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**THE RESURRECTION OF  
GOODS AND SERVICES TAX CLAIMS IN  
BANKRUPTCY**

**BY**

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# **THE RESURRECTION OF GOODS AND SERVICES**

## **TAX CLAIMS IN BANKRUPTCY**

*by Roger P. Simard\**

### **I. INTRODUCTION**

Is there a real trust or right of ownership in favour of the Crown<sup>1</sup> for the sales and services tax portion of an account receivable owed to a bankrupt supplier by its customer?

And if so, does the statutory tax collection mechanism applicable prior to the bankruptcy of the supplier, and the rules applicable thereafter, preclude or impede the Crown's ability to enforce its rights: i) when the taxes remain unpaid, directly

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<sup>1</sup> For the purposes of this paper, the tax authorities will sometimes be referred to simply as the "Crown". It is represented in Québec by the Deputy Minister of Revenue of Québec ("DMRQ"), who collects the QST and is also entitled to act as agent of the federal tax authorities in Québec for the purposes of collecting the GST pursuant to an administrative agreement announced in a press release of the Department of Finance dated August 30, 1990. Elsewhere in Canada, the Crown is represented by Revenue Canada, which over time became the "Canada Customs and Revenue Agency" and is now the "Canada Revenue Agency" for purposes of collecting the GST or, in some provinces, the Harmonized Sales Tax.

against the customer/purchaser or (ii) when the taxes have been paid after bankruptcy, against the trustee or receiver who collected the accounts receivable wherein the taxes are charged from the purchaser?

These are the two questions that have recently been answered by the courts with controversial and opposite conclusions, and which are now before the Supreme Court of Canada.

To answer these questions, we will need to review the applicable provisions of the *Excise Tax Act*<sup>2</sup> (“ETA”) for the goods and services tax (“GST”), *An Act respecting the Québec Sales Tax*<sup>3</sup> (“QSTA”) and *An Act respecting the Ministère du Revenu*<sup>4</sup> (“ARMR”) for the Québec sales tax (“QST”) and discuss how they interact with the *Bankruptcy and Insolvency Act*<sup>5</sup> (“BIA”). The GST and QST are direct taxes payable by the purchaser but collected indirectly from the suppliers, with an input tax credit in favour of each supplier along the economic chain.

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<sup>2</sup> R.S.C. (1985), c. E-15, s. 222(1).

<sup>3</sup> R.S.Q., c. T-0.1.

<sup>4</sup> R.S.Q., c. M-31.

<sup>5</sup> R.S.C. (1985), c. B-3, as amended.

For discussion purposes, we will also compare the arguments and solutions that would be obtained under the Ontario *Retail Sales Tax Act*.<sup>6</sup> Because the Ontario retail sales tax is also a direct tax collected indirectly, but without any input tax credit, it would appear that the Ontario provincial Crown could be in a much better position to assert and prove a right of ownership on the tax portion of the accounts receivable. The forthcoming Supreme Court of Canada ruling could have an impact on the Ontario sales tax collection efforts if the Court draws a distinction based on the collection mechanism.

The issues are particularly complex and this is reflected in the completely opposite conclusions reached, on one side, by the Superior Court of Québec in four cases and, on the other side, by the unanimous Québec Court of Appeal in three of the Superior Court decisions that were appealed. The Court of Appeal granted the appeals against the initial judgments in favour of the DMRQ. The matter of these three appeals is presently before the Supreme Court of Canada and this paper respectfully throws a hat in the ring with yet a third and somewhat different reasoning to the solution of these issues.

It may very well be that the Crown does have a right of ownership in the goods and services taxes owed to a bankrupt supplier by a third party customer and that

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<sup>6</sup> *Retail Sales Tax Act* (Ontario) R.S.O., 1990 c. R.31. On March 26, 2009, the Honourable Dwight Duncan, Minister of Finance of Ontario, tabled the 2009 Ontario Budget and announced that the province's existing 8% retail sales tax will be harmonized with the 5% federal goods and services tax effective July 1, 2010.

such taxes are protected in favour of the Crown by an identifiable trust that can be enforced against the trustee in bankruptcy or a receiver, as the Superior Court of Québec has decided in answering the first question above. It may also well be that the tax collection scheme precludes the Crown from enforcing its rights after bankruptcy, as the Québec Court of Appeal decided in answering the second question above. However, a positive answer to this first question does not resolve completely the issue in favour of the Crown, nor does a positive answer to the second question resolve completely the issue against the Crown. These answers from the Superior Court and the Court of Appeal should be qualified and analysed in the global scheme of the tax legislation.

In our view, the real questions to be answered are: is the Crown entitled to enforce any rights against the purchaser after the supplier's bankruptcy and, if so, which part of the taxes claimed from the purchaser are still owing to the Crown?

By claiming directly against the purchaser, or the trustee/receiver as successor agent of the Crown collecting from the purchaser, the Crown is ignoring the goods and services tax collection scheme enacted by legislation that existed and applied prior to the bankruptcy of the supplier and the legal consequences that result from this collection scheme. The Crown is also ignoring the rules that apply to the trustee after the bankruptcy of the supplier. In our view, even after a positive answer to the first question, it then becomes necessary for the courts to unscramble this collection omelette to determine whether the taxes claimed from the purchaser are, in fact, still owed to the Crown. The amounts claimed from the

purchaser must be applied and identified by the Crown to the amounts owing by the bankrupt supplier, based on a strict application of its own mandate, ownership or trust arguments and a comprehensive reading of the tax legislation as a whole, and not of a single provision imposing the tax on the purchaser.

This process results in an accounting and identification issue that is yet more complex and it may well be that, save for exceptional circumstances, the Crown will not be in a position to ascertain a valid trust or ownership claim on the tax portion of the account receivable that is relating directly to an outstanding claim on all or part of these taxes.

The proposed approach of this paper to the second question is that the “direct” taxes payable by the ultimate purchaser have, for the most part, already been paid “indirectly” by the suppliers along the economic chain as these suppliers were compelled by legislation to remit these taxes by successive instalments, whether they have collected them or not, sometimes weeks or months prior to the ultimate sale. Therefore, the Crown cannot demand payment of what it already received or gave credit for.

Part II of this paper follows the new argument advanced by the Crown and its path through the courts leading to the current appeals pending before the Supreme Court of Canada. Part III reviews the analysis of the Supreme Court of Canada in the references concerning the GST and QST, leading to their qualification as direct taxes and leads to the analysis of the resulting direct liability of the purchaser towards the Crown. Part IV summarizes the collection mechanisms put

in place for the GST and QST and the input tax credit system that enables collection of the tax through the various steps of the economic process. Part V analyzes the effects of the bankruptcy of a supplier on the tax collection statutory mandate. Part VI studies the conditions of existence of a true trust or ownership claim that would apply to these taxes. Part VII answers the second question by trying to link the alleged true trust with the claim of the Crown that may exist after the alleged end of the statutory tax collection mandate given to the supplier. The conclusion evaluates the potential outcomes and consequences of the forthcoming Supreme Court of Canada decision.

## **II. STATUS OF LITIGATION WITH RESPECT TO GST AND QST**

On November 30, 1992, the long awaited reform of the *Bankruptcy Act* was enacted with the coming into force of the *Bankruptcy and Insolvency Act*.<sup>7</sup> One of the major achievements of this reform was the simplification and streamlining of the various priorities that existed in favor of the Crown, as enacted by various federal and provincial legislations. In exchange for obtaining first ranking protection that survives bankruptcy for the payroll source deductions claims,<sup>8</sup> the Crown reluctantly agreed to see its other claims downgraded from the status of

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<sup>7</sup> See *supra*, n. 5.

<sup>8</sup> *Income Tax Act*, R.S.C. c. 1, 5<sup>th</sup> Supp., as amended, at s. 227(4.1). See Roger P. Simard, “The Federal enhanced deemed trust: a new source of liability for financial institutions?”, Annual Review of Insolvency Law 2008, Carswell.

secured or preferred claims to become ordinary unsecured claims, with the exception of security that is available to the Crown as well as to all persons.<sup>9</sup>

In the following years, there appeared to be no issue of law and no doubt that the Crown’s claims for GST and QST were to be directed against the bankrupt estate of the supplier, and that these claims were unsecured. The Crown was consistently filing unsecured proofs of claim in the estates of the bankrupt suppliers. This was the only recourse used by the Crown, other than the personal liability of the directors of the bankrupt supplier, and it was efficient and predictable because the

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<sup>9</sup> S. 86 of the *BIA* provides the following:

86. (1) In relation to a bankruptcy or proposal, all provable claims, including secured claims, of Her Majesty in right of Canada or a province or of any body under an Act respecting workers’ compensation, in this section and in section 87 called a “workers’ compensation body”, rank as unsecured claims.

Exceptions

(2) Subsection (1) does not apply

(a) to claims that are secured by a security or privilege of a kind that can be obtained by persons other than Her Majesty or a workers’ compensation body

(i) pursuant to any law, or

(ii) pursuant to provisions of federal or provincial legislation, where those provisions do not have as their sole or principal purpose the establishment of a means of securing claims of Her Majesty or of a workers’ compensation body; and

(b) to the extent provided in subsection 87(2), to claims that are secured by a security referred to in subsection 87(1), if the security is registered in accordance with that subsection.

Crown’s claim against the supplier is the only one that is reported and accounted for in the tax collection system.

**A. *The new argument advanced by the Crown***

It seems that the giant was awakened by relatively obscure cases that did not even deal directly with the issue at hand. In a comprehensive and well researched paper,<sup>10</sup> author Louise Lalonde explains that the cases of *Williston Wildcatters Oil Corp. (trustee of)*<sup>11</sup> and *Alnav Platinum Group Inc. v. APM Delstar*<sup>12</sup> appear to be the first instances on the issue and from which the new argument advanced by the Crown appears to be developed. The Crown’s argument is based on the following premises: the taxes are owed to the Crown by the purchaser and the supplier is simply acting as agent of the Crown to collect an amount that is owing to the Crown. Therefore, upon bankruptcy of the agent, the Crown can collect directly from the purchaser because the Crown is the owner of the claim. A simple argument is often convincing.

In *Williston Wildcatters*, the Crown was successful in obtaining an order forcing the trustee to pay the GST included in an account receivable generated between

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<sup>10</sup> Louise Lalonde, “La TPS, la TVQ et la «super-priorité» de la Couronne : la Couronne ravive les querelles épiques avec les créanciers garantis et les syndics”, Insight Information, 6<sup>ième</sup> Édition Insolvabilité et Restructuration Commerciale, Montréal, April 7 and 8, 2008.

