SUPREME COURT OF NOVA SCOTIA
IN BANKRUPTCY AND INSOLVENCY

Citation: *Johnstone (re)*, 2022 NSSC 302

Date: 20221025
Docket: No. 43410
Registry: Halifax
Estate Number: 51-2531924

In the Matter of: The Bankruptcy of Tammy Marie Johnstone

Registrar: Raffi A. Balmanoukian, Registrar in Bankruptcy

Heard: July 29, 2022, in Halifax, Nova Scotia

Counsel: Matt Fader, for the Trustee, Allan Marshall & Associates Inc.
Caitlin Ward, for the Objecting Creditor, Canada Revenue Agency
Tammy Marie Johnstone, appearing personally

Balmanoukian, Registrar:

[1] This case poses, apparently for the first time, the question of whether notional capital gains tax should be deducted from a bankrupt's realizable equity in real property. If so, what evidence is required to establish the quantum that should be deducted?

[2] Tammy Marie Johnstone, now 61, is a first time bankrupt. Her total tax liability is such that it engages s. 172.1 of the *Bankruptcy and Insolvency Act*, RSC 1985, c. B-3, as amended (the "BIA"). This is the so-called "high tax debt" provision which precludes an automatic discharge and requires the Court to consider, at a minimum, the four factors outlined in s. 172.1(4).

[3] Originally, CRA objected to the bankrupt's discharge primarily on the basis that it says the Trustee miscalculated the bankrupt's equity in a property in Florida [1](and that its value has increased due to market forces between the bankruptcy in 2019, and now). It also took issue that the bankrupt used the equity from the sale of a property in New Brunswick to purchase the Florida property, at a time when

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[1] Ms. Johnstone said $70,000 in her statement of affairs but indicated $85,000 to the Court. The latter figure is more consistent with the stated purchase price of the Florida property.

her tax liability was accruing and accumulating, rather than using those proceeds to defray that debt.

[4] Later, when the Trustee raised the issue of whether notional capital gains taxes should be deducted from realizable equity, the issue was placed before me. Neither the Trustee nor CRA could identify a case or regulatory policy statement on point.[2]

[5] At another level, the issue raises two contrasting principles for non-exempt asset valuation and treatment when it is retained (that is to say, repurchased) by the bankrupt: first, that the estate should be in the same position that it would have been had the asset been surrendered and realized; and second, that the realization by the estate should be optimized in the interest of maximum recovery to creditors.

[6] This Court has set forth its views on notional valuation matrices (and how those are superseded by actual events, should they occur) in several cases, to ensure consistency of treatment across marketplaces and across Trustees. As

[2] I admit I found this surprising. There may be several reasons for this. First, property that is realized in a bankruptcy may be on a liquidation basis and thus result in no or minimal gains. Second, property that is unrealized may not have had the issue considered at the time of valuation; third, some jurisdictions may take the view that "if you don't incur it, you don't get it," a view rejected by this Court in the sense that it has presented a clear matrix on the valuation and realization of real property, which in some respects has been more conservative than notional realization costs employed by some Trustees in the past; fourth, as these reasons will develop, the tax may not have been the subject of satisfactory evidence and also if incurred after bankruptcy, is not for the account of the estate.

Justice Bodurtha put it in *BDO Canada Ltd. v. Carrigan-Warner*, 2022 NSSC 16 at para. 28:

> Notional equity in real property, on the other hand, is capable of relatively consistent calculation through the application of the Court's matrix, which has been explained in several decisions. Bankrupts should be entitled to expect that their obligations will be calculated consistently from one trustee to the next. So, too, should creditors be entitled to expect that their interests will be protected to the same degree regardless of the firm appointed as trustee.

[7] The issue now is whether notional (or for that matter actual) capital gains should form part of that matrix, and how it fits into the competing principles of putting the estate in its "but-for" position, and maximum realization.

[8] The Trustee says that although it does not have much evidence of what the quantum would be (since the property is in Florida and would be subject to American and Canadian tax regimes, invoke the interplay of relevant tax treaties, and require calculation based on Ms. Johnstone's relevant marginal tax rate in the respective jurisdictions), the guesstimate should be deducted as a notional cost of disposition. CRA takes the position that to do so would, in effect, constitute the estate subsidizing Ms. Johnstone's tax liability, and that there is something of an unjust irony in doing so given the tax-driven nature of her bankruptcy.

