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DIRECTORS' LIABILITY FOR TAX - PART II

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. *PEOPLES DEPARTMENT STORES* DUE DILIGENCE TEST

1. *Peoples Department Stores Inc. (Trustee of) v. Wise,* [2004] S.C.J., No. 64

This Supreme Court of Canada case involved an action by the trustee in bankruptcy of two related corporations, both of which were managed and owned by the Wise brothers. The bankruptcy trustee of Peoples Department Stores claimed that the brothers had favored the interests of Wise stores (the other related corporation) over Peoples Stores to the detriment of Peoples' creditors. This would have been a breach of their duties as directors of both companies under the CBCA.

Although the Supreme Court was dealing specifically with the requirements of due diligence under section 122(1) of the CBCA, its analysis could be applied to the Act, as the wording of this CBCA section is identical to section 227.1 of the Act which states that a director can avoid liability if he can demonstrate that he exercised the degree or care, diligence and skill necessary to prevent the failure to deduct, withhold or remit that a reasonably prudent person would have exercised in comparable circumstances.

The Supreme Court of Canada interpreted the words "comparable circumstances" as requiring the court to take into account the context of the case. It does not, however, indicate employing a subjective test when determining the merits of the due diligence defence based purely on the facts and circumstances of the case, as ***Soper*** concluded. Rather, the Supreme Court of Canada in ***Peoples*** stated that courts will use an objective standard but are allowed to take into consideration relevant subjective factors. An objective standard should be utilized, while still keeping in mind the contextual factors involved on a case-by-case basis.

2. *The Queen v. Buckingham*, 2011 DTC 5078

In this Federal Court of Appeal case, the taxpayer was the chairman of the Board and largest shareholder in a public corporation whose stock traded on the TSX. The

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taxpayer was involved and played a significant role in the day-to-day operations of the Corporation. During 2001 and 2002, the Corporation incurred serious losses and attempted unsuccessfully to obtain financing and secure additional capital in 2002 and again in 2003. In 2003, the Corporation unsuccessfully attempted to sell its assets and part of its business for $1,600,000 in order to pay its creditors but was only able to collect $600,000 from the purchaser. Finally, in September 2003 the Corporation ceased operations.

The taxpayer was subsequently assessed: (i) pursuant to section 227.1 of the Act for the Corporation's failure to remit employee source deductions for the period from October 2002 to August 2003, as well as associated penalties and interest; and (ii) pursuant to section 323 of the ETA for GST/HST remittances which the Corporation had failed to make in March and June of 2003, as well as for associated penalties and interest. The taxpayer appealed all of the assessments to the Tax Court of Canada on the basis of the due diligence defence claiming that he "exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances." The taxpayer argued that he had made serious and reasonable efforts to resolve the financial difficulties faced by the Corporation and as a result this satisfied the due diligence defence under both the Act and the ETA.

The Tax Court of Canada allowed the taxpayer's appeal in part, accepting the taxpayer's due diligence defence with respect to the employee source deductions but reached a different conclusion concerning the failure to remit GST/HST and rejected the taxpayer's due diligence in this regard. The Tax Court began by concluding that the "objective/subjective" test set out in ***Soper*** regarding the standard of care, diligence and skill required under each of the Acts had been modified by the Supreme Court of Canada's decision in ***Peoples Department Stores,*** and held that the objective standard should thus be used for the purposes of applying both subsection 227.1 of the Act and subsection 323(3) of the ETA. The Tax Court was of the view that the analysis required in relation to remittances of employee source deductions should be dealt with separately from the analysis required in relation to remittances of GST/HST due to the fact that unlike GST/HST amounts, the amounts for payroll deductions are not funded by a third party but are paid from whatever resources the company might have available to it.

