

Financial Services Flash

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Leased Assets and Deemed Trust Claims

Canada Revenue Agency (“CRA”) has the power, pursuant to sections 224 and 227 of the *Income Tax Act* (Canada) (the “ITA”), to assert a deemed trust claim on assets held by an insolvent debtor when it has outstanding debts in respect of certain payables owing to CRA. A “super priority” attaches to such deemed trust claims, allowing CRA to collect amounts owing to it ahead of other secured creditors who have a perfected “security interest” under a provincial *Personal Property Security Act* (collectively, the “PPSA Statutes”). Despite this super priority, Canadian Courts have ruled that such deemed trust claims do not, in appropriate circumstances, attach to certain other assets which are leased to the insolvent debtor.

This ruling stems from a line of cases which distinguish between the definitions of the term “security interest” in the ITA and the PPSA Statutes. The definition of “security interest” in subsection 224(1.3) of the ITA does not include the word “lease,” but the PPSA Statutes’ definition of “security interest” specifically states that it includes a “lease.” Further, the PPSA Statutes apply to every transaction, without regard to the party who has title to the collateral, that in substance creates a security interest. Such an expansive application provision is not present in the applicable provisions of the ITA.

Given these distinctions between the ITA and the PPSA Statutes, Courts in Ontario (in *Bank of Nova Scotia v. Turyders Trucking Ltd.*), British Columbia (in *DaimlerChrysler Financial Services (Debis) Canada Inc. v. Mega Pets Ltd.*) and Saskatchewan (in *Minister of National Revenue v. Schwab Construction Ltd.*) have all held that leases in which ownership remains with the lessor are not a “security interest” within the meaning of section 224(1.3) of the ITA and, as such, are not subject to the CRA’s deemed trust claims. To find otherwise would, in the words of the Courts involved, “allow [CRA] to claim, as part of its deemed trust, property not owned by the [debtor] but owned by an innocent third party who had just agreed to allow the [debtor] to use its property for a certain price pursuant to the terms of a lease agreement.” The result would be that the actual owner of the property would be responsible for the income tax obligations of the debtor. It also would allow CRA to expand the scope of the deemed trust by relying on PPSA legislation where the ITA itself does not assist it. Support for these decisions is found in the long-established principle of law that, in the absence of clear language to the contrary, a tax on one person cannot be collected out of property belonging to another.

An important feature of this line of cases is that the distinction between “true leases” and “financing leases” is irrelevant for determining whether assets leased to a debtor are subject to deemed trust claims under the ITA. While the distinction between types of leases may be important for certain considerations under the PPSA Statutes themselves, the case law states that the ITA is a self-standing statute which does not incorporate the PPSA. Therefore, if a lessor retains ownership of a leased asset, it does not form part of the property subject to deemed trust claim until such time as a lessee exercises an option to purchase. In fact, even conditional sales contracts which stipulate that the seller reserves title until the buyer pays for goods in full have, in certain situations, proven to be adequate protection of an interest in the underlying asset from that asset’s inclusion in deemed trust property.

The Financial Services Group at Aird & Berlis LLP has a great deal of experience in advising lessors in financing arrangements and insolvency proceedings and may be able to assist in structuring leasing agreements to ensure assets will not be subject to deemed trust claims by CRA. For more information on leases and deemed trust claims, please contact any member of the Financial Services Group. Details can be found on our [Financial Services, Insolvency and Restructuring web page](#), by clicking on [members](#).

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