

CASE COMMENTS AND NOTES

LEASEBACK FINANCING AND OWNER/TENANT TAX DEPRECIATION ALLOWANCES

In the past five or six years the mortgage field in Alberta has become increasingly occupied by a relatively complicated form of transaction described generally as leasebacks. The breed of transaction is by no means new, having thrived in Great Britain and the Eastern United States for many years,¹ but is still in the early formative stages in our Western Canadian Torrens jurisdictions. In this note the writer proposes to discuss one area of difficulty particularly significant to developers and their solicitors in the documentation of leasebacks, namely, the problem of dealing with tax depreciation allowances on leaseback properties.

First of all, what is the basic form taken by a leaseback transaction? Essentially in all cases it involves three transactions or conveyances. The first transaction comprises the sale of the land which a developer wishes to develop² to a lender for a price that will usually reflect the fair market value³ of the raw or undeveloped land.⁴ Secondly, the lender, as owner of the land (as a result of the sale) will grant to the developer a long-term lease (for a period lasting from 40 to 99 years, depending on the nature of the property and the policy of the lender). Such lease will provide for two types of rent. The first is a basic or ground rent normally fixed at an amount that will yield a return equal to the current mortgage interest rate⁵ on the sum of the land sale price.⁶ The basic rent is payable monthly in advance and is generally subject to upward revision on a periodic basis (normally every 20 or 25 years), such upward revision being based on the value of the bare land⁷ on the re-valuation date. The second type of rent comprises a participation feature.⁸ It provides for the payment, either on a pre-estimated monthly basis or, more commonly, on an annual basis following presentation of annual audited financial statements, of a set percentage of gross income or net income or variations between gross and net.⁹

¹ McMichael & O'Keefe, *Leases: Percentage, Short and Long Term* (5th ed. 1959), ch. 1.

² Leasebacks are not confined to new construction. Sometimes a landowner finds it advantageous to refinance an existing commercial property by leaseback, thereby converting into cash the undepreciable value of the raw land.

³ In the lender's estimate.

⁴ Even on the leaseback refinancing of an existing development the sale price will normally be based on the value of the land alone without improvements.

⁵ Actually, the rate is generally about $\frac{1}{2}\%$ lower than the current mortgage rate and, at the time of writing of this note (June, 1971) is from $8\frac{3}{4}\%$ to $9\frac{1}{4}\%$.

⁶ *E.g.* if the land is purchased for \$150,000.00, the basic rent (at $9\frac{1}{4}\%$) would be \$13,875.00 per annum.

⁷ *I.e.* without improvements.

⁸ To a significant extent, the growth in the number of leasebacks in recent years has been the product of the desire of lenders to participate in the profits of projects they finance and thereby hedge against the effects of inflation. Although some lenders place participation provisions directly into conventional mortgages, most prefer to place such provisions in a lease, where they are not (hopefully) subject to the provisions of the Interest Act, R.S.C. 1970, c. 1-18, and the unconscionable transactions legislation in force in several provinces, and where they cannot be terminated by prepayment of the mortgage balance.

⁹ When participation is based on gross income the developer-lessee is normally required to pay the lender from 3% to 5% of all income received from the property without deduction. Such a participation factor is now falling into disuse because it tends to put the developer in an unfair position if expenses of operation

The third transaction involves a basically conventional mortgage¹⁰ given on the leasehold estate. The proceeds of such mortgage are designed to pay for the cost of construction of the improvements which the lease provisions require to be constructed on the land by the developer.¹¹ Collateral security documents are also often required in accordance with normal financing practice, such as personal guarantees,¹² assignments of rents, chattel mortgages and so forth.

That being the nature of leaseback transactions, what problems are presented by the regulations under the Income Tax Act¹³ in respect to depreciation allowances? Two or three preliminary points might first be made. On leasebacks the owner-lessor does not depreciate the improvements; 100% of the depreciation is left to the lessee-developer to claim. Secondly, the rate of depreciation claimable by the lessee-developer, and particularly his assigns, significantly affects the marketability¹⁴ and hence the value of the leaseback property. Finally, it appears that the developer's rate of depreciation and a subsequent purchaser's rate are not the same.

The depreciation provisions of the Income Tax Act regulations are

escalate. More commonly now lenders endeavour to base participation on net income to avoid the inequitable 3% off-the-top-to-the-lender situation. Generally in net income participation provisions, the developer is entitled to deduct annual taxes, mortgage payments, insurance premiums and basic rental payments as well as a set allowance for miscellaneous expenses (currently about 16% for office buildings) before reaching the sum of income on which participation rent is to be paid. A fixed allowance for general expenses is designed to give the lender some control over the expenses deductible by the developer and generally reflects a fair allowance (in current market conditions) for actual normal expenses.

