Ontario Real Estate Law Developments

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Recent Cases

A Big Win for the Crown — Deemed Trusts Take Priority over Security Interests

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Introduction

It was a big win for the Crown in the recent case of *Her Majesty The Queen v. The Toronto-Dominion Bank*, 2018 FC 538. Mr. Justice Grammond of the Federal Court of Canada held that a statutory deemed trust for unremitted GST amounts took priority over money received by a bank in payment of a loan secured by a mortgage. In reaching this decision, the Court reviewed the history of the deemed trust provisions in the *Income Tax Act* (the "ITA") and the *Excise Tax Act* (the "ETA") and considered the case law relating to the interpretation of these provisions. The Court analysed the bank's obligations to pay to the Crown the money received by the bank, the bank's defence as a *bona fide* purchaser for value, and the policy or fairness arguments raised by the bank. As a consequence of this decision, secured creditors will need to pay attention to these statutory deemed trusts in assessing their lending risk.

Facts

1. Mr. Weisflock (the "Taxpayer") carried on business as a sole proprietorship. In 2007 and 2008, he collected, but failed to remit goods and services tax ("GST") in the total amount of $67,854 to the Receiver General of Canada.
2. In 2010, The Toronto-Dominion Bank (the "Bank") granted the Taxpayer a line of credit and a mortgage, both of which were secured by a registered mortgage over his house. At the time of these loans, the Bank was not aware of the Taxpayer's unremitted GST amounts.
3. In 2011, the Taxpayer sold his house and fully repaid his loans to the Bank out of the proceeds of sale, following which the Bank's security against his house was discharged.
4. In 2013, Canada Revenue Agency ("CRA") issued a demand letter to the Bank seeking repayment of the Taxpayer's unremitted GST in the amount of $97,327 on the basis of the deemed trust provisions in the ETA.
5. In 2015, CRA issued a revised demand letter to the Bank correcting the previous amount claimed to $67,854.
6. When the Bank refused to pay the $67,854, the Crown took legal action against the Bank to recover this amount.

7. The Court found in favour of the Crown and ordered the Bank to pay the Crown the sum of $67,854, together with pre-judgment interest from the date the cause of action arose (namely, October 28, 2011 when the Bank received the proceeds from the sale of the Taxpayer's house), plus post-judgment interest and costs.

The Court's Reasoning

The Court reviewed the history of the deemed trust provisions in the ETA and the ITA. The Court noted that prior to 1997, the legislation merely provided that an employer who deducts or withholds income tax amounts (in the case of the ITA) or a person who collects GST (in the case of the ETA) holds that money in trust for Her Majesty. Following the decision of the Supreme Court of Canada in *Royal Bank of Canada vs. Sparrow Electric Corp*. [1997] 1 SCR 411, the Government announced that it would change the legislation to give absolute priority to deemed trusts over secured creditors. Both the ITA and the ETA were amended to provide that:

1. the deemed trust would extend to property acquired after the trust arises; and
2. the deemed trust would take priority over the security interests of creditors.

The Court then proceeded to determine whether section 222 of the ETA imposed an obligation on the Bank to repay the Crown the amount of $67,854 that the Bank received from the Taxpayer. The Court found that this amount constituted "proceeds" of the sale of the Taxpayer's property which was the subject of the deemed trust. This deemed trust covered the Taxpayer's house, despite the Bank's mortgage registered on title.

The Bank tried to argue that the deemed trust provision only applied in situations where the proceeds were obtained by the secured creditor as a result of enforcing its security and selling the debtor's property to repay the loan. The Court rejected this argument and stated at Page 12:

> "To summarize, the phrase 'the proceeds of the property shall be paid to the Receiver General' in section 222(3) of the ETA encompasses proceeds from the voluntary sale of the tax debtor's property. Upon such a sale, a tax debtor has an obligation to pay the proceeds to the Receiver General. If the tax debtor fails to do so and pays a secured creditor instead, that creditor has an obligation to repay the money to the Crown."

The Court also rejected the Bank's defence that the Bank was a *bona fide* purchaser for value. In the Court's view, the case law clearly established that secured creditors are not entitled to invoke this defence in the context of the deemed trust under the ETA and the IFA. Based on the decision of the Supreme Court of Canada in *First Vancouver Finance v. MRN* [2002] 2 SCR 720 and on the subsequent cases, the Court stated that the *bona fide* purchaser for value defence was not available to secured creditors. According to the Court, Parliament had chosen to treat secured creditors differently. The Court made the following comment at Page 17 on the amendments to the legislation:

> "... the 1998 and 2000 amendments to the ITA and ETA deemed trust provisions are based on the premise that a secured party cannot invoke the *bona fide* purchaser for value defence when it enforces its security or receives a payment from its debtor. If that defence were available, secured creditors would almost always be able to invoke it to defeat the mechanism of the deemed trust. When a secured creditor receives a payment, it usually gives or has given something of value in exchange, whether the granting of the loan or the discharge of the security when the loan is repaid. Moreover, secured creditors are most often unaware of the existence of a tax debt when they receive a payment. Thus, the *bona fide* purchaser for value defence is inconsistent with Parliament's intent."