[9] I have concluded, in the absence of binding adverse authority cited to me, that these two principles are not inconsistent in this case, and that notional (or

actual) capital gains implications should *not* be included in disposition calculations. This is why.

[10] In a normal "asset surrender / repurchase" situation, the objective is to calculate what the estate would have realized had the non-exempt asset been turned over to the Trustee, and the Trustee incurred and paid the realization costs. If the bankrupt retains the asset, the notional disposition costs recognized and accepted by this Court[3] are not "cash out the door," but the estate is not out anything – and in fact may have saved money and/or obtained a higher realization from the debtor (who knows the asset) than on an "as is, where is" transaction that would be typical of a Trustee. The key objections in and by this Court have been (a) improvident valuation (b) excess notional disposition costs and/or (c) failing to recognize that actual higher realizations crystallized before the bankrupt has obtained an absolute, conditional, or suspended order fixing the amount due are for the account of the estate: *McInnis*, *Carrigan-Warner*.

[11] The common thread is that it is the estate that has paid (or but for the bankrupt's agreement to repurchase, would have paid) the "friction" costs of disposition. In the case of a notional or actual disposition after an assignment in

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[3] *Re McInnis*, 2022 NSSC 64; *Re Gavel*, 2021 NSSC 5; *BDO Canada Ltd. v. Carrigan-Warner*, *supra*.

bankruptcy, *the tax implications of that disposition are for the bankrupt and not for the estate*. It follows that the estate should not bear "notional" tax consequences when it would not have incurred them had there been an actual disposition.

[12] Section 128 of the *Income Tax Act*, RSC 1985 c. 1 (5^{th} Supp). reads in part:

> **(2)** Where an individual has become a bankrupt, the following rules are applicable:
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> **(a)** the trustee in bankruptcy shall be deemed to be the agent of the bankrupt for all purposes of this Act;
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> **(b)** the estate of the bankrupt shall be deemed not to be a trust or an estate for the purposes of this Act;
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> **(c)** the income and the taxable income of the individual for any taxation year during which the individual was a bankrupt and for any subsequent year shall be calculated as if
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> > **(i)** the property of the bankrupt did not pass to and vest in the trustee in bankruptcy on the bankruptcy order being made or the assignment filed but remained vested in the bankrupt, and
> >
> > **(ii)** any dealing in the estate of the bankrupt or any act performed in the carrying on of the business of the bankrupt estate by the trustee was done as agent on behalf of the bankrupt and any income of the trustee from such dealing or carrying on is income of the bankrupt and not of the trustee;

[13] In other words: property and income transactions taken by the Trustee are for the account of the bankrupt, not of the estate, for tax purposes. Despite the vesting in the Trustee pursuant to s. 71 BIA, there is no deemed disposition for tax purposes, and the Trustee's dealing with property and income is, for tax purposes, for the account of the bankrupt and not of the estate, including any resultant gains or losses. It follows that there is no distinction, for tax purposes, between an actual

and notional disposition in terms of funds available for distribution amongst creditors, and to deduct such notional (or actual) liabilities from the amount a bankrupt needs to pay on repurchase of an asset is a deprivation to creditors without corresponding fealty to the "but for" principle.

[14] I therefore would *not* allow capital gains implications to be taken into account in calculating Ms. Johnstone's realizable equity.

[15] That is adequate to dispose of this aspect of the case[4]. However, if I am wrong, I add that there was no meaningful evidence of what the tax liability would be, or to whom; I also have no evidence of how bankruptcy events are treated for tax purposes in the United States. The most I had was that the Trustee had made inquiries of American accountants (who were further reluctant to opine in any concrete way), and that there would be significant interplay between Canadian and American authorities given the transnational nature of a notional transaction. One would then have to reconcile this with Ms. Johnstone's own income at the relevant time, and her marginal tax rate. I do not have evidence on any of these points.

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[4] I will add that recently, in *Re Jarvis* 2022 NSSC 95, I taxed an account in which this issue was addressed in the actions taken by the Trustee – coincidentally, the same firm as was Trustee for Ms. Johnstone – in the realization of properties under a proposal. While the actions taken by the Trustee on this point were not in issue on the taxation, I opined that it would be preferable to be clear whether the amounts sought to be realized and distributed were to be net of tax, or not. This underlines the desirability of such clarity, when applicable.

