



Passing-on no defence; unlawfully collected taxes must be refunded, Supreme Court rules

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Governments must refund money they collect through unconstitutional taxes, and cannot rely on the so-called "passing-on" defence to avoid repayment, the Supreme Court ruled in January 2007.¹ The decision clarifies that governments cannot retain unconstitutionally collected taxes, a point that has been unsettled in Canada for some time. Perhaps even more importantly, the court's rejection of the passing-on defence may have major implications in private litigation, particularly competition (antitrust) cases.

Unlawful liquor levy imposed on nightclubs

The appellants were operators of nightclubs in New Brunswick. New Brunswick imposed a user charge calculated as a percentage of the price of liquor they bought. The charge was prescribed by a regulation adopted pursuant to New Brunswick's *Liquor Control Act*.

The nightclubs challenged the user charge as an indirect tax. Under Canada's constitution, provincial governments can only levy "direct" taxes.² The trial judge agreed that the levy is a tax, because it was not related to the cost of providing services to liquor licensees, and it was an indirect tax. Russell J. found as a fact that the nightclubs passed on the cost of the levy to their customers. Russell J. concluded that because the nightclubs had passed on the levy, they were not entitled to recover it from the province.³ The nightclub owners appealed. The Court of Appeal accepted the defence of passing on, but held that it could have no application after the nightclub owners protested the tax by commencing litigation. Accordingly, they could

recover the levy paid after that point. The Supreme Court of Canada granted leave to appeal to the nightclub owners.

Governments must refund unlawful taxes

Governments must refund unconstitutionally collected taxes, Mr. Justice Bastarache, writing for the court, held. The Canadian constitution requires that taxes be imposed only by Parliament or a legislature: "no taxation without representation". Taxes collected under *ultra vires* legislation (that is, legislation that is outside of the scope of powers allocated to the level of government involved, and therefore, invalid) undermine the rule of law; to permit the government to retain such taxes condones this breach. Bastarache J. expressly rejected the suggestion made by Mr. Justice LaForest in a 1989 case that governments should be permitted to keep unlawfully collected taxes.⁴ Bastarache J. noted, however, that it may be open to governments to enact taxing legislation with retroactive effect and thus keep the money.

Bastarache J. then considered what legal mechanism is appropriate for recovery of unlawful taxes. He held that taxpayers have recourse to a remedy as a matter of constitutional right where taxes are collected pursuant to *ultra vires* legislation. In past cases, courts have treated such cases as claims for unjust enrichment. The analytical framework of unjust enrichment is inappropriate for unconstitutional tax cases, Bastarache J. held. Its central requirements, a loss suffered by the plaintiff and corresponding benefit obtained by the defendant, are difficult to apply in such cases.⁵ Using this private law cause of action adds an "unnecessary layer of complexity", he observed.

Thus, he concluded, actions for recovery of taxes collected without legal authority are a distinct category of restitution.

Passing-on defence rejected

Bastarache J. then considered, and rejected, the passing-on defence. He articulated three major criticisms of the defence. First, it is inconsistent with the basic principles of the law of restitution. He agreed with academic commentators that "As between the taxpayer and the Crown, the question of whether the taxpayer has been able to recoup its loss from some other source is simply irrelevant".⁶ He stated: "Restitution law is not concerned by the possibility of the plaintiff obtaining a windfall precisely because it is not founded on the concept of compensation for loss".

The second criticism is that the defence of passing-on is economically misconceived, and the third is that passing-on raises insurmountable difficulties of proof. Here, Bastarache J. adopted Mr. Justice LeBel's comments in *British Columbia v. Canadian Forest Products Ltd.*⁷ That case involved an action by the province of British Columbia to recover the value of timber destroyed by fire. The Supreme Court of Canada held that the province of British Columbia could not recover damages for timber destroyed by a fire because the province used a formula to determine stumpage fees that automatically re-allocated the loss by raising the stumpage fees on timber not consumed by fire. Consequently the province had no loss to recover. The court discussed the pass-on defence, but held that it did not arise because there was no loss to pass on. The majority noted that almost any business will pass on a loss to its customers, but that "It is not generally open to a wrongdoer to dispute the existence of a loss on the basis [that] it has been 'passed on' by the plaintiff. Such an argument would require the court to engage in 'the endlessness and futility of the effort to follow every transaction to its ultimate result'".

LeBel J., in dissenting reasons, went further. He argued that any defendant could argue that any commercial entity has passed on its damages to its customers through higher prices and thus suffered no losses. On this argument, damages might never be recoverable in commercial cases.

