

Blakes Bulletin

Real Estate

Ontario's New Harmonized Sales Tax: Practical Considerations for Landlords and Tenants

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INTRODUCTION

In March 2009, the Ontario government announced the harmonization of the provincial sales tax of 8% (the PST) with the federal goods and services tax of 5% (the GST) to create a harmonized consumption tax of 13% (the HST). Generally, the HST will apply to goods and services in the same manner that GST currently does. In other words, most goods and services on which the GST was levied will become subject to the HST. It is expected that Ontario's HST will be substantially similar to the 1997 introduction of HST in Newfoundland, Nova Scotia and New Brunswick. In anticipation of the HST's effective date of July 1, 2010, this article highlights some issues of relevance to landlords and tenants.

INPUT TAX CREDITS AND THE EFFECT OF HST ON BUSINESSES

Under the current tax regime, with the exception of GST-exempt businesses, GST that is paid by a business is credited against GST that the business collects from its customers, which credit is termed an "Input Tax Credit" or "ITC." A GST-exempt business does not collect GST from its customers, and as such, claims no ITCs. GST-exempt businesses include (but are not limited to) businesses providing the following: health care and dental services; educational services; legal aid services; educational services; and child and personal care services. In addition, supplies provided by public bodies, financial services organizations (such as banks and credit unions) and charities are GST-exempt.

Generally speaking, once the HST is effective, the operating expenses of GST-exempt businesses will increase, as these businesses will be required to pay HST on their rent (and other expenses), but will continue to be ineligible to claim ITCs. On the other

hand, those businesses that are currently permitted to claim ITCs (i.e., non-exempt businesses) will experience a cost savings as currently no credit is available for these businesses on PST paid on goods and services, whereas a full ITC will now be available for HST.

PRACTICAL EFFECT ON LEASES

Large businesses, defined as those with taxable sales in excess of C\$10-million per annum, will be restricted from claiming ITCs on particular transactions. Specifically, until June 30, 2015 (or five years after the date of HST implementation), large businesses will not be able to claim ITCs on the 8% of the HST (i.e., what would have been the PST) that they paid for the following: food and beverages; entertainment; vehicles weighing less than 3,000 kilograms (and fuel associated with the same); telecommunications services (but not including toll-free numbers and Internet services); and energy. Instead, the ITCs for the foregoing services will be phased in during the period from July 1, 2015, to June 30, 2018, with full ITCs becoming available in 2018. In short, during the first five years following the introduction of the HST, the new ITC rules will effectively increase the cost of the foregoing products and services for commercial property owners and managers who are deemed to be large businesses. Therefore, where no ITC is available to a landlord for a portion of operating costs because the landlord qualifies as a large business, the definition of operating costs in leasing documentation should be revised to allow for the recovery of HST not available for ITCs. As a result, the HST regime will adversely affect tenants, since landlords will be reimbursed for their increased operating costs by passing the same onto their tenants.

Landlords should also ensure that all offers to lease, letters of intent, leases and other ancillary lease documentation (such as lease amending agreements) are worded such that the HST to be paid by a tenant is adequately captured. References to GST should be removed from all such documents, and definitions re-crafted so that taxes are defined broadly enough to

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Lease Assignments in Bankruptcy and Insolvency: Where Do We Go From Here?

LAUREN TEMPLE

In September 2009, amendments to the *Bankruptcy and Insolvency Act* (Canada) (BIA) and the *Companies' Creditors Arrangement Act* (Canada) (CCAA) came into effect that gave trustees in bankruptcy and debtors the specific right to assign leases in the course of their bankruptcy or insolvency proceedings. The result, rather than providing some certainty on the matter, is to significantly muddy the waters for landlords seeking to protect themselves and to raise questions as to who are appropriate persons to whom leases can be assigned in bankruptcy and insolvency proceedings.

