

each such expenditure and the amortization period selected for each expenditure.

(2) The provisions of subparagraph (1) of this paragraph shall apply to income tax returns and statements required to be filed after May 4, 1960. Elections properly made in accordance with the provisions of Treasury Decision 6209, approved October 26, 1956 (21 FR 8319, C.B. 1956-2, 1370), continue in effect.

§ 1.178-1 Depreciation or amortization of improvements on leased property and cost of acquiring a lease.

(a) *In general.* Section 178 provides rules for determining the amount of the deduction allowable for any taxable year to a lessee for depreciation or amortization of improvements made on leased property and as amortization of the cost of acquiring a lease. For purposes of section 178 the term *depreciation* means the deduction allowable for exhaustion, wear and tear, or obsolescence under provisions of the Code such as section 167 or 611 and the regulations thereunder and the term *amortization* means the deduction allowable for amortization of buildings or other improvements made on leased property or for amortization of the cost of acquiring a lease under provisions of the Code such as section 162 or 212 and the regulations thereunder. The provisions of section 178 are applicable with respect to costs of acquiring a lease incurred, and improvements begun, after July 28, 1958, other than improvements which, on July 28, 1958, and at all times thereafter, the lessee was under a binding legal obligation to make.

(b) *Determination of amount of deduction.* (1) In determining the amount of the deduction allowable to a lessee (other than a lessee who is related to the lessor within the meaning of § 1.178-2) for any taxable year for depreciation or amortization of improvements made on leased property, or for amortization in respect of the cost of acquiring a lease, the term of the lease shall, except as provided in subparagraph (2) of this paragraph, be treated as including all periods for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee (whether or not specifically provided for in the lease) if:

(i) In the case of any building erected, or other improvements made, by the lessee on the leased property, the portion of the term of the lease (excluding all periods for which the lease may subsequently be renewed, extended, or continued pursuant to an option or options exercisable by the lessee) remaining upon the completion of such building or other improvements is less than 60 percent of the estimated useful life of such building or other improvements; or

(ii) In the case of any cost of acquiring the lease, less than 75 percent of such cost is attributable to the portion of the term of the lease (excluding all periods for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee) remaining on the date of its acquisition.

(2) The rules provided in subparagraph (1) of this paragraph shall not apply if the lessee establishes that, as of the close of the taxable year, it is more probable that the lease will not be renewed, extended, or continued than that the lease will be renewed, extended, or continued. In such case, the cost of improvements made on leased property or the cost of acquiring a lease shall be amortized over the remaining term of the lease without regard to any options exercisable by the lessee to renew, extend, or continue the lease. The probability test referred to in the first sentence of this subparagraph shall be applicable to each option period to which the lease may be renewed, extended, or continued. The establishment by a lessee as of the close of the taxable year that it is more probable that the lease will not be renewed, extended, or continued will ordinarily be effective as of the close of such taxable year and any subsequent taxable year, and the deduction for amortization will be based on the term of the lease without regard to any periods for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee. However, in appropriate cases, if the facts as of the close of any subsequent taxable year indicate that it is

more probable that the lease will be renewed, extended, or continued, the deduction for amortization (or depreciation) shall, beginning with the first day of such subsequent taxable year, be determined by including in the remaining term of the lease all periods for which it is more probable that the lease will be renewed, extended, or continued.

(3) If at any time the remaining term of the lease determined in accordance with section 178 and this section is equal to or of longer duration than the then estimated useful life of the improvements made on the leased property by the lessee, the cost of such improvements shall be depreciated over the estimated useful life of such improvements under the provisions of section 167 and the regulations thereunder.

(4) For purposes of section 178(a)(1) and this section, the date on which the building erected or other improvements made are completed is the date on which the building or improvements are usable, whether or not used.

