# Substantial Modification of Rental Agreements

## Notice 97–72

### PURPOSE

This notice informs taxpayers of certain conditions under which changes in rental payment terms resulting from a refinancing of indebtedness incurred by a lessor to acquire property that is the subject of a rental agreement will not be a substantial modification of the rental agreement for purposes of § 467 of the Internal Revenue Code. The Treasury Department intends to issue final regulations under § 467 that will incorporate these conditions.

### BACKGROUND

On June 3, 1996, the Internal Revenue Service and Treasury issued proposed Income Tax Regulations under § 467, published in a Notice of Proposed Rulemaking (61 Fed. Reg. 27834). The regulations provide that, if a rental agreement is a § 467 rental agreement, the lessor and lessee must take into account for a taxable year the § 467 rent and the § 467 interest for that year. The proposed regulations provide that a rental agreement is a § 467 rental agreement if it has increasing or decreasing rent, or deferred or prepaid rent, and the aggregate rental payments and other consideration to be received for the use of the property exceed $250,000.

Under § 1.467–3 of the proposed regulations, if a § 467 rental agreement is a leaseback or long-term agreement that provides for increases or decreases in rent that have a principal purpose of Federal income tax avoidance (a disqualified leaseback or long-term agreement), the Commissioner may require the lessor and lessee to use constant rental accrual. Section 467(e)(1) provides that the "constant rental amount" is an amount that, if paid at the close of each lease period under the agreement, would result in an aggregate present value equal to the present value of the aggregate payments required under the agreement. Section 467(b)(5) and the § 467 proposed regulations provide certain safe harbor exceptions to the application of constant rental accrual.

The regulations are proposed to be effective for (1) disqualified leasebacks and long-term agreements entered into after June 3, 1996, and (2) all other rental agreements entered into after the date on which final § 467 regulations are published.

Under § 1.467–1(f) of the proposed regulations, if, after the lease term begins, the lessor and lessee agree to a substantial modification of the terms of the lease, the remaining portion of the rental agreement, as modified, is treated as a new rental agreement for purposes of § 467 and the regulations thereunder, including the effective date provisions. Thus, for example, such a rental agreement must be retested to determine whether increases or decreases in rent were motivated by Federal income tax avoidance, or whether a safe harbor exception to constant rental accrual applies.

The proposed regulations provide no guidance regarding whether a substantial modification has occurred. Consequently, commentators have expressed concern that a refinancing of indebtedness incurred to acquire property that is the subject of a rental agreement entered into prior to the effective date of the § 467 regulations will result in a substantial modification of the rental agreement. This treatment may occur because, even though the lessee is not directly obligated to pay the principal of, or interest on, such indebtedness, in many leases, the rent paid by the lessee is affected by the lessor's debt service costs. Thus, the concern of the commentators is that a refinancing of the lessor's indebtedness after June 3, 1996, will cause a change in rental payments that will constitute a substantial modification of the rental agreement and may cause the remaining portion of the rental agreement to be treated as a disqualified leaseback or long-term agreement under the § 467 regulations (and therefore subject to constant rental accrual).

### EFFECT OF REFINANCING

In response to the concerns of commentators, the final regulations under § 467 will provide that the refinancing of any indebtedness incurred by the lessor to acquire the property subject to a rental agreement and secured by the property, together with any corresponding changes in the rights or obligations of the lessee under the rental agreement, will not be treated as a substantial modification of the rental agreement if all of the following conditions are met:

(a) Neither the amount, nor the time for payment, of the principal amount of the new indebtedness differs from the amount and time for payment of the principal amount of the refinanced indebtedness, except for de minimis changes;

(b) For each of the remaining rental periods, the rent allocation schedule, the payments of rent and interest, and the amount accrued under § 467 are changed only as necessary to take into account the change in financing costs, and such changes are made pursuant to the terms of the rental agreement;

(c) The lessor and the lessee are not related persons (as defined in § 1.467–1(h)(7) of the proposed regulations) to each other or to any lender to the lessor with respect to the property (whether under the refinanced indebtedness or the new indebtedness); and

(d) The lessor has a unilateral option (within the meaning of § 1.1001–3(c)(3)), with or without the consent of the lessee, to repay the refinanced indebtedness.

### DRAFTING INFORMATION

The principal author of this notice is Stephen J. Toomey of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Mr. Toomey at (202) 622-4960 (not a toll-free call).