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FINANCING BUSINESS ACTIVITY THROUGH SALE AND LEASEBACK OF REAL PROPERTY—A COMMENT

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The purpose of this paper is to discuss the use of sale and leasebacks by business as a source of capital. The following discussion will deal specifically with sale and leaseback of real property as a means of financing capital investment. Throughout, one should not lose sight of the fact that much use is being made of equipment leasing in order to alleviate the necessity of a capital expenditure and thereby free funds for alternative investment projects.

The technique involved is often a sale of both land and buildings by a business to an investor who simultaneously leases them back on a long-term contract. The most common situation involves two parties—a company seeking capital and a single investor (e.g., a life insurance company) entering a "net lease" arrangement whereby the tenant agrees to pay for real estate taxes, insurance, repairs, maintenance costs, alterations, and improvements. This net lease provision is particularly attractive to institutional buyers who are not normally interested in real estate management. Frequently there are provisions for renewal of the lease and for repurchase of the land and building.

Real estate leaseback financing increased in popularity in the years immediately following World War II. In 1948 the Insurance Companies Act was amended to allow insurance companies to invest up to 3% of their total assets in income-earning real estate and as a

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1 See Beck, (1965) 13 CAN. TAX JOURNAL 493 for an example of a unique use of a leaseback arrangement as part of a gas station tie agreement to achieve certain tax reductions. Also see Britannica House Prospectus (Ontario) (1963) where a sale and leaseback arrangement was part of a financing scheme involving a trust, units of which were sold to the public.

2 For a full discussion of equipment leasing see H. Greenfield & F. Breisgier, SALE-LEASEBACKS AND LEASING IN REAL ESTATE AND EQUIPMENT TRANSACTIONS (McGraw-Hill, 1958) at 66.

3 There is another type of investment which is becoming more common in Ontario and which is of special importance to the insurance companies. This relates to real estate but is of such a prime type that it does not come within the 3% limitation. This is the 'ground rental' which involves ownership of land and a lease thereof for building purposes. A requisite of the ground rental is that the reversion will carry not only the land but the buildings which have been erected on it. Usually the leases are for relatively long terms with interim rental adjustments. See Law Society of Upper Canada, SPECIAL LECTURES 1960 at 125.

4 The typical buyers are life insurance companies and pension trusts who are interested primarily in long term income at a fixed rate of return commensurate with that obtainable from well secured mortgage investments. The prospect of improving this field through lease extensions and eventual sale of the residual property adds a bit of speculative glamour and provides protection against long range inflation.


6 Canadian and British Insurance Companies Act, R.S.C. 1952, chapter 31, section 63(4).
result they have become a major factor in this type of financing. The concept was originally identified with retail establishments which had a large number of outlets in strategic and expensive locations. More recently it has spread to other industries where a substantial portion of assets is invested in store buildings, warehouses, or fixed plants.

It should be emphasized that this section will discuss only the business policy considerations that may induce an enterprise to embark upon this method of finance: this will then be followed by an examination of the tax and legal implications of sale and leasebacks.

The assumption will be made that a certain company requires capital (e.g., permanent working capital) and is studying alternative sources. The normal avenues available are: debt, equity, mortgage, and sale and leaseback. How does a company choose from among these alternatives? Because this paper is dealing specifically with the last method, a detailed dissertation on the others will not be undertaken. Instead, the relative advantages and disadvantages to a company of using leasebacks will be examined in detail.

The first line of inquiry should be the cost of capital to the company from each of these alternatives. Although it is very difficult to generalize, it appears that the interest cost of funds provided by a lease is generally slightly higher than could be arranged on a loan of an equivalent amount. This discrepancy varies in relation to several factors including the general credit standing of the lessee and the ease with which the leased property could be transferred to other uses following a default. Another important factor must be the total availability of funds in the economy and the demand for and supply of funds in each of the particular areas (i.e., debt, equity, etc.). We are presently experiencing a period of very tight money and unusually high interest rates and this puts the investing institutions in a very powerful position in bargaining with any company seeking capital. Thus, any particular company may not even have these alternatives available to it. The availability of capital, as well as the cost from each of these sources, must be carefully examined by any company contemplating raising funds. A great deal of time and effort is required to tailor each leaseback to the specific needs of a particular business. This, together with the fact that leasebacks have less liquidity than a loan are other reasons why leasebacks may be costlier than debt or equity.

