THE LEASE AND CAPITAL EXPENDITURES

Should capital expenditures be considered recoverable operating costs? Are they maintenance and repair costs or are they expenditures that should be borne by the landlord? A fine line separates these two concepts and in this article you will find answers to these questions and more.

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Capital expenses are an important subject because they represent a significant component of operating costs. I remember overhearing a conversation between two building owner reps in a hallway at a conference on these topics. One rep waxed eloquently, with a crafty smile on his face, claiming ignorance as to what a capital expense is! On top of that, he affirmed that the policy at his company was to consider all expenditures of this type as repair expenses and therefore fully recoverable! Obviously, he was joking. But in this regard, all tenants must be wary since it is very tempting for landlords to inflate their repair costs category. During the Trizec era, the landlord had the brilliant idea of incorporating the notion of Major Operating Expenses into its leases. This approach would grant it wider latitude in the application of repair expenses when applying this unusual method of amortizing costs. Indeed, certain expenses would have otherwise been difficult to allocate as simple operating costs in order to become recoverable.

Several years ago, I had to analyze this question within the framework of an important file. With the invaluable collaboration of Paul Mayer (now a Superior Court judge), our analysis developed the analogy of the notion of capital expenses in tax law (for more details, see Développements récents en droit de l'immobilier, Barreau du Québec, 2007, Éditions Yvon Blais. p. 54). In fact, this topic had been amply discussed in fiscal jurisprudence to determine how best to deal with these expenses from a taxation point of view. As pertinent as the connection might appear, the Court of Appeal, as we shall see later, recently found that one should apply this analogy with care.

The ICSC's Dictionary of Shopping Center Terms defines capital expenses as "Payments for something expected to last for several years, and recorded on a balance sheet as assets for a shopping center; these include tenant improvement allowances, work by a landlord to improve a space, and commissions paid to the broker or management company and operating expenditures such as parking lot resurfacing." According to generally accepted accounting principles (GAAP), capital expenses are expenditures used to acquire, replace, add or carry out important repair work on a building or equipment.

This is subject that gives free course to a variety of interpretations! It's the type of expense where the line between that which constitutes a maintenance or repair expenditure and a non-recoverable capital expense is rather thin. Commercial leases generally provide that the tenant will assume both the costs of repairs to the building and the replacement of equipment as determined by generally accepted accounting principles. Sometimes, it does happen that the parties will agree on certain or all capital expenses to be considered recoverable according to specific terms and conditions. Once again, when it comes to discussions concerning the nature of these expenses and their admissibility or exclusion as operating expenses, the lease is the key.

Generally, maintenance and repair expenses that the owner includes as part of operating costs are normally recoverable during the year in which these expenditures are incurred. However, certain expenditures are too significant to be recovered during the current year and must be amortized over a longer span in order to spread out the costs over a more reasonable period. We need only think of replacing air conditioning, ventilation or heating equipment—these are extraordinary expenditures whose importance does not allow them to be paid off as operating expenses over the year of their purchase. Indeed, the question that the parties must ask themselves is whether or not they are in fact operating costs related to maintenance or replacement, or are they capital expenditures which must be assumed by the landlord. For example, the addition of floors to a building is clearly a capital expenditure which in no way can be passed on to the tenant as operating costs.

Sometimes, a landlord will decide to pave an entire parking lot whereas another will simply partially repave every year in order to resurface the entire lot over five years. How should these expenditures be treated?

Although certain decisions have shed light on this matter, Québec jurisprudence has not always been very helpful. In a decision rendered by the Québec Court of Appeal in Executive Investment Canada Ltd. v. Rourque Bourbonnais & Associates Ltd. (C.A.M. 500-09-000713-867, J.E. 91-94), the Court was to determine if the addition of a sprinkler system in a building constituted a capital expenditure or an operating cost. Though the Court of Appeal found that the expenditure constituted a capital expense, it should be noted that there was no sprinkler system in the building beforehand and therefore difficult to pretend that this constituted maintenance or repair. In its analysis, the Court based itself on fiscal jurisprudence established in Le Sous-ministre du revenu du Québec v. Denise Goyer, 1987 R.J.Q 988, which states:

"Our Court, as writ by Judge Vallerand, facing a similar problem in a case of fiscal litigation, distinguishes between expenditures which cause the creation of a capital good and those which seek to preserve it. I share the respondent's opinion, which appears to me in agreement with that of the higher court. The importance of the repairs and the ensuing expenditures can in some cases perhaps suggest a solution. The same can be said for the longevity of the repair, but the essential question, on the one hand, is to determine if the expenditures which are deducted have the effect of creating a capital good rather than replacing it with another capital good, or, on the other, to repair an existing capital good. In formulating this conclusion, I recall the following proposition from the judgment rendered in British Insulated of the Privy Council which I quoted earlier in length and which the appellant erroneously believes to be useful:

"But when an expenditure is made, not only once and for all but with a view to bringing into existence an asset"

and this having been said with regards to the appellant believing once again to have found his deliverance, the decision handed down by the Supreme Court of Canada in Haddon Hall Realty supports this proposition:

"(...) an expenditure made once and for all with a view to bringing into existence an asset or advantage for enduring benefit of a trade is of a capital nature."

