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LIMITS OF THE DEEMED TRUST CREATED UNDER PROVINCIAL TAX LEGISLATION

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IN ITS JUDGMENT IN THE CASE OF *BANQUE NATIONALE DU CANADA V. AGENCE DU REVENU DU QUÉBEC*, 2011 QCCA 1943, ISSUED ON OCTOBER 21, 2011, THE COURT OF APPEAL OF QUEBEC DISCUSSED TWO GROUNDS OF DISPUTE THAT MIGHT BE OF INTEREST TO THE HYPOTHECARY CREDITORS OF TAX DEBTORS WHEN THE TAX AUTHORITIES RELY ON PROVINCIAL STATUTORY PROVISIONS PERTAINING TO DEEMED TRUSTS, NAMELY:

1. THE LIMITS OF THE SCOPE OF THE DEEMED TRUST;
AND
2. THE ESTOPPEL.

SUMMARY OF THE FACTS

The National Bank of Canada (the "**Bank**") held a hypothec on the movable property of Canouxa ImportExport Company Ltd. ("**Canouxa**") as security for Canouxa's obligations resulting from a loan in the amount of \$175,000 granted by the Bank. As additional security for the repayment of this loan, Mr. Lorenzo Egido Sr., the president and shareholder of Canouxa, had given a suretyship in favour of the Bank.

Between 1995 and 1999, Canouxa had failed to remit to Revenu Québec all the deductions at the source on the salaries of its employees for their income taxes and contributions to the Quebec Pension Plan.

On November 2, 1999, Canouxa declared bankruptcy. On February 10, 2000, the Bank served on Canouxa a prior notice of its intention to exercise the hypothecary remedy of taking in payment and then filed a motion for a forced surrender and the exercise of the hypothecary remedy of taking in payment.

Following subsequent discussions between the Bank and Mr. Egido Sr., the latter agreed to pay to the Bank an amount of \$47,295.75 in settlement of the balance owed by Canouxa to the Bank, in consideration for which the Bank agreed to transfer the property subject to its hypothec to Mr. Egido Sr. in the context of the judgment allowing the Bank's motion for the exercise of its hypothecary remedy of taking in payment.

In May 2001, Revenu Québec filed with the trustee in bankruptcy of Canouxa a trust claim requesting that the amount of \$21,560.73 be returned to it.

In June 2001, Revenu Québec learned that the property of Canouxa had been transferred to Mr. Egido Sr. On September 24, 2011, relying on the statutory provisions pertaining to the deemed trust created by tax laws, Revenu Québec gave notice to the Bank to pay it the amount of \$21,560.73.

On June 5, 2003, Revenu Québec instituted a recourse in the context of which it claimed payment of \$21,560.73 from the Bank. In 2008, the amount claimed by Revenu Québec to the Bank was increased to \$32,705.08.

THE JUDGMENT IN FIRST INSTANCE

The Court of Quebec allowed Revenu Québec's recourse and ordered the Bank to pay the amount of \$32,705.08. The judge concluded that Revenu Québec benefited from the deemed trust under section 20 of the *Act respecting the ministère du Revenu*, R.S.Q., c. M31 (the "ARMR"). The judge ruled that this deemed trust covered all the property of the tax debtor (other than property sold in the ordinary course of business), including the proceeds from the sale of the tax debtor's property other than in the ordinary course of business.

The judge concluded that the amount paid by Mr. Egido Sr. to the Bank was paid in consideration for the property of Canouxa subject to the deemed trust, with the result that such amount itself became subject to the deemed trust.

THE DECISION OF THE COURT OF APPEAL OF QUEBEC

The Honourable Pierre Dalfond, J.C.A., writing the reasons for the judgment rendered by the Court, with which reasons Justices Bouchard and Wagner agreed, described the recourse instituted by Revenu Québec against the Bank as follows:

[Translation]

[27] In its simplest terms, the recourse of Revenu Québec is that of the beneficiary of a deemed trust created by provincial legislation, who claims from the NBC the amount received following the sale by the NBC of property subject to the deemed trust and which therefore was not subject to the NBC's security.