<sup>11</sup> *Williston Wildcatters Oil Corp. (Trustee of)*, (1996) 40 C.B.R. (3d) 301 (Sask, Q.B.); 45 C.B.R. (3d) 73 (Sask. C.A.) (“*Williston Wildcatters*”).

<sup>12</sup> *Alnav Platinum Group Inc. v. APM Delstar*, [2001] 32 C.B.R. (4<sup>th</sup>) 1, (“*Alnav*”).

the initial bankruptcy event and the date of bankruptcy, in that case respectively a bankruptcy petition and a receiving order that had a retroactive effect, according to the then applicable law.<sup>13</sup> The deemed retroactive effect of the receiving order had the consequence of deeming that the sale was made “post-bankruptcy”, therefore made notionally by the trustee. As such, the reasoning can now be limited to circumstances where the trustee is himself continuing the business of the bankrupt and generating new accounts receivable.

In *Alnav*, the Crown was again successful in claiming against a trustee an amount of GST that was identifiable or traceable as it had been collected by a receiver prior to the bankruptcy. For the court, these amounts are collected by agents and bypass the bankrupt’s estate. However, the agency relationship was not the ratio of the decision. The court found that a trust existed as the three certainties of intent, object and beneficiary existed.

***B. Québec Superior Court decisions***

The two common law precedents mentioned above had very little echo in Québec, but certainly had an impact on the arguments put forward by the Deputy Minister of Revenue of Québec in his attempts to increase his success rate in the collection of both GST and QST. It did not take long for four Québec Superior Court decisions to come out on the matter and they all found in favour of the DMRQ. This caused quite a surprise and some uproar amongst trustees and bankers.

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<sup>13</sup> S. 71(1) *BIA*, now repealed.

**i. *Chibou-vrac***

The new and improved arguments based on the mandate and real trust were argued in remote Rouyn-Noranda district before the Québec Superior Court. The insolvency community was astounded in August 2003 when the decision was rendered in favour of the DMRQ in *Chibou-vrac*.<sup>14</sup> The Court was reluctant to rule in favour of the DMRQ solely on the basis of a trust, as provincial law opened the door to such an argument, while the federal *ETA* does not provide for any trust, deemed or real, that could continue to apply after bankruptcy. The result would have granted more rights for the province for QST than rights for the federal authorities for GST. However, the Court accepted the mandate argument based on section 265(1)a) *ETA*; the trustee continues the obligations of the bankrupt, as a mere agent of the Crown, and collects from the customer as a mandatory<sup>15</sup> of the Crown. Therefore, the trustee must remit to the Crown the GST and QST portion of any account receivable he collected.

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<sup>14</sup> *Chibou-vrac Inc. (Syndic de)* [2003] R.J.Q. 2811 (“*Chibou-vrac*”).

<sup>15</sup> The word “mandatory” is an inaccurate translation by the Québec legislator, in the *CCQ*, of the French word “mandataire”. It seems the legislator was reluctant to use the English noun “mandatory” in the meaning “one given a mandate”, which could be mistaken with the adjective meaning “containing or constituting a command”, both found in Webster’s 9<sup>th</sup> New Collegiate Dictionary. According to the rules of interpretation, the French version has precedence and the word means “representative”.

The *Chibou-vrac* case had an immediate impact on insolvency practice in Québec. Since 1992, financial institutions, trustees and receivers had worked on the assumption that goods and services tax claims were to be directed by the Crown at the insolvent supplier only and were unsecured claims in the supplier's bankruptcy. Despite the fact that financial institutions would take reserves and provisions for sales taxes due in their coverage ratio calculations for short term revolving loans secured by accounts receivable, and look only at the amount net of taxes due as a notional value of their security, they knew that in practice the gross amount including taxes would be cashed in by the trustee or receiver and applied against their secured advances. The trustees and receivers, for their part, would remit these amounts to creditors without hesitation and often without a specific indemnity, as there appeared to be no possible claim by the Crown resulting from the collection of the sales and service taxes included in the receivable amounts. This result is not as inequitable and unconscionable as it may appear at first sight, as we will discuss below, because the financial institution very often has financed payment of these same taxes to the Crown in the previous reporting periods.

The immediate results of *Chibou-vrac* were a reduction of 12.875% (being the combined composed rates of 5% for GST and 7.5% for QST) of the realisable value of accounts receivable and the need for trustees and receivers to obtain specific indemnities before remitting any such amounts to the secured creditors. It also impeded distribution to unsecured creditors.

The Crown, embled by its success, started to interfere with the realization process of trustees and receivers by claiming the taxes directly from the customers. The Crown demanded that trustees and receivers supply the tax authorities with copies of the invoices and other documents, including the list of accounts receivable, which documents the Crown used to pursue customers. Customers started demanding indemnities from trustees and receivers before accepting to pay their accounts, or simply refused to pay in view of the multiple demands made on them.

**ii. *Alternative Granite and related cases***

The *Chibou-vrac* case was not appealed, so trustees and financial institutions were looking for an opportunity to litigate the matter again with the DMRQ. Many cases were decided, all in favour of the Crown at the Québec Superior Court level, and three of these would find their way to the Québec Court of Appeal and, ultimately, to the Supreme Court of Canada.

In *M.P.X.*,<sup>16</sup> some accounts receivable secured in favour of Caisse Populaire Desjardins de Montmagny had been collected by the trustee and deposited in the estate account when the DMRQ issued letters to the trustee claiming the portion of the amounts so collected representing GST and QST. The bankrupt supplier was apparently up-to-date in its filings and remittances, except for July and

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<sup>16</sup> 9083-4185 *Québec inc.(MPX) (Syndic de)*, J.E. 2006-1005, (“*M.P.X.*”), see paras. 12 and 29 with respect to the absence of a proof of claim for taxes by the DMRQ.

August 2005 when the assignment in bankruptcy was made on September 7, 2005. The DMRQ had decided not to file a proof of claim for GST and QST in the bankrupt supplier's estate, to be consistent with its ownership/mandate argument. However, the DMRQ agent testified that \$13,088.24 was owed by the supplier, net of inputs, on the date of bankruptcy. The judgment is silent on whether the taxes collected by the trustee relate to the period of the alleged claim. The Superior Court of Québec found that the purchasers were liable to the Crown for the taxes, that the trustee was an agent of the Crown for collection purposes and that therefore, the taxes collected by the trustee were not part of the bankrupt estate. The Court applied a simple mathematical "rule of three" to determine which portion of the amounts collected by the trustee could be determined to represent taxes.

In *Alternative Granite*,<sup>17</sup> the receiver appointed by secured creditor National Bank of Canada, the bankruptcy trustee and the DMRQ, in the later case after issuing demand letters directly to customers of the bankrupt, each collected various amounts of GST and QST on accounts receivable of the bankrupt. This is a typical example of the chaos that resulted from the Crown's new argument as three different parties collected a part of the estate's accounts receivable. The trustee, the receiver and the DMRQ asked the court to decide who was entitled to

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<sup>17</sup> *Alternative Granite et Marbre Inc. (Syndic d')* J.E. 2006-1005, 2006 QCCS 2656, reversed in appeal J.E. 2008-155, 2007 QCCA 1813, leave granted to the Supreme Court of Canada on February 15, 2008, file No 32486 ("*Alternative Granite*").

these amounts. The Court found that the bankrupt was collecting taxes as agent of the Crown and therefore, the taxes were not part of the bankrupt's property and could not be subject to the security interest of the bank. The judgment is silent on whether the taxes collected by any of the parties relate to the period of the alleged claim.

In *Consortium Promecan*,<sup>18</sup> the same issue was submitted again to a fourth judge of the Québec Superior Court. The facts reveal that an amount was owing to the bankrupt supplier for services rendered in February and March 2004. The DMRQ had filed a claim based on an estimate of GST and QST owing for these two months immediately preceding the bankruptcy. The Court followed the previous decisions of *Chibou-vrac*, *M.P.X.* and *Alternative Granite*. The Court relied extensively on the law of mandate as enacted by the Civil Code of Québec (“CCQ”). The judgment states that the taxes collected relate to invoices for the claim period but is silent on the issue of ITCs and RTCs (as defined below in Part IV) in that period.

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<sup>18</sup> *Consortium Promecan Inc. (Syndic de)*, 2006 QCCS 6370, reversed in appeal 2007 QCCA 1835, leave granted to the Supreme Court of Canada on February 15, 2008, file No 32489 (“*Consortium Promecan*”).

*C. Québec Court of Appeal decisions*

The main reasons of the Québec Court of Appeal were rendered in the 9083-4185 *Québec inc. (Syndic de)*<sup>19</sup> decision, which is the appeal of the *M.P.X.* case referred above.<sup>20</sup> The trustee's motion for direction and declaratory judgment was granted. The Court ruled against the Crown and declared that the GST and QST claims are unsecured within the meaning of the *BIA* and that the Deputy Minister of Revenue has no rights in the accounts receivable of the bankrupt, that the trustee does not have to hold these taxes in trust, nor does he have to supply the tax authorities with copies of the invoices or any documents, including the list of accounts receivable. The Court further declared that the secured claim of the Caisse Populaire Desjardins de Montmagny was enforceable and had priority over the rights of the DMRQ. Similar conclusions were reached in the *Alternative Granite* and *Consortium Promecan* appeals.

To reach these conclusions, the Honourable Duval Hesler, J.C.A. found that the specific facts of each of the three appeals were not determinative for the resolution of the issue.

The Court of Appeal formulated a limited and alternative question: is the DMRQ the owner of the amounts collected or collectable for GST and QST by the

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<sup>19</sup> 9083-4185 *Québec inc. (Syndic de)*, 2007 QCCA 1837, J.E. 2008-155, [2008] R.J.Q. 39, leave granted to the Supreme Court of Canada on February 15, 2008, file No 32492.

<sup>20</sup> See *supra*, n. 16.

bankrupt supplier on the date of bankruptcy, or, on the contrary, is he an unsecured creditor in the bankruptcy?

This question studies the taxes only from the point of view of the property of the bankrupt and the rights of the Crown against the bankrupt estate. The Court did not address the distinct rights that the Crown may have against the ultimate purchaser, nor the consequences that flow from the qualification of the bankrupt as a simple agent of the Crown and the real function of the supplier in the collection scheme.

The Court of Appeal then sub-divided the issue into three subquestions:

- The first is to determine the nature of the rights conferred by law to the DMRQ, given that the GST and QST are direct taxes payable by the ultimate purchaser;
- Secondly, the Court questioned how a fungible property such as money could be identified and claimed;
- Thirdly, it was necessary to examine the federal bankruptcy legislation as it may impose a scheme of distribution that cannot be modified by the provinces. Obviously that issue is not relevant to the GST claims.