The Court went on to note that this defence of *bona fide* purchaser for value remains available to unsecured creditors, such as suppliers, landlords or public utilities, who receive payments from a tax debtor. The Court commented on Page 19:

> "The results of this may be that unsecured creditors will often be in a position to be *bona fide* purchasers for value, whereas secured creditors cannot. At first blush, this might appear absurd, but on closer examination, it may have been a rational decision for Parliament to make. By definition, security interests are meant to provide a very strong inducement to debtors to pay their secured creditors first, before paying unsecured ones, and, in all likelihood, before paying tax debts to the Crown."

The Bank tried to argue that the deemed trust only came into operation upon the occurrence of a crystallization or a triggering event. The Bank took the position that this event occurred when the Crown sent its first demand letter to the Bank in 2013, at which the time the Bank was no longer a secured creditor of the Taxpayer. The Bank's counsel used the

analogy of the deemed trust being a "net" that can only fall over trust property at a specific moment. In rejecting the need for a triggering event, the Court responded at Page 21 that "Parliament crafted a very special net for Her Majesty, one that is permanently triggered or deployed."

Finally, the Bank raised a number of policy or fairness arguments, based on the proposition that the payment received by the Bank from the Taxpayer was, in effect, being expropriated to satisfy the Taxpayer's debts to the Crown. While acknowledging the principle of protection of private property, the Court said that courts must bow to Parliamentary supremacy. According to the Court, Parliament was fully aware of the consequences of the amendments to the deemed trust provisions on private property and the allocation of financial risk. The Court concluded at Page 23:

> "Nevertheless, Parliament made the choice to disregard the proprietary interest in secured creditors and to grant the Crown an absolute priority. I cannot cut down the scope of the legislation in an attempt to bring it in line with the principle of protection of private property without thwarting Parliament's intent."

The Court acknowledged the argument that the consequences of its interpretation were harsh on secured creditors, especially on loans to individuals as opposed to businesses. However, the Court noted that Parliament had already considered that potential hardship and provided a remedy in section 222(4) of the ETA. This section states that for the purposes of the deemed trust provisions a security interest does not include a "prescribed security interest". The Regulations to the ETA state that a certain portion (set out in the Regulations) of a mortgage over land or a building is a "prescribed security interest" provided that the mortgage is registered before the deemed trust arises. Since Parliament had already considered the potentially harsh consequences of the deemed trust on secured creditors and had drawn a line as to what was exempted, the Court could not draw the line elsewhere.

Conclusions

This case is an important decision that will generate a lot of discussion in the lending and legal community. It serves as a reminder to lenders regarding the importance of considering the effect of statutory deemed trusts on their secured loan transactions. It applies to secured loans, whether the debtor is an individual or a business.

As part of their due diligence process, a lender should specifically ask a prospective debtor whether the debtor is liable for any unremitted amounts under the ITA or the ETA. A lender can also request their prospective debtor to sign the consent forms used by CRA to give the lender access to all of the debtor's individual tax and business program accounts. However, even if CRA discloses information to the lender with the debtor's consent, the lender may not necessarily be able to rely on this disclosure because of the "errors and omissions excepted" qualification.

Some lenders insert a provision in their loan commitments that requires the borrower to provide annual evidence regarding the payment of source deductions, HST, and other amounts that could form the basis for a statutory deemed trust. Even if the borrower provides this information to the lender annually, it does not mean that the borrower has paid all of the proper amounts that were actually due and owing according to the applicable legislation.

Some lenders require a semi-annual confirmation of payment of all super priority claims prepared by the borrower's accountant. While not perfect, this at least causes a degree of external review and due diligence – provided that the lender follows up and requires this confirmation to happen.

Where the security for the loan is a mortgage in favour of the lender over real property, the lender may be able to obtain some measure of protection by obtaining a lender's policy of title insurance. Unless the lender had knowledge of the claim for a statutory deemed trust at the time the mortgage was granted, title insurance would normally protect the lender for unremitted tax amounts owed by the mortgagor up to the registration date of the mortgage. For this reason, it is important to determine when the claim for tax arrears arose, because only those claims that were in existence prior to the date of the title insurance policy would be covered.