Prior to the legislative amendments, the assignment of leases could only be effected by court order and with reliance upon the provisions of individual pieces of provincial legislation. In Ontario, for example, section 38(2) of the *Commercial Tenancies Act* (CTA) permitted a trustee in bankruptcy to assign the lease to any other party upon the consent of the landlord or the approval of the court and upon fulfilling certain conditions (such as paying all arrears of rent). This provision effectively overrode any provisions in the lease to the contrary. Nonetheless, landlords took comfort in that the CTA required that the assignee be a person who was proven to be a "person fit and proper to be put in possession" and that such person could prove that its intended use would not be "more objectionable or hazardous" than the present use under the lease. Moreover, a well-developed line of case law had been established that gave landlords some comfort that the terms of the lease would not be amended wholesale as a result of the bankruptcy or insolvency of the tenant. Rather, the courts tended to focus on ensuring that the landlord ended up with a deal roughly equivalent to what it started with: namely, a tenant with the financial capability to perform all of its obligations under the lease (including abiding by the use clause of the lease).

The new insolvency legislation amendments, however, have thrown the developed case law in every province into some disarray. In particular, the new section 84.1 of the BIA provides:

"(1) On application by a trustee and on notice to every party to an agreement, the court may make an order assigning the rights and obligations of a bankrupt under the agreement to any person who is specified by the court and agrees to the assignment.

...

(3) Subsection (1) does not apply in respect of rights and obligations that are not assignable by reason of their nature....

(4) In deciding whether to make the order, the court is to consider, among other things,

(a) whether the person to whom the rights and obligations are to be assigned is able to perform the obligations; and

(b) whether it is appropriate to assign the rights and obligations to that person.

(5) The court may not make the order unless it is satisfied that all monetary defaults in relation to the agreement – other than those arising by reason only of the person's bankruptcy, insolvency or failure to perform non-monetary obligations – will be remedied on or before the day fixed by the court."

An almost identical provision can be found in the new section 11.3 of the CCAA. Unfortunately, given the newness of the legislation, there are not yet any reported cases that have considered these amendments. It therefore remains to be seen how the courts will interpret the many questions raised by the new legislation.

First and foremost is the question of whether or not these provisions even apply to leases. Both the BIA and the CCAA provisions each make clear that they do not apply to "agreements that are not assignable by their nature." Do leases, which often provide that they are not assignable without consent, fall within this category? This would seem to render the provisions meaningless, although it raises an important question of what it means to have an agreement that is not assignable by its nature. Does this mean only personal licences or personal service agreements? Or does it also include agreements that are not assignable by their

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terms and by the agreement of the parties? Given that the previous incarnation of this amendment specifically excluded commercial leases – an exclusion that was erased by the amendments set forth in the recent *Economic Recovery Act* (Canada) – this argument is unlikely to succeed. If Parliament had meant to exclude leases, it could have done so more clearly (and had done so, previously).

Secondly, if the legislation is applicable to leases (which is almost certain), the legislation creates some uncertainty as to whom the lease may be assigned. The legislation makes clear that a court may consider, among other things, whether the proposed assignee is “able to perform the obligations” and whether “it would be appropriate” to assign the lease to that person. While these considerations seem to indicate a legislative intent to import a “fit and proper person” test, the wording points to a much less exacting standard. Additionally, it is to be noted that the court may consider these factors “among other things,” which lends itself to the expectation that courts may also consider any number of other factors, including the potential impact on the bankrupt or debtor’s restructuring plan or the impact on other creditors. There is a very real risk that courts may be tempted to rewrite leases, particularly those that are above market, for the benefit of the greater good of a pool of creditors or a struggling debtor. For landlords, this risk may taint otherwise advantageous deals.

Finally, the new legislative amendments make clear that monetary defaults, such as arrears of rent, will need to be cured prior to assignment. Or do they? Look carefully. The court is to ensure that monetary defaults are cured, except “those arising by reason only of the person’s bankruptcy, insolvency or failure to perform non-monetary obligations.” Did the arrears of rent arise *because* of the tenant’s bankruptcy? Some monetary defaults, such as the obligation to pay three months’ accelerated rent or the requirement to pay back the unamortized costs of leasehold improvement allowances, typically only arise on the tenant’s bankruptcy or insolvency, and the legislative amendments would suggest that they do not need to be paid. Additionally, the legislative amendments suggest that bankruptcy or insolvency stops the clock on arrears of rent, forgiving everything arising after the date of filing. Indeed, if one is to take the interpretation to the extreme, it might also be possible to argue that

any arrears of rent should be forgiven (regardless of the formal date of filing), given that the very inability to pay rent is often one of the hallmarks of an insolvent or bankrupt person. For landlords in jurisdictions where the requirement to pay arrears is not necessarily a precondition of assignment in bankruptcy or insolvency, such as British Columbia, this will not necessarily seem out of order. But for landlords where payment of arrears was a necessary precondition of assignment, such as Ontario, this will appear as an unwelcome step backward.