On the first sub-question, the Court went on to analyze the history of the tax and bankruptcy legislations on the priority of Crown claims. The Court concluded that the rights of the Crown against the estate of the bankrupt supplier were meant by

the 1992 reform to be unsecured, and that the deemed trust for GST and QST against the estate of the supplier does not survive bankruptcy. The Court then turned to the Crown's argument that the taxes were collected as agent and mandatory of the Crown. The Court did not address the consequences of an agency relationship, but reduced the argument to the existence and enforceability of a trust under section 67 *BIA*. Because of the input tax credit system, the Court denied the existence of a true trust.

On the issue of fungibility, the Court relied on the decision of *British Columbia v. Henfrey Samson Béclair*,<sup>21</sup> which is a case on the enforceability of a provincial deemed trust. The Court of Appeal found that the taxes could not be identified in a specific invoice or payment, as they sometimes are included in the global price, or remitted by the supplier prior to collection, or uncollected.

This finding is a debatable. In each dollar collected by the trustee or receiver, it can be easily established that \$x are GST and \$y are QST and the balance is the account itself. The taxes can be identified, but we agree with the Court of Appeal that they cannot be identified as the specific taxes claimed and owing, at least if it is not showed that they are not remitted.

On the third issue, the Court of Appeal concluded that provincial legislation cannot upset the federal bankruptcy scheme of distribution. Even if this issue was not central to the debate, this finding will have an important effect if a province

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<sup>21</sup> *British Columbia v. Henfrey Samson Béclair* [1989] 2 R.C.S. 24.

attempts to fix its tax legislation to circumvent an eventual ruling of the Supreme Court against its arguments.

The question formulated by the Court of Appeal does not require mutually exclusive answers: the Crown can in theory have an unsecured claim against the supplier and also have a distinct and autonomous right of ownership claimable against the customer. To make that determination, in our view, the specific facts of each case are essential to determine if a Crown claim still exists for these taxes.

Although the result reached by the Court of Appeal resolves a problem that created a major economic uncertainty, the finding that the input tax credit system denies the possibility of a true trust seems to contradict the finding that the taxes are and remain direct taxes payable by the purchaser, despite the fact that they are collected indirectly. In other words, the Court of Appeal seems to say that because the taxes are collected indirectly, they must be treated as indirect taxes in a bankruptcy. That is why this paper suggests arriving at that same conclusion by analyzing if the tax legislation affords any direct rights against the purchaser and, if so, to determine if the taxes have actually been paid or not.

***D. Supreme Court of Canada***

Appeals from the three cases mentioned above<sup>22</sup> have been heard and taken under reserve by the Supreme Court of Canada.

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<sup>22</sup> See *supra*, n. 17, 18 and 19.

The fact that the DMRQ obtained leave to appeal these cases is in itself somewhat unusual in many respects.

First, the Supreme Court is usually reluctant to grant leave to appeal to the tax authorities on enforcement matters, because tax laws are constantly changed to improve and correct deficiencies in tax collection procedures. In this case, it is not clear if the provincial legislators could have circumvented the Québec Court of Appeal reasoning by enhancing their rights against the purchaser and limiting the trustee's alleged mandate to collect the taxes.

Second, the Court of Appeal decision was unanimous and does not directly contradict the Saskatchewan Court of Appeal reasoning in *Williston Wildcatters*. In principle, there was no issue of uniform application of federal tax and insolvency laws across Canada.

All these indicate that the Supreme Court bench sitting on the leave application found either an apparent weakness in the Court of Appeal decisions or simply wanted to intervene to resolve the issue at a national level without going through years of uncertainty in other provinces. In our view, it may also be that the Supreme Court found the reasoning or conclusion reached by the Court of Appeal irreconcilable with those of the Supreme Court in the *GST Reference* and the *QST Reference*,<sup>23</sup> possibly on the Supreme Court's previous finding that the tax

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<sup>23</sup> See *infra*, Part III.

collection scheme does not change the nature of the taxes and therefore, the direct liability of the purchaser to the Crown.

### III. QUALIFICATION OF GST AND QST AS DIRECT TAXES

Taxpayers are faced with only two certainties: death and taxes.<sup>24</sup> Whether a tax is direct or indirect would not seem too relevant to both the living and the dead. However, a proper qualification of the true nature of the tax is necessary to establish the respective roles of the parties involved and their respective rights. The Supreme Court of Canada rendered decisions on two constitutional references, one with respect to the GST and one with respect to the QST and in doing so, provided valuable comments and insight into the tax system and resulting respective rights and obligations of the Crown, the supplier and the customer.

There is now no issue that the GST and QST are direct taxes. The Superior Court concluded that this qualification was sufficient to establish an absolute right to the taxes in favour of the Crown against the purchaser as tax debtor. The Court of Appeal also qualified the taxes as direct, but ruled that the tax collection mechanism superseded or had the effect of replacing the direct liability of the

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<sup>24</sup> *“Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes.”* Benjamin Franklin in Letter to Jean-Baptiste Leroy (13 November 1789), found at [http://en.wikiquote.org/wiki/Benjamin\\_Franklin](http://en.wikiquote.org/wiki/Benjamin_Franklin).

customer in favour of an indirect liability of the supplier, not as collection agent but, in essence, as tax debtor. Under this indirect liability, the recourses of the Crown were limited to those available under the *BIA*.

We are of the view that the *GST Reference* and the *QST Reference* have decided this issue and that the tax collection scheme does not change the direct nature of the tax. Therefore, the collection scheme cannot have the effect of negating the direct liability of the purchaser. But the collection scheme is relevant in determining first, if the Crown has a recourse against the purchaser and second, if the taxes owed by the purchaser have already been paid over to the Crown by the suppliers, in whole or in part, for and on behalf of the purchaser, along the economic chain leading to the final sale. In other words, how are we to determine if the purchaser has discharged his obligation to pay if not by inquiring into the payments made by the suppliers on behalf of the purchaser in compliance with the provisions of the *ETA* and *QSTA*?

**A. *Reference re Goods and Services Tax***

In the *Reference re Goods and Services Tax*,<sup>25</sup> the Supreme Court provided the following comments:

The GST, in contrast, does not apply to exports. It applies to the domestic provision of taxable supplies, and it is the purchaser, rather than the supplier, which is liable to pay the tax. Indeed, the tax only becomes payable by virtue of

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<sup>25</sup> *Reference re Goods and Services Tax*, [1992] 2 S.C.R. 445, (sub nom. “*GST Reference*”).

transactions in which some property interest has left the supplier and become vested in the purchaser. Clearly, therefore, it is the purchaser, not the vendor, which is taxed.<sup>26</sup>

The Court went further and qualified the collection scheme as a mere administrative burden:

The most that can be said of the collection and remittance obligations created by the GST Act is that they impose certain administrative burdens on commercial entities operating in the province. It is only in so far as the province operates as a commercial entity that it becomes subject to these burdens.<sup>27</sup>

Therefore, it would seem inconsistent with the *GST Reference* to find that the collection scheme has the effect of transforming the GST from its true nature as a direct tax payable by the ultimate purchaser into an indirect tax. The Supreme Court had considered this collection scheme before ruling that the tax was a direct tax nonetheless.

**B. Reference re Québec Sales Tax**

In the *Reference re Québec Sales Tax*,<sup>28</sup> the issue of the direct tax was central to the ratio of the decision. The Court explained the QST tax system as follows:

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<sup>26</sup> *Ibid.*, at p. 480.

<sup>27</sup> *Ibid.*, at pp. 484-485.

<sup>28</sup> *Reference re Québec Sales Tax*, [1994] 2 S.C.R. 715 (sub nom. “*QST Reference*”).

The general operation of the proposed tax is clear from an examination of the concept of taxable supply. A taxable supply is defined in s. 1 of the draft Act as the provision of property or a service in any manner, including sale, transfer, barter, exchange, licence, lease, gift or alienation in the course of a commercial activity. Every purchaser of a taxable supply must pay a tax equal to 8 percent of the value of the consideration given for the supply (in certain cases reduced to 4 or 0 percent (zero-rated supplies); draft Act, s. 2). As with the GST, the purchaser of a taxable supply who uses that good or service in the production of other taxable supplies will be entitled to a refund from the government equal to the amount of tax initially paid on its inputs (the input tax refund or the input tax credit under the GST; draft Act, s. 13). To the extent that taxable supplies are not used by the purchaser to produce other taxable supplies, by definition they will be consumed by the purchaser for non-commercial purposes. In such a case, the purchaser will not be eligible for an input tax refund. The tax will thus be collected and refunded at each stage of the production and marketing process until the ultimate consumer is reached. The input tax refund mechanism, in the case of taxable supplies, thus ensures that the tax is paid by the ultimate consumer.

(...)

The collection of the tax will be assured by every person engaged in commercial activities who makes a taxable supply. The persons collecting the tax are agents of the Minister of Revenue and are required to be registered with the Minister (draft Act, s. 25 and 28). Registration must occur before a taxable supply is made and is a condition precedent of eligibility for the input tax refund. Registrants are required to file returns in which they calculate their net tax for a reporting period (draft Act, s. 30). The net tax is essentially the difference between the amount of tax collected and the input tax refund for which the person is eligible

in a given reporting period (draft Act, s. 29). On the basis of these calculations, the registrant will either be entitled to a refund from the government or be obliged to pay over the excess tax collected.<sup>29</sup>

The issue of the direct taxation was based on the *Constitution Act, 1867*:

The central issue in this reference is whether the proposed tax, in its general operation as well as its specific details, is a tax within the provincial taxing power contained in s. 92(2) of the *Constitution Act, 1867*. Section 92(2) stipulates:

**92.** In each Province the Legislature may exclusively make Laws in relation to Matters coming within the Classes of Subjects next hereinafter enumerated; that is to say,

(...)

2. Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes.<sup>30</sup>

The Court relied on the usual authorities to define what is a direct tax:

It is well established that whether a given tax is direct or indirect in terms of the *Constitution Act, 1867* is a question of law and not of economic incidence. The test predominately relied on in the jurisprudence to distinguish between the two types of taxes is the formulation employed by John Stuart Mill in his 1848 treatise, *Principles of Political Economy*, Book V, c. III, at p. 371:

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<sup>29</sup> *Ibid.*, at pp. 721-3.

<sup>30</sup> *Ibid.*, at pp. 723-4.

