

*Note: This is an expanded version of the Federal Insight column that was published in the November/December 2015 issue of ELFA's Equipment Leasing & Finance Magazine.*

## **Non-Level Rents: Issues and Opportunities**

### **Detailed Analysis**

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#### **Background**

The leasing industry is known for creativity as well as its ability to adapt to industry changes such as the types of assets leased and tax law changes. Congress long ago recognized that tax benefits can promote investment in capital assets by lowering the net present value cost of acquiring assets.

Similarly within the tax leasing world, long ago leasing professionals realized the power of the time value of money and of tax benefits. They recognized the benefit of accelerating tax deductions and deferring taxable revenues.

These practitioners realized that there was little they could do to affect the existing tax depreciation rules that established the basis and method for depreciating assets, but they continued to seek the benefits from deferring rental income, suitable especially for lessees with excellent credit. Perceived abuses prompted the Treasury to establish tax rules to limit the deferral of rents.

#### **Application of Tax Laws (*in general*)**

For many years Congress sought to craft tax rules to rein in the perceived structuring abuses. As it turned out, not all lease payment structuring was purely tax-motivated. Often rental structuring was to accommodate the seasonality of the lessee's business or underlying cash flow availability. In the real estate market, lessors argued that leases were often for extended terms and the norm was to start rents at a defined level and escalate them annually consistent with usual inflationary trends to cover rising operating expenses such as maintenance and energy costs.

Finally in 1984 Congress drafted Section 467 of the Internal Revenue Code ("IRC") and included it in the Deficit Reduction Act of 1984. Fifteen years later in 1999, final Treasury regulations were issued with additional revisions issued in 2001. Clearly, the long delays indicate that the rules were much more complicated in the details than on the surface.

These Section 467 rules, sometimes referred to as the "level rent" rules, established the baseline rules when lease payments are level enough and also when they may be reallocated by the IRS. In essence, Section 467 created a series of safe-harbors for rental patterns that would be respected and not challenged by the IRS.

In general, some forms of uneven rents, especially contingent rents, are acceptable, such as those

that vary (i) due to asset usage (such as mileage incurred), (ii) due to changes in third-party costs (such as utility costs) or (iii) based on an underlying index (such as the cost of funds).

The first basic safe-harbor was for leases in which the aggregate rents are equal to or less than \$250,000. If total rental payments under a lease are equal or less than \$250,000, then the lease will not be considered a Section 467 rental agreement.

The second basic safe-harbor permitted an initial deferral of rents (called a *rent holiday*) for up to 3 months with no need to justify or validate the holiday.

The third basic safe-harbor rule pertaining to equipment leasing is often described as the “90/110” rule. The 90/110 rule states that as long as the rents fall within 90% and 110% of the average annualized rents, they will be respected insofar as the non-level nature of the rents is concerned. This also incorporates the rent holiday rules mentioned above related to equipment leasing.

With respect to leases involving real estate, Section 467 created a safe-harbor which was somewhat broader than the equipment safe-harbor. For leases involving real estate assets, the rents may vary as much as 85% and 115% of the average annualized rents and still be respected by the IRS with respect to the evenness of the rents. In determining whether the 85/115 uneven rent test has been met, any rent allocated to a rent holiday period that does not exceed the lesser of 24 months or 10 percent of the lease term would be disregarded.

Note that real estate tax rules extend to certain facilities which may contain a substantial equipment component. Under Section 467, real property will follow the definition set forth for real property in Treas. Reg. Section 1.856-3(d). For example, a datacenter is a building that often includes a large component of its cost in assets that are characterized as equipment for tax depreciation purposes and thus has a shorter tax depreciable life, often 7-years. The question here would be whether the lease is subject to the 90/110 rules or the 85/115 rules. It would naturally be more conservative to comply with the 90/110 rules when the underlying assets can be considered to be a mix of real estate plus equipment. For the 85/115 exception to apply, at least 90 percent of the leased property (determined on the basis of fair market value as of the lease agreement date) must consist of real property.

### **Specific Tax Rules (*in detail*)**

Section 467 concerns the timing of the recognition of income and deductions by lessors and lessees under certain leases that do not have level rental payments. Congress believed that the parties should report rents on an accrual basis under certain leases. Also, Congress believed that if rents are not paid on a current basis, an interest element is present as an economic matter.

The Section 467 rules generally “trump” other federal income tax rules governing the recognition of income and deductions.<sup>1</sup> For example, the normal rule that requires a lessor to recognize advance rentals in the year of receipt, regardless of when the period covered or

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<sup>1</sup> Section 467(a).

taxpayer's method of accounting, are overridden by Section 467.<sup>2</sup> Similarly, the general rules governing deductions and "economic performance" for a lessee are superseded by Section 467.<sup>3</sup> Thus, if Section 467 applies, the amount of rent and interest that a lessor or lessee must recognize for federal income tax purposes will be determined under the Section 467 rules. In effect, within broad statutory parameters, the Section 467 rules allow a lessor and lessee to determine their own tax reporting arrangement. The flexibility afforded to taxpayers is not without limitation; in certain cases, the IRS can reallocate the rental schedule set forth in a lease under the "constant rental accrual" method.

