

Crown Debt: Can It Be Given As a Security?

DEBORAH HOLBROOK

The author discusses when, under Canadian law, a creditor can accept an assignment or pledge of debts owed by the Crown to a taxpayer.

According to Section 67 of the *Financial Administration Act*, the assignment or pledge of debts owed by the federal Crown to a taxpayer is expressly prohibited, except as permitted elsewhere in the *Financial Administration Act* or other Act of Parliament.¹ Several provinces and territories, including Alberta, New Brunswick, Northwest Territories, Nunavut, and the Yukon, have similar restrictions with respect to provincial or territorial Crown debt in their Financial Administration Acts,² although no such restriction exists with respect to Ontario Crown debts. There are, however, several exceptions to this rule that permit taxpayers to assign, and even pledge, debts of the federal Crown to third parties (albeit without granting those third parties recourse against the Crown). These exceptions fall into the following three categories:

- (1) exceptions under the Financial Administration Act;
- (2) exceptions under the Income Tax Act;³ and
- (3) exceptions under the Tax Rebate Discounting Act.⁴

Deborah Holbrook is an associate in Aird & Berlis LLP's Financial Services Practice Group.

EXCEPTIONS UNDER THE FINANCIAL ADMINISTRATION ACT

Section 70 of the Financial Administration Act provides that the prohibition against the assignment of Crown debt does not apply to three kinds of debt.⁵ First, it does not apply to negotiable instruments, which include cheques, drafts, traveller's cheques, bills of exchange, postal notes, money orders, postal remittances and other similar instruments. Second, it does not apply to debts owed by certain Crown corporations, including the Canada Post Corporation, Royal Canadian Mint, and Business Development Bank of Canada. (A complete list of Crown corporations whose debts are exempt from the prohibition is set out in Parts I and II of Schedule III to the Financial Administration Act.) Finally, the prohibition does not apply to any securities issued under Part IV of the Act, in relation to public debt. Crown debts that fall into any of these categories are excluded altogether from the prohibition against assignment and can be assigned, pledged, or otherwise encumbered.

In addition to these exclusions, Section 68 of the Financial Administration Act sets out criteria for Crown debts that *may* be assigned, notwithstanding Section 67.⁶ First, the debt must be an amount due or becoming due under a contract that involves the payment of money by the Crown.⁷ Second, the assignment must be absolute, in writing, and made under the hand of the assignor (or, in the case of a corporation, the appropriate officers of the corporation, as set out in the Act). Third, the assignment must *not* be by way of charge only. Lastly, notice of the assignment must be given to the Crown in the manner set out in the appropriate regulation made under the Act.⁸ The section stipulates, however, that notwithstanding the foregoing, amounts owing to a taxpayer on account of salary, wages, pay, or pay and allowances are not assignable under any circumstances.

At one time, it was believed that assignments made in breach of the prohibition against assignment, and therefore ineffective as between the assignor and the Crown, were nevertheless effective as between the assignor and assignee. This line of thinking was supported by the 1981 decision of a Nova Scotia Supreme Court judge who, in *Re Northward Airlines Ltd.*,⁹ accepted the argument that, even if the assignment was

ineffective vis-à-vis the assignor and the Crown as creditor, it was effective between the assignor and assignee once the funds had come into the hands of the assignor because the assignee would then have a beneficial interest in the funds. This reasoning and result was expressly rejected, however, by the Supreme Court of Canada in *Marzetti v. Marzetti*.¹⁰ In this 1994 decision, Justice Iacobucci held that assignments caught by Section 67 not only deny the assignee any rights vis-à-vis the Crown, but also deny the assignee any rights vis-à-vis the assignor. Specifically, Justice Iacobucci held that, under Section 67,

a purported assignment of a Crown debt is rendered absolutely ineffective, as between debtor and creditor, and as between assignor and assignee.¹¹

In 2002, the Ontario Court of Appeal followed the Supreme Court's decision in *Marzetti* and further clarified that a security interest given with respect to a Crown debt is also prohibited by Section 67. It had been thought by some lawyers that the grant of a security interest in a Crown debt might not be caught by Section 67 since, under the modern Personal Property Security Acts, the grant of a security interest did not necessarily involve an assignment. However, in *Profitt v. Wasserman*,¹² the Court found that the security interest granted therein violated the prohibition set out in Section 67 of the Act.

The results in both *Marzetti* and *Profitt* suggest that the courts are prepared to give the widest possible interpretation to the prohibition against assigning federal Crown debts. That being said, there is nevertheless room for lenders to take advantage of debts owed by the Crown to potential borrowers. Where the debts meet the criteria set out in Section 68 of the Act, lenders can arrange for their borrowers to assign those debts absolutely as part of their repayment plan or can otherwise take those amounts into account when structuring loan transactions.

