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The Federal enhanced deemed trust:
a new source of liability for financial institutions ?

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TABLE OF CONTENTS

I.	INTRODUCTION.....	1
II.	HISTORY AND EVOLUTION OF THE DEEMED TRUST PROVISION	4
	A. Dauphin Plains	5
	B. Sparrow Electric.....	6
	C. First Vancouver Finance	7
III.	REVENUE CANADA’S INTERPRETATION OF <i>FIRST VANCOUVER FINANCE</i> AND THE 2004 FEDERAL COURT OF APPEAL CASES OF <i>NATIONAL BANK OF CANADA</i>	10
	A. Revenue Canada’s Interpretation	10
	B. Common Law Jurisdiction Precedents.....	11
	C. Civil Law Precedents	12
IV.	<i>CAISSE POPULAIRE DE L’EST DE DRUMMOND</i>	16
V.	THE DEEMED TRUST IN THE CONTEXT OF CROWN REMEDIES.....	17
	A. A Priority Provision	18
	B. A Floating Charge.....	18
	C. Not a Liability Provision.....	21
	D. The Minister’s Certificate	22
	E. The Liability of a Specified Person with Influence	24
	F. Deemed Trust, Theft, Receiving Stolen Property and the Banks	25
VI.	POTENTIAL OUTCOMES OF THE SUPREME COURT DECISION.....	26
	A. The Date of Payment and Definition of Security.....	26
	B. Comments on the National Bank of Canada Cases	26
	C. The Issue of Personal Liability	26
VII.	POTENTIAL LIABILITY OF THE FINANCIAL INSTITUTIONS	26
VIII.	CONCLUSION	28

The Federal enhanced deemed trust: a new source of liability for financial institutions?

Roger P. Simard*

I. INTRODUCTION

This paper addresses a controversial topic that has been written about by authors, legislators and judges for more than twenty years and that continues to affect insolvency practice across Canada: the famous super-priority federal deemed trust applicable to payroll source deductions. The enforcement of the relevant provision of the *Income Tax Act*¹ (“ITA”) by Revenue Canada² continues to generate a “ferociously complex body of jurisprudence”.³

What makes it such a difficult topic to tackle for authors, legislators and the courts is its position in the field of Canadian constitutional law. It is essentially a tax enforcement provision, well within the scope of the federal government,⁴ but tax laws can’t operate outside of the economic reality created by property and civil rights as enacted by the laws of the provinces.⁵ It is therefore inevitable that the federal provision, which purports to deal with priority, property and ownership in the vacuum of tax legislation, will clash with the legitimate rights of third parties derived from transactions governed by civil or common law, mostly involving sales, transfers and payments.

For a *civiliste*, the notions of “property”, “ownership” and “payment” are sacrosanct, clearly defined by the *Civil Code of Québec* (“C.C.Q.”),⁶ and before that by the *Civil Code of Lower Canada*,⁷ and before that by the French *Code Napoléon*, and before that by the Coutume de Paris, and before that by Roman law. In civil law, it can be simply stated that you own property or you don’t. Notions like “beneficial ownership”, “equity of redemption”, and “licence to sell” are foreign and cannot be merged easily through a tax law. So the results sought by the Crown through a deemed trust mechanism are not easily accepted and certainly difficult to integrate with the provincial law and the civil law regime of Québec.

The Crown had been mostly absent from the insolvency process after being relegated from its status as a preferred creditor to an ordinary unsecured creditor status on November 30, 1992, with the coming into force of the *Bankruptcy and Insolvency Act*⁸ (“BIA”), with the exception of

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¹ *Income Tax Act*, R.S.C. c. 1, 5th Suppl., as amended, at subsection 227(4.1).

² For the purposes of this paper, we will ignore the disguises adopted from time to time by the federal tax authorities into the “Canada Customs and Revenue Agency” or “Canada Revenue Agency”.

³ Jacob S. Ziegel, Crown Priorities, Deemed Trusts and Floating Charges: *First Vancouver Finance v. Minister of National Revenue*, 45 C.B.R. (4th) 244, at the first paragraph.

⁴ Section 91 of the *Constitution Act*, 1867.

⁵ Subsection 92(13) of the *Constitution Act*, 1867.

⁶ Since January 1st, 1994, L.Q. 1991, c. 64.

⁷ From 1866 until December 31, 1993.

⁸ R.S.C., 1985, c. B-3, as amended.

payroll withholding amounts. The rights of the Crown are again of interest because of the recent and aggressive return of the Crown in the insolvency process, which resulted in this priority issue coming once again before the Supreme Court of Canada. This new vigour is not the result of legislative changes, it is the result of a wide reaching interpretation of the law by Revenue Canada.

Not satisfied of the results of collection of payroll tax deductions from the proceeds of liquidation of the tax debtor's assets, or from the directors' liability, Revenue Canada is now pursuing third parties who have dealt with the tax debtor and received property by way of payment. These transactions are done in what could be referred to as the ordinary or normal course of business, in the sense that they are not payments received through a liquidation or receivership or while the financial institution is in control of the affairs of the tax debtor.

Under the *BIA*, if money is actually held in trust as provided under a tax legislative provision, then the Crown will be entitled to claim the money under subsections 67(1)(a) and 67(2) *BIA*.⁹ If the money is only deemed held in trust under federal or provincial legislation, only the Crown claims protected by subsection 67(3) *BIA*¹⁰ will be enforceable in bankruptcy. These withholding claims¹¹ include:

- Federal income tax payroll source deductions;¹²

⁹ 67(1) The property of a bankrupt divisible among his creditors shall not comprise
(a) property held by the bankrupt in trust for any other person;

Deemed trusts

67(2) Subject to subsection (3), notwithstanding any provision in federal or provincial legislation that has the effect of deeming property to be held in trust for Her Majesty, property of a bankrupt shall not be regarded as held in trust for Her Majesty for the purpose of paragraph (1)(a) unless it would be so regarded in the absence of that statutory provision.

¹⁰ Exceptions

67(3) Subsection (2) does not apply in respect of amounts deemed to be held in trust under subsection 227(4) or (4.1) of the *Income Tax Act*, subsection 23(3) or (4) of the *Canada Pension Plan* or subsection 86(2) or (2.1) of the *Employment Insurance Act* (each of which is in this subsection referred to as a "federal provision") nor in respect of amounts deemed to be held in trust under any law of a province that creates a deemed trust the sole purpose of which is to ensure remittance to Her Majesty in right of the province of amounts deducted or withheld under a law of the province where

(a) that law of the province imposes a tax similar in nature to the tax imposed under the *Income Tax Act* and the amounts deducted or withheld under that law of the province are of the same nature as the amounts referred to in subsection 227(4) or (4.1) of the *Income Tax Act*, or

(b) the province is a "province providing a comprehensive pension plan" as defined in subsection 3(1) of the *Canada Pension Plan*, that law of the province establishes a "provincial pension plan" as defined in that subsection and the amounts deducted or withheld under that law of the province are of the same nature as amounts referred to in subsection 23(3) or (4) of the *Canada Pension Plan*,

and for the purpose of this subsection, any provision of a law of a province that creates a deemed trust is, notwithstanding any Act of Canada or of a province or any other law, deemed to have the same effect and scope against any creditor, however secured, as the corresponding federal provision.

¹¹ Ss. 227(10.1) *ITA*.

¹² Ss. 227(9.4) *ITA*.

- Canada Pension Plan contributions;¹³
- Employment insurance contributions;¹⁴
- Québec provincial income tax payroll source deductions;¹⁵
- Québec pension plan source deductions;¹⁶
- the amount withheld, penalty and interest payable by the person acquiring a taxable Canadian asset from a non-resident.¹⁷

Under advisement before the Supreme Court of Canada since February 29, 2008 is the case of *Caisse Populaire Desjardins de l'Est de Drummond, aux droits de la Caisse populaire du Bon conseil v. Her Majesty the Queen in Right of Canada*¹⁸, on appeal from the Federal Court of Appeal, involving once again the enhanced deemed trust for payroll source deductions at subsection 227 (4.1) *ITA*. The Federal Court of Appeal found a financial institution liable for the amount of the payroll deductions owing by its customer as a result of a normal credit transaction. This paper will review how the provision and case-law evolved and suggest that this finding of liability is not justified by the current legislation.

As it involves payroll source deductions, the forthcoming Supreme Court of Canada decision could have a significant impact on insolvency practice across Canada and even widen the scope of financial institution liability for other Crown withholding claims outside of the bankruptcy process.

Caisse Populaire de l'Est de Drummond puts front and center the issue of direct personal liability of a financial institution receiving payment from a tax debtor while the federal enhanced deemed trust is in existence.

Part II of this paper follows the long and winding road that led to the current version of the enhanced deemed trust and studies its evolution through three interpretations by the Supreme Court of Canada. Part III reviews Revenue Canada's interpretation and its acceptance by the lower courts since the Supreme Court of Canada last visited the issue. Part IV summarizes the issues of the *Caisse Populaire de l'Est de Drummond* case currently under advisement in the Supreme Court. Part V analyzes the deemed trust provision in the context of the *ITA*. Parts VI, VII and the conclusion evaluate the potential outcomes and consequences of the Supreme Court decision. This should be known after delivery of this paper and before its presentation at the

¹³ *Canada Pension Plan*, R.S.C. (1985) c. C-8, s. 22.