Section 467 is applicable to leases of tangible property.<sup>4</sup> Accordingly, the initial determination is whether the agreement between the parties is a lease for tax purposes or another type of agreement (e.g., sale, financing, service contract, partnership, etc.).

Next, the determination whether any payment under the lease should be characterized as rent must be made by the parties. There is no specific definition of rent under the Code and Treasury Regulations. Rent includes amounts received or accrued for the occupancy of property.<sup>5</sup> Rents do not include payments required for use or possession of property if the taxpayer is taking an equity interest.<sup>6</sup> In addition, rents do not include capital improvements on property of which the taxpayer is a lessee, unless the costs of such improvements are structured as substitutions of rent.<sup>7</sup> Thus, whether payments will be considered rent is a question of fact that will be determined in light of all facts and circumstances surrounding the payments.

After it has been determined that (a) the transaction is a lease; and (b) the payments under the transaction are rent; then a lease will be treated as a Section 467 rental agreement if the lease has increasing or decreasing rent or has prepaid or deferred rent. A rental agreement has increasing or decreasing rent if the annualized fixed rent that is allocated to any rental period exceeds the annualized fixed rent allocated to any other rental period. Deferred rent ("Deferred Rent") exists if the cumulative amount of rent allocated as of the close of a calendar year exceeds the cumulative amount of rent payable as of the close of the succeeding calendar year. Prepaid rent ("Prepaid Rent") exists if the cumulative amount of rent payable as of the close of a calendar year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year.

As discussed above, if the total fixed rent to be paid under the lease is \$250,000 or less, Section 467 will not apply to the agreement regardless if the lease has increasing or decreasing rent. Also, an agreement will not have increasing or decreasing rent if such increase is solely attributable to a rent holiday provision allowing for reduced rent (or no rent) for a period of three months or less at the beginning of the lease term.

In addition, generally, contingent rent will not cause a rental agreement to be subject to Section 467 because the rents may increase or decrease. The regulations under Section 467 disregard

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<sup>2</sup> Treas. Reg. Sections 1.61-8 and 1.451-1(g).

<sup>3</sup> Treas. Reg. Sections 1.461-1(a)(1) and 1(2)(iii)(E) and 4(d)(3)(ii)(B).

<sup>4</sup> To the extent the agreement is for the use of intangible rights, Section 467 would not apply.

<sup>5</sup> Treas. Reg. Section 1.61-8(a).

<sup>6</sup> Section 162(a)(3).

<sup>7</sup> Treas. Reg. Section 1.162-11(b).

certain categories of contingent rent in determining whether a lease has increasing or decreasing rent:

1. Qualified percentage rent (e.g., % of gross rent)
2. Adjustments based on a reasonable price index
3. A provision requiring the lessee to pay third-party costs
4. A provision requiring the payment of late payment charges
5. A loss payment provision
6. A qualified terminal rental adjustment clause (TRAC)
7. A residual condition provision
8. A tax indemnity provision
9. A variable interest rate provision

After it has been determined that (a) the transaction is a lease; (b) the payments under the transaction are rent; and (c) the lease is a Section 467 rental agreement, the timing of the amount of fixed rent recognized by both the lessor and lessee is determined using one of three rental accrual methods under Section 467: (i) rental agreement accrual; (ii) proportion rental accrual; and (iii) constant rental accrual.

If the agreement is a Section 467 lease agreement that has Prepaid Rent or Deferred Rent and does not provide for adequate interest, the fixed rent of each rental period is the proportional rental accrual amount. Generally, the proportional rental accrual method is applied if the payment schedule under the lease is different than the accrual schedule under the lease. This provision allows taxpayers to elect to apply the rent leveling provisions of Section 467 to the agreement by establishing a payment schedule that does not equal a separately stated allocation schedule. Proportional rental accrual will create a deemed Section 467 loan.

The constant rental accrual method applies if the Section 467 rental agreement is a leaseback or long-term agreement and it is disqualified. A rental agreement is long-term if the lease term exceeds 75% of the property's statutory recovery period (real estate has a recovery period of 19 years for Section 467 purposes). The lease term includes any period during which the lessee has the use of the property including options to renew if the lessee is reasonably expected to exercise the option. All lessor options are deemed exercised. A lease is disqualified if the Commissioner of the IRS determines that the principal purpose for providing increasing or decreasing rent is the avoidance of federal income tax. Constant rental accrual will create a deemed Section 467 loan.

