Crown priority under section 222(3) of the Excise Tax Act

Blog Restructuring Roundup

McCarthy Tétrault LLP

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We have recently profiled conflicting cases (available here and here) dealing with a priority contest between super-priority charges granted pursuant to creditor protection legislation and deemed trusts arising under the *Income Tax Act*. This is not the only instance where creditors and tax authorities will clash over statutory trusts in the insolvency context. In *Canada v Callidus Capital Corporation*, the Federal Court of Appeal interpreted section 222(3) of the *Excise Tax Act*, which creates a trust over GST collected but not remitted to the receiver general. The decision in *Canada v Callidus* is a win for the CRA as it provides the Crown with priority to sale proceeds paid by a tax debtor to a secured creditor notwithstanding the subsequent bankruptcy of the debtor.

The background facts in the decision are simple. The tax debtor made various debt repayments to its senior secured lender while it also owed GST obligations to the receiver general. On November 7, 2013, at the request of the senior secured lender, the debtor made an assignment in bankruptcy. The Crown subsequently claimed the unremitted GST from the lender on the basis of the deemed trust mechanism governed by section 222 of the *ETA.* The lender took the position that the deemed trust had ceased to operate upon the bankruptcy of the debtor and that the pre-bankruptcy payments it had received were protected on that basis.

The question before the court was whether the bankruptcy of a tax debtor rendered the deemed trust under section 222 of the *ETA* ineffective as against a secured creditor who received, prior to the

bankruptcy, proceeds from the assets of the tax debtor that were subject to the deemed trust. The lower court held in favour of the senior lender, who successfully argued that the bankruptcy of a tax debtor, under operation of section 222(1.1) of the *ETA*, extinguished the deemed trust and any accompanying liability of the lender.

The majority at the Federal Court of Appeal reversed the lower court's decision, and held in favour of the Crown, with Justice Pelletier J.A. dissenting. The Court noted that the issue in the appeal concerned the Crown's recovery mechanisms for dispositions that were made prior to the bankruptcy – in other words, the timing of the dispositions which is reflected in section 222(3).

The Court cited both the Supreme Court of Canada in *First Vancouver Finance*, where the enhanced priority of the Crown through the operation of deemed trusts under the *Income Tax Act* was confirmed, and the Federal Court of Appeal case of *Banque Nationale*, where the Crown's absolute priority over proceeds from property subject to a deemed trust was held to impose a positive obligation on the secured creditor to pay the Receiver General such proceeds. *Banque Nationale* further held that a secured creditor who does not comply with this obligation "is personally liable," and the amount is "payable" to the Receiver General and may be enforced as a cause of action under the appropriate *ITA* provisions. Although *Banque Nationale* concerned the *ITA*, the Federal Court of Appeal noted the near-identical language of the *ITA* and the *ETA* and consequently applied similar reasoning on the priority issue.

The findings in *Canada v Callidus* have important implications for secured creditors. The lower court decision and the previous understanding of section 222(3) of the *ETA* suggested that a bankruptcy would preserve a secured creditor's priority position even if the impugned payment is made prior to the bankruptcy. Lenders should be aware of the current interpretation of section 222(3) of the *ETA* by the Federal Court of Appeal and the risk of pre-bankruptcy payments now being challenged by the CRA.

McCarthy Tétrault LLP - Walker W. MacLeod and Lan Nguyen