¹⁴ *Employment Insurance Act*, L.C. (1996) c. 23, s. 85 and 99.

¹⁵ As protected by ss. 86(3) *BIA*, section 15 of the *Act respecting the Ministère du Revenu*, R.S.Q., c. M-31.

¹⁶ *Ibid.*

¹⁷ S. 116, ss. 227(9), 227(9.2), (9.3) and (9.4) *ITA*.

¹⁸ *The Caisse Populaire Desjardins de l'Est de Drummond, in right of the Caisse populaire du Bon Conseil v. Her Majesty the Queen in Right of Canada* (sub nom. “*Caisse Populaire de l'Est de Drummond*”), 2006 FCA 366; leave to appeal to the Supreme Court of Canada granted, file 31787; it appears that the sister case of *Caisse populaire Desjardins de Lyster/Inverness/Val-Alain v. the Attorney General of Canada*, 2006 FCA 367, was not appealed to the S.C.C.

conference. The writer asks for your indulgence for any of his arguments that are moot by that time.

II. HISTORY AND EVOLUTION OF THE DEEMED TRUST PROVISION

“*Vingt fois sur le métier remettez votre ouvrage*” wrote Boileau.¹⁹ This quote would be more properly translated by a citation or proverb: « *It’s not that I’m so smart, it’s just that I stay with problems longer.*” ~Albert Einstein, or “ *Fall seven times, stand up eight.*” ~Japanese Proverb²⁰ or even the classic “practice makes perfect”. The literal translation is “Twenty times on the loom, put back your work”.²¹ And Parliament’s work is still quite imperfect.

Trial and error, and in fact many trials and appeals, is just about what the federal legislator had to do to finally come up with an effective deemed trust provision. Achieving this result took more than twenty years and twenty trips to the courthouses, including many to the Supreme Court of Canada.

The legislator faced numerous difficulties. On the one hand, it could not simply enact a direct liability for deep pockets financial institutions, as it had done for too-often empty pockets directors.²² The legislator could not impose a liability to a third party without enacting provisions that would enable such party to discharge this liability, otherwise it would be viewed as equivalent to an expropriation without compensation.

Despite the small informational advantage that a financial institution may have over unsecured creditors and the tax authorities, presumably derived from its knowledge of the affairs of a tax debtor, in reality these financial institutions have no direct control over the affairs of their customers and rely on (and are often victims of) inaccurate financial information provided by management. More so in the vicinity of insolvency. Thus, the government could not, and did not, go as far as enacting a clear personal liability provision for financial institutions, which could easily have been drafted clearly. That is why arriving at the same destination by the convoluted route drawn by the Crown’s argument is so unconvincing.

On the other hand, the tax system is essentially a self-assessment system that relies on each individual tax debtor to “volunteer” information and payments, and it is not a system where tax authorities can monitor in real time each tax debtor and enforce their claims. The backbone of these “voluntary” payments is the employer tax withholding on salaries paid to employees. Thus,

¹⁹ French writer.

²⁰ <http://www.quotearden.com/perseverance.html>.

²¹ Collins Robert French Dictionary 8th Edition, Harper Collins Publishers 2006, suggests: “You should keep going back to your work and improving it”.

²² Ss. 227.1(1) *ITA*:

“Where a corporation has failed to deduct or withhold an amount as required by subsection 135(3) or 135.1(7) or section 153 or 215, has failed to remit such an amount or has failed to pay an amount of tax for a taxation year as required under Part VII or VIII, the directors of the corporation at the time the corporation was required to deduct, withhold, remit or pay the amount are jointly and severally, or solidarily, liable, together with the corporation, to pay that amount and any interest or penalties relating to it.”

the government needed a provision that could be given an effect once tax authorities realized that they had a claim against the employer/tax debtor and it was unpaid. The courts were quite willing to recognize the importance of the source deductions in the tax collection system and they did give effect to clear language used by Parliament, even if it had the effect of reducing security interests and competing claims to zero.

To achieve this noble end result, the government attempted to draft a provision that gave Her Majesty a priority that would come in existence at the time of a realization of the assets of a tax debtor. However, security mechanisms in common law jurisdiction and sometimes in the civil law jurisdiction, provided for a transfer of ownership to the financial institution as security. The most notable of these is certainly the inventory security under the *Bank Act*.²³

A. *Dauphin Plains*

In the case of *Dauphin Plains Credit Union Ltd. v. Xyloid Industries Ltd.*,²⁴ the Supreme Court of Canada considered the original version of the deemed trust at subsections 227(4) and 227(5) *ITA*, which read:

(4) Every person who deducts or withholds any amount under this Act shall be deemed to hold the amount so deducted or withheld in trust for Her Majesty.

(5) All amounts deducted or withheld by a person under this Act shall be kept separate and apart from his own moneys and in the event of any liquidation, assignment or bankruptcy the said amounts shall remain apart and form no part of the estate in liquidation, assignment or bankruptcy.

The Court granted priority to the Crown over a floating charge that had not crystallized prior to bankruptcy. In *Dauphin Plains*, the Court reflected the state of the law at that time and classified the secured creditor's claim in last rank because it did not achieve a transfer of ownership prior to the coming in force of the deemed trust:

It should first be observed that, for reasons similar to those on which the decision in the *Avco* case, *supra*, was based, the claim for Pension Plan and Unemployment Insurance deductions cannot affect the proceeds of realization of property subject to a fixed and specific charge. From the moment such charge was created, the assets subject thereto, were no longer the property of the debtor except subject to that charge. The claim for the deductions arose subsequently and thus cannot affect this charge in the absence of a statute specifically so providing. However, the floating charge did not crystallize prior to the issue of the writ and the appointment of the receiver. In the present case it makes no difference which of the two dates is selected, both are subsequent to the deductions. [Our underline]

But the problem remained for the Crown that its deemed trust did not achieve priority over security interests in the form of transfer of ownership or specific charge, despite the trust language. The Court gave its first free advice to the Crown by indicating that the deemed trust could be drafted to defeat security interest that purport to transfer ownership of the tax debtor property.

²³ R.S.C. c. B-1, s. 427.

²⁴ *Dauphin Plains Credit Union Ltd. v. Xyloid Industries Ltd.*, [1980] 1 S.C.R. 1182, 33 C.B.R. (N.S.) 107 (S.C.C.) (sub nom. "*Dauphin Plains*").

B. Sparrow Electric

The next visit of the gallant taxman to the Supreme Court of Canada was in *Royal Bank of Canada v. Sparrow Electric Corp.*²⁵

Sparrow Electric involves a classic priority dispute between the holder of *Bank Act* security and the Crown invoking a deemed trust.

At that time, the new and improved relevant provisions were still subsections 227(4) and 227(5) *ITA*, which then read as follows:

(4) Every person who deducts or withholds any amount under this Act shall be deemed to hold the amount so deducted or withheld in trust for Her Majesty.

(5) Notwithstanding any provision of the *Bankruptcy Act*, in the event of any liquidation, assignment, receivership or bankruptcy of or by a person, an amount equal to any amount

(a) deemed by subsection (4) to be held in trust for Her Majesty [...]

shall be deemed to be separate from and form no part of the estate in liquidation, assignment, receivership or bankruptcy, whether or not that amount has in fact been kept separate and apart from the person's own moneys or from the assets of the estate.

Good drafting for a deemed trust, but obviously not good enough. Firstly, the provision still provided for a triggering event (liquidation, assignment, receivership or bankruptcy) to happen before the deemed trust came into existence. Secondly, a reference was made to the “estate in liquidation”, which is still a reference to ownership by the tax debtor.

The bank's argument in *Sparrow Electric* was simple: the deemed trust came into existence when liquidation occurred; and at that time, the inventory had already been transferred to the bank by the “*sui generis*” right of ownership resulting from *Bank Act* security. The inventory was no longer property of the tax debtor when the deemed trust came into existence. The bank's argument prevailed and the deemed trust was therefore ineffective as a priority mechanism.

The Court went on to make recommendations to the legislator, who was in dire need of expert advice to achieve his goal. The Court suggested that the Crown should follow the same route it had used to make sure its enhanced requirement to pay would have effect over security interests, even those security interests defined as a transfer of ownership:

112 Finally, I wish to emphasize that it is open to Parliament to step in and assign absolute priority to the deemed trust. A clear illustration of how this might be done is afforded by s. 224(1.2) *ITA*, which vests certain moneys in the Crown “notwithstanding any security interest in those moneys” and provides that they “shall be paid to the Receiver General in priority to any such security interest”. All that is needed to effect the desired result is clear language of that kind. In the absence of such clear language, judicial innovation is undesirable, both because the issue is policy charged and because a legislative mandate is apt to be clearer than a rule whose precise bounds will become fixed only as a result of expensive and lengthy litigation.

²⁵ *Royal Bank of Canada v. Sparrow Electric Corp.*²⁵ (sub nom. “*Sparrow Electric*”), [1997] 1 S.C.R. 411.

Parliament followed the advice of the Supreme Court of Canada and amended the deemed trust provision in two major respects: it removed the triggering event of liquidation for the coming into existence of the trust and it provided clear priority over security interest, including security mechanism involving a transfer of ownership.

Parliament missed grossly on the “clear language” of the “legislative mandate” and the deemed trust “precise bounds”. The enhanced deemed trust provision would have to return twice to the Supreme Court in the next ten years to “become fixed only as a result of expensive and lengthy litigation”, despite the prudent advice given by Iacobucci J. in *Sparrow Electric*.

