Date: 20050520

Docket: T-1253-02

Citation: 2005 FC 731

OTTAWA, Ontario, Friday, the 20th day of May 2005

PRESENT: MADAM PROTHONOTARY MIREILLE TABIB

BETWEEN:

HER MAJESTY THE QUEEN IN RIGHT OF CANADA
(Minister of National Revenue)

Plaintiff

- and -

CAISSE POPULAIRE DU BON CONSEIL

Defendant

REASONS FOR JUDGMENT AND JUDGMENT

INTRODUCTION

[1] This case raises the issue of how the provisions of the *Income Tax Act* and the *Employment Insurance Act*, establishing a deemed trust in favour of Her Majesty, apply to the set-off or compensation vehicle for loans secured by term deposit certificates.

[2] The deemed trust vehicle, established in subsections 227(4.1) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the ITA) and 86(2.1) of the *Employment Insurance Act*, S.C. 1996, c. 23 (the EIA), is one of the measures instituted to ensure that employers' source deductions on employees' pay under the ITA and EIA are in fact paid to Her Majesty.

[3] Both the ITA and the EIA require that employers deduct from employees' salaries the amounts that the employees must pay as income tax or employment insurance contributions and remit these amounts to the Receiver General. Under subsections 227(4) of the ITA and 86(2) of the EIA, the employer is deemed to hold the amounts withheld at source in trust for Her Majesty. Under subsections 227(4.1) of the ITA and 86(2.1) of the EIA, once an employer fails to pay the sums deducted on the date provided by regulation, a deemed trust is automatically and retroactively created as of the date of the deduction on all of the employer's property, up to the amount of the sums deducted. This trust extends to any property given by the employer as security and has priority over any security interest, irrespective of whether it was constituted before or after the deemed trust becomes effective. Furthermore, a secured creditor who executes his security interest on the property subject to the trust is required to remit to the Receiver General, in priority, the proceeds from the property up to the amount of the unpaid source deductions. In view of the potential for hidden accumulation of unpaid source deductions by an employer and the reduction in the value of the financial securities held by other creditors that this entails, it is not surprising that financial institutions try to circumscribe the application of the deemed trust or at least to probe its limits. Notwithstanding the modest sums involved in this case, the stakes are of some importance, therefore.

THE FACTS

[4] On September 25, 2000, as consideration for a credit line of $277,000, Les Entreprises Camvrac Inc. (hereinafter, the debtor) deposited with the defendant, Caisse populaire du Bon Conseil, the sum of $200,000 which will be held by the defendant in the form of a term deposit certificate maturing October 16, 2005. Coterminous with the term deposit certificate, the defendant and the debtor signed a security agreement the most relevant terms of which read as follows:

> [TRANSLATION]
>
> 1. **Right of retention and compensation**: To guarantee the repayment in principal, interest, costs and incidental fees of all sums that are or may be payable to the Caisse by the depositor under a line of credit agreement for $277,000 which was granted to it on September 18, 2000, under all debts or obligations present or future, direct or indirect, of the depositor, the depositor undertakes to maintain and agrees that the Caisse shall retain, in the account(s) or on the certificate(s) of deposit referred to hereinafter, the sum of $200,000.
>
> 7. **Default:** The depositor shall be in default in the following situations:
>
> (a) if any of the obligations provided in the credit agreements or herein are not complied with;
>
> (b) if the depositor or the borrower become insolvent or bankrupt or if they make a proposal and it is rejected or cancelled;
>
> . . .
>
> In case of default:
>
> (a) all sums owing under the credit agreements will forthwith become due and payable;
>
> (b) there will be compensation between the credit agreement(s) and the deposit certificate or sum of money indicated above, irrespective of whether they have or have not matured;
>
> . . .

> The consequences of a default are to the exclusive benefit of the Caisse and it may expressly waive them. It may, for example, without prejudice to its rights, await the maturity date of the deposit certificate(s) before exercising the rights provided in clauses (b) and (c) above.

[5] From May to October 2000, the debtor failed to remit to Her Majesty some source deductions under the ITA and the EIA totalling $5,558.72. In November 2000, but at a date that was not adduced in evidence, deductions of $3,253.10 were made but not remitted. On November 25, the debtor failed to pay the interest portion of its debt to the defendant. From December 2000 to January 2001, the total deductions made but not remitted increased by $18,051.71, raising the total deductions owing to Her Majesty to $26,863.53. On February 7, 2001, the debtor made an assignment of its property. However, it was not until February 21, 2001, that the defendant noted the compensation of $200,000 between the proceeds of the deposit certificate and the $277,000 owing to it by the debtor. On June 12, 2001, Her Majesty gave formal notice to the defendant to pay her the sums owing by the debtor as proceeds from the property covered by the deemed trust.

