.

In New York City, for example, many space leases in office buildings have 15-year (or longer) terms, and many of those leases also include rent adjustment clauses that increase the rent at, for example, five-year intervals. Because such garden variety leases would be within the scope of Section 467, and therefore potentially subject to rent-leveling, we believe it is appropriate to apply broader safe harbors to real estate leases.[114]

Second, the 90/110 Safe Harbor, discussed below, makes no sense in the context of a long-term real estate lease (which by definition has a term exceeding 14.5 years), since the average annual increase would have to be less than 1.5% per annum to qualify -- increases that are well below the historic rate of inflation. The 90/110 Safe Harbor has rarely, ii ever, been applied in the real estate context. Instead, many real estate leases contain rent schedules that provide for fixed increases in rent (e.g., 10% even-five years), or increases based on a third-party benchmark (such as CPI). While the latter formulation (CPI) should satisfy the reasonable price index safe harbor, the former formulation would generally not fit within any safe harbor.

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[113] A lease is a long-term agreement if the lease-term exceeds 75 percent of the statutory recovery period in the property (which for purposes of § 467 is 19 years in the case of real estate).

[114] As an alternative solution to that described below, we would recommend that § 467 be amended to reflect the longer recovery periods applicable to real property under current law.

Therefore, we suggest that consideration be given to providing a special real estate safe harbor which permits certain increases in rents. We believe that a reasonable rule would be one which allows the parties to periodically increase (or decrease) the rent allocated under a rental agreement by a fixed percentage[115] based on the average of an appropriate index over some period prior to the date the lease is entered into.[116] The parties could agree, for example, to increase rent each year based on 90% of the average of the CPI in the five years prior to the date of the lease agreement. The parties should also be allowed to adjust the rent in such manner less frequently than annually, say every five years. This safe harbor could not be used in conjunction with the 90/110 Safe Harbor, or with a price index adjustment of the type described in Prop. Reg. § 1.467-3(c)(ii)(B). However, it may be appropriate in this context to allow it to be used in conjunction with the other Disqualified Lease Safe Harbors.[117]

The Proposed Regulations further provide that a leaseback or long-term lease will not be disqualified if it does not provide for total rental payments in excess of $2,000,000. In

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[115] This percentage should not in any circumstance exceed 100%, and, perhaps, should be limited to some lesser traction of the index.

[116] Alternatively, consideration should be given to expanding the 90/110 Safe Harbor in the case of real estate leases to, perhaps, an 80/120 safe harbor. However, this formulation seems not particularly helpful since it only allows taxpayers to increase rents by about 2% per year in the case of a 20 year lease, which seems too small even in today's low inflationary environment. Some members of the Committee believe that a real estate safe harbor should additionally permit parties to a real estate lease to provide for fixed periodic escalations of rent of no more than a fixed percentage, as well as escalations based on bona-fide reappraisals of the leased property.

[117] E.g., third party costs, percentage of lessee receipts, and, possibly, a reasonable rent holiday.

view of the relative length of long-term real estate leases as compared to other leases, we suggest that in the case of real estate leases the final regulations provide that the exclusion be some function of the term of the lease, for example, $300,000 per year. This would properly recognize that a long-term real estate lease entered into by even a small taxpayer can readily exceed the $2,000,000 threshold.

3. Contingent Rent

3.1. General

The Proposed Regulations reserved on the treatment of contingent rent in general. However, contingent rent is generally taken into account under Prop. Reg. §1.467-1(c)(2)(iii) in determining whether a lease has increasing or decreasing rent. In addition, contingent rent is generally taken into account in determining whether a rental agreement qualifies under the Disqualified Lease Safe Harbors. As discussed above, if rules are promulgated to deal with contingent rent generally, we would suggest that contingent rent also be taken into account on a projected basis in testing qualification of a rental agreement under the 90/110 Safe Harbor.