C. First Vancouver Finance

The last time the Supreme Court of Canada ruled on this issue was in *First Vancouver Finance v. M.N.R.*²⁶ The matter involved a standard account receivable factoring agreement. Under this type of arrangement, the debtor sells his trade accounts receivable to the creditor against immediate payment. The factor/creditor retains a recourse in the event that the third party debtor fails to pay the amount owing under the account. This indemnification provision does not make the assignment conditional and the sale is a true sale. It effects a transfer of ownership to the factor and the property is no longer property of the tax debtor. This qualification of the transaction is important because a payment also operates a transfer of ownership from the property of the tax debtor to the property of the receiving party. A payment should therefore have the same consequence as a sale.

By that time, Parliament had attempted to follow *Sparrow Electric* and the *Income Tax Act* read as follows:

227. [...]

(4) [Trust for moneys deducted] Every person who deducts or withholds an amount under this Act is deemed, notwithstanding any security interest (as defined in subsection 224(1.3)) in the amount so deducted or withheld, to hold the amount separate and apart from the property of the person and from property held by any secured creditor (as defined in subsection 224(1.3)) of that person that but for the security interest would be property of the person, in trust for Her Majesty and for payment to Her Majesty in the manner and at the time provided under this Act.

(4.1) [Extension of trust] Notwithstanding any other provision of this Act, the *Bankruptcy and Insolvency Act* (except sections 81.1 and 81.2 of that Act), any other enactment of Canada, any enactment of a province or any other law, where at any time an amount deemed by subsection (4) to be held by a person in trust for Her Majesty is not paid to Her Majesty in the manner and at the time provided under this Act, property of the person and property held by any secured creditor (as defined in subsection 224(1.3)) of that person that but for a security interest (as defined in subsection 224(1.3)) would be property of the person, equal in value to the amount so deemed to be held in trust is deemed

(a) to be held, from the time the amount was deducted or withheld by the person, separate and apart from the property of the person, in trust for Her Majesty whether or not the property is subject to such a security interest, and

²⁶ *First Vancouver Finance v. M.N.R.* (sub nom. “*First Vancouver Finance*”), [2002] 2 S.C.R. 720, 2002 SCC 49.

(b) to form no part of the estate or property of the person from the time the amount was so deducted or withheld, whether or not the property has in fact been kept separate and apart from the estate or property of the person and whether or not the property is subject to such a security interest

and is property beneficially owned by Her Majesty notwithstanding any security interest in such property and in the proceeds thereof, and the proceeds of such property shall be paid and to the Receiver General in priority to all such security interests.

The above is the current version of what could be referred to as the “enhanced deemed trust”.

Again, Parliament offered poor drafting. The *civilistes* teeth were grinding loudly at words like “beneficially owned” and “security interest”. Everybody was left guessing about who was to pay and if the reference to proceeds implied a liquidation or any transfer. There was no indication as to how the mechanism would work if enforced outside of a liquidation.

The Supreme Court decided in *First Vancouver Finance* that when property was transferred to a for-value purchaser, the deemed trust only attached to the “proceeds” received by the tax debtor and no longer attached to the sold property.

That was the only question before the Court, and the only question decided based on the specific facts of the case. The Court did not decide and did not have to decide about any other type of transfers or payments made by the tax debtor while the deemed trust was in existence.

The Supreme Court having somewhat defined the nature and effect of the last version of the deemed trust, it was again left to litigants to determine if a different outcome would result when property was removed from the ownership of the tax debtor by a payment, a seizure and sale, and a foreclosure or taking in payment.

Some of the comments of the Supreme Court would be the object of numerous arguments in the lower courts in the following years, so they need to be reviewed in detail.

i. The Floating Charge Analogy

The Court compared the enhanced deemed trust mechanism to a floating charge security:

4 For the reasons set forth below, I find that the s. 227(4.1) deemed trust is similar in principle to a floating charge over all the tax debtor’s assets in favour of Her Majesty. The trust arises the moment the tax debtor fails to remit source deductions by the specified due date, but is deemed to have been in existence from the moment the deductions were made. As long as the tax debtor continues to be in default, the trust continues to float over the tax debtor’s property. Thus, at any given point in time, whatever property then belonging to the tax debtor is subject to the deemed trust.

5 Viewed in this way, it is clear that, as property comes into possession of the tax debtor, it is caught by the trust and becomes subject to Her Majesty’s interest. Similarly, property which the tax debtor disposes of is thereby released from the deemed trust. This mutuality of treatment between incoming and outgoing property relating to the deemed trust is supported by both the plain language of the provisions as well as their purpose and intent. Most importantly, Her Majesty’s interest in the tax debtor’s property is protected because, while property which is sold to third party purchasers is released from the trust, at the same time, the proceeds of disposition of the alienated property are captured by the trust. Moreover, commercial certainty is promoted

owing to the fact that third party purchasers are free to transact with tax debtors or suspected tax debtors without fearing that Her Majesty may subsequently assert an interest in the property so acquired. [Our underline]

In doing so, the Court was addressing the issue of after-acquired property discussed in the lower courts and confirmed that all current and after-acquired property of the tax debtor would be captured by the deemed trust. The clear language of the Court dictated, on the basis of mutual treatment, that all outgoing property is released, despite the fact that the *ratio decidendi* is limited to a for-value transfer.

ii. The Property Subject to a Security Interest

The Court found that the deemed trust was a priority provision that would resolve simultaneous claims against the property of the debtor:

28 It is apparent from these changes that the intent of Parliament when drafting ss. 227(4) and 227(4.1) was to grant priority to the deemed trust in respect of property that is also subject to a security interest regardless of when the security interest arose in relation to the time the source deductions were made or when the deemed trust takes effect. This is clear from the use of the words “notwithstanding any security interest” in both ss. 227(4) and 227(4.1). In other words, Parliament has reacted to the interpretation of the deemed trust provisions in *Sparrow Electric*, and has amended the provisions to grant priority to the deemed trust in situations where the Minister and secured creditors of a tax debtor both claim an interest in the tax debtor’s property. [Our underline]

The Supreme Court used clear language to decide that only property of the tax debtor (or property that would be property of the tax debtor if the security interest is disregarded) is deemed property of the Crown. Based on this finding, there would seem to be no issue that any payment or transfer that is not for security purposes releases the property from the deemed trust.

iii. A Priority on the Property of the Tax Debtor

In *First Vancouver Finance*, the Court concluded that the deemed trust would apply to all property of a tax debtor, even that property that was notionally-owned by the secured creditor under a security mechanism. In doing so, the Crown got confirmation that the enhanced deemed trust had achieved its goal of obtaining priority over all forms of security interests.

27 In response to *Sparrow Electric*, the deemed trust provisions were amended in 1998 (retroactively to 1994) to their current form. Most notably, the words “notwithstanding any security interest [...] in the amount so deducted or withheld” were added to s. 227(4). As well, s. 227(4.1) (formerly s. 227(5)) expanded the scope of the deemed trust to include “property held by any secured creditor [...] that but for a security interest [...] would be property of the person”. Section 227(4.1) was also amended to remove reference to the triggering events of liquidation, bankruptcy, etc., instead deeming property of the tax debtor and of secured creditors to be held in trust “at any time an amount deemed by subsection (4) to be held by a person in trust for Her Majesty is not paid to Her Majesty in the manner and at the time provided under this Act”. Finally, s. 227(4.1) now explicitly deems the trust to operate “from the time the amount was deducted or withheld”.

iv. The Disappearance of the Triggering Event of Liquidation

The Supreme Court found that the deemed trust exists from the default of the tax debtor without any triggering event. Again, the Crown had achieved the second objective necessary to defeat the results in *Sparrow Electric*. Iacobucci J. continues in *First Vancouver Finance*:

29 As noted above, Parliament has also amended the deemed trust provisions in regard to the timing of the trust. Reference to events triggering operation of the deemed trust such as liquidation or bankruptcy have been removed. Section 227(4.1) now states that the deemed trust begins to operate “at any time [source deductions are] [...] not paid to Her Majesty in the manner and at the time provided under this Act” (emphasis added). Thus, the deemed trust is now triggered at the moment a default in remitting source deductions occurs. Further, pursuant to s. 227(4.1)(a), the trust is deemed to be in effect “from the time the amount was deducted or retroactively to the time the source deductions were made. It is evident from these changes that Parliament has made a concerted effort to broaden and strengthen the deemed trust in order to facilitate the collection efforts of the Minister.

After *First Vancouver Finance*, the Minister’s rights were somewhat clarified. The Minister has priority over all competing security interest, even those that purport to create a transfer of ownership.²⁷ The Minister could not however trace property replaced by proceeds. The Minister could still pursue liquidators, receivers and directors if its priority had been forgotten under the Certificate provision.²⁸ The Minister could pursue persons in control of the affairs of a debtor that played a role in the non-payment of the source deductions.²⁹ The Minister was magnanimous and had conceded that property of a third party, even if the possession and control of the tax debtor, did not enter in the deemed trust. That way, property of lessors under a lease or rental agreement, conditional vendors, vendors on consignment was not attached.³⁰ There remained the question raised by the Crown about tax debtor property going out of trust without equivalent proceeds entering the deemed trust at the concurrent time.

First Vancouver Finance left, in the view of the Crown, many unanswered questions about the true nature of the enhanced deemed trust and its effects.

