DECEMBER 2012

Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

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This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, the editor, or the head of our Corporate/Commercial Group:

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IN THIS ISSUE:

Planning for the Small Business Deduction May Lead to Traps Along the Way
Paul L. Schnier

That's What It Says... But It's *Not* What We Meant: Rectifying a Contract
Bradley Phillips

Canada and China Sign Major Agreement to Stimulate Direct Foreign Investment
Patrick Gervais and Nailah Gordon-Decicieo

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PLANNING FOR THE SMALL BUSINESS DEDUCTION MAY LEAD TO TRAPS ALONG THE WAY

Paul L. Schnier

Followers of the U.S. political scene have heard the term "small business owner" used endlessly in the last several months. The concept, however, is not unique to the United States, as many Canadians own small businesses too, and the "small business deduction" is one of the foremost tax planning tools available to Canadian companies.

While the small business deduction is understandably popular, prudence in its use is strongly advised, for what you hope for is not necessarily what you always get.

Briefly, a Canadian-controlled private corporation (i.e. one that is privately owned and not controlled by non-residents or public corporations) is afforded a significantly lower tax rate on its first $500,000 of active business income in any year. For example, in Ontario a corporation that can avail itself of this rate will pay tax at 15.5 per cent rather than at the general corporate rate of 26.5 per cent. This means an immediate tax saving of $55,000.

With this type of saving available, it is only natural that strategies have emerged to multiply the benefit. For example, two spouses engaged in separate but similar businesses may each form a corporation to carry on one of those respective businesses. Although the Canada Revenue Agency (CRA) has the discretion to deem these businesses "associated," and thus obliged to share this tax benefit, this structure has the potential to allow the 11 percentage point tax saving to apply to $1 million of active business income annually rather than $500,000.

Strategies have emerged as well that provide for a family corporation to be owned by a family trust, and thus enjoy the small business deduction benefit, too. When used in succession planning, family trusts create a further opportunity by allowing not only father and mother, but also children, access to the $750,000 capital gains exemption when shares of these family companies are sold. As one might expect, the CRA will take a very close look at these structures.

The first line of attack that the CRA might use when it examines the use of the small business deduction is through the "association" rules. The *Income Tax Act* contains a number of technical rules on share ownership that could cause such corporations to be deemed as associated and thus

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required to share the low rate of tax on the first $500,000 of active business income. As suggested previously, the CRA has the discretion to deem such companies to be associated if there is no valid non-tax reason for these businesses to be carried on in separate corporations. As well, under the association rules, shares of a company owned by a family trust can be deemed to be owned by the beneficiaries and shares owned by a trust in which minors are beneficiaries are deemed to be owned by the parents.

These rules can easily trip up an ownership structure, particularly where estate freezes are involved or where younger generations own shares in the same corporations as older generations. A common situation where shares of one company are owned by a parent while shares of a completely separate business are owned by an adult child could be caught if some of the usual planning techniques are utilized.

Another line of attack available to the CRA where family trusts are involved relates to the sale of such shares by family trusts which have minor beneficiaries. Under recently enacted legislation, the profits from such sales can be taxed as dividends at the highest marginal tax rate (32.5 per cent) rather than as capital gains, which could be taxed at up to 23 per cent if not eligible for the capital gains exemption.

To sum up, then, the small business deduction can be a compelling instrument. In fact, it might even be considered the holy grail of tax planning.

Keep in mind, however, that there can be many traps along the way to maximizing its benefit. ■

THAT'S WHAT IT SAYS... BUT IT'S *NOT* WHAT WE MEANT: RECTIFYING A CONTRACT

Bradley Phillips

Parties to a contract (or one party to a contract) may discover that the contract they signed and filed away in their desks does not accurately reflect the deal into which they thought they had entered. This can lead to a significant dispute when steps are taken by one party to enforce a provision that the other does not believe accurately reflects the original intention of the parties.