¹⁰ Additions to the conventional type of mortgage form are, of course, necessary to make it suitable for a leasehold mortgage. *E.g.* provisions have to be added to make a default under the lease a default under the mortgage, to permit the mortgagee to cure the lessee's defaults and charge the cost to the mortgage account, *etc.* In Alberta, and presumably in other Torrens system jurisdictions, the Land Titles Act mortgage (as distinct from a mortgage by way of sublease or assignment of lease: see *Falconbridge on Mortgages* 85 (3rd ed.)) is entirely suitable for a leasehold mortgage. The Alberta Land Titles Act definition of "land" in s. 2(1) R.S.A. 1970, c. 198, is sufficiently broad to include leasehold estates: see *Falmouth v. Thomas* (1832) 149 E.R. 326; *Inmon v. Stamp* 171 E.R. 386; *Edge v. Stafford* (1831) 148 E.R. 1474; *cf. F. C. Richert Co. Ltd. v. Registrar* [1937] 3 W.W.R. 632 (Alta. C.A.); and the definition of "mortgage" includes "any charge on land" (s. 2(o)) and should therefore include a charge on leasehold estates. Indeed s. 103 of the Act clearly envisages mortgages of leasehold estates.

¹¹ Or, in the case of an existing building, designed to pay for the value of the building. Normally the amount of the mortgage will be 75% of the total cost or building value due to the need for some equity to be held by the developer.

¹² Usually guarantees of both the lease and mortgage are required.

¹³ R.S.C. 1970, c. I-5. It is not clear whether the new tax legislation passed in December of 1971 will alter the operation or nature of the problem herein discussed. The writer believes not, although the regulations under the new legislation are not yet available. Section 20(1)(a) of the new legislation (which allows deduction of depreciation allowances from income) is the same (except for section reference numbers) as s. 11(1)(a) of the 1970 Act. Furthermore, although new regulations are proposed in respect to capital cost allowances on real estate [see *Stikeman's, Income Tax Act Annotated* 662-663 (1972)], the changes are designed only to prevent write-off of depreciation expense from rental properties against non-rental income. There is no suggestion to date that the depreciation allowances themselves will be amended.

It may be that the tax and regulation changes will significantly affect the market for rental properties in the sense that professional and other people not actively engaged in real estate development or business will no longer be buying rental properties as a tax shelter. That, however, does not affect the question of applicable depreciation allowances.

¹⁴ Recent experience in Alberta has shown that, principally due to the depreciation problem hereinafter related, leaseback properties have been very difficult to sell, particularly apartment buildings. The chief market for such properties in recent years has been professional and business people who seek the benefit of a tax shelter or write-off that can be found in the 10% depreciation allowance for walk-up apartments and the 5% allowance on masonry structures. However, on a fully-constructed leaseback property, for the reasons hereinafter stated, a buyer may acquire only a 2½% allowance; which is completely unmarketable on walk-ups and almost so on masonry structures. However, as indicated in n. 13, *supra*, the tax-shelter market may now largely disappear under tax changes instituted in 1971.

A further recent development that may well adversely affect the attractiveness of leasebacks is found in the decision of the Supreme Court of Canada in *M.N.R. v. Allarco Developments Ltd.* 72 D.T.C. 6154. In that case the M.N.R. was successful in levying income tax against profit obtained by the developer on the leaseback sale to a lender. The developer had acquired the lands for substantially less than the \$1,000,000.00 consideration received on the transfer that formed part of the leaseback transaction. The result of the case for some developers (those who may be considered to be in the business of trading in real estate) will be to catch them in a squeeze between an income tax levy if they transfer the land to the lender for a sum greater than the land assembly costs and the realization of a relatively small amount of capital if they transfer the land to the lender at cost.

found in section 1100 and following. Under section 1100(1)(a) a taxpayer is permitted to deduct from his income in each year such part of the capital cost as is allowable for the class of asset in question:

Under paragraph (a) of subsection (1) of section 11 of the Act, there is hereby allowed to the taxpayer, in computing his income from a business or property, as the case may be, deductions for each taxation year equal to

(a) such amounts as he may claim in respect of property of each of the following classes in Schedule B not exceeding in respect of property [here the classes and rates are listed] of the amount remaining, if any, after deducting the amounts, determined under sections 1107 and 1110 in respect of the class, from the undepreciated capital cost to him as of the end of the taxation year (before making any deduction under this subsection for the taxation year) of property of the class;

That allows, *e.g.*, a 10% allowance for walk-up apartments (Schedule B, class 6) and a five percent allowance for other buildings not specified in other classes.¹⁵ This is the allowance an owner of a building can claim, and is the allowance that would apply to a building financed by purely conventional means rather than leaseback.

The allowance for leasehold interests is found in section 1100(1)(b), which permits a deduction calculated in accordance with Schedule H in respect to the capital cost to the taxpayer of property in class 13 in Schedule B:

such amount, not exceeding the amount for the year calculated in accordance with Schedule H, as he may claim in respect of the capital cost to him of property class 13 in Schedule B.

