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Super Priority or Super Powers? FCA Rules That CRA Can Collect Unremitted GST on Proceeds of Third-Party Secured Interest

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In *The Toronto-Dominion Bank v Queen* (2020 FCA 80), the Federal Court of Appeal (FCA) confirmed a Federal Court (FC) decision and ruled that a secured creditor had a statutory obligation to pay the Canada Revenue Agency (CRA) for a tax debt of an arm's-length borrower because the secured creditor had received proceeds from the sale of the borrower's property which was deemed to be held in trust by the Crown under the *Excise Tax Act* (ETA). The Canadian Bankers Association raised practical concerns, notably that the CRA may hold on to its GST claim for some time while a secured creditor remains on the hook for a third-party debt. However, the FCA confirmed that the deemed trust conveys an absolute super priority over secured creditors.

Background

The Toronto-Dominion Bank (the Bank) loaned amounts to a new client (the Debtor), secured against a property of the Debtor (the Property). At the time the loan was issued, the Debtor had collected, but not remitted, $67,854 of GST (the GST Debt) on supplies made as a sole proprietor, unbeknownst to the Bank. Months later, the Debtor sold the Property and issued trust cheques to the Bank to repay the loaned amounts. A few years later, invoking the deemed trust in its favour, the Crown claimed from the Bank an amount equal to the GST Debt.

By virtue of the ETA, all amounts collected by a person as (or on account of) GST are deemed to be held by this person in trust for the Crown, despite any security interest in the amount, which excludes a pre-existing mortgage, until the amount is either remitted to the CRA or withdrawn as an input tax credit or a deduction from net tax. This deemed trust recognizes that registered suppliers act as agents on behalf of the Crown and ensures that the amounts of GST collected never enter the suppliers' patrimony.

If GST collected is not remitted to the CRA, property of the person (and property held by its secured creditors), including proceeds of the property, equal in value to the tax debt, are deemed to be the property of the Crown, taking priority over any security interest.

At issue was whether the Bank, as a secured creditor, had to pay the Debtor's GST Debt to the CRA because the Bank had received proceeds from the Debtor's Property at a time when the Debtor owed unremitted GST amounts, in priority to the Bank's security interest.

The FCA's Decision

Following a textual, contextual and purposive analysis of section 222 of the ETA, the FCA dismissed the appeal, concluding that the deemed trust created a super priority on the Property in favour of the Crown. The Bank therefore had a statutory obligation to pay the Debtor's GST Debt out of the proceeds received from the Debtor from the sale of the Property. The FCA addressed all three issues raised by the Bank, concluding the following:

i. The deemed trust does not require a triggering event in order to take effect – indeed, while triggering events used to be included in the legislation, they were subsequently removed.

ii. Secured creditors cannot avail themselves of the defence of the bona fide purchaser for value since that would render the deemed trust void – thereby narrowing the interpretation to the contrary made by the Supreme Court of Canada (SCC) in the case *First Vancouver Finance v M.N.R.* (2002 SCC 49).

iii. The fact that the security interests of the Bank were not created and granted in a transaction providing financing to the Debtor's business is irrelevant to the application of the deemed trust.

The FCA also briefly addressed the Canadian Bankers Association's practical concerns. While the FCA acknowledged that its interpretation of section 222 ETA may result in somewhat unfortunate circumstances for secured creditors, the FCA stated that the ETA is clear as to Parliament's intent to prioritize Crown's claims for unremitted GST over those of the secured creditors. From a policy perspective, the FCA found that the "absolute priority" created by the deemed trust principle had been conferred to the Crown in exchange for such priority not surviving procedures under the *Bankruptcy and Insolvency Act* (BIA) or the *Companies' Creditors Arrangement Act* (CCAA). The FCA went on to suggest that secured creditors have "some ability to manage the risk posed by deemed trusts." For example, they "may identify higher risk borrowers (which might include persons operating sole proprietorships), require borrowers to give evidence of tax compliance, or require borrowers to provide authorization to allow the lender to verify with the Canada Revenue Agency whether there are outstanding GST liabilities then known to the Agency."

Takeaways

Without the defence of the bona fide purchaser for value made available to them, the secured creditors are left to deal with the uncertainty stemming from a possible hidden or unknown Crown's super priority. Because of the private and confidential nature of the tax information on which such a super priority is based, the secured creditors can only mitigate the risk of a pre-existing tax debt for unremitted GST/HST without totally removing it. Although this can be done through different mechanisms, such as requesting additional conditions or guarantees, these mechanisms can be daunting for the parties or prove to be ineffective.

In these circumstances, secured creditors may be tempted, as a last resort, to turn themselves to rescue and insolvency procedures. Indeed, and as acknowledged by the FCA, an assignment of a tax debtor's property for the benefit of its creditors under the BIA or the CCAA has the effect of extinguishing the deemed trust, with the result that the Crown's debt then becomes an ordinary unsecured claim.[1] In such a situation, a secured creditor would not be liable for the GST debt of the tax debtor on the proceeds of a secured interest, notwithstanding that a claim may have been asserted by the CRA against the secured creditor prior to the bankruptcy or arrangement under the CCAA, as was recently confirmed by the SCC in *Callidus Capital Corporation v Her Majesty The Queen* (2018 SCC 47), which we summarized here.

[1] Absent an enhanced garnishment under 317(3) ETA (see *Québec (Revenue) v Caisse populaire Desjardins de Montmagny*, 2009 SCC 49) or any other extraordinary circumstances.

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