In accepting the taxpayer's due diligence defence regarding the employee source deductions, the Tax Court was of the view that reasonable business measures were taken in 2002 and in early 2003 to address the financial difficulties of the Corporation and to avoid failure to remit source deductions, including work on a proposed equity issue, attempts to secure a line of credit, reductions in expenditures, and attempts to merge with another company. The trial judge further noted that following the failure to secure new funding, the Corporation had attempted to sell its assets in order to pay its creditors. The Tax Court of Canada concluded that the taxpayer had done all he could in the circumstances to secure additional financing for the Corporation through various means

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and consequently he had met the standard of care required of him under subsection 227.1(3) of the Act. The Tax Court of Canada reached a different conclusion concerning the failure to remit GST/HST rejecting the due diligence defence of the taxpayer holding that the liquidation of assets was not undertaken to prevent failures to remit GST/HST but was done to pay its bills. The Crown argued that the trial judge committed an error of law by incorporating cash flow analysis into the due diligence defence and appealed the decision to the Federal Court of Appeal.

In allowing the Crown's appeal, The Federal Court of Appeal began by affirming that the "objective/subjective" standard set out in ***Soper*** has been replaced by the objective standard laid down by the Supreme Court of Canada in ***Peoples Department Stores***. The Federal Court of Appeal then concluded that the cash-flow analysis proposed by the Tax Court was incompatible with the applicable provisions of the Act because the liability of the directors under subsection 227.1(1) is not conditional on the existence of sufficient cash in the Corporation to pay the remittances of employee source deductions. The Federal Court of Appeal also held that the cash-flow analysis was flawed because it assumed that the time frame in which to assess the director's conduct began when the Corporation runs out of cash whereas it should begin when it becomes apparent to the director, acting reasonably, that the Corporation is entering a period of financial difficulties. In considering the merits of the taxpayer's defence, the Federal Court of Appeal held that a director of a corporation cannot justify a due diligence defence where he condones the continued operation of the corporation by diverting employee source deductions to other purposes. The Federal Court of Appeal concluded that although the taxpayer had a reasonable expectation that the sale of the business assets could result in a large payment which could be used to satisfy creditors, he consciously transferred part of the risk associated with this transaction to the Crown by continuing operations knowing that employee source deductions would not be remitted and as a result, no successful due diligence defence could be sustained.

B. RESIGNATION BY A DIRECTOR

Care should be taken to ensure that all proper corporate proceedings are taken regarding the resignation of a director. Pursuant to the provisions of section 121 of the *Ontario Business Corporations Act* ("OBCA"), a director of a corporation ceases to hold office when the director (i) dies; (ii) subject to section 119 (2) of the OBCA, resigns; (iii) is removed from office by a resolution of the shareholders of the corporation at an annual or special meeting of the shareholders pursuant to section 122 of the OBCA; or (iv) becomes disqualified from being a director under section 118 of the OBCA.

A resignation of a director becomes effective at the time a written resignation is received by the corporation or at the time specified in the resignation, whichever is later. It is advisable for the director to file a notice confirming the director's resignation with the Ministry of Consumer and Commercial Relations. Pursuant to the provisions of section

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119 of the OBCA, a resignation of any of the first directors of the corporation who are named in the Articles of Incorporation does not become effective until a successor is elected or appointed.

Pursuant to the provisions of section 118 of the OBCA, a person is disqualified from being a director of a corporation if the person (i) a person who is found to be incapable of managing property under the *Substitute Decisions Act*, *Mental Health Act* or by a court in Canada or elsewhere; or (ii) becomes personally bankrupt. An individual continues to be a director of a corporation, although with reduced rights and powers, after the appointment of a trustee, receiver or liquidator of the corporation.

Pursuant to subsection 227.1(4) of the *Income Tax Act*, (the “Act”), proceedings to recover any amount from a director may not be commenced more than two years after the individual ceased to be a director. According to ***Larocque v M.N.R.***, [1991] 2 C.T.C. 2151, the two-year limitation period includes the day on which the director resigns. Therefore, if a director were to resign on January 1, 2013, he or she could be assessed under subsection 227.1(1) of the Act on any day up to and including January 1, 2015, but an assessment would be statute-barred on January 2, 2015 and on any day thereafter.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

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