FINAL REGULATIONS ON THE TREATMENT OF RENT AND INTEREST UNDER SECTION 467 RENTAL AGREEMENTS

SIMPSON THACHER & BARTLETT LLP

JUNE 14, 1999

On May 17, 1999, the Internal Revenue Service (the "**IRS**") issued final regulations (the "**Final Regulations**") under Section 467 of the Internal Revenue Code of 1986, as amended (the "**Code**"),[1] relating to the treatment of rent and interest under agreements providing for the lease of tangible property. The Final Regulations amend and adopt the regulations proposed under Section 467 by the IRS on June 3, 1996 (the "**Proposed Regulations**").

The Final Regulations modify and amplify the Proposed Regulations in several important respects. First, for long-term leases of real estate, the Final Regulations add an "85/115" safe harbor and disregard certain rent holidays in applying the "uneven rent" test. Second, the Final Regulations incorporate the safe harbors found in the Proposed Regulations and provide additional safe harbors for certain types of "contingent rent." Third, the Final Regulations follow the Proposed Regulations in providing that the Commissioner, rather than the parties to the rental agreement, will determine whether a rental agreement is a disqualified leaseback or a long-term agreement. For purposes of determining whether a leaseback or a long-term agreement is disqualified, the Final Regulations also provide a definition of "tax avoidance" and several safe harbor provisions which may be used as guidance by the parties to a leasing transaction. Finally, the Final Regulations clarify when the modification of a rental agreement is deemed to be "substantial" so as to require that the modified agreement be treated as a new rental agreement for purposes of analysis under Section 467. These modifications and amplifications are described in greater detail below.

APPLICATION OF THE FINAL REGULATIONS.

In general, the Final Regulations follow the Proposed Regulations in dividing the universe of leasing transactions into three categories as follows:

- Non-§467 Rental Agreements, which are not subject to the Final Regulations at all;

[1] Unless otherwise indicated, all references to "Section" are to the Code.

- §467 Rental Agreements (other than "disqualified leasebacks and long-term agreements"), which are subject to new tax accounting rules only if the agreement provides for rent to be significantly prepaid or deferred; and
- Disqualified Leasebacks and Long-Term Agreements, which are subject to constant rental accrual.

We will refer to the three categories of leasing agreements as "**Non-§467 Agreements**", "**§467 Agreements**" and "**Disqualified Agreements**", respectively.

This memorandum is intended to provide preliminary guidance to taxpayers engaged in conventional leveraged leases or single investor leases. Because taxpayers should be able to structure transactions that will not be treated as Disqualified Agreements and not include rent that is significantly prepaid or deferred, no explanation is offered of the interest adequacy standards, the rules for "Section 467 loans", or the constant rental accrual rules that apply to Disqualified Agreements.

ANTI-ABUSE Provision.

In light of the recent IRS attack on cross-border "lease in - lease out" transactions, where taxpayers had endeavored to achieve tax arbitrage by accounting for prepaid rents under the head lease and "low/high" rents under the sublease in accordance with a literal construction of certain provisions of the Proposed Regulations,[2] it is no surprise that the Final Regulations contain an anti-abuse provision. Notwithstanding how Section 467 and the Final Regulations would apply to a leasing transaction, the Final Regulations provide that the IRS may go outside of the rules of Section 467 and the Final Regulations and apply other sections of the Code or other judicial authorities, including the substance-over-form doctrine, in order to determine the appropriate accounting of income and expense for a rental agreement.

However, notwithstanding this caveat in the Final Regulations, we believe that the IRS should not prevail in an effort to frustrate the taxpayers' tax accounting expectations where (i) in instances where the rental agreement calls for increasing and decreasing rents, the rent schedule complies with the "90/110" or "85/115" safe harbor described below (whether or not used in tandem with an initial rent holiday that complies with the initial rent holiday safe harbor more fully described below), (ii) the rent that is allocated by the agreement to particular rent payment periods is never scheduled to be paid so much in advance or so far in arrears of the relevant rent payment period as to cause such rental amount to be characterized either as "prepaid rent" or "deferred rent" under the Final Regulations, as more fully discussed below, and (iii) the transaction does not involve defeasance arrangements or include other, similar elements that might present "substance-over-form" recharacterization issues.

2 See, Rev. Rul. 99-14, 1999-1 IRB 3, in which the IRS attacked such transactions as lacking substance.

NON-§467 Agreements.