POSITIONS OF THE PARTIES

[6] The plaintiff, Her Majesty the Queen, states that the term deposit certificate held by the defendant was property of the debtor subject to the deemed trust and that by exercising its security interest in the certificate of deposit on February 21, 2001, the defendant was realizing the proceeds, which it should have remitted in priority to the Receiver General up to the amounts withheld at source.

[7] The defendant, for its part, contends that its obligation to Her Majesty applies only to the [TRANSLATION] “proceeds from” the property subject to the trust, and that in reality it has not received any “proceeds from” the term deposit certificate. The defendant submits that under the security agreement executed between it and the debtor, the debtor’s default rendered both the debtor’s debt to it and its debt to the debtor, represented by the term deposit certificate, simultaneously due and payable. By the application of articles 1672 and 1673 of the *Civil Code of Québec*, the compensation was effected by operation of law between these two debts, so that the defendant’s “debt” to the debtor, represented by the term deposit certificate, was extinguished simultaneously with the debtor’s debt to it, in the amount up to $200,000. According to the defendant’s interpretation, it did not “redeem” the term deposit certificate; there were no “proceeds” thereof; it was simply extinguished by compensation.

[8] If the defendant’s argument is accepted without reservation, the date on which the compensation was effected is irrelevant: In every case the property to which the trust applied provided no proceeds that had to be remitted to the Receiver General. The defendant submits nevertheless, in the alternative, that if the Court were to find that the execution of the security interest by the bank is an operation which results in any “proceeds thereof”, the date on which this operation occurred must be fixed at November 25, 2000, the date on which the debtor failed to pay the interest owing under the credit agreement, so that the deemed trust should apply only to the deductions made before that date.

ANALYSIS

[9] It is worth reproducing here the text of subsections 277(4) and 277(4.1) of the ITA (subsections 86(2) and 86(2.1) of the EIA are for any useful purpose in this analysis, identical):

(4) "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) "Toute personne qui déduit ou retient un montant en vertu de la présente loi est réputée, malgré toute autre garantie au sens du paragraphe 224(1.3) le concernant, le détenir en fiducie pour Sa Majesté, séparé de ses propres biens et des biens détenus par son créancier garanti au sens de ce paragraphe qui, en l'absence de la garantie, seraient ceux de la personne, et en vue de le verser à Sa Majesté selon les modalités et dans le délai prévus par la présente loi.
(4.1) 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 227(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	(4.1) Malgré les autres dispositions de la présente loi, la Loi sur la faillite et l'insolvabilité (sauf ses articles 81.1 et 81.2), tout autre texte législatif fédéral ou provincial ou toute règle de droit, en cas de non-versement à Sa Majesté, selon les modalités et dans le délai prévus par la présente loi, d'un montant qu'une personne est réputée par le paragraphe (4) détenir en fiducie pour Sa Majesté, les biens de la personne, et les biens détenus par son créancier garanti au sens du paragraphe 224(1.3) qui, en l'absence d'une garantie au sens du même paragraphe, seraient ceux de la personne, d'une valeur égale à ce montant sont réputés :
(*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	*a*) être détenus en fiducie pour Sa Majesté, à compter du moment où le montant est déduit ou retenu, séparés des propres biens de la personne, qu'ils soient ou non assujettis à une telle garantie;
(*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 to the Receiver General in priority to	*b*) ne pas faire partie du patrimoine ou des biens de la personne à compter du moment où le montant est déduit ou retenu, que ces biens aient été ou non tenus séparés de ses propres biens ou de son patrimoine et qu'ils soient ou non assujettis à une telle garantie. Ces biens sont des biens dans lesquels Sa Majesté a un droit de bénéficiaire malgré toute autre garantie sur ces biens ou sur le produit en découlant, et le produit découlant de ces biens est payé au receveur général par priorité sur une telle garantie."

all such security interests."

