



August 28, 2019

Section 467 Leases: Having Your Cake and Eating It Too?

By: *Ezra Dyckman and Charles S. Nelson*

There are a number of approaches for owners of rental real estate to monetize low-basis real estate while maintaining tax deferral. One method that can achieve these objectives is a long-term lease with a large initial payment of rent.

Section 467 of the Internal Revenue Code generally governs the income tax treatment of leases with prepaid rent. Prior to the enactment of Section 467, if a tenant made a large initial payment of rent, the tenant was required to amortize the payment over the term of the lease, but the landlord was required to include the entire payment in income for the first year. To avoid this unfavorable result, Congress enacted Section 467.

Under Section 467, if an upfront payment of rent is made upon entering into a lease, the landlord and tenant can agree to allocate that prepayment ratably over the lease term. If such an allocation is made, then the initial prepayment of rent is treated as a loan from the tenant to the landlord (the “467 loan”), and receipt of this money is therefore tax-free for the landlord. Each year in the lease term, the landlord is deemed to receive an amount of rent that includes both the rent that is actually paid and the portion of the prepaid rent allocated to that year (and that is determined after applying an interest factor).

Ezra Dyckman is a partner, and Charles S. Nelson is an associate, in the law firm of Roberts & Holland LLP.

In addition, each year, the extra rent that the landlord is deemed to receive (i.e., the excess of the rent it is deemed to receive over the rent that is actually paid) is considered to be used by the landlord to make payments of interest and principal to the tenant with respect to the 467 loan. At the end of the lease term, the 467 loan balance will be zero as a result of the debt service payments deemed to be made over the lease term. Each year, the landlord will have (i) rental income that includes the extra rent that is deemed to be paid (in addition to the rent that is actually paid) and (ii) a deduction for the interest deemed to be paid. Similarly, the tenant will have (a) a rental deduction that includes the extra rent deemed to be paid (in addition to the rent that is actually paid) and (b) interest income on account of the interest that is deemed to be paid.

Section 467 can therefore enable a landlord to receive a large tax-free payment of prepaid rent upon entering into a lease. The cost of a landlord receiving this tax-free upfront money is that the landlord will have “phantom income” (i.e., taxable income in excess of cash received) in the subsequent years. This phantom income will generally be back-loaded, with the landlord recognizing the highest amounts in the later years of the lease term. For example, in a simple case of a lease with a large initial rent payment and no recurring rent payments, taxable income will increase over time as

the deemed rental income remains constant but the deemed interest deductions decrease as the 467 loan is amortized.

Despite these benefits, a Section 467 lease with a large initial rent payment can raise several other tax issues. For example, for lessees of commercial property in Manhattan, New York City generally imposes a commercial rent tax in the amount of 3.9% of rent payments. A lessee that subleases the property is entitled to reduce the tax base by the amount of rent it receives from subtenants. However, because the commercial rent tax is determined on a cash basis, in the case of a lease with a large initial rent payment, the lessee will owe commercial rent tax on the initial payment. The lessee will usually not be able to obtain much benefit from the sublease credit, because the rents from subtenants will be received over the term of the lease, and not accelerated in the first year.

In addition, the division of rent payments into separate interest and rent components may have other unintended tax consequences. For example, new Section 461(l) of the Internal Revenue Code generally prevents taxpayers from using business losses to offset more than \$250,000 of portfolio income (or \$500,000 in the case of a married couple filing a joint tax return). The tenant under a Section 467 lease with prepaid rent will generally have interest income and an offsetting increase in its rental deduction. However, in light of Section 461(l), it is possible that the tenant may not be

able to use the rental deduction to offset income.

Also, new Section 163(j) of the Internal Revenue Code generally limits interest deductions to an amount equal to interest income plus 30% of a taxpayer's taxable income (with certain adjustments). The landlord under a Section 467 lease will generally have interest deductions and offsetting rental income, but under Section 163(j), the interest may not be entirely deductible unless certain exceptions apply.

A Section 467 lease is one of several different tax-efficient approaches to monetize an interest in real estate, and can allow the owner to receive a large upfront payment without immediate tax consequences. Of course, the income is only deferred and will eventually be recognized over the term of the lease. Also, as noted above, there are various tax issues that need to be considered in order to evaluate the overall tax consequences of a Section 467 lease. In sum, a determination of whether entering into a Sec-

tion 467 lease with prepaid rent is the best option for a landlord to monetize real estate in a tax-efficient manner will depend on the particular facts and business objectives.

Reprinted with permission from the August 28, 2019 edition of the *New York Law Journal* © 2019 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. ALMReprints.com 877-257-3382 – reprints@alm.com.