Because the Final Regulations only apply the rules of Section 467 to "Section 467 rental agreements", it is possible to structure a transaction that avoids the coverage of the Final Regulations altogether. However, most conventional leases, including those structured to meet the modified "90/110" and "85/115" safe harbors, will constitute §467 Agreements.

§467 Agreements.

The term "Section 467 rental agreement" includes all rental agreements (i) that have either increasing or decreasing rents *or* prepaid or deferred rents *and* (ii) that provide for total payments of more than $250,000.

Increasing / Decreasing Rents.

Like the Proposed Regulations, the Final Regulations characterize a rental agreement that allocates fixed rent to any rental period in excess of the annualized fixed rent allocated to any other rental period in the lease term, as having increasing or decreasing rent. For the purpose of determining whether a rental agreement has increasing or decreasing rents, an initial rent holiday of three months or less is ignored.

In addition, the Final Regulations characterize a rental agreement as having increasing or decreasing rent if the agreement requires or may require the payment of "contingent rent." Contingent rent is defined as "any rent that is not fixed rent, including any amount reflecting an adjustment based on a reasonable price index or a variable interest provision." However, the Final Regulations reserve guidance on the Section 467 treatment of contingent rent.

The Final Regulations adopt the safe harbors of the Proposed Regulations, as well as provide additional ones, under which contingent rent will be disregarded to the extent it is the result of one or more of the following (collectively, the "**Disregarded Contingent Rent Provisions**"):

- a provision basing rents on a fixed percentage of the lessee's gross or net receipts, but only if the percentage remains constant throughout the lease (a "**qualified** percentage **rents provision**");
- a provision basing the adjustments in rents paid on a reasonable price index, as further described below (a "**reasonable price index provision**");
- a provision requiring the lessee to pay third-party costs, such as real estate taxes, insurance premiums, maintenance costs, and any other costs (excluding debt service costs) that relate to the leased property and which are not within the control of the lessor or lessee or any person related to the lessor or lessee (a "**third party costs provision**");
- a provision requiring the payment of late payment charges (a "**late payment** charges **provision**");

- a provision requiring the lessee to pay the lessor a sum of money if the property subject to the rental agreement is lost, stolen, damaged, destroyed or otherwise rendered unsuitable for any use (a "**loss payment provision**");

- a provision requiring a payment by either the lessor or the lessee to the other party to the agreement based on the difference between the actual condition of the property subject to the agreement, determined as of the expiration of the lease term, and the expected condition of the property at the expiration of the lease term, as set forth in the agreement (a "**residual condition provision**");

- a provision requiring the lessee to make one or more payments to the lessor in the event that the Federal, foreign, state or local income tax consequences actually realized by a lessor from owning the property subject to the rental agreement and leasing it to the lessee differ from the consequences reasonably expected by the lessor, but only if these differences result from a misrepresentation, act, or failure to act on the part of the lessee, or any other factor not within the control of the lessor or any related person (a "**tax indemnity provision**");[3] or

- a provision that requires the rent payable by the lessee to be adjusted by the dollar amount of changes in the amount of interest payable by the lessor on any indebtedness that was incurred to acquire the property subject to the agreement, but only (i) to the extent the changes are attributable to changes in the interest rate and (ii) if the indebtedness provides for interest at one or more qualified floating rates (within the meaning of Treasury regulations applicable to variable debt instruments) or the changes are attributable to a refinancing at a fixed rate or one or more qualified floating rates and (iii) if the lessor and the lender are not related (a "**variable interest rate provision**").

The Final Regulations elaborate upon the safe harbor for a reasonable price index provision found in the Proposed Regulations. Generally, an adjustment based upon a reasonable price index will not constitute contingent rent if the adjustment reflects inflation or deflation occurring over a period during the rental agreement term and if determined consistently under a generally recognized index for measuring inflation or deflation, such as the Consumer Price Index. An adjustment will not fail to be treated as a reasonable price index provision merely because the provision limits the adjustment to a fixed percentage, provided that the parties reasonably expect, as of any date between the agreement and the lease date, that the fixed percentage will actually limit the amount of rent payable during less than 50 percent of the lease term.[4] The Final Regulations provide no guidance as to an appropriate basis for a

[3] Although a safe harbor has been provided for a "tax indemnity provision," curiously no safe harbor expressly covers a general indemnity provision.

[4] According to the Preamble to the Final Regulations, this safe harbor for a reasonable price was designed so that the index provision will not apply if the limitation in the rental agreement represents, in substance, a series of fixed increases in rent. For example, if the limitation is

taxpayer's reasonable expectations and one is therefore left with certain unanswered questions. For example, for a 20-year lease, is it reasonable to look to the history of the preceding 5 years, or must some longer period be taken into account?

