BSR
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Mortgage and Real Property Law Report

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Recent Changes to Qualification Rules for CMHC-Insured Mortgages

Effective April 19, 2010, the federal government has implemented new measures aimed at bolstering stability in the housing market and encouraging home ownership for Canadians, by changing the rules relating to government-backed mortgages insured by the Canada Mortgage and Housing Corporation (CMHC).

Primary among the changes is a new requirement that all borrowers must meet the standards for a five-year fixed rate mortgage, even if they choose a mortgage with a lower interest rate and shorter term. (This addresses longer-term housing market stability by preparing homeowners for higher interest rates in the future). Specifically:

- For fixed-rate mortgages with a term of less than five years, and for all variable-rate mortgages regardless of term, the qualifying interest rate is either the benchmark rate (*i.e.* the Chartered Bank conventional mortgage 5-year rate most recently published by the Bank of Canada) or the contract interest rate, whichever is higher. For fixed-rate loans with a term of five years or more the qualifying interest rate is simply the contract interest rate.
- For mortgages with multiple interest rates (e.g. multi-component mortgages), each individual component must comply with the criteria relevant to that component.

In light of these requirements, CMHC will no longer offer insurance for mortgages which fall outside the defined parameters.

The changes imposed by the federal government also include the following:

- Lowering the maximum amount that homeowners can withdraw when refinancing their mortgages. Formerly, the amount was 95% of the home's value, but it has now been reduced to 90%.
- Requiring a minimum down payment of 20% for government-backed mortgage insurance on investment properties, *i.e.* non-owner-occupied properties purchased for speculation.

In response to these government initiatives, CMHC has also implemented changes affecting borrowers who own rental income properties, in terms of how their total debt service ratio is calculated. Also, both self-employed borrowers with more than three years in the same business, and all commissioned-income borrowers are now subject to new requirements in connection with providing income validation as part of qualifying for CMHC-insured mortgage loans. Income validation can be provided through financial statements, contracts, T4 forms, and other third-party sources.

Strict Compliance with Builder-Developer Charge-Back Clauses

In a recent case heard by the Ontario Court of Appeal, the key issue was whether a developer was validly entitled to charge-back repair costs that it was invoicing builders for under the terms of the agreement between them. The Court ultimately concluded that in order to qualify for repayment the developer had to abide by the clear and strict wording of the contract, which it had not done.

The facts involved written Lot Sale Agreements between a developer and various builders, which contained a provision allowing the developer to make repairs on behalf of those builders, and then invoice them for the costs. The builders had each provided letters of credit to serve as security deposits, and these allowed the developer to draw from them at the bank without obtaining the builder's approval. However, the Lot Sale Agreement required the developer to give written notice of any damage or default for which it intended to make the builder liable, and gave the builder seven days within which to remedy the problem itself.

Work proceeded on the subdivision, and the developer started submitting invoices to the builders for various work it had done without giving the requisite notice. These items included cleaning the subdivision, removing garbage, installing and cleaning catch basins, installing signs and fencing, various landscaping, repairing damaged curbs and sidewalks, and cleaning mailbox pads. The builders paid some of the invoices, but refused to pay others. The developer drew on the letters of credit; the builders refused to reinstate the security deposit and the matter came before the court.

Although the court determined that all of the tasks were performed and the charges were reasonable, it held that the developer was still not entitled to invoice the builder for them. Rather, the Lot Sale Agreement between the parties was clear: simply stated, it only allowed the developer to be reimbursed if it had given the required notice. If the necessary notice was *not* given, then the developer could not insist on payment and had no right to draw from the letters of credit. In the end, the court found that the developer had been acting in accordance with its own, misguided interpretation of the notice provisions, and in this case, it unfortunately did so at its own risk. See *Tas-Mari Inc. v. DiBattista*Gambin Developments Ltd*., 2009 (ONCA).

HST and Commercial Landlords

The upcoming introduction of Harmonized Sales Tax (HST) in Ontario will have broad-ranging repercussions among industries and businesses of all types, including real estate and leasing. This article will examine the specific impact that the HST will have on commercial property owners and managers who are designated as "large businesses" as part of the new tax changes.

As most are aware by now, the HST comes into

force on July 1, 2010, and represents a blending of the 8% provincial sales tax (PST) and the 5% federal goods and services tax (GST) for a total of 13% in tax. It will generally apply to all goods and services which are currently subject to the GST.

Under the current system, the GST paid by businesses is credited against the GST collected from the business's customers, the result being "input tax credits" (ITCs).

Once HST is implemented, most businesses will experience a cost savings because the full ITC will be available for HST paid (in contrast to the current situation, which does not allow a credit for PST paid). However, the effect will be the opposite for GST-exempt businesses, of which there is a broad array.

(These include businesses which provide health and dental services, educational services; legal aid services; and child and personal care services. Certain supplies provided by public bodies, charities, and financial services organizations – such as banks and credit unions – are also GST-exempt.) This is because once the HST is implemented, operating expenses for these kinds of businesses will increase since they will be subject to paying HST on rent and other expenses, but will still be ineligible to claim ITCs.

