NEWS Release

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# But I'm not Paying for That.... It's a Capital Cost!

The typical commercial net lease provides that the tenant will pay a share of the costs incurred by the landlord to maintain and repair the property ("Operating Costs"). It typically also characterizes replacements as a type of repair (e.g., if the roof membrane needs a complete overhaul instead of a patch job, the landlord considers the replacement cost to be an Operating Cost). Tenants often take the position that Operating Costs should only include costs that accountants characterize as "expense" costs, as distinct from "capital" costs, which should be excluded. When a tenant successfully negotiates the exclusion of capital costs from Operating Costs, the question is what exactly is a "capital" cost?

## The *RioCan* Decision

The recent decision of the Ontario Superior Court of Justice in *RioCan Holdings Inc. v. Metro Ontario Real Estate Ltd.* (*RioCan*) shines a light on this question, but provides no illumination.

The central issue in the *RioCan* case was whether the landlord was entitled to recover from the tenant the cost of certain work done to the parking area. In 2002, the landlord resurfaced the pavement of the shopping centre to remedy cracking and distress caused by wear and tear at a total cost of approximately $431,000. The landlord decided to amortize the cost over twenty years. It billed the tenant for its proportionate share of the annual amortized amount. Under the lease, the tenant was required to pay its proportionate share of repairs and maintenance of sidewalks and paved areas, but "expenditures, which by generally accepted accounting practice are of a capital nature" were excluded. Neither "generally accepted accounting practice" nor "capital" was defined in the lease.

From 2003-2006, the tenant paid its monthly installment of the charges without question. However, in 2007 the tenant reviewed its operating cost statements and concluded that the parking lot work was a capital expenditure that it should not have paid. In 2010, it unilaterally took a credit for the 2007-2008 charges against its total rent and declined to pay any further amounts towards the annual amortization of the parking lot repair. The landlord brought an application to the Court seeking payment of the amounts withheld by the tenant.

The landlord claimed that, in accordance with generally accepted accounting practice in 2002, the cost of the work to the parking lot was a repair cost and not a capital expense. The landlord relied on tax accounting principles to assert that a capital expense is one that leads to an increase in the future net cash flow of the asset, and that, in this case, the asset was the shopping centre, not the parking lot. The parking lot was, in the landlord's view, merely a part of the asset and it was appropriate to recognize that parking lots would, over the life of a shopping centre, need to be repaired. The landlord argued that since the work did not result in a direct increase in rent or revenue for the shopping centre, and since it did not extend the useful life of the shopping centre, it should not be characterized as a capital expenditure.

The tenant argued that the work to the parking lot was a major rehabilitation, not a repair, and accordingly, it was a capital expenditure that was not recoverable. The tenant claimed that the parking lot was a major component of the property, had the capacity to indirectly contribute to the future net cash flow of the shopping centre because the work led to a significant increase in the useful life of the parking lot, and resulted in a substantial reduction in the landlord's ongoing operating costs.

The Court ruled in favour of the tenant, holding that a significant increase in the useful life of a major component of the property will lead to an increase in the useful life of the property as a whole and its service potential. The Court found that the landlord's decision to amortize the cost of the work over a period of twenty years was evidence that the landlord itself regarded the cost as being on account of capital. The Court concluded that the work to the parking lot was a capital expenditure, which should not have been passed on to the tenant.

**What does this mean for Landlords and Tenants going forward?**

As a result of this case, commercial landlords whose leases exclude capital costs from Operating Costs may be discouraged from conducting major repairs. They may consider it preferable to repeatedly repair worn elements rather than risk that a major expenditure will be considered as on account of capital.

Post-*RioCan*, landlords may also hesitate to soften the blow of major expenditures by amortizing them. If the Courts perceive amortization as an indicator of a capital expenditure, landlords may be inclined to charge the full amount of the expense in the year it was incurred.

The *RioCan* decision is being appealed and the next Court's analysis will be closely scrutinized.

**ANNOUNCEMENT**

Daoust Vukovich LLP is pleased to announce a new addition to our team: CANDACE COOPER joined our firm in July as an associate in the commercial real estate department. Candace graduated from the J.D./LL.B law program at the University of Windsor and the University of Detroit Mercy, receiving both an American and Canadian law degree. She was called to the Ontario Bar in 2007, and admitted to the New York State Bar in 2008. Candace can be reached at: (416- 597-8578) (ccooper@dv-law.com).

We are also pleased to welcome back JENNA MORLEY. Jenna was both a summer and articling student with us and has now joined the firm as an associate in the commercial leasing department. Jenna was called to the Ontario Bar in 2012 after receiving her law degree from Osgoode Hall Law School. Jenna can be reached at: (416-597-9225) (jmorley@dv-law.com)




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