As well, it is very difficult to determine whether an entity has passed on its losses, and to what degree, by raising prices. Even if the entity raised prices, this may have affected sales. As well, it would be impossible to show that the entity could not have raised prices in any event and thus increased its profits. Thus, whether an entity has in fact passed on its losses is "virtually unascertainable".

Implications for private litigation under the *Competition Act*

Taken together, *Kingstreet Investments* and *Canadian Forest Products* stand for a complete rejection of the passing-on defence by Canada's highest court. This has important implications for actions for damages for price fixing conspiracies under the *Competition Act*. It is perhaps noteworthy that in discussing LeBel J.'s remarks, Bastarache J. cited *Hanover Shoe*,⁸ a case relied on by LeBel J. In that case, the US Supreme Court rejected the passing-on defence in antitrust cases. The court held that defendants cannot argue that those who purchased product from them for resale (so-called "direct purchasers") passed on the higher prices to their customers (known as "indirect purchasers"), thus suffering no damages.

Conversely, to succeed in proving their damages, indirect purchasers must establish that the direct purchasers passed on the higher prices to them. Thus the corollary of *Hanover Shoe* is *Illinois Brick*,⁹ where the US Supreme Court ruled that indirect purchasers cannot maintain an action for antitrust damages. In *Illinois Brick*, the US Supreme Court recognized that the rule should apply equally to both the defensive and offensive uses of pass-on. That is, if a defendant cannot invoke it to escape liability, neither can a plaintiff, to establish it. The court's reasoning in *Hanover Shoe* and *Illinois Brick* was based in large part on the economic uncertainties and difficulties of proving pass-on.

Now that Canada has a rule barring the defensive use of pass-on, will courts take the next logical step and bar the offensive use of pass-on? In *Chadha v. Bayer*, the Ontario Court of Appeal recognized the nearly insuperable difficulties indirect purchasers face in trying to prove losses caused by pass-on. But the court stopped short of adopting a rule barring actions by indirect purchasers.¹⁰ In

subsequent interlocutory decisions in class actions, Ontario courts have approved attempts to avoid the problem of proving pass-on by combining direct and indirect purchasers in the same class.¹¹ But this merely postpones the problem, as the question of pass-on must be faced when attempting to prove at

trial that indirect purchasers suffered a loss (because loss is an essential element of a cause of action under the *Competition Act*), or when allocating settlement proceeds between indirect and direct purchasers.



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¹ *Kingstreet Investments v. New Brunswick (Department of Finance)*, 2007 SCC 1

² Not surprisingly, this restriction of provincial taxing power has spawned an enormous volume of litigation. Early on, courts adopted John Stuart Mills distinction between direct and indirect taxes: “Taxes are either direct or indirect. 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...” See *Bank of Toronto v. Lambe* (1887), 12 A.C. 575 (P.C.). Flat rate licence fees and property taxes imposed on businesses been considered direct taxes. Taxes that are “related or relateable, directly or indirectly, to a unit of the commodity or its price, imposed when the commodity is in the course of being manufactured or marketed” are indirect. See *Allard Contractors Ltd. v. Coquitlam (District)*, [1993] 4 S.C.R. 371 at ¶39. Thus, for instance, a sales tax imposed on any distributor or retailer is indirect; a sales tax imposed on the consumer is a direct tax.

³ [2004] N.B.J. No. 75.

⁴ *Air Canada v. British Columbia*, [1989] 1 S.C.R. 1161. LaForest J.’s comments were in *obiter*, and he spoke for three of six judges on this point.

⁵ The third element is lack of juristic reason for the enrichment.

⁶ Citing Maddaugh, Peter D. and John D. McCamus, *The Law of Restitution*, Aurora, Ont.: Canada Law Book, 2004, p. 11-45.

⁷ [2004] 2 S.C.R. 74.

⁸ *Hanover Shoe Inc. v. United Shoe Machinery Corp.*, 392 U.S. 481 (1968).

⁹ 431 U.S. 720 (1977).

¹⁰ (2003), 63 O.R. (3d) 22 (C.A.). See Michael Osborne, “Court refuses to certify consumer class action for price fixing”, *The Litigator*, 28 Nov 2003, <http://www.agolaw.com/reslibrary.asp?pubid=competition>

¹¹ See for instance *Vitapharm Canada Ltd. v. F. Hoffmann-La Roche Ltd.*, [2000] O.J. No. 4594 (S.C.J.) at ¶36-46 and *Vitapharm Canada Ltd. v. F. Hoffmann-La Roche Ltd.*, [2005] O.J. No. 1118 at ¶23 (S.C.J.).