



The Federal Court of Appeal Protects the

"SUPER PRIORITY" OF THE TAX AUTHORITIES IN RELATION TO IMMOVABLE HYPOTHECS

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On April 29, 2020, the **Federal Court of Appeal** rendered judgment in *Toronto-Dominion Bank v. Canada*¹, which will undoubtedly have a **major impact in the areas of financing and hypothec recovery** in that it could increase **uncertainty for all creditors holding immovable hypothecs**.

Approximately ten years ago, the Federal Court of Appeal rendered a decision in *The Toronto-Dominion Bank v. Canada*², which left an **opening as to the non-application of the rules regarding deemed trusts when an immovable property of the fiscal debtor is encumbered by a hypothec**.

With regard to movable hypothecs however, the question seemed settled, since the *Civil Code of Quebec* indicates that the priority claim of the State for amounts due under tax laws can be enforced on the debtor's movable property.³ On the other hand, Canadian courts have already ordered a creditor holding a movable hypothec to reimburse the tax debt of his debtor affected by the deemed trust.⁴ At the very least, **the practice in the area of financing and mortgage recovery was such that a lender could be required to repay the tax debts of its borrowers from the proceeds received from the sale of the mortgaged movable property given their subjugation to the deemed trust of the Crown**.

However, **prior to April 29, 2020, the courts had not ruled directly on the application of the legislation regarding deemed trusts** in situations involving a tax debtor who had immovable assets and who reimbursed a loan granted by his financial institution.

The Legislative Context

Before 1997, article 222 of the *Excise Tax Act* (hereinafter the "**Act**") provided that a person collecting GST held these funds in trust for the Canada Revenue Agency (hereinafter after the "**CRA**"). In *Royal Bank of Canada v. Sparrow Electric Corp*⁵, the Supreme Court of Canada was seized with a dispute between the deemed trust and the security interests of a creditor taken in respect of the property of a tax debtor. **The country's highest court ruled that the deemed trust could not take precedence over a pre-existing security**, which thwarted the Crown's request.

Following this judgment, the legislator modified these articles in order to give them the character of a super-priority, despite the existence of a pre-existing security.⁶

The decision of the Federal Court of Appeal in *Toronto-Dominion Bank v. Canada* confirms the **validity of this legislative modification**.

The *Toronto-Dominion Bank v. Canada* (April 29, 2020)

In this case, the **tax debtor carried on an individual landscaping business** and was therefore **required**, under the Act, **to collect GST and to remit it to the CRA**. In 2007 and 2008, the **debtor failed to remit \$67,854.00**, which he had collected as GST over the course of his business.

In 2010, the Toronto-Dominion Bank (hereinafter the "**Bank**") **granted loans to the debtor, which were secured by an immovable hypothec on a property**. The **debtor subsequently sold the property** in question to third-party buyers. The proceeds of this sale enabled the debtor to repay the loans granted by the Bank, without the Bank having to exercise its rights to recover its debt.

After noting the sale of the building however, the CRA claimed \$67,854.00 from the Bank on the grounds that it was subject to the deemed trust in accordance with subsection 222 (1) of the Act. When the **Bank refused to pay the amount claimed by the CRA**, the Crown turned to the Federal Court to request that the Bank remit to it the amounts that should have been collected and remitted to the CRA by the tax debtor, namely the sum of \$67,854.00, plus interest and costs.



The Federal Court Judgment

In first instance, the Federal Court found that subsection 222 (3) of the Act imposed on the Bank, as a secured creditor, the **obligation to remit to the CRA the portion of the proceeds of the sale of the**

property of the debtor subject to the deemed trust. Since the debtor had failed to discharge his tax debt from the proceeds of the sale of his property when he was required to do so, the **Federal Court concluded that the Bank should reimburse to the CRA the amount of \$67,854.00, plus interest and costs.**

The Federal Court Of Appeal Judgment

The Bank's appeal was based upon the proper interpretation of subsections 222 (1) and (3) of the Act and more specifically raised the following question:

- When a tax debtor owes GST to the State, **is a secured creditor** who receives the proceeds from the sale of the property of the tax debtor **required to pay to the CRA the proceeds, or a portion thereof equal to the tax debt owed, in priority over all security interests?**

In considering the grammatical and ordinary meaning of the wording of subsections 222 (1) and (3) of the Act, the **Federal Court of Appeal concluded that the legislator intended to give a super-priority to the deemed trust with regard to property which is also subject to a security interest, regardless of when the security interest arose versus when the GST was collected.** The judges of the Federal Court of Appeal unanimously held that such an interpretation is justified in particular by the use made by the legislator of the expression “despite any security interest in the amount” in subsection 222 (1) of the Act.



