

A Primer on CRA's Collection Powers and its Effect on Secured and Unsecured Creditors

Scott R. Venton, Vern W. DaRe, and Teodora Prpa, Fogler, Rubinoff LLP¹

The Canada Revenue Agency (“CRA”) has several collection powers under the *Income Tax Act*² (“ITA”) and the *Excise Tax Act*³ (“ETA”) to ensure the remittance of taxes. When taxes are not remitted, the CRA has an arsenal of collection tools including the deemed trust, garnishment, and certification of tax debts with the Federal Court to obtain a judgment. These remedies have different impacts on secured creditors and unsecured (judgment) creditors. They are also treated differently in a bankruptcy situation, with some of the remedies maintaining Crown priority and others losing priority status.

It is important to understand the distinctions between the collection mechanisms and how they operate under the ITA and the ETA in order to advise secured and unsecured creditors or lenders working with individuals who have a tax debt. This article examines each of the collection mechanisms and attempts to clarify the distinctions between them.

Overview

Unremitted employee source deductions under the ITA and collected but unremitted Harmonized Sales Tax and Goods and Services Tax (“HST/GST”) under the ETA, are obligations owing to the Crown which give rise to a deemed trust. The deemed trust applies to the whole of the tax debtor’s property and to the proceeds of that property equal in value to the amount owed to the Crown. In particular, the deemed trust provides the Crown with a super-priority against all other secured and unsecured creditors (with one exception dealing with “prescribed security interests” as discussed below), if the CRA enforces its deemed trust claim.

Where an obligation owed to the Crown arises from other provisions in the ITA or the ETA (e.g., individual income tax, corporation income tax, benefit overpayments, defaulted Canada Student Loans), or arises under some other statute (e.g., customs or levies under the *Customs Act*⁴ or the *Excise Act*),⁵ there are various other collection remedies available to the CRA within the legislative schemes, like garnishment or certification of the tax debt with the Federal Court, but they do not necessarily provide the Crown with a super-priority as against secured or unsecured creditors.

¹ Scott R. Venton and Vern DaRe are partners in the bankruptcy and insolvency department of Fogler, Rubinoff LLP and Teodora Prpa is an associate with Fogler, Rubinoff LLP.

² R.S.C. 1985, c. 1 (5th Supp.).

³ R.S.C. 1985, c. E-15.

⁴ R.S.C. 1985, c. 1 (2nd Supp.).

⁵ R.S.C. 1985, c. E-14.

When a bankruptcy occurs, the Crown is treated as an unsecured creditor by operation of s. 86 of the *Bankruptcy and Insolvency Act* (“BIA”),⁶ except in respect of unremitted employee source deductions owing to the Crown under the ITA. In that case, the deemed trust created under the ITA survives. By contrast, the deemed trust created under the ETA for collected but unremitted HST/GST amounts is extinguished on a bankruptcy. Obligations owed to the Crown under the *Canada Pension Plan*⁷ and the *Employment Insurance Act*⁸ are treated the same as the deemed trust created under the ITA within and outside of bankruptcy.

Where the Crown proceeds to collect on an outstanding obligation through garnishment, its Requirement to Pay issued under the ITA or the ETA will survive a bankruptcy if the statutory requirements are satisfied before a bankruptcy occurs. If the Crown certifies its tax debt in Federal Court and obtains a judgment, the Crown may enforce the judgment through execution processes available to other judgment creditors. However, the Crown will rank as an unsecured creditor unless the Crown takes the necessary steps to secure the judgment.

Deemed Trusts

Deemed trusts that arise in conjunction with the obligation to remit employee source deductions under the ITA and HST/GST under the ETA exist by operation of law. A deemed trust exists continuously from the date of the initial collection of source deductions or HST/GST not remitted to the CRA.⁹ It attaches to the property of the debtor (and to any proceeds of the property) to the extent of the amount of the unremitted deductions. This is true whether or not the property is subject to a security interest. Where a deemed trust exists, the Crown can enforce its deemed trust against the debtor and any creditor who has obtained proceeds which are rightly owing to the Crown equal in value to the amount of the unremitted tax, and the CRA does not have to take any steps to enforce its deemed trust (i.e. notice, registration).¹⁰

The implications of a deemed trust are the same for secured creditors and unsecured creditors, except where a secured creditor holds a “prescribed security interest”. A prescribed security interest is an interest in land or in a building (a mortgage or hypothec) registered against the tax debtor’s property *before* the tax debtor failed to remit the deductions which gave rise to the deemed trust in favour of the Crown.¹¹

Deemed Trusts and Secured Creditors

Unless a secured creditor’s interest satisfies the “prescribed security interest” exception described above, secured creditors are vulnerable to the Crown’s deemed trust claim. Where

⁶ R.S.C. 1985, c. B-3.

