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# DUE DILIGENCE IN LEASING

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It is fairly common and in fact recommended, to proceed with a due diligence review of a property before its acquisition. At a minimum, title to the property is confirmed through a title search review. Often times, a much more thorough review is completed. Matters such as zoning and other legal compliance are reviewed together with the status of realty taxes owing as well as a physical and environmental inspection. All of these elements should be reviewed by a purchaser, even where the sale is made with legal warranty, that is where the vendor sells on the basis of its warranty that it owns the property and that the property is in good condition. In commercial transactions, a property is often sold without warranty or with limited warranties, such that the onus is on the purchaser to ensure itself of the quality and condition of the property it intends to acquire.

What is less common, but is also as important, is to complete a due diligence review of a property when a party is considering simply leasing a property. The level of due diligence required will vary greatly depending on the nature of the lease. For example a review required when a party leases a small area in an office tower will be different from the case of a single tenant lease of an industrial facility. That being said in both scenarios, and those in between, some due diligence review will be required. The extent of the review required will depend on the obligations that the tenant will assume under the terms of the lease. The following are certain items that a tenant should confirm or review in the context of a lease.

## TITLE

This review will confirm the ownership of the property. In many cases, the party signing the lease is not necessarily the owner of the property, either by error or where the owner prefers to act by another party, a property manager for example. In any event it is preferable for a tenant to have the lease signed by the owner or at a minimum, establish the consent of the owner and its authorization to have a party represent it for the purposes of the lease. A review of title will also show signs as to the landlord's financial situation, in that, it will indicate if it is default as to realty taxes, its lenders, and if there are any construction liens. This would be an indication of an owner's financial situation and its ability to respect its obligations under a lease.

## CONDITIONS OF PREMISES

This review is of particular concern where under the terms of the lease, notably in a single tenant industrial or retail setting, the tenant will accept the leased premises as is, and agree to assume either through the payment of operating expenses or otherwise, the costs of repairs and maintenance. For example the roof may cost a significant amount of money to repair. Upon contemplating a lease of a single tenant facility, some inspection (which report can be requested from the landlord) on the condition of the roof should be conducted. This will allow the parties to clearly understand the possible liabilities and set out who will have the responsibility for any repairs either minor or major. Another example may be the existence of any environmental issues together with the existence of asbestos, PCBs and lead (again it would be common to require reports from the landlord). Typically any repair issues related to these are to the account of the landlord, but it remains preferable to have complete knowledge of the situation to clearly state each parties' responsibility in relation thereto.

## ZONING AND LEGAL COMPLIANCE

In most leases, the landlord will not warrant or certify that the intended use therein will comply with applicable zoning rules. Even where a landlord has confirmed the use, the cost, inconvenience and damages incurred by a tenant will be difficult to recuperate in any related litigation, if in fact the use is not permitted. In an industrial or manufacturing situation, zoning by-laws may have restrictions as to access, noise and emissions. Retail situations will have limitations as to the nature of operations. A tenant therefore would typically need to confirm these elements.

## GENERAL

Finally, a more general review of the transaction is also required. A lease can be viewed as a long term business relationship, where both landlord and tenant will be called upon to work together on a regular

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basis over a five (5) or ten (10) year term, if not more. Therefore it is important for a tenant to consider the record of the landlord in dealing with its tenants, the maintenance of the property and the landlord's overall financial situation. Where there is a record of poor management or where the landlord may have limited financial means otherwise required to conserve and maintain the value of the property, it is likely that there will be issues when problems need to be corrected even where the landlord has clear obligations under the lease.

### SUMMARY

As with any commercial transaction a level of due diligence is required. What that level is will be subject to any number of factors, which can be determined with legal counsel. Not to forget, *tenant beware* applies to leases.

# FACTORS EXAMINED BY THE SUPREME COURT IN DETERMINING THE VALIDITY OF A MUNICIPAL BYLAW

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In January the Supreme Court ruled on the factors to be examined in determining the validity of a municipal bylaw. Canada's highest court innovated by introducing the possibility of contesting a municipal bylaw deemed unreasonable in light of the factors considered by the municipal councillors at the time of enactment.

Catalyst Paper Corporation, one of Western Canada's largest producers of specialty paper and newsprint, has a paper mill in the District of North Cowichan on Vancouver Island.

The District provided the ideal environment for Catalyst's production as it was close to the ocean and surrounded by forests. In this context, Catalyst has always paid, without contesting, large portion of the modest property taxes collected by the District.

Over time, residential zones expanded as the population increased. The District began building roads, water mains, schools and hospitals, and developed a full range of municipal services.