[16] While I can take judicial notice that taxable capital gains in Canada is currently at a 50% inclusion rate, and *perhaps* that Ms. Johnstone's Canadian marginal tax rate based on her representation of having a current income of approximately $85,000 would be in the 40% range, I have no evidence of how this would dovetail with Florida implications or what if any credit that would have in Canada. Again, I can only take notice of the existence of a Canada- US tax treaty, not of its implications given that proof of foreign (i.e. Florida and US federal tax) law is a question of fact and there are no such facts before me.

[17] With that said. I do have concerns with how the Trustee "ran the matrix" for the property in question. It appears to have used assessed value of $75,838 (US) in 2018, less 5% for commission and $3,500 (US) for legal fees. There was no evidence of what legal fees in Florida would be, and the Trustee admitted these were more or less arbitrarily assigned. They appear high, absent evidence, and are contrary to this Court's default matrix.

[18] By 2021 the assessment had risen to $100,940 US. The Trustee advises that the bankrupt had not fully paid for the Trustee's estimate of value until May 2021. No conditional order was in place "freezing" the bankrupt's obligation, nor was any other relevant order had or obtained from the Court which would fix the value

at any time prior to the discharge hearing.[5] I therefore consider it open to re-visit these valuations; I direct the Trustee to do so based on this Court's matrix, at this value, allowing for 5% real estate fees (plus tax if applicable) and $1,000 (US) legal fees. The amount remaining payable by the bankrupt is to be calculated by the Trustee and provided to me, to the bankrupt, and to CRA. Stakeholders will have 15 days from receipt to provide comment to the Court or to request a hearing on this point.

[19] The date for the conversion rate from American to Canadian funds was not argued. My gut reaction is to use the interbank exchange rate as of date of bankruptcy. If the Trustee or CRA disagree, it may be brought back before me.

[20] I now turn to s. 172.1 of the BIA. As noted above, that section precludes an automatic (or early) discharge, and requires me to consider four factors, in addition any others I consider relevant. This Court has set out its views and approach to s. 172.1 debts in *Re Sorochan*, 2021 NSSC 200; *Re Smith* 2021 NSSC 205; *Re Harding* 2021 NSSC 219, and most recently in *Re Cole*, 2022 NSSC 62.

[21] The first factor I must consider is "the circumstances of the bankrupt at the time the personal income tax debt was incurred" – S. 172.1(4)(a).

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[5] For a discussion on the effect of a conditional, suspended, or absolute order on valuation and obligations, as opposed to files such as Ms. Johnstone's in which there is no such order, see *Re Gavel, supra*, at paras. 14-39.

[22] The tax debt in question arose between 2012 and 2016. Ms. Johnstone told the Court that at the relevant time, she was working as a field administrator in Alberta, and she "fell apart" when her purse was stolen with all of her documentation, and her accountant (at H&R Block) quit. She had approximately $20,000 garnished (the CRA's affidavit confirms this) and she paid a lump sum of $24,000 in 2014 or 2015 (although she equivocated that this may have been on account of GST/HST).

[23] The second factor is "the efforts, if any, made by the bankrupt to pay the personal income tax debt" – S. 172.1(4)(b).

[24] The CRA attested that "the bankrupt did not make any voluntary payments towards her tax debts…" These totalled $396,487.45 as of the bankruptcy filing, of which $221,837.04 was tax principal and another $136,478.92 interest and penalties that would be captured by the definition of "personal income tax debt" in s. 172.1 (the balance is CPP, GST/HST, and interest/penalties thereon; and in fairness, is less than the $429,603.95 that the CRA proved when Ms. Johnstone attempted to make a proposal). This almost all of Ms. Johnstone's declared debt. I have set out the involuntary payments above.

[25] More disconcerting, from CRA's perspective – which I share – is that Ms. Johnstone diverted her share of proceeds from the 2014 sale of her New Brunswick property – apparently approximately $85,000 Canadian – towards the Florida purchase, rather than to defray her tax debt which was by then at least $150,000 based on her 2013 NOA.

[26] Ms. Johnstone admitted she was "100% negligent" in doing this instead of paying towards her tax bill.

[27] In fairness to her, I am advised that her post-bankruptcy taxes have been filed and paid to and including 2021.

[28] The third factor I am mandated to consider is "whether the bankrupt made payments in respect of other debts while failing to make reasonable efforts to pay the personal income tax debt" – S. 172.1(4)(c).

