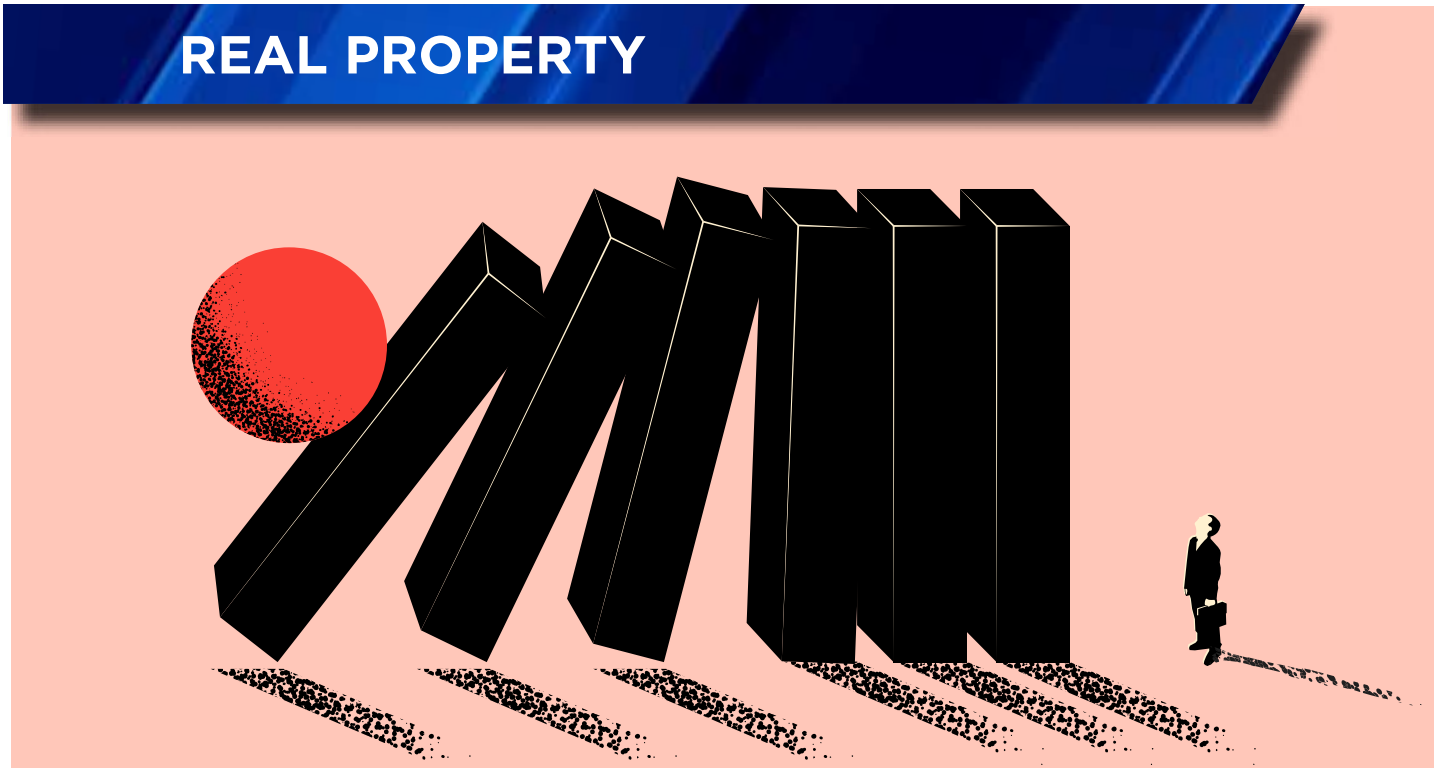

Section 467 Leases: Maximizing Tax Benefits while Minimizing Bankruptcy Risks

By: Kris Ferranti and Derek Kershaw[1]

This article discuss certain benefits and risks for leases that fall under Section 467 of the Internal Revenue Code.

As the economy continues to face challenges and the threat of bankruptcy becomes more prevalent among businesses, landlords must be more vigilant in protecting their interests in commercial leases. One area of particular concern is leases that fall under Section 467 of the Internal Revenue Code ("Section 467 Leases").

Section 467 Leases can be a great way for landlords to maximize tax benefits. These leases allow landlords to spread out the recognition of income over the term of the lease instead of recognizing it all at once. Tenants may also take advantage of a Section 467 Lease by using it to sway sellers to structure the sale of a property as a ground lease transaction instead. This can be a cost-efficient way for buyers to finance the purchase and preserve an existing fee mortgage with potentially more favorable debt terms.

When structuring this type of ground lease transaction, the tenant would make a large upfront rent prepayment, being an amount close to the sale proceeds the seller would otherwise receive. The rent payments made throughout the lease term would then be commensurate with the debt service payable under the fee mortgage. As an additional tax benefit, this structure often allows for the buyer/tenant to claim depreciation on the improvements and deduct rent payments for use of the land as a business expense. Overall, the framework of a Section 467 Lease can unlock significant cost savings and help minimize expenses for both parties.