Although the Court of Appeal ultimately confirmed the principles relied upon by the trial judge and intervened only to reduce the amount that the Bank was ordered to pay, its decision is particularly interesting because it highlights two grounds for dispute on which hypothecary creditors can base themselves when put in a situation similar to that of the Bank.

THE NATURE AND SCOPE OF THE PROPERTY INCLUDED IN THE DEEMED TRUST CREATED BY SECTION 20 OF THE ARMR

The Court of Appeal noted that the deemed trust created under the ARMR covers the amounts collected by a taxpayer and, in the event that those amounts are not remitted to the tax authorities, it covers equivalent amounts belonging to the tax debtor. Contrary to the wording of subsection 227(4) of the *Income Tax Act*, R.S.C. (1985), C1 (5th Supp), the deemed trust created under the ARMR does not extend to the other assets of the tax debtor.

The Court of Appeal noted that the lawyers for Revenu Québec had recognized this difference between the provincial and federal legislation and that they had maintained that it is of no consequence because, according to the *Bankruptcy and Insolvency Act*, R.S.C. (1985), c. B-2, the property included in the deemed trust created by a provincial statute and the rights resulting from it are equivalent to those created by the similar legislative provisions of federal statutes.

The Court did not seem convinced by Revenu Québec's assertion in this respect and made the following remark:

[Translation]

[34] One may wonder about an interpretation of the BIA, a federal statute, which has the effect of increasing the rights of, or the property included in, the deemed trust created under section 20 of the ARMR, a provincial statute. That under the principle of federal paramountcy in matters respecting bankruptcy, it is obvious that the rights of Her Majesty in right of a province under a deemed trust may be reduced in the event of a bankruptcy; however, that they would be increased is worth thinking about. Since that was not pleaded by the NBC or the trustee, a decision does not have to be made.

This *obiter dictum* of the Court opens the door to a possible contestation concerning the issue of what property is included in the deemed trust created by section 20 of the ARMR. Indeed, the tax authorities adopt an interpretation concerning the extent of such property that, at first glance, goes beyond what is stated in section 20 of the ARMR.

THE DEGREE OF DILIGENCE REQUIRED OF THE TAX AUTHORITIES

As previously mentioned, the Court of Appeal intervened only to reduce the amount that the Bank was ordered to pay from \$32,705.08 to \$21,560.73. The Court of Appeal found the slowness of the tax authorities in clarifying the amount of their claim unacceptable: the amounts claimed pertained to the years 1995 to 1999 and the tax authorities revised their claim upwards only in 2008. According to Mr. Justice Dalphond, [translation] "*an estoppel could be opposed to the increase of the claim of the tax authorities in view of the circumstances and [...] the judge should have allowed the objection of the NBC.*"

Thus, although the rights of the tax authorities under their deemed trust were recognized¹, the Court of Appeal ruled that the exercise of such rights can be subject to estoppel when it appears from the facts that the tax authorities have been negligent or failed to exercise them diligently.

CONCLUSION

If the deemed trust is a powerful tool for collecting tax debts, secured creditors, who are increasingly affected by its use, often many years after the exercise of their own rights, may henceforth consider making an estoppel argument.

Furthermore, an interesting debate will likely be taking place before long as to the scope of the deemed trust in favour of the provincial tax authorities under section 20 of the ARMR. We shall see if the *Bankruptcy and Insolvency Act*, a federal statute, can be relied upon to extend the scope of the ARMR, a provincial statute.

To be continued...

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¹ *Canada (Attorney General) v. National Bank of Canada; Canada (Attorney General) v. Caisse populaire d'Amos; Canada (Attorney General) v. Caisse populaire Desjardins de Lebel-sur-Quévillon*, 2004 FCA 92 (CanLII), 3 C.B.R. (5th) 1 (F.C.A.), 2004 FCA 92, leave to appeal to the S.C.C. denied, October 14, 2004, 30311.

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