III. REVENUE CANADA’S INTERPRETATION OF *FIRST VANCOUVER FINANCE* AND THE 2004 FEDERAL COURT OF APPEAL CASES OF *NATIONAL BANK OF CANADA*

A. Revenue Canada’s Interpretation

The unanswered question concerning payments and transfers made by the tax debtor to a third party while the deemed trust was in existence received one predictable response from Revenue Canada. Their interpretation was mostly approved by the lower courts and culminated in the

²⁷ Except the demand for repossession of the unpaid vendor at 81.1 *BIA* and the claim by the unpaid farmer, fisherman and aqua-culturist at 81.2 *BIA*, and also except for the prescribed security interest described in the Regulation SOR 99/322, mainly the non-revolving land mortgage or immovable hypothec.

²⁸ *Infra*, at Part V Section D.

²⁹ Ss. 227(5), (5.1) and (5.2) *ITA*, see *infra* Part V, Section E at pages 24-25.

³⁰ As defined at s. 224(1.3) *ITA*.

*National Bank of Canada*³¹ cases. That decision is really the *ratio* behind the finding of liability in *Caisse Populaire de l'Est de Drummond* in the Federal Court of Appeal. This section will review this interpretation by Revenue Canada and the line of jurisprudence that led to the matter now before the Supreme Court of Canada.

The Crown's interpretation of *First Vancouver Finance* was a reading at the first level, without any qualifications or *caveats* about what the Supreme Court had decided and how it reached its conclusion. To the Crown, only a concurrent for-value transfer to an arm's length party without knowledge of the deemed trust permitted property of the debtor to exit the deemed trust. Any other payment or transfer would be an illegal payment or transfer of the property of the Crown and the payee or transferee was therefore liable for the property so transferred up to the amount owed to the Crown. This liability is not found in the *ITA*, so it can be assumed that it is the result of the common law and civil law liability of the thief and the person receiving stolen property. The transfers that were targeted were payments to financial institutions, transfers of property through legal recourses and writs of seizure and execution and taking in payment resulting from judgments or voluntary deeds. The Crown's argument was unconcerned with any effect of any provincial law concerning property and civil rights, nor with the authority of the courts. The King can do no wrong...

The Crown continued to put forward the argument that it could trace property of the tax debtor into the hands of third parties. The Crown had a strong preference for tracing cash, but when it was not a cash or money transfer, they deemed the property to have been transformed into cash.

B. Common Law Jurisdiction Precedents

It seems that the first matter under this new approach to make its way to the courts in common law jurisdiction is *M.N.R v. HSBC Bank of Canada*.³² In that case the bank cashed in a certificate of deposit, issued by another institution, which was held to secure an obligation on a letter of credit issued by HSBC.

This is for the bank the most secure, easy and normal banking transaction. It is a low risk, low cost service to a customer that the bank really doesn't need to know and most probably the bank doesn't really know its affairs.

HSBC argued that the Minister's floating charge, as defined in *First Vancouver Finance*, had not crystallized when it paid itself. HSBC had no knowledge of the tax claim. HSBC had given value to the tax debtor when it paid the amount owing by the tax debtor to the beneficiary of the letter of credit.

The Federal Court found that the fact that HSBC was a secured creditor of the tax debtor at the time created an obligation to enquire with the Minister if any money was owed for source deduction. The Court found that HSBC could have obtained personal guarantees instead of

³¹ *Canada (M.N.R.) v. National Bank of Canada* (sub nom. "*National Bank of Canada* cases"); etc. 2004 CA 92, 3 CBR (5th) 1, 2004 Carswell Nat 1866, leave to appeal to the Supreme Court of Canada denied October 14, 2004, SCC 30311.

³² 2004 FC 467, March 26, 2004, J. J. Gauthier (F.C.).

security. This finding will surely be questioned by line bankers who know that guarantees are not a very reliable source of repayment. Not being a “third party purchaser for value without knowledge”, HSBC should have paid the proceeds of the term deposit to the Crown.

It is interesting to note that this type of transaction is normal in banking arrangements and that the operation of set-off would not appear to be subject to the Minister’s certificate provisions,³³ nor constitute the management of the affairs of the tax debtor.³⁴

The next matter to come up in common law jurisdiction was a case involving landlord distraint.³⁵ The landlord had exercised his right of distraint and seized the tenant’s property. The landlord purchased the property through a numbered company and auctioned it two years later to third parties. The Crown claimed the proceeds from both the numbered company and subsequent purchasers at the auction, on the basis of its enhanced deemed trust claim. The Court embraced the Crown’s argument. The Court found that, once exercised, the right to distrain creates a lien and falls under the definition of “security interest” at 224(1.3) *ITA*. The question was squarely put: did the forced alienation cause the deemed trust to cease to apply to the property? The Court found that the sale to the landlord’s related company was not “a sale at arm’s length to a legitimate third party purchaser for value without notice”. Only such a sale would have defeated the deemed trust.

This finding is very far away from the statutory provision and incorporates many notions that cannot be found anywhere in the legislation. With respect, the right to distrain implies two operations: the sale of the chattels and the payment of the proceeds to the landlord. The first part is a for value transfer and the proceeds are deemed received by the tax debtor by the forced alienation of his property. The second part, being the payment to the landlord, is made in the course of business (in the larger sense) while the deemed trust has not crystallized. It may very well be that a bailiff carrying out a forced sale under a right to distrain or a writ of seizure is a person that could be subject to the obligation to seek and obtain a Minister’s certificate or, if not, that such a provision could even be incorporated in the tax laws. But it is difficult to accept a finding of direct personal liability for a creditor, secured or not, who enforces his legal rights through a legal process. The decision was nonetheless confirmed by the Ontario Court of Appeal.³⁶

C. Civil Law Precedents

The issue had to be addressed in Québec by considering the specific provisions of the *Civil Code of Québec* on hypothecary recourses. These recourses are the only remedies available to the holder of an hypothec and their exercise and effect are codified. One of these recourses is the “taking in payment”,³⁷ where the hypothecated property is transferred to the creditor against

³³ *Infra*, at Part V Section D.

³⁴ Ss. 227(5) *ITA*, *infra* at Part V Section E.

³⁵ *Canada (Attorney General) v. Community Expansion Inc.*, 5 C.B.R. (5th) 210, April 13, 2004, J. Reilly (Ont. S.C.J.).

³⁶ *Canada (Attorney General) v. Community Expansion Inc.*, (2005) 2005 Carswell Ont 214 (Ont. C.A.).

³⁷ Art. 2778 ss. *C.C.Q.*

extinction of the debt. This can happen by consensual agreement in a voluntary surrender,³⁸ or by order of the court in the forced surrender.³⁹ There is no liquidation or receiver appointed and, unless one wants to consider the judge issuing the order as the person responsible for the liquidation, such a recourse appears to fall outside of the scope of application of the Minister certificate. At best, in a voluntary surrender, the directors of the company may be liable for failing to apply for the Minister certificate, but this liability already pre-exists the surrender in the case of source deductions.

The *Civil Code of Québec* prescribes that the creditor becomes the owner of the property taken in payment.⁴⁰ The logical conclusion is that it is no longer property of the tax debtor, no longer subject to a security interest and is the property of the (former) secured creditor.

The taking in payment is a true and complete transfer of ownership. The consideration or counterpart is not given at the exact same time as it is when a transfer to a for-value purchaser occurs, but consideration is given nonetheless. It has usually been given by the creditor when he advanced the loan, the proceeds of which entered the deemed trust at that time and where converted or disappeared over time through the operations of the tax debtor.

Given the qualification of the deemed trust as “similar in principle to a floating charge”, and given the known circumstances where a liquidation would trigger liability for a receiver, a practice developed to take in payment the hypothecated property to avoid potential uncertainty for tax claims. Provincial Crown priorities against the debtor’s property do not follow the property taken in payment in the hands of the creditor.

Also, an alternative was to let the directors sell the assets of the debtor company and pay the proceeds to the financial institution against release and discharge of the security. By doing so, they often engaged their personal liability for a liquidation without the Minister’s certificate.

Four test cases, the *National Bank of Canada* cases, where pursued by the Crown in Québec against financial institutions and made their way to the Federal Court⁴¹ and to the Federal Court of Appeal.⁴²

The secured creditors had received payment from the tax debtor in four various ways in these four cases. These represent four different methods of obtaining payment under the *Civil Code of Québec*. In one case, the payment was the result of a judgment followed by a writ of execution or seizure and sale where the bailiff remitted the proceeds to the creditor. In a second case, property was taken in payment by forced surrender by a judgment of the court. In a third case, the surrender for taking in payment was voluntary through a deed, but has the same legal effect as a judgment. The creditor then sold the property taken in payment. In the fourth case, the property

³⁸ Art. 2781 *C.C.Q.*

³⁹ Art. 2783 *C.C.Q.*

⁴⁰ Art. 2783 *C.C.Q.*

⁴¹ *A.G.C. v. National Bank of Canada*, 2002 DTC 7468, *A.G.C. v. National Bank of Canada*, 2002 DTC 7477, *A.G.C. v. Caisse Populaire Desjardins de Lebel-sur-Quévillon*, 2002 DTC 7493, *A.G.C. v. Caisse Populaire d’Amos*, 2002 DTC 7484, (F.C.).

