

Return to Certainty: Supreme Court of Canada Provides Clarity to GST/HST Deemed Trust and the Liability of Secured Creditors for Funds Received

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January 8, 2019

Overview

On November 8, 2018, the Supreme Court of Canada delivered its reasons for reversing the Federal Court of Appeal's decision in *Callidus Capital Corporation v Her Majesty the Queen*, 2018 SCC 47. The question before the court was whether, as a result of the deemed trust provisions of the *Excise Tax Act* (the ETA), a secured creditor who received the proceeds of a debtor's assets prior to the debtor's bankruptcy was liable to remit those funds to the Crown on account of the debtor's unremitted GST/HST following the debtor's bankruptcy.

This decision that the deemed trust provisions of the ETA become inoperative on bankruptcy, and therefore secured creditors are not liable to account for proceeds received from a debtor pre-bankruptcy, is an important one for secured creditors. The Supreme Court's ruling overturns the Federal Court of Appeal's decision which held that a secured creditor who accepted payment prior to a bankruptcy from a debtor while there was unremitted GST/HST would be liable to remit those funds to the Crown even after the debtor's bankruptcy. The Federal Court of Appeal's decision meant that a secured creditor could not obtain certainty regarding priority to payments received from a debtor, and risked encouraging secured creditors to bankrupt distressed debtors instead of agreeing to some form of work-out or other reorganisation.

The Supreme Court of Canada's decision that the deemed trust is ineffective in relation to a bankrupt and its secured creditors, including in relation to funds received by a secured creditor pre-bankruptcy, returns certainty to the priority regime. It allows for a return to the long-standing prior practice where, as part of its risk analysis, secured creditors can rely on the bankruptcy of a debtor to terminate the deemed trust in favour of the Crown in connection with any GST/HST amounts owed, and relegate these claims to being unsecured.

Case Facts

Callidus dealt with the Crown's proceedings against Callidus Capital Corporation (Callidus), a secured creditor of the bankrupt Cheese Factory Road Holdings Inc. (CFRH), that had unpaid GST/HST owing. Callidus had purchased the debt obligations of CFRH and related security from the Royal Bank of Canada

and, at the same time, entered into a forbearance agreement. Under the forbearance agreement, certain segregated bank accounts were created in the name of CFRH and daily cash sweeps were initiated from the accounts to reduce the outstanding obligations owed to Callidus. While Callidus was receiving these payments, amounts were owed by CFRH to the Crown for unremitted GST/HST. The Crown sent a demand letter to Callidus on April 2, 2012, claiming such amounts on the basis of the deemed trust under the ETA. On November 7, 2013, the debtor made an assignment under the *Bankruptcy and Insolvency Act* (the BIA) at the request of Callidus. It is important to note that the Crown did not issue a Requirement to Pay to Callidus in relation to CFRH.

GST/HST Deemed Trust Under the ETA

Subsection 222(1) of the ETA provides that GST or HST collected but not remitted is deemed to be held in trust by the collector for the Crown. Subsection 222(1.1), however, provides that the deemed trust created in subsection 222(1) does not apply upon bankruptcy of the tax debtor. If collected amounts are not paid under subsection 222(1), subsection 222(3) of the ETA extends the deemed trust to the property of the tax debtor in an amount equal to the GST/HST owing, despite of, and in priority to, any security interests. Unlike subsection 222(1.1), there is no equivalent subsection addressing how the deemed trust over the general assets of the tax debtor in subsection 222(3) is treated on bankruptcy.

Federal Court Decision

The Federal Court's trial level decision held that the deemed trust and its super priority are extinguished upon bankruptcy, causing the Crown to become an unsecured creditor in connection with unremitted GST/HST amounts. The Court based its reasoning on, in its view, a plain reading of the legislation.

Citing well established case law, the Federal Court also observed that Parliament has made clear exceptions to the general rule under the BIA that deemed trusts are ineffective in bankruptcy, and unremitted GST/HST amounts do not fall into those exceptions. Subsection 67(2) of the BIA renders deemed trusts held for the benefit of the Crown inoperative in bankruptcy subject to subsection 67(3), which expressly upholds deemed trusts for certain unremitted employee source deductions.

Federal Court of Appeal Decision and Subsequent Reversal

The Federal Court of Appeal overturned the Federal Court and held that although subsection 222(1.1) releases the bankrupt from the deemed trust on bankruptcy, it does not release a secured creditor's liability for receiving proceeds deemed to be held in trust for the Crown pre-bankruptcy. The Federal Court of Appeal held that the claim against the secured creditor continued to exist because it arises as a result of the secured creditor's breach of its statutory obligation under the ETA to remit the deemed trust property it received to the Crown. The unpaid GST/HST amounts, therefore, could be pursued by the Crown against third-party recipients, independent of any subsequent bankruptcy of the tax debtor. If this was not the case,

the Federal Court of Appeal held, then the deemed trust mechanism would be ineffective: the termination of the deemed trust on bankruptcy would allow secured creditors to benefit from the debtor's failure to remit pre-bankruptcy.

As a basis for its decision, the Federal Court of Appeal cited *Canada (Procureure Generale) c. Banque du Canada*, 2004 FCT 92. In that case, the Federal Court held that the Crown has priority over proceeds from property subject to a deemed trust under the source deductions provisions of the *Income Tax Act* (the ITA), and a secured creditor receiving those proceeds is liable to account to the Crown for them. Justice Rennie extended this reasoning to *Callidus* and drew no distinction between the deemed trust obligation in respect of withholding taxes under the ITA on one hand and unremitted GST/HST under the ETA following bankruptcy on the other.

Justice Pelletier dissented from the majority of the Federal Court of Appeal. In his view, Parliament's intention was to move away from having the Crown claim priority in bankruptcy. He found that the trust over the property of the tax debtor created by subsection 222(3) of the ETA ceased to exist following the debtor's bankruptcy because it was entirely reliant on the deemed trust in subsection 222(1) over GST/HST collected and not remitted, which ceases to apply on bankruptcy pursuant to subsection 222(1.1):

Subsection (1.1) provides that at or after the time of bankruptcy, subsection (1) does not apply to any amounts that were collected on account of tax prior to that time. The result is that after bankruptcy, there is no amount deemed to be held in trust pursuant to subsection (1) for amounts collected as tax but not remitted pre-bankruptcy. The subsection (3) trust which arose prior to bankruptcy no longer has any subject matter because the trust only attached to property of the tax debtor to the extent of the subsection (1) trust which no longer exists. This is true for the tax debtor as well as for the tax debtor's secured creditors.

The Supreme Court of Canada unanimously reversed the decision of the Federal Court of Appeal and adopted the reasons of Justice Pelletier's dissent in the Federal Court of Appeal. In its decision, the top court explicitly declined to rule on whether a creditor would be liable to the Crown for a debtor's unpaid GST/HST amounts outside of the bankruptcy context.

Conclusions for Lenders

The Federal Court of Appeal decision in *Callidus* created uncertainty for secured lenders, particularly where a debtor was in financial distress. It was feared that the prospect of unremitted GST/HST obligations would encourage secured creditors to force distressed borrowers into bankruptcy, as opposed to allowing other restructuring options to be pursued. With this uncertainty removed, secured creditors can now consider a wider set of work out options and take comfort that a bankruptcy will relieve deemed trust obligations under the ETA, including in relation to funds received pre-bankruptcy.

For further information regarding this matter, please contact Jeremy Bornstein or any other member of the

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