Similar to the safe harbor rules for determining if a lease is a Section 467 rental agreement, the Regulations under Section 467 contain certain safe harbors for determining whether a Section 467 rental agreement should be disqualified, and thereby at risk for the IRS to require the parties of the lease to utilize the constant rent accrual method:

Safe Harbors: Lease is Not Disqualified

- i. Uneven rent safe harbor
  1. Personal property: 10% variance
  2. Real property: 15% variance if long term agreement
- ii. Rent holiday:

1. Lesser of 24 months and 10% of the lease term; and
  2. Such rent holiday is commercially reasonable.
- iii. Contingent rent
1. Qualified percentage rent (e.g., % of gross rent)
  2. Adjustments based on a reasonable price index
  3. A provision requiring the lessee to pay third-party costs
  4. A provision requiring the payment of late payment charges
  5. A loss payment provision
  6. A qualified terminal rental adjustment clause (TRAC)
  7. A residual condition provision
  8. A tax indemnity provision
  9. A variable interest rate provision

If the constant rental accrual and the proportional rental accrual method do not apply, the lessor and lessee accrue fixed rent for each rental period as allocated by the rental agreement. If the lease does not contain a separately stated allocation schedule, the payment schedule will be treated as the allocation schedule. Note that the IRS may apply other authorities such as Section 446(b) clear-reflection-of-income principles, Section 482 and the substance-over-form doctrine to determine the income and expense from a rental agreement.

### **Possible IRS Reallocation**

It may be appropriate at this time to mention that a lease may be structured with non-level rent variations and when such rent variations comply with the safe-harbor general tax rules indicated above, the rental payment structure will be respected by the IRS. When the rent structure fails the Section 467 safe-harbor level rent rules, the IRS may challenge the rent allocation and attempt to reallocate the rents to be in compliance with Section 467.

Thus, when a lease rent structure fails the Section 467 safe harbor guidance, the lessor and lessee should consider the risks of such a failure, especially the economic effects of a reallocation of the rents by the IRS, not to mention the other avenues of audit that such an action by the IRS may open.

Subsequently we will refer only to the 90/110 rules (not 85/115) as most equipment lessors are affected more by the 90/110 rules. Once the rents fall outside those 90/110 parameters and the other safe harbor criteria, the IRS may challenge the allocation of the taxable revenue and may change it to comply with the limitations. Essentially what the IRS would do is to re-characterize any rents which fall outside a straight line allocation schedule, initially as a deemed Section 467 loan between the lessee and lessor as the case may be and then subsequent cash rent payments would be allocated to rents and then loan interest and principal repayment.

By the end of the lease, the gross amount of the taxable rental revenue from the lease is reallocated and recognized as a combination of taxable rental revenue and tax deductible interest expense for the lessor, or in the case of the lessee as tax deductible rental expense and taxable interest income in the case of decreasing rent.

In the end, the total taxable revenue reported *is exactly the same* as before the allocation; only the *timing* of the taxable income is different. If the rent payments are underpayments at the inception of the lease, with much greater payments later, an opposite pattern is experienced. That is, the lease payments could result in either a deemed Section 467 loan *from the lessee to the lessor* or a deemed Section 467 loan *from the lessor to the lessee*. Note that the deemed Section 467 loan could swing back and forth during the life of the lease; that is, in the case of large variations in the rental structures, the lessor could be either a tax loan lender or tax loan borrower.

### **Applicability of Section 467 in a Lease Transaction**

A Section 467 loan can be *intentionally* incorporated into a lease structure to achieve a particular objective. For instance a lessor may desire to receive a large advance rent payment to act as a credit enhancement to the lease. Additionally by permitting a large rent deferral, the lessor may be assisting with the lessee's cash flow.

Absent an acceptable credit rating or an established operating history and substantial financial strength, investors often seek to mitigate credit risk with other forms of credit support. Often structural enhancements are needed to make an investment palatable for the investing community. Here is where the Section 467 loan structure may be used to receive a large advance payment of rent to improve the credit profile of the transaction.

That is, by receiving a large advance rent payment, the lessor can better support granting credit to the lessee, partially because by reducing up front the lessor's net investment in the lease with this large payment, the liquidation value of the leased asset better supports the outstanding lease balance. Often at the inception of a lease the liquidation value of the asset is only a portion of the lessor's net investment in the lease. The lessor normally views this difference as an unsecured risk. In a lease to a non-investment grade lessee, paying down the net investment earlier reduces the unsecured risk and improves the credit profile of the transaction.

The existence of a Section 467 loan does not affect the tax characterization of a lease, i.e., its existence does not recharacterize a tax lease as a loan for tax purposes. However, there are situations where the size of the advance rent payment may 'jeopardize' the tax treatment of the lease if the prepayment of rent is deemed an actual loan between the lessee and lessor, something not permitted under Revenue Procedures 2001-28 and 29. Each use of a prepayment of rent may warrant a separate analysis by tax counsel.