⁴² *National Bank of Canada*, *supra*, note 31, at 11.

was sold through a forced sale in the exercise of the hypothecary recourse of sale under control of justice.

On October 11, 2002, the Crown’s claim against the secured creditors were dismissed by the Federal Court. The Court attempted to reconcile the deemed trust provision with the reality of civil law. Given the current efforts of the federal government to harmonize civil law and common law in the context of a federal regime, the approach seeking to respect property and civil laws, and respecting the authority of the judgments of the courts, was commendable. However, the Federal Court of Appeal held a different view, as appears from the stinging summary it made of the reasons of the lower court:⁴³

Decision under appeal

[14] Since “the federal provisions do not indicate the manner or specific procedure whereby Her Majesty may assert her beneficial ownership”, the provincial provisions must be followed as they are “neither contrary to nor inconsistent with the federal provisions, and do not prevent Her Majesty exercising her beneficial right and relying on her preferred claim”. Accordingly, since the appellant has not become a party to the provincial proceedings brought by the respondents, the latter retain their title to the property taken in payment, seized or surrendered, and to the proceeds of their sale. The notion of “beneficial ownership”, which is unknown in Quebec, does not affect this result in any way.

[15] Going one step further, Martineau J. cites the “Rule of Law” and finds that the provincial provisions must apply in this case.

[16] The trial judge criticized the appellant not only for failing to challenge the proceedings undertaken by the respondents but also for failing to take steps against the recalcitrant debtors. Although the appellant explained, in files A-627-02 and A-628-02, that it is generally unable to take timely action, the judge criticized it for failing to prove that it was unable to act. He added that the Crown’s inability to act should not bar the application of the provincial law.

[17] Subsections 227(4.1) of the ITA and 86(2.1) of the EIA “[do] not as such confer any real right or right of pursuit over the property”. The respondents, being “*bona fide* purchaser[s]”, must be protected against personal actions brought against them by the appellant if we are to ensure certainty in commercial and legal transactions. If Parliament intends to hold third parties liable for the debts of others, it must do so clearly and explicitly.

[18] Finally, the trial judge notes that “since the federal provisions indicate no deadline for asserting Her Majesty’s beneficial ownership and priority claim, she should have asserted them within the deadlines” laid down in the provincial law.

The Federal Court of Appeal found direct personal liability of the financial institution towards the Crown in each case. It found that the financial institutions were not *bona fide* purchasers that could argue that the property they had received was excluded from the deemed trust. In doing so, the Federal Court of Appeal did not have to answer the more complex question of integrating the suppletive provincial law in the federal scheme of enforcing the enhanced deemed trust. It decided that the deemed trust was a stand-alone measure that did not have to rely on any notions of property or procedure to be enforced.

⁴³ *National Bank of Canada*, *supra*, note 31, at 11.

i. Application and Interpretation of *First Vancouver Finance*

Surprisingly, the Federal Court of Appeal found all its answers in *First Vancouver Finance* which it read as follows in the *National Bank of Canada* cases:

[27] The Court held that the property, at the time of its acquisition by the tax debtor, was part of the deemed trust but that its sale to a third party in the normal course of business had removed it from the trust. Throughout its reasons, the Court compares the situation of the third party purchaser for value to that of the secured creditor, and finds that while property acquired by the third party purchasers was not caught by the amendments to the deemed trust provisions, in the absence of specific language to that effect, property taken in payment by the secured creditors in the exercise of their security interest was covered. In respect of the secured creditors, the Court was unambiguously of the view that the new provisions responded to the invitation it had issued to Parliament to give the Crown an “absolute priority”.

[29] As the Court explains later in its reasons, the deemed trust resembles a floating charge that hovers over all the assets of the tax debtor in the amount of the default. The trust continues to apply to all the assets for as long as the default continues. The only property that may be immune to it is property that the tax debtor alienates in the normal course of its business, in which case the trust extends to the proceeds of sale or the replacement property (reasons, paragraph 40).

[30] This decision, which is not referred to by the trial judge in his reasons, establishes unambiguously that the Banks or the Caisses in the present cases are not comparable to third party purchasers. They are secured creditors and the property over which they asserted their security interest continued to be subject to the deemed trust and remained so at the time of its sale. It follows that, in accordance with the final words of subsections 227(4.1) of the ITA and 86(2.1) of the EIA, the proceeds from the sale had to be “paid” to the Receiver General in priority to the security interest they held. [Our underline]

It is difficult to find such a decisive conclusion from *First Vancouver Finance*, as the Supreme Court gave no indication on an obligation to pay by someone other than the tax debtor. The Supreme Court also gave no indication that the deemed trust could retain any effect once ownership of property passes on to a secured creditor and the security is extinguished,

ii. The Payment Made Under a Floating Charge

Obviously, if the Crown recognized that the payment out of the deemed trust property was equivalent to a payment from property under a floating charge, there would be no issue. The tax debtor would be free to deal with his property until the floating charge had crystallized. So the Crown argued that the deemed trust continued even if the property was no longer owned by the tax debtor.

By denying any integration of property and civil rights in the federal tax law, the Federal Court of Appeal in the *National Bank of Canada* cases entered in a circular argument that is difficult to accept. The property is owned by the tax debtor. Therefore, once the deemed trust comes into existence, it is property of the Crown. When it is no longer owned by the tax debtor, it is still property of the Crown because the court denies the basis on which it entered: the rules of civil or common law.

IV. *CAISSE POPULAIRE DE L'EST DE DRUMMOND*

After these successive wins of Revenue Canada in the lower courts interpreting *First Vancouver Finance* in a way that transformed the floating nature of the charge into a specific charge where all property would be free to enter the trust but none could go out of the trust, its not surprising that Supreme Court had to agree once again to hear a deemed trust case after denying to do so in the *National Bank of Canada* cases.

The *Caisse populaire de l'Est de Drummond*⁴⁴ case is not that different from the other precedents mentioned above.

A credit union (“Caisse”) loaned \$200,000 against its own certificate of deposit. After default, the Caisse paid itself by set-off (it also had security in the form of a pledge, which it was not invoking in argument). The debtor went bankrupt thereafter. The bookkeeping entries reflected the set-off at the date of defaults but where made after the bankruptcy. The Crown claimed directly against the Caisse \$28,000 due (in a small part) on the date of the loan, for source deductions under the enhanced deemed trust. The Federal Court of Appeal⁴⁵ decided in favour of the Crown relying on the direct personal liability finding it had made previously in the *National Bank of Canada* cases:

[4] In answer to the first question, we are satisfied that the judge did not make any error in the interpretation of the provisions of subsections 227(4) and (4.1) of the ITA. The definition of “security” in subsection 224(1.3) is sufficiently broad to include the right of retention and setoff which the appellant had in connection with the tax debtor’s certificate of deposit. To use the exact terms of the definition in subsection 224(1.3), the appellant had “any interest in property that secures payment of performance of an obligation” (in French a “droit sur un bien qui garantit l’exécution d’une obligation, notamment un paiement”).

[5] Moreover, the appellant had a contractual right of retention and compensation. This right was specified in a [TRANSLATION] “Security Agreement Secured by Savings”. Contrary to the appellant’s claims, the judge correctly concluded that this was not a case of legal compensation, but rather one of conventional compensation, i.e. a contractual right, and pursuant to this security agreement, the appellant could and had to invoke this right for compensation to be effected.

[6] Accordingly, the judge did not err in applying the provisions of subsections 227(4.1) of the ITA and 86(2.1) of the EIA to the appellant to recover the amounts due.

This 10-paragraph decision was granted leave to appeal in the Supreme Court on a relatively narrow issue, when a few years earlier the Supreme Court had refused leave on four other Federal Court of Appeal cases involving the very nature of the deemed trust provision. Revenue Canada, by widening the effects of the enhanced deemed trust, may have given to the Supreme Court the opportunity to reconsider the wisdom of the *National Bank of Canada* cases.

The Caisse’s argument is that the super priority deemed trust attaches to the assets of a tax debtor, in this case the “certificate of deposit”. This certificate of deposit is, in fact and in civil law, a loan made by the tax debtor to the Caisse. If this asset or claim is extinguished by set-off,

⁴⁴ *Caisse Populaire de l'Est de Drummond*, *supra*, note 18, at 3.

⁴⁵ *Caisse Populaire de l'Est de Drummond*, *supra*, note 18, at 3.

there is no longer an asset of the tax debtor on which the deemed trust can attach. Once again, we see that we have to revert back to civil law to determine what is the property of the tax debtor.

The relevance of the argument is that if this property can exit the deemed trust when a set-off is made, it should also exit the trust when a payment is made.

The Caisse also argues that set-off occurred on the date of default and prior to the coming in existence of part of the Crown claim. The arguments in court also revolved around the definition of security at subsection 224(1.3) *Income Tax Act* and on whether or not a right of set-off is included in that definition of security. So there is a lot of room for the Supreme Court of Canada to clarify these issues.

If a person holding a right of set-off is a “secured creditor” under the *ITA*, then the deemed trust will prime this right. But the deemed trust also has priority over the rights of an unsecured creditor. So a supplier having received payment by set-off may find the Crown claiming at his door months after he ceased doing business with a client. Another supplier receiving payment by an exchange of cheques could be in the same situation if the deemed trust can trace payments made out of trust.

