

**Fourth Annual Pan Canadian Insolvency and Restructuring Conference
September 18-19, 2008
Four Seasons Hotel
Vancouver, B.C.**

**TAKING IT ALL AWAY – TRAPS SET FOR DEBTORS
TRYING TO DODGE THE TAXMAN**

**Katherine M. Wellburn
Murray Jamieson
Barristers and Solicitors
200 - 1152 Mainland Street
Vancouver, BC V6B 4X2
Telephone: 604-688-0777**

**TAKING IT ALL AWAY – TRAPS SET FOR DEBTORS
TRYING TO DODGE THE TAXMAN**

The power to tax means little without the power to collect. As a result, the *Income Tax Act* provides a myriad of powers to collect taxes owed that would otherwise not be obtainable when taxpayers attempt to evade their creditors.

Canada v. Livingston, 2008 FCA 89 CanLII

While a debtor with tax debts can make an assignment into bankruptcy to extinguish those debts, or make a proposal to creditors including tax debts, there are special provisions and legal principles that apply to tax debts that should be considered prior to any insolvency filing.

If the tax debt is the reason why the debtor wants to make an insolvency filing it is prudent to consider the viability of an appeal from the tax assessment prior to the debtor making the filing, particularly if the debtor would not be insolvent if the appeal is successful.

WILL BANKRUPTCY SOLVE THE PROBLEM?

The *Bankruptcy and Insolvency Act* binds the Crown unless the debt is one that falls within s.178 and would survive the bankruptcy.

Bankruptcy and Insolvency Act, s. 4.1;

Threlfall v. Rossi, [1937] 19 CBR 80 (Que. S.C.).

However, while the debt owing by the bankrupt taxpayer may be extinguished by the bankruptcy, a bankruptcy does not prevent Canada Revenue Agency (“CRA”) from pursuing its remedies against directors of a bankrupt company and its right to collect from parties related to the bankrupt taxpayer who have received transfers of assets from the taxpayer for less than fair market value.

Collection of Taxes From Parties Related To The Debtor

Even if the tax debtor is bankrupt, CRA may pursue other persons related to the bankrupt pursuant to s.160 of the *Income Tax Act* or section 325 of the *Excise Tax Act*. The purpose of these sections is to preserve the value of the existing assets of the taxpayer for collection by CRA by preventing a taxpayer from transferring property to a spouse or other non-arm’s length individual in order to thwart the Minister’s efforts to collect taxes.

Raphael v. Canada, 2002 FCA 23 CanLII;
Canada v. Livingston, supra;
Medland v. Canada, [1998] F.C.J. No 708 Q.L. (F.C.A.);
Heavyside v. Canada, [1996] F.C.J. No. 1608 (F.C.A.) (QL).

For a section 160 assessment to be raised:

- 1) There must be a transfer of property;
- 2) The parties must not be dealing at arm's length;
- 3) There must be no consideration or inadequate consideration flowing from the transferee to the transferor and
- 4) The transferor must be liable to pay tax under the *Act* at the time of the transfer.

Raphael v. Canada, supra;
Canada v. Livingston, supra.

While the intention of the parties to defraud CRA as a creditor is relevant, the assessment may be upheld even if there is no such intention and when the transferee is unaware of the tax debt.

Wannan v. Canada, 2003 FCA 423 CanLII.

The section imposes absolute liability; there is no due diligence defence.

Waugh v. The Queen, 2007 TCC 494.

The section applies even if the taxpayer maintains some control over transferred funds because its purpose would be defeated where a transferor allows a transferee to use the money to pay the debts of the transferor for the purpose of preferring certain creditors over CRA.

Canada v. Livingston, supra.

Once the conditions of section 160 have been met, the transferee becomes personally liable to pay the tax determined under that section. The liability is joint and several with that of the transferor and will only disappear with payment. The transferor's discharge from bankruptcy relieves that person from paying CRA the amount due but the order of discharge does not extinguish the debt and does not affect the liability of the transferee who is jointly bound. Section 160 gives CRA an additional means of collecting outstanding tax debts of the bankrupt outside the bankruptcy.

Heavyside v. Canada, supra;

Wannan v. Canada, supra.

A person assessed under s 160 of the *Income Tax Act* has the right to challenge the underlying assessment to the primary taxpayer, unless the taxpayer had objected and the assessment was upheld on appeal.

Gaucher v. The Queen, 2000 TCC 278 Can LII 278;

Ramey v. The Queen, [1993] F.C.J. No 142 Q.L. (T.C.C.).