(5)(i) For purposes of section 178(a)(2) and this section, the portion of the cost of acquiring a lease which is attributable to the term of the lease remaining on the date of its acquisition without regard to options exercisable by the lessee to renew, extend, or continue the lease shall be determined on the basis of the facts and circumstances of each case. In some cases, it may be appropriate to determine such portion of the cost of acquiring a lease by applying the principles used to measure the present value of an annuity. Where that method is used, such portion shall be determined by multiplying the cost of the lease by a fraction, the numerator comprised of a factor representing the present value of an annually recurring savings of \$1 per year for the period of the remaining term of the lease (without regard to options to renew, extend, or continue the lease) at an appropriate rate of interest (determined on the basis of all the facts and circumstances in each case), and the denominator comprised of a factor representing the present value of \$1 per year for the period of the remaining term of the lease including the options to renew, extend, or continue the lease at an appropriate rate of interest.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. Lessee A acquires a lease with respect to unimproved property at a cost of \$100,000 at which time there are 21 years remaining in the original term of the lease with two renewal options of 21 years each. The lease provides for a uniform annual rental for the remaining term of the lease and the renewal periods. It has been determined that this is an appropriate case for the application of the principles used to measure the present value of an annuity. Assume that in this case the appropriate rate of interest is 5 percent. By applying the tables (Inwood) used to measure the present value of an annuity of \$1 per year, the factor representing the present value of \$1 per annum for 21 years at 5% is ascertained to be 12.821, and the factor representing the present value of \$1 per annum for 63 years at 5% is 19.075. The portion of the cost of the lease (\$100,000) attributable to the remaining term of the original lease (21 years) is 67.21% or \$67,210 determined as follows:

$12.821/19.075$ or 67.21%.

(6) 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 is commenced on August 1, 1958, and is completed and placed in service on December 31, 1958, at which time A has 15 years remaining on his lease with an option to renew for an additional 20 years. Lessee A computes his taxable income on a calendar year basis. Lessee A was not, on July 28, 1958, under a binding legal obligation to erect the building. The building has an estimated useful life of 30 years. A is not related to B. Since the portion of the term of the lease (without regard to any renewals) remaining upon completion of the building (15 years) is less than 60 percent of the estimated useful life of the building (60 percent of 30 years, or 18 years), the term of the lease shall be treated as including the remaining portion of the original lease period and the renewal period, or 35 years. Since the estimated useful life of the building (30 years) is less than 35 years, the cost of the building shall, in accord with paragraph (b)(3) of this section, be depreciated under the provisions of section 167, over its estimated useful life. If, however, lessee A establishes, as of the close of the taxable year 1958, it is more probable that the lease will not be renewed than that it will be renewed, then in such case the remaining term of the lease shall be treated as including only the 15-year period remaining in the original lease. Since this is less than the estimated useful life of the building, the

remaining cost of the building would be amortized over such 15-year period under the provisions of section 162 and the regulations thereunder.

Example 2. Assume the same facts as in *Example 1*, except that A has 21 years remaining on his lease with an option to renew for an additional 10 years. Section 178(a) and paragraph (b)(1) of this section do not apply since the term of the lease remaining on the date of completion of the building (21 years) is not less than 60 percent of the estimated useful life of the building (60 percent of 30 years, or 18 years).

Example 3. Assume the same facts as in *Example 1*, except that A has no renewal option until July 1, 1961, when lessor B grants A an option to renew the lease for a 10-year period. Because there is no option to renew the lease, the term of the lease is, for the taxable years 1959 and 1960 and for the first six months of the taxable year 1961, determined without regard to section 178(a). However, as of July 1, 1961, the date the renewal option is granted, section 178(a) and paragraph (b)(1) of this section become applicable since the portion of the term of the lease remaining upon completion of the building (15 years) was less than 60 percent of the estimated useful life of the building (60 percent of 30 years, or 18 years). As of July 1, 1961, the term of the lease shall be treated as including the remaining portion of the original lease period (12 1/2 years) and the 10-year renewal period, or 22 1/2 years, unless lessee A can establish that, as of the close of 1961, it is more probable that the lease will not be renewed than that it will be.

