



December 23, 2015

## Just Kidding? IRS Requires Rent Allocations to Have Teeth

By: *Ezra Dyckman and Daniel W. Stahl*

Prior to the enactment of Internal Revenue Code section 467, a landlord receiving a payment of prepaid rent would recognize income upon receipt of the prepayment. The tenant making the prepayment, on the other hand, would have an intangible asset that would be amortized over the duration of the lease term. Section 467 enables the landlord and tenant to avoid this generally undesirable result by creating a framework under which they can agree as to how rent will be allocated. However, a lease must satisfy certain specific requirements in order for its allocation of rent to be respected under section 467. A recent Chief Counsel Advice issued by the IRS illustrates a common pitfall that can cause an allocation of rent to fail.

### Background

Section 467 generally governs the income tax treatment of leases with either increasing or decreasing rents. For a lease that is subject to section 467, the landlord and tenant can agree to make a “specific allocation of fixed rent,” in which case the rental income for the landlord and deduction for the tenant will generally be determined based on the allocation (as adjusted, in certain cases, to take into account present values). The Treasury Regulations provide

that a lease “specifically allocates fixed rent” if it “unambiguously specifies, for periods no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during that period.” In addition, the total amount of fixed rent *allocated* must be equal to the total amount of fixed rent *payable* over all periods.

If a tenant makes a prepayment of rent upon signing a lease, the lease could include a “specific allocation of fixed rent” pursuant to which the prepayment is allocated to subsequent periods. If so, then the tenant is deemed to initially transfer the prepaid rent to the landlord as a loan (a “section 467 loan”). As the prepaid rent accrues, the landlord is deemed to use a portion of the rent that it is considered to receive in order to pay interest and principal with respect to the loan.

If a lease with prepaid rent does not provide for a “specific allocation of fixed rent,” then the amount of fixed rent allocated to each rental period is generally equal to the amount of fixed rent that is payable during the rental period.

### CCA 201549027

Chief Counsel Advice (“CCA”) 201549027,<sup>1</sup> which was recently released by the IRS, addressed whether a rental agreement is considered to provide for a “specific allocation of fixed rent” if it includes a provision stating that the section 467 loan balance is reduced to zero and fully discharged for all

purposes upon any termination of the lease.

As background to the question at hand, the CCA quoted the provision in the Treasury Regulations that a lease specifically allocates rent if it “unambiguously specifies, for periods no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during that period, and the total amount of fixed rent specified is equal to the total amount of fixed rent payable under the lease.” The CCA also quoted a clarification in the Treasury Regulations that a lease stating only when rent is *payable* does not specifically *allocate* rent.

Based on this language in the Treasury Regulations, the CCA explained that an allocation of fixed rents under section 467 “must be meaningful” in that it “must actually represent the amount of rent for which the lessee is liable for using the property.” Therefore, the CCA concluded, a rental agreement cannot have a “specific allocation of fixed rent” if it provides that the rent allocation exists only for tax purposes, since it “does not represent amounts for which the lessee becomes liable on account of the use of the property during that period.”

The CCA then used this principle to evaluate the impact of a lease providing that a section 467 loan balance is reduced to zero and fully discharged upon any termination of the lease. As the CCA noted, if a lease allocates prepaid rent to

---

*Ezra Dyckman is a partner in, and Daniel W. Stahl an associate of, the law firm of Roberts & Holland LLP.*

subsequent periods, then the tenant is paying this amount to the landlord before the tenant becomes liable to the landlord for this amount on account of its use of the property. The Treasury Regulations logically treat the prepayment as a loan from the tenant to the landlord.

However, if a lease with prepaid rent provides that the section 467 loan balance is reduced to zero upon any termination of the lease, then the landlord is entitled to keep the prepayment whether or not the tenant has possession of the premises in the subsequent periods to which the prepayment is allocated. If so, then the allocations of rent have no impact at all. The CCA determined that in such a case it would be the payment schedule—and not the allocation schedule—that represents the amount of rent for which the tenant becomes liable on account of the use of the property.

Accordingly, the CCA concluded that a lease cannot be considered to have a “specific allocation of fixed rents” if it provides that the section 467 loan balance is reduced to zero and fully discharged for all purposes upon any termination of the lease. It follows that, if a rental agreement includes such a provision, the landlord would recognize the

prepayment as income in the year in which it is received notwithstanding any purported allocation of the prepayment to subsequent years.

#### **Analysis**

While section 467 enables a landlord and tenant to agree as to how prepaid rent will be allocated, their lease must adhere to important requirements in order to have the “specific allocation of fixed rent” that is necessary for the allocation to be respected under the Treasury Regulations. One requirement is that *all* fixed rent must be allocated (i.e., the total amount of fixed rent allocated must be equal to the total amount of fixed rent payable over all periods). A failure to allocate even \$1 of fixed rent would invalidate a lease’s entire allocation of fixed rent. It is therefore advisable for a lease allocating rent under section 467 to include a schedule that explicitly sets forth the fixed rent payable and fixed rent allocable to each period and demonstrates that their totals are equal.

In addition, the lease must provide for the amount of rent allocated to each period to “actually represent the amount of rent for which the lessee is liable for using the property” for the period. Real

estate and bankruptcy counsel sometimes worry that, if the tenant were to go into bankruptcy and “reject” the lease, this language could cause the landlord to be required to repay any outstanding balance on the section 467 loan (which generally would be at odds with the agreed upon business deal). We have seen various approaches for dealing with this concern, including the provisions addressed by the CCA providing that “the rent allocation exists only for tax purposes” or “the section 467 loan balance is reduced to zero and fully discharged upon any termination of the lease.” While these clauses would undermine the allocation of fixed rent and were rejected by the CCA, taxpayers should seek less extreme techniques that could still help protect a landlord in the event of a bankruptcy of its tenant.

In sum, section 467 can be helpful for parties to a lease by enabling them to allocate rent in an agreed upon manner. CCA 201549027 should remind taxpayers, though, that the benefits of section 467 cannot be achieved without complying with the detailed criteria of the Treasury Regulations.

---

<sup>1</sup> CCA 201549027 (Dec. 4, 2015).

**Reprinted with permission from the December 23, 2015 edition of the *New York Law Journal***

**© 2017 ALM Media Properties, LLC,**

**All rights reserved.**

**Further duplication without permission is prohibited.  
[ALMReprints.com](http://ALMReprints.com) – 877-257-3382 – [reprints@alm.com](mailto:reprints@alm.com).**