[10] The relevant articles of the *Civil Code of Québec*, on which the defendant bases its argument, are as follows:

1671. "Obligations are extinguished not only by the causes of extinction contemplated in other provisions of this Code, such as payment, the expiry of an extinctive term, novation or prescription, but also by compensation, confusion, release, impossibility of performance or discharge of the debtor.	1671. "Outre les autres causes d'extinction prévues ailleurs dans ce code, tels le paiement, l'arrivée d'un terme extinctif, la novation ou la prescription, l'obligation est éteinte par la compensation, par la confusion, par la remise, par l'impossibilité de l'exécuter ou, encore, par la libération du débiteur.
1672. Where two persons are reciprocally debtor and creditor of each other, the debts for which they are liable are extinguished by compensation, up to the amount of the lesser debt.	1672. Lorsque deux personnes se trouvent réciproquement débitrices et créancières l'une de l'autre, les dettes auxquelles elles sont tenues s'éteignent par compensation jusqu'à concurrence de la moindre.
Compensation may not be claimed from the State, but the State may claim it.	La compensation ne peut être invoquée contre l'État, mais celui-ci peut s'en prévaloir.
1673. Compensation is effected by operation of law upon the coexistence of debts that are certain, liquid and exigible and the object of both of which is a sum of money or a certain quantity of fungible property identical in kind.	1673. La compensation s'opère de plein droit dès que coexistent des dettes qui sont l'une et l'autre certaines, liquides et exigibles et qui ont pour objet une somme d'argent ou une certaine quantité de biens fongibles de même espèce.
A person may apply for judicial liquidation of a debt in order to set it up for compensation."	Une partie peut demander la liquidation judiciaire d'une dette afin de l'opposer en compensation."

[11] I would also add the following to the relevant articles from the *Civil Code*:

1681. Compensation may neither be effected nor be renounced to the prejudice of the acquired rights of a third person."	1681. La compensation n'a pas lieu, et on ne peut non plus y renoncer, au préjudice des droits acquis à un tiers."

[12] From a purely conceptual standpoint, the defendant's argument conflicts *prima facie* with the rationale of the deemed trust and the absolute priority it was held to have by the Supreme

Court of Canada in *First Vancouver Finance v. Canada (M.N.R.)*, [2002] 2 S.C.R. 720 (*First Vancouver*) and more recently by the Federal Court of Appeal in *Canada (M.N.R.) v. National Bank et al.*, 2004 FCA 92 (leave to appeal to the Supreme Court of Canada dismissed on October 14, 2004, docket SCC 30311 (*National Bank*).

[13] The importance of the source deductions system for the collection of taxes and the role played by the vehicle of the deemed trust in ensuring their collection was acknowledged in these words by the Supreme Court in the *First Vancouver* case, at pages 729 and 730:

> The collection of source deductions has been recognized as "at the heart" of income tax collection in Canada: see *Pembina on the Red Development Corp. v. Triman Industries Ltd.* (1991), 85 D.L.R. (4th) 29 (Man. C.A.), at p. 51, *per* Lyon J.A. (dissenting), quoted with approval by Gonthier J. (dissenting on another issue) in *Royal Bank of Canada v. Sparrow Electric Corp.*, [1997] 1 S.C.R. 411, at para. 36. Because of the importance of collecting source deductions, the legislation in question gives the Minister the vehicle of the deemed trust to recover employee tax deductions which employers fail to remit to the Minister.
>
> It has also been noted that, in contrast to a tax debtor's bank which is familiar with the tax debtor's business and finances, the Minister does not have the same level of knowledge of the tax debtor or its creditors, and cannot structure its affairs with the tax debtor accordingly. Thus, as an "involuntary creditor", the Minister must rely on its ability to collect source deductions under the ITA: *Pembina on the Red Development*, *supra*, at pp. 33-34, *per* Scott C.J.M., approved by Cory J. in *Alberta (Treasury Branches)*, *supra*, at paras. 16-18. For the above reasons, under the terms of the ITA, the Minister has been given special priority over other creditors to collect unremitted taxes.

[14] Furthermore, Parliament's clear intention to have the deemed trust prevail over any other security interest that is held, and more particularly exercised, by other secured creditors was acknowledged at pages 732 and 733, in the following passages:

> 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.
>
> [Emphasis added]

[15] And in paragraph 34 of the *National Bank* judgment:

> [34] However, the ITA and EIA deemed trust provisions are complete and explicit as to their effect on property taken in possession by secured creditors in the exercise of their security interest, judging from the Supreme Court's reasons in *First Vancouver*: the Crown has an absolute priority over the proceeds from the property subject to the deemed trust, which must be paid to the Receiver General.
>
> [Emphasis added]

[16] From the wording of the statutory provisions and the courts' interpretation thereof, there is no escaping the conclusion that Parliament's intention is to ensure that a secured creditor who enforces its security interest is required to remit to the Crown in priority, from the proceeds of realization of its security interest, the sums owing by its debtor as source deductions.