The bankrupt tax debtor's statement of affairs and CRA's proof of claim is some evidence of the validity of the underlying assessment.

D'Aoust v. The Queen, 1998 TCC 318 CanLII.

The transferee has the burden of establishing fair market value of any consideration alleged to have been provided for the transferred property.

Machtinger v. Canada, [2000] F.C.J. No. 1991 Q.L. (F.C.A.)

While an outright transfer of a property may be obviously caught by s.160, CRA will frequently look to see whether the tax debtor has made any payments that increased the value of an asset held by a related party, for example by making mortgage payments on property owned by the related party. Numerous cases have considered whether mortgage payments made by a tax debtor or transfers of money for household expenses are payments made for valuable consideration, having been made pursuant to the debtor's obligation to support his or her family.

Directors' Liability

A corporation continues to exist when it becomes bankrupt and a trustee is appointed. The directors may no longer be operating the bankrupt corporation but they are still directors.

National Trust Company Limited v. Ebro Irrigation and Power Company Ltd. et al, [1954] O.R. 463 (Ont. S.C.);

Kalef v. The Queen, 95 DTC 487 (T.C.C.), 96 DTC 6132; leave to appeal S.C.C. dismissed [1996] S.C.C.A. No. 219, File No. 25290.

If a bankrupt corporation has failed to remit taxes or GST, the directors of the corporation at the time of the failure may be liable to pay those taxes.

Income Tax Act, s. 227.1;

Excise Tax Act, s. 323.

The directors' liability sections in the *Income Tax Act* and *Excise Tax Act* were enacted to impose liability, subject to certain conditions, on the directors of a corporation that failed to remit tax collected from others, such as source deductions for employees' wages, and GST collected from customers. Normally, the Crown's remedies against a corporation would be limited to the corporation's assets. The sections are meant to deter corporations from failing to remit taxes while paying other creditors, based on the presumption that a decision by a corporation to default on its remittance obligations originates with its directors

Soper v. Canada, (1997) 149 D.L.R. (4th) 297, (F.C.A.);

Kalef v. Canada, *supra*.

The sections provide that, if a company is bankrupt, a director may be found liable if a claim for the amount of the corporation's liability is proven within six months after the date of the assignment or bankruptcy order.

A director who has satisfied a claim for directors' liability is entitled to contribution from the other directors who were liable for the claim.

Section 227.1(4) of the *Income Tax Act* provides that there is a two year limitation from the time the director last ceased to be a director of the corporation for the assessment to be made against the director. A former director must lead evidence to show that he or she resigned as a director to have the benefit of the limitation period.

Kern v. Canada, [2006] F.C.J. No. 1094 Q.L. (F.C.A.).

If the company is struck from the register of companies within the two year period, CRA may bring an application to have the company restored to the register which will have the effect of restoring all directors who were directors at the date of the dissolution. This is the case even for directors who have given notice of their resignation during the period that the company was dissolved.

A director does not cease to hold that office when the company ceases commercial operations because the cessation of business operations does not deprive directors of the powers granted to them by statute and does not relieve them from the corresponding obligations and responsibilities.

Bremner v. The Queen, 2007 TCC 509.

A person who has not been properly appointed under the applicable corporate law as a director or who has resigned from that office may be considered a de facto director and fixed with liability if he or she performs the functions of a director of the company.

Wheeliker v. the Queen, [1999] 2 C.T.C. 395 (F.C.A.).

The general rule is that it is not appropriate to assess an alleged "de facto" director if there are legally appointed directors in office at the relevant times. The assessment of a de facto director should be considered only in cases where a person represents that he or she is a director. There should be written evidence of such behavior available to support the assessment.

Scavuzzo v The Queen, 2005 TCC 772 Can LII

A director may avoid liability if he or she exercised diligence to prevent the failure by the corporation to remit the tax owing. A director relying on the due diligence defence will be required to lead evidence that, as a director, he or she exercised the degree of care, diligence and skill to prevent the on-going failure to deduct and remit tax that a reasonably prudent person would have exercised in the circumstances.

Income Tax Act, s. 227.1(3);

Hanson v. Canada, 2000 FCA 16336 CanLII.

More diligence is required of experienced businesspersons and, generally, more diligence from an inside director than an outside director.

Wheeliker v. The Queen, supra, leave to appeal refused SCC;
Soper v. Canada, supra;
Drover v. Canada, 1998 FCA 7889 CanLII.

An outside director will meet the standard required by ensuring that the business is viable before investing money in it and if: (a) there are reliable and competent people who undertake the day-to-day management of the business; (b) the director stays generally informed about what is happening; (c) nothing happens which should arouse suspicion about the payment of the corporation's liabilities; and (d) the director acts quickly when problems arise.