In *First Vancouver Finance*, the Supreme Court of Canada resolved the issue of property going out of the trust in a sale and being replaced by proceeds of sale. The Court implied that the tax debtor should continue its business in the normal course and that implies making payments, where property goes out of the trust and is not replaced by proceeds. There was no intention of Parliament to freeze the property. Also, the Court gave indications that the obligation to pay the proceeds is only an obligation of the tax debtor.

V. THE DEEMED TRUST IN THE CONTEXT OF CROWN REMEDIES

The *Caisse populaire de l’Est de Drummond* case may or may not resolve the questions on the true nature and effects of the enhanced deemed trust on payments made by the tax debtor. Despite overwhelming authorities supporting the Crown’s position and unequivocally finding liability for a payee, I believe that an analysis of the reasons in *First Vancouver Finance* and of the real consequences of the Crown’s interpretation lead to the opposite conclusion. For this analysis, the deemed trust must be analyzed in the context of all the remedies available to the Crown under the *ITA* and other laws.

In my view, the Crown has, in general, three types of mechanisms to collect its due: priority provisions,⁴⁶ liability provisions⁴⁷ and enforcement procedures.⁴⁸ This last category would

⁴⁶ For example article 2651(4) *C.C.Q.*

⁴⁷ When Parliament imposes a joint liability on persons other than the tax debtor, it proceeds by way of assessment, as it does in sections 160 and 227.1 *ITA*, *supra*, note 22 at 4.

⁴⁸ Section 222 of the *ITA* provides the following remedy:

222. All taxes, interest, penalties, costs and other amounts payable under this Act are debts due to Her Majesty and recoverable as such in the Federal Court or any other court of competent jurisdiction or in any other manner provided by this Act.

include requirements to pay and legal hypothecs. The various mechanisms are not mutually exclusive, and the Crown can seek to recover its debt by applying any or all of the mechanisms concurrently. The deemed trust is a priority provision. As a stand-alone measure, it doesn't state clearly who else, apart from the tax debtor, is liable and what these third parties would be liable for. Also, the enhanced deemed trust provision has to be interpreted in the context of all the remedies available to the Crown under the *Income Tax Act* and under other general laws to understand its purpose and application within the general scheme of the *Income Tax Act* and find the true intent of Parliament and an interpretation that is not completely incompatible with the common and civil laws of the provinces.

A. A Priority Provision

The Supreme Court of Canada repeatedly stated that the deemed trust is a priority provision,⁴⁹ aimed at providing the Crown with a first rank position against unsecured and secured creditors and enhanced to include a wide definition of security interest. Successive drafting of the provision did not change that clear and constant nature of the remedy. In general, a priority will be enforceable in the event of forced liquidation of the property of a debtor. Contrary to a security interest or hypothec, the priority does not vest an interest in the property of the debtor of the priority, and the priority will not follow the property into the hands of a third party, for value or not, informed of the priority or not.

However, to make sure that this priority was respected, Parliament assorted it with a deemed transfer of ownership. Parliament could have qualified it as a specific charge, and it wouldn't change the outcome. While the property is in the hands of the tax debtor, the "priority/deemed transfer of ownership/specific and floating charge" can be enforced against all other secured and unsecured creditors, bankruptcy trustees, receivers and managers, and against any proceeds thereof if it has been liquidated while it was the property of the tax debtor. That was the result in the initial drafting of the deemed trust as was seen in *Dauphin Plains*. Subsequent amendments only had the effect of enhancing this priority over all security interest and making sure that all debtor property was captured. The question remains on the right of the tax debtor to transfer his property while the trust is in existence and the qualification of the enhanced deemed trust as a priority provision is certainly relevant to understand the intent and purpose of the provision.

B. A Floating Charge

The Supreme Court of Canada did not write that the enhanced deemed trust is a floating charge. It stated that it is *similar* in principle to a floating charge. So to apply the *First Vancouver Finance* reasoning to other factual situations studied by the lower courts and involving transfers of property, it is interesting to consider the nature of the floating charge, to see, under this analogy, what would be the result.

⁴⁹ See *First Vancouver Finance* at para. 28, *supra*, at page 7; the Court uses the words "to grant priority" twice.

i. Nature of the Floating Charge

Again, in *First Vancouver Finance*, the Court stated:

40 In my view, the scheme envisioned by Parliament in enacting ss. 227(4) and 227(4.1) is that the deemed trust is in principle similar to a floating charge over all the assets of the tax debtor in the amount of the default. As noted above, the trust has priority from the time the source deductions are made, and remains in existence as long as the default continues. However, the trust does not attach specifically to any particular assets of the tax debtor so as to prevent their sale. As such, the debtor is free to alienate its property in the ordinary course, in which case the trust property is replaced by the proceeds of sale of such property. [Our underline]

By its nature, a floating charge does not create an ownership interest or a right in specific property. When property exits the floating charge, it is no longer affected by the security interest of the holder.

The Supreme Court seemed to concede that the tax debtor could dispose of its property in the normal course and that was the intent of Parliament. That is the real relevance of the floating charge analogy. When the property is owned by the tax debtor, it is owned by the Crown. When it is no longer owned by the tax debtor, it is no longer owned by the Crown. That is *similar* to the consequences of a floating charge. That is inconsistent with the Crown’s arguments in the lower courts.

The weakness of the Crown’s “for-value only” argument is that the deemed trust would then be a one-way trust, where all property enters freely but no property can exit unless being concurrently replaced. In doing so, we end up with the exact opposite of the “equivalent to a floating charge” notion put forward by the Supreme Court and have the “similar in principle to a specific charge”. The Crown’s argument also results in an uncertainty of commerce that the Supreme Court had sought to avoid. The Crown’s argument disregards completely the mutuality of treatment between the ingoing and outgoing properties decided by the Supreme Court.

ii. Effect of the Floating Charge

The debtor who granted a floating charge to a creditor is allowed to deal with his property as he sees fit until the charge has crystallized.

Professor Ziegel analysed this aspect of the question⁵⁰ shortly after *First Vancouver Finance* and before Revenue Canada started to pursue third party transferees and payees. The author recognized the benefits of the floating charge analogy by permitting the tax debtor to continue in business and protecting purchasers against an unpublished security interest. Also, he commended the objective realized by Iacobucci J. in recognizing that the “[...] deemed trust is in substance only a non-consensual security interest conferred on the Crown to protect its priority position vis-à-vis the taxpayer’s other creditors.”

⁵⁰ Jacob S. Ziegel, *supra*, note 3 at 1.

However, Professor Ziegel found that the floating trust conceptualization may have been superfluous in *First Vancouver Finance* as trust law, and probably deemed trust law, already protect the purchaser for value without notice.

But as Diane Winters⁵¹ pointed out, the factor had notice of the deemed trust when it purchased the accounts in *First Vancouver Finance*.

Professor Ziegel found five objections to the floating charge analogy:

1. Referring to *Dauphin Plains*, the Supreme Court must have considered the deemed trust as a present property interest to allow the Crown to defeat a secured creditor's floating charge that had not crystallized.
2. The floating charge arises only after default of the tax debtor but the Crown is free to enforce its charge at any time.
3. The right to claim proceeds does not mean that the tax debtor can carry on business as usual, as such a right to proceeds also arises in conventional security.
4. It is not clear if the analogy is limited to property sold in the ordinary course of business and if the charge is also a fixed charge.
5. The floating charge has all but been eliminated from provincial statutes.

In conclusion, Professor Ziegel called for a *Crown Priorities Act*. This would certainly provide the financial institutions and the Crown with a clearer basis to assert their respective rights, rather than having the Act drafted in bits and pieces by the courts.

These issues are real, but by properly describing the deemed trust as a “floating ownership qualification”, the rights of third parties will be fully protected without having to resort to complex issues of notice and good faith. More importantly, creditors will have the certainty that decisions of the courts will not be superseded by a government claim as the taking in payment decisions have been in the *National Bank of Canada* cases.

The Crown had conceded in argument in *First Vancouver Finance* that their reading of the deemed trust as a true and irrevocable transfer of ownership to the Crown would have the consequence of enabling the Crown to seek payment from even a consumer who purchased property of the tax debtor for value in the ordinary course. The fact that the Crown would probably not do this didn't seem a convincing argument, and the Supreme Court validated the exit from the deemed trust of all for-value transfers, whether to a consumer or outside of the normal course of business. By doing so, the Court necessarily confirms that the tax debtor is still free to deal with his property and he is not illegally dealing with the Crown's property.

⁵¹ Diane Winters, *The Continuing Evolution of the Deemed trust: The Case of First Vancouver Finance*, 14 *Comm. Insol. Rep.* 57.

In *First Vancouver Finance*:

44 Although it is not necessary to resort to policy arguments, in my view it is worthwhile noting that to allow s. 227(4.1) to override the rights of purchasers for value would result in an unprecedented level of uncertainty. In fact, in oral argument, counsel for the Minister conceded that such an interpretation would, in theory, allow the Minister to go so far as to assert an interest in assets sold by tax debtors to ordinary consumers. In my view, it is no exaggeration to say that adopting this interpretation of the deemed trust would have a general chilling effect on commercial transactions.