A direct tax is one which is demanded from the very persons who, it is intended or desired, should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another; such as the excise or customs.<sup>31</sup>

Once qualified as a direct tax, the collection scheme cannot alter the nature of the tax:

The final proposition of relevance in determining the constitutional validity of the proposed value-added tax is that the nature of a tax is not affected by the system of collection (see *Kingcome, supra*; *Atlantic Smoke Shops, supra*, and *Cairns, supra*). The fact that a retailer collects the tax from a consumer on behalf of the government and then physically pays the money over to the government does not alter the characterization of such a tax as direct. The person intended to bear the burden of the tax, the consumer, is still the one who in reality pays it even though the retailer as agent for the government collects it. It is true that the retailer bears a burden in relation to the collection of the tax; however, this burden is part of the general cost of doing business and cannot be related to or passed on in a recognizable form with any particular good.<sup>32</sup>

The Court concluded that the tax is collected by instalments from the customer throughout the process:

As noted above, the proposed tax will be paid and then reimbursed at each stage until final consumption. Imposing the tax at each level in the consumption chain

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<sup>31</sup> *Ibid.*, at p. 724.

<sup>32</sup> *Ibid.*, at p. 727.

is simply a method of tax collection by instalments. The persons who collect the tax along the chain and who are reimbursed are really tax collectors. The draft Act, it will be remembered, explicitly identifies these persons as agents of the Minister of Revenue in their capacity as tax collectors (draft Act, s. 28). Rather than putting forward a new and different type of tax, the essence of the proposed amendments is simply to substitute a new mechanism of collection.

The availability of the input tax refunds is the key to understanding what is truly going on prior to the stage of ultimate consumption. Eligibility for an input tax refund relieves the consumer turned supplier from the burden of the tax which is then charged to the person who purchases the good. The reimbursement of the tax initially “paid” through the mechanism of the input tax refund means that there is no tax to be passed on. The input tax refund thus guarantees that the person who ultimately pays the tax is the one who was intended should bear the burden and that therefore the proposed tax is a form of direct taxation. Though the input tax refund mechanism operates behind the scenes to produce this result and though the GST, for example, can be included in the price and appear only on the final invoice, consumers are fully aware, often to their dismay, that they are paying the tax. Indeed the federal government made it very clear in the background papers to the GST, that in replacing the hidden federal sales tax it was “committed to ensuring that Canadians [be] informed in a clear and visible manner that the GST is being applied” (*Goods and Services Tax: An Overview*, Department of Finance, August 1989, at p. 20; see also *Budget 89: The Goods and Services Tax*, Department of Finance, April 27, 1989, at pp. 19 and 25). As noted above, such transparency is one of the hallmarks of direct taxation.<sup>33</sup>

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<sup>33</sup> *Ibid.*, at pp. 730-1.

Therefore, if the suppliers along the chain are tax collectors acting for the Crown, it is difficult to conceive that the Crown can suddenly claim the full amount from the end user without regard for what it received throughout the process from its collectors. The mere fact that the purchaser has not yet paid the taxes does not mean that they are unpaid to the Crown. This situation is the result not only of the instalment scheme but also the result of the accrual accounting system forcing suppliers to remit taxes that they have not yet collected.

***C. Liability of the purchaser***

The ultimate liability of the purchaser towards the Crown is made clear from the legislation. It is an essential component of the qualification of the GST and QST as direct taxes. But it is not the real question that needs to be answered. That question is whether or not the taxes are payable directly to the Crown and if so, whether they have already been paid to the Crown, for and on behalf of the purchaser, by one or more various suppliers along the economic chain? Each supplier pays the taxes and is entitled to a credit.

***i. Section 165(1) ETA***

Section 165(1) *ETA* reads as follows:

Imposition of goods and services tax

**165.** (1) Subject to this Part, every recipient of a taxable supply made in Canada shall pay to Her Majesty in right of Canada tax in respect of the supply calculated at the rate of 5% on the value of the consideration for the supply.

The clear, plain language of this provision, has lead many judges to conclude that, as the recipient must pay the tax to the Crown, then the Crown is entitled to collect the tax directly from the recipient. This conclusion is a first level reading of one single section the Act and would be right if the section was a stand-alone, self-supporting, provision of law. It may well be the case for the Ontario sales tax,<sup>34</sup> once it is shown that the supplier/agent has not remitted the amount so claimed. However, section 165(1) *ETA* is to be interpreted in the general scheme of the Act, the object of the Act and to reflect the intention of Parliament.<sup>35</sup>

**ii. Section 16 *QSTA***

Section 16 *QSTA* reads:

Taxable supply made in Québec.

16. Every recipient of a taxable supply made in Québec shall pay to the Minister of Revenue a tax in respect of the supply calculated at the rate of 7.5% on the value of the consideration for the supply.

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<sup>34</sup> S. 2 of the Ontario *Retail Sales Tax Act* reads:

2. (1) Every purchaser of tangible personal property, except the classes thereof referred to in subsection (2), shall pay to Her Majesty in right of Ontario a tax in respect of the consumption or use thereof, computed at the rate of 8 per cent of the fair value thereof. R.S.O. 1990, c. R.31, s. 2 (1).

<sup>35</sup> As suggested by Cory J. in *Alberta (Treasury Branches) v. M.N.R.*, [1996] 1 S.C.R. 963 at pp. 976-77.

Zero-rated supply.

However, the rate of the tax in respect of a taxable supply that is a zero-rated supply is 0%.

In reviewing the reasons in the *GST Reference* and the *QST Reference*, we find that the recipient is to pay the tax to its supplier as an ultimate step in a long instalment collection scheme put in place by the *ETA* and *QSTA*. Nowhere in the *ETA* and *QSTA* can we find a provision stating that this direct obligation to pay creates a direct authorization to collect the GST and QST that supersedes the collection scheme. The *ETA* and *QSTA* not only state that the purchaser must pay the taxes to the Crown, they also state how and when and to whom they are to be paid and by whom they are to be remitted. The acts are based on compliance through self-assessments of the suppliers and they do not address the consequences of a default of a supplier other than by recourse against the supplier. The Crown's position is that, upon default of the supplier, it may make an administrative decision to fill in this legislative gap by suspending application of the collection provisions and electing to claim against the purchaser.

#### **IV. COLLECTION MECHANISMS AND THE INVOLUNTARY STATUTORY MANDATE GIVEN TO THE SUPPLIER TO COLLECT FROM THE PURCHASER**

This part will review the collection mechanisms found in the tax laws that enable the Crown to collect the GST and QST by instalments through the various steps of

the economic process. In essence, this is the system of input tax credits for the GST (“ITCs”) and refundable tax credits for the QST (“RTCs”). Each supplier of goods and services along the economic chain is appointed as agent<sup>36</sup> of the Crown by the tax legislation to collect the taxes from its purchasers, until the ultimate purchaser (consumer) ends up paying the whole amount of the taxes applicable to the service or product, most of which has already been remitted to the Crown.

The use of common or civil law concepts such as mandate, agency, suretyship or other concepts in tax legislation is always problematic. The Supreme Court of Canada had occasion to qualify such a concept in the matter of *Husky Oil Operations Ltd. v. Minister of National Revenue*.<sup>37</sup>

[50] (...) As a result, the principal is compelled by statute to act as the surety for the contractor’s obligation to the Board. I therefore believe that it is more accurate to characterize this provision as creating a form of involuntary, statutory suretyship. (our underline)

So, to paraphrase the Supreme Court, we will qualify the relationship between the supplier and the Crown under the *ETA* and *QSTA* as an involuntary statutory mandate.

As anything statutory, it is a somewhat defective mandate that violates the tenets of what should be a principal/agent relationship. While the agent normally acts

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<sup>36</sup> See *infra*, n. 27.

<sup>37</sup> *Husky Oil Operations Ltd. v. Minister of National Revenue* [1995] 3 S.C.R. 453.

only in this capacity and with no personal liability for the object of the mandate,<sup>38</sup> the *ETA* forces the supplier to pay the taxes to the Crown even if they have not been collected, something an agent would never do, but a distributor, wholesaler or independent contractor would. The *ETA* makes the payment the personal liability of the supplier, in complete contradiction to the general rules of a mandate. Therefore, the leap of faith made in some precedents that the mere existence of an alleged agency relationship necessarily resulted in the application of the normal consequences of the mandate relationship is simply unjustified.<sup>39</sup> The fact that the legislation qualifies or names the supplier as an “agent” is not

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<sup>38</sup> *Victuni v. Minister of Revenue (Que)* [1980] 1 S.C.R. 580, at pp. 584-585:

“Under the general principles of the law of mandate, it is clear that the obligation of a mandatary towards the mandator is not a debt. The person who has bought property on behalf of a third party who wishes to remain unknown is no more indebted for the price paid than he is the owner of the property. The true owner is the mandator, and the obligation of the mandatary nominee is to render an account to the mandator and deliver over what he has received on his behalf (*C.C.*, art. 1713).

What he receives, even if it is money, does not belong to him: he is obliged to keep it separate from his own property. It is a crime for him to take control of it so as to make himself a debtor thereof instead of a mandatary: *R. v. Légaré*. In the recent decision of this Court, *Canadian Pioneer Management Ltd. v. Saskatchewan Labour Relations Board*, Beetz J. pointed out the importance of this distinction, citing *inter alia* the decision of the Privy Council on unclaimed deposits: *Attorney General for Canada v. Attorney General for the Province of Québec*.” (references omitted).

<sup>39</sup> See *infra*, n. 16.

conclusive in any way on the respective right of the Court, the supplier and the purchaser.

In that sense, it is only after the duties imposed on the “agent” have been mitigated by the indemnities or benefits granted by the legislation, in the form of ITCs, RTCs and deductions for bad debts that, at the end of the process, the agent will be left with the responsibility of remitting only the net taxes collected representing his share of the purchaser’s tax liability under the instalment scheme. It is only on that limited net and direct obligation that ownership and trust arguments can be applicable, if this obligation can be isolated and identified.

If the “mandate” is interrupted by bankruptcy and disregarded by the Crown, we are left with a Crown claim against a supplier that has acted as an independent contractor who may or may not have collected the taxes and may or may not have remitted them.

**A. *The federal statutory mandate***

Section 221 (1) *ETA* reads as follows:

Collection of tax

**221.** (1) Every person who makes a taxable supply shall, as agent of Her Majesty in right of Canada, collect the tax under Division II payable by the recipient in respect of the supply.

This short provision is a stand-alone involuntary statutory mandate imposed by the Crown to all suppliers along the economic process until the full amount of the

direct tax becomes payable and paid by the customer or recipient. It completes section 165(1) *ETA* by confirming to the purchaser how and to whom the tax should be paid. It follows that it is not to be paid directly to the Crown, and the use of the word “agent” is not conclusive.