[29] I have previously stated that I consider whether one took cash on hand and allocated it to non-tax ends, or incurred debt and then paid it off in preference to tax liabilities, to be something of a distinction without a difference: *Sorochan*, para. 108; *Cole*, para. 49. Through that lens, the allocation by Ms. Johnstone of her equity in the New Brunswick property remains germane.

[30] She does not remember paying any other bills, save ordinary living expenses. Her statement of affairs show three comparatively modest credit card debts, all in the four figures and totaling $18,500.

[31] The fourth and final statutory factor I must consider is “the bankrupt’s financial prospects for the future” – S. 172.1(4)(d). This will often, as here, carry significant weight.

[32] Ms. Johnstone told the Court that she works “about half time” for a British Columbia company, A&B Pipelines, earning approximately $3,000 a week until August 2022. She estimated that she made $85,000 in 2021 which was a “high year.” Her prior notices of assessment (of which 2012 and 2014 were calculated by CRA) show “line 150” total income as follows:

2012: $199,321

2013: $142,081

2014: $284,808

2015: $142,397

2016: $125,547

[33] Based on these, I find it difficult to conclude that $85,000 is a “high year,” even in a cyclical – one may say ‘fickle’ – industry and even as Ms. Johnstone’s years advance. She retains the ability to maintain Canadian residency with an interest in a Florida *pied a terre*. She appears to have skills which have adequate demand that she can live at one end of our vast dominion while working in another; and her weekly wage as stated to the Court appears roughly consistent with the 2013, 2015, and 2016 years which appear to have been calculated by her rather than by CRA.

[34] In Ms. Johnstone’s favour, she has been described as a “model bankrupt” by the Trustee, having filed and paid her post-bankruptcy taxes. I listened to and observed her and have a fair level of confidence that she has taken the rehabilitative objectives of the BIA to heart. I think she is well on her way to having the tools at hand, upon her exit from this process, to go forth and sin no more.

[35] That said, I have also been clear in the past that I believe that s. 172.1 requires the Court to tell the bankrupt to do “something more” than merely her pro forma ss. 68 and 158 duties. In *Sorochan,* I said:

> **Dispositions should generally be “something more” than normal duties under ss. 68 and 158**

[40] In *McKee*, *supra*, Registrar Thompson said:

> [15] In cases where there is evidence of a bankrupt's indifference to tax obligations, the integrity of the bankruptcy system requires the court to consider imposing stringent conditions of discharge. (*Re Newson*, 2014 SKQB 106, 443 Sask R 72).
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> [16] In cases where a reasonable person would be offended if the bankrupt were allowed to exit bankruptcy with significant exempt assets acquired while the bankrupt failed to pay his or her income tax liabilities, this Court has ordered a significant payment as a condition of discharge (*Re Hagerman*, 2014 SKQB 185, 448 Sask R 308).

[41] Similarly, in *Re Monaghan*, 2018 SKQB 210, she stated:

> [54] Mr. Monaghan is a 61 year-old man in poor health. He testified that he no longer lives with his wife. Despite his health and marital issues, I have no doubt that a reasonable person would be offended by the idea that an individual can avoid tax obligations for 10 years and then turn around and claim bankruptcy, exiting the process with exempt assets in the amount of $765,786.00.

[42] I leave to another case the extent, if any, to which non-exempt assets are a consideration in setting conditions for a tax-driven (or other) bankruptcy, as they do not apply to the case at bar. However, I take the more general view for current purposes that if a "reasonable person would be offended" by a bankrupt being able to "skate away" from tax obligations through the bankruptcy process, the Court should give priority to system integrity and, at its core, the public good. This Court should not be a tool to achieve what a reasonable person would consider to be FDR's "civilization at a discount." *Salus populi suprema lex esto* is as true today as it was for Cicero. What Master Young described as a "freeloader" in *Re Crischuk*, 2013 BCSC 1413, should not expect succor from this Court.

[43] While not wishing to be exhaustive, I would consider factors such as those set out in *Re Yeo*, 2020 NSSC 135, to be relevant to whether the particular debtor at bar would offend a reasonable and civic-minded fellow taxpayer. For current purposes, it is adequate to say that if a person has been cavalier in their declaration, reporting, and payment of tax obligations, the Court's disposition should be proportionate; and, in recognizing that such obligations will recur in the bankrupt's future, I consider bringing the repeat nature of such obligations to the mind of the debtor to be an integral part of the BIA's rehabilitative function as well.