Although the courts are generally loath to interfere with executed, written documents entered between commercial parties, in certain, limited circumstances, a court may enable a party to "rectify" the agreement to reflect what was actually intended.

There are two ways to seek rectification -- by establishing a mutual mistake (i.e. when entering into the written agreement, neither party intended to create the obligations set out), or by proving a unilateral mistake [where one party negligently entered into the agreement while the other party was aware of the (disputed) provision at the time the agreement was entered into and such other party intended to rely on it]. The "tests" to establish rectification differ, depending on the argument presented.

Mutual Mistake

Traditionally, proving a mutual mistake was the only route to rectification. In *Royal Bank of Canada v. El-Bris Ltd.*, the Ontario Court of Appeal makes it clear that the prerequisites for

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"In order to get rectification, it is necessary to show that the parties were in complete agreement on the terms of their contract..."

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rectification in respect of a unilateral mistake (set out below) do not apply in common or mutual mistake cases. Rather than setting out an express test for a mutual mistake, the Court cited, with approval, the following portion of the reasons of Lord Denning of the English Court of Appeal in *Frederick E. Rose (London) Ltd. v. Wm. H. Pim Jnr. & Co.*:

> **In order to get rectification, it is necessary to show that the parties were in complete agreement on the terms of their contract,** but by an error wrote them down wrongly. **And in this regard, in order to ascertain the terms of their contract, you do not look into the inner minds of the parties - into their intentions - any more than you do in the formation of any other contract. You look at their outward acts, i.e., at what they said or wrote to one another in coming to their agreement, and then compare it with the document which they have signed. If you can predicate with certainty what their contract was,** and that it is, by a common mistake, wrongly expressed in the document, **then you rectify the document.**[emphasis added]

Evidence of later conduct (throughout the contract's terms) consistent with a claim for rectification is also relevant and admissible when seeking a claim for rectification.

Unilateral Mistake

The concept of rectification of a unilateral mistake is newer, and because only one party is contending that a mistake was made, the standard to prove entitlement to rectification is much higher than the standard for proving a mutual mistake.

In *Performance Industries Ltd. et al. v. Sylvan Lake Golf & Tennis Club Ltd.*, the Supreme Court of Canada sets out the conditions precedent for rectification where a unilateral mistake has been made.

Mr. Justice Ian Binnie, writing for the court, sets out four prerequisites for parties seeking rectification of a unilateral mistake: (i) a previous oral agreement inconsistent with the written document; (ii) the other party knew, or ought to have known, of the mistake and permitting that party to take advantage of the mistake would amount to unfair dealing; (iii) the document can be precisely rewritten to express the parties' intention; and (iv) each of the first three prerequisites must be demonstrated by convincing proof (i.e. proof that may fall well short of the criminal standard but that goes beyond the sort of proof that only reluctantly, and with hesitation, scrapes over the low end of the civil "more probable than not" standard).

As can be seen, the test to establish rectification of a unilateral mistake comes close to requiring that a party prove that a fraud has been committed. While the concept is available to an aggrieved party, the number of cases in which a unilateral mistake has been proved is rare, and pursuing rectification on this basis must be considered carefully based upon the unique facts of each potential claim. ■

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"Designed to stimulate and protect Canadian and Chinese investments and investors, the agreement defines rules and obligations to regulate foreign investments to and from each country, including mandatory arbitration for dispute settlement."

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CANADA AND CHINA SIGN MAJOR AGREEMENT TO STIMULATE DIRECT FOREIGN INVESTMENT

Patrick Gervais and Nailah Gordon-Decicieo

Canada and China have signed a *Foreign Investment Promotion and Protection Agreement* (FIPA) intended to increase direct investment in both countries. Canada was scheduled to ratify the agreement some time in November. It was to take effect one month after ratification by both countries.

For Canadian investors, the effect of the ratified FIPA may be greater direct investment in China. Alternatively, Chinese investors will have the potential to drive expansion of operations located in Canada.