Class 13 in Schedule B is "property that is a leasehold interest". Schedule H, which applies to such interest with an exception described below, provides in sections 1 and 2 that the depreciation rate will be the lesser of (a) one-fifth of the capital cost of the lease or (b) the amount determined by dividing the capital cost of the lease by the number of years remaining in the lease term at the time when the capital cost is incurred, not exceeding 40:

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1. For the purpose of paragraph (b) of subsection (1) of section 1100, the amount that may be deducted in computing the income of a taxpayer for a taxation year in respect of the capital cost of property of class 13 in Schedule B is the lesser of
 - (a) the aggregate of each amount determined in accordance with section 2 of this Schedule that is a prorated portion of the part of the capital cost to him, incurred in a particular taxation year, of a particular leasehold interest; or
 - (b) the undepreciated capital cost to the taxpayer as of the end of the taxation year (before making any deduction under section 1100) of property of the class.
2. Subject to section 3 of this Schedule, the prorated portion for the year of the part of the capital cost, incurred in a particular taxation year, of a particular leasehold interest is the lesser of
 - (a) one-fifth of that part of the capital cost; or
 - (b) the amount determined by dividing that part of the capital cost by the number of 12-month periods (not exceeding 40 such periods) falling within the period commencing with the beginning of the particular taxation year in which the capital cost was incurred and ending with the day the lease is to terminate.

Thus, when a taxpayer acquires a lease with a term remaining in excess of 40 years, he may depreciate his capital cost for the leasehold

¹⁵ This includes high-rises, office buildings and other buildings of masonry construction.

estate at $100/40 = 2\frac{1}{2}\%$ per year. If a taxpayer acquires a lease with a remaining term of 30 years, he may depreciate at $100/30 = 3\frac{1}{3}\%$ per year. If the remaining term is 10 years, he may depreciate at 10%.

Of course, with most leasebacks including terms of 40 to 99 years, the rate allowable to purchasers ($2\frac{1}{2}\%$) is significantly less than that claimable by an owner (10% or 5% depending on the type of structure).

There is a significant exception to the general leasehold allowance found in section 1102(5) as follows:

Where the taxpayer has a leasehold interest in a property, a reference in Schedule B to a property that is a building or other structure shall be deemed to include a reference to that part of the leasehold interest acquired by reason of the fact that the taxpayer has

- (a) erected a building or structure on leased land,
- (b) made an alteration to a leased building or structure, or
- (c) made alterations to a leased property which substantially change the nature of the property,

unless the property is included in class 23 in Schedule B.

A similar provision is contained in section 1102(4) in relation to minor alterations and improvements by tenants. These provisions permit the lessee to depreciate his own improvements¹⁶ at the same rate as if he were an owner of those improvements if he completes a lease prior to the construction of the improvements.¹⁷ The same does not apply, however, to a developer who enters into a leaseback after completion of construction or, more significantly, to a purchaser who buys the leasehold estate after completion of construction. This fact has proven to have a significant depressive effect on the marketability of leaseback properties.

Essentially, two devices have been employed in the industry to date to overcome the disparity between the initial developer's depreciation rate and a purchaser's rate. The first and most commonly used involves an effort to create a type of common law emphyteutic lease, that is to say, a lease under which the building during the term is owned by the lessee. The Quebec Civil Code, in Articles 567 to 582, provides expressly for such leases which give the lessee "all the rights attached to the quality of a proprietor,"¹⁸ and provides that he "may alienate, transfer and hypothecate the immovable so leased".¹⁹ As to such leases, the Exchequer Court in *Cohen v. M.N.R.*²⁰ has held that the lessee, whether he be the builder or a purchaser who buys after completion of construction, may depreciate as an owner rather than at the lower lessee's general rate.

Developers and lenders seek to obtain the same result in common law jurisdictions by providing in the lease for separate ownership of the building by the lessee during the term of the lease.²¹ Whether or

¹⁶ I.e. those he constructs himself.

¹⁷ As indicated above, the typical lease on leaseback transactions for new developments provides that the lessee will construct the improvements at his own cost, although, of course, financing for such construction is provided in the leasehold mortgage. It is important for the developer to complete and register the lease before he commences any construction, for the practice of the tax department is to allow the greater depreciation rates only for work done after completion of the lease.

¹⁸ Article 569 of the Civil Code of Quebec.

¹⁹ Article 570 of the Civil Code of Quebec.

²⁰ (1967) C.T.C. 254.

²¹ A sample provision is the following, taken from a leaseback of an Edmonton property:

The Lessor and the Lessee agree that the building and all other fixed improvements which the Lessee may construct upon the lands from time to time are and shall be fixtures to the lands and are in-

not the Tax Department will treat leases containing such provisions in the same way as emphyteutic leases are treated in Quebec is not yet clear, although the judgment of the Exchequer Court in *Leitman v. M.N.R.*²² suggests that the emphyteusis principle will not readily be found or supported in common law jurisdictions.²³

Even if emphyteusis provisions such as those being utilized in Alberta are successful in solving the tax depreciation problem, they present numerous other problems that, from the lender's point of view at least, make them an undesirable solution. The concept is completely alien to established principles of real property tenure in common law jurisdictions such as Alberta and presents at the very least conveyancing problems in our Torrens system of land titles.

At common law, real property consists of land and all things affixed above and beneath it, in the absence of any expression to the contrary:²⁴

The law of fixtures is based upon the old maxim *quidquid plantatur solo, solo cedit*, planted being used in the broad sense of attached, and soil including anything attached in turn to the soil so as to become part of it in the eyes of the law. The maxim has been freely translated as 'whatever is fixed to the freehold of land becomes part of the freehold or inheritance' (per Lord Cairns L.C. in *Bain v. Brand* (1876) 1 App. Cas. 762 at 767 (H.L.)).