Cadrin v. Canada, [1999] F.C.J. No. 60 Q.L. (F.C.A.).

A director is required only to act reasonably in the circumstances. The fact that his or her efforts are unsuccessful does not establish that he or she has failed to act reasonably.

Smith v. Canada, 2001 FCA 84 CanLII.

A director who has been assessed for under these sections has the right to challenge the underlying assessment to the company.

Scavuzzo v. The Queen, supra;
Kern v. Canada, supra.

If a receiver is in control of the company, this may afford the director a defence for tax not remitted during that period.

Danielson v. M.N.R. [1986] F.C.J. No. 524 Q.L. (F.C.T.D.).

Section 231 Demands

CRA has broad powers to require third parties to provide information. Section 231.2 (1) of the *Income Tax Act* provides that the Minister may require anyone to provide information or documents for "any purpose related to the administration or enforcement of this *Act*, including the collection of any amount payable under this *Act* by any person". Federal Court cases have

decided that a demand made pursuant to section 231.2 of the *Income Tax Act* is not a "proceeding" as defined by section 69.3 of the *Bankruptcy and Insolvency Act* so the stay provisions of the *Bankruptcy and Insolvency Act* do not apply. Even though there is a bankruptcy, CRA is permitted to use its powers to make demands for books and records from various third parties, including the trustee and the bankrupt.

Vancouver Trade Mart Inc. v. Canada, (1997), 50 C.B.R. (3rd) 138 (F.C.C.);

Carrefour Langelier Inc. v. Canada (Customs and Revenue Agency), 2003 FC 1403 CanLII.

The effect of subsection 69.3(1) of the *Bankruptcy and Insolvency Act* is to prevent independent action by any creditor against property of the debtor, vested in the trustee. It has no effect on the right of the Minister under section 231.2 of the *Income Tax Act* to obtain further information relevant to the tax debt. Once the information is obtained, CRA may share the information with the trustee for the benefit of the other creditors in the bankruptcy.

Carrefour Langelier Inc. v. Canada (Customs and Revenue Agency, supra.

The demands for documents may be very broad and are not limited to source documents. Documents demanded may properly include the trustee's working papers and analyses.

Vancouver Trade Mart Inc., supra.

The demand may require a third party to provide written answers to questions and may include documents that contain information about private transactions involving individuals not under investigation.

Tower v. M.N.R., 2003 FCA 307 (F.C.A.).

In some cases CRA will make extensive demands from the bankrupt's accountant. There is no privilege for tax advice from an accountant so all information and documents must be produced.

Tower, supra.

Limitation period

In *Markevich v. Canada*, [2003] 1 S.C.R. 94, the Supreme Court of Canada held that a six-year limitation period applied to collection proceedings under the *Income Tax Act*. That decision was "overruled" when parliament amended section 222 of the *Income Tax Act* to provide for a 10 year limitation period.

Collins v. Canada, 2005 FCA 1431 CanLII.

The amendment applies to any judgment made after March 3, 2004 that declares a tax debt not to be payable by a taxpayer because a limitation period ended before Royal Assent was given. Subsection (10) goes even further in deeming such tax debts to have become payable on March 4, 2004.

Canada v. Gibson, 2005 FCA 180 CanLII.

The limitation is extended if CRA is not permitted or restricted from taking action as a result of the *Bankruptcy and Insolvency Act*, *Companies' Creditors Arrangement Act* or *Farm Debt Mediation Act*.

PROPOSALS

There are certain required terms concerning tax debts that must be included in a proposal or it will not be approved by the court. Under s. 60(1.1) of the *Bankruptcy and Insolvency Act*, absent the Crown's consent, the court may only approve a proposal which pays the Crown in full any amounts owing which "are of a kind that could be subject to a demand under subsection 224(1.2) of the *Income Tax Act*" within 6 months of court approval.

Section 224(1.2) provides a super-priority garnishing power for source deductions under the *Income Tax Act*, *Canada Pension Plan*, and *Employment Insurance Act*. The effect of the section is stayed by a bankruptcy filing due to s. 69.1 of the *Bankruptcy and Insolvency Act*. Section 60(1.1) of the *Bankruptcy and Insolvency Act* was enacted to protect the Crown's interests during the stay of its garnishing powers.

Re Dav-Jor, 2006 BCCA 330.

The court will not approve a proposal that contains a clause that purports to discharge all federal and provincial tax liabilities that might arise as a result of the forgiveness of debt in the proposal and its completion.