⁷ R.S.C. 1985, c. C-8.

⁸ S.C. 1996, c. 23.

⁹ *Canada v. Toronto-Dominion Bank*, 2018 FC 538 at para. 54 [*Bank FC*], aff’d 2020 FCA 80 [*Bank Appeal*]; *Callidus Capital Corporation v. Canada*, 2017 FCA 162 at paras. 51-57, rev’d 2018 SCC 47, dissenting reasons of Pelletier J.A. adopted at para. 1 [*Callidus*].

¹⁰ *Bank FC*, *supra* note 9 at paras. 17, 31; *First Vancouver Finance v. M.N.R.*, 2002 SCC 49 at paras. 1-6.

¹¹ *Royal Bank v Sparrow Electric Corp.*, [1997] 1 S.C.R. 411. A “prescribed security interest” will give a secured creditor priority over the Crown’s deemed trust claim where the criteria have been satisfied.

a secured creditor holds a security interest in the property of a tax debtor who has outstanding obligations under s. 227(4) of the ITA or s. 222(3) of the ETA, the secured creditor's interest is subordinate to the Crown's deemed trust claim. This is true even where the secured creditor realizes on its security. If a deemed trust exists in favour of the Crown, it attaches to the tax debtor's property and to any proceeds of that property. The Crown may enforce its deemed trust against the secured creditor up to the amount owing against any amounts collected by the secured creditor from the tax debtor.

The Federal Court's decision in *Canada v. Toronto-Dominion Bank*, recently upheld by the Federal Court of Appeal,¹² affirmed the law regarding the formation of a deemed trust. In that case, the debtor owned and operated a landscaping business as a sole proprietorship which was required to collect and remit GST to the CRA. In 2007 and 2008, the debtor collected but failed to remit GST in the amount of \$67,854. In 2010, the Toronto-Dominion Bank (the "Bank") extended two loans to the debtor which were secured by a residential Home Equity Line of Credit and a residential mortgage in favour of the Bank against the debtor's property in the amounts of \$246,000 and \$352,000 respectively. The security did not qualify as an eligible "prescribed security interest" since it was created after the failure to remit. At the time of both loan applications, the Bank was unaware of any debts owed by the debtor to CRA.

In 2011, the tax debtor sold and transferred the property to third party purchasers. Following payment of the loans by the debtor from the sale proceeds, the Bank discharged the charges registered against the property. In 2013 and 2015, the Crown asserted a deemed trust claim under s. 222 of the ETA against the Bank and sought payment from the proceeds received by the Bank in the amount of \$67,854. It was easier for the Crown to pursue the Bank, instead of the debtor directly.

The Federal Court found that s. 222(3) of the ETA obliged the Bank to remit that portion of the sale proceeds caught by the deemed trust. The Court found that the amounts paid by the debtor to the Bank were "proceeds" of the sale of the debtor's property and were subject to the deemed trust.¹³ The debtor was obliged to pay his tax debt out of the sale proceeds of the property, but paid the Bank, a secured creditor, instead.¹⁴ The Court therefore held that the Bank had a statutory obligation to pay the tax debt out of the sale proceeds.¹⁵ The Federal Court also held that as a secured creditor, the Bank could not invoke the *bona fide* purchaser defence to counter the statutory obligation,¹⁶ and held that no triggering or crystallizing event was necessary to bring the deemed trust created by s. 222 of the Act into operation.¹⁷

¹² *Bank Appeal*, *supra* note 9.

¹³ *Bank FC*, *supra* note 9 at para. 16.

¹⁴ *Ibid.* at para. 31.

¹⁵ *Ibid.* at para. 33.

¹⁶ *Ibid.* at paras. 44, 46: To allow the Bank to invoke the defence would defeat the purpose of the deemed trust, rendering it meaningless. Another exception may include those whose interest arises from leases or conditional sales contracts.