As a result, it is customary for a parcel of land to be described in any conveyance simply by reference to its perimeter, without any mention of buildings, since all affixed improvements present and future are automatically incorporated into the land. An infinite number of interests or estates may be carved out of a parcel of land, including leases, mortgages, life estates, easements, etc. However, one normally

tended to be and shall become the absolute property of the Lessor upon the expiration or earlier termination of this lease, but as between the Lessor and the Lessee and until the expiration or earlier termination of this lease, shall be deemed to be the separate property of the Lessee and not of the Lessor, but subject to and governed by all of the provisions of this lease applicable thereto notwithstanding such right of the Lessee; provided always that the absolute right of property of the Lessor in the building and other fixed improvements upon the lands to arise upon the expiration or earlier termination of this lease shall be prior to any other interest which may now or hereafter be created by the Lessee in the building and such fixed improvements, and the Lessee covenants and agrees with the Lessor that all dealings by the Lessee with the building or such fixed improvements which in any way affect title thereto shall be made expressly subject to this right of the Lessor, and that the Lessee shall not assign, encumber or otherwise deal with the building or such fixed improvements separately or apart from any assignment or other permitted dealing by the Lessee with its leasehold interest under this lease, to the intent that no person shall hold or enjoy any interest in this lease acquired from the Lessee unless at the same time holding and enjoying a like interest in the building and such fixed improvements (having regard to the nature of the Lessee's interest in the lands and in the building and such fixed improvements respectively), but the above proviso shall not apply to subleases and agreements for tenancies permitted by Section 17.01(5) and shall not apply so as to prevent the Lessee subleasing the building alone and not the lands from an assignee to whom the Lessee has assigned this lease and all its interest in the building in compliance with Article 17.01(6).

This form is certainly not as broad or empowering, from the Lessee's point of view, as the emphyteusis provisions in the Civil Code, which provide as follows:

Art. 569 Emphyteusis carries with it alienation; so long as it lasts, the lessee enjoys all the rights attached to the quality of a proprietor. He alone can constitute it who has the free disposal of his property.

Art. 570 The lessee who is in the exercise of his rights, may alienate, transfer and hypothecate the immoveable so leased, without prejudice to the rights of the lessor; . . .

Art. 571 Immovables held under emphyteusis may be seized as real property, under execution against the lessee by his creditors, who may bring them to sale with the formalities of a sheriff's sale.

Lenders are not likely to want to go so far in terms of granting rights to the developer-lessees, and this disinclination may itself destroy the effectiveness of "emphyteusis" provisions such as the sample quoted above. Paul H. Folwell discusses the practical considerations of these provisions in *Future Developments in Leases*, 1965 Law Society of Upper Canada Special Lectures 369 to 373.

²² [1967] C.T.C. 368.

²³ In Alberta we have no statutory provisions remotely similar to the emphyteusis provisions of the Civil Code. The writer believes that if a common law or contractual emphyteusis is to succeed here it will have to be expressed in very clear terms and be no more restricted than the Quebec emphyteusis.

²⁴ Anger and Honsberger, *Canadian Law of Real Property* 454 (1959).

conveys by mortgage, lease, easement, etc., an estate in the land and all that goes with it rather than conveying in absolute terms a separate portion of the land or air space or part of a structure. In the light of this system, separate ownership of a building for 75 years is both artificial and ill-adapted.

Of course, our law does not prevent the separation of ownership of a building. Indeed the Condominium Property Act²⁵ allows for precisely that in appropriate cases. However, the separation must be workable in the light of all our laws in Alberta. Certainly an emphyteusis provision in an otherwise conventional lease does not come within the condominium legislation. The writer believes it cannot be practically workable within our other laws unless emphyteusis is legislatively sanctioned as it has been in Quebec.

It is not entirely clear what is intended by the typical clause separating ownership of the building. Is it intended to operate as a conveyance of legal title to the building? Is the building to be treated as realty or as a chattel in the lessee's hands? The clause should be explicit as to what is being conveyed, for if it has no substance as a conveyance, it is neither likely to function effectively nor fool the Tax Department. Yet the provisions the writer has seen in use in this jurisdiction do not have that quality.

Typically, the lease is entered into before the building is constructed, and the emphyteusis clause will state that

(a) during the term the building is deemed to be owned by the lessee, and

(b) on termination the building will belong solely to the lessor.

Thus, before construction, the parties agree to sever from the land the building to be constructed by the lessee. This creates a very difficult problem as to the application of the rules against perpetuities. Even if the building so severed from the land is realty, can it be said that there is, at the time of execution of the lease, a vesting of a reversionary interest in the building in favour of the lessor? The point is at least arguable, and the answer may well be negative. If so, then there is clearly a violation of the perpetuity rule described by Farwell L.J., as follows:²⁶

Our Courts have from the earliest times set their face against the suspense or abeyance of the inheritance and have from time to time laid down various rules to prevent perpetuity. One of those is the rule that a preceding estate of freehold is indispensably necessary to support a contingent remainder: Co. Litt. 342 b, Butler's note; another is the rule laid down in *Purefoy v. Rogers*, 2 Wms. Sound. (Ed. 1871), 768 at pp. 781-9 that no limitation shall be construed as an executory or shifting use which can by possibility take effect by way of remainder; and another (and probably the oldest) was the rule in question forbidding the raising of successive estates by purchase to unborn children, i.e., to the unborn child of an unborn child. The most modern rule, arising out of the development of executory limitations and shifting uses, is what is now usually called the rule against perpetuities, namely that all estates and interests must vest indefeasibly within a life in being and twenty-one years after. But this is an addition to, not a substitution for, the former rules.