H.M.T.Q. v. Beach, 2001 BCCA 7.

CRA will frequently require a clause to be included in the proposal whereby the debtor covenants to keep all filings, remittances and installments to CRA current during the term of the proposal. These are proper terms to be included in a proposal.

Re Silbernagel, 2006 CanLII 13427 (Ont. S.C.).

DEEMED SECURITY PROVISIONS OF THE *INCOME TAX ACT*

Under s.223 (5)(b) of the *Income Tax Act*, CRA may register a certificate, called a memorial, against real or personal property of the debtor. The memorial has the effect of a judgment, but on the bankruptcy of the tax debtor, the memorial is deemed to be secured and ranks as a secured claim under s. 87(1) of the *Bankruptcy and Insolvency Act*. These provisions were enacted to ensure that any security created under s.223 of the *Income Tax Act* would survive a bankruptcy.

Registration of a memorial in the personal property registry will create a security interest in the bankrupt's RRSP.

Attorney General of Canada v. Keith G. Collins Ltd., 2008 MBQB 64;
affirmed 2008 MBCA 92.

A proposal containing terms that CRA will take no action to enforce its security interest arising from a memorial registered against the debtor's property under the *Income Tax Act* and that it will discharge its charge upon issuance of a Certificate of Full Performance of the proposal may be effective, even if CRA votes against the proposal, provided that it files a proof of claim as an unsecured creditor.

Re Cox, 2007 BCSC 1665.

DISCHARGE APPLICATIONS

The primary objects of the *Bankruptcy and Insolvency Act* are to equitably distribute the assets of the debtor and for the rehabilitation of the bankrupt, unfettered by past debts. At the time of the bankrupt's discharge application the court will consider the bankrupt's conduct both before and during the bankruptcy.

Industrial Acceptance Corporation v. Lalonde, [1952] 2 S.C.R. 109;

Links v. Robinson (1970), 16 C.B.R. (N.S.) 180 (Alta. C.A.).

The law has developed so that a bankrupt with a large tax debt is treated differently from other bankrupts when the court is considering terms for discharge. This distinction is because everyone in the country must share the burden of taxes.

Re Katari, (1989), 74 C.B.R. (N.S.) 178 (Ont. S.C.).

The courts may refuse discharge for debtors who have persistently ignored tax obligations and scoffed at the tax system by letting tax arrears build up and enjoying tax-free income until bankruptcy.

Re Raymer, (1997), 43 C.B.R. (3d) 263 (Ont. Gen. Div.);

Re Wehner, 2000 CanLII 19763 (Sask Q.B.).

To prevent the bankruptcy system from being abused, the court will provide a significant sanction to a bankrupt who has displayed an apparent indifference or disregard towards tax obligations. Usually the sanction will take the form of a significant conditional order of discharge based on a percentage of the tax debt.

Re Steward, 1991 CanLII 1519 (B.C.C.A.), (1991), 4 C.B.R. (3d) 240, affirmed 76 C.B.R. (N.S.) 181 (B.C.C.A.);

Re Toal (1993), 20 C.B.R. (3d) 120 (Alta. Q.B.); affirmed (1996), 39 C.B.R. (3d) 39 (Alta. C.A.);

Re Martino, 2004 CanLII 17978 (Ont. S.C.);

Re Martens, [1994] A.J. No. 1265 Q.L. (Alta Q.B.);

Re Graham, [1997] S.J. No. 35 (Sask. Q.B.);;

Re LeMaigre (1997), 46 C.B.R.(3d) 236 (Sask Q.B.);

Links v. Robinson (1970), 16 C.B.R. (N.S.) 180 (Alta. C.A.).

The question of whether a bankruptcy arises through unfortunate events on the one hand, or through indifference to obligations on the other hand, is an important distinction on the discharge of a bankrupt with significant tax debts. The court will consider the evidence presented to determine if the bankrupt preferred creditors over CRA and whether the bankruptcy was designed to avoid payment of tax debts.

Re Steward, supra.

If the court chooses to impose conditions for discharge it must be within the bankrupt's capacity to fulfill those conditions and to fulfill them within a reasonable period of time.

Re McCallum, (1988) 29 B.C.L.R. 2, 333 (B.C.C.A.)

Re: Boucher, 2007 BSCS 644.

Even in a tax driven bankruptcy, the court may not order a monetary conditional discharge if the bankrupt has no ability to pay and the only realistic source of payment is the bankrupt's spouse. In some circumstances the court may adjourn the discharge application for a period of time in order to determine the bankrupt's ability to pay a conditional order of discharge in the future.