[17] In this case there is no doubt — and it is basically conceded — that the defendant was holding the $200,000 certificate of deposit as security for the sums owing under the line of credit, that the receipt of the certificate of deposit (or, to use the vocabulary recommended by the defendant, the compensation or set-off between the debtor's claim and the certificate of deposit) constituted the realization on the defendant's security as a result of a default and that the bank thereby received the full benefit of the realization on its security. Nor is there any doubt that when the defendant realized on its security, whether it was November 25, 2000 or February 21, 2001, the term deposit certificate was subject to the deemed trust.

[18] As a consequence of the foregoing, it is clear that the defendant received the benefit of the term deposit certificate, whether it was through its receipt in payment of its claim or through the extinguishment of its claim by compensation up to the value of the term deposit certificate.

[19] In my opinion, this benefit should be considered the “proceeds” from the certificate of deposit. There is no indication in the language of the ITA or the EIA that the “proceeds from” the property held as security are limited to the sums received in cash; the “proceeds from a property” must be construed as including any set-off or benefit received in exchange or in consideration of the property.

[20] Neither the ITA nor the EIA defines the words “proceeds” (“produits découlant”) as used in the relevant provisions. The dictionaries of common usage define them as follows in their commercial context:

> Proceeds: “That which proceeds, is derived or results from something; that which is obtained or gained by any transaction; produce, outcome, profit.”
>
> *Oxford English Dictionary*, 2nd Ed., 1989, Oxford University Press, England
>
> Produit: “Ce que rapporte une charge, une propriété foncière, un patrimoine; profit, bénéfice qu’on retire d’une activité.”
>
> *Le Nouveau Petit Robert*, Paris, 2002
>
> “Contrepartie reçue en espèce ou autrement lors de la cession d’un bien, de l’obtention d’un prêt ou de l’émission de titres.”

> *Le Grand dictionnaire terminologique*, Office québécois de la langue française (février 2005) http://www.granddictionnaire.com
>
> [Emphasis added]

[21] In at least one case in which the word "proceeds" was judicially construed in a commercial context, the result was the same, i.e. to give it a non-restrictive meaning, and to include in it any valuable consideration received in exchange in a transaction. *ITT Commercial Finance Ltd. v. Co-op Centre Credit Union* (1988), 59 Alta. L.R. (2d) 39, at page 41, concerned a conditional sales financing agreement under which the debtor, a mobile homes dealer, retained the "proceeds of sale" of the mobile homes in trust on behalf of the creditor pending full payment. The Alberta Court of Appeal held that the security thereby granted on the proceeds of sale extended to the used vehicles received in partial payment of the sale price.

> "We are all of the view that the learned trial judge was correct to find, in the circumstances of this case, that the word "proceeds" in the assignment agreement meant not just any cash paid by a buyer but also any other property of value that was handed by a retail buyer to the dealer to help pay for the sale of the new motor homes."

[22] Thus the value of the benefit conferred on the defendant through the realization on its security interest in the certificate of deposit constitutes the proceeds from the certificate of deposit, and must be paid to the Receiver General. To conclude otherwise would allow secured creditors to elude the clear intention of Parliament by accepting, in consideraton of the property held as security and also subject to the deemed trust, earnings or instruments that are convertible into cash, albeit not monetary.

[23] Apart from the conceptual objection discussed above, the defendant's thesis has no basis in Quebec civil law, because it disregards article 1681 of the *Civil Code*, which provides that compensation may not be effected to the prejudice of the acquired rights of a third party. At the date of the compensation (whichever it is), Her Majesty had acquired a priority security interest in the certificate of deposit. The defendant could not, therefore, effect compensation in the full amount of the certificate of deposit without prejudice to the Crown's right. While the Supreme Court held, in *First Vancouver*, that a debtor may validly sell property subject to the deemed trust in the normal course of its business, this was on the assumption that the debtor would receive in consideration an equivalent value on which the trust in favour of the Crown would be carried forward. If we were to accept that compensation can operate outside the normal course of business between the debtor's debt and the term deposit certificate, this compensation would be effected to the prejudice of the acquired rights of the Crown, since the term deposit certificate would disappear from the debtor's asset base without any convertible consideration for the Crown replacing it.

[24] Finally, the defendant cites the automatic functioning of the legal compensation as provided in the *Civil Code of Québec* in arguing that the term deposit certificate was extinguished as debt without the defendant having to [TRANSLATION] "redeem" it, and that this transaction occurred automatically upon the date of the initial default of the debtor, on November 25, 2000.