Which brings us to commercial landlords: under the new HST regime, "large businesses" (which are defined by legislation as being those with taxable sales in excess of $10 million per year) will similarly be restricted from claiming ITCs on the 8% of the HST (*i.e.* the portion formerly representing PST) on specific transactions, including amounts paid for:

- Food and beverages;
- Entertainment;
- Telecommunication services (excluding Internet and toll-free services);
- Energy; and
- Vehicles weighing less than 3,000 kgs, as well as the fuel needs associated with them.

In other words, for those commercial landlords and property managers whose operations fall within the definition of "large businesses", this means that the overall costs of these items and services will increase, because no ITC will be available on that portion of their operating costs.

(And by extension, the introduction of HST will also adversely affect tenants, since commercial landlords will aim to be reimbursed for their increased operating costs by passing these increases on to their tenants).

These restrictions remain in place for five years after HST comes into force, *i.e.* until June 30, 2015. However, the ITCs for these items will be phased in over three years starting July 1, 2015, with full ITCs becoming available after June 30, 2018.

So what are the practical repercussions for commercial landlords, once the HST is in force? For one thing, commercial landlords should ensure that all Offers to Lease, Letters of Intent, Leases, Amending Agreements, and related lease documentation are worded to reflect the HST payable by tenants. References to GST should be removed from all of these documents.

Also, the definition of "operating costs" in all Leases should be revised to allow recovery of the HST which is not available to count towards the ITCs.

Note that from a commercial landlord's perspective the existence of obsolete references to GST, or inaccurate references to sales tax will not render a Lease void or the tax uncollectible. (This is because tax legislation expressly designates that they are nonetheless payable on all taxable items, even if the Lease agreement is silent). Still, this kind of post-HST "tidying" of Lease documentation ultimately benefits the commercial landlord, because a tenant's failure to pay the necessary taxes can trigger a default in the Lease. It is therefore to the commercial landlord's advantage to make the lease terms as clear, specific, and accurate as possible.

Allocating Insured Risks Between Landlords and Tenants

A recent decision by the Ontario Court of Appeal addressed the allocation of loss risk between a tenant and a landlord in a situation where there was no formal lease.

The tenant in the landlord's strip mall used it as an automobile repair shop. A fire which started in the repair shop caused property damage and interrupted the landlord's business, so the landlord sued the tenant for negligence. The issue was whether the tenant or its insurer was prevented from sustaining the claim.

The motions judge held that – because there was no formal lease between the landlord and tenant – the Offer to Lease governed the relationship between them. Under this document, the tenant assumed the risk of loss for any fire in its unit.

The tenant appealed the judge's ruling, and was successful. The Offer to Lease contained a clause that said the tenant was required to pay "all costs in respect of … insurance". (Although it did not specify fire insurance, the court had no difficulty in concluding this type of insurance was covered). Accordingly, the tenant's obligation in the Offer to Lease to contribute to the cost of insurance essentially had the effect of allocating the risk of fire loss to the landlord. To conclude otherwise meant that the tenant would have no benefit at all from its contribution to the insurance cost; such an outcome could only occur if the Offer to Lease expressly provided so in clear language. Therefore – and in light of the tenant's obligation pursuant to the Offer to Lease to contribute to the cost of insurance – it followed that neither the landlord nor the insurer could proceed with its negligence claim against the tenant. The appeal was allowed. See *1044589 Ontario Inc. v. AB Autorama Ltd.* (2009 ONCA).

LEGAL ALERTS

Michael Wilchesky Joins the Firm

BSR is pleased to announce that Michael Wilchesky has recently joined the firm, practising in the litigation, real estate and power of sale departments. Michael received his law degree in 2008 from Osgoode Hall Law School, and was called to the New York State Bar in 2008, and to the Ontario Bar in 2010.

CMHC Examines Islamic Housing Finance

In early 2010, the Canada Mortgage and Housing Corporation (CMHC) released a report entitled "Islamic Housing Finance in Canada", which analyzes Islamic housing finance against the background of the Canadian legal system. CMHC's report notes that a number of Canadian companies, pioneered mainly by housing cooperative organizations, now offer Shariah-law compliant mortgages to Canadian borrowers, and that there may be growing focus in this area among lenders.

Small Claims Court Limit Increased

Effective January 1, 2010, the monetary limit for bringing an action in the Ontario Small Claims Court has been increased from $10,000 to $25,000. The Court also has greater discretion in awarding legal costs for those litigants who are represented by counsel. These changes are part of an overhaul of the Ontario Rules of Civil Procedure and related statutes, which is intended to achieve greater efficiency in the court system of the province.

The statements of law and comments contained in this Newsletter are of a general nature. Prior to applying the law or comments to any specific problem, please obtain appropriate legal advice.