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by Robert Antenore, Michael Friedman, and Stephanie Robinson

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# Amendments Would Remove Obstacle to Defeasance Transactions

*by Robert Antenore, Michael Friedman, and Stephanie Robinson*

Proposed amendments to the regulations to the Income Tax Act (Canada) were published on June 23, 2007, which, when enacted, will formally expand the scope of what validly constitutes a "qualified investment" for Canadian tax purposes.

As noted in the "Regulatory Impact Analysis Statement" that accompanied the release of the proposed amendments, the definition of a qualified investment will be "amended to ensure that a mortgage certificate will not lose its qualified investment status if a mortgage that was registered in connection with the certificate is released in exchange for the provision of other high- quality substitute security." The new, expanded definition of a qualified investment is proposed to apply, with retroactive effect, after 2005.

## Background

Over the past decade, the size of the Canadian commercial mortgage-backed securities (CMBS) market has grown at a dramatic rate. It has been reported that more than $4.5 billion of Canadian CMBS were issued in 2006 alone.[1]

As the size of the Canadian CMBS market expanded, the prevalence of defeasance transactions also increased. In 2006, 37 loans, totalling more than $560 million, were defeased.[2]

In the context of securitized mortgage loans, in its simplest form, defeasance is the process by which a borrower replaces real property security in respect of a particular debt obligation with personal property security. The mortgage is discharged from the real property security, and the borrower is free to sell or refinance the property as it wishes. All obligations under the loan and the mortgage, other than those related to the use, operation, or ownership of the original real property security remain in place, such as the obligation to continue to make payments under the loan. In exchange for a release of its security interest in the real property, a mortgagee receives a pledge of bonds from the borrower. The bonds are generally high-quality, triple-A-rated, sovereign risk (such as government of Canada bonds) and are purchased in such a combination that the proceeds from the maturity and coupons of the bonds match the future payments that will be due under the loan. Thus, provided an efficient portfolio of bonds has been assembled, each future payment under the loan is matched to a bond within the portfolio that comes due, or pays a coupon, on or before a payment date such that the remaining payments under the loan are fully covered by the income stream from the bonds.

As a means of maximizing the marketability of particular CMBS offerings, some CMBS are structured so as to permit Canadian registered retirement savings plans, registered retirement income funds, deferred profit sharing plans, and registered education savings plans (collectively, registered plans) to validly acquire and hold the CMBS product without triggering harsh tax consequences.

The Tax Act generally provides that a registered plan may be subject to special Canadian tax liabilities if the plan holds property other than qualified investments. The regulations to the Tax Act have historically provided that a certificate evidencing an

[1]Erin Stafford, "Canadian CMBS Industry Recap" (Canadian Mortgage Securities Association, May 9, 2007).

[2]*Id.*

undivided interest in one or more properties constitutes a qualified investment where: (i) all or substantially all[3] of the fair market value of the certificate is attributable to property that is, or is incidental to, a debt obligation secured by a mortgage, charge, hypothec, or similar instrument in respect of real property situated in Canada; (ii) the certificate has, at the time of its acquisition by the registered plan, an investment grade rating with a bond rating agency that rates debt in the ordinary course of its business (the bond rating test); and (iii) the certificate is issued as part of an issue of certificates by the issuer for a total amount of at least $25,000,000 (the offering test).

The documentation governing a CMBS offering will frequently provide that no defeasance transactions will be permitted to be undertaken if the defeasance will compromise the status of the CMBS as a qualified investment for Canadian tax purposes (a qualified investment limitation). Hence, to the extent that a borrower wished to undertake a defeasance transaction in respect of a CMBS that was encumbered by a qualified investment limitation, concerns would arise if the real property security being released had a fair market value in excess of 10 percent of the fair market value of all of the property used to secure the operative debt obligation. Such concerns were particularly acute when dealing with debt obligations that were secured by a small number of sizeable Canadian real properties.

At the end of August 2006, the Canadian Department of Finance was asked to expand the applicable definition of a qualified investment to capture CMBS that were initially secured by Canadian real property, yet were subsequently fully defeased by the pledging of debt obligations as replacement security. On August 30, 2006, the Department of Finance issued a comfort letter confirming that it would recommend to the Minister of Finance that the regulations to the Tax Act be amended to allow for bonds secured by Canadian real property to be fully defeased with high-quality debt instruments without jeopardizing the status of a CMBS as a qualified investment for Canadian tax purposes.

On the enactment of the proposed amendments, a certificate that satisfies the bond-rating test and the offering test will be a qualified investment provided all or substantially all of the fair market value of the certificate is attributable to property that is, or is incidental to, a debt obligation secured by either: (a) a mortgage, charge, hypothec, or similar instrument in respect of real or immoveable property situated in Canada; or (b) certain bonds, debentures, notes, mortgages, hypothecary claims, or similar obligations of the Canadian or a provincial government, including bonds guaranteed by the government of Canada, that were substituted for the security referred to in paragraph (a) under the terms of the debt obligation.

It is expected that the new, expanded definition of a qualified investment will remove a potential obstacle to defeasance transactions, particularly in respect of debt obligations that are secured against a small number of large pieces of Canadian real property. ◆

♦ *Robert Antenore, Michael Friedman, and Stephanie Robinson, McMillan Binch Mendelsohn LLP, Toronto*

[3]The Canada Revenue Agency generally asserts that the phrase "all or substantially all" represents 90 percent or more of a particular amount.