Unfortunately for the lender, the title insurance coverage ceases when the mortgage loan is repaid. This means that title insurance offers no protection to the lender if CRA makes demand upon a lender seeking repayment of the mortgagor's unremitted tax amounts after the mortgage has been repaid and discharged.

In conclusion, the onus is clearly on secured creditors to make these inquiries relating to deemed trusts and to assess their lending risk.

RECENT CASES

Judge Erred in Finding Respondents Established Requirements for Prescriptive Easement

Ontario Court of Appeal, July 18, 2018

The parties were neighbouring homeowners with a 14-foot wide strip of land between their houses (the "driveway"). The appellants had purchased their home in 2003 and the respondents in 1980. When the respondents purchased their property, they obtained a survey describing an unregistered right-of-way. The parties' garages were behind their homes and were accessed exclusively through the driveway. The property line ran down the center of the driveway. In 2016, the appellants erected a fence down the center of the driveway. As a result, the respondents could no longer fit their car through the driveway because a retaining wall at the front of their house narrowed the driveway at that point. The predecessors in title to the properties had entered into an agreement in 1980 that recorded mutual grants of a "right-of-way" over portions of the driveway. The agreement stated that the "laneway" would be used to access the rear of both lots, that the parties to the agreement agreed not to block the laneway, and that they would split repair costs. The agreement was limited to 21 years.

The respondents applied for an order that they were entitled to a prescriptive easement over the appellants' driveway based on the doctrine of lost modern grant. The application judge, on the basis of the historical use of the disputed land, granted the application and ordered that the appellants remove the fence. The appellants appealed, taking the position that the requirements for a prescriptive easement had not been established.

The appeal was allowed. Based on case law, the Court found that the respondents had to prove uninterrupted and unchallenged use "as of right" for the prescriptive period from 1957 to 1979. The evidence indicated that, at best, the predecessors in title, acting as "good neighbours," permitted each other to cross the property line to access their garages. There was no evidence that either did so as a matter of right. Further, the agreement was compelling evidence that the use was by way of permission. If the agreement only clarified the existing rights of the owners in 1979, and had there been a pre-existing right-of-way, the 21-year limit would not make sense. The record suggested that both predecessor owners were unsure of their rights. The Court held that the application judge had erred in finding that the witness evidence of the son of the respondents' predecessor in title along with the survey, supported the inference of acquiescence during 20 years of use. Accordingly, the claim for a prescriptive easement had to fail.

The Court further found that the application judge had also erred in holding that the right-of-way was reasonably necessary for the enjoyment of the respondents' property. The question turned on the placement of the retaining wall. The application judge had found that there was no reason to assume that the wall was not practically necessary to the property. The Court stated that the application judge had engaged in impermissible speculation and reversed the onus of proof, requiring the appellants to establish that the easement was not necessary and that the retaining wall could be taken out. When confronted with the question, the respondents did not address the issue of the origin of the wall. It was up to the respondents to establish that the easement was reasonably necessary to the enjoyment of their property.

English v. Perras
2018 OREG ¶ 59,294

No Error in Finding Sales Invalid Where Enforcement Rights Were Suspended Under *Mortgages Act*

Ontario Court of Appeal, July 27, 2018

The appellant, Robert Van Alphen ("Robert"), operated a business in a building owned by the respondent, 1463096 Ontario Inc. (the "landlord"). The property was leased to Robert's company, the appellant, 1358329 Ontario Inc. ("135"). In March 2008, the landlord defaulted on its mortgage. The mortgagee issued a notice of sale to the landlord in November 2008. In January 2009, Robert's other company, the appellant 1173928 Ontario Inc. ("117"), purchased the mortgage from the mortgagee for the balance owing and listed the property for sale. 117 received an assignment of the mortgage. The landlord brought an application under section 20 of the *Commercial Tenancies Act* seeking arrears of rent,

and seeking to restrain 117 from enforcing the mortgage. In March 2009, 117 brought a mortgage action. In October 2009, 117, as mortgagee, entered into an agreement of purchase and sale with itself as purchaser to buy the property. Since 117 did not have an interest in the mortgage, as it had assigned the mortgage to another party, the sale was not valid. In November 2009, a judge granted 117 an interim order relieving it from forfeiture of the lease. In August 2010, the judge ordered that 117 and Robert pay rental arrears for January 2007 to August 2010. In October 2010, 117 attempted to purchase the property again, purporting to convey the property to itself under power of sale. 117 then purported to convey the property in fee simple to the landlord. All of the attempts to sell the property were based on the original notice of sale issued by the original mortgagee.