Another provision that the courts have referred to is section 265 *ETA*, to qualify the trustee or receiver as successor of the bankrupt agent and to impose on them the same duties that the Crown claims to apply.

The object of this provision however is not to qualify the trustee as a successor agent of the Crown. It is merely a provision enacted to avoid the tax consequences of the deemed transfer of property from the bankrupt to the trustee and to provide accounting and reporting of the ITCs. In principle, the transfer would be a taxable supply, resulting in the estate owing to the bankrupt a considerable amount of taxes, which would thereupon create an entitlement to an input tax credit for the estate.

***B. The provincial statutory mandate***

Section 422 *QSTA* reads as follows:

**422.** Every person who makes a taxable supply shall, as a mandatary of the Minister, collect the tax payable by the recipient under section 16 in respect of the supply. (...)

It is interesting to note that, according to both section 422 *QSTA* and section 221 *ETA*, the involuntary statutory mandate to collect on behalf of the

Minister is imposed not only on registrant but to all persons who make a taxable supply, except for limited exceptions related to small suppliers and persons with no commercial activities in Canada. Under section 1 *QSTA* and section 123 *ETA* every person who has registered, or should have registered, is a “registrant” for the purposes of these acts.

**C. *Duration or term of the mandate***

There is no time limit on the legislative statutory mandate. There is no reference to the supplementary rules that would apply to interpret or complete such a mandate. In the *GST Reference*, the Supreme Court had occasion to discuss these rules, as a constitutional argument was raised to the effect that provincial governments could claim fees and indemnities for their role as federal collection agents, as they could under common law, under Question 3 which reads:

3. Having regard to s. 103 of the *Constitution Act, 1867* and the common law, are suppliers entitled to charge and to collect from the Consolidated Revenue Fund of Canada all costs, charges and expenses incidental to collecting and paying a remittance under the *GST Act*?<sup>40</sup>

The ruling is complex and the summary reflects the views of the Court on the issue:

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<sup>40</sup> See *supra*, n. 25 at p. 458.

The registered suppliers under the GST Act do not have a right, under s. 103 of the Constitution Act, 1867, to be reimbursed from the consolidated revenue fund of Canada for all expenses and charges incurred in collecting the GST. (...)

As well, the vendors of taxable supplies, as agents of the government for the collection and remittance of the GST, are not entitled to recover at common law the expenses incurred in the course of the agency. Firstly, the presumption that compensation is to be paid where property is taken under a statutory scheme, unless this is expressly excluded by the terms of the statute, has no application in the case of the GST collection regime since no property of the supplier is “taken” by the imposition of the GST collection and remittance obligations. Secondly, Parliament has the right to legislate to impose duties relating to the collection of taxes without reimbursing those upon whom the duties are imposed. In any case, the GST Act does contemplate a limited right of reimbursement in the form of the transitional credit for small businesses. Since Parliament did direct its attention to the question of compensation by providing partial compensation in certain cases, common law rights which might have operated but for the statute cannot be relied upon. Thirdly, there is no question of any contractual relationship between the vendors of taxable supplies and the Government of Canada. In the absence of a contract, the common law duty of principals to pay remuneration for services rendered has no application to vendors of taxable supplies. Fourthly, while the principal has a duty to indemnify an agent for tortious liability to third parties incurred in good faith in the course of the agency, compliance with a statutorily imposed duty would constitute a defence in the unlikely event that such claims of liability were to arise. Finally, the suggestion that registered suppliers have a restitutionary claim against the federal government for the costs and expenses of collecting the GST is without merit.

This leads to the conclusion that the involuntary statutory mandate is autonomous and that contract law, whether civil law or common law, is of no use in qualifying the respective rights and obligations of the parties under the “mandate” imposed by legislation. This issue is relevant to determine when the mandate will expire or terminate and also in determining the obligations and liabilities of both the supplier/agent and the Crown/principal. In Québec civil law, the mandate ends automatically upon bankruptcy of the mandatory, pursuant to article 2175 *CCQ*:

**2175.** In addition to the causes of extinction common to obligations, revocation of the mandate by the mandator, renunciation by the mandatary, the extinction of the power conferred on the mandatary or the death of one of the parties terminates the mandate.

The mandate is also terminated by bankruptcy, except where it was given by gratuitous title in anticipation of the mandator’s incapacity; it may be terminated as well, in certain cases, by the institution of protective supervision in respect of one of the parties.

As established in the *GST Reference*, we cannot rely on the common or civil law to determine the term of the statutory mandate given to the suppliers by the tax legislation, nor can we use these rules to establish the rights of the principal against third parties who dealt with the agent, such as the purchaser. Given the purpose of the acts and the general scheme of the legislation, we suggest that Parliament intended the statutory mandate to continue until the taxes are paid by the purchaser to the supplier. Given section 265 *ETA* that forces the bankruptcy trustee to continue the reporting obligations of the bankrupt supplier, it seems that

bankruptcy, in itself, does not have the effect of terminating the statutory mandate. At the very least, there is no clear intent of Parliament to do so.

Given the special nature of the mandate, its continuation by the trustee does not necessarily mean that the taxes collected have to be remitted in full. First, we must consider if the tax legislation creates a clear obligation that supersedes the bankruptcy legislation. Then, it becomes necessary to determine if the taxes that may be collected by the trustee are owing to the Crown or if they have been paid in advance by the suppliers.

***D. Effect of the registration***

Pursuant to section 242(1) *ETA*, the Minister has the power to cancel the registration if he is convinced that the registration is not necessary for the application of the Part IX of the *ETA*.<sup>41</sup>

This notice must be dated, and must confirm the date of the cancellation of the registration pursuant to section 242(3) *ETA*. The Minister is not obliged to explain the reasons for the cancellation of the registration. Usually, the reasons for

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<sup>41</sup> Revenue Québec may also suspend or revoke the registration certificate pursuant to section 17.5 *ARMR*. The suspension and the revocation of the registration are effective from the date of the notification of the decision to the registrant pursuant to sections 17.8 and 17.9 *ARMR* respectively. However, the revocation will only be effective upon the expiry of 15 days after the notification if the reasons for the revocation are the ones identified at paragraphs b), c) and j) to o) of the section 17.5 *ARMR*.

cancelling a registration are the non-production of the tax reports, or the Minister is of the opinion that the registrant no longer has commercial activities.

A registrant may cancel his account if he files form RC 145. At the end of the registration, the registrant is deemed to have made a supply of all his goods and collected, at this time, the taxes related to those goods calculated at the fair market value. Also, the registrant is deemed to cease his commercial activity pursuant to section 171(1) *ETA*.

Finally, the registrant is deemed to have two distinct tax reports pursuant to section 251(1) *ETA*. The first tax report will begin on the first day of the tax report and will end the day before the taxpayer ceased to be a registrant. The second tax report is deemed to begin the day on which the taxpayer ceased to be a registrant and will end on the last day of the month in which the taxpayer ceased to be a registrant.

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The registration of a supplier for the purposes of the GST and QST seems to have no effect on the term and scope of the statutory mandate as it existed on the date of bankruptcy. Therefore, terminating the administrative registration of a registrant supplier would not have the effect of terminating the statutory mandate.

In fact, the only benefit of the registration is to enable the supplier to claim ITCs and RTCs, which an unregistered supplier is not entitled to do, resulting in an obligation to remit the taxes in full. However, if the supplier was registered at the date of bankruptcy, the Crown should not be allowed, by an administrative recourse, to enhance its position in the estate. In other words, the determination of the rights of the Crown with respect to the taxes should be made on the date of the initial bankruptcy event or on the date of bankruptcy. If federal legislation was enacted to allow the Crown to terminate the statutory mandate and the registration, notwithstanding the *Bankruptcy and Insolvency Act*, it would result in an increased Crown claim and put the GST and QST in the same situation as the current Ontario retail sales tax. Therefore, it is difficult to conceive that the same result can be achieved without such a clear legislative provision.

***E. The Input systems***

A comprehensive analysis of the rationale behind the input tax credit system was done by author Jean-Daniel Breton.<sup>42</sup> He explains the legislative choices made by Parliament in enacting the *ETA* and by the National Assembly of Québec in enacting the *QSTA*. The first decision was to tax all transactions with the objective to capture those transactions which involve the end user and are subject to the direct tax. To mitigate the effects and avoid double taxation, input credits were given to the suppliers. The second decision was to use an accrual system and not a

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<sup>42</sup> Jean-Daniel Breton, “Crown claims in Insolvency Proceedings, Die Unendliche Geschichte”, *Banking & Finance Law Review*, Vol. 24 N° 1, p. 193.

cash system, to be more aligned with the accounting systems of businesses. This resulted in taxes being remitted before they were actually collected, and credits being granted before the supplier's payables are actually paid.

When bankruptcy intervenes in the process, there is an obvious disruption both on the collection side and on the credit side.

The tax authorities have put in place different mechanisms in order to use a refund owed to a taxpayer to pay any tax debt of the latter, whether he is bankrupt or not.

Firstly, pursuant to section 30.1 *ARMR* the Minister may withhold any refund to a taxpayer if the latter has not filed all the returns and reports that is he was obliged to file under a tax law or regulations adopted under such law.

Also, pursuant to section 31 *ARMR*, the Minister is entitled to apply any refund to a tax debt even though the taxpayer is not yet a debtor under a tax law or any other law. Furthermore, Revenue Québec may apply the remainder of the refund owed to a taxpayer on a debt owed by this person under an Act of the Parliament of Canada administered by Revenue Québec.

When a taxpayer becomes bankrupt or files a proposal or a notice of intention, any refund with respect to a reporting period or for a taxation year ending on or before the date of the bankruptcy is equal to zero pursuant to section 30.3 *ARMR*. As well, no refund may be applied for a return filed for a period or a taxation year ending after the date of the bankruptcy. Section 30.3 *ARMR* will not apply if the bankrupt has filed his returns and reports for the periods or taxation years ending

on or before the date of the bankruptcy, or the date of the filing of the proposal, and if an amount equal to the amount payable before such date with respect to the aforementioned periods was paid.

***F. Claims and recourses of the Crown against its bankrupt agent***

We have seen that throughout the economic process, the suppliers were bound to collect and remit the taxes ultimately payable by the purchaser or recipient. In the bankruptcy of any normal agent, the principal would have a claim only against the estate of the agent for amounts received by the agent on behalf of the principal, within the authority of the mandate, prior to the date of bankruptcy. The third party would be discharged by the payment made previously to the agent.

For amounts that have not yet been collected by the agent in a normal mandate, Québec provincial law provides for the termination of the mandate upon bankruptcy of the mandatory. From then on, the principal is free to collect directly from the third parties and the trustee of the agent has no basis to interfere. There would then be no claim against the agent for these amounts.