The reasonable price index provision may prove impractical to exploit. Most indices have fluctuated so greatly in recent years that taxpayers , including both lessees and equity participants, may be unwilling to live with such uncertainty. Moreover, because a reasonable price index provision may only reflect changes in the index *during* the lease term, taxpayers apparently will not be able to reduce the risk by using a 5 or 10-year moving average that takes into account changes in the index covering periods preceding the lease term.

Deferred / Prepaid Rent.

The Final Regulations follow the rules of the Proposed Regulations regarding deferred or prepaid rent. A rental agreement is deemed to have deferred rent for purposes of Section 467 ("**deferred rent**") only if the amount of rent allocated to a calendar year, when added to the rent allocated to all preceding calendar years, exceeds the cumulative amount of rent payable as of the close of the succeeding calendar year. In practice, this means that the transaction will not be deemed to involve deferred rent if the payment of the rent that is allocated to a rent period falling entirely within a calendar year is required to be paid no later than the last day of the ensuing calendar year. Where certain rent periods overlap from one calendar year to the next, the rent payment schedule must be carefully designed in order to avoid having deferred rent.

Conversely, an agreement is deemed to have prepaid rent for purposes of Section 467 ("prepaid rent") only if the rent allocated to a calendar year, when added to the rent allocated to all preceding calendar years, is less than the rent payable before the beginning of the preceding calendar year. Though these concepts may seem complicated at first, they afford considerable latitude in developing a rent structure that optimizes the desired outcome for the participants, while avoiding deferred or prepaid rent. This is of considerable importance because a §467 Agreement that has no deferred or prepaid rent will not be subject to the complex rules that measure the adequacy of interest and, where inadequate, impute a deemed loan (a "**Section 467 loan**"). The Final Regulations thus facilitate the use of rent structures that alternate between advance and arrears payments.

Accounting for §467 Agreements.

As long as a §467 Agreement (i) contains no prepaid or deferred rents, (ii) specifically allocates all of the fixed rent payable under the lease to specified lease periods of a year or less, and (iii) unambiguously provides that the fixed amount of rent so allocated to each period constitutes the amount for which the lessee will be liable on account of the use of the property during that period, then the lessor's tax accounting follows conventional tax accounting

substantially below the level of inflation reasonably expected during the rental agreement term, the limitation is, in substance, a series of fixed increases in rent.

principles. In other words, the lessor's rent accrual for each calendar year will be the sum of (1) the fixed rent allocated to any lease period that begins and ends in the calendar year and (2) a ratable portion of the fixed rent allocated to each lease period that falls partly within and partly without the calendar year. For the purpose of determining the appropriate income accrual, any reasonable counting convention (such as 30 days per month/360 days per year) may be used, and rental periods of the same descriptive length (such as of the months of January and February) may be treated as having equal length.

Recapture upon Disposition.

If a §467 Agreement has increasing rents, the lessor's disposition of the leased property may be subject to a special recapture rule that would require the lessor to recharacterize a portion of any gain (the "recapture amount") as ordinary income. The recapture amount is the lesser of (i) the portion of the taxable gain that would otherwise be treated as capital gain and (ii) the excess, if any, of (a) the aggregate amount of Section 467 rent and interest for the period during which the lessor held the property, determined as if the transaction had constituted a Disqualified Agreement, over (b) the corresponding amounts that were actually accrued by the lessor during that period.

DISQUALIFIED AGREEMENTS.

The constant rental accounting method is required for "leasebacks" or "long-term agreements" that are disqualified under the Final Regulations.

Leaseback.

A lease constitutes a leaseback if the lessee (or a related person) had an interest in the leased property at any time within the two year period ending on the date the parties enter into a binding written contract that substantially sets forth the terms under which the property will be leased or, if earlier, the date the lessee first obtains the right to use the property that is the subject of the lease.

Long-Term Agreement.

An agreement is a long-term agreement if it is for a term in excess of 75% of the applicable period for the property determined under Section 467(e)(3)(A), *e.g.*, 7 years for 7-year property. If a lease relates to two or more related properties that have different recovery periods, the applicable period is the weighted average of the properties (based on their respective fair market values).

Leasebacks and Long-Term Agreements as Disqualified Agreements.