[44] So what should those "stringent conditions" be? While again, every case turns on its own facts, I consider as a general principle that they should be conditions that are over and above those applicable to a non-s.172.1 bankrupt who is not otherwise eligible for an automatic discharge. To put their obligations on the same footing – for example, to

> purchase a non-exempt asset or to file missing financial information – would reward a s. 172.1 debtor who has not done those things, while punish a s. 172.1 debtor who has.
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> [45] How? Just this: suppose a s. 172.1 first or second time filer has done everything they have to do under ss. 68 and 158 of the BIA. They still have to come to Court and the Court cannot grant an absolute discharge. In contrast, another s. 172.1 first or second time filer who has outstanding s. 68/158 obligations comes to Court, and the Court's disposition is "do those things and then get your discharge." The first, compliant, debtor by definition has to do something more than the second, however nominal. That is unjust and penalizes diligence while rewarding indolence.
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> [46] The requirement for continued filing of income/expense information and filing of tax returns under s. 172.1(5) only applies when the Court imposes a suspension (whether alone or in conjunction with some other condition). In fact, that may be one of the very few cases in which a stand alone suspension is not "always meaningless" (*Re Crowley* (1984), 66 NSR (2d) 390 (SC, TD) at para. 69, a decision which pre-dated s. 172.1). It will be noted that the requirement is to file, not to file and pay.
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> [47] The Court may, but is not required to, order such filings in other cases. Indeed I frequently impose a requirement for the debtor to file, be assessed for, and pay post-bankruptcy returns as a condition of a discharge from a tax-driven bankruptcy.
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> [48] In my opinion, in the case of chronic non-filing or non-payment, it should be a standard condition of discharge that a high-tax bankrupt be required to file, be assessed for, *and pay* relevant returns for a period appropriate to the facts of that case. This is over and above the other s. 68, 158, and if applicable s. 172.1 requirements on the bankrupt. Whether there are additional financial obligations on the bankrupt will vary more widely, bearing in mind all relevant factors and especially (but not only) those in s. 172.1(4).
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> [emphasis added at paras. 44-45]

[36] Ordinarily, I would require Ms. Johnstone, as a condition of her discharge, to file, be assessed for, and pay her post-bankruptcy taxes (including, as applicable, payroll and HST) for a period following her bankruptcy; and potentially to pay an amount that is achievable over a 4-6 year period. In this case, she has already demonstrated good filing habits, and payment of a notable amount into her estate (albeit funds which should have been earmarked for taxes in the first place), over a

period slightly under two years[6]. I have already said that I think her financial prospects are healthy.

[37] I believe a payment of her remaining portion of equity in the Florida property (if any), plus a requirement to file, be assessed for, and pay her relevant taxes to and including 2022, plus an additional noticeable but achievable sum certain fairly balance the interests in this case. She paid only nominal amounts to CRA (and then, involuntarily) in years of significant income. Her allocation of proceeds to the Florida property cannot be condoned. And, she is capable of generating a notable income.

[38] Against that, and to reiterate, she has demonstrated post-bankruptcy conduct which is exemplary, and which will provide a notable if not substantial dividend to creditors, of whom CRA is far and away the most significant. Ms. Johnstone will have to pay additional funds as a result of market forces between the time of bankruptcy and the time of hearing[7] . This, combined with the additional tax compliance requirement and a further payment of $5,000, will fairly balance the Court's sanction of the pre-bankruptcy events (in particular the decision to purchase the Florida property, and the deprivation of the benefit of its subsequent

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[6] She made payments from the assignment in August 2019 to May 2021.

[7] All parties agreed that the increase in value of the Florida property was due to the market, not to any physical change or improvement to the property.

increase in value), while recognizing post-bankruptcy rehabilitation of which Ms. Johnstone is well on her way. For clarity, this is not to say that "payment of the market value of equity as at the date of the discharge hearing" is an added requirement to one's ss. 68/158 duties, but takes in context the payments Ms. Johnstone has already made, plus the emphasis on future tax compliance, and my decision to pay a noticeable but achievable additional sum certain that will provide additional return to creditors. In my discretion, I believe this fairly balances stakeholder, and public, interests.

[39] The Trustee will circulate an order to Ms. Ward and to the Court for review. I thank all stakeholders for their courtesy and respect in these proceedings.

Balmanoukian, R.