Supreme Court of Canada to Rule on CRA Superpriorities

April 06, 2018

On March 22, 2018, the Supreme Court of Canada granted leave to appeal in *Canada v Callidus Capital Corporation*[1] ("*Callidus*"), meaning the extent of the post-bankruptcy superpriority held by the Canada Revenue Agency (the "CRA") over unremitted Goods and services tax/Harmonized sales tax ("GST/HST") amounts (and other comparable provincial and federal superpriorities)[2] remains a live issue. Secured creditors, insolvency and tax professionals will be awaiting this guidance from the Court, given its significant implications to priority schemes and the ability of secured creditors to recover from assets subject to CRA deemed trust claims.

Background

Callidus involves the common financing scenario where Callidus, a secured creditor, received rental payments a debtor, Cheese Factory Road Holdings Inc. ("CFR"), received from its tenants by way of blocked bank accounts. Callidus also received proceeds from CFR's sale of real property. Callidus applied these amounts as payments against CFR's outstanding indebtedness and obligations.[3] After several years of financial difficulties, CFR, at the request of Callidus, made an assignment in bankruptcy under the *Bankruptcy and Insolvency Act.*[4] The CRA then commenced an action against Callidus to recover unremitted GST/HST amounts collected by CFR, the bulk of which was paid to Callidus to reduce the secured debt before the debtor's assignment in bankruptcy.

Section 222 of the *Excise Tax Act* (the "ETA") creates a deemed trust in favour of the Crown over a debtor's property, which has the effect of giving the Crown superpriority over other creditors for certain tax liabilities. This deemed trust applies to secured creditors who have received proceeds from a debtor's assets subject to the deemed trust. When a debtor becomes bankrupt, this deemed trust is extinguished, and CRA no longer has priority — *i.e.* the bankruptcy "reverses" the priority, subordinates the CRA to claims by secured creditors and treats the CRA as an unsecured creditor. In particular, ETA section 222(1.1) specifically provides that the trust provisions no longer apply "at or after the time a person becomes a bankrupt." In defending the CRA's action, Callidus argued that CFR's bankruptcy rendered the CRA's deemed trust ineffective.

Federal Court of Appeal Decision

At issue before the Federal Court and Federal Court of Appeal was the effect of CFR's bankruptcy on the deemed trust, and in particular whether Callidus could be liable to the CRA for amounts Callidus received from CFR prior to its bankruptcy. The Federal Court of Appeal decided this issue in favour of the CRA. The Federal Court of Appeal held that even where a debtor's assets are released from the deemed trust upon bankruptcy, the trust remains engaged over amounts received by the secured creditor prior to the bankruptcy, in effect, rendering the secured creditor liable for its debtor's GST/HST obligations. The Federal Court of Appeal justified this conclusion, stating that a secured creditor is personally liable for the tax obligation in respect of proceeds the secured creditor receives from the deemed trust. This personal liability is said to create a separate cause of action which the CRA can pursue notwithstanding any subsequent bankruptcy proceedings.[5]

Pending Ruling

Callidus has sought leave to the Supreme Court of Canada, challenging the concept that the secured creditor's obligations exist independently of the deemed trust, and questioning whether the ETA imposes a post-bankruptcy obligation on a secured creditor independent of the deemed trust, to pay the Crown proceeds of property received by the secured creditor prior to the debtor's bankruptcy.[6]

The Supreme Court of Canada's consideration of this issue will provide much needed certainty to priority disputes across Canada, in particular with respect to the ETA deemed trust, but possibly in respect of deemed trust mechanisms in other statutes, such as the *Income Tax Act*, *Alcohol and Gaming Regulation and Public Protection Act*; *The Tax Administration and Miscellaneous Taxes Act*; and *Revenue Administration Act*.[7]

As it currently stands, the Federal Court of Appeal's decision requires secured creditors to pay to the Crown proceeds derived from debtor property subject to a deemed trust, irrespective of the debtor's subsequent bankruptcy.[8] As argued by counsel for Callidus, the Federal Court of Appeal decision renders secured creditors personally liable for their tax debtor's HST liability, regardless of the secured creditor's knowledge of the debtor's tax obligations, and provides the Crown with the power to recover tax from a bankrupt debtor's secured creditors where the ETA explicitly bars the Crown from doing so directly from the bankrupt debtor themselves.[9] This arguably disincentivizes secured creditors from pursuing alternatives to their debtor's liquidation and bankruptcy. Further, this increased uncertainty regarding a debtor's tax liabilities could increase the costs of borrowing.10

Should you have any questions regarding the issues raised in *Callidus* and how they might apply to your circumstances, please contact us or a member of our Insolvency or Tax Litigation and Disputes groups.

1 2017 FCA 162; Callidus Capital Corporation, Supreme Court of Canada Application for Leave to Appeal, submitted September 26, 2017 at para 5 ("Leave Application").

2 Leave Application, *ibid*; see also *Income Tax Act*, RSC 1985, c 1 (5th Supp);*Alcohol and Gaming Regulation and Public Protection Act*,*1996*SO 1996, c 26, Sch;*The Tax Administration and Miscellaneous Taxes Act*, CCSM c R-150; and *Revenue Administration Act*, SNB 1983, c R-10.22.

3 2017 FCA 162 at paras 8-16.

4 *Ibid* at para 18; RSC 1985, c B-3.

5 *Ibid* at para 26.

6 *Leave Application*, para 15.

7 *Supra,* note 2.

8 *Leave Application*, para 13.

9 *Ibid* at para 35.

10 *Ibid* at para 37.

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