8 P. Hunt, C. Williams & G. Donaldson, Basic Business Finance (Richard D. Irwin Inc., 1961) at 380 states “it is fair to say that the interest cost of the funds provided by a lease is seldom less than 0.5 to 1 percent higher than could be arranged on a loan of equivalent amount”. The investors canvassed in this jurisdiction were not prepared to make such a generalization. They preferred to examine each individual situation independently. Indeed, the interest rate employed in a triple A company to calculate the rent payments could very likely be the same rate that the company would have to pay in the bond market.
9 Id., at 380.
10 Any standard finance text can be consulted for a full discussion on the cost of capital. Basic Business Finance (supra note 8) has a good discussion.
After calculating the cost of leasebacks relative to the other available sources of capital, the exercise has just begun. It then becomes imperative to examine the 'practical' advantages and disadvantages to a company of using them; there are considerations from a business policy viewpoint that may outweigh any cost differential. What are these additional factors?

Upon entering a leaseback arrangement the company permanently gives up title to the property (unless there is an option to repurchase). Therefore, a major consideration must be the company's estimate of the property's usefulness to the business at the expiration of the lease. The company may at that time still have a desire to remain on that same site and, hence, it may be advantageous for it to retain title to the property. If the purchasing power of the dollar declines markedly during the long period of the lease this may mean a substantial expenditure compared to ownership advantages had other financing methods been adopted. Alternatively, the tenant may have excellent reasons for seeking a new location due to changes in markets, sources of raw materials or labour supply; furthermore, the owner may be willing to continue to lease or sell the property at that time to the lessee. It is therefore imperative for the business to be able to attach a figure representing the usefulness to the business of this property at a date far in the future. Any positive amount will have to be included in the cost calculations referred to above. If it is substantial, it may preclude the company from considering a leaseback.

Another decision requiring foresight involves the fact that when a company finds that a plant is no longer profitable, it may be sold if owned. This mobility is severely hampered by a long-term lease which requires a company to continue to pay rent even though the facility is no longer being used.

Depending on the physical structure of any company, leasebacks may present an opportunity of co-ordinating lease obligations with the need for funds. A company with several buildings can work sale and leaseback arrangements as the need for funds arises. This can be contrasted with the situation in straight debt financing where the high cost involved may necessitate taking all the required funds at once. Of course, if piecemeal financing is required and there is only one large building, then a leaseback may not be practical.

The fact that a leaseback represents a form of off-the-balance sheet financing accounted for much of its early popularity. No long-term debt appears on the liability side and fixed assets are replaced by current assets. This would prima facie appear to improve the financial ratios of this company and, hence, improve its credit stand-

11 H. Greenfield & F. Breisinger, supra note 2, at 55.
12 Id. 55.
13 There is a possibility of sub-lease but the timing of this arrangement may coincide with the time when other companies are having similar difficulties and, therefore, the sub-lease may be negotiated at a tremendous sacrifice.
14 Cary, supra note 7, at 9.
ing. CICA Bulletin Number 20\textsuperscript{16} deals with standards of disclosure in financial statements. It states that particulars of any contractual obligation that are significant in relation to a company's financial position or to its future operations such as commitments that will govern the level of a certain type of expenditure for a considerable period into the future (e.g., under long-term leases) should be disclosed by note unless otherwise apparent in the financial statements. This required disclosure will, therefore, enable sophisticated investors to capitalize these lease payments,\textsuperscript{17} and, in effect, treat the leaseback as a debt issue in any financial analysis of the company. Thus, the credit standing will not be improved, in all likelihood, by financing through leasebacks.

A sound enterprise with predictable future revenues may find that a leaseback transaction will release more capital than can be secured through conventional borrowing. Management may not wish to issue a large amount of debt securities, or the market may not be receptive to a large debt issue (or indeed to any debt issue) of a company at any given time. The same reasoning is applicable to a potential equity issue. Also, to the extent that money is advanced on the basis of the property of the company, either the law or the investor's internal policy or both may prevent a loan of greater than a certain percentage of the value of the property.\textsuperscript{18} With a leaseback, however, a company can secure funds equal to the full value of the property.

A business must decide whether it wants its capital tied up in fixed property. If one accepts the fact that assets produce profits because they are \textit{used} not because they are \textit{owned},\textsuperscript{19} then it may be preferable not to tie up funds in unproductive real property in comparison to the more dynamic investment of cash in labour and materials. One should not jump to the conclusion that leasebacks operate as an effective hedge against obsolescence since the risk of obsolescence normally will be reflected in the terms of the lease.

