

YOUR HALLOWEEN EDITION: THE GHOST OF THE TERMINATED GST/HST DEEMED TRUST

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In a recent split decision in *The Queen v. Callidus Capital Corporation*,^[1] the Federal Court of Appeal decided that proceeds of sale of a debtor's assets paid to a secured creditor prior to a debtor's bankruptcy, which are subject to the Crown's GST/HST deemed trust interest, remain vulnerable to a Crown claim subsequent to the debtor's bankruptcy. Moreover, the secured creditor may be personally liable to the Crown for the amount of the deemed trust.

The majority in the Federal Court of Appeal reversed a Federal Court decision,^[2] which relied on ss. 222(1.1) of the *Excise Tax Act* ("ETA")^[3] to give effect to the priority scheme in s. 67 of the *Bankruptcy and Insolvency Act* (the "BIA").^[4] Subsection 67(2) of the BIA collapses a GST/HST deemed trust in a bankruptcy.

The Supreme Court of Canada may yet weigh in on the issue, as the secured creditor has applied for leave to appeal. In view of the current uncertainty, secured creditors may wish to consider any outstanding ETA liabilities when accepting payment on account of a loan from a debtor in the vicinity of insolvency.

Background

Beginning in 2010, Cheese Factory Road Holdings Inc. ("Cheese Factory") collected, but failed to remit to the Canada Revenue Agency, GST and HST on sales. In 2011, Cheese Factory defaulted under the credit facility extended to it by its secured creditor. In exchange for forbearance on the secured creditor's rights under the credit facility, Cheese Factory agreed to sell or rent out two properties it owned, and to deliver the proceeds to its lender in partial satisfaction of Cheese Factory's indebtedness.

In 2012, the Crown claimed from the secured creditor priority over the amount that Cheese Factory had collected and failed to remit as taxes (deemed trust monies) on the basis of the GST/HST deemed trust provisions in section 222 of the ETA. In 2013, at the request of its secured creditor, Cheese Factory made an assignment under the BIA with a view to extinguishing the GST/HST deemed trust in favour of the Crown.

Thereafter, the Crown sued the secured creditor to recover the taxes that Cheese Factory had collected, but failed to remit, between 2010 and 2013 on the basis of personal liability for the secured creditor created under

ss. 222(3) of the ETA. Under this provision, the Crown's deemed trust created under ss. 222(1) over GST/HST collected is extended to any of the debtor's property equal to the taxes collected, despite any security interest in the property. Under the deemed trust, the property is "beneficially owned by" the Crown "despite any security interest in the property or in the proceeds thereof and the proceeds of the property shall be paid to the Receiver General in priority to all security interests." [Emphasis added]

Federal Court Decision

The Federal Court agreed with the secured creditor in holding that Cheese Factory's bankruptcy engaged ss. 222(1.1) of the ETA and thus relieved the secured creditor of obligations it would otherwise have had under ss. 222(3) of the ETA to pay its sale proceeds to the Crown. To give effect to ss. 67(2) of the BIA, subsection 222(1.1) extinguished the Crown's GST/HST deemed trust claim. The Crown appealed the Federal Court's decision.

Federal Court of Appeal Decision

The majority in the Federal Court of Appeal overturned the lower court decision. The Federal Court of Appeal held that the above-noted underlined portion of ss. 222(3) of the ETA, in effect, crystallized prior to the bankruptcy a positive obligation of the secured creditor to pay the realized proceeds to the Crown because the Crown's beneficial interest in the unremitted GST/HST extended to the proceeds.

To support this conclusion, the majority relied on (*Procureure générale*) c. *Banque Nationale du Canada* ("*Banque Nationale*").^[5] In that case, the Federal Court of Appeal analyzed the language of the deemed trust provision under s. 227 of the *Income Tax Act* (the "ITA").^[6] With language virtually identical to the above-underlined portion of ss. 222(3) of the ETA, ss. 227(4.1) of the ITA similarly extends the deemed trust for source deductions. In *Banque Nationale*, the Federal Court of Appeal allowed the Minister to pursue a claim against the secured creditor to recover proceeds realized from the sale of the debtor's assets that were subject to the relevant security interest. The court noted that a secured creditor who does not comply with this obligation is personally liable to the Crown, irrespective of the debtor's subsequent bankruptcy.

In *Callidus*, Justice Pelletier wrote a cogent and lengthy dissent. In his view, the deemed trust lapsed once Cheese Factory went into bankruptcy. As of the date of bankruptcy, due to ss. 222(1.1) of the ETA (giving effect to ss. 67(2) of the BIA), there were no remaining amounts subject to the deemed trust under ss. 222(1) of the ETA. The subject matter of the deemed trust no longer existed.

Without the deemed trust, Justice Pelletier reasoned, the extension of the deemed trust to the proceeds of sale under ss. 222(3) of the ETA was impossible. There was no longer any deemed trust to be extended to, and asserted against, the proceeds to the exclusion of any security interest. Justice Pelletier saw no basis for distinguishing between: (1) reducing the ss. 222(1) GST/HST deemed trust due to payments made on account of

the GST/HST collected; and (2) a reduction of the deemed trust that occurs by operation of law (as the result of the bankruptcy).