Leasebacks and long-term agreements will constitute Disqualified Agreements only if: (1) total rent payments exceed $2 million;[5] (2) a principal purpose for providing increasing or decreasing rent is the avoidance of federal income tax; and (3) the IRS determines that it is appropriate to treat the agreement as a disqualified leaseback or long-term agreement. Taxpayers intentionally failing the applicable safe harbors cannot be ensured that they will be able to account for the rental agreement using constant rental accrual.

Determination of Principal Purpose.

The determination of the principal purpose for providing increasing or decreasing rent will generally be based on all of the facts and circumstances, but agreements involving tax-exempt entities (within the meaning of Section 168(h)(2)) will be "closely scrutinized" to establish that tax avoidance is not a principal purpose. Like the Proposed Regulations, the Final Regulations provide that only the IRS may determine that a §467 Agreement should be treated as a disqualified leaseback or long-term agreement by virtue of a principal purpose of tax avoidance.

Unlike the Proposed Regulations, the Final Regulations specifically provide that if a significant difference between the marginal Federal income tax rates of the lessor and lessee can reasonably be expected at some time during the lease term, the agreement will be closely scrutinized by the IRS, and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent. The marginal tax rates of the lessee and the lessor are determined not only by reference to the Federal income tax status of the taxpayer, but also to the specific circumstances of each taxpayer. For example, if a corporation is subject to the alternative minimum tax or has available net operating losses or credits to carry forward from an earlier taxable year, the corporation's marginal tax rate will be determined on the basis of such circumstances. Further, the marginal tax rate of an S corporation or partnership will be determined by taking into account the amounts of income or deductions allocable to its shareholders or partners, respectively, and the marginal tax rates of these shareholders or partners, respectively.

The Final Regulations adopt the safe harbors of the Proposed Regulations and provide additional safe harbors under which a § 467 Agreement will not be treated as having a principal purpose of tax avoidance. Several of the safe harbors listed below are explicitly mentioned in Section 467(b)(5), while others relate to certain types of contingent payments which have been listed above as being disregarded for purposes of determining whether a rental agreement has increasing or decreasing rents. The modified "90/110" and "85/115" safe harbor (the "**uneven rent test**") is based in part upon the legislative history to Section 467.

[5] The IRS issued proposed Treasury regulations at the same time the Final Regulations were issued which would eliminate the $2 million floor in clause (1) above, effective as of July 19, 1999.

Overview of Applicable Safe Harbors.

Tax avoidance will not be considered to be a principal purpose for providing increasing or decreasing rent if:

(i) the increasing or decreasing rent is wholly attributable to one or more of the following provisions:

- a Disregarded Contingent Rent Provision; or
- a provision under which changes in amounts are due to certain rent holidays, as further described below; or

(ii) the uneven rent test, as further described below, is met.

Rent Holiday Safe Harbor

The Final Regulations provide a safe harbor for a single rent holiday provision which allows reduced (or no) rent for one consecutive period during the lease term, but only if one of the following two conditions are met. In all cases, the rent holiday may be for a period of 3 months or less at the beginning of the lease term but for no other period (the "**initial rent holiday safe harbor**"). In the case of real property, a rent holiday may be permissible if its duration is reasonable, as determined by reference to commercial practice (as of the agreement date) in the locality where the use of the property occurs, and does not exceed the lesser of 24 months or 10 percent of the lease term (the "**commercially-reasonable rent holiday safe harbor**"). The Final Regulations have deleted the requirement that a substantial business purpose exist for the rent holiday and have substituted the "commercially-reasonable" test found in the legislative history of Section 467. The Final Regulations do not afford any guidance as to how a taxpayer may establish what is commercially reasonable. Reliance upon a report from an independent appraiser would be prudent only where the appraiser's report is supported by the recitation of specific commercial transactions that provide comparable rent holidays.

Uneven Rent Test — The "90/110" Safe Harbor and the New "85/115" Safe Harbor.

The Final Regulations also adopt the first uneven rent test contained in ¶4.081 of Revenue Procedure 75-28 and the Proposed Regulations with several helpful clarifications and one excruciating blunder, which was presumably not intended by the authors. Consistent with the Proposed Regulations, tax avoidance will *not* be considered the principal purpose for increasing or decreasing rent if the rent allocated to each *calendar year* does not vary from the average rent allocated to all calendar years by more than 10 percent. However, this "90/110" safe harbor departs from the Proposed Regulations in acknowledging that it can be used in tandem with the initial rent holiday safe harbor (but not with the commercially-reasonable rent holiday safe harbor). Accordingly, a rent holiday period not qualifying for the initial rent holiday safe harbor must be included as part of the over-all period that is tested under the "90/110" rule.