A company may, as a result of an outstanding debt issue, be severely tied up with restrictions which prevent the contracting of further debt unless rigid requirements are met. If the indenture does not prevent leasebacks, then this may represent a possible source of capital in such a situation. Investors soon got wise to the ingenuity of businessmen and as a result many of the indentures today that accompany debt issues contain restrictive conditions applicable to leasebacks also. On the other hand, these legal restrictions appearing in bond indentures, term loan agreements, and preferred stock certificates are themselves responsible for the popularity of leasebacks. The danger of creditors interfering with the future financing of the busi-

\begin{itemize}
\item \textsuperscript{16} \textit{Accounting and Auditing Practices Statements issued by the Research Committee of the Canadian Institute of Chartered Accountants}, Bulletin 20, July, 1964, at 9.
\item \textsuperscript{17} It is common practice to capitalize the annual lease obligations by a multiplier of ten.
\item \textsuperscript{18} Cary, \textit{supra} note 7, at 7.
\item \textsuperscript{19} H. Greenfield & F. Breisinger, \textit{supra} note 2, at 2.
\end{itemize}
ness through these conditions may induce a company to use a leaseback even where it may prefer to finance otherwise but for this factor. One need only examine a common bond indenture to appreciate the distaste that management may have for entering such an arrangement. Nevertheless, one must not lose sight of the fact that a lease does use up credit and it uses up as much of a company's borrowing capacity as would a loan of equivalent terms.

Where a company's debt-equity ratio precludes the issuance of any more debt, the use of a leaseback may avoid the necessity of selling additional stock (assuming this is possible) which may upset the balance of equity control by diluting the ownership. Some people are prepared to pay a steep price in order to retain control—the extent is a decision that management must make.

A most serious and complex decision-making process is involved whenever a company decides that it will raise funds. After determining the cost related to the various alternative sources available to the company, management must then look to the practical advantages and disadvantages of each to determine whether any cost differential may be compensated for by such other considerations as have been outlined above. Only after such a detailed examination can the proper choice be made.

One more very important business consideration that has been ignored thus far is the tax implications of leasebacks. Basically, the lessee in a sale and leaseback transaction can deduct his annual rental payments to the extent that they are reasonable.

Generally, leasehold property falls within class 13 of Schedule B of the regulations. Regulation 1100(1)(b) allows the lessee to claim an allowance in accordance with Schedule 4 in respect of the capital cost to him of Class 13 property. In addition to an amount actually expended to acquire a lease, the capital cost of class 13 property also includes by virtue of Regulation 1102(4), improvements and alterations of a minor nature actually made by the taxpayer to the leasehold property. Under Schedule H the capital cost is written off on a straight line basis over the term of the lease remaining when the cost is incurred plus one renewal period (if any) and the maximum rate is 20% while the minimum is 2½%. If the lease expires, is cancelled or otherwise disposed of before the cost has been amortized, the taxpayer can take a terminal loss within Regulation 1100(2) if there are no assets left in the class.

Regulation 1102(5) provides for a different treatment for certain leasehold interests. Where a person who has a leasehold interest in property 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 changes the nature of the property, he must include the amount expended in

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20 Each company has a theoretically ideal debt–equity ratio in its capital structure and it may, therefore, be impossible for a company to issue more debt without also increasing the outstanding equity.

21 Income Tax Act, R.S.C. 1952, Chapter 148 as amended (all references are to the C.C.H. Consolidation), Sections 4, 12(i)(d), 12(2).
class 3 and, therefore, claim capital cost allowance as if he were the owner of that portion of the property. Thus, on such amounts his capital cost allowance will be 5% of the declining balance. This covers the normal ground lease situation where A sells his land to a financial institution and then takes back a long term lease. The lessor loans A the money to put up a building on the security of his lease. A falls squarely within Regulation 1102(5)(a) and can claim capital cost allowance on the building as a class 3 property. An assignee or sub-lessee of the original lessee (who erected the building) cannot generally claim capital cost allowance under class 3 because he did not erect the building and is, therefore, not within regulation 1102(5).

The only question is whether, under the common law, a person who has a leasehold interest in land can have ownership of the buildings on the land. In Reitman v. M.N.R., the court found that all the appellant in fact had was a leasehold interest in the property, and suggested that at common law a person could not have a mere leasehold interest in land, and yet own the building on it. Perhaps, if it were provided by contract that the builder of the building on leased land was to own the bricks, etc., and the lessor could purchase it at the end of the term, the same result as in Cohen (property considered class 3 asset) would be achieved. The original lessee could then assign his leasehold interest in the land and equity in the building and the assignee could claim capital cost allowance under class 3 even though he was not within Regulation 1102(5).