When the Bank granted its loans to the debtor and published its security, the latter's property was already considered, up to the amount of the tax debt, as the **property of the Crown** since the GST had been collected. It follows that when the debtor's property was sold, under subsection 222 (3) of the Act, the Bank was required to return to the Crown the proceeds of the sale (up to the tax debt) it had received. The purpose of this provision is to **protect the collection of GST which has not been remitted by the debtor.** This objective is achieved by granting the deemed trust super-

priority with respect to property that is also subject to a security, regardless of when the security of the Bank was granted in relation to when the GST has been collected.

The Bank argued that the deemed trust required a triggering event to crystallize around the specified assets of the debtor. According to the Bank, events such as bankruptcy, the opening of a procedure by the Crown for the recovery of unpaid taxes and the exercise of a security are all triggering events which would have the effect of crystallizing the priority of the deemed trust. In this case, the Bank argued that it was not a secured creditor at the time the CRA asserted its claim since the debtor's debt to the Bank was extinguished when the debt was repaid.

Despite the Bank's arguments, the Federal Court of Appeal determined that the deemed trust did not require a triggering event in order to be invoked by the CRA. In the Court's opinion, the Bank had not taken into account the legislative development of the deemed trust provisions, which demonstrated that the legislator did not intend to subject the validity of the deemed trust to any event whatsoever. According to the Act, **both the property of a tax debtor and the property covered by the deemed trust that is held by his secured creditor** (in this case the proceeds from the sale of the property) **belong to the CRA as soon as GST is collected but not remitted.**

Finally, the Federal Court of Appeal held that it would **be irrational for the Act**, in an effort to ensure that the GST collected and not remitted would be recovered in priority over all debts, **to allow the bona fide purchaser for value defense.** Such a defense would cause the CRA to lose its super priority in the property of the deemed trust and ultimately render the provisions relating to that notion meaningless. **The Bank, despite being unaware of the debtor's debts owed to the CRA, was therefore required to pay the GST which had not been remitted by the tax debtor.**

In light of the above, the Bank's appeal was dismissed with costs.

Conclusion

Although the time for appeal has not yet elapsed at the time of publication of this newsletter, we wish to clarify that **an appeal to the Supreme Court of Canada remains possible.** Nonetheless, it is worth highlighting the **growing consistency of Canadian case law**, on which the Federal Court of Appeal has relied, with respect to the deemed trust mechanism established by the legislator.

It should be added that judges of the **Federal Court** and the **Federal Court of Appeal** were **sensitive to the impact of their decisions on secured creditors.** Both at trial and on appeal, the full texts of the judgments allude to the *Security Interest (GST/HST) Regulations*, which provides that a certain portion of an immovable hypothec will be considered to be automatically excluded from the deemed trust of the CRA, provided the hypothec in question is registered before the deemed trust is born. The method of calculating this portion is provided for in the said regulations.

It is worth remembering that this judgment confirms that in matters of deemed trusts of the tax authorities, the timing of the security interest has no impact, subject to the possible exclusion under the *Security Interest (GST/HST) Regulations*. **Even if a hypothec is registered before GST is collected, but not remitted, the super priority of the deemed trust will have to be paid in preference to the repayment of the debt secured by said hypothec.**

In the future, **banks will not be completely deprived of their ability to manage the risks associated with deemed trusts.** For example, they can identify high-risk borrowers (for example, those carrying on sole proprietorships), require borrowers to prove that their tax debts have been paid, or require borrowers



to provide authorization to verify with the Canada Revenue Agency or Revenu Québec if there are outstanding tax debts then known to the authorities.

The information and commentary set forth herein are for the general information of the reader and are not intended as legal advice or as an opinion to be relied upon in relation to any particular circumstances.

If you have any questions regarding the impact this judgment may have on your business, please contact one of our specialized lawyers who will be happy to advise you.

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¹ *Toronto-Dominion Bank v. Canada* 2020 FCA 80 (on appeal from *Canada v. Toronto-Dominion Bank*, 2018 FC 538).

² *Toronto-Dominion Bank v. Canada*, 2010 CAF 174 (Appeal dismissed in 2012 CSC 1).

³ Art. 2653 of the Civil Code of Quebec.

⁴ See *Canada (Attorney General) v. National Bank of Canada*, 2004 FCA 92.

⁵ *Royal Bank of Canada v. Sparrow Electric Corp.*, 1997 CanLII 377 (CSC).

⁶ Supra note 1.