

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

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other location would be as suitable for Corporation A's business as the leased property. Since the facts do not show with reasonable certainty that the initial term of the lease will be renewed, extended, or continued, Corporation A shall amortize the cost of the building over the remaining term of the lease, or 29 years.

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

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