

GST/HST POLICY AND COURT DECISIONS

**AVAILABILITY TO CLAIM
INPUT TAX CREDITS IN AN
INSOLVENCY**

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In *Castor Holdings Ltd. (Trustee of) v. R.*,¹ the Tax Court grappled with the issue of whether to allow input tax credits (“ITCs”) claimed by Richter & Associates Inc. (“Richter”) in its capacity as trustee to the bankrupt estate of Castor Holdings Ltd. (“Castor”). The case deals with a number of difficult issues, including interpreting complex provisions in Part IX of the *Excise Tax Act* (Canada) (the “ETA”),² and the inter-relationship between the ETA and the *Bankruptcy and Insolvency Act* (the “BIA”).³ In an insolvency situation, it is particularly

1 2005 TCC 92 (T.C.C. [General Procedure]).

2 R.S.C. 1985, Chapter E-15, Parts VIII and IX enacted by S.C. 1990, c.45, as subsequently amended.

3 R.S.C. 1985, c. B-3, as amended.

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important to understand in what capacity a trustee, receiver or liquidator is acting in particular circumstances to determine the appropriate GST implications. Furthermore, it may act in more than one capacity. Otherwise, the estate, or the person responsible for the estate, risk non-compliance with the GST requirements and missed ITCs and other GST recovery opportunities.

Facts

The relevant facts of the case are as follows. Prior to bankruptcy, Castor engaged primarily in activities consisting of lending funds to real estate enterprises. Castor was registered for the GST because it had a small amount of taxable activities. At the time that Richter was appointed trustee in bankruptcy for Castor on July 9, 1992, Castor's audited financial statements, prepared by Coopers & Lybrand ("C&L"), indicated that Castor had \$1.8 billion of assets. By the time the trustee had completed the liquidation of the assets by 1994, it had become apparent that there was a substantial shortfall, with proceeds of less than \$25 million realized. Castor's various creditors (the "Creditors") sued C&L for in excess of \$1 billion in damages for alleged negligent preparation of Castor's financial statements. As trustee on behalf of Castor, Richter also initiated a lawsuit seeking \$40 million of damages against C&L alleging that C&L had failed to fulfill its contractual duties as Castor's auditor.

In 1993, Richter and certain of the Creditors (the "Participating Creditors") entered into a Participation Agreement in which it was agreed that Richter, having first-hand knowledge of Castor's assets and records and the appropriate expertise, would provide litigation support services. The Participating Creditors had filed in excess of \$800 million of claims against C&L. The Participating Creditors funded, by way of loans, Richter's fees and expenses to conduct its litigation support services. The loans would be reimbursed in full if the damages recovered exceeded the total fees and expenses and partially reimbursed if the recovery was less than the total fees and expenses. For the period from October 1, 1994 to March 31, 2001, Richter claimed on Castor's GST returns close to \$2.5 million of ITCs to recover GST paid on expenses incurred to liquidate the bankrupt estate and to conduct the litigation support business. The Minister du Revenu du Quebec (the "Minister"), acting as agent on behalf of the Canada Revenue Agency, disallowed those ITCs claimed on Castor's GST returns on the basis that they related to Castor's exempt financial services.

Tax Court's Analysis and Findings

In resolving whether to allow Richter's appeal of the disallowed ITCs, the Tax Court considered the application of a number of legislative provisions in the ETA and the BIA. Of fundamental importance, the court found that Richter engaged in its liquidation and litigation support activities as agent on behalf of Castor pursuant to section 265 of the ETA. The Minister argued that section 265 could not apply to the litigation support activities, a "commercial activity"⁴ for GST purposes, because a

trustee in bankruptcy cannot commence a new business in the bankrupt's name. The court disagreed and found that section 265 of the ETA does not restrict the trustee to the bankrupt's business carried on before the bankruptcy. The court found further support for its interpretation in the BIA. It found that section 32 of the BIA does not require the trustee to carry on the bankrupt's business. Furthermore, section 30 of the BIA authorized Richter, as trustee, to supervise the litigation against C&L, to hire solicitors for such purpose, and to borrow funds from the Participating Creditors to fund such litigation.

The Minister argued that all Richter's activities related to the wind-up of Castor's exempt financial business and, as such, pursuant to paragraph 141.1(3)(b) of the ETA, those activities were considered part of Richter's financial activities. For the reasons discussed in the preceding paragraph, the court found that Richter engaged in the distinct business of providing litigation support services. To lend support for its finding, the court relied on *Borrowers' Action Society v. R.*,⁵ in which the Tax Court found that the taxpayer "engaged in the business of promoting, instituting and prosecuting a legal action against credit card companies financed by monies received from individuals who wished to participate in the litigation."⁶

On the basis of the above, the court allowed Castor's ITCs to the extent that they were claimed in relation to its litigation support business pursuant to paragraph 169(1)(c) of the ETA. The court found that the estate's (Castor's) allocation of taxable expenses between its exempt financial activities and taxable commercial activities was fair and reasonable in accordance with subsection 141.01(5) of the ETA. The court allowed \$2,354,362 of ITCs relating to the litigation business. Richter had acknowledged that approximately \$120,000 of GST paid could reasonably be allocated to expenses incurred to liquidate Castor's exempt financial business, including prosecuting Castor's claims against C&L, and so were ineligible for ITCs.

Conclusion

The case provides insight into interpreting certain complex provisions in the ETA and how they interact with the BIA. It also highlights the importance of keeping track of the different capacities in which a trustee, receiver or liquidator may act and how that may impact on GST compliance and recovery opportunities. While the court probably reached the right economic result as to the availability of ITCs, one is left wondering whether the appropriate party claimed those ITCs. While it is unclear from the case, at least on our reading, it appears Richter may have reported and accounted for the GST collectible on its litigation support fees on its own GST returns. It may have made more sense for the GST collectible *and* ITCs relating to Richter's litigation support business to be reported on its own GST returns. Arguably, it acted in its own capacity as a provider of providing litigation support services to the Participating Creditors. In any event, to be consistent with the

⁵ [1996] G.S.T.C. 61 (T.C.C.).

⁶ *Supra* note 1, paragraph 54.

⁴ Defined in subsection 123(1) of the *GST Act*.

structure and spirit of the ETA, the GST collectible *and* ITCs relating to the litigation support business should be reported on one and the same legal entity's GST returns.
