

than the remaining estimated useful life of improvements made by the lessee on leased property for purposes of determining the amount of deduction allowable to the lessee for such taxable year for depreciation or amortization in respect of any building erected or other improvements made on leased property. If the lessee and lessor cease to be related persons during any taxable year, then for the immediately following and subsequent taxable years during which they continue to be unrelated, the amount allowable to the lessee as a deduction shall be determined without reference to section 178(b) and in accordance with section 178(a) or section 178(c), whichever is applicable.

(ii) Although the related lessee and lessor rule of section 178(b) and § 1.178-2 does not apply in determining the period over which the cost of acquiring a lease may be amortized, the relationship between a lessee and lessor will be a significant factor in applying section 178 (a) and (c) in cases in which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee.

(2) The application of the provisions of this paragraph may be illustrated by the following examples:

Example 1. Lessee A constructs a building on land leased from lessor B. The construction was commenced on August 1, 1958, and was completed and put in service on December 31, 1958. Lessee A was not on July 28, 1958, under a binding legal obligation to erect the building. On the completion date of the building, lessee A had 20 years remaining in his original lease period with an option to renew for an additional 20 years. The building has an estimated useful life of 50 years. During the taxable years 1959 and 1960, A and B are related persons within the meaning of section 178(b)(2) and § 1.178-2, but they are not related persons at any time during the taxable year 1961 or during any subsequent taxable year. Since A and B are related persons during the taxable years 1959 and 1960, the term of the lease shall, for each of those years, be treated as 50 years. Section 178(a) and paragraph (b)(1) of this section become applicable in the taxable year 1961 since A and B are not related persons at any time during that year and because the portion of the original lease period remaining at the time the building was completed (20 years) is less than 60 percent of the estimated useful life of the building (60 percent of 50 years, or 30 years). Thus, the term of the lease shall, beginning on January 1, 1961, be treated as

including the remaining portion of the original lease period (18 years) and the renewal period (20 years), or 38 years, unless lessee A can establish that, as of the close of the taxable year 1961 or any subsequent taxable year, it is more probable that the lease will not be renewed than that it will be renewed. *Example 2.* Assume the same facts as in *Example 1*, except that the estimated useful life of the building is 30 years. During the taxable years 1959 and 1960, the term of the lease shall be treated as 30 years. For the taxable year 1961, however, neither section 178(a) nor section 178(b) apply since the percentage requirement of section 178(a) and paragraph (b) of this section are not satisfied and A and B are not related persons within the meaning of section 178(b)(2) and § 1.178-2.

[T.D. 6520, 25 FR 13689, Dec. 24, 1960]

§ 1.178-2 Related lessee and lessor.

(a) For purposes of section 178 and § 1.178-1, a lessor and lessee shall be considered to be related persons if:

(1) The lessor and lessee are members of an affiliated group, as defined in section 1504 and the regulations thereunder; or

(2) The relationship between the lessor and lessee is one described in section 267(b), except that the phrase “80 percent or more” shall be substituted for the phrase “more than 50 percent” wherever such phrase appears in section 267(b).

(b) In the application of section 267(b) for purposes of section 178, the rules provided in section 267(c) shall apply, except that the family of an individual shall include only his spouse, ancestors, and lineal descendants. Thus, if the lessee is the brother or sister of the lessor, the lessee and lessor will not be considered to be related persons for purposes of section 178 and § 1.178-1. If the lessor leases property to a corporation of which he owns 80 percent or more in value of the outstanding stock, the lessor and lessee shall be considered to be related persons. On the other hand, if the lessor leases property to a corporation of which he owns less than 80 percent in value of the outstanding stock and his brother owns the remaining stock, the lessor and lessee will not be considered to be related persons.

(c) If a relationship described in section 267(b) exists independently of family status, the brother-sister exception does not apply. For example, if the lessor leases property to the fiduciary of a

trust of which he is the grantor, the lessor and lessee will be considered to be related persons for purposes of section 178. This result obtains whether or not the fiduciary is the brother or sister of the lessor since the disqualifying relationship exists because of the grantor-fiduciary status and not because of family status.

[T.D. 6520, 25 FR 13691, Dec. 24, 1960]

§ 1.178-3 Reasonable certainty test.

(a) In any case in which neither section 178 (a) nor (b) applies, the determination as to the amount of the deduction allowable to a lessee for any taxable year for depreciation or amortization in respect of any building erected, or other improvements made, on leased property, or in respect of any cost of acquiring a lease, shall be made with reference to the original term of the lease (excluding any period for which the lease may subsequently be renewed, extended, or continued pursuant to an option exercisable by the lessee) unless the lease has been renewed, extended, or continued, or the facts show with reasonable certainty that the lease will be renewed, extended, or continued. In a case in which the facts show with reasonable certainty that the lease will be renewed, extended, or continued, the term of the lease shall, beginning with the taxable year in which such reasonable certainty is shown, be treated as including the period or periods for which it is reasonably certain that the lease will be renewed, extended, or continued. If the lessee has given notice to the lessor of his intention to renew, extend, or continue a lease, the lease shall be considered as renewed, extended, or continued for the periods specified in the notice. See paragraph (c) of §1.178-1.

(b) The reasonable certainty test is applicable to each option to which the lease is subject. Thus, in a case of two successive options, the facts in a particular taxable year may show with reasonable certainty that the lease will be renewed pursuant to an exercise of only the first option; and, beginning with such year, the term of the lease will be treated as including the first option, but not the second. If in a subsequent taxable year the facts show with reasonable certainty that the sec-

ond option will also be exercised, the term of the lease shall, beginning with such subsequent taxable year, be treated as including both options. Although the related lessee and lessor rule of section 178(b) and paragraph (d) of §1.178-1 does not apply in determining the period over which the cost of acquiring a lease may be amortized, the relationship between the lessee and lessor will be a significant factor in determining whether the "reasonable certainty" rule of section 178(c) and this section applies.

(c) The application of the provisions of this section may be illustrated by the following examples:

Example 1. Corporation A leases land from lessor B for a period of 30 years beginning with January 1, 1958. Corporation A and lessor B are not related persons. The lease provides that Corporation A will have two renewal options of 5 years each at the same annual rental as specified in the lease for the initial 30 years. Corporation A constructs a factory building on the leased land at a cost of \$100,000. Corporation A was not, on July 28, 1958, under a binding legal obligation to erect the building. The construction was commenced on August 1, 1958, and was completed and placed in service on December 31, 1958. On January 1, 1959, Corporation A has 29 years remaining in the initial term of the lease. The estimated useful life of the building on January 1, 1959, is 40 years. The location of the leased property is particularly suitable for Corporation A's business and the annual rental of the property is lower than A would have to pay for other suitable property. No factors are present which establish that these conditions will not continue to exist beyond the initial term of the lease. Since the period remaining in the initial term of the lease on January 1, 1959 (29 years) is not less than 60 percent of the estimated useful life of the building (60 percent of 40 years, or 24 years), the provisions of section 178(a) and paragraph (b)(1) of §1.178-1 do not apply, and since Corporation A and lessor B are not related, section 178(b) and paragraph (d) of §1.178-1 do not apply. However, since the facts show with reasonable certainty that Corporation A will renew the lease for the period of the two options (10 years), the cost of the building shall be amortized over the term of the lease, including the two renewal options, or 39 years.

Example 2. Assume the same facts as in *Example 1*, except that a term of 30 years is the longest period that lessor B is willing to lease the unimproved property; that there was no agreement that Corporation A will have any renewal options; and that any