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Why Prepaid Rent (Unfortunately) Isn't Nonqualified Financial Property

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Occasionally new markets tax credit (NMTC) transactions are structured such that the qualified active low-income community business (QALICB) makes a one-time, up-front, rent payment to its lessor. A frequently raised issue is whether this prepayment could be reclassified as a loan by the Internal Revenue Service (IRS) or a court, which presumably would make the prepayment a prohibited nonqualified financial property (NQFP). This article argues that in the non-NMTC world, and even though many taxpayers would prefer otherwise, pre-paid rent is almost never classified as a loan. Given this, this article maintains that it is extremely unlikely that the IRS could take the position that prepaid rent is NQFP because it is simply contrary to the law and would create enormous income tax deferral opportunities. This month, part one of this two-part series on prepaid rent explains the rules that existed before Congress and the IRS got smart and started making our tax system take into account the time value of money concepts. Next month, part two will deal with what happens under Section 467 of the Internal Revenue Code (IRC).

Under Section 45D of the IRC, community development entities (CDEs) are authorized to designate investors' equity contributions into those CDEs as qualified equity investments (QEIs), entitling the investors to NMTCs. The CDEs are then required to use such QEIs to make qualified low-income community investments (QLICIs) in QALICBs during a seven-year compliance period. Section 45D(d)(2) sets forth the various tests that must be satisfied in order for the borrower to be a QALICB, one of which is that the adjusted basis of any NQFP held by the QALICB can't exceed 5 percent of the adjusted basis of all of the QALICB's assets. Loans are NQFP, as is stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts and annuities. The legislative history of the NMTC is sparse, but presumably the policy rationale of the NQFP prohibition is that Congress wants to subsidize active business activity, not passive investing.

The Rules When Code Section 467 Does Not Apply

When a lessee pays a dollar of rent to the lessor, the tax consequences are generally straightforward: the lessee has a dollar of ordinary and necessary deduction under IRC section 162(a), and the lessor has a corresponding dollar of income under section 61(a)(5). As long as the lessor and the lessee are in the same tax bracket, everything matches and there is no incentive for the parties to get cute. But when the lessee is in a lower tax bracket than the lessor or, even better, when the lessee is tax indifferent, the parties may be incentivized to try and book the payment from the lessee to the lessor as something other than rent. If the parties can get the payment to the lessor on a tax-free basis, then the lessor might well be willing to charge the lessee a lower overall "price" for the use of the property; in that circumstance both the lessor and the lessee benefit from this creative tax planning.

So how would the lessee get the payment to the lessor on a tax-free basis? One popular idea was to have the tenant prepay all of the rent that would otherwise be due under the lease, and then book the prepayment as a loan. In the Tax Court (TC) Memo regarding the *Spa Building Corpora-*

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tion in 1974, the court found that: "this type of issue is litigated with a fair degree of frequency." But the courts aren't so keen on this strategy. In *U.S. v. Williams*, (395 F.2d 508 (C.A.5. 1968)) the court found that: "The terms of the agreement, its formality and structure, cannot disguise the economic reality of the transaction [which was prepaid rent, not a loan]." And in *Blue Flame Gas Co.* (54 TC 584 (1970)) the court ruled that: "The assertion that payment from a lessee constitutes a loan will normally invite close scrutiny [and] the burden of proof … is particularly heavy where the purported loan is received from the lessee under circumstances suggesting the payment is … of advance rentals." Further, in *Seahill Co.*, in TC Memo 1964-56, the court found that: "Petitioner has not proved that the amount was a loan or anything other than what it purported to be; that is, advance rental payments." And finally, in *Kohler-Campbell Corp. v. U.S.*, (189 F. Supp. 818 (1960)) the court found "it was only after agents of the Revenue Department had constituted and filed the assessment that a loan agreement was made known and contented for."

In some of the forgoing cases the taxpayers did a really great job of dressing up the arrangement; in others, not so much, but in each instance the court roundly rejected the taxpayers' assertions and reclassified the "loans" as exactly what they really were: prepaid rent, also known as gross income, subject to tax under IRC section 61(a).

Treasury also got wind of these games and, to make it perfectly clear that prepaid rent is not a loan, promulgated Treas. Reg. § 1.61-8(b) in 1957. That regulation specifically requires that regardless of its accounting method, the lessor must take into income any amounts received for the use of property, with one exception. The exception is if the enormously complicated rules under IRC Section 467 apply. The regulations implementing these rules, which span more than 30 pages, basically apply the time value of money concepts to payments for the use of property. Section 467 applies in a number of instances, including when there is "prepaid rent" as defined in Treas. Reg. § 1.467-1(c)(3). Is this the loophole pursuant to which a lessee can get rent tax free to a lessor? If so, is this what the IRS would use to recharacterize prepaid rent as a loan, which would presumably be NQFP? These questions will be discussed in next month's article.

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