Violation of the rule occurs since the lessor's interest in the building may not vest until some time after the perpetuity period.

²⁵ R.S.A. 1970, c. 62.

²⁶ *Re Nash, Cook v. Frederick* [1910] 1 Ch. 1 at 7, 79 L.J. Ch. 1 at 3.

If the severed building is personalty²⁷ during the term of the lease, then the lessor's position is even less acceptable. The law knows nothing of successive estates in personalty,²⁸ and the lessor's right to acquire ownership of the "chattel" building on termination of the lease would not be recognized in law.

If by the lease it is intended to convey ownership of the building as realty, then, quite apart from the question of the appropriateness of the conveyance, the subdivision laws and regulations present a serious impediment. Section 16 of the Planning Act²⁹ provides that land shall not be subdivided unless the procedures and requirements of that section are met. "Subdivision" is defined in section 2(s) of that Act to include "a division of a parcel by means of . . . agreement or any instrument." A lease containing an emphyteusis provision would probably come within this definition and would purport to affect a subdivision, for it purports to sever the ownership of part only of a parcel of land (namely, the building).

Difficulties are presented by our Torrens system of land titles registration and by other practical considerations. Briefly stated, some of them are as follows:

1. When taking a mortgage, the lender would normally describe the property to be mortgaged as a leasehold estate. With a separation-of-building-ownership clause, the mortgage would have to show that what is being mortgaged is a leasehold estate in the land and some other kind of estate in the building amounting to complete ownership. If the ownership of the building is not properly registered at the Land Titles Office by mere registration of the lease, then the mortgage, insofar as it charges ownership of the building will not be secured by registration. Presumably also, on a foreclosure the mortgagee would foreclose both the leasehold estate and the owned building, and would have to take care to claim precisely such relief. The latter is admittedly not a serious problem.
2. What is to be done with the certificates of title at the Land Titles Office on registration of an "emphyteutic" lease? Normally with long-term leases a separate leasehold title will be requested.³⁰ On doing that, the Registrar will show the fee simple title to be cancelled only as to a leasehold estate and will create a leasehold title showing only a "leasehold estate in possession" for a term of years. That will not correctly reflect the true state of ownership, for the lessee will have more than merely a leasehold estate in possession in the buildings, and the fee simple title will contain something less than the whole ownership other than the leasehold estate in possession. Furthermore, the emphyteusis provision in the lease³¹ will not meet the requirements of section 68 of the Land Titles Act³² as to the form of a transfer of land and should not therefore be sufficient to permit issue of a separate title to the building.³³ If a separate transfer of the building were issued

²⁷ Fixtures may be severed by agreement from the land and treated as personalty: See Anger and Honsberger, *supra*, n. 24 at 522 to 526. Whether this can include severance of an entire building is open to question.

²⁸ *Bennett & White (Calgary) Limited v. M.D. of Sugar City* (1951) 3 W.W.R. (N.S.) 111 at 126 (P.C.).

²⁹ R.S.A. 1970, c. 276.

³⁰ As permitted by s. 36 of the Land Titles Act, R.S.A. 1970, c. 198.

³¹ If in form similar to that recited *supra*, n. 21.

³² R.S.A. 1970, c. 198.

³³ Even assuming that the Planning Act presents no impediment.

by the lessor in favour of the lessee, the transaction might be workable from the point of view of our land titles system, but then the impediments of the Planning Act would be clearly prohibitive of effective conveyance.

3. If the building, treated by the lease as being severed from the realty, is a chattel, then should a chattel mortgage rather than a land mortgage be registered by the lender? This suggestion may be somewhat fantastic, but it is possible by agreement to treat fixtures as being severed from realty.³⁴

4. If the lessee owns the building, does the lender-lessor have any insurable interest therein?

5. Builder's lien claimants as well as the Tax Department would have an interest in attacking the effectiveness of the emphyteusis clause. Under the Builders' Lien Act,³⁵ section 12, lien claimants hold remedies they would not have were the building separately owned, specifically, the right to pay rents and take over the lease as lessee and the right, on notice, to charge the whole fee simple interest in the land unless the lessor denies responsibility for improvements done or to be done by the lien claimant. The writer suspects that the courts would in any contest with lien claimants be inclined towards viewing the lease as a lease pure and simple. Even if the separation of ownership is effective, builders' liens could become a matter of consequence to the lender near the end of the lease term if they attach to the building and not merely the leasehold estate.

