

Commercial Leasing Bulletin:

Tips for TIPs: Deductibility of Tenant Inducement Payments

May 11, 2021

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Update RE: Fuller Landau Group Inc. in its capacity as trustee in bankruptcy of *7636156 Canada Inc. v. OMERS Realty Corporation, 2020 ONCA 681*

In October 2020, the Ontario Court of Appeal (ONCA) released its decision in [7636156 Canada Inc. \(Re\), 2020 ONCA 681](#) (reviewed in greater detail in our Bulletin [here](#)). The ONCA held that a landlord's entitlement to draw on a bankrupt tenant's line of credit is not limited to the landlord's preferred claim for three months' worth of accelerated rent under the [Bankruptcy and Insolvency Act](#). On April 22, 2021, the Supreme Court of Canada (SCC) dismissed the application for leave to appeal, upholding the Ontario Court of Appeal decision.

Tips for TIPs: Deductibility of Tenant Inducement Payments?

Commercial landlords have long competed to attract new tenants, often going to great lengths to induce tenants to choose a unit in their building. This is where the concept of tenant inducement payments comes into play. A tenant inducement payment ("TIP") is an instrument, most often a payment, used by a landlord to attract prospective commercial tenants to their premises. Given the often significant value of these payments, their tax treatment can substantially impact the landlord's finances.

In 1997, the SCC simultaneously released three rulings ("SCC Trilogy"), which had significant tax consequences for landlords who pay and for tenants who receive TIPs. In *Candere! Ltd. v. R.* ("Candere!") and *Toronto College Park Limited v. R.* ("Toronto College Park"), the SCC was called upon to determine the appropriate manner in which a landlord may deduct a TIP from its business income. In the third case *Ikea Ltd. v. R.* ("Ikea"), the SCC was called upon to determine how a TIP was to be treated in the hands of a tenant. The SCC Trilogy established a set of principles to determine how to draw the most accurate picture of a landlord's profit in a given year, including how it chooses to deduct its TIPs.

The SCC Trilogy

SCC Trilogy Quick Summary

In *Canderel* and *Toronto College Park*, the SCC concluded that the primary purpose of the payments in question were to induce the tenants to enter into leases and provide immediate benefits to the landlord. In both cases, the landlord was entitled to deduct the TIPs in the year in which they were paid, rather than amortizing the TIPs over the term of the lease to which it relates. In both of these cases, the TIPs yielded immediate benefits for the landlords and, perhaps more importantly, they were not linked to any capital outlays by tenants. In *Ikea*, the SCC held that the tenant was required to include the entire TIP in its income in the year received. Further details provided below.

*Canderel Ltd. v. R.*¹

In *Canderel*, the landlord entered into an agreement to develop a commercial office in downtown Ottawa. During construction, vacancy rates rose tremendously and Canderel was forced into intense competition for new tenants. In response, Canderel reallocated losses to TIPs.² That year Canderel deducted the entire amount of those TIPs but was reassessed by the Minister of National Revenue ("MNR"). The case was subsequently appealed until presented at the SCC.

The SCC held that the determination of profit is a question of law and the goal is to obtain an accurate picture of a taxpayer's profit for a given year. Once a taxpayer has established that he/she/it has provided an accurate picture of income for the year and the tax treatment used is not inconsistent with (i) the *Income Tax Act*, (ii) established case law principles, and (iii) well-accepted business principles, the onus shifts to the MNR to show that the figure provided by the taxpayer is not accurate or that another method of computation would provide a *more* accurate picture.

Applying these principles, the SCC allowed the landlord to fully deduct the TIPs from its business income in the year in which they were paid, explaining that the amortization of the TIPs over the lease terms, as argued by the MNR, did not provide a *more* accurate picture of the landlord's income for the year.

*Toronto College Park Limited v. R.*³

In *Toronto College Park*, the landlord made two TIPs – one for a future tenant and the other for contractors employed by the Ministry of Government Services of Ontario (for the Ministry's benefit) – after suffering start-up rental losses in a new commercial building in Toronto. All parties agreed that the payments were being made in the ordinary course of business and for the purpose of

¹ *Canderel Limited v R*, [1998] 1 SCR 147, 155 DLR (4th) 257.

² *Ibid*, at para 11.

³ *Toronto College Park Limited v R*, [1998] 1 SCR 183, 155 DLR (4th) 285.

earning income.⁴ The MNR reassessed the landlord's 1983 tax return, claiming the payments were capital in nature and requiring the TIP deductions to be amortized over the lease term.

As in *Candere*, the SCC faced the same critical question: did the method of tax deduction chosen by the taxpayer create an accurate picture of its profit for tax purposes. Following the principles established in *Candere*, the SCC ruled in favour of the landlord. It agreed with the trial court that the primary purpose of the TIPs was to achieve an immediate benefit, which was realized entirely in 1983.⁵ It created an even stronger judgment than in *Candere*, where some of the benefits were yielded in the year of expenditure and some over the lease term.

*Ikea Ltd. v. R.*⁶

In *Ikea*, the SCC held that in determining whether a TIP received by a tenant is a "revenue receipt" or a "capital receipt", the crucial matter to be considered is the nature of the expense that the TIP is designed to reimburse. It is important to note that there was no obligation in the lease on Ikea to use the money for any particular purpose.