For the purpose of determining the lease term to be analyzed for purposes of the "90/110" safe harbor, however, the Final Regulations inexplicably fail to ignore an option period where the lessee has the option to renew at fair rental value. This blunder is discussed in more detail below under "Definition of Lease Term."

In addition, the Final Regulations add a modified uneven rent test for long-term agreements where at least 90 percent of the property subject to the agreement (determined on the basis of fair market value as of the date of the agreement) consists of real property. Under this modified test, tax avoidance will not be considered the principal purpose for increasing or decreasing rent if the rent allocated to each *calendar year* does not vary from the average rent allocated to all calendar years by more than 15 percent. In contrast to the "90/110" safe harbor, this "85/115" safe harbor can be used in tandem either with the initial rent holiday safe harbor or with the commercially-reasonable rent holiday safe harbor, but only if providing less than the average rent for the rent holiday is reasonable, as determined by reference to commercial practice (as of the agreement date) in the locality where the use of the property occurs.

For purposes of the "85/115" safe harbor, real property is defined in the same manner as under the Treasury regulations governing the qualification of real estate investment trusts (the "**REIT Regulations**"). Under the REIT Regulations, the term "real property" means land or improvements thereon, such as buildings or other inherently permanent structures, including items which are structural components of such buildings or structures. The definition of real property also includes the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building. The definition of real property does *not* include assets accessory to the operation of a business, such as machinery, office equipment, refrigerators, individual air-conditioning units, grocery counters, or furnishings of a motel, hotel or office building, even though such items may be fixtures under local law. In addition, if property is of a type which was deemed "tangible personal property" under the investment tax credit rules, it will not be considered to be real property for purposes of the REIT Regulations, and therefore for purposes of the "85/115" safe harbor.

In situations where a substantial percentage of the assets covered by a rental agreement consists of real property for the purposes of the "85/115" safe harbor but where the actual 90 percent threshold cannot be met, a taxpayer should be able to employ two separate leases (or provide separate rent schedules for two classes of assets), where *all* real property is subject to one lease (or rent schedule) complying with the "85/115" safe harbor and *all* personal property is subject to another lease (or rent schedule) complying with the "90/110" safe harbor.[6]

[6] However, it should be noted that under Section 1.467-1(c)(4)(ii)(C) of the Final Regulations, all rental agreements that are part of the same transaction or series of related transactions involving the same lessee (or any related person) and the same lessor (or any related person) are treated as a single rental agreement

When applying the uneven rent test, both the "90/110" safe harbor and the "85/115" safe harbor ignore all the Disregarded Contingent Rent Provisions, except the qualifying percentage rent provision and the reasonable price index provision. As a consequence, taxpayers are not permitted when taking advantage of the "90/110" safe harbor to also employ either a qualifying percentage rent provision or a reasonable price index provision.

OTHER PROVISIONS OF the FINAL REGULATIONS.

Treatment of Modifications.

The Final Regulations retain the rule of the Proposed Regulations that, if the lessor and the lessee agree to a "substantial modification" of the terms of an existing rental agreement, the modified rental agreement will be treated as a new rental agreement for purposes of Section 467. If a substantial modification occurs after June 3, 1996 but before May 18, 1999, the post-modification agreement is treated as a new agreement, for purposes of determining whether it is a §467 Agreement or a Disqualified Agreement and for purposes of applying the effective date provisions of the Final Regulations, *only if* the rental agreement being modified is a post-June 3, 1996 Disqualified Agreement or the rental agreement after modification could constitute a Disqualified Agreement.

The Final Regulations provide guidance as to when a substantial modification of a rental agreement has occurred. The Final Regulations define a modification as substantial only if the legal rights or obligations of the parties that are altered and the degree to which they are altered are economically substantial. In general, all the facts and circumstances surrounding the modification will be examined in determining whether a substantial modification has occurred. As it is difficult for taxpayers to make definitive determinations under a "facts and circumstances" test, the Final Regulations also provide several safe harbor provisions.

First, the modifications that are likely to affect the character of a rental agreement for purposes of Section 467 are those which change the amount or timing of rent allocated or rent payable for the use of the property, or the identity of the taxpayer taking those amounts into account. Thus, a substantial modification will not result from changes in any provision for the payment of third-party costs or any other provision that is ignored for purposes of determining whether the agreement provides for contingent rent. In the case of a transfer of leased property by a lessor or a substitution of a lessee, the Final Regulations provide that the transfer or substitution in and of itself will be treated as a substantial modification only if a principal purpose of the transaction is the avoidance of Federal income tax.

