



A Cautionary Tale in Bankruptcy: When HST Came Back to Bite

In the past 18 months, the CRA has become more active in reversing the input tax credits on HST payables for bankrupt companies, on the premise that underlying payables will not be paid. John Hendriks discusses why this can have important consequences for Trustees, creditors and even corporate directors.

The case of Pretendco

Consider the not-uncommon tale of Pretendco, an Ontario corporation. Prior to bankruptcy, Pretendco reported its Harmonized Sales Tax (HST) as any other company would. Each month, it recorded the HST charged to its clients, deducted the HST [input tax credits](#) (HST ITCs) on the expenses it incurred, and remitted the difference to the Canada Revenue Agency (CRA). For Pretendco, it was usually a small difference between the two, resulting in payments to CRA some months and refunds in others.

These HST calculations were always done on an accrual basis, consistent with the company's accounts receivables (AR) and accounts payable (AP) which were typically outstanding for 60 days.

When Pretendco went bankrupt, it was required to prepare a Statement of Affairs (SOA) that set out its AR and AP. Following the company's bankruptcy, the CRA advised that they were reversing the HST ITCs on their APs recorded in the SOA, pursuant to paragraph 296(1) of the *Excise Tax Act*. The rationale was that Pretendco would not be paying its accrued payables and should therefore not be claiming the ITCs applicable to them.

For the company, the potential result of this was a sizeable HST liability, where one did not exist prior to the bankruptcy, with consequences for the Trustee, the creditors, and even the directors of Pretendco.

A domino effect on interested parties

The impacts of the CRA's action were soon felt by Pretendco's Trustee, as well as its secured and unsecured creditors. The Trustee had been expecting to collect a pre-filing HST refund, but the CRA reassessment meant that these funds might not be available to fund the estate or trustee fees or potential dividends other unsecured creditors.

The CRA's reassessment resulted in an unexpected unsecured liability in bankruptcy, meaning that CRA's claim would give it a bigger piece of the pie—to the detriment of the other unsecured creditors. For the secured creditors, things were a little more complicated. While in receivership, the secured creditors were expecting an HST refund based on the company's normal monthly filing. There would be no direct effect of the reassessment on the secured creditor as the bankruptcy filing makes the HST payables part of the unsecured pool; however, the CRA reassessment could significantly or completely eliminate the expected HST refund from the funds available to satisfy the secured creditor indebtedness.

The reassessment also caused some sleepless nights for the directors of Pretendco, since s.323 of the *Excise Tax Act* can impose personal liability on directors if the corporation failed to remit taxes, payments, interests or penalties as required under subsection 228(2) or (2.3), or under section 230.1.

Challenging the CRA

In reviewing the CRA's calculations, the Trustee found areas where the reassessment was overstated, since the CRA assumed HST ITCs had been claimed on certain payables not subject to HST. In fact, HST had not been claimed on several items on the payables list in the SOA, including, pension payables, municipal taxes, termination and severance payables, WSIB amounts, union dues, insurance, and sundry loans. The Trustee was able to correct for these amounts by providing details of the payables that the CRA auditors did not have when they reassessed. By doing so they were able to lower the CRA liability substantially, much to the benefit of other creditors.

In the meantime, Pretendco's directors decided to seek legal counsel out of prudence. Generally, a director will not be held liable if it can be shown that the director exercised a reasonably prudent degree of care, diligence and skill in the circumstances. Counsel's view was that the corporation did not fail to remit taxes as required, since the HST ITCs on reversed accounts payable were not due to be remitted to the CRA prior to the bankruptcy. Rather, the directors had acted responsibly and ensured the company was paying its HST obligations as they came due and had maintained the practice of applying the HST on payables to HST on receivables in the ordinary course prior to bankruptcy.

To have reversed all of the company's payables on the eve of bankruptcy would have been impractical and unwarranted. Though the directors were never called on to defend their actions or those of Pretendco, they did incur legal costs from consulting with counsel, which they were able to recover from their directors' and officers' (D&O) insurance, subject to a small deductible.

Lessons learned

Ultimately, the HST ITCs are only as good as the payables on which they are based. If the payables are no longer honoured, the CRA auditors can make a valid claim to reassess the HST, with consequences for the Trustee, and for distributions to Pretendco's creditors. As the CRA reassessment may be based on the SOA, which will not have details of all HST assumed, the Trustee may have considerable work to do with the CRA in determining the relevant amounts. In the case of directors, it is important to be aware of the due diligence defense involved and be ready to seek the advice and assistance of legal counsel and D&O insurers if the situation arises.

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