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CRA's Super Priority Gains Strength: Federal Crown's deemed trust priority for unremitted GST/HST survives bankruptcy in Canada v. Callidus Capital Corporation

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Recently, the Federal Court of Appeal confirmed that a tax debtor's bankruptcy does not extinguish the federal Crown's priority to proceeds a secured creditor obtains from that tax debtor's assets before its bankruptcy. Instead, the creditor's positive obligation to pay any proceeds to the Crown in an amount up to the debtor's GST/HST debt survives the debtor's bankruptcy – and a creditor that fails to comply with this obligation will be personally liable to the Crown. It's still possible the Crown's deemed trust mechanism will find itself before the Supreme Court of Canada. But until then, creditors are well-advised to consider – carefully – a debtor's tax situation when assessing whether to enforce security in light of the Appeal Court's decision in **Canada v. Callidus Capital Corporation**. Here's why.

The Crown's deemed trust priority arises under section 222 of the *Excise Tax Act (ETA)*: it allows the Crown to claim a tax debtor's GST/HST arrears against a creditor that obtains proceeds from the debtor's assets. Subsections 222(1) and 222(3) of the ETA provide that every person who collects GST or HST is deemed to hold the collected amount in trust for the Crown until it's been remitted to the Receiver General. This deemed trust gives the Crown a super priority over all competing security interests in the debtor's real and personal property up to the amount of the unremitted tax arrears (subject to prior registered mortgages, which is discussed in further details below). But subsection 222(1.1) provides that the deemed trust does not apply “at or after the time a person becomes a bankrupt”.

In the past, creditors have argued that subsection 222(1.1) confirms that a tax debtor's bankruptcy triggers a priority reversal and retroactively extinguishes the Crown's priority over the tax debtor's assets, including any proceeds a creditor obtains by enforcing its security over the assets. A creditor that successfully enforced its security against the debtor's assets would thus not be liable to the Crown upon the debtor's bankruptcy, and could keep any amounts it recovered from the debtor. But the Appeal Court's decision confirms that, at least for the time being, this strategy is no longer available to creditors. Here's why creditors should carefully consider a debtor's tax situation when deciding whether to enforce its security:

The Crown isn't required to give notice of a debtor's GST/HST arrears. A creditor is obligated to pay proceeds from a tax debtor's assets to the Crown whether – or not – that creditor is aware the debtor hasn't remitted its taxes. The Crown's deemed trust priority doesn't require a crystallizing event, so the Crown isn't required to give notice to creditors of the debtor's tax arrears for the priority to exist.

The creditor can be personally liable for the debtor's GST/HST arrears. Creditors should carefully consider the debtor's financial situation and the possibility it may have unremitted taxes (for example, examining whether the Crown has obtained judgment against the debtor): a creditor is personally liable to pay to the Crown any proceeds it obtains from the debtor's assets up to the amount of the debtor's unremitted taxes and won't be protected by the debtor's subsequent bankruptcy.

Bankruptcy might act as a catalyst for litigation against creditors. Once a tax debtor becomes bankrupt, the Crown loses its priority over the debtor's assets and becomes an unsecured creditor for the balance of the unremitted taxes, significantly diminishing its ability to recover from the bankrupt debtor. Now that the Appeal Court has confirmed the creditor's personal liability to the Crown for amounts obtained from the debtor's assets, the Crown might more aggressively pursue creditors post-bankruptcy to recover amounts obtained from the debtor's assets.

The deemed trust does not take priority over “prescribed security interests” . The Appeal Court’s decision doesn’t specifically address mortgages, but it’s important to note that subsection 222(4) of the ETA provides that the Crown’s deemed trust priority excludes “prescribed security interests”. Regulation defines this as the part of a mortgage that secures performance by the tax debtor of an obligation that is registered against the debtor’s real property before the debtor failed to remit collected taxes. However, the regulations also provide that the amount of a creditor’s prescribed security interest will be reduced by the value of any other security it holds to secure payment of the debtor’s obligations and any amounts paid towards the mortgage. Further, a deemed trust arising before the mortgage is registered will take priority and must be satisfied in full by the sale proceeds before any payments can be made to the creditor.

In **Canada v. Callidus Capital Corporation**, Cheese Factory Road Holdings Inc. failed to remit to the Crown the GST and HST it collected as part of its business operations, and defaulted on its obligations to Callidus under certain credit facilities. As part of a forbearance agreement with Callidus, Cheese Factory sold real property and transferred the net sale proceeds to Callidus. But before the sale closed, the Crown sent a letter to Callidus requesting that it pay the sale proceeds to the Crown up to the amount of Cheese Factory’s unremitted taxes pursuant to the deemed trust provisions. Callidus did not comply with the Crown’s letter and, several months later, Cheese Factory filed an assignment into bankruptcy at Callidus’ request. Shortly after the bankruptcy, the Crown sued Callidus seeking recovery of the sale proceeds on the basis it had priority over the amounts pursuant to the ETA’s deemed trust provisions. Callidus argued the bankruptcy retroactively extinguished the deemed trust and the Crown’s priority over the sale proceeds, so Callidus was entitled to keep the proceeds. Callidus succeeded at the initial hearing. The Crown appealed to the Federal Court of Appeal – and won:

Not at the Crown’s Expense. A secured creditor shouldn’t be allowed to recover from the debtor’s assets and avoid the consequences of the Crown’s deemed trust priority by subsequently petitioning the debtor into bankruptcy. In fact, Callidus conceded on appeal that the Crown had priority to the sale proceeds pre-bankruptcy, and Callidus had failed to abide with this priority. The Appeal Court decided a creditor should not be able to “choose the time of bankruptcy and liquidate the deemed trust assets so as to satisfy their interests at the expense of the Crown.”

Not Retroactively Extinguished. A debtor’s bankruptcy releases a tax debtor’s assets from the deemed trust under ETA section 222(1.1) – but it doesn’t retroactively extinguish the Crown’s deemed trust priority over the debtor’s assets. So a creditor that enforces its security and obtains proceeds from the debtor’s assets before the bankruptcy can be held personally liable to pay the Crown the proceeds up to the amount of the debtor’s tax arrears. In fact, the Crown’s cause of action against the creditor for breaching its statutory obligation to remit the proceeds to the Crown survives the debtor’s bankruptcy – meaning the Crown can sue creditors after a tax debtor’s bankruptcy for any proceeds recovered from the debtor’s assets.

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