



Warren & Selbert

Simple as ABC.

467 Rent Structures

The Internal Revenue Service released final regulations for Section 467 Rental Agreements in May 1999. These regulations addressed the issue of how to report rental income for rental structures with increasing or decreasing rent payments that were outside the 90-110 limits required by the IRS Rent Test in Rev. Proc. 75-21.

The cash rent pattern may differ significantly from the IRS's required 90-110 rental income pattern by use of a 467 loan that keeps track of the cumulative difference between the cash received to date and the allocated rental income reported to date.¹ These 467 prepaid/deferred rental structures are based on the concept that the present value at 110% of the Applicable Federal Rate (AFR)² of the cash rent received equals the present value of the allocated rent that conforms to the 90-110 rent test. Although this comparison of cash rent to allocated rent can be performed on either an annual or rental periodicity basis, the annual method is more common.

Since the present value of the cash rent equals the present value of the allocated rent and the total taxable income must equal the cash received, the tax effect of the rent is split between allocated rent (which satisfies the 90-110 IRS Rent Test) and allocated interest calculated using a 467 loan. A 467 loan has a starting balance of zero and debt services equal to the periodic or annual difference between allocated rent and cash rent. The balance on the 467 loan represents the cumulative difference to date between cash rent received and taxable income accrued and is called the Prepaid/Deferred Balance.

In renewable energy structures, there is often a large prepayment of rent resulting in a corresponding Prepaid Balance. This can benefit the economics of the transaction because the lessor receives cash at the beginning of the transaction but the taxable income is spread over the life of the lease by the 467 loan. The prepayment reduces the lessor's net investment and allows for lower future rent and lower total rent than had there been no prepayment.

The calculation of Termination Values must take into account the Prepaid/Deferred Balance to make cash and taxable income agree upon termination. There can be either a Cash Adjustment, with the Lessor refunding the prepaid rent balance to the Lessee or collecting any deferred rent balance from the Lessee; or with a Tax Adjustment, with the Lessor taking into income the prepaid rent balance or removing from income any deferred rent balance. For both methods, the net Termination Value that the lessee pays is the same.

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¹ No 467 loan is required for rental structures where cumulative cash rent through any calendar year is least as much as the cumulative allocated rent through the previous calendar year and no more than the cumulative allocated rent through the following calendar year. This structure is referred to as a three-year window structure.

² Applicable Federal Rates are published monthly by the IRS and can be found at <https://apps.irs.gov/app/picklist/list/federalRates.html>