

## **DIRECTORS' LIABILITY FOR TAX - PART III**

**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 Taxation Law, and also as a Specialist in Corporate and Commercial Law.**

### **A. DE FACTO DIRECTORS**

Section 227.1 of 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 deduct or withhold taxes on tax deferred shares when a share is redeemed, acquired or cancelled by the corporation or an arm's length party; (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; (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 or VIII of the Act.

The Courts have held that liability under section 227.1 of the Act also applies to *de facto* directors. If an individual carries out the duties of directors then that individual can be subject to director's liability under section 227.1 of the Act, regardless of whether or not they are qualified to have the status of director.

### **B. CHALLENGING THE UNDERLYING ASSESSMENT OF THE CORPORATION**

#### **Scavuzzo v. Canada, 2006 DTC 2136**

In this Tax Court of Canada case, the taxpayers, S and J, were assessed vicariously as directors of R corporation for unremitted source deductions and unremitted

GST payments. Two numbered companies (the “employer companies”) paid the corporation’s employees and invoiced it accordingly. In the taxpayers’ appeal to the Tax Court of Canada, the Court outlined several issues for determination: (i) whether directors who have been assessed under the vicarious liability provisions can challenge the underlying corporate assessment; (ii) whether the wrong corporation was assessed; (iii) whether J had resigned from his position as *de facto* director of R corporation at the time of the assessments; and (iv) whether S was a nominal director or *de facto* director of R corporation.

The Tax Court allowed the taxpayers’ appeals. Based on the Federal Court of Appeal decision in *Gaucher v. The Queen*, 2000 DTC 6678, (which involved a challenge to a vicariously liability assessment under section 160 of the Act) the taxpayers were entitled to challenge the underlying assessment against R corporation. In addition, R was the wrong corporation to assess in this case; it was the employer companies who were responsible for remitting the deductions in question. The Court held that J had in fact resigned as a director of R corporation, despite the fact that he continued as general manager with signing authority. After his resignation, J did not hold himself out as a director and did not exercise the level of control over R corporation that could be expected from a director. S was found to only be a nominal director of R corporation, since he was in no position to influence whether R corporation made GST remittances or whether the employer companies remitted the required source deductions. The vicarious liability assessments against J and S were vacated accordingly.

### C. ADDITIONAL PROVISIONS OF THE ACT

Pursuant to subsection 227.1(6), where a director pays an amount in respect of a corporation’s liability under section 227(1) of the Act that is proved in liquidation, dissolution or bankruptcy proceedings, the director is entitled to any preference that the Crown would have been entitled to if the amount owed by the corporation had remained unpaid. Where a certificate that relates to such amount has been registered by the Crown, the director is entitled to an assignment of the certificate to the extent of his payment. In addition, under subsections 227(4) and 227(5) of the Act, funds that are deducted and withheld are deemed to have been set aside in trust for the Crown, even if they have not in fact been set aside. Therefore, the Crown has an absolute claim to any assets of the corporation, in priority even to secured creditors, for the amount of the tax that has been withheld. Although this priority may not apply to interest and penalties for which a director may be liable, the Crown may have a priority over certain unsecured creditors regarding such interest and penalties under the *Bankruptcy and Insolvency Act*. A director who is required to pay an amount pursuant to subsection 227(1) of the Act is entitled to the benefit of these types of priorities of the Crown.

Pursuant to the provisions of subsection 227.1(7) of the Act, a director who has satisfied a claim by the CRA under this provision is entitled to a contribution from the other

directors who were liable for the claim. This will entitle the director to recover a proportionate share of the claim from the other directors who were also liable for the claim.

Section 242 of the Act also imposes a potential tax liability upon directors of a corporation in connection with the following tax obligations of the corporation: (i) the failure to file a return as and when required under the Act; (ii) the failure to keep proper books and records as required under the Act; and (iii) the failure to comply with the search and seizure requirements under the Act. A conviction arising out of any of the above-noted offences gives rise to a penalty of not less than \$1,000 and not more than \$25,000, or the amount of that fine together with imprisonment for a term of not more than twelve months.

In addition, a director may be found liable under section 242 of the Act for: (i) making false or deceptive entries or omitting certain material in the records or books of account; (ii) evading tax by destroying, altering or hiding records or books of account; (iii) making false or deceptive entries or omitting certain material in the records or books of account of the taxpayer; or (iv) wilfully evading or attempting to evade a payment of tax under the Act. A conviction of a director arising out of these offences could result in a penalty of either (i) a fine of not less than 50% and not more than 200% of the amount of the tax that was sought to be evaded; or (ii) both the fine and imprisonment for a term not exceeding 2 years.

#### **D. DIRECTORS' LIABILITY FOR TAX UNDER OTHER LEGISLATION**

Under section 323 the ETA, which deals with the GST, directors of corporations are jointly and severally liable to pay the net GST, interest and penalties assessed and unpaid unless they have exercised the degree of care, diligence and skill of a reasonably prudent person in the circumstances. Furthermore, under section 96, 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 liable on conviction to the punishment provided for the offence, whether or not the corporation itself has been prosecuted or convicted. There is similar liability under the *Canada Pension Plan* and the *Unemployment Insurance Act*.

Similarly, Ontario's *Employer Health Tax Act*, *Fuel Tax Act*, *Tobacco Tax Act* and *Gasoline Tax Act* each impose joint and several liability upon directors, subject to a due diligence defence, for any health, tobacco, fuel or gasoline taxes payable under any of the above-noted Acts which has not been paid by the corporation.

**E. INCOME TAX, CANADA PENSION PLAN AND EMPLOYMENT INSURANCE COLLECTION RULES**

Employees' Canada Pension Plan ("CPP") and employment insurance ("EI") benefits are fully protected in the event of the bankruptcy of an employer. In particular, subsection 224(1.2) of the Act gives the Minister of National Revenue an enhanced garnishment power to intercept payments owed to a tax debtor or to a secured creditor of the tax debtor who has a security interest such as an assignment of receivables. When a person who owes money to another person who has failed to remit source deductions receives an enhanced garnishment letter, the garnished amount becomes the property of the Crown and must be paid to the Receiver General in priority over any secured interest in that money.

The *Bankruptcy and Insolvency Act*, the *Canada Pension Plan* and the *Employment Insurance Act* confirm that the priority established pursuant to section 224(1.2) of the Act applies to *Canada Pension Plan* and *Employment Insurance Act* contributions or premiums of both the employer and employee notwithstanding bankruptcy.

Income tax regulations have been made regarding the collection of unpaid employee source deductions under the Act. In particular, while subsections 227(4), (4.1) and (4.2) of the Act provide for a statutory deemed trust of the Crown in connection with unremitted source deductions of any person, which will supersede any other security interest, there is a limited exception to the priority of these deemed trusts in the case of "prescribed security interests". These income tax regulations define a "prescribed security interest" as a mortgage in land or a building registered before a deemed trust arises under the Act. As a result, any mortgage registered after a deemed trust arises will be subordinated to such deemed trust. Further technical restrictions are applicable in determining what constitutes a "prescribed security interest".

While these enhanced collection powers of the Minister act to the detriment of creditors, they are beneficial to the directors of a corporation. The more unpaid source deductions that the CRA is able to collect from creditors, the less will be the joint and several liability exposure of directors under section 227.1 of the Act.

**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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