6. There may be problems in reconveying "title" to the building on termination of the lease. Section 56 of the Land Titles Act³⁶ provides that after a certificate of title has been granted for any land no instrument is effectual to pass any estate or interest in that land unless the instrument is executed in accordance with the provisions of the Act and is duly registered thereunder but upon the registration of any such instrument in the manner prescribed the estate or interest specified therein passes. The lease itself will be registered but there are two possible arguments. One is that a separation of ownership provision is not properly registered when incorporated in the registered lease;³⁷ for example, it was apparently thought necessary to include a specific statutory provision in the Land Titles Act³⁸ that a right of the lessee to purchase land may be stipulated in the lease and that the lessor is, when the right has been exercised, bound to execute a transfer. The other is that it is not clear that an instrument can be a delayed-action conveyance, and it is to be noted that under section 57 of the Land Titles Act it is provided that "so soon as registered every instrument becomes operative according to the tenor and intent thereof, and thereupon creates, transfers, surrenders, charges or discharges, as the case may be, the land or the estate or interest therein mentioned in the instrument." Even if this is taken to mean that whatever is in the instrument goes, it does seem to be inconsistent with the future passing of title and might be said to convey at the moment insofar as the

³⁴ *Supra*, n. 27.

³⁵ R.S.A. 1970, c. 35.

³⁶ R.S.A. 1970, c. 198.

³⁷ As is suggested in paragraph 2 above.

³⁸ S. 98(3).

lessor's reversion is concerned only the right to receive title to the building at a later date. If so, it is arguable that a further conveyance would be needed at the end of the term and this may well be difficult to obtain, especially if the term is ended as a result of defaults of the tenant.

7. The long-established principles of compensation applicable to expropriations of leasehold property may not apply to transactions taking this form. The lessor has at least a reversionary interest in the building. With new construction, expropriation is unlikely to take place. If at all, it will occur late in the lease term, and at that time the value of the buildings to the lender-lessor will be correspondingly greater than in the early years. This fact may not be taken into consideration if at the time of expropriation the lessee owns the building.

The above may be only a few of many practical and legal impediments to the successful functioning of emphyteusis in Alberta; the writer does not pretend to assert that the list given is exhaustive. The point behind all of them is that the emphyteusis provisions employed in Alberta are both artificial and ill-suited to our laws.

Some lenders have accordingly sought out an alternative solution to the depreciation problem raised by leasebacks. Although it appears to present almost as many problems as the emphyteusis clause, it may be a workable solution.

Schedule H, paragraph 3(b), of the Income Tax Regulations provides that the term considered for the purpose of calculating depreciation rates for purely leasehold interests is the balance of the principal term existing at the time of the acquisition of the leasehold estate plus the first renewal term thereof:

Schedule H 3(b)

where, under a lease, a tenant has a right to renew the lease for an additional term, or for more than one additional term, after the term that includes the end of the particular taxation year in which the capital cost was incurred, the lease shall be deemed to terminate on the day on which the term next succeeding the term in which the capital cost was incurred is to terminate;

For example, if a leasehold interest having an initial term of 20 years and three five-year renewal terms is acquired in the fifth year of the principal term, the amortization of the capital cost of the leasehold interest may be spread over 20 years (yielding a depreciation rate of five per cent), even though the total potential lease term remaining at the time of acquisition is 30 years. Some lenders have accordingly proposed leases that have initial terms of, *e.g.*, 20 years followed by a succession of perhaps 10 or more five-year renewal terms. In theory, any purchaser acquiring such a lease from the initial developer will be able to claim depreciation at a rate of no less than four per cent (if he acquires in the first year of the principal term) and perhaps as high as $16\frac{2}{3}\%$ (if he acquires in the last year of the principal term or the last year of any renewal term).

The solution presents three basic problems³⁹ that are entirely practical in nature as well as several problems created by the operation of our Torrens system. None, however are insoluble; and, although this type of solution is in the very earliest stages of use, some guidelines for its use have been set.

³⁹ Apart from the possibility of the Tax Department attacking it as artificial.

The first basic and practical problem is the very real possibility of notices of exercise of the option to renew being missed by the developer, particularly in the later years of the lease. The second is the difficulty presented in terms of refinancing the leasehold interest. The third is the problem involved in the fact that the lender's mortgage itself is normally amortized over 30 years in order to provide repayment levels that are realistic for the income to be produced by the property: if the initial lease term is only 20 years in duration, how does the lender secure his position under his own mortgage?

The problem that would be of chief concern to the developer is the one of obtaining financing on the security of the leasehold estate. Although the lessor-lender is satisfied to issue the initial financing on the project, it is doubtful that another lending institution would be prepared to provide new financing secured on the lease at any time after the 15th lease year. After that time the lease is limited in existing term to a maximum of five years, and that is not likely to be a term of sufficient duration to provide acceptable financing security. Any future renewal, being no more than a conditional option available if the lessee is in good standing under the lease,⁴⁰ would not be a substantial enough right, until exercised, to provide security.

Several alternative option arrangements have been considered to overcome this problem. Term arrangements of 20, 5, 25, 25; 20, 5, 20, 5, 25; and 20, 5, 25, 15, 10 have been examined on 75-year leasebacks. Each has the defect that for at least a part of the 75 years there is either no cure for the depreciation problem or there is an existing term of too short a duration to justify secondary or other financing.