At the trial of the mortgage and lease actions, the judge found that the second sale was invalid, because 117 lacked good faith when purporting to transfer its security to itself. The third sale was also invalidated, since 117 did not have title to the property at the time. Accordingly, the landlord held title throughout. The judge granted judgment in the lease action in favour of the landlord. All amounts owed under the mortgage were paid in full by November 2014, and 117 thus held no further rights under the mortgage. The mortgage action was dismissed. The appellants appealed.

The appeal was dismissed. The Court held that there was no error in the trial judge's finding that 117 had failed to provide updated statements of account to the landlord to reflect the reduction of the mortgage balance that resulted from the attornment of rents. Consequently, the landlord was prejudiced in its ability to assess its position under the mortgage. The actual mortgage amount could not be determined without a trial. This was contrary to subsections 22(2) and (3) of the *Mortgages Act*. As the second and third sales were executed at a time when 117's enforcement rights were statutorily suspended under section 22(2), the second and third sales were invalid. This was a sufficient basis on which to dismiss the appeal.

The Court further found that the trial judge had not erred in holding that the original mortgagee's notice of sale was invalid under section 31 of the *Mortgages Act*. The notice of sale did not reflect the correct amount that was needed to redeem the mortgage. The Court did not accept that errors in the amounts in the notice of sale did not materially affect the landlord's ability to redeem. The Court also did not accept the argument that partial mortgage arrears payments do not automatically lead to the requirement of a new notice of sale. While the trial judge found that a fresh notice of sale was required due to the flow of time and the change in the stream of attorned rental payments, a notice of sale, being a point-in-time document, does not become inaccurate with the flow of time. Changes in accounts are addressed through a mortgage statement under section 22 of the *Mortgages Act*, not a fresh notice of sale.

1173928 Ontario Inc. v. 1463096 Ontario Inc.
2018 OREG ¶ 59,295

Court Found Sale Was for Residential Unit Subject to HST Exemption

Ontario Superior Court of Justice, July 5, 2018

The plaintiff vendor owned a large parcel of land in Oakville that it had subdivided into three lots, lot 27, 28, and 29. A home that was on the original parcel straddled lots 28 and 29 and an indoor pool house structure was located on lot 27. The pool house was linked to the home by a covered hallway that was partially on lot 28. In March 2015, the parties executed an agreement of purchase and sale ("APS") for lot 27, which was listed as vacant land, for $2.8 million. The parties addressesd the issue of the payment of HST on the property. The APS stated, "If the sale of the property is not subject to HST, Seller agrees to certify on or before closing, that the sale of the property is not subject to HST." On the closing date, the vendor provided a statutory declaration stating that the sale was exempt from section 2, 3, or 4 of Part 1 of Schedule V of the *Excise Tax Act* (the Act), as it was a "used residential complex." The APS required that any existing structures be demolished by the vendor, which the vendor did after closing.

One year after closing, while applying for a building permit, the purchaser was advised that the Town of Oakville would be charging a development fee of $58,097. After requesting the payment of this from the vendor pursuant to the terms of the APS, the vendor advised the purchaser that the development charge would be set off against the $364,000 in HST that was allegedly owed by the purchaser. The vendor brought a motion for summary judgment seeking payment of the HST. The purchaser brought a cross-motion, seeking payment of the development fee. The vendor had filed a tax return with respect to the HST that it believed was owing but had not yet remitted the payment.

The motion was dismissed. The cross-motion was granted. Pursuant to case law, the material time for determining whether the property was a "residential complex" and a "residential unit" subject to an HST exemption under the Act was the time of closing. The onus was on the vendor to establish that the exemption did not apply and that HST was therefore payable. The definition of residential complex, as found in subsection 123(1) of the Act, includes any appurtenances to the building. The pool house was attached to the main home by a permanently-covered stone hallway, was made of the same stone as the house, and was insulated and drywalled.

The Court concluded that, at the time of closing, the residence and pool structure constituted a complete structure that was suitable for habitation and that the pool house was an appurtenance to the detached home. The Court found that, although the APS required the demolition of the pool house, the purchaser had become the owner of the land as of closing, at which time the property still contained the pool house. The transaction was thus for a used residential unit, and was therefore exempt under the Act. Accordingly, HST was not payable. In the alternative, the Court found that the vendor's statutory declaration was intended to be relied on and the purchaser did rely on it. If HST was payable, it was payable by the vendor and the vendor had no claim against the purchaser for it. The vendor offered no substantive defence to the cross-motion. Under the APS, the development fees were payable by the vendor.