Most of the legal and taxation problems which arise under a sale and leaseback transaction occur where there is an option to repurchase as part of the agreement. Tax cases are reported dealing with both the lessor and the lessee's position. With respect to the lessee's position, tax planners have put in much time and effort concerning themselves with the old Section 18 (now repealed) of the Income Tax Act.

Section 18 was first enacted in the 1948 Income Tax Act. It was implemented to overcome the use of lease-option agreements which gave the lessee a much faster write-off (in the form of rent deductions) as compared to the person who bought the property and claimed capital cost allowance. Although Section 18 only applied to moveable property in 1948, it was amended in 1950 so that it would apply to non-moveable property (real estate) since real estate leasing was growing in popularity. The effect of Section 18 was that a lease of depreciable property which provided for the property to vest in the lessee, on the satisfaction of a condition was "deemed" to be an

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23 Cohen and Zalkind v. M.N.R., 67 D.T.C. 5175 (Ex. Ct.). There it was held that although a taxpayer did not come within Regulation 1102(5) it did not automatically mean he had to compute capital cost allowance as provided in Schedule H. Although the appellant was the assignee of an emphyteutic lease, the lease provided by its terms that the appellants were the owners of the building even though they leased the land. The general scheme of Regulation 1100(1)(a) is to allow capital cost allowance on buildings owned by a taxpayer, and therefore he could claim the building as a class 3 property, not by virtue of Regulation 1102(5) but because he owned the building.
agreement for the sale of the property. The lessee could not deduct any rent or consideration paid under the agreement but, in an arm's length transaction, was granted Capital Cost Allowance on a capital cost equal to the price fixed by the contract. Where the property included both depreciable and non-depreciable property subsection (2) provided that the contract price should be reduced by the fair market value of the non-depreciable property at the time of the contract.

Throughout the early 1950's, the tax expert tried to avoid Section 18 in order that his clients might write off the rental expense as he incurred it and he arranged his clients' affairs accordingly. In the later 1950's there appears to have been a reversal of intent and the tax experts arranged long term sale and leaseback agreements so that they would fall squarely within the confines of Section 18. These leases were so arranged that the capital cost allowance granted by S. 18(1) was greatly in excess of the rental payments, and, through this, a considerable tax reduction or avoidance was achieved. Thus, the psychology of the tax expert and the businessman was directed to creating a substantial tax advantage that was not envisaged by the tax authorities when the section was originally passed.

It became clear that Section 18 was not working well. However, it was not until 1963 following the *Harris v. M.N.R.* decision that the entire section was repealed. In the Harris Case a 200 year lease, with a rent of $3100 a year and an option to purchase on termination for $19,500, was entered into by the plaintiff. It was argued that the price fixed for the agreement was the capitalized value of the rent for 200 years plus the option price less the fair market value of the land. Thus the capital cost allowance claimed on a gas station property recently purchased would have been in excess of $30,000 in the first year. The taxpayer's appeal was dismissed by the Supreme Court of Canada on the ground that the arrangement violated the rule against perpetuities, and that in any event, (a) the final option price was the purchase price on which capital cost allowances should be calculated and (b) the allowance claimed would artificially reduce the taxpayer's income and should be disallowed under Section 137(1). With this decision Section 18 came to an end since the final option price was deemed to be the purchase price. Since most option prices would be nominal, there would be no tax advantage in coming within Section 18.

The effect of repealing Section 18 was to allow, once again, the lessee in a sale and leaseback arrangement, to deduct the rental payments as an expense that had been incurred and charged to income. Thus, it appears that Section 18 has been replaced by an implicit discretionary rule. This would mean that the Revenue authorities would be able to disallow rental payments which are totally unreasonable in the circumstances, and thus prevent abuses in the sale and leaseback agreements.

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Where an option to repurchase is involved in the sale and leaseback, the lessor is also faced with problems. The Board has had to decide whether the instalment payments under the lease with an option to repurchase takes the form of rent or capital for taxation purposes. Further, since the repeal of Section 18, no litigation has arisen over the “reasonableness” of leaseback arrangements in terms of allowable deductions. Thus, other sections of the Act will have to be applied in these circumstances.