Two examples where leases with prepayments of rent have arisen in recent years are as follows:

- (i) Small Solar Energy Projects - An example of the use of a prepayment of rent is within the smaller solar energy sector (non-utility grade). Individual smaller solar energy projects are often developed and sold to a special purpose entity ("SPE") so that the contract to sell that energy, known as the production purchase agreement ("PPA") and the resultant revenues associated with the sale of the energy, can be isolated to ensure that the project repays its investors. Under certain structures the developer owns the SPE but does not guarantee the obligations of the SPE. Even if the owner did guarantee the obligations of the

SPE, often the developer's assets and resources are not sufficient for a lessor to rely on. Thus, in the event of a default, the lessor has only the remaining rent obligations and the underlying collateral value of the asset to pay back their obligations.

In a usual sequence, the developer sells the solar project to the SPE, earns a profit on the development and construction and tries to "cash out" their profit as soon as possible. The lessor/investors on the other hand are usually investing in the projects for an economic return, often relying on the tax benefits as a major element of those returns.

In cases where a sale-leaseback is appropriate, the project is sold to an investor (the lessor) which then leases it back to the SPE. The developer acts as a manager of the SPE and is able to retain any revenues from the PPA that are in excess of the lease payments. These structures are typically for somewhat smaller projects which do not warrant a more highly-structured financial arrangement.

To ensure that the developer remains committed to the project and is available to ensure that the project continues to operate as expected and that the PPA produces the revenues expected to provide that return, lessor/investors usually will desire to limit the developer's ability to withdraw cash from the SPE and to also retain a cash "cushion" in the event the project does not deliver the power levels incorporated into its economic plan.

Herein lies an additional reason to incorporate a prepayment; namely to ensure that the developer maintains an economic investment in the project. In this case the prepayment was incorporated principally as a credit enhancement element. And, by structuring the transaction to meet the proportional rental accrual method requirements under Section 467, *the lessor will not have to recognize all of the prepaid rent as income* when received. By requiring a payment of about 20% early in the lease, the lessor may feel more comfortable that this advance payment brings their net investment down to be more in line with the projected liquidation of the leased asset.

- (ii) Cell Tower lease; another recently seen type of transaction incorporating Section 467 structuring within a lease, is for a lease of cell towers. In this case the developer identifies a suitable location for the cell-tower, secures lease rights to the underlying land, obtains access to power, and assembles the actual tower.

In this case the lessor may actually request a lease rental payment equal to the present value of 100% of the rents due! This will be explained further below. Under these scenarios, tax counsel will examine the terms and conditions of the lease to ensure that despite the 100% upfront rental payment, the lease

continues to qualify as a true tax lease for tax purposes. In this case, the transaction is being driven by the demands of the cell tower lessor, who wants to safeguard payment on the lease on the tower.

### **Step-by-Step Structuring of a Lease with a Section 467 Loan**

When a lessor requires a large upfront rent payment, rather than fail the Section 467 rules and be subject to a potential IRS allocation, a lessor and lessee may intentionally establish and document in advance a Section 467 loan within a tax lease structure. That is, they both agree that the lease structure includes a Section 467 loan and incorporate it into both the transaction economics and the documentation of the lease. This is accomplished by having a rent payment schedule and separately stated rental allocation schedule which meets the Section 467 safe harbor requirements set forth in the lease.

*Note that a deemed Section 467 loan is not a loan for accounting or legal purposes.*

In general and from what we have seen in the leasing industry, a few basic constraints have emerged when structuring a lease to intentionally include a Section 467 loan;

- (i) First, the large rental payment that creates the 467 loan is generally made at least a month or two after the inception of the lease. The purpose for this delay is to demonstrate that the asset could be financed by the lessor without the providing of the Section 467 loan. Revenue Procedure 2001-28 (“Rev. Proc. 2001-28”) prohibits a lessee from making a loan to the lessor to fund the purchase of the asset, at the risk of having the lease challenged by the IRS as not being a true tax lease. Rev. Proc. 2001-28 is the safe-harbor guidance often used for structuring complex tax-leveraged leases, but it has been adopted by the leasing industry as good guidance when structuring single-investor (i.e., internally funded) leases.

By structuring the large Section 467 rental payment in theory after the purchase of the asset has been completed by the lessor, the lessor has demonstrated that the Section 467 loan is not an actual loan in the legal sense, but merely an advance rental payment that creates a Section 467 loan.

- (ii) Second, the interest rate established within the Section 467 loan should be not less than 110% of the Applicable Federal Rate for a similarly-termed loan. When structuring a lease with a Section 467 loan, the lessor and lessee stipulate an actual interest rate that will be used by both parties when filing their tax returns. An excessively low rate would create only a nominal allocation of interest from the Section 467 loan.
- (iii) Third, for Section 467 loans that are part of an equipment sale-leaseback from the lessee to the lessor, the maximum amount of an initial rent payment that creates the Section 467 loan is usually limited by tax counsel to about 20%. This 20% is an industry-established level at this time, found usually within transactions which involve a sale from the lessee to the lessor with a

subsequent leaseback. We believe this “comfort level” was established by tax opinion-providing tax counsels so as to again ensure that the Section 467 loan is not an actual loan used to fund the asset acquisition by the lessor.