For purposes of determining whether a rental agreement has increasing or decreasing rent and for purposes of determining whether a rental agreement qualifies under the Disqualified Lease Sate Harbors, certain items of contingent rent are ignored, i.e., contingent rent based on a lessee's receipts, a reasonable price index, or third-party costs. These exclusions are generally parallel for these two purposes, although it is not it is not entirely clear that the exclusions can be used in combination in

determining whether a rental agreement has increasing or decreasing rent.[118]

We believe that these exclusions are unnecessarily narrow. We believe it is important that the final regulations provide that contingent rent which is not expected on a projected basis to produce predictable net upward or downward adjustments in rent, as well as rent payable only upon remote contingencies or in incidental amounts, is ignored for purposes of determining whether a rental agreement (a) has increasing or decreasing rent, (b) qualifies under the Disqualified Lease Safe Harbors and (c) qualifies under the 90/110 Safe Harbor (such purposes, "Section 467 Testing Purposes"). Thus, such contingent rent would be treated in a manner similar to third-party costs under the Proposed Regulations.

In particular, as more fully discussed below, the final regulations should provide that the following types of rent are ignored for Section 467 Testing Purposes: (a) rental adjustments based on changes in qualified floating rates applied to fixed debt repayment schedules, (b) rent payable only upon remote contingencies or in incidental amount s. (c) fluctuations in the U.S. dollar value of rent due to fluctuations in foreign currency in which the rent is payable, (d) rent payable pursuant to certain TRAC provisions and (e) rental adjustments based on certain refinancing reset provisions. If these types of rent are

[118] The Preamble indicates that the exclusions can be used in combination. However, the Proposed Regulations provide that the rent described in each category of exclusion is ignored it the rent is contingent solely as a result of such contingency. The use of the work "solely" creates ambiguity as to the intent of these provisions. The final regulations should clarify whether the exclusions can be combined.

not provided for under general rules dealing with contingent rent, or are not otherwise treated as third-party costs, the final regulations should, in any event, specifically provide that the listed types of rent are ignored for Section 467 Testing Purposes.

3.2. Adjustments Based on Qualified Floating Rate Indices Applied to Fixed Debt Repayment Schedules

The final regulations should make clear that rental adjustments based on changes in a qualified floating rate (as defined in Reg. § 1.1275-5(b)[119]) as applied to a fixed debt repayment schedule are ignored for Section 467 Testing Purposes.

We understand that it is common for a lessor under a leveraged lease to borrow at a qualified floating rate and pass-through to the lessee as an adjustment to rent the difference (positive and negative) between its interest cost based on the qualified floating rate, and the debt service costs projected at the inception of the lease based on a fixed rate substitute. Under the final regulations, variations from the projected rate should be ignored for Section 467 Testing Purposes. Thus, for instance, if the rental agreement would qualify for the 90/110 Safe Harbor based on the projected fixed rate costs,[120] the rental agreement would continue to qualify for the 90/110 Safe Harbor

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[119] Query whether caps, floors or governors should be permitted if they would be expected to have a significant limiting effect. See Reg. § 1.1275-5(b)(3).

[120] In determining whether a rental agreement based on the projected fixed rate cost would qualify, proper consideration should be given to any effect on rents of prepayment options and/or interest rate reset options. See Section 3.6, infra, regarding resets, and Section 4.2, infra, regarding alternative payment schedules.

notwithstanding provision for rental adjustments based on qualified floating rates.[121]

The approach would similarly cover the case where the qualified floating rate is applied to a notional, rather than an actual, debt schedule (e.g., variations in rent to cover the difference between (a) interest at a qualified floating rate applied to a notional debt schedule and (b) interest at the fixed rate substitute applied to the same notional debt schedule, would be ignored for Section 467 Testing Purposes). In this regard, we understand that it is common in the equipment leasing industry for leases to contain a provision whereby the rental amount is adjusted to reflect changes in interests rates (e.g., based on commercial paper, LIBOR or Treasury indices) without regard to whether such an adjustment can be traced to any particular cost of the lessor (for instance, in cases where debt is incurred to purchase multiple properties).

The above described rental adjustments provide no meaningful potential for tax avoidance as it cannot be predicted in advance whether the adjustments will produce a net upward or downward adjustment to rent, and specific provision for such adjustments is important to provide assurance, in the leveraged lease and other contexts, that the Disqualified Lease Safe Harbors and 90/110 Safe Harbor will be available to lessors that borrow at variable rates.[122]

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[121] We note that the Service has never interpreted the 90/110 safe harbor provided in Rev. Proc. 75-21 as prohibiting such adjustments.