45 Furthermore, to allow the deemed trust to attach to property sold to third parties would be more likely to hinder, rather than help, the Minister's collection efforts. For example, in the case at bar, if First Vancouver had thought that it could not purchase Great West's assets free and clear of Her Majesty's claim, it would have been unlikely to have entered into the factoring agreement with Great West. As a result, Her Majesty would not have received the semi-monthly payments of \$10,000 from First Vancouver. More generally, the interpretation advocated by the Minister would likely frustrate the ability of a tax debtor to convert hard assets into cash in order to pay "the proceeds of such property [...] to the Receiver General" as contemplated by s. 27(4.1), because prospective purchasers would fear that the Minister would assert an interest in these assets. The practical effect of this would be to freeze the tax debtor's assets and prevent it from carrying on business. In my view, this is clearly not a result intended by Parliament.

So Parliament intended to allow the tax debtor to carry on business. That necessarily means paying employees, landlords, suppliers, interests on loans, etc. All these often happen subsequent to the counterpart consideration entering the deemed trust.

Underlying the debate before the Supreme Court of Canada in *Caisse Populaire de l'Est de Drummond*, the issue of the effects of a payment made by the tax debtor while the deemed trust was in existence may very well come to light. Even if the issues before the Court related to the date of the payment made to the Caisse and the amount of the deemed trust claim on that date, or on the effect of set-off, the fundamental question of the right of a tax debtor to operate his business and make payments while the deemed trust floats over his assets may be decided.

C. Not a Liability Provision

In *First Vancouver Finance*:

42 Indeed, it is the logical corollary to my conclusion on the first issue, namely that the deemed trust attaches to after-acquired property of the tax debtor, that the trust also releases property alienated by the tax debtor. In this way, when an asset is sold by the tax debtor, the deemed trust ceases to operate over that asset; however, the property received by the tax debtor in exchange becomes subject to the deemed trust. As such, the trust is neither depleted nor enhanced; it simply floats over the property belonging to the tax debtor at any given time, for as long as the default in remittances continues.

43 Although it would be open to Parliament to extend the trust to property alienated by the tax debtor, such an interpretation is simply not supported by the language of the ITA. It is significant in this regard that purchasers for value are not included in ss. 227(4) and 227(4.1) whereas secured creditors are. In *Pembina on the Red Development*, *supra*, Twaddle J.A. took note of the "long-established principle of law that, in the absence of clear language to the contrary, a tax on one person cannot be collected out of property belonging to another" (p. 46). In *Sparrow Electric*, *supra*, at para. 39, Gonthier J. also referred to this principle, stating that:

[T]his provision does not permit Her Majesty to attach Her beneficial interest to property which, at the time of liquidation, assignment, receivership or bankruptcy, in law belongs to a party other than the tax debtor. Section 227(4) and (5) are manifestly directed towards the property of the tax debtor, and it would be contrary to well-established authority to stretch the interpretation of s. 227(5) [now s. 227(4.1)] to permit the expropriation of the property of third parties who are not specifically mentioned in the statute. [Our underline]

It is interesting to note that the Court in *First Vancouver Finance* refers to the minority opinion of Gonthier J. in *Sparrow Electric*. Honorable Justice Gonthier, a *civiliste*, was again making a strong argument for the importance of ownership and the need for clear and unambiguous language to cause the deemed trust to carry over to the property owned by a third party. Once a payment is effected, the tax debtor’s property becomes the property of the secured creditor, and all seem to agree that such is excluded from the deemed trust.

The Crown’s position is pure tracing of the assets that were part of the deemed trust in the hands of a third party.⁵² It renders the financial institution personally liable as a co-debtor of the tax debtor.

In essence, if a person falls under the definition of “secured creditor” under the *Income Tax Act*, and because that person is simply mentioned in the section for the sole purpose of subordinating its security, any money received may be Crown money and might have to be reimbursed in the same manner as if it had been stolen and received by the secured creditor as stolen property.

Once again, there is a fundamental flaw in the argument. All the property of the tax debtor is subject to the deemed trust, even the property acquired or coming into existence after the deemed trust is created. This property includes not only the property owned (beneficially owned in common law) by the tax debtor, but also the property that the tax debtor would own, were it not for the security instrument. As mentioned before, this addition of the secured creditor in the section of the *ITA* was to defeat security mechanisms in the form of a transfer of ownership. The deemed trust does not purport to attach property of the secured creditor. So no distinction can be drawn from the mention of the secured creditor at section 224 *ITA* between the rights of the Crown against transferees that are unsecured creditors and those that are secured creditors.

D. The Minister’s Certificate

In *First Vancouver Finance*, the Supreme Court analyzed the deemed trust without considering any other provisions of the *ITA*. The Court did not have to do so to resolve the issue of property exiting the trust for value. However, the deemed trust and its qualification as a first priority floating charge is even better understood in its context in the *ITA*. The disappearance of the “liquidation” as a pre-condition for the coming in existence of the trust doesn’t negate its significance in the enforcement and application of the deemed trust. It also is paramount in understanding the retention of the word “proceeds” in the deemed trust provision.

⁵² The tracing of property was rejected in *First Vancouver Finance* at para. 36 and 37.

The reason is that absent a bankruptcy,⁵³ the deemed trust provision is to be read and completed by the certificate provision in case of a distribution found at subsection 159(2) of the *Income Tax Act*, which clearly states the circumstances when liability of a third party liquidator/receiver/agent dealing with the property of a tax debtor will be triggered. It enables the Crown to enforce its deemed trust priority and obtain payment from the proceeds prior to issuing the certificate. Failure to comply triggers the personal liability of the person.

Once again, if a situation is not captured by the Minister Certificate provision, Parliament is free to pass new legislation that would compel the issuance of the certificate. For example, a bailiff could be added to the list, or a banker intending to make a set-off. In reality, it's not practical and it would seriously impede commerce. That is the reason why the *ITA* cannot be drafted nor construed in a way to achieve this result.

Section 159(2) of the *Income Tax Act* reads:

- (1) For the purposes of this Act, where a person is a legal representative of a taxpayer at any time,
 - (a) the legal representative is jointly and severally liable with the taxpayer
 - (i) to pay each amount payable under this Act by the taxpayer at or before that time and that remains unpaid, to the extent that the legal representative is at that time in possession or control, in the capacity of legal representative, of property that belongs or belonged to, or that is or was held for the benefit of, the taxpayer or the taxpayer's estate, and
 - (ii) to perform any obligation or duty imposed under this Act on the taxpayer at or before that time and that remains outstanding, to the extent that the obligation or duty can reasonably be considered to relate to the responsibilities of the legal representative acting in that capacity; and
 - (b) any action or proceeding in respect of the taxpayer taken under this Act at or after that time by the Minister may be so taken in the name of the legal representative acting in that capacity and, when so taken, has the same effect as if it had been taken directly against the taxpayer and, if the taxpayer no longer exists, as if the taxpayer continued to exist.

Certificate before distribution

- (2) Every legal representative (other than a trustee in bankruptcy) of a taxpayer shall, before distributing to one or more persons any property in the possession or control of the legal representative acting in that capacity, obtain a certificate from the Minister, by applying for one in prescribed form, certifying that all amounts
 - (a) for which the taxpayer is or can reasonably be expected to become liable under this Act at or before the time the distribution is made, and
 - (b) for the payment of which the legal representative is or can reasonably be expected to become liable in that capacityhave been paid or that security for the payment thereof has been accepted by the Minister.

⁵³ Absent a bankruptcy, because the *BIA* provides a structured manner to deal with the property of a bankrupt and the claims of the Crown. Section 159(2) of the *ITA* specifically excludes from its application a trustee in bankruptcy.

Personal liability

(3) Where a legal representative (other than a trustee in bankruptcy) of a taxpayer distributes to one or more persons property in the possession or control of the legal representative, acting in that capacity, without obtaining a certificate under subsection 159(2) in respect of the amounts referred to in that subsection, the legal representative is personally liable for the payment of those amounts to the extent of the value of the property distributed, and the Minister may at any time assess the legal representative in respect of any amount payable because of this subsection, and the provisions of this Division apply, with any modifications that the circumstances require, to an assessment made under this subsection as though it had been made under section 152.

Read together, the certificate provision and deemed trust provision make sense of the reference to “proceeds” and the need to convert the tax debtor property into cash for payment to the Minister, as the Minister is ill-equipped to deal with property other than proceeds, in particular where this property could be perishable. And prior to that, the tax debtor can operate freely as he would under a floating charge.

E. The Liability of a Specified Person with Influence

The *Income Tax Act* provides at subsections 227(5), (5.1) and (5.2) for the direct liability of secured creditors (at 227(5.1)h) *ITA*) in specific circumstances:

Payments by trustees, etc.

(5) Where a specified person in relation to a particular person (in this subsection referred to as the “payer”) has any direct or indirect influence over the disbursements, property, business or estate of the payer and the specified person, alone or together with another person, authorizes or otherwise causes a payment referred to in subsection 135(3), 135.1(7) or 153(1), or on or in respect of which tax is payable under Part XII.5 or XIII, to be made by or on behalf of the payer, the specified person

(a) is, for the purposes of subsections 135(3) and 153(1), section 215 and this section, deemed to be a person who made the payment;

(a.1) is, for the purposes of subsections 135.1(7) and 211.8(2), deemed to be a person who redeemed, acquired or cancelled a share and made the payment as a consequence of the redemption, acquisition or cancellation;

(b) is jointly and severally liable with the payer to pay to the Receiver General

(i) all amounts payable by the payer because of any of subsections 135(3), 135.1(7), 153(1) and 211.8(2) and section 215 in respect of the payment, and

(ii) all amounts payable under this Act by the payer because of any failure to comply with any of those provisions in respect of the payment; and

(c) is entitled to deduct or withhold from any amount paid or credited by the specified person to the payer or otherwise recover from the payer any amount paid under this subsection by the specified person in respect of the payment.