With certain leasing transactions, the advance rate of a rent payment that initially establishes the Section 467 can be as high as 100% of the present value of the rents otherwise due. Those transactions are most often closely examined by tax counsel to ensure that the lease meets the tax guidance and that tax ownership clearly resides with the lessor. Those transactions are usually originated without a sale-leaseback from the lessee, so the question of a lessor using a lessee loan to acquire the asset is less of an issue.

Once the Section 467 constraints are determined, other standard pricing elements of the lease are determined, such as the targeted return value and method (pre-tax return-on-equity (PT-ROE), after-tax return-on-equity (AT-ROE), internal rate of return (IRR), etc.), leverage of the underlying investment, tax depreciation method, tax rates etc.

For instance, if the lease is to be structured with a two-month rent holiday and a 20% rent payment and straight-line allocation to create the Section 467 loan, using the other target parameters and constraints input into the pricing model, the lease pricing model will determine the other rents needed to achieve the yield desired, including selected safe harbor constraints. Additional yield or lower rate can be obtained from the lessor or lessee’s perspective by either front-loading or back-loading the allocation schedule within the 90/110 (low-high) or 110/90 (high-low) safe harbors.

The pricing models provide various reports needed to document the lease (including the Section 467 loan).

The forms of the output documentation include:

- (i) a Cash Rent Payment Schedule, detailing the actual cash payments the lessee will make,
- (ii) a Rent Allocation Schedule, allocating the rent paid over the lease term that complies with the Section 467 safe harbor requirements and detailing the rent that both the lessee and lessor agree will be reported on their respective tax returns, and
- (iii) the Section 467 Loan and Amortization Schedule, detailing the amount the lessor and lessee agree will be (for tax-reporting purposes only) the Section 467 loan and hypothetical payment amounts allocated to that loan, along with an allocation between rent and interest.

Examples of the reports are included in the Appendix below.

Sounds easy? Thank goodness for the modern computer and linear programming! Trying to manually duplicate the steps that the pricing programs take to arrive at a Section 467 lease structure would probably take an enormous amount of time and can frustrate one when trying to understand how the results were created.

In general, the best known pricing models for optimizing lease structures with Section 467 loans are (i) Warner & Selbert's ABC, (ii) Interet's pricing model and (iii) Ivory Consulting's SuperTRUMP. The examples presented within this report were developed using SuperTrump.

### **Administration of a Section 467 Lease**

A lease with a Section 467 loan included is not as complicated as one might think. Obviously it is more complex than simply following the basic 90/110 rules, which most lessors generally follow when structuring single-investor leases.

However as you have seen above, there are circumstances when a Section 467 loan is a logical addition to a lease structure. For the most part, structuring a lease with the addition of a Section 467 loan is based on the facts and circumstances of the situation; that is, what amount of advance rent is desired by the lessor, what is needed to be compliant with tax rules and what is acceptable to the lessee.

Administratively we have found that most of the commonly available lease-accounting software packages do not include the ability to account for a lease with a Section 467 loan. Most lease accounting software allows for a separate book and tax treatment of the transactions, but generally not with a Section 467 loan. Instead, the Accounting and Tax Departments of the lessor must determine the administrative or reporting details.

We have found that there are essentially two fundamental approaches to accounting for leases with Section 467 loans; either by using the "portfolio" capabilities of the pricing models or by simply tracking the Section 467 loan's effect on manually maintained Excel worksheets. The portfolio-capabilities of the pricing models aggregate a portfolio of leases and provide portfolio-level reporting.

Nonetheless, it is still complicated and for this reason leases with Section 467 loans have generally been more prevalent in the big ticket arena; that is leases which are usually well-above \$50 million.

We do believe however that administering a portfolio of leases with Section 467 loans included can be adequately administered on an Excel worksheet and that perhaps the economic benefit to the lessor may be worth the effort.

### **Financial Implications**

To illustrate the effect of incorporating a Section 467 loan into a lease, we have provided the following basic examples. We start with a lease without a Section 467 loan as the base case; then add the Section 467 loan as a means of resolving a credit-related.

#### Example 1a - Base Case; Lease without Section 467 advance

Acme Solar is a small developer of moderate sized solar energy installations. Acme Solar has

successfully developed other solar installations but has a balance sheet of only \$2.0 million.

The typical installation costs Acme about \$8.0 million to which they will add a markup of \$2.0 million and then sell it for \$10.0 million to a project level special purpose entity (“SPE”) called Acme Solar Trust. The \$10.0 million is the fair market value of the solar facility based on the amount of energy it can produce and sell over the next 25 years.

Acme Solar does not have the tax capacity to utilize the 30% federal tax credit available for the installation nor the 5-year MACRS accelerated depreciation of the facility, both of which would normally pass through Acme Solar Trust to Acme Solar.