This discrepancy reveals a problem at the very heart of the new legislative amendments. By choosing the lowest common denominator between the provincial requirements, the federal legislation has exposed the inequity among them. And by leaving some landlords worse off than they were before, the new amendments will inevitably raise a question as to whether or not it is appropriate for the federal government to be legislating in an area that was adequately (albeit unevenly) being dealt with before by the provinces. Indeed, previous attempts by the federal government to include similar provisions in the BIA were struck down by the courts in 1929 as being outside the legislative scope of the federal government and belonging instead to the provincial sphere of influence over property and civil rights. It is certainly therefore open to landlords to argue that the new amendments are beyond the powers or legal authority of the federal government.

In the meantime, however, landlords are left with an uncertain legislative landscape and questions as to how best to protect themselves. Prudent landlords should consider carefully crafting use provisions to make clear not only what uses are permitted, but what uses are prohibited, particularly outlining any restrictive covenants or exclusives the landlord has granted to third parties. In doing so, the lease may send a strong signal to the courts of what effect their interference might cause.

International Financial Reporting Standards and Operating Cost Recoveries

JOSEPH GRIGNANO

INTRODUCTION

On January 1, 2011, Canadian Generally Accepted Accounting Principles (GAAP) will be replaced by the International Financial Reporting Standards (IFRS) as the financial reporting standard required for Canadian businesses that are "publicly accountable enterprises." The IFRS system of reporting is used around the world and is widely regarded as a single set of high-quality, understandable and enforceable global standards. The transition to IFRS promises enhanced comparability and transparency of the financial health of companies.

Landlords that are publicly accountable enterprises (e.g., publicly traded real estate companies and REITs, as well as many insurance companies and pension funds) are included in the group of businesses that will be required to move to IFRS. Landlords that do not fall within this group (e.g., family-run or closely held landlord companies) have the option of adopting either IFRS or new private enterprise standards that are in accordance with Canadian GAAP for private enterprises.

IFRS AND TREATMENT OF INVESTMENT PROPERTIES

The specific IFRS reporting standards applicable to investment properties (e.g., shopping centres and office towers) are known as IAS 40 – Investment Property (IAS stands for International Accounting Standards). Under current Canadian GAAP rules, a landlord of an investment property must record and carry the property on its books on a historic cost basis in each year deducting any accumulated depreciated value of the property. Under the IFRS standard, a landlord must initially record the investment property at cost but, following initial recognition, has the choice to record the property using either: (a) a fair value model (being fair market value of the property as at the last day of the then-current accounting period), with any changes in the value of the property being recognized as a profit or loss during the accounting period in which it arises; or (b) a cost model that contemplates the deduction of accumulated depreciation from the original cost (in a

manner generally similar to current GAAP). The ability to report property using the fair value model represents the biggest change for investment properties over current GAAP.

IFRS OPERATING COST RECOVERABILITY ISSUES

In determining the carrying amount of investment property under the fair value model, a landlord is not permitted to double-count assets or liabilities that could be recognized as separate assets or liabilities. Accordingly, if a piece of equipment or a particular facility (e.g., an HVAC unit or roof) forms an integral part of a property, then that value must be included in the fair value of the property, instead of being separately recognized. On the other hand, the cost model requires a landlord to utilize what is called a "component" approach to recognition of parts of an asset that will likely be replaced sooner than, and separately from, the rest of the asset (for many properties, the above-noted examples of an HVAC unit and roof would qualify as separate components). Under the cost model, each separate component is recorded and depreciated separately.

In light of the foregoing, leases that simply link the calculation and recovery of operating costs to IFRS (such as through the use of statements like "operating costs will be calculated in accordance with IFRS" or "capital costs will be amortized in accordance with IFRS") could lead to unfavourable results for both landlords and tenants. This is because there is, in effect, no recognition of amortization or depreciation under the IFRS fair value model. For example, if a shopping centre replaces its roof at a cost of C\$2-million dollars, there would be no amortization of the cost under the fair value model (i.e., the cost could be expensed in the year incurred); instead, the value of the building at the end of the accounting period would simply be compared to the fair value at the start of the period and any change would be recognized as a profit or loss. Under the cost model, the roof would likely be recorded and carried as a separate item on a depreciated basis. A tenant that sought to have capital costs amortized "in accordance with IFRS" might be in for a surprise later on down the road if the landlord adopted or took the position that the fair value model of IFRS applied because such capital cost could then be expensed in the year incurred.

