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

Part Two

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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 by the Internal Revenue Service (IRS) or a court as a loan, which presumably would make it a prohibited nonqualified financial property (NQFP). This article argues that in the non-NMTC world, and even though many taxpayers would prefer otherwise, prepaid 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. Last month, part one of this two-part series on prepaid rent explained 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. This 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) of the IRC 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 cannot exceed 5 percent of the adjusted basis of all of the QALICB's assets. Loans are NQFP, as are 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.

Last month's article argued that the IRS would be unlikely to argue under pre-IRC Section 467 law that prepaid rent paid by a QALICB to its lessor would be a loan because of the enormous deferral opportunities that position would create in non-NMTC transactions. Under pre-IRC Section 467, those payments are income to the lessor, so they cannot also be loans. If they are not loans, then they should not constitute NQFP. This month, part two of this two-part series on prepaid rent, explains the rules that exist under IRC Section 467.

Section 467 Rental Agreements

IRC Section 467 applies to rental agreements. A "467 rental agreement" includes rental agreements that contain "increasing or decreasing rents;" "deferred rents;" or "prepaid rents." Each of these terms has a peculiar definition. The peculiarity stems from the fact that the 467 regulations assume that the rent schedules in most leases have three columns rather than the two columns with which we are typically familiar: the year and the amount to be paid in that year. The strange new third column is labeled "rent allocation." In other words, the regulations assume (and permit, within certain limitations) that the parties might decide to book the tax consequences of the rent payments other than as they are paid. For example, in a three-year lease, the parties might pay even amounts of rent in each year, but book all

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the income and deductions in the last year.

For purposes of analyzing prepaid rent, let's say we have a 10-year lease for $1 million, all of which is paid in the first year. Since no rent is paid in the second year, it certainly sounds like we have either decreasing rents or prepaid rent, either of which would mean we have a 467 rental agreement that would be subject to the complicated IRC Section 467 rules.

Increasing or decreasing rents exist if the "annualized fixed rent" allocated to any "rental period" exceeds the annualized fixed rent allocated to any other rental period in the lease term. Annualized fixed rent is determined by multiplying the "fixed rent" "allocated to the rental period" by the number of periods of the rental period's length in a calendar year. Fixed rent is any rent to the extent its amount and the time at which it is required to be paid are fixed and determinable. Importantly, the taxpayer in determining what constitutes fixed rent is specifically required to ignore the possibility of default under the rental agreement, as well as the possibility that one of the parties may be insolvent. See Treas. Reg. § 1.467-1(h)(1) & (2).

How is this fixed rent allocated to the rental period? If the rental agreement specifically allocates (a) for periods no longer than a year, an amount of rent for which the lessee becomes liable on account of the lease during that period, and (b) the total amount (for all periods), so specified totals the total amount due under the lease, then the amount "allocated to each rental period" will be whatever is specified on the rent schedule.

So do we have increasing or decreasing rents and therefore a 467 rental agreement? That depends on how we allocate the rent for tax purposes on the rent schedule in the third column discussed above. Let's take two scenarios based on our $1 million prepayment example above: in the first, assume we spread the $1 million rent allocation over the 10-year term, such that $100,000 is allocated to each year; in the second, assume that we simply allocate the $1 million just as we paid it: i.e. the full $1 million in the first year. Note in both instances the total rent allocated equals the total amount paid.

In the first scenario, because the rental amount allocated to each year is the same, the annualized fixed rent allocated to any rental period obviously can't exceed the annualized fixed rent allocated to any other period, so we have don't have increasing or decreasing rents. In the second scenario, because the annualized fixed rent allocated to the first year exceeds the annualized fixed rent allocated to the second year (and every year thereafter), we have increasing or decreasing rents and therefore have a 467 rental agreement.

Because, under the second scenario, we have a 467 rental agree-

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If the rental agreement specifically allocates (a) for periods no longer than a year, an amount of rent for which the lessee becomes liable on account of the lease during that period, and (b) the total amount (for all periods), so specified totals the total amount due under the lease, then the amount "allocated to each rental period" will be whatever is specified on the rent schedule.

ment, we have to determine how to allocate the rent. There are three methods of doing this, which are mandated to be applied and are not optional. The first, "constant rental accrual," requires that the Commissioner affirmatively determine that because of a tax avoidance purpose, the agreement should be treated as a "long term lease" or a "disqualified leaseback." If the lessor and the lessee's marginal tax rates do not differ by more than 10 percent, there is what amounts to a "no tax avoidance purpose" safe harbor and constant rental accrual should not apply. See Treas. Reg. § 1.467-3(c)(2)(ii). For our purposes, we will assume the lessor and lessee have the same tax rates.

The second method, called "proportional rental accrual," applies if the constant rental accrual method above does not apply (and we concluded above it doesn't) and the 467 rental agreement does not provide "adequate stated interest on fixed rent." When proportional rental accrual applies, then the fixed rent for a rental period is the "proportional rent amount."

The third method, called "Section 467 rental accrual," applies if the 467 rental agreement does provide adequate stated interest on fixed rent. If this method applies, then the fixed rent for the rental period is whatever is written on the rent schedule.

Given this, whether we apply the second or the third method turns on whether we have adequate stated interest with respect to the 467 rental agreement. A 467 rental agreement provides adequate stated interest if, among other things, it does not contain prepaid rent.

One could reasonably conclude we have prepaid rent given we are paying all the rent in the first year. However, for these purposes prepaid rent exists only if the cumulative amount of rent payable at the end of a year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year. The rent payable under our lease is all paid in the first year and, under our second example, the allocated rents and payable rents are identical since the allocated rent is also being booked in year one. Given this, the cumulative amount of rent payable as of the close of the first year cannot exceed the cumulative amount allocated as of the close of the succeeding year, because there is no rent paid or

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allocated in the second year. The same rationale applies for all the remaining years. Given this, we do not have prepaid rent, so we have adequate stated interest, and we are therefore required to use the Section 467 rental accrual method.

Note however, that in the first example in which we prepaid all the rent but spread the allocation out over the entire lease, then we would have prepaid rent because the million dollars paid in the first year would exceed the $200,000 allocated by the end of the second year. If we had prepaid rent, we would have a 467 rental agreement but would not have adequate stated interest, so the proportional rental accrual method would apply. But making proportional rental not apply is generally as simple as booking the rent payments as they are actually paid.

Conclusion

The bottom line is that so long as you book the tax consequences of rent payments in the years in which they are paid, and as long as the lessor and the lessee's marginal rates are not expected to differ by more than 10 percent during the term of the lease, you will never have prepaid rent or deferred rent for purposes of Section 467, even if the rent is prepaid or deferred in common parlance. If you don't have prepaid rent or deferred rent for purposes of Section 467, then the rent allocations are simply those stated on the rent schedule: no complicated interest calculations are required. Complicated calculations which could raise NQFP issues will generally only arise if the parties are trying to book the rent allocations other than as they are being paid. Given this, under both Section 467 and the authority that existed before Section 467, none of the rent is required (or, indeed, permitted) to be recharacterized as a loan. If none of it is a loan, none of it should be NQFP.

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