The projected future value of the facility is \$2.0 million (20%) at the end of a 15-year period Lease period. Acme Solar has arranged for a Power Purchase Agreement (PPA) for 20 years between Acme Solar Trust and Big Green Markets, an investment grade off-taker. Big Green will purchase all of the power generated by the facility over the next 20 years at a rate that will start at a rate about equal to the initial rents and will increase 2% annually, consistent with the long-term increases typically seen in their power market. Acme Solar will also maintain the facility during the term of the PPA and will receive a maintenance fee from Acme Solar Trust during the PPA term.

Acme Solar is seeking a lease which will match, to the extent possible, the projected cash flows from the PPA. Acme Solar is also seeking as much of a deferral in rents as is possible so that it can extract as much free cash from the trust as is possible.

Acme Solar has approached TriStar Leasing Inc to provide a lease to Acme Solar Trust based on the equipment value, the PPA between Acme Solar Trust and Big Green, and a corporate guarantee from Acme Solar. TriStar is a full taxpayer with a weighted average tax rate of 38.58% which includes the Federal rate of 35.0% and a 5.5% state tax rate. TriStar has sufficient tax capacity and capital to provide the lease. TriStar would require a 16% nominal pre-tax return-on-equity (“PT-ROE”) and would leverage the investment 10% equity and 90% debt with an internal cost of funds of 5%. TriStar is comfortable putting a 10% residual value assumption into the lease pricing.

TriStar calculates the lease rents assuming a level structure using quarterly lease payments in arrears for 62 quarters and assuming they can rely on Acme’s guarantee, believing it carries an S&P “A” rating. The total lease rents are thus \$7,070,982 with a quarterly rent of \$114,048. This lease provides TriStar Leasing with a PT-ROE of 15.80%.

Acme is satisfied with the lease structure and asks TriStar to commence their credit analysis and to provide a firm proposal.

(See the schedules which follow the article for summaries of the lease structures).

#### Example 1b – Base Case lease with a Section 467 loan added

Upon analyzing Acme’s financial statements, TriStar’s Senior Credit Officer (“SCO”) realizes

that Acme's financial position is insufficient to rely on the Acme guarantee.

TriStar's sales management would like to provide the lease and argues that TriStar will be receiving a \$3.0 million (30%) alternative energy investment tax credit upon entering the transaction and that the tax write-off of the asset is worth another \$3.3 million (project cost of \$10.0 million less 15% basis adjustment from the ITC times the 38.58% tax rate). TriStar's sales management thus asserts that 63% (\$6.3 million) of the \$10.0 million investment is returned simply through the tax benefits.

Understanding that Acme is profiting from the construction of the project and "cashing out" that profit when the asset is sold to them, TriStar's SCO wants to ensure that Acme stays involved with the running of the facility and also to enhance the credit profile of the transaction. The SCO thus requests that the first rental payment be maximized while still being compliant with the tax rules. After consulting with the Tax Department, sales management incorporates a 20% advance rent payment.

The aggregate rents are restructured such that the resultant rent structure is comprised of an upfront rent payment of \$2,000,000 and then 62 subsequent quarterly rents of \$81,790 for the same \$7,070,982. (For purposes of simplicity we have not included any initial rent holiday period before receiving the \$2,000,000 upfront rent; also some rounding has been incorporated.)

Analysis – Note that by incorporating the Section 467 loan structure into the lease the lessor has satisfied their SCO's credit risk concerns. By creating a large upfront rent payment through the Section 467 loan, the lessor has received more cash upfront in the lease and has also improved the economic return from the lease (see below). Obviously negotiating such conditions come with tradeoffs that the lessee may also request. The point of this is to illustrate how a Section 467 loan structure can help solve a credit related challenge while potentially improving a lessor yield or at least improving the chance of closing the lease transaction.

This structure has improved the PT-ROE to TriStar to 31.41% because while it accelerated the rents for cash purposes, it has not accelerated them for tax purposes to the same extent. The schedules which follow illustrate the cash flows and tax reporting. Likely the lessee would ask for a change in the aggregate rent amount given the large upfront payment; however we have maintained the aggregate total rents for illustrative purposes only.

Schedules 1-3 below represent the typical schedules to a lease which includes a Section 467 structure using the example discussed above. Schedule 4 illustrates the combined Section 467 rents with the Section 467 interest expense, demonstrating that the taxable income is the same, albeit recognized in a different pattern over the lease term.

#### Example 2 – 100% Prepayment of rents

Under this example, an existing lessor, Tower Leasing (the "lessor"), owns a large cell tower that is "old and cold" (i.e. Tower Leasing has been operating and using the property in its trade or business for many years prior and it is fully paid for and fully depreciated for tax purposes). The asset has a continuing value as a cell tower and a fair market value of \$125 million.