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Simply making reference to IFRS without further detail could also lead to unfavourable results for landlords who seek to recover the original cost of big-ticket items on a "sinking fund" or "depreciated basis." For example, a tenant could argue that, since the lease requires operating costs to be calculated "in accordance with IFRS," the landlord is not entitled to continue to pass through the amortization or depreciation of costs incurred prior to the tenant's lease commencement date item, as the fair value model of IFRS dictates that the cost of the item should be reflected in the fair value of property and cannot be carried as a separate item on a depreciated basis.

LEASE DRAFTING RECOMMENDATIONS

From both a landlord's and tenant's perspective, simple references to GAAP and IFRS as a means of providing guidance in relation to the recoverability of certain pass-through operating costs should be avoided as this could lead to confusion and unintended consequences. As noted above, making reference to IFRS without further amplification could also lead to unintended consequences given that the treatment of capital expenditures is quite different depending on whether the fair value or cost model is adopted. Additional confusion and unintended consequences could also arise where the original landlord may utilize one model, but its successor (i.e., a purchaser) may utilize a different model. In addition, unless the lease expressly recognizes that the parties have turned their attention to the differences between GAAP and IFRS, making reference to GAAP could be subsequently interpreted by a court to mean IFRS, particularly where the landlord is required to report using IFRS standards.

In light of these and other problems, both landlords and tenants would be wise to expressly articulate in their leases their intent as to how and which capital or big-ticket items may be recovered through operating costs. This should be accomplished not by making reference to GAAP, IFRS or any other accounting standard but rather by explicit and precise language that clearly captures the full intent of the parties. Possible approaches could be:

- including a detailed list of what original (as opposed to repairs or replacements) equipment and facilities capital costs could be recovered on a depreciated/sinking fund basis
- including a detailed list of what repair/replacement items would be considered a capital cost or deeming repair/replacement costs for specified items in excess of a stated amount to be capital in nature
- expressly articulating the amortization period for recovery of big-ticket items, such as over a set number of years or over the useful life of the item in question
- expressly setting out the interest rate applicable to any depreciation/amortization

Lease Take-Overs: Key Issues and Concerns

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A lease take-over is an arrangement whereby a landlord agrees to assume some or all of the prospective tenant's remaining obligations under its existing lease in order to induce the tenant to enter into a new lease for premises in the landlord's building. The landlord would typically assume these obligations under the tenant's existing lease from and after the commencement date of the new lease.

Such arrangements often arise in the context of the construction of new, large office buildings wherein the financing of the project may be dependant on lease agreements having been signed with tenants representing a certain percentage of the leasable square footage of the building. In such situations, the landlord is incentivized to induce one or two significant-sized "anchor" tenants into lease agreements in order to meet such financing thresholds. Sophisticated tenants, however, are conscious of the probability of delays inherent in any large construction endeavour and are wary of the risks that may result. The new building may take several months or even years to complete, and the planned completion date may be delayed by construction or other issues. As a result, a tenant may lack some degree of certainty as to when it will be able to occupy its new premises and, in the interim, how to deal with its existing premises and landlord. In particular, the tenant may lack the ability to overhold in its existing premises and be forced to face the very real possibility of having nowhere to go after the expiry of its existing lease if the new premises are not ready for occupancy at that time. Most tenants cannot bear the business interruption risk of office downtime between lease arrangements.

The lease take-over solves many of these problems. For the landlord, it allows it to sign up a lease in order to meet financing thresholds. For the tenant, the lease take-over provision in the tenant's new lease would provide for a period of lease overlap, thereby averting the business interruption risk. Additionally, lease take-overs may accommodate issues created by prior expansions of the tenant's existing premises where termination dates may vary or the leased premises may no longer be contiguous. The tenant may therefore wish

to take advantage of the lease take-over arrangement as an opportunity to consolidate premises or termination dates.