[122] For the same reason, the final regulations should provide that adjustments to rent to reflect adjustments to debt service costs occasioned by reason of a change in a lessor's or lessee's credit rating will not disqualify a lease from the 90/110 Safe Harbor.

3.3. Remote and Incidental Contingencies

Rent payable only on the occurrence of a remote contingency that is not within the control of the parties to a rental agreement presents no potential for tax avoidance. The same holds true for contingencies that are expected to result in incidental payments of minor amounts. Adjustments in rent based on such contingencies should be ignored for Section 467 Testing Purposes.[123]

For instance, a leveraged lease will typically contain an indemnity to a lessor or lender to cover actual costs of the lessor or lender under credit agreement provisions for withholding tax gross ups, "increased costs" and other indemnifications of the lenders for the range of costs covered by a typical indemnity. Under the Proposed Regulations, these costs would arguably not be considered third-party costs by reason of being debt-service costs. Nevertheless, if, as is typically the case, the likelihood of such indemnities being triggered is remote, such costs should, if not otherwise excluded as third-party costs, be excluded for Section 467 Testing Purposes.[124]

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[123] The Proposed Regulations provide support for this suggestion in the definition of fixed rent which provides that "the possibility of a breach or other early termination of the rental agreement ... are disregarded in determining whether amounts specified in the agreement are fixed rent." Prop. Reg. § 1.467-1(h)(3). See also, Reg. § 1.1275-2(h) (ignoring payments under a debt instrument subject to remote or incidental contingencies until contingency occurs); Reg. § 1.514(c)-2(g) (disregarding for certain purposes of Section 514 loss or deductions which have a low likelihood of occurring).

[124] Consideration should be given to providing that certain contingencies, such as changes in law, would be considered per se remote, or that rent payable upon the occurrence of such events would not be considered contingent rent for Section 467 Testing Purposes. For example, that the rate of withholding applicable to a loan made to a foreign lessor may be in flux should not, in itself, cause a leveraged lease to tail to qualify for the 90/110 Safe Harbor.

3.4. Foreign Currency Denominated Rent

Section 988 of the Code requires that foreign currency denominated rent be translated into U.S. dollars. Expressed in U.S. dollars, the foreign currency denominated rent fluctuates based on the exchange rates at the time of conversion. Accordingly, even though the rent denominated in foreign currency may otherwise qualify as “fixed rent” for purposes of Section 467 and the Proposed Regulations, it appears that the rent would not be treated as fixed rent. We believe that providing for rents which are payable in a foreign currency would not seem to present a meaningful opportunity for tax avoidance -- at least in cases in which the foreign currency bears a reasonable relationship to the transaction -- and that the amount of rent which is contingent because it is denominated in such a foreign currency should be excluded in determining whether a rental agreement has increasing or decreasing rent.[125]

3.5. TRAC Provisions

Section 7701(h) of the Code contains rules that are designed to permit lease characterization for federal income tax purposes for motor vehicle operating agreements, notwithstanding

[125] This relief provision should be limited to cases where the foreign currency is a functional currency of the lessor or lessee, or is related to the location where the property is used. If the parties to a lease were permitted to select any foreign currency, it would be possible 10 select a currency which is expected to either depreciate or appreciate with respect to the dollar, depending upon the historic relative levels of inflation in the United States and the jurisdiction that issued the foreign currency, and thus, in effect, provide for increasing or decreasing rents. However, if the foreign currency exception were adopted in the manner suggested, the final regulations might usefully provide an example demonstrating a non-tax avoidance use of a foreign currency which is not the functional currency of the lessee, the lessor or related to the leased property, for example, where the currency of the lessee s jurisdiction is weak, and transactions in the jurisdiction of the lessee are routinely effected in a stronger currency of another jurisdiction.

