

## Security Interests / Tax law

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### Can Quebec Refundable Tax Credits Still Be Validly Hypothecated?

*Special collaboration\**

On August 7, 2006, the Superior Court of Montréal rendered a judgment that carried heavy consequences for new economy companies (i.e. R&D, biotech, film, etc.) in Quebec that are eligible for refundable tax credits. According to the Court, Quebec refundable tax credits could not be hypothecated, which reduced the asset base that could be used for financing.

The facts of *In the matter of the bankruptcy of 111295 Canada Inc. and H.H. Davis & Assoc. Inc. v. Royal Bank of Canada*<sup>1</sup> are relatively simple. Please note that leave to appeal this judgment was granted on September 14, 2006.

The company, 111295 Canada Inc., filed an assignment in bankruptcy under the *Bankruptcy and Insolvency Act*. The trustee, H.H. Davis & Assoc. Inc., petitioned the Superior Court for instructions as to whom the refundable tax credits from the Government of Canada and the Government of Quebec in its possession should be remitted. These refundable tax credits had been hypothecated in favour of the Royal Bank of Canada pursuant to a hypothec deed duly published in the Register of Personal and Movable Real Rights.

The debate arose from severe statutory limits that apply to the assignment of Crown debts. A major reason for such limits has always consisted in ensuring that any assignment made between two taxpayers is in no way binding upon the Crown. The judge then reviewed these statutory limits and the acts and legislative amendments adopted over the years by the two levels of government in order to mitigate the negative impacts of these limits on the financing of companies.

Specifically, the acts and amendments studied on the federal front were Sections 67 and 68 of the *Financial Administration Act*, as well as Subsections 220(6) and 220(7) of the *Income Tax Act* (Canada) (together, referred to as the “Federal Legislation”). On the provincial front, it was Section 33 of the *Act Respecting the Ministère du Revenu* (the “Quebec Revenue Act”) and Section 1055.2 of the *Taxation Act* (Quebec) (the “QTA”) (together, referred to as the “Quebec Legislation”).

By all appearances, the legislator’s intention in passing these acts and amendments was to facilitate the use of refundable tax credits to allow new economy companies to finance their operations by hypothecating these credits in favour of lending institutions. Government programs like those sponsored by Investissement Québec have since completed these funding mechanisms.

The judge devoted a large part of his ruling to showing that the Federal Legislation and the Quebec Legislation provided only for the assignment of Crown debt and nothing else. With the entry into force of the *Civil Code of Québec* in 1994, a new security interest regime was introduced—that is to say, prior

claims and hypothecs—which eliminated the assignment of claims for security purposes under the former *Civil Code of Lower Canada*.

From the judge's point of view, because a hypothec is not an assignment, it was therefore not affected by the provisions of the Federal Legislation that restricted the assignment of Crown debts. Because the hypothec granted to the Royal Bank otherwise met all the conditions for its validity and enforceability under the Quebec civil law, the trustee therefore had to remit the Federal tax refunds it had received to the Bank.

The same conclusion was not, however, possible for the Quebec refundable tax credits. The Court noted, in fact, that Section 33 of the Quebec Revenue Act provides that not only are Crown debts inalienable, they are also unseizable. Now as to Section 1055.2 of the QTA, it provides for an exception to the inalienable nature of claims, but does not change their unseizable nature. The judge reiterated the clear terms of Section 2668 of the *Civil Code of Québec*: property exempt from seizure may not be hypothecated. Therefore, he declared that the hypothec on Quebec refundable tax credits was inopposable to the trustee, who in turn could remit these amounts to the body of creditors.

This legal decision not only jeopardizes the future granting of hypothecs on Quebec refundable tax credits, but also invalidates or renders inopposable any such hypothec granted since March 9, 1999, which is the date Section 1055.2 of the QTA came into force. It is easy to envision the considerable impact this decision had on the banking community and new economy businesses.

Not surprisingly, this matter was brought to the attention of the ministère des Finances of Quebec during the 2006 Roundtable Conference of the Association de planification fiscale et financière held at the beginning of October. Consequently, it does not come as a shock that, on October 16, this same ministère published the latest Information Bulletin /2006-3, which announced that tax legislation would be amended in order to allow a corporation to hypothecate the entitlement to an amount payable to it under the QTA.

It also announces that this amendment will apply retroactively to the entry into force of Section 1055.2 of the QTA, i.e. March 9, 1999, but it will not apply retroactively to amounts owed by the State and being the object of proceedings pending before a court on the date of the publication of the Information Bulletin /2006-3.

By so acting, the Quebec legislator seems to be reiterating its tax policy, which aims to facilitate the financing of new economy businesses through moveable hypothecs on Quebec refundable tax credits.

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1) *111295 Canada inc. (Syndic de)*, 2006 QCCS 4455 (CanLII); C.S.M.: 500-11-025249-059, August 7, 2006, Joël Silcoff, J.S.C.; See: [www.canlii.org/qc/cas/qccs/2006/2006qccs4455.html](http://www.canlii.org/qc/cas/qccs/2006/2006qccs4455.html);  
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