5255 Yonge Street Suite 800 Toronto, Canada M2N 6P4 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

DIRECTORS' LIABILITY FOR TAX - PART I

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on the potential liability of a corporation's directors under the Income Tax Act (Canada) and other taxation statutes.

Alpert Law Firm is experienced in providing legal services to its clients in tax dispute resolution and tax litigation, tax and estate planning matters, corporate-commercial transactions and estate administration. Howard Alpert has been certified by the Law Society as a Specialist in Estates and Trusts Law, and also as a Specialist in Corporate and Commercial Law.

A. DIRECTORS' LIABILITY FOR UNPAID TAXES

(i) SECTION 227.1 OF THE INCOME TAX ACT

Section 227.1 of the *Income Tax Act* (the "Act") renders a director jointly and severally liable with his corporation for failure to deduct, withhold or remit amounts required, together with any interest or penalty in relation thereto, pursuant to the following sections of the Act:

(i) subsection 135(3), which imposes withholding obligations upon cooperative corporations that pay amounts to their resident customers as patronage dividends;

(ii) subsection 135.1(7), which imposes an obligation on an agricultural cooperative corporation to withhold taxes when a tax deferred share is redeemed, acquired or cancelled by the corporation or by a person or partnership with whom the corporation does not deal at arm's length;

(iii) section 153, which imposes an obligation to deduct or withhold from a payment of salary, wages and other amounts, an amount determined in accordance with the regulations under the Act and to remit that amount within the time limits prescribed by the said regulations (i.e. source deductions);

(iv) section 215, which relates to the obligation imposed upon a person resident in Canada to withhold and remit taxes for payments or credit in the form of dividends, interest or royalties made to a non-resident person; and

(v) for failure to pay tax under Part VII (section 192) or VIII (section 194) of the Act.

The potential liability does not include the corporation's regular Part I tax liability. Liability under section 227.1 of the Act only arises in the event that one of the following three conditions is satisfied:

(i) a certificate for the amount of the corporation's liability has been registered in the Federal Court of Canada and an execution for the amount in question has been returned unsatisfied in whole or in part;

(ii) the corporation has commenced liquidation or dissolution proceedings or has been dissolved and a claim for the amount of the corporation's liability under subsection 227.1(1) has been proved within six months after the earlier of the date of commencement of the proceedings and the date of dissolution; or

(iii) the corporation has made an assignment, or a receiving order has been made against the corporation, under the *Bankruptcy and Insolvency Act*, and a claim for the amount of the corporation's liability under subsection 227.1(1) has been proved within six months after the date of the assignment or receiving order.

Pursuant to subsection 227.1(4), proceedings to recover any amount from a director may not be commenced more than two years after the individual ceased to be a director. Subsection 227.1(5) provides that the amount recoverable from a director is only the amount remaining unsatisfied after execution.

Under subsection 227.1(6), if a director pays an amount that is proved in dissolution or bankruptcy proceedings in respect of the liability of a corporation under subsection 227.1(1), the director is given the same preference as a creditor of the corporation. The director would also be entitled to contribution from the other directors of the corporation who were liable for the claim.

(ii) SECTION 323 OF THE EXCISE TAX ACT

Section 323 of the *Excise Tax Act* (the "ETA") provides that a director may be personally liable 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.

As is the case in the Act, director liability in respect of the ETA arises only if one of the three conditions are satisfied:

(i) a certificate for the amount of the corporation's liability referred to in that subsection has been registered in the Federal Court under section 316 of the ETA and execution for that amount has been returned unsatisfied in whole or in part;

(ii) the corporation has commenced liquidation or dissolution proceedings or has been dissolved and a claim for the amount of the corporation's liability referred to in subsection (1) of the ETA has been proved within six months after the earlier of the date of commencement of the proceedings and the date of dissolution; or

(iii) the corporation has made an assignment or a bankruptcy order has been made against it under the *Bankruptcy and Insolvency Act* and a claim for the amount of the corporation's liability referred to in subsection (1) of the ETA has been proved within six months after the date of the assignment or bankruptcy order.

Subsection 323(3) of the ETA provides that a director is not liable if he or she has exercised the degree of care, diligence and skill to prevent the failure under subsection (1) that a reasonable person in the same circumstances would have exercised.

Furthermore, section 330 of the ETA provides that where a director acquiesces or participates in the commission of an offence as set out in the GST legislation, he is considered a party to and guilty of the offence and will be, whether the corporation itself has been prosecuted or convicted.

B. DUE DILIGENCE DEFENCE

Until recently, the standard applicable to a director in determining whether he had been duly diligent was the objective-subjective test set forth in ***Soper v. the Queen***, 1997 D.T.C. 5407. The test was partly objective, in that one had to assess what a reasonably prudent person would have done to be duly diligent, and partly subjective, in that the circumstances of each case must have also been considered. Pursuant to the test set forth in ***Soper***, a passive director was not required to exhibit the same degree of care, diligence and skill as an active director.