But, while the Section 467 Lease structure can provide significant benefits, it's important to remember that it comes with potential risks, particularly when a tenant files for bankruptcy. Under the rent allocation framework provided by Section 467 Leases, prepaid rent is essentially treated as a loan to the landlord, which is forgiven over time during the lease term. As a result, in the event of a tenant's bankruptcy, the framework of these leases can create unintended consequences for landlords, resulting in the landlord being obligated to pay the tenant the unforgiven portion of the so-called "loan" advance the landlord received at the start of the lease.

To qualify as a Section 467 Lease, the lease must go beyond mere language indicating that the allocation of the upfront payment exists only for tax purposes. The lease must have a

"substantive" allocation of rent, meaning the tenant would receive a rebate of the Section 467 Lease loan balance upon a termination unless the tenant is at fault. This means that the lease agreement must not only clearly spell out the amount of upfront rent allocated to each period but also how the landlord generally is entitled to keep the rent allocated to a period only if the tenant uses the property during that period. This is essential in order for the landlord to maximize tax deferral benefits under Section 467.

It's important to note that, even if the terms of the agreement state that it is a Section 467 Lease, the IRS and the courts are not bound by the labels chosen by the parties. The court will determine whether the advance payments landlords receive are considered prepaid rent or a security deposit based on the rights and obligations of the parties under the lease with respect to the payment, not the payment's label in the lease. For example, if the lease agreement frontloads payments at the start of the lease but does not specifically indicate the purpose of the advance payments and the framework that will be used to account for said payments, it may not be considered a Section 467 Lease by the IRS.

It's crucial for landlords to understand the potential consequences of a tenant's rejection of a Section 467 Lease in the event of the tenant's bankruptcy. The tax regulations for Section 467 Leases require that the lease provide "unambiguously" the amount of rent allocated to each period and that the allocated amount actually represent the liability of the tenant for using the property in that period. This is important because in the event of a tenant bankruptcy, there is no precedent for analyzing the implications of a bankrupt tenant rejecting a Section 467 Lease. Under the rules of Chapter 11 Bankruptcy, a tenant bound as of the date of filing its bankruptcy petition by an unexpired, nonresidential lease or executory contract, must choose one of three options: to assume the lease and continue to honor all of their obligations under that agreement, assume the lease and assign it to a third party, or reject the lease and vacate the premises. This can have significant consequences for landlords as in the event of a tenant's rejection of an unexpired lease, the breach is deemed to occur at the time the bankruptcy petition was filed. This results in the landlord developing a general unsecured claim for damages caused by that rejection, which is capped under § 502(b)(6) of the Bankruptcy Code at the unpaid rent for the greater of one year or 15% of the remaining lease term, not to exceed three years from the earlier of the petition date or the date of surrender or repossession. As a general unsecured creditor, the landlord will share pro rata with other general unsecured creditors, who are subordinate to other classes of claimants.

Thus, when structuring and negotiating a Section 467 Lease, landlords must carefully consider the potential risk of a tenant bankruptcy and how it may impact their rights as a landlord and may even trigger an obligation to repay a portion of the upfront lease payments to the tenant's bankruptcy estate for the benefit of other creditors if the upfront payment is characterized as a loan to the landlord. This risk should be taken into account when deciding to pursue the tax benefits of a Section 467 Lease, pricing the transaction, and evaluating the creditworthiness of the proposed tenant entity and any guarantors. Additionally, landlords should take a close look at the terms of the lease, to ensure that they are adequately protected in the event of a tenant bankruptcy and should consider whether a security deposit or other forms of credit support are necessary to help mitigate this risk. It is also important for landlords to stay informed about the current economic climate and any changes to bankruptcy laws, as well as understand what state law governs the Section 467 Lease, as these can also have an impact on the risk associated with Section 467 Leases. Ultimately, landlords must take a comprehensive approach when evaluating the potential benefits and risks of a Section 467 Lease, weigh the potential tax benefits against the risk of a tenant bankruptcy, and take appropriate measures to protect their interests.

Endnotes

1. Kris Ferranti is the Team Leader and a Partner in the Real Estate Group at Shearman & Sterling LLP. He has extensive experience representing clients in complex commercial real estate transactions, including in the areas of acquisitions, dispositions, joint ventures, development projects, foreign investment, financings, and ground and space leasing. Kris regularly represents financial institutions, sovereign wealth funds, investment funds, family offices, and individual and institutional investors, developers, and sponsors.

Derek Kershaw is a partner in the Tax practice at Shearman & Sterling LLP. He advises clients on a range of areas of tax law. His practice includes domestic and international transactional work, including mergers and acquisitions, joint ventures, private equity and hedge fund investments and structuring, REITs and other pass-through entities, and real estate.