Tower Leasing would like to monetize the value of the asset so they can obtain cash to grow its business elsewhere but would prefer to avoid borrowing against the tower and a potential lease of the tower. Tower Leasing is thus deciding between selling the property and leasing the property. If they lease the tower and then borrow from a bank using the tower and the lease as collateral, should the lessee default there is a risk that the lenders would repossess the asset.

For purposes of this example, again assume the property is fully depreciated and that the lessor's tax rate is 35%. If the lessor sells the property they will receive proceeds equal to 100% of the value of the property (\$125 million), but will recognize a large taxable gain on the transaction; thus their net after-tax cash would be 65% of the sale price (\$81.25 million).

If the lessor instead leases the property under a Section 467 proportional rent prepaid lease structure, the lease will be taxed as rental income in accordance with the Section 467 schedule, with net interest deductions spread over the entire lease term as determined by the proportional rental allocation rules under Section 467 and no gain is recognized by the lessor because no sale has occurred. The lessor will receive proceeds upfront, but only equal to the present value of the fair market rent to be paid under the lease and not all of it is taxed upfront.

For example, assume;

- (i) the term of the lease is 20 years,
- (ii) the fair market value of the property is \$125,000,000 as above;
- (iii) the lessee prepays on the lease commencement date pursuant to the lease payment schedule, \$100,000,000 which equals 100% of rent due under the lease,
- (iv) the lessee and lessor assume a Section 467 loan interest rate of 3.180% annual interest,
- (v) the lease contains a separate allocation schedule that allocates the Section 467 taxable rent annually straight line (i.e., \$5,000,000/year) in arrears for each year of the lease (i.e., resulting in approximately \$6,833,927 Section 467 rent each year under the proportional rent accrual method), and
- (vi) a reasonable estimate of the fair market value of the leased property at the end of the lease term is \$66,332,443.

Analysis – Schedule 5 below presents the allocated Section 467 rent less the Section 467 interest expense and the net tax due on those amounts during the lease term.

In this scenario Tower Leasing has avoided a sale of their property for tax purposes but has received a significant upfront cash receipt, similar to that cash receipt as if they had sold the property, however the tax due on the transaction has been spread out over 20 years.

Assuming the lessee has the cash to pay the upfront lease payment, they are somewhat indifferent economically compared to buying and owning the asset because their tax deductible rents are somewhat consistent with how the asset would be depreciated for tax purposes. Note that this example is actually consistent with real transactions that have been seen in the marketplace.

To measure the economic benefit for Tower Leasing, we examine the net present value benefit

compared to selling the tower outright and paying a 35% tax. In this case Tower Leasing has obtained \$100 million as an upfront cash rental payment and pays future taxes on those rents over the next 20 years. The present value of the future tax payments discounted at 5% is \$23.68 million, providing Tower a net present value benefit of \$76.32 million.

On top of this, Tower Leasing still owns the tower which they expect to sell for \$66.33 million in 20 years. Assuming that is taxed at 35%, the net present value cash benefit from the future sale of the tower is \$14.33 million. Thus, Tower has obtained a net present value benefit of \$90.65 million (\$76.32 + \$14.33 million) compared to an outright sale of \$81.25 million.

This analysis would change based on the discount rate assumed and the facts and circumstances of the situation, but as in this case, one might find that the net present value benefit is greater for a Section 467 lease transaction than if the asset were merely sold outright. For example, if the future projected residual was only \$35 million, a greater portion of the benefit would be coming from the rents rather than the future residual value.

Essentially what the Section 467 lease structure has done is to enable the lessor to recognize the taxable gain on the transaction over 20-years rather than upfront. They have been able to receive and utilize upfront the \$100 million in cash while deferring the taxation of that amount.

Additionally the lessor still retains ownership of the tower and any value from it after the 20-year lease term.

A final potential benefit can also be experienced should the U.S. Congress actually reform the Tax Code and lower the corporate tax rate in the future as they have been promoting. In that case the future allocated Section 467 rents would be taxed at an even lower tax rate than the 35% indicated above.

## **Summary**

The power of a Section 467 lease structure can be used to enhance the credit profile of lessees as well as enhance the after-tax yield of transactions. It can also position the taxation of a lease to be prepared to take advantage of a potential corporate tax rate decrease should that occur.

Not all lease transactions can use a Section 467 tax loan structure because of the upfront cash rent required from the lessee. However as a tool a Section 467 lease should be considered for transactions where the unique circumstances may arise. As with many lease structuring techniques, knowing the tools that are available and testing their applicability through modeling and analysis is an important step to consider. You may find that the Section 467 tax loan structures could open the door to additional potential transactions.