In ***The Queen v. Buckingham***, 2011 GTC 2024, the Federal Court of Appeal developed a different approach to the application of the due diligence test holding that the objective-subjective test in ***Soper*** had been replaced by a purely objective test as a result of the decision of the Supreme Court of Canada in ***Peoples Department Stores Inc. (Trustee of) v. Wise***, [2004] S.C.J., No. 64. The objective test set aside the common law principle that a director's management of a corporation is to be judged according to

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his own personal skills, knowledge, abilities and capacities. It created a stricter standard on which a director is to be judged and seeks to discourage the appointment of inactive directors chosen for show or who fail to discharge their duties as director by leaving decisions to the active directors.

While the law in this area of the due diligence defence is still developing, other principles which can be gleaned from the case law are as follows:

(i) Positive steps that should be taken by a director to ensure that such taxes are paid include: (i) requesting information regarding the procedures in place with respect to withholding, and if such procedures are not in place or appear to be inadequate, establishing such procedures and ensuring that a competent person is in charge to see that these procedures are instituted and followed; (ii) calling upon financial officers of the corporation to report regularly on the continued implementation of these procedures; (iii) informing the CRA expeditiously if there is a withholding problem; (iv) obtaining regular confirmation that withholdings and remittances have in fact been made during all relevant periods; and (v) obtaining an opinion, where required, from a qualified tax advisor if it is believed that withholding is not required at law;

(ii) Where a director cannot insist upon the implementation of the foregoing steps because he is the minority, he should nevertheless recommend those steps at a directors' meeting and ensure that the minutes of the meeting duly record this recommendation;

(iii) Where a company is in financial difficulty, the directors have special responsibilities in addition to those outlined above. These special responsibilities could include obtaining a reliable undertaking from a financial institution to pay all related deductions or, failing that, establishing a separate payroll trust account into which gross payroll would be deposited for subsequent disbursement to employees with the difference to be remitted to the CRA when due;

(iv) The company's historical pattern of remittances, both before and after default, may be considered in determining due diligence. In addition, in certain circumstances, the remittance pattern of other companies of which the person is a director may also be examined;

(v) In determining whether a director has been duly diligent, he will not be held responsible for the acts of other directors;

(vi) Where a receiver-manager is appointed or a bank, either directly or through an agent, takes control of the company's operations, a director may consider resigning in order to minimize the likelihood that he will be a director at the

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time that a failure to remit arises, thereby avoiding the need to establish a due diligence defence; and

(vii) A director is not liable for defaults occurring after he ceases to be a director. In addition, no action may be commenced against a director under subsection 227.1 more than two years after the director last ceased to be a director.

C. CASE LAW

***Facchini v. The Queen*, 2004 DTC 3677**

In this Tax Court of Canada case, the taxpayer, who was represented by Alpert Law Firm, was assessed as a director of a corporation for the corporation's failure to remit employee source deductions and goods and services tax. Specifically, the Minister asserted that the taxpayer did not exercise the degree of care, diligence, and skill to prevent the failure of the construction business to remit $38,000 in GST and $92,000 in income tax a reasonably prudent person would have exercised in comparable circumstances.

In his defence the taxpayer asserted that he used the necessary skill and due diligence required of him, considering (i) his lack of education; (ii) his minimal involvement in the business operations of the office; and (iii) his resulting reliance on the office experience of another director. While the taxpayer was a skilled carpenter, he demonstrated that he had extremely limited reading and writing abilities since he had emigrated from Italy at the age of 13 and his education was limited to grade 3 in Italy and a mere 8 months in Canada. Due to this lack of education and general lack of sophistication, the taxpayer argued that he was required to adhere to a lower standard of due diligence.

The taxpayer also indicated that his role as a director of the corporation did not consist of any significant involvement in the "paper end" of the business. Rather, his principal duty was as a foreman, for the completion of subcontracts for various construction projects outside of Toronto. He very rarely went to head office and when he did, it was usually only to deliver time sheets and pick up pay checks for his employees. The taxpayer's lack of involvement was corroborated by the corporation's former bookkeeper, accountant and secretary to the other director, who was explicitly responsible for the office and management of financial matters.

The taxpayer argued that given his lack of education and sophistication in business matters, he had no other choice but to rely absolutely on the expertise of the other director, who had office management skills and was responsible for filing the corporation's tax returns. The taxpayer contended that while he took no active steps to ensure that the

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corporation would make its required remittance, but relied on the other director to remit what had to be remitted, he did so because he not have the expertise, ability, or know-how to do anything else.

The court held that the taxpayer exercised the degree of care, diligence and skill to prevent the failure of the corporation to remit that a reasonably prudent person would have exercised in comparable circumstances, namely none. While the court stated that the taxpayer was indeed an "inside" director, the court put considerable weight on the evidence which indicated that the taxpayer was also an uneducated, unsophisticated individual who reasonably relied on the experience of another director, who was responsible for managing the office and filing the corporation's tax returns.

In coming to this conclusion, the court was of the view that the taxpayer was not personally liable for the corporation's failure to remit income tax since the taxpayer had very little education, no accounting or business experience, nothing to do with business matters of the corporation, and left all the decision-making to another director. The court found that given the taxpayer's limited education and skill it was appropriate for the taxpayer to rely on expertise of the other director, expanding on the finding in ***A.G. Can. v. Dilorenzo***, 2003 GTC 1538, where the court found it was reasonable for the taxpayer to rely on the expertise of the corporation's accountant.