¹⁷ *Ibid.* at paras. 54-56.

On appeal, the Bank argued, *inter alia*, that the Federal Court erred by finding that the deemed trust did not require a triggering event to cause the deemed trust to crystallize around specific assets, and erred by finding that secured creditors could not avail themselves of the *bona fide* purchaser defence.¹⁸ The Federal Court of Appeal dismissed the Bank's arguments and dismissed the appeal, holding that the Federal Court did not err in its interpretation and application of the deemed trust provisions of the ETA.¹⁹

The Bank is seeking leave to appeal the Federal Court of Appeal's decision. Since the debtor sold the business or property in order to repay loans, one can only speculate that it did not make economic sense for the Bank to pursue directly a "no asset" debtor. *Canada v. Toronto-Dominion Bank* serves as a cautionary tale to secured creditors who fail to obtain full and complete information concerning a prospective debtor's tax liabilities. Only secured interests which satisfy the criteria for a "prescribed security interest" are immune to a deemed trust in favour of the Crown.

Deemed Trusts and Unsecured Creditors

Unsecured creditors, or judgment creditors who undergo an enforcement process like filing a writ of seizure and sale, are vulnerable to the Crown's deemed trust claim without exception under the legislation. If an unsecured creditor enforces its judgment and commences the execution process, the Crown can enforce a deemed trust claim against the judgment or unsecured creditor and override the execution process until obligations owing to the Crown are satisfied. The Crown can also "claw-back" any amounts distributed to the judgment creditor by the Sheriff under the *Creditors' Relief Act, 2010*.²⁰ If an unsecured creditor never had any right or title to the proceeds of the property subject to a deemed trust, the Crown is entitled to enforce its deemed trust claim and seek repayment of the proceeds made to any execution creditors.

*Canada (Attorney General) v. GlassCell Isofab Inc.*²¹ is an example of how a deemed trust takes precedence over a judgment creditor. In that case, GlassCell Isofab Inc. ("GlassCell") commenced an action against the tax debtor for the costs of goods sold and delivered. After obtaining default judgment against the debtor for \$219,460.90 plus costs, GlassCell had a Writ of Seizure & Sale issued against the tax debtor as a judgment debtor and had three garnishments issued and served. The garnishments included \$129,000 owing to the debtor from a third party and \$9,177.40 and \$435.15 from two of the tax debtor's bank accounts all of which were paid to the Sheriff pursuant to the garnishments.²²

On February 10, 2010, the Sheriff issued three notices of proposed distribution relating to the three garnishments naming GlassCell and the Province of Ontario under corporate tax legislation, as creditors. CRA disputed the notices of proposed distribution and asserted that

¹⁸ *Bank Appeal*, *supra* note 9 at para. 18.

¹⁹ *Ibid.* at paras. 69, 78, 86.

²⁰ S.O. 2010, c. 16, Sched. 4.

²¹ 2011 ONSC 2660 [*GlassCell*].

²² *Ibid.* at paras. 1-3.

the amounts were the property of the Crown because the tax debtor had failed to remit source deductions from 2006 up to and including the date of issuance of the garnishments and the date of distribution.²³ The Sheriff dismissed CRA's objections due to a procedural deficiency, following which the CRA brought a motion seeking an extension of time to contest the proposed distribution of funds. The Court declined CRA's relief and the Sheriff paid GlassCell and other execution creditors the garnished amounts.²⁴ The CRA brought an application to require GlassCell to pay the amount obtained through the execution process to the Crown.²⁵

The Ontario Superior Court held that the garnishment by GlassCell of its judgment debt was ineffective because the tax debtor's interest in the garnished property was subject to the Crown's super-priority under the deemed trust for unremitted source deductions. Accordingly, the garnishment and the proposed distribution of the proceeds of garnishment were ineffective. GlassCell and other execution creditors under the Sheriff's scheme of distribution had no right or title to the proceeds of garnishment until the full amount of the claim under the deemed trust was satisfied.²⁶ The Court also held that the Crown's involvement in the distribution process did not preclude it from asserting and obtaining the relief sought in this application.

Based on *Canada (Attorney General) v. GlassCell*, an unsecured creditor's interest is subordinate to the Crown's deemed trust, regardless of whether the unsecured creditor chooses to enforce its judgment.