that the agreements may contain TRAC provisions, provided the general requirements for qualifying as a lease for federal income tax purposes, and certain specific requirements set forth in such section, are satisfied. A TRAC provision generally permits, or requires, the rental price to be adjusted by reference to the amount realized by the lessor under the agreement upon sale or other disposition of the leased vehicle. TRAC provisions are widely used by the motor vehicle leasing industry, and were devised for the non-tax purpose of providing a financial incentive for the lessee/user, who is the party to the transaction best able to control the maintenance of the vehicle, to keep the vehicle in good repair.[126]

A TRAC provision does not invoke the concerns of Congress that prompted the enactment of Section 467 as taxpayers generally cannot manipulate the amount of the TRAC payment and there is no attempt to mismatch income and deductions between taxpayers using different methods of accounting. Further, Congress has explicitly provided in Section 7701(h) for a certain treatment of leases which contain TRAC provisions, which treatment would be substantially complicated if such leases were subject to the rent-leveling provisions of Section 467. Therefore, we suggest that the final regulations specifically provide that a TRAC provision will not be considered to result in a lease having increasing or decreasing rents provided that the TRAC amount is based on a reasonable expectation of actual selling prices based on an objective standard, such as the N.A.D.A. Official Commercial Truck Guide.

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[126] See Blue Book at 87.

3.6 Adjustments Based on Refinancing Rest Provisions

Leveraged leases, particularly long-term leases, often contain a refinancing reset provision which provides for adjustments in rent to reflect refinancing of debt by the lessor. These provisions permit the parties to avail themselves of reduced costs that a refinancing may provide, and are necessary in cases where the lessor's debt financing has a shorter maturity than the term of the lease.[127] In many, if not most cases, such resets result in a reduction in a lessee's rents, and provision for them is often insisted on by a lessee. Similarly, where rent varies as a function of an interest rate index, without regard to specifically identified debt, we understand that it is a common to offer the lessee a feature that allows the lessee to elect to subsequently switch to a fixed rate based on a specified fixed rate index. Such resets are common, represent reasonable commercial practice and have little if any potential for tax avoidance. Accordingly, we believe that the final regulations should be drafted to accommodate refinancing resets.[128] Note that the treatment of resets may properly be addressed under rules relating to the treatment of alternative payment schedules under a lease or substantial modification of a lease.

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[127] In some cases, there may be construction or bridge financing in place at the inception of the lease which the parties intend will be replaced by permanent financing.

[128] An additional issue in this regard is this treatment of the pass-through of costs associated with a refinancing, such as the premiums payable on repayment of the original financing or the fees of the new lenders. To the extent the amount of such costs were not reasonably estimable at inception of the lease, it would seem clear that reimbursement of the same is not tax motivated.

4. Options to Extend Term/Alternative Payment Schedules

4.1. Options to Extend Term

The Proposed Regulations provide that a “lease term” includes any option period if it is expected that the option to renew will be exercised. The regulations provide that a lessor's or lessee's renewal option generally will be expected to be exercised if the rent during the renewal term is higher or lower, respectively, than the expected fair market value rents at the time of renewal.[129] The Proposed Regulations further provide that a lessor's or lessee's determination that an option period is either included in or excluded from the lease term is not binding on the Commissioner.

Since there can be no certainly that the conclusion of the parties as to the projected fair market value of rent at the time of renewal will be respected for purposes of the determination of whether the reasonable expectation rule is satisfied, the parties to a lease with a renewal term could not be certain whether a renewal term would be taken into account in determining whether a lease is a long-term agreement, or in applying the 90/110 Sale Harbor.

We would suggest that the final regulations address this uncertainty in an appropriate manner. One reasonable approach would be to respect a taxpayer's determination as to projected

[129] Prop. Reg. § 1.467-1(h)(5).

fair market value provided it is not unreasonable and provided appropriate documentation is maintained.[130]

4.2. Options to Prepay/Defer and Alternative Payment Schedules

The Proposed Regulations do not address the treatment of options to prepay or defer rent, or alternative payment schedules relating to the payment of rent. Presumably, however, since the Proposed Regulations provide that rent is “fixed” only to the extent the amount of the rent and the time at which the rent will be paid are fixed and determinable, all rent subject to options or alternative payment schedules would be treated as contingent rent.[131]

This potentially has two consequences. First, in the absence of guidance concerning how to deal with contingencies regarding payment, parties to a lease may take positions that avoid the Section 467 loan rules. For instance, a lease might nominally be structured to provide tor payments that match allocations, while providing an option to either prepay, or defer, payments. If such option were exercised, the result under the Section 467 loan rules is unclear.

