

Financial Services Flash

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The Taxman Cometh: How Receivers and Trustees Can Avoid Tax Liability

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When determining whether a distribution of property should be made, the tax consequences not only for the taxpayer, but also for its legal representatives, must be considered. Failing to properly analyze the tax implications of a distribution can expose trustees (including both trustees in bankruptcy and proposal trustees) and receivers to liability for the taxpayer's obligations.

Legal Representatives

Subsection 248(1) of the *Income Tax Act* (Canada) (the "ITA") provides a broad definition of "legal representative". A legal representative of a taxpayer is defined to include, among others, trustees and receivers of any kind who deal in a representative or fiduciary capacity with property that belongs or belonged to the taxpayer. Accordingly, both privately-appointed and court-appointed receivers are captured by this definition.

Liability: Failure to Obtain a Clearance Certificate

Pursuant to subsection 159(2) of the ITA, every legal representative (other than a trustee in bankruptcy) is required to obtain a certificate (a "Certificate") from federal and provincial authorities, where and as applicable, prior to the distribution of a taxpayer's property that is in the legal representative's possession or control. If the taxpayer's receiver or trustee distributes property in the legal representative's possession or control to any person, including unsecured creditors, without first obtaining the required Certificate, subsection 159(3) of the ITA provides that the legal representative will be

held jointly and severally liable for the payment of the taxpayer's unpaid taxes and outstanding obligations to the extent of the value of the property distributed.

Trustees in bankruptcy are granted an explicit exemption from the requirement to obtain a Certificate and will not be held jointly and severally liable for the taxpayer's unpaid taxes and outstanding obligations. Additional protection is granted to trustees in bankruptcy, pursuant to subsection 41(8) of the *Bankruptcy and Insolvency Act* (the "BIA"), which absolves trustees in bankruptcy from liability once they have been discharged by the court, provided that they have acted in good faith. However, trustees in bankruptcy may still be held liable for bankruptcy taxes and for the taxes arising in connection of taxation years that were completed during the bankruptcy.

Monitors and proposal trustees are generally excluded from liability under subsection 159(2) of the ITA because they do not have either possession or control of the debtor's property. However, monitors and proposal trustees who distribute property that is in their possession or control to unsecured creditors will be liable under subsection 159(2) of the ITA if they fail to obtain a Certificate, as discussed.

Secured Creditors vs. Unsecured Creditors

It is not clear that the payment of a liability owed to a creditor constitutes a "distribution" for purposes of subsection 159(2). The Canada Revenue Agency ("CRA") draws a distinction between payments made to unsecured creditors and to secured creditors. The CRA

views repayments of debt made to unsecured creditors to constitute a “distribution” for purposes of subsection 159(2) of the ITA. However, the CRA’s longstanding administrative position is that repayments of secured debt made to properly secured creditors (not in excess of the secured amount) should not be considered “distributions” to which subsection 159(2) of the ITA applies.

Prior to the payment of any amount (whether in-kind or not) to the creditors of a taxpayer, the taxpayer’s legal representative should consider whether all or any portion of such payment falls within the scope of the provision and, if so, obtain a Certificate.

Conclusion

Trustees and receivers should protect their interests when acting on behalf of a taxpayer and should obtain a Certificate prior to any distributions to unsecured creditors. These legal representatives may also choose to disclose foreseeable issues to CRA early in the process to resolve ambiguities and to prevent potential issues or roadblocks from developing.

Practically, if CRA is unwilling or unable (for example, where at least a portion of the taxes remain outstanding) to issue a Certificate, or if a Certificate cannot be obtained

within the required time period, legal representatives may wish to consider alternative solutions that include:

- obtaining a comfort letter from CRA;
- making an interim distribution to creditors with CRA approval; or
- if acting as a receiver or trustee for a taxpayer who can be declared bankrupt, considering a strategic transition of the receivership into bankruptcy to limit liability when acting as a trustee in bankruptcy.

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