The problem might be solved if, instead of having each renewal option exercisable at the end of each preceding term, it be made to be exercisable in the 15th year preceding the renewal term commencement date. For example, the first renewal option would have to be exercised in the fifth year of the principal term, the second in the 10th year, and so on. This arrangement, though awkward, would be legally workable and would have the advantage of making the existing term at any point during the first 60 years to be between 15 and 25 years in duration. This would certainly assist the developer in obtaining financing on the security of his interest without detracting from his depreciation position. Like any arrangement of a 20-year principal term and subsequent renewals, however, it still presents a problem in terms of the exercise of options, that is, the meeting of notice requirements.

In addition, the last mentioned arrangement does not completely solve the problem of the divergence between the principal lease term and the mortgage term (20 years and 30 years respectively). Although the divergence would not affect the legality of the mortgage (a mortgage of a lease charges both the principal term and all renewals until paid and would be registerable against any leasehold title issued as to the principal term),⁴¹ our Torrens land registry system would present practical difficulties. On registration of the lease, a leasehold title would issue which would relate to or protect only the original 20-year

⁴⁰ Typically, the option to renew will be expressed as being conditional upon the lessee well and truly paying all rents and performing all covenants during the existing term.

⁴¹ Falconbridge, *The Law of Mortgages* 91 to 93 (3rd ed. 1942).

term.⁴² Although the renewal options are caveatable interests in land within the definition of "land" in the Alberta Land Titles Act,⁴³ they cannot be the subject of issue of a certificate of title until they are in fact exercised.⁴⁴ As is indicated in Thom's Canadian Torrens System,⁴⁵ the correct practice for documenting the exercise of renewals of lease in Alberta is to execute a new lease upon the exercise and to register the same.

As a result it would appear that on the initial closing, in addition to registering the lease and causing issue of a 20-year leasehold title, the lessee would want to caveat the fee simple title claiming an interest in renewal rights contained in the lease. The mortgagee in turn, having charged all renewals in its mortgage, would want to caveat the fee simple title as to its mortgagee's interest in renewals.⁴⁶ Later, on the exercise of the first option to renew, the lessee would want to have a further leasehold title issued for the first renewal term, and the mortgagee in turn would want to have its mortgage recorded on such leasehold title. The mortgagee's caveat on the freehold title giving notice of a mortgage charging all renewal terms, should in fact follow and appear as an encumbrance on the new leasehold title. However, for the final 10 years of the mortgage term the mortgagee will have to be satisfied with protection of its mortgage by such caveat. To require the execution and registration of a new mortgage for each exercised renewal term would not be legally workable unless the terms of the initial mortgage were to mature before the expiry of the principal lease term, as there would otherwise be two registered mortgages securing the same debt. It might also create problems of priority of charges if any encumbrances were registered after the initial closing of the leaseback.

Registration by caveat has the disadvantage that in Alberta caveats can be removed on 60 days' notice unless proceedings are commenced in respect to the caveat.⁴⁷ If for any reason a notice to commence proceedings were missed or overlooked by the mortgagee the registration of the charge would be lost. This, however, would seem to be a danger the mortgagee would have to accept for the last 10 years if the 20-year principal lease term and renewal arrangement is to be followed.

Because the first leasehold title will be effective for only 20 years, and because the mortgagee will wish to have some practical control over documentation at the end of that 20 years, the conventional mortgage form should provide for maturity in 20 years, on the first day of the last month of the principal lease term. In addition, since the

⁴² Registration of a lease may not, of itself, protect or be registration of renewal options: *Fels v. Knowles* 26 N.Z.L.R. 604 at 622 to 623; Baalman, *The Torrens System in New South Wales* 232 to 234 (1951); Thom's *Canadian Torrens System* 54 (2nd ed.). See *contra Pearson v. The Aotea District Mauri Land Board* [1945] Gaz. L.R. 205 (N.Z.). The fact that a lease for one year with two one-year renewals has been held in Alberta (*Le Corporation Episcopale Catholique Romane of St. Albert v. R.J. Sheppard & Co. Ltd.* (1913) 3 W.W.R. 814) not to be a three-year lease may to some extent support the view suggested by the writer. The same may be true of the fact that the Alberta legislators felt the need to expressly deal with an option to purchase contained in a lease (Land Titles Act, R.S.A. 1970, c. 198, s. 98(3)) but have not similarly dealt with lease renewal options.

⁴³ On the principle set out in *Inmon v. Stamp* 171 E.R. 386 and *Edge v. Stafford* (1831) 148 E.R. 1474. Cf. *Beesly v. Hallwood Estates Ltd.* [1960] 1 W.L.R. 549; *affirmed* [1961] 2 W.L.R. 36.

⁴⁴ Thom's, *Canadian Torrens System* 54 (2nd ed.). Cf. *Beesly v. Hallwood Estates Ltd.*, *supra*, n. 43.

⁴⁵ *Supra*, n. 44 at 54.

⁴⁶ The Registrar at Edmonton will accept a caveat by the lender on its own fee simple title.

⁴⁷ Land Titles Act, R.S.A. 1970, c. 198, s. 144.

lessee will want to have some assurance of renewal of the mortgage for the last 10 years, yet avoid the cost of refinancing, and since the mortgagee in turn will want to be able to stipulate its original interest rate, the mortgage should provide for an extension of the mortgage maturity date in the event of the exercise of lease renewals.