The Tax Appeal Board has waivered in its interpretation of leasing arrangements with options to purchase. In 1950, the Board ruled that payments received under such an arrangement did not become capital payments on the exercise of the option.\(^\text{25}\) Therefore, the vendor was required to include the payments in his taxable income. A year later the Board held that payments under a lease option agreement (while these cases did not deal with a sale and leaseback situation, the principles are the same when a sale and leaseback agreement contains an option to purchase) were to be treated as a non-taxable capital receipt.\(^\text{26}\) The Board looked at the substance of the arrangements rather than the form. Such factors as the absence of an option price requirement, the fact that the purchaser had paid the property taxes and insurance and that the purchaser could have paid any sum at any time up to termination were interpreted by the Board as showing an intention to pass title rather than a strict leasing arrangement. Perhaps the two decisions above might be distinguishable on their facts, but a discrepancy still exists. In the Pitman case the Board expressly held that the exercise of the option to purchase did not change the nature of the payments from that of rent to capital. But the Foster decision suggests that the exercise of the option to purchase shows an intention to pass title as between the parties and thus determining, at a later date, the true nature of the payments made previously.

Subsequent decisions have failed to clear up this discrepancy in the Board’s approach. In Marcotte v. M.N.R.,\(^\text{27}\) the Board looked for the parties’ intention, and held, as in Foster, that the exercising of the option determines previous payments as on account of capital and thus being exempt from taxation. But in Schouten v. M.N.R.,\(^\text{28}\) the Board held that a contract to pay a rent of $10,000 for one year with an option to purchase for $85,000 less the rent paid was a contract for the sale of the land, notwithstanding the fact that the purchaser failed to exercise the option. Thus, whether the option is exercised or not was held to be irrelevant, while it appeared to be the operative factor in Foster.

In Katzman v. M.N.R.,\(^\text{29}\) the Board held that a portion of a rent payment that was to be set off against the price required on the exercising of the option was a capital receipt. The Board could hardly

\(^{27}\) Marcotte v. M.N.R., 60 D.T.C. 519.
\(^{28}\) 63 D.T.C. 357.
\(^{29}\) 64 D.T.C. 10.
have done otherwise since this portion had previously been held to be capital when the purchaser questioned the application of Section 18 to the arrangement. The approach used in these two cases suggests that the payment could be called capital in the hands of the lessee and rent in the hands of the lessor. Recently, the Board has attempted to clear up these problems. In *J. F. Burns Sand and Gravel v. M.N.R.* the *Pitman* approach was expressly accepted. The Board stated:

...since it has long been settled law that an option contained in a lease is collateral to, independent of an incidental to the relationship of landlord and tenant, the exercise of an option contained in a lease does not have a retroactive effect insofar as the payments originally received as rental payments are concerned so as to change the character of such rental payments to payments on account of capital.

Further the Board expressly stated that this decision was of universal application in nature and not confined to its facts. The *Katzman*, *Schouten*, and *Foster* cases are distinguished on their facts. While there is an apparent conflict in deciding an issue and then claiming to set out a universal principle, this decision does serve as a warning as to the Board’s present position.

The above rent-capital problem might raise a further problem of diverse verdicts. If payments under a lease amounted to say $40,000 on a contract calling for $50,000 in instalments and a $1 option price, what happens on default after payment of the $40,000? If the payments are rent, then the lessor has no claim on what he has paid and the lessee can sue for breach of covenant to pay rent. If the $40,000 is held to be capital, the lessor may have an action in equity to recover part of the $40,000 as being a penalty. Thus, it is conceivable that the Board will call instalment payments a capital nature based on the *Burns* approach, while a court denies the lessor an action in equity if they regard the payments as capital in nature.

A further problem has arisen since the repeal of Section 18 in that now a lessee must deduct such payments as being rental expenses, if he is to deduct at all. On the other hand, the lessor may claim that these payments are of a capital nature. If successful the Revenue authorities must then disallow the lessee’s previous deductions. The complications and uncertainty that arise out of this system are apparent.