Definition of “specified person”

(5.1) In subsection 227(5), a “specified person” in relation to a particular person means a person who is, in relation to the particular person or the disbursements, property, business or estate of the particular person,

(a) a trustee;

(b) a liquidator;

(c) a receiver;

(d) an interim receiver;

(e) a receiver-manager;

(f) a trustee in bankruptcy or other person appointed under the *Bankruptcy and Insolvency Act*;

(g) an assignee;

(h) a secured creditor (as defined in subsection 224(1.3));

(i) an executor, a liquidator of a succession or an administrator;

(j) any person acting in a capacity similar to that of a person referred to in any of paragraphs 227(5.1)(a) to 227(5.1)(i);

(k) a person appointed (otherwise than as an employee of the creditor) at the request of, or on the advice of, a secured creditor in relation to the particular person to monitor, or provide advice in respect of, the disbursements, property, business or estate of the particular person under circumstances such that it is reasonable to conclude that the person is appointed to protect or advance the interests of the creditor; or

(l) an agent of a specified person referred to in any of paragraphs 227(5.1)(a) to 227(5.1)(k).

“Person” includes partnership

(5.2) For the purposes of this section, references in subsections 227(5) and 227(5.1) to persons include partnerships.

After considering such a lengthy provision, it is difficult to conceive a finding of direct liability completely outside of the scope enacted by Parliament in the *ITA*.

F. Deemed Trust, Theft, Receiving Stolen Property and the Banks

Viewed this way, did the Caisse distribute any of the tax debtor’s assets by refusing to pay the certificate of deposit to its bankrupt debtor and applying the debt to pay its own claim?

These successes in the Federal Court of Appeal have sent the Québec federal Justice department in a frenzy of writing letters to trustees, receivers and financial institutions, for amounts received by them in the past while a source deduction claim existed. Any payment received by a bank is viewed as illegal and the financial institution is deemed to be liable in the same manner as a person would be for knowingly receiving stolen property.

VI. POTENTIAL OUTCOMES OF THE SUPREME COURT DECISION

If the Supreme Court of Canada maintains in the *Caisse Populaire de l'Est de Drummond* case the interpretation of the effects of the deemed trust provision put forward by the Federal Court of Appeal in the *National Bank of Canada* cases, one can certainly question whether any of the other remedies of the Crown will continue to be used. What would be the need for an enhanced requirement to pay, an attack on a preferential payment or transfer, a garnishment or any other remedy when the Crown can simply wait and claim from the financial institution at any time in the future?

A. The Date of Payment and Definition of Security

The Supreme Court could decide the *Caisse Populaire de l'Est de Drummond* case on the basis that the payment occurred in part before the deemed trust came into existence, or simply that the set-off does not constitute security within the meaning of the *ITA*. If the set-off right does not constitute security, the Court may validate all payments made by the tax debtor.

B. Comments on the National Bank of Canada Cases

If the Supreme Court finds that the term deposit entered the deemed trust, they will have to consider the circumstances of its exit from the trust and will have to interpret and consider *First Vancouver Finance* and its application in the *National Bank of Canada* cases. The exit from the deemed trust by a payment or transfer will have to be considered and the Court may conclude that all such payments and transfers are authorized.

C. The Issue of Personal Liability

Therefore, it is likely that the *Caisse Populaire de l'Est de Drummond* case will resolve the issue of personal liability in a way that will be applicable not only to financial institution but to every person dealing with a tax debtor and receiving payments while a deemed trust is in existence. If no liability is found, the issues will be resolved, if not, consequences will be significant.

If the Supreme Court of Canada does not affirm the finding of personal liability accepted in *National Bank of Canada* cases, Revenue Canada will be in a position to prosecute financial institutions in many other circumstances in its collection attempts, as I will discuss in the following section.

VII. POTENTIAL LIABILITY OF THE FINANCIAL INSTITUTIONS

Revenue Canada has targeted mainly the financial institutions for payment of unpaid deemed trust claims, obviously when the tax debtor has failed to make the payment. The financial institutions and their advisors will have to consider how these claims will proceed and evolve if the Crown's argument succeeds.

If a payment, transfer or a taking in payment from the tax debtor has triggered the personal liability of the financial institution towards the Crown, would a subsequent bankruptcy of the tax debtor cause this direct liability to disappear?

The answer is no, according to case-law that the Crown has already started to invoke. The Crown's recourses against the bankrupt and the bankrupt's property may be suspended or stayed by a bankruptcy, but nowhere in the *BIA* is there a provision that would suspend the direct claim of the Crown against the financial institution for a liability that is consummated prior to the initial bankruptcy event.

The situation is somewhat equivalent to that of a debenture holder realizing on its security against a debtor, obtaining payment of proceeds without the Minister's certificate and then relying on the subsequent bankruptcy of the debtor to deny its personal liability. That is what happened in *Procureur Général du Canada v. Banque Canadienne Impériale de Commerce*⁵⁴ and the Court found the receiver liable. A subsequent bankruptcy does not affect a situation that is completed and crystallized between third parties prior to the bankruptcy of their common debtor.

The Crown has enhanced deemed trusts for virtually all its withholding claims, including those under the *Excise Tax Act*⁵⁵ for GST. There is also an enhanced requirement to pay provision in the *Excise Tax Act*. However, they cannot be enforced after bankruptcy against the secured creditors or the estate of the tax debtor.

Why would a claim against a third party for violation of these GST deemed trusts be stayed by bankruptcy? The Crown picked up on the argument and is now seeking direct payment from financial institutions for receipts prior to bankruptcy of non-source deduction claims such as GST and Québec provincial sales tax. Because these claims are usually larger, more frequent and very difficult to establish due to the input credit mechanism, the consequences for financial institutions could be severe.

According to the theory put forward by the Crown, the liability of a payee would be triggered if the payment occurred while the deemed trust was in existence and the liability would remain until all Crown claims are extinguished, notwithstanding bankruptcy.

Based on the Crown's theory, no payment made from the trust property should be excluded. That would include payment to suppliers and even to employees. The Crown has already pursued successfully a landlord,⁵⁶ so what is to stop it from going after other creditors if the circumstances make it possible. In other words, the lack of a secured creditor will only divert the Crown towards other creditors.

⁵⁴ *Procureur Général du Canada v. Banque Canadienne Impériale de Commerce* L.P.J. 93-1069, 500-05-005754-898.

⁵⁵ R.S.C. (1985), c. E-15, s. 222(1).

⁵⁶ *Canada (Attorney General) v. Community Expansion Inc.*, *supra*, note 35 at 12.

VIII. CONCLUSION

At pages 976-77 of *Alberta (Treasury Branches) v. M.N.R.*,⁵⁷ one of the many cases dealing with the enhanced requirement to pay, Cory J. concluded:

Thus, when there is neither any doubt as to the meaning of the legislation nor any ambiguity in its application to the facts then the statutory provision must be applied regardless of its object or purpose. I recognize that agile legal minds could probably find an ambiguity in as simple a request as “close the door please” and most certainly in even the shortest and clearest of the ten commandments. However, the very history of this case with the clear differences of opinion expressed as between the trial judges and the Court of Appeal of Alberta indicates that for able and experienced legal minds, neither the meaning of the legislation nor its application to the facts is clear. It would therefore seem to be appropriate to consider the object and purpose of the legislation. Even if the ambiguity were not apparent, it is significant that in order to determine the clear and plain meaning of the statute it is always appropriate to consider the “scheme of the Act, the object of the Act, and the intention of Parliament”. [Our underline]

That is the course of interpretation that should be followed to apply the deemed trust provision to third party liability. The object and purpose of the deemed trust provision is, and has been since its inception, to provide the Crown with a priority in the form of a rolling first ranking security interest on the property owned by the tax debtor, that can be enforced when a transaction occurs outside of the normal course of the affairs of a tax debtor, normally a liquidation of assets or a realization by a secured creditor.

The *ITA* deemed trust provision no longer provides for a realization as a triggering event for the coming into existence of the deemed trust, but a form of crystallization into proceeds, while the property is still owned by the tax debtor, should still be required for its enforcement against third parties. The scheme of the *ITA* is not consistent with a finding of direct liability against third parties based solely on the current deemed trust provision. There is no expression of any intention of Parliament to create such a responsibility for a person receiving a payment in circumstances not captured by the array of the other provisions of the *ITA* and certainly no language that would overrule a duly rendered court decision transferring ownership of the property of the tax debtor.

Because this finding of direct liability results from a payment received or a judgment obtained, there is reason to believe that a subsequent bankruptcy would not affect the Crown’s recourse against the financial institution. If that is the unwarranted result of this line of reasoning, then the Crown will be free to enforce this liability not only for source deductions, but also for G.S.T. and other provincial taxes, even after bankruptcy, thereby upsetting the result achieved in 1992 when Crown priorities were limited to provide the *BIA* with a workable scheme of distribution.

The security of commerce demands that a payment made in the normal course by a tax debtor to its financial institution, or to any one else, should not be attacked outside of the normal recourses already available to the Crown, on the basis of an unwritten liability for the consequences of ignoring an unpublished charge.

⁵⁷ *Alberta (Treasury Branches) v. M.N.R.*, [1996] 1 S.C.R. 963.