The documentation for this second type of lease arrangement would tend to become rather complex and cumbersome. Every five years there would have to be a new lease drawn and registered, and eventually it is conceivable that there would exist 12 separate leasehold titles. The lessor may eventually have difficulty in obtaining discharges of the several leases or cancellation of leasehold titles. Although the Land Titles Act⁴⁸ provides that the Registrar of Land Titles may cancel registration of a lease on being satisfied that the lessor has re-entered and gone into possession, the present practice of the Registrar is to avoid using such power and to discharge a lease only upon receipt of a registerable surrender or court order. Accordingly, if at the end of the lease term (that is, the ultimate end) the lessee refuses to co-operate in executing a surrender, the lender may have, at its own cost, to obtain a court order directing vacation of leases. It would probably not, in a practical sense, avail the lender much to stipulate in its lease that such cost will be borne by the lessee or that the lessee will execute surrenders; the "corporate shell" lessee would have no further interest in the matter, nor likely any exigible assets. Furthermore, an order for discharge may be difficult to obtain if the "ultimate end" is due to forfeiture, for our courts would be likely to require that notice be given to the lessee and the lessee would be likely to seek relief against the forfeiture.

If there are no renewals exercised, the last 10 years of mortgage payments will be unsecured. This problem may not be practically solvable at all as long as the initial term of the lease is 20 years and the mortgage amortization period is 30 years. The problem derives, not so much from the maturity date in the mortgage, as from the amortization period; and unless the mortgage payments are both amortized and payable over 20 years the only truly effective way to secure the whole mortgage sum would be to provide for an initial lease term of at least 30 years.

That unfortunately would defeat the aim of assisting the developer with depreciation problems. If the initial lease term is made to exceed thirty years, it may as well be extended to the full seventy-five years, or whatever the case may be.

To require the lessee to exercise the first two or three renewals at the commencement of the leaseback transaction may well be no different in result than setting an initial term of thirty-five or forty years. Certainly, the Tax Department would be apt to argue in favour of such a position, and we doubt if the developer would be willing to accept the risk of the Tax Department succeeding in such an argument.

If the lender is going to accept any lease term shorter than thirty years, it simply has to run the risk of finding itself holding an unsecured balloon principal balance, although requiring renewal options to be

⁴⁸ *Id.* s. 101.

exercised 15 years in advance may practically solve this problem in most cases. The lender does, in any event, face the very same risk in any case in which the lease is forfeited within the mortgage term, whatever the initial lease term may be.

The problem might be helped somewhat if provisions (akin to the provisions allowing the mortgagee to cure defaults) are added to the conventional mortgage form allowing the mortgagee to give notice and exercise renewal rights for and on behalf of the mortgagor. It would not be prudent to have the mortgagor obliged to exercise renewal rights, and this is true whether such obligation be contained in the lease, mortgage or otherwise.⁴⁹ Nor would it be advisable for the renewal rights to be assigned to the mortgagee, as such an assignment could render the mortgagee liable for the lessee's covenants on renewal.⁵⁰ Although the lessee is not likely to seek enforcement against itself as mortgagee, leaseback mortgages must be drawn in a manner that will permit the mortgagee to stand on his own apart from the lessor's position, *i.e.*, that will render the mortgage a marketable investment.⁵¹ The mortgagee should have no more than a right to renew for the mortgagor in order to give it freedom to choose not to renew.

On balance, it is not desirable to add to the lease any provisions stating that notice will be sufficiently given if given by a mortgagee of the lessee's interest. Although such a provision might be of value to any mortgagee, it may not be in the lender's interest as lessor to allow mortgagees other than itself to gain the benefit of such a provision. A time may come when neither the lessor nor the lessee want the lease renewed while another mortgagee does.

These then are some guidelines for the working of the second solution to the depreciation problem. None of the difficulties related above are substantive, and notwithstanding their complexity, it would seem to the writer that the alternative can be worked. There remains the danger that the Tax Department may successfully attack a lease of the breed suggested as artificial and in substance a 75-year lease (or whatever), but that result would leave the developer or subsequent purchaser in no worse position than he would be without the device.

Certainly, on balance, the second solution is both more workable and legally justifiable than the first, and it is expected that lenders will increasingly turn to it.

—E. MIRTH*

⁴⁹ Such an obligation may include legal liability for any failure to exercise or perhaps estoppel.

⁵⁰ Falconbridge, *The Law of Mortgages* 90 (3rd ed.).

⁵¹ The reason for this is two-fold. Firstly, the two positions should be distinct and self-contained if the entire leaseback transaction is not to be construed to be in substance a mortgage, on the principles set out in *G. & C. Kregliner v. New Patagonia Meat & Cold Storage Company Ltd.* (1914) 83 L.J. Ch. 79 (H.L.) and *Noakes v. Rice* (1902) 71 L.J. Ch. 139 (H.L.). Secondly, each position or interest should be separately marketable. The lender normally wishes to preserve the ability to market either the fee simple title or the leasehold mortgage if future economic conditions make the sale of either desirable.

* B.A., LL.B. (Alta.) member of the Alberta Bar. The writer wishes to express his gratitude to his associates Wm. H. Hurlburt and Jean E. L. Cote for their valuable assistance in discussion and development of some of the matters raised in this note, but hastens to add that they hold no responsibility for any deficiencies the note may have.