This simple and efficient solution was not enacted in the tax laws, although it could have been and maybe should have been. The main difficulty results from the fact that the taxes have often been advanced or prepaid by the suppliers, which makes the termination of the mandate and the non-payment by the recipient on the date of bankruptcy much less relevant. In fact, if the legislation was modified to provide for termination of the mandate upon bankruptcy, it would result in double payment of the taxes to the Crown to the prejudice of the estate.

It may very well be that a legislative change is required, and that may be the advice that will be given by the Supreme Court of Canada to the tax authorities, as the Court has done in matters involving the enhanced deemed trust for income tax source deductions in *Royal Bank of Canada v. Sparrow Electric Corp.*<sup>43</sup> Whether or not the statutory mandate came at an end or can be terminated by the Crown, the Crown will retain, under current tax legislation, a claim against the bankrupt supplier who is liable to collect the amounts. That claim is based on the obligation to remit, not on the basis of collections by the “agent”.

For amounts that have been collected by the supplier, the *BIA* provides that the Crown claim will be unsecured and that no deemed trust will be enforceable against the estate.

Thus, whether the taxes have been collected or not prior to bankruptcy, the Crown only has an unsecured claim against its bankrupt “agent”.

## **V. EFFECTS OF THE BANKRUPTCY ON THE INVOLUNTARY STATUTORY MANDATE**

In order to determine the effects of bankruptcy on the involuntary statutory mandate, we have to review the rights of the supplier with respect to the taxes.

Section 427 *QSTA* reads as follows:

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<sup>43</sup> *Royal Bank of Canada v. Sparrow Electric Corp.*[1997] 1 S.C.R. 411.

Right of the supplier to sue for tax.

**427.** Where a supplier has made a taxable supply to a recipient, is required under this Title to collect tax from the recipient in respect of the supply, has complied with section 425 in respect of the supply and has accounted for or remitted the tax payable by the recipient in respect of the supply to the Minister but has not collected the tax from the recipient, the supplier may bring an action in a court of competent jurisdiction to recover the tax from the recipient as though it were a debt due by the recipient to the supplier. (our underline)

Section 224 *ETA* is to the same effect:

**224.** Where a supplier has made a taxable supply to a recipient, is required under this Part to collect tax from the recipient in respect of the supply, has complied with subsection 223(1) in respect of the supply and has accounted for or remitted the tax payable by the recipient in respect of the supply to the Receiver General but has not collected the tax from the recipient, the supplier may bring an action in a court of competent jurisdiction to recover the tax from the recipient as though it were a debt due by the recipient to the supplier. (our underline)

This provision gives us a true indication of the intention of Parliament to segregate into two parts the collection process. On the one side, the supplier invoices, collects and accounts for or remits taxes to the Crown, net of inputs. On the other side, the supplier is solely responsible to collect the taxes. A supplier that is a registrant is required to collect the tax and he must indicate the tax on the invoice. Section 223(1) *ETA* states:

**223.** (1) If a registrant makes a taxable supply, other than a zero-rated supply, the registrant shall indicate to the recipient, either in prescribed manner or in the invoice or receipt issued to, or in an agreement in writing entered into with, the recipient in respect of the supply,

(a) the consideration paid or payable by the recipient for the supply and the tax payable in respect of the supply in a manner that clearly indicates the amount of the tax; or

(b) that the amount paid or payable by the recipient for the supply includes the tax payable in respect of the supply.<sup>44</sup>

After issuing the invoice, pursuant to section 427 *QSTA* the registrant supplier must “account for” or “remit” the tax, whether or not collected. Accounting for the tax means filing the periodic reports for the taxes charged, less credits allowed for bad debts, less ITCs. Section 427 *QSTA* continues to state that the supplier can then sue the purchaser for collection of the “taxes” “as though it were a debt due by the recipient to the supplier”. By giving a clear right of action to the supplier against the recipient, the legislator clearly denies the same right of action in favor of the Crown. That is where the true nature of the relationship emerges: in reality, the supplier is no longer collecting taxes appearing on the invoice, but he is collecting an indemnification for taxes either already paid or at the very least accounted for.

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<sup>44</sup> Section 425 *QSTA* is to the same effect.

This leads us to the conclusion that we are faced with an autonomous, involuntary statutory mandate that does not end on the date of bankruptcy, as no provision of the tax laws provide for such a termination. Furthermore, by reason of the registry system, even if the tax authorities have withdrawn the registrant status of the supplier, the statutory mandate remains in force and that legal situation is crystallized at the date of bankruptcy. Can the authorities withdraw by administrative decision a mandate conferred by law? Even if they could do so, such an action after bankruptcy should not modify the rights of the Crown.

When the Crown attempts to collect the taxes directly from the purchaser, it claims two things: first, it claims ownership of the taxes; second, it claims that the right of its agent to collect these taxes is suspended or terminated. Otherwise, the purchaser would have to pay the taxes twice. The second part of the proposition is obviously a recourse against the bankrupt for the purpose of collecting a claim otherwise payable by the bankrupt. Until the tax laws are changed, it appears that this part of the recourse is suspended by the effect of section 69.3 *BIA*.

**VI. EXISTENCE OF A REAL TRUST FOR GST AND QST ON IDENTIFIABLE TAXES THAT ARE PART OF AN ACCOUNT RECEIVABLE OWED TO A BANKRUPT**

The courts have concluded in some cases that a real trust could exist for GST and QST. On the face of an account receivable, an amount of taxes is shown and

appears to be identifiable as taxes. That identification was viewed as sufficient to conclude to the existence of a trust. It is worthwhile to discuss why it is not so.

Before discussing these trusts, real or deemed, it is necessary to make a brief history of the relevant legislative provisions and legislative choices that were made with respect to GST and QST. These provisions have in general been ineffective in bankruptcy and insolvency situations. The attempts of legislators, both provincial and federal, to fix the problem have resulted in the current laws which are not adapted to a value-added tax and do not support the Crown's arguments of trust in any way.

Retail tax laws will often force a supplier to act as collection agent. As such, the laws would impose on the supplier an obligation to collect, retain and remit the total amount of these taxes, without any input tax credits. The laws would further compel the supplier to retain these taxes separate from its own funds until they are remitted on their due date.

If the supplier did comply with the legislation and maintained a segregated identifiable fund, the Crown could claim the property on the basis of a real trust. The three certainties would exist.

In the vast majority of insolvency situations, the funds were not in fact held in trust and separate, thus making enforcement against trustees and receivers impossible as the missing funds could not be traced and identified.

However, when the taxes were not yet collected and could be identified and traced to an account receivable, the legal obligation to hold separate and remit in full could be a valid argument to support a subsequent Crown claim for these taxes against a trustee or receiver. When enacting a value-added tax such as the GST, the federal legislator knew that only a portion of the taxes would have to be remitted and did not impose an obligation to hold separate and remit the GST in full.

Instead, the federal legislator preferred to enact a deemed trust floating on all the property of the supplier for an amount equivalent to the GST owing by this supplier.

Section 222 *ETA* reads:

**222.** (1) 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).

Amounts collected before bankruptcy

(1.1) Subsection (1) does not apply, at or after the time a person becomes a bankrupt (within the meaning of the *Bankruptcy and Insolvency Act*), to any amounts that, before that time, were collected or became collectible by the person as or on account of tax under Division II.

Withdrawal from trust

(2) A person who holds tax or amounts in trust by reason of subsection (1) may withdraw from the aggregate of the moneys so held in trust

(a) the amount of any input tax credit claimed by the person in a return under this Division filed by the person in respect of a reporting period of the person, and

(b) any amount that may be deducted by the person in determining the net tax of the person for a reporting period of the person,

as and when the return under this Division for the reporting period in which the input tax credit is claimed or the deduction is made is filed with the Minister.

Extension of trust

(3) Despite any other provision of this Act (except subsection (4)), any other enactment of Canada (except the *Bankruptcy and Insolvency Act*), any enactment of a province or any other law, if at any time an amount deemed by subsection (1) to be held by a person in trust for Her Majesty is not remitted to the Receiver General or withdrawn in the manner and at the time provided under this Part, property of the person and property held by any secured creditor of the person that, but for a security interest, would be property of the person, equal in value to the amount so deemed to be held in trust, is deemed

(a) to be held, from the time the amount was collected by the person, in trust for Her Majesty, separate and apart from the property of the person, whether or not the property is subject to a security interest, and

(b) to form no part of the estate or property of the person from the time the amount was collected, whether or not the property has in fact been kept

separate and apart from the estate or property of the person and whether or not the property is subject to a security interest and is property beneficially owned by Her Majesty in right of Canada despite any security interest in the property or in the proceeds thereof and the proceeds of the property shall be paid to the Receiver General in priority to all security interests.

Meaning of security interest

(4) For the purposes of subsections (1) and (3), a security interest does not include a prescribed security interest.

Therefore, section 222(1.1) *ETA* makes it clear that no deemed trust survives bankruptcy on the amounts that may be collected or became collectable by the supplier and no other trust is imposed by the *ETA*.

In Ontario, the provincial legislator also elected to choose a deemed trust, although an obligation to retain the retail sales tax separate would have enhanced the trust argument that could be made on uncollected accounts receivable.

Section 22 *Retail Sales Tax Act* (Ontario) reads:

Trust for money collected

22.(1) Any amount collected or collectable as or on account of tax under this Act by a vendor shall be deemed, despite any security interest in the amount so collected or collectable, to be held in trust for Her Majesty in right of Ontario and separate and apart from the vendor's property and from property held by any secured creditor that but for the security interest would be the vendor's property and shall be paid over by the vendor in the manner and at the time provided under this Act and the regulations.

Extension of trust

(2) Despite any provision of this or any other Act, where at any time an amount deemed by subsection (1) to be held in trust is not paid as required under this Act, property of the vendor and property held by any secured creditor of the vendor that but for a security interest would be property of the vendor, equal in value to the amount so deemed to be held in trust shall be deemed,

(a) to be held, from the time the amount was collected or collectable by the vendor, separate and apart from the property of the vendor in trust for Her Majesty in right of Ontario whether or not the property is subject to a security interest; and

(b) to form no part of the estate or property of the vendor from the time the amount was so collected or collectable whether or not the property has in fact been kept separate and apart from the estate or property of the vendor and whether or not the property is subject to such security interest.

Same

(3) The property described in subsection (2) shall be deemed to be beneficially owned by Her Majesty in right of Ontario despite any security interest in such property or in the proceeds of such property, and the proceeds of such property shall be paid to the Minister in priority to all such security interests.