EXCEPTIONS UNDER THE *INCOME TAX ACT*

Subsection 220(6) of the Income Tax Act provides another exception to the prohibition against assigning a federal Crown debt by expressly

permitting the assignment by corporations of amounts payable under the Income Tax Act:

(6) Notwithstanding section 67 of the Financial Administration Act and any other provision of a law of Canada or province, a corporation may assign any amount payable to it under this Act.¹³

It is noteworthy that this provision does not require that the assignment be absolute and not by way of charge only. Accordingly, corporations may assign *or* pledge any amounts owing to them by the Crown under the Income Tax Act, and lenders can take security in corporate taxpayers' income tax returns, rebates, or other tax credits.

For example, where a corporate borrower is entitled to a tax credit under the Scientific Research and Experimental Development Expenditures Program, which is administered by Canada Revenue Agency, a lender can take advantage of this exception by entering into an assignment agreement with the corporate borrower, whereby the borrower assigns to the lender any and all present or future tax credits that the borrower is entitled to receive thereunder.

It should be noted, however, that subsection 220(7) of the Income Tax Act provides that such assignments are not binding on the Crown. Specifically, the subsection provides (a) that the Minister is not required to pay the assigned amount to the assignee, (b) that the assignment does not create any liability on the part of the Crown to the assignee, and (c) that the rights of the assignee remain subject to the Crown's right to set-off amounts owing to the taxpayer against debts owing by the taxpayer to the Crown. This means that an assignee is put in the unusual situation, where, although it may hold a valid assignment of amounts owed by the Crown, it nevertheless cannot exercise any remedy against the Crown should the Crown not pay the assigned amounts.

EXCEPTIONS UNDER THE *TAX REBATE DISCOUNTING ACT*

The Tax Rebate Discounting Act permits a person (referred to as a "Discounter" in the Act) to purchase, and thereby acquire, the right to a

taxpayer's income tax refund.¹⁴ The Act regulates the amount of consideration that the Discounter must pay to acquire the right to a taxpayer's tax refund by way of a formula¹⁵ and sets out the potential acts of Discounters that constitute offences under the Act.¹⁶ Again, it should be noted that, although the right acquired under the Act permits the Minister of National Revenue to pay the income tax refund directly to the Discounter and deems such payment to constitute payment of the refund to the taxpayer, the right to the refund is acquired as between the Discounter and the taxpayer *only* and is not enforceable against the Crown.¹⁷

Although this exception is not as directly relevant to lenders as it is to accountants and others who prepare tax returns and advance monies in relation thereto, it is nevertheless useful for lenders to be aware of this Act in the event that they lend to such a Discounter or that they find they need to take advantage of it to obtain direct access and entitlement to a borrower's income tax refund.

CONCLUSION

It is extremely important for lenders to be aware of the fact that there are restrictions on the assignability and enforceability of the assignment of Crown debts, both federally and, in some cases, provincially. This is relevant both for determining what receivables can be included in a borrower's borrowing base, as well as ensuring that the security taken with respect to a borrower sufficiently covers the loan. However, it is equally important for lenders to be aware of the exceptions to these restrictions and to recognize that there are creative ways to take advantage of them.

NOTES

¹ Financial Administration Act, R.S.C. 1985, c. F-11, s. 67

² Financial Administration Act, R.S.A. 2000, c. F-12, s. 94; Financial Administration Act, R.S.N.B. 1973, C. F-11, ss. 50-52; Financial Administration Act, R.S.N.W.T. 1988, c. F-4, s. 69; Financial Administration Act, R.S.Y. 2002, c. 87, s. 26

³ Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.)

⁴ Tax Rebate Discounting Act, R.S.C. 1985, c. T-3

⁵ *Supra* note 1 at s. 70.

⁶ *Ibid.* at s. 68.

⁷ *Ibid.* at ss. 66 and 68.

⁸ Assignment of Crown Debt Regulations, Regulation C.R.C., c. 675 made under the Financial Administration Act, R.S.C. 1985, c. F-11.

⁹ *Re Northward Airlines Ltd.* (1981), 37 C.B.R. (N.S.) 137 (N.S.S.C.)

¹⁰ *Marzetti v. Marzetti*, [1994] 2 S.C.R. 765, 116 D.L.R. (4th) 577 (S.C.C.)

¹¹ *Ibid.* at p. 805.

¹² *Profitt v. Wasserman* (2002), 32 C.B.R. (4th) 94, (2002), 157 O.A.C. 356 (Ont. C.A.)

¹³ *Supra* note 3 at ss. 220(6).

¹⁴ *Supra* note 4 at s. 2(2).

¹⁵ *Ibid.* at ss. 2(1).

¹⁶ *Ibid.* at ss. 3-6.1.

¹⁷ *Ibid.* at ss. 2(3).