While lease take-overs provide a useful response to a number of leasing issues in new office buildings, there are several key areas of concern of which both tenants and landlords should be aware. From the tenant's perspective, following commencement of the new lease, although no longer in physical possession or occupation of its old premises and notwithstanding that the new landlord may have agreed to assume the tenant's existing rent obligations, the tenant remains primarily liable to fulfil its obligations under the existing lease and is therefore responsible for any default of the new landlord in making such rental payments. Tenants should therefore seek to include provisions in the new lease to mitigate such risk by allowing them to set off any payments owing under the new lease against rent arrears under the existing lease. If the landlord (or in some cases, the landlord's lender) will not agree to the tenant's right to set off such amounts, as a fall-back position, the tenant should consider requesting a letter of credit to secure the landlord's obligation to make the rental payments under its existing lease. Additionally, the tenant may wish to include provisions entitling it to receive a portion of any consideration arising from the early surrender of the existing lease where negotiated between the new and existing landlords. Further, although the landlord is agreeing to assume certain of the tenant's remaining financial obligations under its existing lease, the tenant should consider requiring the new landlord to assume all of its lease obligations, as there may be restoration, repair, insurance or other obligations that the tenant will continue to be responsible for during and at the end of the term of the existing lease.

On the other hand, there are a number of issues that the new landlord should seek to address. The new landlord should ensure that the lease take-over provision is drafted so that its obligations are contingent on: (i) reviewing and approving the existing lease (in particular, the new landlord will want to confirm that the existing lease provisions on assignment or subletting are not unduly restrictive); and (ii) requiring the tenant to obtain an estoppel certificate from the existing landlord for the existing lease confirming that the existing lease is in good standing.

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It goes without saying that the landlord will wish to recover as much of the cost of carrying the balance of the tenant's existing lease commitments as possible by trying to assign or sublet the premises to a third party or negotiating an early surrender agreement with the existing landlord. However, since the legal relationship under the existing lease is between the tenant and the existing landlord, the landlord has no legal standing under which to take any action with respect to the existing premises. As such, the lease take-over agreement should require the tenant to co-operate fully with the new landlord with respect to its efforts to assign the existing lease, sublet the existing premises, or to arrange a surrender of the existing lease or otherwise dispose of the existing premises. The tenant should also be required to seek all necessary consents or to provide any executed documents required in connection with such efforts by the landlord. The tenant should not be permitted to renew, extend or otherwise amend the existing lease without the new landlord's prior written consent. Additionally, the tenant should be contractually obliged to execute any consents or other documents within a reasonable or specific period of time, regardless of any alleged defaults or other outstanding issues existing between the tenant and the new landlord. From the new landlord's perspective, the lease take-over provision should explicitly provide that any rent, additional rent or other monies payable by any subtenant, assignee or occupant or by the existing landlord in connection with the existing premises shall be the property of the new landlord. Finally, the new landlord should ensure that the new lease requires the tenant to vacate the premises under the existing lease so that the landlord may undertake to assign or sublet the old space as expeditiously as possible.

Although lease take-overs can clearly offer both landlords and tenants flexibility in addressing certain leasing issues, they can also create additional risks to either party if key areas are not considered and addressed when drafting lease take-over provisions.

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include the HST. A failure to make the foregoing changes to one's documentation is not fatal, as legislation codifies that sales taxes (including HST) must be collected on taxable items, and as such, even where a lease is silent with respect to sales tax, it is deemed to apply. However, specific references to taxes in leases are for the landlord's benefit, for if the tenant fails to pay the same, a lease default is triggered.

HST AND RENT PAYMENTS – TRANSITIONAL RULES

Under the new HST regime, the 13% HST will generally apply to commercial lease rent payments due on or after July 1, 2010. However, landlords and tenants should also be aware that certain transitional rules apply to rent payments made prior to July 1. In this regard, it should be noted that as a general rule of thumb, HST will also apply to rent payments made on or after May 1, 2010, if part of the rent payment relates to a lease period that begins on or after July 1, 2010. For example, a tenant who makes a semi-annual rent payment for the period May 1, 2010, to October 31, 2010, would have to pay HST for the months of July, August, September and October but not for May and June. This rule does not apply, however, if the lease period ends before July 31, 2010. For example, a tenant who makes a lease payment for the lease interval from May 15, 2010, to July 14, 2010, would not have to pay HST on any portion of the payment as the lease interval ends before July 31.

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