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Real Estate

Federal Court of Appeal affirms priority to Crown for unremitted HST over creditors

By **Steven Pordage**

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(May 12, 2020, 12:30 PM EDT) -- The deemed trust provisions of the *Excise Tax Act*, R.S.C. 1985, c. E-15 strike fear in lenders, and the recent Federal Court of Appeal decision of *Toronto-Dominion Bank v. Canada* 2020 FCA 80 has affirmed that lenders are right to be fearful.

In the *Toronto-Dominion Bank* decision, the debtor was a sole proprietor who collected, but did not remit HST in 2007 and 2008. In March 2010, the bank granted a line of credit to the debtor and his wife with a credit limit of $246,000. The following month, the bank extended a loan to the debtor and his wife in the amount of $352,000. Both debts were secured by separate mortgages registered against the property.

At the time of both loan applications, the bank was not aware of any debts owed by the debtor pursuant to the Act.

In late 2011, the debtor sold and transferred the property to third-party purchasers for $881,000. The bank did not enforce its security against the debtor. Rather, the debtor's lawyer issued two trust cheques to the bank in the amounts of $245,147.78 and $334,546.49 to repay the line of credit and the mortgage and discharge the charges registered against the property. The bank subsequently discharged its two mortgages registered against the property.

On April 18, 2013, and Feb. 2, 2015, the Canada Revenue Agency (CRA) asserted a deemed trust claim under s. 222 of the Act against the bank on the basis that the proceeds it received from the sale of the property ought to have been paid to the Receiver General up to the amount deemed to be held in trust. The amount of the deemed trust claim was $67,854.

Subsection 221(1) of the Act provides that:

Subject to subsection (1.1), every person who collects an amount as or on account of tax under Division II is deemed, for all purposes and despite any security interest in the amount, to hold the amount in trust for Her Majesty in right of Canada, separate and apart from the property of the person and from property held by any secured creditor of the person that, but for a security interest, would be property of the person, until the amount is remitted to the Receiver General or withdrawn under subsection (2).

Subsection 222(3) of the Act extends the trust created by subsection (1) to the property of the tax debtor and property of the tax debtor held by any secured creditor.

The central issue raised on appeal was the correct interpretation of subsections 222(1) and (3) of the Act; namely, is a secured creditor who receives proceeds from a tax debtor's property at a time when the debtor owes GST to the Crown required to pay the proceeds, or a portion thereof equalling the tax debt, to the Receiver General in priority to all security interests? The short answer is a qualified yes.

The court found that when the bank lent money to the debtor and took its security interests, the debtor's property to the extent of the tax debt was already deemed to be beneficially owned by the Crown. The court therefore held that when the debtor's property was sold, by operation of subsection

222(3) of the Act, the bank was under a statutory obligation to remit the proceeds it received to the Crown.

The reason that the priority is qualified is because in its decision the court confirmed that: (i) the priority does not survive bankruptcy under the *Bankruptcy and Insolvency Act* and does not apply to arrangements under the *Companies' Creditors Arrangement Act*; and (ii) "security interest" does not include a prescribed security interest (as such term is defined in *Security Interest (GST/HST) Regulations*, S.O.R./2011-55.

Absent these situations, however, secured creditors could find themselves in a situation where funds that they have received from a debtor in exchange for a discharge of their security must be paid to the Crown, leaving a lender with little alternative but to commence a claim against a debtor who may not have any assets.

The court did propose certain solutions for secured creditors to mitigate their risks, suggesting that lenders could require borrowers to give evidence of tax compliance, or require borrowers to provide authorization to allow the lender to verify with the CRA whether there are outstanding GST liabilities then known to the CRA. While this is true in theory, no details were provided on what this evidence would look like and this author is skeptical that the CRA will be able to provide unqualified assurances in a timely manner to give lenders absolute comfort.

The implications of the *Toronto-Dominion Bank* decision are far reaching and will certainly alter lending practices in the years to come. How lending practices are altered, however, remains to be seen.

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