Urban development led to a rise in residential property values — but not in the value of Catalyst's facilities. Nevertheless, the District decided to keep residential property taxes at a low level and instead, increase the tax rate applicable to Catalyst's properties. The company thus found itself paying a disproportionately large share of the property taxes without benefiting from the municipal services offered to residents.

Unhappy with its situation, Catalyst led the District to gradually reduce the tax-roll value of its properties. But this was not enough for Catalyst, which finally decided to attack the validity of the bylaw in question.

Was Catalyst justified in its claim that the bylaw should be quashed because it was unreasonable in light of objective factors such as the use of municipal services? That is the issue addressed by the Supreme Court in this ruling.

### THE BYLAW IS REASONABLE

Catalyst claimed that the municipal bylaw should be quashed because it did not meet an objective criterion, i.e., the company in no way benefited from municipal services. Catalyst therefore considered itself overtaxed in relation to the benefits provided. However, the Court responded that in the decision-making process leading up to the adoption of the bylaw, the District Council had analyzed a number of subjective factors essential to the prosperity of the ongoing growth of the city.

The legislation authorized the District to enact property tax bylaws distinguishing between the various types of property. Even if the bylaw is ultimately favourable to residential property, it is not unreasonably so, since the purpose of its enactment was based on essential and reasonable factors.

The District Council had reasonably weighed the fact that the property tax rate threatened the very operation of the Catalyst mill, against the impact that a large property tax hike could have on fixed-income residents.

Tribunals would be unjustified in quashing the municipal bylaw solely on the basis that it places a larger tax burden on a targeted category of ratepayers.

### DETERMINING THE VALIDITY OF A MUNICIPAL BYLAW

The power exercised by municipal councillors when they adopt bylaws involves a whole set of social, economic and political considerations, since the exercise of this power is liable to have an impact on the community. Municipal bylaws are therefore the result of the exercise of legislative, rather than adjudicative, power.

Historically, courts have always shown great restraint in terms of controlling the exercise of legislative power. To declare a bylaw null and void, the courts had first to conclude that it was illegal, unenforceable or unconstitutional, or that there had been an abuse of power, without having to examine the soundness of the bylaw itself.

The court's position with respect to control of the legislative power remains the same. However, according to the Supreme Court, deference does not apply in the same way to the legislative power delegated to a municipality. In such cases, it is appropriate to question the reasonability of the exercise of power by the public administration. The power delegated to the municipality must be exercised in accordance with the law, first and foremost, and the courts must serve as a check-and-balance in the exercise of this power.

In administrative law, there are a series of rules applicable to judiciary control governing the court's power to intervene. One of these rules is not to intervene unless the decision of the public administration is unreasonable. The Supreme Court, basing itself on this principle, is of opinion that controlling a municipal council decision resulting from the exercise of delegated legislative power must be done using the "reasonableness" standard of review.

Therefore the question to be asked is whether the bylaw is reasonable in light of the process leading to its adoption and whether it is within the range of possible reasonable outcomes based on certain factors.

The "reasonableness" standard implies that the determination of the bylaw's validity must be done with all due respect to the duty of elected officials to act in the citizens' interests. The court's power to quash a municipal bylaw thus remains limited, but the Supreme Court has opened the door to a new basis for contesting the validity of a municipal bylaw.

### REASONABILITY

It should be remembered that the "reasonableness" standard is, above all, circumscribed by the legislative scheme that gives municipalities the power to adopt bylaws. Inarguably, the bylaw adoption process must meet the established legislative standards, and delegated power may only be exercised for legitimate purposes.

Subsequently, a contextual analysis of the decision-making process is essential for determining if the municipal council acted reasonably by adopting the bylaw and whether the bylaw is within the range of reasonable outcomes available to the legislator. In addition, the situation must be studied in light of the many factors, both objective and subjective, taken into account during this process. The subjective factors may be of a social, economic or political nature. A court asked to determine the reasonability of a bylaw must do so in light of the wide range of factors which the elected municipal councillors may have legitimately taken into account when they adopted the bylaw. In other words, the soundness of the municipality's decision must be examined.

Were the court to conclude that reasonability should be based solely on objective factors, it would mean that municipalities — which have been given discretionary power to act in the community's interests — could never exercise the power conferred on them by law.

In conclusion, the District bylaw could only have been quashed if the court had concluded that it had not been adopted by a body acting reasonably by taking such factors into account.