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Cash Rent Payment Schedule

<u>Yearly Cash Rents Due</u>	<u>Annual Cash Rent Due Rents Quarterly @ \$81,790</u>
0	2,000,000
1	163,580
2	327,160
3	327,160
4	327,160
5	327,160
6	327,160
7	327,160
8	327,160
9	327,160
10	327,160
11	327,160
12	327,160
13	327,160
14	327,160
15	327,160
16	<u>327,160</u>
Total rents	<u>7,070,980</u>

Section 467 Calculated Rent Schedule

<u>Year</u>	<u>Annual Taxable Rental Income</u>
1	239,123
2	475,604
3	475,604
4	475,604
5	475,604
6	475,604
7	475,604
8	475,604
9	555,165
10	581,294
11	581,294
12	581,294
13	581,294
14	581,294
15	581,294
16	<u>579,680</u>
Total rents	<u>8,190,960</u>

**Section 467 Loan and Amortization Schedule**

<u>Year</u>	<u>Section 467 Loan Balance</u>	<u>Section 467 Interest Expense</u>	<u>Section loan 467 Repayment</u>
1	2,163,580	0	0
2	2,370,614	118,997	( 88,037)
3	2,352,553	130,384	148,444
4	2,333,500	129,390	148,444
5	2,313,398	128,342	148,444
6	2,292,191	127,237	148,444
7	2,269,015	126,071	149,247
8	1,215,400	124,796	1,178,410
9	1,028,114	66,847	254,134
10	830,526	56,546	254,134
11	622,071	45,679	254,134
12	402,151	34,214	254,134
13	170,135	22,118	254,134
14	0	9,357	179,493
15	0	0	0
16	0	0	0
Total		<u>1,119,978</u>	

**Summary of Annual Gross Taxable Rents less Sec 467 Interest Expense**

<b><u>Year</u></b>	<b><u>Calculated Rents</u></b>	<b><u>Sec 467 Interest Expense</u></b>	<b><u>Net Taxable Income (excluding depreciation)</u></b>
1	239,123	0	239,123
2	475,604	118,997	356,607
3	475,604	130,384	345,220
4	475,604	129,390	346,214
5	475,604	128,342	347,262
6	475,604	127,237	348,367
7	475,604	126,071	349,533
8	475,604	124,796	350,808
9	555,165	66,847	488,318
10	581,294	56,546	524,748
11	581,294	45,679	535,615
12	581,294	34,214	547,080
13	581,294	22,118	559,176
14	581,294	9,357	571,937
15	581,294	0	581,294
16	<u>579,680</u>	<u>0</u>	<u>579,680</u>
Total	<u>8,190,960</u>	<u>1,119,978</u>	<u>7,070,982</u>

Schedule 5

Tower Leasing Section 467 Advance Rent Analysis

<u>Year</u>	<u>Cash from Lease and Asset Sale</u>	<u>Calculated Sec 467 Rents</u>	<u>Section 467 Interest Expense @ 3.18%</u>	<u>Taxable Income</u>	<u>Taxes Payable @ 35%</u>	<u>After Tax Cash</u>
0	100,000,000				0	100,000,000
1		6,833,927	(3,180,000)	3,653,927	1,278,874	(1,278,874)
2		6,833,927	(3,063,805)	3,770,122	1,319,543	(1,319,543)
3		6,833,927	(2,943,915)	3,890,012	1,361,504	(1,361,504)
4		6,833,927	(2,820,213)	4,013,714	1,404,800	(1,404,800)
5		6,833,927	(2,692,577)	4,141,350	1,449,473	(1,449,473)
6		6,833,927	(2,560,882)	4,273,045	1,495,566	(1,495,566)
7		6,833,927	(2,424,999)	4,408,928	1,543,125	(1,543,125)
8		6,833,927	(2,284,795)	4,549,132	1,592,196	(1,592,196)
9		6,833,927	(2,140,133)	4,693,794	1,642,828	(1,642,828)
10		6,833,927	(1,990,870)	4,843,057	1,695,070	(1,695,070)
11		6,833,927	(1,836,861)	4,997,066	1,748,973	(1,748,973)
12		6,833,927	(1,677,954)	5,155,973	1,804,590	(1,804,590)
13		6,833,927	(1,513,994)	5,319,933	1,861,976	(1,861,976)
14		6,833,927	(1,344,820)	5,489,107	1,921,187	(1,921,187)
15		6,833,927	(1,170,267)	5,663,660	1,982,281	(1,982,281)
16		6,833,927	( 990,162)	5,843,765	2,045,318	(2,045,318)
17		6,833,927	( 804,331)	6,029,596	2,110,359	(2,110,359)
18		6,833,927	( 612,589)	6,221,338	2,177,468	(2,177,468)
19		6,833,927	( 414,751)	6,419,176	2,246,712	(2,246,712)
20	<u>66,332,443</u>	<u>6,833,927</u>	<u>( 210,621)</u>	<u>72,955,748</u>	<u>25,534,512</u>	<u>40,797,931</u>
Total	<u>166,332,443</u>	<u>136,678,539</u>	<u>(36,678,539)</u>	<u>166,332,443</u>	<u>58,216,355</u>	<u>108,116,088</u>