Deemed Trusts in a Bankruptcy

Section 67(2) of the BIA eliminates all federal and provincial deemed trusts unless the trust exists under common law or where a trust has been adopted by Parliament under s. 67(3). Notably, s. 67(3) preserves the deemed trust under the ITA for unremitted employee source deductions, but eliminates the deemed trust under the ETA for collected but unremitted HST/GST amounts.²⁷ Section 222(1.1) of the ETA states that the deemed trust does not apply, at or any time after the person becomes bankrupt, to any amounts of tax collected or collectible by the person before that time.

In *Callidus Capital Corporation v. Canada*, the Supreme Court of Canada held that because a debtor's bankruptcy triggers s. 222(1.1) of the ETA and extinguishes the s. 222(1) deemed trust for unremitted HST/GST, the super-priority granted to the Crown by s. 222 becomes ineffective as against a secured creditor in bankruptcy.²⁸

²³ *Ibid.* at para. 37.

²⁴ *Ibid.* at paras. 8-9.

²⁵ *Ibid.* at paras. 4-7.

²⁶ *Ibid.* at para. 30.

²⁷ *Callidus*, *supra* note 9.

²⁸ *Ibid.* at para. 63.

Collection Mechanism: Garnishment

As indicated above, the deemed trust applies to two tax obligations: unremitted employee source deductions under the ITA and collected but unremitted HST/GST under the ETA. The deemed trust provides ultimate protection to the Crown, subordinating almost all other interests. However, where the obligation owed to the Crown arises from other provisions in the ITA or the ETA (e.g., individual income tax, corporation income tax, benefit overpayments, defaulted Canada Student Loans), or arises under some other statute (e.g., customs or levies under the *Customs Act* or the *Excise Act*), there are various collection mechanisms within the legislative schemes which remain available to the CRA, such as garnishment or certification of the tax debt with the Federal Court.

Garnishment can be used by the CRA to intercept funds that a third party, such as an employer or a bank, owes the tax debtor or holds for the tax debtor. Under s. 224(1) of the ITA and s. 317(1) of the ETA, the CRA can require the third party to pay any funds otherwise payable to the tax debtor to the Crown.

In order to garnish these funds from third parties, the CRA sends the third party a “Requirement to Pay” (“RTP”), which instructs the third party to send the funds to the CRA. The RTP gives the Crown priority over all creditors except secured creditors. However, where the obligation owed to the Crown is source deductions or HST/GST, the CRA may choose to send an “Enhanced Requirement to Pay”, which gives the CRA priority over secured creditors. It is the nature of the obligation which gives the Crown priority.

Garnishments on a Bankruptcy

On a bankruptcy, any funds subject to an RTP become the Crown’s property when the garnishee receives the RTP. If the garnishment provisions of the ITA or the ETA are properly complied with, s. 70 of the BIA does not affect the Crown’s interest in those funds, because the Crown has effectively garnished the funds prior to the bankruptcy.²⁹

Collection Mechanism: Certification of Judgments

If a tax debtor’s obligation to the Crown does not create a deemed trust, the Crown may certify its tax debt with the Federal Court of Canada. In this way the CRA obtains a certificate confirming the amounts owed to the Crown. Once registered, the certificate has the same force and effect as a court judgment obtained by an unsecured creditor.

Under s. 223 of the ITA and s. 316 of the ETA, an “amount payable” or any part thereof pursuant to a tax obligation owed by a debtor under the ITA or the ETA which has not been paid to the Crown may be certified by the Minister of National Revenue (the “Minister”) as an “amount payable” by the debtor. A certificate registered in the Federal Court, a document issued by the

²⁹ *Toronto Dominion Bank v. Canada*, 2012 SCC 1 aff’g 2010 FCA 174 at para. 53. Though the decision focuses on s. 317 in the ETA, the guidance in this decision should apply equally to s. 224(1.2) of the ITA to recover liabilities owed to the Crown.

Federal Court evidencing such certificate, or a writ of that Court issued pursuant to the certificate (either referred to in the legislation as a "memorial"), may be filed for the purpose of creating a charge, lien, or priority on the debtor's property in the same manner as a judgment of the superior court of the province where the property resides.

