

January 25, 2013

I've Distraigned Against My Tenant's Property. Did I Just Do the Canada Revenue Agency a Favour?

The following scenario is a familiar one: A tenant falls into arrears of rent under a commercial lease. The landlord decides not to terminate the lease but rather to exercise its right to distraint (which allows the landlord to seize and sell the tenant's property (excluding its trade fixtures) in the premises). Before distraint, the landlord conducts a search against the tenant and determines that it has no outstanding executions and that its property is not subject to any security interest. The landlord sells the tenant's property and the sale proceeds are applied to the tenant's arrears of rent. Several months later, Canada Revenue Agency (CRA) contacts the landlord to advise that the tenant failed to remit amounts withheld from employees for income tax, employment insurance, and Canada pension plan contributions, as well as sales taxes collected from customers. CRA demands that the landlord remit the proceeds from the sale of the tenant's property to the CRA on account of the amounts owing by the tenant. Does the landlord have to comply? Likely yes, but if the steps described below are taken, and CRA does not respond to them, there is a reasonable chance that the proceeds from the sale can be retained by a landlord despite CRA's claim.

What is the Basis of CRA's Claim to the Sale Proceeds?

CRA's entitlement to the sale proceeds results from a statutory trust imposed on a taxpayer's property for deductions made from employees' pay for income tax, employment insurance premiums and Canada Pension Plan contributions, as well as federal and provincial sales taxes collected from consumers. The purpose of the trust is to facilitate the remittance to CRA of taxes and source deductions collected on behalf of the federal and provincial governments by creating a super-priority for these amounts in favour of CRA ahead of all creditors.

How Does the Statutory Deemed Trust Work?

The federal and provincial statutes that create trusts in favour of governments all work in a similar manner. First, a person is deemed to hold in trust, separate and apart from their own property and for the benefit of the government, all amounts collected or deducted for taxes or source deductions. Second, where these amounts are not properly remitted to the CRA, the property of that person, to the extent of the amounts owing, is deemed not to form a part of their property and instead is held in trust for the government from the time the tax or source deduction was required to be collected.

In the case of *The Attorney General of Canada v. Community Expansion Inc. et al.*, the Supreme Court of Canada likened the statutory deemed trust provision in the *Income Tax Act* to a floating charge. The trust floats over the tax debtor's property from the time the deductions were required to be made and continues to float while they remain outstanding. The trust does not attach to the tax debtor's assets; consequently, it is free to deal with its assets in the ordinary course. However, once it sells an asset to a third party in the ordinary course, the trust (in relation to that asset) attaches to the sale proceeds.

But what if CRA has not taken steps to enforce its claim at the time the landlord sells the property on which it has distrainted? The Supreme Court of Canada made it clear that no steps are required to be taken by CRA to enforce collection of the debt before the trust affects the tax debtor's property. In fact, the Court held that the trust will not affect property sold to a purchaser for value in good faith in the ordinary course, but will attach to the sale proceeds. The Court likened a landlord who has distrainted against a tenant's property to a secured creditor and held that the trust specifically takes priority over the claims of secured creditors. As a result, the sale proceeds are subject to the trust and therefore must be relinquished to government creditors.

Has the Introduction of the HST Changed Anything?

Prior to the introduction of the HST, the Ministry of Revenue maintained a reporting system for creditors to make enquiries into a taxpayer's unremitted sales taxes. Landlords were able to determine whether a tenant was in arrears of provincial sales taxes before incurring the costs of distraint. No similar reporting system was available through the CRA for federal taxes and source deductions.

With the introduction of the HST, the federal government has taken over the administration of provincial sales taxes. Consequently, reporting on provincial sales tax arrears by the Ministry of Revenue will continue for an indeterminate period of time, after which no information will be available to landlords.

Bottom line: Should I Distrain and What Steps Should I Take?

Since there is now no way to determine whether a deemed trust exists before proceeding with a distress, and considering the fact that a tenant in arrears of rent will likely also be behind in its remittances to the federal or provincial governments, the remedy is risky.

Although little can be done to bullet-proof the landlord's sale proceeds, a landlord can exert some control by informing the CRA of steps being taken during the distraint process. For example, once the landlord seizes the property of the tenant and before incurring the expense of a sale, the landlord should notify CRA that it has seized the tenant's property, that the property will be sold within a particular period of time, and request that it be advised of any existing trust claim. If a response is not received from CRA, the landlord may decide to proceed with the sale (although CRA may still demand that the proceeds be applied to satisfy its trust claim).

Once the sale is completed, the landlord should again notify CRA of the sale of the property and again request notification of any trust claim, specifying a reasonable time frame for response. If no response is received, the landlord is well positioned to argue that CRA is estopped from relying on a deemed trust at a later date. If the CRA responds by claiming a right to the proceeds, it is our understanding that it will normally allow the landlord to retain from the proceeds its costs of conducting the sale.

ANNOUNCEMENT

Daoust Vukovich LLP is pleased to announce that **JAMIE PAQUIN** has been admitted to partnership. Jamie was called to the Ontario Bar in 2005 and joined **Daoust Vukovich LLP** in January, 2006. Throughout his legal career, Jamie has focused primarily on commercial leasing, acting for commercial retail, office and industrial developers, landlords and tenants. Jamie's versatile real estate practice also includes handling the acquisition, sale and financing of commercial properties and facilitating the acquisition and sale of businesses. Jamie can be reached at: **(416-598-7059)** (jpaquin@dv-law.com).



Our secret for closing files lies as much in what is taken out as in what is put in. By eliminating exorbitant expenses and excess time, by shortening the process through practical application of our knowledge, and by efficiently working to implement the best course of action, we keep our clients' needs foremost in our minds. There is beauty in simplicity. We avoid clutter and invest in results.

Often a deal will change complexion in mid-stage. At this critical juncture, you will find us responsive, flexible and able to adjust to the changing situation very quickly and creatively. We turn a problem into an opportunity. That is because we are business minded lawyers who move deals forward. The energy our lawyers invest in the deal is palpable; it makes our clients' experience of the law invigorating.

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