Designed to stimulate and protect Canadian and Chinese investments and investors, the agreement defines rules and obligations to regulate foreign investments to and from each country, including mandatory arbitration for dispute settlement.

The main obligations created by the agreement include: (i) non-discriminatory government treatment for investments made by Canadian investors in China and Chinese investors in Canada, (ii) provisions to protect investors in case of expropriation, and (iii) a defined dispute settlement mechanism.

Key Distinctions

Canada currently has 24 FIPAs in force. Most are similar in form and substance. The agreement with China differs by adopting standards more common in Chinese bilateral investment treaties. The main distinctions between the Canada-China agreement and the others are:

1. Agreement Lifespan of 31 Years

Unlike other FIPAs with an indefinite term and a termination provision with one year's notice by either party, the Canada-China FIPA would have an initial lifespan of 15 years, with the standard one year notice for termination thereafter. If ratified, investments made prior to termination would be subject to the Canada-China FIPA for an additional 15 year period after the effective termination date. An investment made prior to its initial termination could be subject to the agreement for 31 years after its entry into force. For example, if the FIPA were ratified in 2012 and the investment was made during the last year of its operation (i.e. 2028), the FIPA would apply to that investment until 2043.

2. No 'National Treatment' at the Establishment and Acquisition Stage

A second key distinction in the Canada-China agreement is that it does not provide prospective new investments into China with 'national treatment' (where foreign firms are treated as though they were Chinese firms).

In other Canadian FIPAs, such as the one with Jordan, investors receive 'national treatment' at the establishment and acquisition stages. Although the Canada-China FIPA affords 'most-favoured-nation treatment' at the usual establishment and acquisition stages, it excludes 'national treatment' from these stages. In effect, the protection is limited to stages arising after a deal closes, including the expansion, management, conduct, operation and sale or other disposition of investments in its territory. This is more in line with practices found in other Chinese bilateral investment treaties than with those of Canada.

BLANEYS ON BUSINESS

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The *Investment Canada Act* and its Chinese equivalent still apply, allowing both governments to veto investments at the establishment and acquisition stages when they are viewed as not providing a net benefit to their country.

3. Default Dispute Resolution Out of Public View

As in other FIPAs, Canada's agreement with China provides for arbitration to settle disputes pertaining to breaches of the agreement. In contrast to the standard FIPAs, however, the arbitration hearings of the parties are, by default, private, unless the host government determines that it would be in the public interest to make the dispute resolution public. For example, an arbitration hearing for a Canadian investor in China claiming damages under the FIPA would be private unless China decided it was in the public interest to make it public. This is a departure from the general Canadian practice in other bilateral investment treaties.

Exceptions

As in other FIPAs, specified industries are explicitly exempt from the application of the Canada-China accord. In particular, measures pertaining to cultural industries (broadly defined to include publishing, film or video recordings, music recordings and radio communications) are excluded. Other exceptions include certain environmental measures, security matters, and the protection of essential security interests. Free trade areas, aviation, fisheries or maritime matters are excluded solely from the 'most-favoured-nation treatment' protection.

Expropriation

The expropriation provisions of the Canada-China FIPA are standard and prohibit the expropriation of investments or returns of investors, other than for a public purpose and against compensation at fair-market value. The mechanism for determining fair market value is specified in the FIPA.

Looking Forward

The government of Canada believes that the Canada-China FIPA will promote greater direct investment between the two countries. Canadian and Chinese firms contemplating foreign direct investment in the other country should be aware that conflicts could be resolved by private arbitration should the host country decide public arbitration is not in the public interest.

In addition, the government of Canada can anticipate that it may experience several claims by Chinese firms given the increasing number of Chinese inbound investments in Canada. This may result in greater exposure by the Canadian government to potential damages if Chinese investors are wronged by the Canadian government's actions. ■

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