Exception

(4) This section and subsection 36(2.1) do not apply in proceedings to which the *Bankruptcy and Insolvency Act* (Canada) or the *Companies' Creditors Arrangement Act* (Canada) apply.

The Québec legislator had decided to keep the best of both worlds: a deemed trust was enacted, but an obligation to retain the amounts separate was also retained initially.<sup>45</sup> However, an amendment in 2004<sup>46</sup> abolished the obligation to retain the funds separate in favor of the deemed trust. The *QSTA* contains no provision on trusts, and the *ARMR* contains only the following general provision applicable to all Québec tax claims, at section 20:

Amount held in trust.

**20.** Every person who deducts, withholds or collects any amount under a fiscal law is deemed to hold it in trust for the State, separately from the person's patrimony and the person's own funds, for payment to the State in the manner and at the time provided under a fiscal law.

Non-payment.

Where at any time an amount deemed by the first paragraph to be held by a person in trust for the State is not paid to the State in the manner and at the time provided under a fiscal law, an amount equal to the amount thus deducted, withheld or collected is deemed, from the time the amount is deducted, withheld or collected, to be held in trust for the State, separately from the person's patrimony and the person's own funds, and to form a separate fund not forming part of the property of that person, whether or not the amount has in fact been held separately from that person's patrimony or that person's own funds.

Withdrawal of amounts.

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<sup>45</sup> That former section applied to the facts in *Chibou-vrac*, see *infra*, n. 14.

<sup>46</sup> L.Q. 2004, c. 4.

However, the person may, when filing a return with the Minister under section 468 or 470 of the Act respecting the Québec sales tax (chapter T-0.1), withdraw from the total amount that the person is deemed by the first paragraph to hold in trust for the State, the amounts that the person is entitled to deduct and that the person has actually deducted in the calculation of the amount to be remitted.

The effect of these provisions is that, when there is no bankruptcy, all of the taxpayer's property will be deemed to be property of the Crown up to the amount of the tax claim, including all of the accounts receivable and any "tax" portion therein.

However, upon bankruptcy, there will be no deemed trust<sup>47</sup> and no legislative provision remains to support a real trust argument.

**A. *Conditions of existence of a common law trust***

Three certainties are required to conclude in the existence of a common law trust: certainty of intent, certainty of object and certainty of beneficiary. It is doubtful that any of these certainties exist in the case of the GST and QST, given the tax collection scheme.

**i. *Intent to create a trust***

The purchaser and supplier express no intention with respect to the taxes when they enter into a transaction. They simply comply with the law. The purchaser

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<sup>47</sup> *Québec (Sous-ministre du revenu) v. De Courval*, 2009 QCCA 409.

pays an amount that he is forced to pay and the supplier collects an amount that he is entitled to collect, whether or not he has remitted the taxes. The Crown may have an intent to create a trust, but that would only be a deemed trust.

In fact, suppliers have absolutely no intention of segregating these funds and maintaining them for the Crown. Their only obligation is to remit, on the periodic due date, a net amount of GST and a net amount of QST. In the meantime, they will use the gross proceeds of their receivable accounts to pay their liabilities, including the gross amount of their payable accounts which include taxes.

**ii. Object of the trust**

The object of the trust would be the taxes. However, as we have seen, that may only be the case in a retail sales tax such as the Ontario sales tax. In the case of the GST and QST, the supplier is actually collecting an indemnification for the taxes paid or accounted for. By law, the Crown has no authority to interfere and therefore cannot argue that there can be a trust, except possibly if it is shown that taxes are owing and relate to the specific transaction at hand.

**iii. Beneficiary**

We can argue that the beneficiary is not certain, as in most cases the supplier is collecting to indemnify himself of taxes already accounted for.

***B. Conditions of existence of a civil law trust***

The *CCQ* establishes the conditions for the existence of a trust in the province of Québec. Article 1262 *CCQ* states that a trust is established by a contract, onerously or gratuitously, by will or by operation of law. Pursuant to article 1260 *CCQ*, the trust results from the transfer of property from the settler's patrimony to another patrimony, for a particular purpose. Then, a trustee undertakes to hold and administer the aforementioned property. In this respect, the trust will be constituted after the acceptance of the trustee.

The conditions of existence of a civil law trust are strict. They are not met by the legal situation that result from the involuntary statutory mandate.

***C. The trustee as agent of the Crown***

The trustee will be responsible for filing the tax reports of the bankrupt. The reporting period is the same as that the bankrupt. The trustee will use the registration number of the bankrupt with respect to the activities of the bankrupt.

We have seen that the supplier has distinct rights against the purchaser under the applicable tax legislation. In the absence of a specific provision of law to the contrary, the trustee has the same rights.

## **VII. EXISTENCE OF A CROWN CLAIM RELATED TO THE REAL TRUST**

Although there appears to be no right for the Crown to terminate the involuntary statutory mandate while the indemnification portion of the mandate is still in progress, and there also appears to be no real trust with respect to the taxes, it is interesting to discuss how any of these taxes can be accounted for under the tax collection scheme of the legislation. The difficulties faced in identifying the portion of the taxes that remain unpaid show the weaknesses of the argument.

The existence of a real and identifiable trust on the taxes appearing in an account receivable of a bankrupt, or a right of ownership of the Crown in these taxes, appear to be the wrong question. The *GST Reference* and *QST Reference* make it clear that these taxes are owed by the purchaser to the Crown. The last remaining real questions are: have they been paid and on what remaining claim can they be applied?

### ***A. Payment of the claim while the statutory mandate was in place***

Answering in favor of the Crown the first question about its rights on the tax portion of an account receivable of a bankrupt does not completely resolve the issue nor lead to the necessary conclusion that these sums must therefore be paid over to the Crown. This is the result that was achieved in Québec Superior Court and maybe this was not a justified conclusion.

Even if we assume a positive answer in favor of the Crown, based on the trust or mandate relationship and on the direct liability of the ultimate purchaser, there remains an issue of ascribing this payment against an amount owing to the Crown.

In fact, the Superior Court judgments, all rendered in favor of the Crown and accepting its argument, have concluded that the identifiable taxes should be paid over to the Crown.

That is however an oversimplification of the problem, as it completely disregards the factual and legal relationship that existed prior to the bankruptcy between the supplier, the purchaser and the Crown for purposes of collecting these taxes.

The relationship created an involuntary statutory mandate imposed on the supplier as collection agent for the Crown. While it existed, GST and QST were collected and remitted or accounted for, after taking and setting -off proper credits or inputs.

This raises the second question that must be answered to fully resolve the issue: does the Crown still have an unpaid claim against which these specific unpaid taxes can be applied?

Because the tax laws force the supplier to remit the taxes to the tax authorities at the end of the reporting period in which an invoice is sent, whether or not paid by the purchaser, whether or not payable, there is a strong possibility that the taxes included in an invoice still owing to the bankrupt on the date of bankruptcy have already been remitted to the Crown.

We will use practical examples to consider this issue.

**Example 1**

As an example that we will use throughout this text, we will assume that a company has gone bankrupt on September 1<sup>st</sup> of a given year. This company was reporting monthly its GST and QST and has failed to do so only for the month of August, which report and any applicable payment would have been due on September 30<sup>th</sup>.<sup>48</sup> The trustee, pursuant to its duties imposed by law, filed the August GST and QST returns in September and, after claiming authorized tax inputs, shows an unpaid amount of \$5,000.00 for GST and \$5,000.00 for QST, which amounts are promptly claimed by the tax authorities in the bankruptcy of the supplier. Experiencing financial difficulties, our company made its August sales cash on delivery and collected and used the tax portion of the amounts so received in its operations before the bankruptcy.

Amongst the assets of the bankrupt estate, accounts receivable for invoices issued in March of the same year remain unpaid at the date of bankruptcy for \$100,000.00 plus \$5,000.00 of GST and \$7,875.00 of QST and these were collected by the bankruptcy trustee in September.

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<sup>48</sup> S. 238(1)(b) *ETA*.

**Analysis of Example 1**

Can the Crown claim these March \$5,000.00 GST and \$7,875.00 QST to apply it to its August GST and QST claims respectively?

In our view, the answer should be no.

Despite the fact that the Crown has unsecured claims of \$10,000.00 for GST and QST against its bankrupt agent/supplier, its argument on the taxes collected by the trustee relate to a real trust and agency relationship. The Crown can't argue that a deemed trust survived bankruptcy and applies to these taxes as against the bankrupt estate. In other words, the taxes collected by the trustee are not the taxes claimed, and, the opposite is also true, the taxes claimed as unpaid by the supplier are not those that have been collected by the trustee.

The justification for this solution is simple and equitable. After the March reporting period ended, sometime in April, the supplier remitted the net taxes, thereby advancing to the tax authorities some taxes that were yet uncollected by the agent/supplier. The bank or short term secured lender of the supplier probably granted credit to make these payments to the Crown.

Can it be said that the supplier was collecting GST and QST thereafter on those accounts receivable, and was the trustee collecting GST and QST? In our view, the supplier and thereafter the trustee were really claiming an amount from the purchaser as an indemnification for taxes already remitted by the supplier to the authorities as agent. So in reality the agent/supplier and its trustee are collecting

their indemnity for taxes they paid and not actual taxes they may owe to the Crown, as they are authorized to do by legislation.

Where it not for subsequent commercial activities in August, the supplier and trustee would have been fully entitled to these taxes without opposition from the Crown. There is no reason to mitigate that entitlement to indemnification for taxes previously remitted on the basis of an alleged subsequently created trust that relates to different taxes.

### **Example 2**

In this example, our company is entitled to more credits in August than taxes owing for invoices issued in August. However, the July GST and QST remittances are owing. The Crown will apply set-off between the August credits and the July amounts owing, but a July amount remains owing. Can the Crown claim the GST and QST from an August invoice?

### **Analysis of Example 2**

Again, the answer should be no, for the same reasons. The August taxes have been paid in full by the credits or inputs. The supplier having “paid” or “accounted for” the taxes, he, or his trustee or secured creditor, is seeking indemnification from the customer. There can be no real trust in favor of the Crown with respect to the August taxes.

This leads us to argue that, despite the existence of a claim related to GST and QST in the bankruptcy, the Crown should also establish that it has a claim related

directly to the taxes it seeks to collect and alleges to own. In other words, the Crown must show that these taxes have not been paid while the involuntary statutory mandate existed. There should be a presumption of fact that the supplier complied with its statutory obligations towards the Crown, so that the Crown has the burden of establishing its claim against the recipient on what is otherwise an estate asset in the form of an indemnification claim.