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[130] Cf. Reg. § 1.1275-4(b)(4)(v) (providing that an issuer's determination of the yield and payment schedule of a contingent payment debt instrument issued for money will be respected provided such determinations are reasonable, are based on reliable, complete and accurate data, and are made in good faith).

[131] Prop. Reg. § 1.467-1(h)(3).

Second, although the Proposed Regulations are not entirely clear on this point, any rental agreement which provides for a contingency as to payment would appear to be a Section 467 rental agreement, and would appear automatically disqualified from both the Disqualified Lease and 90/110 Safe Harbors.[132] Thus, a loan agreement subject to options or alternative payment schedules would be ineligible for these safe harbors.

We believe the final regulations should address these concerns and contain rules dealing with options and alternative payment schedules. Consideration should be given to promulgating a rule analogous to that used in the OID regulations. Under such a rule, if there are one or more alternate payment schedules, and one payment schedule is significantly more likely to occur than the others, Section 467 would be applied on the basis of that schedule. See Reg. § 1.1272-1(c)(2). Further, if the exercise of a lessee prepayment or deferral option would reduce the net present value of rents (determined at 110% of AFR), it would be deemed exercised, whereas it the exercise of a lessor option would increase the net present value of rents, it would be deemed exercised. See Reg. § 1.1272-1(c)(5). If the assumption as to exercise did not occur, the lease agreement would be treated as substantially modified and retested under Section 467. See Reg. § 1.1272-1(c)(6).

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[132] Prop. Reg. § 1.467-2(c)(2)(iii)(A) provides that a rental agreement has increasing or decreasing rent if it requires (or may require) the payment (rather than allocation) of contingent rent.

5. Effective Date Issues

Although the general effective date set forth in the regulations is the date that final regulations are published in the Federal Register, the Proposed Regulations are effective immediately in the case of disqualified leasebacks and long-term agreements entered into after June 3, 1996, the date the Proposed Regulations appeared in the Federal Register.

In response to the immediate effective date for disqualified leasebacks and long-term agreements, we understand that lessors and lessees have, in many cases, switched from rental patterns that conformed with prior law, for instance the standards set forth in Rev. Proc. 75-21, but which did not come within the safe harbors of the Proposed Regulations (e.g., 90/110), to rental patterns that satisfy the safe harbors of the Proposed Regulations. Old law would apparently control treatment of such restructured lease agreements, since the restructured leases are not disqualified within the meaning of the Proposed Regulations, and the such treatment under old law differs in significant respects from the treatment provided by the Proposed Regulations.

For example, the Proposed Regulations provide that rents allocated to a rental period that straddles the end of the year are to be taken into account ratably over the rental period, whether paid in the first calendar year or the second, whereas under old law the full amount of any such rent paid in the first calendar year would have been taken into income in that year, regardless of the fact that pan of the payment was allocable to the second calendar year.

It seems unfair to require taxpayers to structure leases to conform with the standards of the Proposed Regulations to avoid constant rental accrual, but then not allow the treatment of their restructured lease to be governed by the Proposed Regulations. In other words, it a taxpayer conforms its rent schedule to the Proposed Regulations (which may be disadvantageous to the taxpayer, but which the taxpayer may be economically compelled to do to avoid the penalties applicable to a "disqualified" agreement), it should be allowed to apply the Proposed Regulations if such application would be advantageous to it.

We therefore suggest that consideration be given to permitting taxpayers to choose to voluntarily apply the Proposed Regulations to any rental agreement that is a long-term agreement or leaseback entered into subsequent to promulgation of the Proposed Regulations and prior to promulgation of final regulations.[133]

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[133] Query, however, with respect to the need for lessee/lessor consistency in this regard since it may be difficult to structure the election so that it binds both panics. A consistency requirement would seem most appropriate in the case where a lessee and lessor are related.