Where a memorial has been filed, registered, or recorded in accordance with the above sections, s. 223(6) of the ITA and s. 316(5) of the ETA state that the charge, lien, or priority created on the property is subordinate to any charge, lien, priority or binding interest in respect of which "*all steps necessary to make it effective against other creditors were taken before the time the memorial was filed, registered, or otherwise recorded.*"

Therefore, when the CRA proceeds with collection of a tax debt by registering with the Federal Court the Crown acknowledges that its priority is subordinate to all other interests which have been perfected against other creditors at that time, which is no different than the status afforded to other judgment creditors.³⁰ In those circumstances the Crown is an unsecured creditor, whose interest is subordinate to secured creditors.

Certified Tax Debts in a Bankruptcy

Other than where the obligation owed by the tax debtor to the Crown is for employee source deductions under the ITA (which are subject to a deemed trust that survives a bankruptcy (s. 86(3) of the BIA)), the Crown is an unsecured creditor in bankruptcy by operation of s. 86 of the BIA. Unsecured creditors rank *pari passu* in a bankruptcy. However, the Crown may, prior to a bankruptcy, register its charge, lien, or priority in accordance with s. 87(1) of the BIA pursuant to s. 223(11.1) of the ITA and s. 316(10.1) of the ETA. Where an amount owing is registered in accordance with the system of securities registration prescribed in s. 111 of the *Bankruptcy and Insolvency General Rules*, it is deemed to be a claim secured by a security and ranks as a secured claim under the BIA, but is subordinate to securities properly registered ahead of it (s. 87(2)).

Through registration the Crown can acquire secured creditor status.³¹ However, in the event of a bankruptcy the Crown's secured interest will be limited to the amount owing at the time of the registration under s. 87(2) of the BIA. This is different than a deemed trust which increases as the value of the obligation owed to the Crown increases.

Conclusion

The CRA has a number of enforcement options. Of all the obligations a tax debtor may owe to the Crown under the ITA and the ETA, Parliament has given the most protection to unremitted employee source deductions under the ITA and collected but unremitted Harmonized Sales Tax and Goods and Services Tax ("HST/GST") under the ETA. Where the Crown holds a deemed trust, it may enforce the deemed trust against any unsecured or secured creditor irrespective

³⁰ *Trang v. Nguyen*, 2012 ONCA 885 at paras. 7-8, 13, 76-78; *Krates v. Crate*, 2018 ONSC 2399.

³¹ *Ledrew, Re.*, 2005 CarswellOnt 2751.

of the creditor's relationship to the debtor and the debtor's property, except a secured creditor who holds a "prescribed security interest".

Where the obligation owed to the Crown arises from other provisions of the ITA or the ETA, or arises under another statute, there are various collection mechanisms within the legislative schemes which the CRA can employ, such as garnishment or certification of the tax debt with the Federal Court. Under these mechanisms, the Crown is an unsecured creditor subordinate to secured creditors (subject to the Enhanced RTP issued to garnishees where the obligation owed is for source deductions or HST/GST). As long as the Crown completes all necessary steps before bankruptcy, a garnishment will survive a bankruptcy. Otherwise the Crown loses its priority in bankruptcy.

The Crown may also register and certify its tax debt with the Federal Court of Canada and in so doing become an unsecured judgment creditor. The Crown's interest will be subordinate to all other judgment creditors who took steps to enforce their judgment before the Crown registered its interest.

In the event of a bankruptcy, the Crown's deemed trust will survive in respect of unremitted source deductions but not in respect of collected but unremitted HST/GST. For other obligations owed to the Crown, the Crown may choose to improve its position in the event of a bankruptcy by registering its lien in accordance with the BIA. In doing so, the Crown retains a secured creditor status, but its interest remains subordinate to securities registered before the Crown's interest.

The Crown has enhanced powers to collect amounts owed under revenue statutes. Though the priority afforded the Crown may seem harsh to lenders or creditors, it serves to protect employees first and foremost. Lenders and other creditors are cautioned to make thorough inquiries to determine the tax liabilities of prospective debtors to avoid unfortunate surprises when they enforce their secured or unsecured debt.

For further information concerning the contents of this article please contact:
Scott R. Venton, Vern W. DaRe, or Teodora Prpa of Fogler, Rubinoff LLP.