To conclude otherwise would lead to the taxes being paid twice to the Crown: once by each one the suppliers along the economic chain at the end of their reporting periods and a second time by the purchaser after the last supplier's bankruptcy. This is an unacceptable result.

As an example, one of the specific facts relevant to the issue at hand can be found in the Superior Court judgment of *M.P.X.*<sup>49</sup>

It is stated that the Crown did not file a proof of claim against the estate with the trustee. The Crown, being the principal in the statutory involuntary mandate, was concerned that a claim against its agent's bankruptcy estate could constitute an estoppel from claiming directly against the third party debtor, in this case the recipient or purchaser.

The non-filing of a claim would normally lead to the conclusion that the Crown has no claim against its agent for the whole reporting period prior to the

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<sup>49</sup> See *supra*, n. 16.

bankruptcy. Therefore, one could assume that all taxes have been remitted by the bankrupt supplier. Then what is the Crown seeking to collect and where will they apply this payment, if not as a double payment? However, the absence of a proof of claim only precludes a creditor from exercising its rights in the bankruptcy, such as voting at meetings and participating in a distribution by way of dividends. The non-filing of a claim may affect the standing in Court of a party, but would not be conclusive of the rights of a creditor, such as the Crown, against a third party, such as the purchaser.

The absence of a proof of claim by the Crown is sometimes a determinative factual element that would or should, in itself, resolve this case in favor of the trustee. In *M.P.X.*,<sup>50</sup> the minister's representative testified that a net claim existed, but the judgment doesn't tell us if it related to the accounts collected by the trustee. At the very least, failure to file a proof of claim should be sufficient to deny standing to the Crown when it seeks access to the bankruptcy court to obtain, against the trustee, rights on a claim that is otherwise payable to the trustee.

In the *Alternative Granite* case, it appears that this evidence was not offered to the Superior Court, and that it cannot be established if the taxes collected by the trustee or receiver relate to a reporting period for which taxes are still owing by the supplier to the Crown.

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<sup>50</sup> See *supra*, n. 16.

It is obvious that the position advanced by the Crown on the issue of “ownership” of the taxes may lead the trustees and receivers in a quagmire of accounting for the purposes of linking the taxes owing to the taxes collected.

These difficulties should not however deter the courts from pursuing the reasoning and applying the law.

At the end of the process, the issue may be resolved by determining who has the burden of proof.

The mere fact that taxes, or more correctly “an amount representing the indemnification of the supplier for taxes that may or may not have been remitted”, appear to have been collected by the trustee is not sufficient, in itself, to conclude that these taxes should be paid to the Crown.

Only if the Crown has filed a proof of claim can we foresee the possibility that the GST and QST owing by the customer may still be unremitted and may belong to the Crown.

In general, a claimant has the burden of proving its claim in the bankruptcy. Therefore, the Crown should have the burden of proving that the taxes collected or collectable are related to a reporting period for which there are taxes owing.

Even then, the solution is not that simple, and it raises a third question.

***B. Applying tax inputs to an unpaid claim***

This question arises when we try to determine, within a specific reporting period, what amount of taxes must be remitted in relation to a specific invoice.

**Example 3**

For example, going back to our general example, if there is an amount of \$100,000.00 owing for March to the Crown, this may result from \$300,000.00 of taxes charged by the supplier on March invoices and \$200,000.00 of tax credits for March inputs that the supplier was entitled to offset. In general, in every reporting period, a registrant will have conducted economic activities and purchased goods and services that entitle the registrant to ITCs and RTCs. There will also be an accounting for bad debts and other items that generate the final amount remitted to the tax authorities.

**Analysis of Example 3**

Once again the banker has extended credit to the company to pay these March suppliers, including taxes, and should be entitled to receive the benefit of the indemnification once the taxes are collected. In this example, one could argue that two thirds of the taxes are “paid” or “accounted for” by offset and only one third remains “unpaid”. Why would all these taxes be those outstanding after the bankruptcy on September 1<sup>st</sup> and not those collected between March and September (which have been used by the supplier and have become part of an unsecured proof of claim)?

Logic would dictate that only one third of the taxes mentioned in each March invoice are unremitted taxes, otherwise we would end up with a trust that is only deemed and not real.

*C. Re-assessing prior reporting periods*

Another difficulty and a fourth question will arise when the Crown attempts to ascertain if an amount is owing in respect to a specific reporting period.

**Example 4**

In our previous example for the March taxes, a \$200,000.00 tax credit for inputs was claimed by the supplier. However if the invoices related to these inputs are part of the claims in bankruptcy and unpaid, the suppliers of the now bankrupt supplier will be entitled to take a reserve on their account receivable and deduct it from their next report. At the end, these taxes will not be remitted to the government, who will seek to “cancel the inputs” and re-establish its claim for March to the full amount of \$300,000.00, therefore arguing that all of the March invoices taxes have not been remitted.

**Analysis of Example 4**

To properly account for the period, we now see that all unsecured claims must be reviewed. However, this process of “canceling the inputs” should not enable the Crown to recreate its alleged real trust that had disappeared by reason of the offset. At best, the Crown will only be entitled to an unsecured proof of claim in

the bankruptcy of the supplier for the tax on the purchases of goods and services for which the tax has not been remitted.

A complete review of the issues relating to cancellation of the tax inputs can be read in Jean-Daniel Breton's article.<sup>51</sup> The author concludes that this practice, as it is applied by the Crown, is not supported by the legislation and in fact results in double taxation.

***D. Practical Application***

To conclude on our theory, we will make a practical demonstration.

**Example 5**

We will assume a simple economic chain, where one supplier sells \$50,000.00 worth of material to our company (the bankrupt). This supplier is not entitled to any ITCs or RTCs as it purchases in the USA and has only labour costs. As a registrant, the supplier will remit 12.875% of this sale to the Crown, or \$6,437.50. Our company adds some labour to its material and sells the resulting product for \$100,000.00 to three customers, one for \$90,000.00 and two each for \$5,000.00, plus applicable taxes of \$12,875.00 in total. During the period, the company reports its GST and QST by netting out the taxes payable by the customers of \$12,875.00, collected or not, with the ITCs and RTCs of \$6,437.50, leaving a balance due to the Crown of \$6,437.50.

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<sup>51</sup> Breton.

In the following month, the invoice of \$90,000.00 is paid to the company, plus taxes, and the money goes into the general account and is commingled with the other property of the company. On the date of the bankruptcy, only the two \$5,000.00 accounts receivable (\$10,000.00) remain unpaid and they are collected by the trustee, along with \$1,287.50 in GST and QST.

### **Analysis of Example 5**

In this example, the Crown has collected \$6,437.50 of the taxes payable by the customers of the company, and it did so from the original supplier. Half the taxes of the reporting period have therefore been paid or credited or accounted for. The fact that the tax authorities may grant relief to the original supplier if he fails to collect his receivable is not relevant, in our view, to the trust and ownership argument put forth in the estate of the company.

A portion of the taxes on the sale for \$90,000.00, being \$11,587.50 has been collected by the company. Therefore, the Crown can only claim against its bankrupt agent. In fact, its claim is limited to \$5,793.75, being half the taxes after applying the inputs for the relevant period.

Of the remaining amounts, totaling \$1,287.50, half are non-remitted taxes and half represent the inputs to which the company is entitled.

So if we analyse the result for the total taxes for the reporting period, we find:

- \$6,437.50 remitted by the original supplier to the Crown;

- \$5,793.75 paid by the customers to the supplier before its bankruptcy;
- \$643.75 paid by customers to the trustee and representing the inputs for the period;
- \$643.75 paid by customers to the trustee and representing the net taxes for the period;
- \$12,875.00 total, which is our original amount for the period.

If we were to add the amount of \$643.75 paid by customers to the trustee and representing the inputs for the period to the \$643.75 paid by customers to the trustee and representing the net taxes for the period, and remit in full the \$1,287.50 collected by the trustee, we would end up with a superior total amount and this would be the double taxation that the Crown is attempting to claim.

Therefore, at best, the Crown can argue that it owns a portion of the taxes of a specific period that is calculated by multiplying the taxes on an invoice of the period by the inputs of the period divided by the total taxes of the period:

In our Example 5

\$10,000.00 of gross invoices remaining on bankruptcy represent \$1,287.50 of taxes. The period taxes of the company are \$100,000.00 and the inputs are \$50,000.00.

$$\$1,287.50 \times \frac{50,000}{100,000} = \$643.75$$

Making such a calculation in a bankruptcy or receivership would require an accounting of each tax reporting period for both invoices and inputs. It is certainly not the unpractical solution that was intended by Parliament in the 1992 reform of the *Bankruptcy Act*.

### **VIII. CONCLUSION**

Different questions lead to different answers. The insolvency practice may be greatly modified depending on how the Supreme Court addresses the complex issues related to the GST and QST components of an account receivable of a bankrupt.

We can safely state that the GST and QST components of an account receivable of a bankrupt are, in principle, ultimately payable to the Crown as a direct tax. However, they are first payable to the supplier, and the supplier is then obliged to remit an amount net of ITCs and RTCS and other adjustments for the relevant period. Upon the supplier's bankruptcy, the Crown's rights are limited by the tax legislation to recourses against the supplier in the form of an unsecured ordinary proof of claim and other statutory rights of set-off or resulting from deregistration of the supplier.

It is far more difficult to determine the portion of these taxes owing to the supplier that might still be owing to the Crown after the payments and credits made

through the general collection scheme of the *ETA* and *QSTA* that is in place before the bankruptcy.

It may be inequitable for a trustee or receiver, acting on behalf of secured or unsecured creditors of a supplier, to collect and retain taxes imposed by the Crown on a non-bankrupt recipient/customer and still unpaid. If that is the case, then maybe all or part of the GST and QST should be remitted to the Crown once they are identified and the payment can be applied by the Crown to a proper claim existing under the global instalment payment scheme of the tax legislations.

However, in the absence of a valid legislative deemed trust for GST and QST after bankruptcy of a supplier, the Crown should have to establish that it is entitled to terminate the involuntary statutory mandate given to the supplier, and that the taxes owing by the purchaser are those that remain unpaid at the date of bankruptcy of the supplier and have not been paid during the course of the mandates imposed on all suppliers in the economic chain. Even then, only a specific portion of the taxes may be claimed by reason of the inputs that would apply against each invoice. Only then can the Crown argue that it owns a specific portion of these taxes.

In the absence of a real legislative duty of the supplier to collect, retain separate and remit the specific GST and QST outstanding on the date of bankruptcy and in the absence of a real identifiable trust or right of ownership on these taxes, the resurrection of the goods and services tax claims in bankruptcy may end up being

short lived as the Supreme Court of Canada ruling that will conclude this particular issue is expected in the next few months.