---

for the purpose of determining whether the "rental agreement" involves total payments of $250,000 or less. Even though such integration of two or more rental agreements is not *expressly* required for other purposes of the Final Regulations, taxpayers may be risking such integration if a two lease (or two rent schedule) structure is used, the lease (or separate schedule) of real property includes personal property as well, and the total personal property involved in the integrated transactions exceeds 10 percent.

In addition, the Final Regulations track the interim guidance issued by the IRS in Notice 97-72 by providing that the refinancing of indebtedness on a leveraged lease will not be treated as a substantial modification of the lease if certain conditions are met. First, neither the amount, nor the time for payment, of the principal amount of the new indebtedness differs by more than a *de minimis* amount from the amount or time for payment of the remaining principal amount of the refinanced indebtedness. This provision prevents a taxpayer from reoptimizing the debt, for the schedule for amortizing principal can only be changed to a *de minimis* extent. Second, neither the lessor nor the lessee may be related to each other or to any lender to the lessor with respect to the property. Third, with respect to the indebtedness being refinanced, the lender must have granted the lessor a unilateral option to repay the refinanced indebtedness, exercisable with or without the lessee's consent. Finally, for each of the remaining rental periods, the rent allocation schedule, the payments of rent and interest, and the amount accrued under Section 467 are changed only to the extent necessary to take into account a change in financing costs, and such changes are made pursuant to the terms of a rental agreement in effect before the modification.

The Final Regulations also set forth accounting rules for the effect of modifications, whether substantial or not, occurring after May 18, 1999.

Definition of Lease Term.

In determining the term of a lease for purposes of Section 467, the Final Regulations depart from the Proposed Regulations in several important respects, not all of which were intended. At least we hope not. In contrast to the Proposed Regulations, the Final Regulations provide that all lessor options are treated as if they have been exercised. Therefore, under the Final Regulations, a term of a lease with a lessor put option will include both the initial term and any optional renewal terms. This change is consistent with Section 4(2) of Revenue Procedure 75-21, which embraced the concept that the lease term includes all renewal or extension periods *except* those that were at the lessee's option at fair rental value at the time of such renewal or extension.

In dealing with lessee options, the Final Regulations include two significant departures from the Proposed Regulations. First, where the Proposed Regulations would include a renewal period that was at lessee's option only where it was expected, as of the agreement date, that the option would be exercised, the Final Regulations reverse the presumption. Now the renewal period will only be excluded from the term of the lease where it is reasonably expected, as of the agreement date, that the option will *not* be exercised by the lessee. Moreover, the Proposed Regulations explained that a lessee would be expected to exercise an option where, as of the agreement date, the rent fixed for the option period *is less than* the expected market rental for the property, raising a clear implication that a lessee should not be expected to exercise an option that would be at the appraised fair rental value at the time of exercise. This helpful guidance was eliminated in the Final Regulations.

As a result of these changes, the Final Regulations would literally require a renewal period subject to the lessee's option at fair rental value to be included as part of the lease term — eliminating the comfort of the "90/110" and "85/115" safe harbors in transactions involving such options. We cannot believe that this result was intended by the authors of the Final Regulations. The Explanation of Provisions attached by the authors explained that they intended to "retain the rule of the proposed regulations . . . for lessee options" while treating all lessor options as exercised.[7]

EFFECTIVE DATES.

The Final Regulations apply by their terms to Disqualified Agreements entered into after June 3, 1996, and to other rental agreements entered into after May 18, 1999. However, the Final Regulations warn that in appropriate circumstances the IRS may also apply the provisions to Disqualified Agreements entered into before June 3, 1996. In addition, taxpayers may rely on the provisions of the Proposed Regulations in the case of any Disqualified Agreement entered into during the "Interim Period," i.e., after June 3, 1996 and before May 18, 1999.

* * *

The Regulations significantly alter the federal income tax treatment of rental agreements, while leaving many unresolved issues. If you have any questions regarding their application, please contact Michael Simonson (212-455-3360), Moshe Schwerd (212-455-2543), Marti Awad (212-455-3041), Rob Holo (212-455-2514), Jennifer Franklin (212-455-3597), or any other member of our Tax Department.

SIMPSON THACHER & BARTLETT LLP

[7] Moreover, the Explanation indicates an intention not to deviate from the rule of Revenue Procedure 75-21 in the case of lessee options. As noted above in the main text, that revenue procedure excluded from the lease term renewals at the option of the lessee at fair rental value.