[25] The essential conditions for compensation by operation of law are clearly listed in article 1673 C.C.Q.: the reciprocal debts must be certain, liquid and exigible. It is not disputed that the

line of credit and the term deposit certificate are certain and liquid debts. As to exigibility, the term deposit certificate matured on October 16, 2005, and so it was not, on its face, exigible as of the date of default. The defendant contends that the debtor's default effectively deprived it of the benefit of the term, so both debts became immediately exigible on the date of default notwithstanding the date of maturity of the term deposit. That may well be the case for the debtor's debt to the defendant, but not insofar as the term deposit certificate is concerned. In fact, while the savings security agreement specifically provides for acceleration of the term of the credit agreements in the event of default (clause 7, 2nd paragraph, (a): "all sums owing under the credit agreements will forthwith become due and payable"), no such clause is provided in regard to the deposit certificates.

[26] The defendant apparently concludes that because the savings security agreement provides for compensation between the credit agreement and the term deposit, it necessarily provides for the immediate exigibility of the deposit certificate through reciprocal acceleration of its term. However, nothing in the terms of the agreement or in the applicable law dictates such an interpretation. While legal compensation by operation of law cannot be effected owing to the fact that the deposit certificate is not exigible at the time of default, there is nothing to preclude the default clause in the security agreement from taking effect as conventional compensation. The existence of conventional compensation, when the conditions required by law are not fulfilled, is recognized in the cases and authorities (Beaudoin, Jean Louis and Jobin, Pierre Gabriel, *Les Obligations* (Cowansville: Les Éditions Yvon Blais Inc., 1998), para. 931, pp. 781-782; *2862-3718 Québec Inc. v. Michel Provost*, J.E. 93-904).

[27] Being conventional instead of legal, the compensation, if it was effected between the defendant and the debtor, was not effected automatically and independently of their will upon the actual date of default: it required a specific and palpable intention on the part of the defendant. This is what is indicated by the agreement executed between the parties. The security agreement specifically stipulates that the compensation is to the exclusive benefit of the defendant, that it may expressly waive it and that it has the option of awaiting the maturity of the certificates of deposit before exercising its right to compensation. The obligation in the agreement that the defendant exercise and manifest its intention to exercise its right in order to give effect to the compensation has the advantage as well of being consistent with the fact that the defendant continued to have the interest owing on the line of credit run against the debtor until February 2001, which could not validly have been done if the debt had been extinguished by compensation as of the default of November 25, 2000.

[28] In my opinion, therefore, it is necessary to construe the compensation clause in the security agreement between the debtor and the defendant as a clause allowing the defendant to realize on its security in the term deposit certificates by effecting conventional compensation between sums owing under the credit agreements and the unmatured term deposit certificates. This transaction is not automatic legal compensation but is a function of the unilateral will of the defendant and requires that the defendant demonstrate its intention to avail itself of its right. This conclusion, then, answers the ancillary question posed by the defendant, as to the date on which the compensation or realization of the defendant’s security is deemed to have occurred, that is,

February 25, 2001, the date on which the defendant manifested its intention to exercise its right by noting the compensation.

JUDGMENT

FOR THESE REASONS, THE COURT:

1. Orders the defendant to pay the plaintiff the sum of $26,863.53 with the interest under subsections 36(2) and 37(2) of the *Federal Courts Act* at the prescribed rate under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), capitalized daily from February 26, 2001, pending full payment thereof.

2. With costs.

"Mireille Tabib"
Prothonotary

Certified true translation

K.A. Harvey

FEDERAL COURT

SOLICITORS OF RECORD

DOCKET:	T-1253-02
STYLE:	Her Majesty the Queen in right of Canada v. Caisse Populaire du Bon Conseil
PLACE OF HEARING:	Montréal, Quebec
DATE OF HEARING:	November 17, 2004
REASONS FOR JUDGMENT AND JUDGMENT:	Madam Prothonotary Mireille Tabib
DATE OF REASONS:	May 20, 2005

APPEARANCES:

Nadine Dupuis	FOR THE PLAINTIFF
Christian Méthot	FOR THE DEFENDANT

SOLICITORS OF RECORD:

JOHN H. SIMS Deputy Attorney General of Canada Ottawa, Ontario	FOR THE PLAINTIFF
BOUDREAU, MÉTHOT, TOURIGNY Drummondville, Quebec	FOR THE DEFENDANT