# INCORPORATED EMPLOYEES FACE NEW OBSTACLES

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Some individuals choose to offer their services via a corporation rather than as an employee in order to benefit from the low tax rates enjoyed by corporations. To discourage individuals from doing this, the Minister of National Revenue (the **"Minister"**) introduced the concept of "Personal Services Business" (**"PSB"**) in order to place restrictions on certain expense deductions and disallow the "Small Business Deduction" (**"SBD"**), which allows businesses to be taxed at a reduced corporate rate. Until recently, despite these restrictions, PSBs still offered certain fiscal advantages. However, on October 31, 2011, the Minister introduced a new deterrent, effectively increasing the corporate tax rate for PSBs and thereby considerably reducing the fiscal advantages of operating a PSB.

First of all, it is important to understand what factors cause a corporation to be considered a PSB. The *Income Tax Act* [1] (the **"Act"**) provides that a corporation is considered a PSB when the following conditions are met:

(1) an individual performs services on behalf of a corporation and holds, alone or together with non-arm's-length persons, 10% or more of any class of the corporation's issued shares; and

(2) the individual could reasonably be regarded as an employee of the person to whom the services are provided but for the existence of the corporation.

Despite the foregoing, the corporation is not considered a PSB if it employs more than five full-time employees for business operations. Note that the expression "more than five employees" has been exhaustively defined by case law and that several criteria, such as number of hours worked, frequency and type of work (e.g., seasonal employment), must be met in order for this exception to apply. In this respect, the concept of an employee is a factual issue, and determining the status of an employee generally requires thorough analysis that will not be addressed in this article.

### THE EXISTING PSB PLAN

The Act provides two deterrents that apply to corporations that are considered PSBs. Firstly, a PSB is not entitled to the low tax rate enjoyed by businesses eligible for the SBD, because the PSB is not considered to carry an "active business". Secondly, the Act provides that only certain expenses incurred by a PSB can be deducted when calculating its income. Generally, these expenses include salaries paid out to the incorporated employee, as well as any expenses for which a deduction against employment income would be allowed.

Before the October 31, 2011 announcement, an employee providing services through a PSB could benefit from the principle of integration and could take advantage of tax deferrals by keeping the earnings in the corporation rather than paying them to the employee-shareholder in the form

[1] R.S.C. (1985), c. 1, 5th Supp., c. 1 as amended. The provisions of the Act are considered to be the same as the provisions in the *Taxation Act*, R.S.Q., c. I-3 as amended (Quebec) unless specifically indicated otherwise.

of dividends. Basically, as a result of the principle of integration, the income earned by an individual through a corporation should be taxed at a similar effective tax rate that the one applicable to income earned directly by an individual. In the case of a PSB, this meant that deferring an individual shareholder's dividend payment to subsequent years allowed a tax deferral as the income taxed at the corporate level was still taxed at the lower general corporate rate.

## PROPOSED CHANGE TO THE ACT

On October 31, 2011, the Minister proposed a bill for an additional measure to discourage employees from providing services via a PSB. For taxation years beginning after October 31, 2011, PSBs are no longer eligible for the reduction in the general corporate tax rate, which stands at 13% for 2012, a measure that essentially raises the corporate tax rate for PSBs and prevents application of the principle of integration.

As a result, income earned by a PSB in Quebec in 2012 is now taxed at a combined (federal/provincial) rate of 39.9%, rather than the previous rate of 26.9%. For 2012, any income paid by a PSB to an individual in the form of dividends will now be taxed at a combined marginal effective rate of 59.62%. Thus, in addition to eliminating the possibility of deferring taxes through a PSB, the Minister is taxing PSB income at a considerably higher rate than individual employment income (48.2% marginal rate in 2012).

For example, Mr. X is employed by Canco, who pays him an annual salary of $500,000. In 2012, Mr. X is taxed on his salary at a marginal rate of 48.22%, leaving him with a net amount of $258,900. On the other hand, we have Mr. Y, who provides the same services as Mr. X via a PSB, to which Canco pays fees totaling $500,000 per year. In 2012, the $500,000 income of the PSB will be subject to a rate of 39.9%, resulting in $199,500 in taxes. If the PSB pays the balance to Mr. Y as a dividend, Mr. Y will be taxed at the marginal rate of 32.81% on the dividend, and must therefore pay $98,590 in taxes, leaving him with a net amount of $201,900 in his pocket. Mr. Y pays $57,000 more in taxes than Mr. X.

In order to mitigate the negative tax implications of this measure, it may be wise to reorganize certain corporate structures that cause the corporation to be considered a PSB. In addition, for PSB taxation years beginning after October 31, 2011, it may be advantageous to pay the entire annual income in salary to the individual, in order to benefit from a deduction of the same amount and therefore reduce the PSB's taxable income down to zero.

If you operate a PSB, or if you think that a corporation in which you own shares is a PSB, it may be wise to review the legitimacy of the expenses claimed by the corporation and the existing corporate structure as soon as possible in order to minimize any negative tax and financial consequences.



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