Re Alexander, [2007] BCSC 564

Katherine M. Wellburn
Murray Jamieson
Barristers and Solicitors
200 - 1152 Mainland Street
Vancouver, BC V6B 4X2

LIST OF CASES

Re Alexander, [2007] BCSC 564

Attorney General of Canada v. Keith G. Collins Ltd., 2008 MBQB 64;
affirmed 2008 MBCA 92

Bremner v. The Queen, 2007 TCC 509

Re: Boucher, 2007 BSCS 644

Cadrin v. Canada, [1999] F.C.J. No. 60 Q.L. (F.C.A.)

Canada v. Gibson, 2005 FCA 180 CanLII

Canada v. Livingston, 2008 FCA 89 CanLII

Carrefour Langelier Inc. v. Canada (Customs and Revenue Agency), 2003 FCA 1403 CanLII

Collins v. Canada, 2005 FCA 1431 CanLII

Re Cox, 2007 BCSC 1665

Danielson v. M.N.R. [1986] F.C.J. No. 524 Q.L. (F.C.T.D.)

D'Aoust v. The Queen, 1998 TCC 318 CanLII

Re Dav-Jor, 2006 BCCA 330

Drover v. Canada, 1998 FCA 7889 CanLII

Gaucher v. The Queen, 2000 TCC 278 Can LII 278

Re Graham , [1997] S.J. No. 35 (Sask. Q.B.);

Hanson v. Canada, 2000 FCA 16336 CanLII

Heavyside v. Canada, [1996] F.C.J. No. 1608 (F.C.A.) (QL)

H.M.T.Q. v. Beach, 2001 BCCA 7

Industrial Acceptance Corporation v. Lalonde, [1952] 2 S.C.R. 109

Kalef v. The Queen, 95 DTC 487 (T.C.C.), 96 DTC 6132. leave to appeal S.C.C. dismissed [1996] S.C.C.A. No. 219, File No. 25290

Re Katari, (1989), 74 C.B.R. (N.S.) 178 (Ont. S.C.)

Kern v. Canada, [2006] F.C.J. No. 1094 Q.L. (F.C.A.)

Links v. Robinson (1970), 16 C.B.R. (N.S.) 180 (Alta. C.A.)

Re LeMaigre (1997), 46 C.B.R. (3d) 236 (Sask Q.B.)

Machtinger v. Canada, [2000] F.C.J. No. 1991 Q.L. (F.C.A.)

Markevich v. Canada, [2003] 1 S.C.R. 94

Re Martino, 2004 CanLII 17978 (Ont. S.C.);

Re Martens, [1994] A.J. No. 1265 Q.L. (Alta Q.B.)

Re McCallum, (1988) 29 B.C.L.R. 2, 333 (B.C.C.A.)

Medland v. Canada, [1998] F.C.J. No 708 Q.L. (F.C.A.)

National Trust Company Limited v. Ebro Irrigation and Power Company Ltd. et al, [1954] O.R. 463 (Ont. S.C.)

Ramey v. The Queen, [1993] F.C.J. No 142 Q.L. (T.C.C.)

Raphael v. Canada, 2002 FCA 23 CanLII

Re Raymer, (1997), 43 C.B.R. (3d) 263 (Ont. Gen. Div.)

Scavuzzo v The Queen, 2005 TCC 772 Can LII

Re Silbernagel, 2006 CanLII 13427 (Ont. S.C.)

Sinnot v. The Queen, (2002) C.B.R. (4th) 151 (T.C.C.)

Smith v. Canada, 2001 FCA 84 CanLII

Soper v. Canada, (1997) 149 D.L.R. (4th) 297, (F.C.A.)

Re Steward, 1991 CanLII 1519 (B.C.C.A.), (1991), 4 C.B.R. (3d) 240, affirmed 76 C.B.R. (N.S.) 181 (B.C.C.A.)

Threlfall v. Rossi, [1937] 19 C.B.R. 80 (Que. S.C.)

Re Toal (1993), 20 C.B.R. (3d) 120 (Alta. Q.B.); affirmed (1996), 39 C.B.R. (3d) 39 (Alta. C.A.);

Tower v. M.N.R., 2003 FCA 307 CanLII

Vancouver Trade Mart Inc. v. Canada, (1997) 50 C.B.R. (3rd) 138 (F.C.C.)

Wannan v. Canada, 2003 FCA 423 CanLII

Waugh v. The Queen, 2007 TCC 494

Re Wehner, 2000 CanLII 19763 (Sask Q.B.)

Wheeliker v. The Queen, [1999] 2 C.T.C. 395 (F.C.A.)