2137691 Ontario Ltd. v. Park
2018 OREG ¶ 59,296

Applicant Did Not Establish That Discharge of Restrictive Covenant Was Warranted

Ontario Superior Court of Justice, July 6, 2018

In 2005, the applicant purchased a property in the City of Vaughan from the respondent numbered company. The property was occupied by a hotel and designated as an "urban growth centre" under the provincial growth plan. The respondent was the owner of lots surrounding the sold property, which amounted to approximately 70 acres. As part of the purchase, the applicant entered into a restrictive covenant agreement ("RCA") with the respondent, which was registered on title. The agreement provided that the subject site was not to be used for any purpose other than the construction, development, operation, and management of a hotel, and that any development plans or construction had to be approved by the respondent.

The applicant proposed to develop the site to include three mixed-use towers, which was a non-hotel use. The respondent took the position that this proposal had the potential to negatively impact its own development plans for the surrounding lots and create competition. Accordingly, the respondent refused to consent to modifying or discharging the restrictive covenants in the RCA. The applicant applied under section 61(1) of the *Conveyancing and Law of Property Act* for an order deleting the restrictive covenants from title to its lands.

The application was dismissed. The Court found that the applicant had not established that the restrictive covenants under the RCA were spent, and that their assertion by the respondent would thus be vexatious. When the RCA was entered into, the area including the site had already been identified as an area for greater intensification. The planning policies in place at the time were similar to those currently in place. The parties were aware of the possibility for future development of the site and agreed to address it through restrictions in the RCA. The applicant did not establish that the circumstances had changed in ways that were sufficiently material for the Court to conclude that the purposes for which the restrictive covenants were given have been eliminated.

The applicant also did not establish that the restrictive covenants were "so unsuitable as to be of no value." The Court did not agree with the applicant's submission that the analysis only required an explanation of the effect of the modification or discharge of a restrictive covenant on the monetary value of the respondent's land, The question of whether the respondent's lands were monetarily affected was only part of the analysis. There was no suggestion that the respondent did not negotiate the RCA in good faith for the purpose of protecting its legitimate interests. The applicant also did not show that the respondent's interests were no longer legitimate. The Court refused to discharge the restrictive covenants.

Icona Hospitality Inc. v. 2748355 Canada Inc.
2018 OREG ¶ 59,297

Purchaser Could Not Rely on Subsection 21(4) of *Business Corporations Act* for Return of Deposit

Ontario Superior Court of Justice, July 24, 2018

The plaintiff purchaser and defendant vendor entered into an agreement of purchase and sale ("APS") for three adjacent houses for $7 million. The purchaser signed the APS describing the purchaser as "Salvatore Benedetto In Trust For A Company to be Incorporated without any Personal liabilities". The purchaser did not ultimately incorporate a company. He paid a deposit totalling $100,000, which was held by the defendant realtor.

The purchaser failed to close the transaction on the basis that he "decided not to proceed." He requested the return of the deposit, which the vendor refused. The purchaser brought a claim for the return of the deposit, taking the position that, because he had complied with subsection 21(4) of the *Business Corporations Act* and entered into the APS on behalf of a company to be incorporated without personal liability, the deposit must be returned to him despite his failure to close. The vendor brought a motion for summary judgment, seeking an order for the release of the deposit.

The motion was granted. The language of subsection 21(4) and case law established that a person can exclude personal liability under a pre-incorporation contract by expressly stating that he or she is entering into the contract in the name of, or on behalf of, a corporation to be incorporated without personal liability. The Court relied on *Adamis v. Aviks*, 1983 CarswellOnt 3436 (Co. Ct.) ("*Adamis*"), which involved almost identical contractual language with respect to an APS and where the purchaser, who had bought the property "in trust with no personal liability," was not permitted to recover the deposit, because the Court found that he was not justified in refusing to close. The Court in *Adamis* relied on the exclusion of personal liability to dismiss the vendors' claim for damages over and above the deposit only. There was no basis for the submission that *Adamis* would have been decided differently had subsection 21(4) been promulgated at the time.

The approach in *Adamis* was also consistent with the relevant principles of law. A deposit is compensation for the vendor taking the property off the market and for its loss of bargaining power. A deposit is not related to damages and is not a pre-incorporation contract to which a purchaser could be bound or otherwise exposed to personal liability. If the purchaser's position were accepted, the deposit, as a means of protecting the vendor, would be meaningless and would be commercially unreasonable. The purchaser's claim was therefore dismissed.

Benedetto v. 2453912 Ontario Inc.
2018 OREG ¶ 59,298

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