Analysis

The majority of the Federal Court of Appeal treated the obligation to pay the proceeds to the Crown as a crystallizing event, which could not be undone by the debtor's bankruptcy. As the Federal Court and Justice Pelletier in dissent at the Federal Court of Appeal note, however, the extension of the deemed trust in ss. 222(3) of the ETA cannot, arguably, be detached from the underlying deemed trust created by ss. 222(1). If one accepts that premise, it follows that once the deemed trust no longer exists, the Crown's interest in the proceeds should become unsecured, as the Crown no longer has any beneficial interest in the proceeds under the extinguished deemed trust.

This reasoning is consistent with the Supreme Court of Canada's observation in *First Vancouver Finance v Minister of National Revenue*.^[7] Once the sale of the debtor's property occurs, which is subject to the extended GST/HST deemed trust claim by the Crown under ss. 222(3) of the ETA, the Crown's deemed trust claim attaches to sale proceeds. The proceeds **replace** the property as the subject matter of the deemed trust claim.

The majority at the Federal Court of Appeal seems, effectively, to have treated the secured creditor's obligation to pay the proceeds as a "requirement to pay" similar to the one in s. 317 of the ETA. Under this interpretation, ss. 222(3) garnishes the proceeds of sale otherwise available to the secured creditor without the Crown ever having to actually issue a Requirement to Pay under s. 317 of the ETA.

Consistent with the Supreme Court of Canada's decision in *Royal Bank of Canada v Sparrow Electric Corp* ("*Sparrow*"),^[8] the language in s. 317 of the ETA, providing for the issuance of a Requirement to Pay, is sufficiently clear to reflect Parliament's intent to expropriate the secured party's property interest without compensation. Thus, the issuance of a Requirement to Pay permits the Crown to garnish proceeds of sale and become the absolute owner of the proceeds without regard to any security interest. It seems that had the Crown issued a Requirement to Pay to Cheese Factory before the proceeds were transferred to the secured creditor, the Crown could have garnished the proceeds and intercepted them to become the absolute owner of the proceeds. In that case, Cheese Factory's subsequent bankruptcy would have been irrelevant.

The Parliamentary intent reflected in s. 317 of the ETA is not clearly reflected in the GST/HST deemed trust provision in s. 222 of that same statute. What appears clear from ss. 222(1.1) of the ETA is that to give effect to ss. 67(2) of the BIA, a GST/HST deemed trust should be collapsed on the debtor's bankruptcy.

Insofar as the majority at the Federal Court of Appeal relied on its decision in *Banque Nationale*, that case is arguably distinguishable because it concerned ss. 227(4.1) of the ITA, which provides expressly for the survival of

the Crown's deemed trust even after a debtor's bankruptcy.^[9] The same cannot be said for the GST/HST deemed trust.^[10]

Final Comments

Following the reasons of the majority in *Callidus*, creditors may be deterred from giving a debtor more time to turn around their businesses. Rather, secured creditors would seem to have an incentive to petition their debtors into bankruptcy before realizing on their security, or make some other insolvency filing that extinguishes the GST/HST deemed trust. This incentive may exist irrespective of whether the Crown actually has a deemed trust claim for GST/HST collected, but unremitted, because the Crown is not obligated to give notice of a debtor's unremitted GST/HST collected prior to a demand for payment or issuing a Requirement to Pay. Unfortunately, this result arguably compromises one of the fundamental objectives of insolvency reform that Parliament intended to advance through the extinguishment of a GST/HST deemed trust claim upon a debtor's bankruptcy.

As a first precautionary measure, in their credit and loan agreements with debtors, creditors may wish to impose obligations on their debtors to notify them of any outstanding deemed trust claims available to the Crown. In addition, McMillan has considered and developed a number of risk mitigation strategies for parties impacted by the decision in *Callidus* that it would be pleased to discuss.

by Jamie Wilks, Jeffrey Levine and Nicole Rozario

[1] *The Queen v. Callidus Capital Corporation*, 2017 FCA 162 ("*Callidus*").^[ps2id id='1' target='']

[2] *The Queen v. Callidus Corporation*, 2015 FC 977.^[ps2id id='2' target='']

[3] *Excise Tax Act*, R.S.C., 1985, c. E-15, as amended.^[ps2id id='3' target='']

[4] *Bankruptcy and Insolvency Act*, R.S.C., 1985, c. B-3, as amended.^[ps2id id='4' target='']

[5] *Canada (Procureure générale) c. Banque Nationale du Canada*, 2004 FCA 92^[ps2id id='5' target='']

[6] *Income Tax Act*, R.S.C., 1985, c. 1 (5th Supp.), as amended.^[ps2id id='6' target='']

[7] *First Vancouver Finance v Minister of National Revenue*, 2002 SCC 49.^[ps2id id='7' target='']

[8] *Royal Bank of Canada v Sparrow Electric Corp*, [1997] SCR 411.^[ps2id id='8' target='']

[9] BIA, ss. 67(3).^[ps2id id='9' target='']

[10] BIA, ss. 67(2).^[ps2id id='10' target='']

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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