Ikea did not want to include the full amount of the TIP in its 1986 income, but rather wanted to amortize it over the lease term. The MNR declared the TIP represented income and was to be wholly included in the year of receipt. The Tax Court of Canada (and subsequently the Federal Court of Appeal) found no basis to amortize the balance of the TIP as the payment was an integral element of the day-to-day costs of running the business.⁷ Upon appeal to the SCC, Ikea argued that the TIP was a capital receipt and not income, based on *Woodward Stores Ltd. v. R.*⁸ The SCC distinguished *Woodward* because the payment in *Woodward* was specifically allocated as a "fixturing allowance", constituting a capital receipt given for the purpose of reimbursing a capital expense. Further, the payment was given free from conditions or stipulations as to its use,⁹ pulling it further from any inference it was to be a capital receipt.

⁴ *Ibid*, at para 2.

⁵ *Ibid*, at para 22.

⁶ *Ikea Ltd v R*, [1998] 1 SCR 196, 155 DLR (4th) 295.

⁷ *Ibid*, at para 14.

⁸ *Woodward Stores Ltd v R*, [1991] 91 DTC 5090.

⁹ *Supra* note 6 at para 33.

Recent TIPs Decisions

*Motter c. Agence du Revenu du Québec (“Motter”)*¹⁰

Now that we are familiar with the principles set out in the SCC Trilogy, let’s turn our attention to *Motter*, a recent case where the Quebec Court of Appeal (“QCCA”) rejected the landlord’s argument that the TIP was wholly deductible in the year it was paid.

In *Motter*, the landlord leased a not-yet-constructed building to a tenant in 2005. The landlord offered the tenant a leasehold improvement allowance and the tenant hired the landlord as the principal contractor to complete the leasehold improvements while constructing the building.¹¹ When the landlord deducted the entire amount from its 2005 income, Revenu du Québec reassessed and denied the deduction claiming it was a capital expenditure because it was provided before the building’s construction. The landlord argued that the TIP was an incentive to the tenant (who wanted leasehold improvements); the improvements were tenant-specific, providing no benefit to the landlord other than the signing of the lease; and the improvements did not add permanent benefits or value to the premises.¹²

At the Court of Québec, the trial judge distinguished this case from *Canderele* and *Toronto College Park* on the facts.¹³ *Canderele* demonstrated a particularly difficult, competitive real estate market and *Toronto College Park* displayed ordinary business practice in the Toronto real estate climate at that time, but the landlord in *Motter* had not produced evidence that real estate market conditions compelled it to make the payment for an immediate benefit. In contrast, the landlord’s payment to the tenant was made for the sole benefit of constructing the building and collecting future rent, and therefore could not be considered an ‘expense category’. This reasoning was upheld and the distinction between current expenses and capital expenses was explained in greater detail.

Takeaways from Motter

The takeaway for taxpayers, commercial landlords, and owners alike is this: costs of regular maintenance and repair to preserve a building are current expenses and therefore deductible wholly in the year the costs are incurred, while work that constitutes a permanent improvement to the building, increases its value or results in higher rent are capital expenses and therefore not deductible wholly in the year the costs are incurred.¹⁴

¹⁰ *Motter c Agence du Revenu du Québec*, 2021 QCCA 72.

¹¹ Manjit Singh, “Quebec Court of Appeal: TIPs Not a Subset of Current Expenses”, online: (2021) 21:2 Tax for the Owner-Manager.

¹² *Ibid.*

¹³ *Ibid.*

¹⁴ *Supra* note 10.

The QCCA confirmed that TIPs are not an automatic expense category when calculating business income, and their deductibility will differ from case to case. The Court reiterated that in *Candere!* and *Toronto College Park* the TIPs were current expenditures and the issue was whether they could be deducted in a single year or amortized. In this case, however, the court rejected the landlord's argument regarding the nature of the work. The QCCA affirmed that the nature of the work determines the true nature of the expenditure,¹⁵ and the landlord was unable to prove that the TIP was to be used for the tenant's specific needs, did not add value to the building, and was offered to induce the tenant to enter into the lease.

Motter serves as an important reminder that landlords should proceed cautiously. A landlord's entitlement to wholly deduct a TIP in the year of payment is not absolute and the tax treatment of a TIP is decided on a case-by-case basis. Simply providing the payment to a tenant does not give the automatic right to wholly deduct as a current expense, unless there is factual evidence which supports that the costs are permissible current expenses. Ultimately it will be up to the responsible revenue agency, or potentially the court, to decide on the tax treatment of such payments.

Tips for TIPs

Needless to say, it would be prudent for a commercial landlord who is considering a TIP and wants to deduct it wholly in the year in which it is paid, to ensure that:

1. the lease documentation is clear and unequivocal stipulating that the purpose of the payment is to induce the tenant to lease the premises (and even better, detail the reasons for such inducement); and
2. such tax deductibility is supported by factual evidence to withstand scrutiny of tax authorities and courts (e.g. be prepared to demonstrate competitive real estate conditions which compelled the landlord to pay a TIP to protect its market condition, or demonstrate that the work was for the tenant's specific needs, was of no use to other tenants, and did not add value to the building).

We will continue to provide updates on commercial leasing topics of interest. If you have any questions or would like to obtain legal advice on any leasing issues or litigation, please contact any lawyer in our [Commercial Leasing Group](#).

Special thank you to [Alyssa Girardi](#) (Associate) – [Commercial Leasing Group](#) in her contribution to this article.

¹⁵ *Supra* note 10.



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