May 28, 1999

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
L'Esplanade Laurier
21 Floor – East Tower
140 O'Connor Street
Ottawa, Ontario
K1A 0G5

Dear Minister:

Re: **Changes Proposed to Income Tax, Canada Pension Plan and Employment Insurance Collection Rules (draft legislation amending the *Bankruptcy and Insolvency Act* and other statutes and Draft amendments to the *Income Tax Regulations*, as announced in Press Release 99-026, March 11, 1999)**
Ship's Mortgages

I am writing on behalf of the National Maritime Law Section of the Canadian Bar Association (CBA) to urge that mortgages on ships be exempted from the priority granted to Revenue Canada claims, as proposed in the above-noted legislative amendments.

One of our principal concerns is that the amendments will allow deemed trusts to take priority over *fixed* charges, even where there are no unremitted source deductions owing at the time the fixed charge was granted. In a letter dated April 20, 1998, the Chair of the National Real Property Section of the CBA wrote to you regarding concerns with the deemed trust provisions for unremitted source deductions as proposed by Bill C-28. Munir A. Sheikh, the Assistant Deputy Minister of the Tax Branch, responded, advising:

> However, security interests that compete with the Crown's deemed trust will be affected, but in a manner that does not take anyone by surprise as it merely **preserves the "status quo"** "ante" the Supreme Court decision in *Her Majesty the Queen v. Royal Bank of Canada*. It had always been the government's position that the deemed trusts ranked ahead of security interests such as *Bank Act* securities and General Security Agreements. [emphasis added]

Unfortunately, it would appear that the current proposed regulations go beyond the original intent of Bill C-28, which was to maintain the *status quo* as it was prior to *The Queen v. Royal Bank* (1997), 97 D.T.C. 5089 (S.C.C.). At pages 5092 and 5102-03 of the *Royal Bank* case, the Court indicated that deemed trusts only take priority over *fixed* charges if there are unremitted source deductions owing at the time the fixed charge was granted. This is because the granting of a fixed charge to a lender effectively transfers title to the debtor's property to the lender. Consequently, the debtor has no property to which the deemed trust can attach at the time his or her source deductions are supposed to have been made. By failing to exempt *all* fixed charges from the application of the new deemed trust provisions, the proposed legislation is clearly going beyond the *status quo* and exceeding the mandate granted by Parliament.

Although the mandate of the National Maritime Law Section is only to deal with maritime issues, we would note that even with respect to mortgages over real property, the legislation goes beyond the *status quo*. Firstly, it imposes a requirement of marshalling against other available security, so as to require a creditor holding multiple securities to first exhaust its remedies against assets not subject to a Revenue Canada deemed trust. Secondly, it doesn't allow the holder of a fixed charge to have priority for further advances if there are unremitted source deductions due at the time of those further advances.

From the maritime law perspective, application of the new deemed trust provisions to mortgages on ships will increase the difficulties vessel owners already face in borrowing money. As it is, the marine industry has difficulty persuading lenders to lend money secured by marine mortgages for a number of reasons, including the following:

1. ships are mobile assets which can be difficult for creditors to locate when a loan is in default;

2. ships can deteriorate quickly if not looked after and are expensive to maintain while under seizure;

3. in the case of fishing vessels, the Minister of Fisheries does not recognize a property right in fishing licences, despite the fact that many fishing vessels have little value without a licence; and

4. the ships' registry is not insured for defects in title, as is the Torrens-type land registry system in most jurisdictions in Canada.

In addition, many of the marine industries in Canada are now facing significant financial hardship. For example, the British Columbia tug and tow industry is facing difficulties caused by a recession in the forest industry. The fishing industry on the East coast is still suffering from the closure of the cod fishery. The British Columbia salmon fishery is also suffering badly. As a result of area licensing imposed by the Mifflin Plan, British Columbia salmon fishermen must often purchase an additional fishing licence to remain viable in the fishing industry, which creates a real dilemma because banks will not lend money against the value of a fishing licence.

Another problem is created by the fact that provincial repairer's lien legislation does not apply to ships. This makes it difficult for vessel owners to persuade shipyards to release their possessory liens over vessels, which would allow the owners to return to work to earn funds to pay their repair bills. In some cases, the owner overcomes this difficulty by granting a mortgage to the shipyard to secure the payment of the bill. Since many vessels are already encumbered by first mortgages, this often means that a shipyard will have to give up its top priority in exchange for a second or third mortgage. If shipyards are faced with the prospect of also having to stand behind Revenue Canada for source deductions, it is unlikely that they will extend this type of credit to vessel owners.

Another problem with the new deemed trust provisions is their retroactive effect. If these provisions are applied retroactively, holders of ships' mortgages (and other fixed charges) will be prejudiced as they had no advance notice of these provisions.

We are also concerned about the risk which this legislation creates for *bona fide* purchasers for value. Section 227(4.1) of the *Income Tax Act* now provides that "property of the person . . . is deemed . . . to form no part of the estate or property of the person from the time the amount was so deducted or withheld . . .". It is clear that a vendor of property impressed with a deemed trust therefore now has no property to give to a *bona fide* purchaser for value. This was clearly not the status quo prior to the *Royal Bank* case (see, in particular, page 5103).

We are concerned that this change creates a trap for unwary solicitors advising clients who are purchasing vessels. We fear that if Revenue Canada changes its policy and decides to make a claim against a *bona fide* purchaser for value, it will be a lawyer's liability insurance policy and not the purchaser of the property which will be paying the claim. Further, we understand that Revenue Canada has no way of expeditiously providing information to prospective creditors as to the state of a taxpayer's remittance profile. Accordingly, this makes it very difficult for a solicitor to properly evaluate the priority of a fixed charge on certain property.

In light of all of the foregoing considerations, we would urge you to fully exempt fixed charges over ships from the application of section 227(4) and (4.1) of the *Income Tax Act*. We would also urge you to fully exempt fixed charges over ships from the similar provisions recently added to the Canada Pension Plan, the *Employment Insurance Act* and the *Excise Tax Act*.

To protect *bona fide* purchasers for value, we agree with the previous submission of the National Real Property Section that the validity a Revenue Canada deemed trust be conditional upon filing notice in the appropriate registry. In the case of registered ships, this would be the Ships Registry administered by Transport Canada. In the case of licenced vessels, this would be the personal property security registry of the province in which the vessel is located.

We appreciate the opportunity of being able to provide you with the comments of the National Maritime Law Section of the Canadian Bar Association.

Yours truly,

Doug Schmitt

Douglas Schmitt

Chair, National Maritime Section

c.c. Munir A. Sheikh, Assistant Deputy Minister, Tax Policy Branch, Finance Canada
Marc Cuerrier, Tax Counsel Division, Finance Canada
J. Scott Wilkie, Chair, National Taxation Section
Robert A. Klotz, Chair, National Bankruptcy and Insolvency Section
Brian A. Tabor, Chair, National Real Property Section