Example 4. On January 1, 1959, lessee A pays \$10,000 to acquire a lease for 20 years with two options exercisable by him to renew for periods of 5 years each. Of the total \$10,000 cost to acquire the lease, \$7,000 was paid for the original 20-year lease period and the balance of \$3,000 was paid for the renewal options. Since the \$7,000 cost of acquiring the initial lease is less than 75 percent of the \$10,000 cost of the lease (\$7,500), the term of the lease shall be treated as including the original lease period and the 2 renewal periods, or 30 years. However, if lessee A establishes that, as of the close of the taxable year 1959, it is more probable that the lease will not be renewed than that it will be renewed, the term of the lease shall be treated as including only the original lease period, or 20 years.

Example 5. Assume the same facts as in *Example 4*, except that the portion of the total cost (\$10,000) paid for the 20-year original lease period is \$8,000. Since the \$8,000 cost of acquiring the original lease is not less than 75 percent of the \$10,000 cost of the lease (\$7,500), section 178(a) and paragraph (b)(1) of this section do not apply.

(c) *Application of section 178(a) where lessee gives notice to lessor of intention to exercise option.* (1) If the lessee has given notice to the lessor of his intention to renew, extend, or continue a lease, the lessee shall, for purposes of applying the provisions of section 178(a) and paragraph (b)(1) of this section, take into account such renewal or extension in determining the portion of the term of the lease remaining upon the completion of the improvements or on the date of the acquisition of the lease.

(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 September 1, 1958, and was completed and placed in service on December 31, 1958. Lessee A was not, on July 28, 1958, under a binding legal obligation to erect the building. A and B are not related. At the time the building was completed (December 31, 1958), lessee A had 3 years remaining on his lease with 2 options to renew for periods of 20 years each. The estimated useful life of the building is 50 years. Prior to completion of the building, lessee A gives notice to lessor B of his intention to exercise the first 20-year option. Therefore, the portion of the term of the lease remaining on January 1, 1959, shall be the 3 years remaining in the original lease period plus the 20-year renewal period, or 23 years. Since the term of the lease remaining upon completion of the building (23 years) is less than 60 percent of the estimated useful life of the building (60 percent of 50 years, or 30 years), the provisions of section 178(a) and paragraph (b)(1) of this section are applicable. Accordingly, the term of the lease shall be treated as including the aggregate of the remaining term of the original lease (23 years) and the second 20-year renewal period or 43 years, unless lessee A establishes that it is more probable that the lease will not be renewed, extended, or continued under the second 20-year option than that it will be so renewed, extended, or continued under such option. If this is established by lessee A, then the term of the lease shall be treated as including only the remaining portion of the original lease period and the first 20-year renewal period, or 23 years.

Example 2. Assume the same facts as in *Example 1*, except that the estimated useful life of the building is 30 years. Since the term of the lease remaining upon completion of the building (23 years) is not less than 60 percent of the estimated life of the building (60 percent of 30 years, or 18 years), the provisions

§ 1.178-2

26 CFR Ch. I (4-1-04 Edition)

of section 178(a) and paragraph (b)(1) of this section do not apply.

Example 3. If in *Examples 1* and *(2)*, the lessee failed to give notice of his intention to exercise the renewal option, the renewal period would not be taken into account in computing the percentage requirements under section 178(a) and paragraph (b)(1) of this section. Thus, unless lessee A establishes the required probability, the provisions of section 178(a) and paragraph (b)(1) of this section would apply in both examples since the term of the lease remaining upon completion of the building (3 years) is less than 60 percent of the estimated useful life of the building in either example (60 percent of 50 years, or 30 years; 60 percent of 30 years, or 18 years).

(d) *Application of section 178 where lessee is related to lessor.* (1)(i) If the lessee and lessor are related persons within the meaning of section 178(b)(2) and § 1.178-2 at any time during the taxable year, the lease shall be treated as including a period of not less duration 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 Decem-

ber 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,