In summary, it appears that the Board looks to the intention of the parties to determine whether a sale or rental occurred. Such factors as payment of taxes, insurance and the relative size of rent and option prices are considered. In the United States, similar factors such as nominal option price, excessive rent in relation to fair market value, the designation of part of the rent as an interest payment or applying the rent payments to the lessee’s equity have

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30 Poole Electronic Supplies Ltd. v. M.N.R., 60 D.T.C. 369.
31 68 D.T.C. 226.
32 Id. 229.
33 Quartzite Stone Co., 30 T.C. 511.
34 Bowen, 12 T.C. 446.
35 Judson Mills, 11 T.C. 25.
36 Bowen, *supra* note 34.
been considered. It appears that the rent payments under the usual sale and leaseback arrangements would be considered of a rental nature, and the purchaser would be entitled to some deductions for taxation purposes. To what extent one may improve his tax position through the use of a sale and leaseback technique has not been determined in the courts.

It is generally believed that arrangements that tend to unreasonably hasten the write off of capital assets would be attacked by the Minister under section 12(2) and Section 137(1). The *Harris* case first raised this suggestion when Cartwright J. (as he then was) held that even if the arrangement was not void as per the Rule against Perpetuities, he was prepared to call it artificial according to Section 137(1). The Minister has been reluctant to employ this section against a taxpayer and it is invoked only in blatant cases. Thus, the normal sale and leaseback employing a reasonable rent would not be affected.

Section 12(2) is perhaps more directly related to the sale and leaseback arrangement. It has been invoked in many varied situations. Yachts and Cadillacs have been held to be unreasonable in the circumstances while frequenting night clubs was held to be a reasonable cost of doing business. While no leaseback arrangement has been interpreted in terms of Section 12(2)'s requirement of reasonableness, one lease was investigated. A dentist renting his office from his wife was denied the right to deduct all of the rent he paid to her. The Board heard the testimony of real estate experts and allowed a rental deduction in line with a fair rental value under the circumstances. This approach raises the question as to whether the Board would consider such factors as financing considerations, protection of title and part of the rent being in actuality a payment of interest, in determining the reasonableness of the rental payments in a sale and leaseback situation. Surely these factors should be considered.

One question of interest might be raised in regard to Section 137(1) and 12(2). In the *Shulman* decision the Board held that an arrangement whereby a lawyer paid an office management fee to a company owned solely by him and his wife to be reasonable in the circumstances as per Section 12(2) but, that it unduly reduced his

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37 Section 12(e). "In computing income no deduction shall be made in respect of an outlay or expense otherwise deductible except to the extent that the outlay or expense was reasonable in the circumstances."

38 Section 137(1). "In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that if allowed would unduly or artificially reduce the income."

39 *Supra* note 24.


45 *Supra* note 40.
income for taxation purposes as per Section 137(1). Conceptually, it is difficult to see how an expense can be reasonable in the circumstances and yet unduly reduce income. Perhaps Section 12(2) applies to the transaction while Section 137(1) applies to the amount of the deduction resulting from the transaction. Thus, if the usual leaseback is considered reasonable in the circumstances (as it probably should be) then Section 12(2) should not apply. But, further, if such a transaction is reasonable surely it is not artificial. Thus the sole area left is the "unduly" section in 137(1). Therefore, perhaps the rent paid under the usual sale and leaseback arrangement can only be attacked if it unduly reduces income.

In conclusion, the payments under a sale a leaseback would probably be treated as rental income to the lessee, if they expressed such an intention and the transaction did not unduly reduce income. Section 137(1) has been applied twice to arrangements where the resulting capital cost allowance was considered excessive. Perhaps Section 12(2) can be applied to amounts as well as transactions, providing for an evaluation of reasonableness in the circumstances.

There have been several suggestions as to how to resolve these discrepancies. Gwyneth McGregor recommended a provision that would allow a deduction equal to the lesser of the actual rent paid or the capital cost allowance computed on the total rental payments plus option price. But, for example, by adding a third party, the rent or capital cost allowance may be unduly inflated and thus Sections 12(2) or 137(1) would still have to be employed. The Carter Commission recommends a system whereby a fair rent is deductible and a capital cost allowance allowed on any excess. If the option is not exercised, the lessee is subject to recapture on the capital cost allowance which he has claimed. This proposal, it is submitted, eliminates the danger of excessive rent being deducted in leaseback arrangements which contain an option to repurchase, and also avoid the problems raised by a fact situation similar to Harris.

In the present economic context of tight money and high interest rates, sale and leaseback of real property will become an increasingly more important method of financing Canadian business activity. Lawyers should be prepared to advise their clients intelligently and this requires a sound knowledge of financial considerations of which the tax aspects form only a part.

47 1963 CAN. TAX JOURNAL 129 at 134.
49 Supra note 25.