Maintenance and repairs are activities carried out in order to preserve a capital good. Generally speaking, it's not a big deal if one changes a few planks on a veranda or replaces a few pieces of pipe every year—which undeniably are maintenance expenses—or having let a good fall into disrepair, one sees oneself obligated to make durable major repairs. As long as one does not create a new capital good, that one does not increase the good's normal capital worth, or that one does not replace the existing good by another, it is a question of repair and maintenance to bring back the value of the good to its rightful

normal capital worth.

Lastly, in spite of some residual ambiguity, I am of the opinion that article 1019 C.C. allows a ruling in favour of the respondent: there is no doubt that it is the latter who finds himself "obliged" in the sense of this article since the proof shows that the lease was effectively prepared by the representative of the appellant." [Translation]

A more recent decision brings some interesting elucidation on this matter, namely, the decision of Skyline Holding Inc. v. Scarves and Allied Arts Inc., REJB 2000-19795. In this case, it was a question of determining if the tenant should incur the cost of replacing the roof on a building as an operating cost. The parties used fiscal jurisprudence as a starting point to allocate the various expenses which can be deducted from revenues and other expenses which must be dealt as capital expenditures. The parties based themselves largely on the decision of Le Sous-ministre du revenue du Québec v. Denise Goyer, 1987 R.J.Q. 988. The Court of Appeal came to the following conclusion:

"It is my opinion that, without being stripped of all relevance, fiscal jurisprudence is not a reliable guide. The proposition to be interpreted is contractual and non-statutory. In spite of the mention within the lease that operating expenses include expenses normally deducted from income, we must first refer to the rules of interpretation from Civil Law before proceeding to a comparison with similar situations in Public Law. In this respect, even if the consultant's report presented by the plaintiff in appellant was admissible, its usefulness is limited in that it lacks detail.

The first observation that becomes evident upon reading the clauses concerning the operating costs is that the majority of the expenditures are recurrent and are related to the use of the building. This goes for the heating, electricity, maintenance expenses, the janitor's salary, etc. Other expenses can be related to a combination of causes, namely because of the tenants' use, such as insurance, taxes and permits, etc. These expenditures are current, recurring and highly foreseeable throughout the duration of the lease. In accordance with Article 1020 C.C.L.C. no matter how general the terms may appear to be, their meaning must be limited to those things which the parties had agreed to contract. The application of this rule of interpretation would not allow the inclusion of a repair which was neither current nor foreseeable within the duration of the lease.

The replacement of a roof cannot be deemed a current expense. The appellant's counsel mentioned in his testimony that they had chosen to distribute the expenditure to the tenant over three years because they deemed it extraneous:

This was an extraneous charge, one-time charge and we thought they'd be able to cope with it easier if we split it over three years.

Even in the eyes of the appellant's counsel, it is not an expense normally foreseeable during a 5 year lease." [Translation]

Once again, the importance of the language of the lease is fundamental since the Court was interested in the type of expenses described in the clause defining operation costs to reach the conclusion that these must be current expenditures, repetitive and highly foreseeable. In this respect, the Court adds that such an important expenditure on a five (5) year lease is inadmissible. The tenants would never have agreed to pay such a significant amount during a lease of such short duration and which indeed allowed the landlord to improve the condition of the building to the detriment of the tenant. Therefore, the Court concluded that "the replacement of a roof is not an expenditure which can be reasonably considered as an operation cost to be assumed by the tenant, unless a clause makes this explicit." [Translation] However, this reservation in terms of the parallel that can be established with fiscal jurisprudence is from my point of view debatable.

Thus, one can retain the following principles:

- All expenses related to major renovations, to the construction of a building, all major expenditures related to the structure of a building or all other expenses related to construction defects would normally not be recoverable expenses in terms of operating costs.
- A tenant should not have to assume expenses which result in the substantial improvement of a building as opposed to those required to maintain its value. The addition of a floor to a building, the replacement of single windows by double windows are not recoverable expenditures.
- For example, important renovation or expansion expenditures, major washroom renovations, or new tree planting as part of a new landscaping initiative should not be included as operational expenses. The renovation of a lobby could legitimately be considered a repair expense if the object is not to increase the value of the property.
- Judgment and common sense must prevail according to the circumstances. Indeed, if the landlord replaces dead or ungainly trees with refreshed landscaping, or if twenty-year-old bathrooms are replaced by new ones, these types of expenses would be considered recoverable as operating expenses.
- In addition, capital expenditures designed to lower operating costs, such as a new heating and air-conditioning system, should normally be billed as operating expenses and depreciated over their lifespan. In this respect, leases will generally include an explicit clause to deal specifically with such an expenditure.

There is no denying that the landlord and the tenant both have an interest in that the office building, shopping mall, or property in which the premises are located, be properly maintained so that important expenditures are only occasionally incurred. In conclusion, it is incumbent upon the landlord and the tenant to foresee in the lease who will assume these costs in view of avoiding future misunderstandings. Consequently, good judgment should dictate the conduct of both parties. ●