1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

# DIRECTORS' LIABILITY FOR TAX

**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 relating to directors' liability for tax and other tax, corporate and estate planning matters.**

## A. DIRECTORS' LIABILITY UNDER THE INCOME TAX ACT (CANADA)

Section 227.1 of the Income Tax Act (Canada) (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) 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; (iii) 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 (iv) for failure to pay tax under Part VII or VIII of the Act.

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 Act, and a claim for the amount of the corporations liability under Subsection 227.1(1) has been proved within six months after the date of the assignment or receiving order.

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

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.

## B. DUE DILIGENCE DEFENCE

A director can avoid liability under Section 227.1 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. An analysis of the judicial interpretation of this "due diligence" defence reveals a trend towards the adoption of a more lenient attitude in assessing the due diligence requirements. While the law in this area of the due diligence defence is still developing, the principles which can be gleamed from the existing case law can be summarized as follows:

(a) The standard applicable to a director in determining if he has been duly diligent is partly objective, in that one must assess what a reasonably prudent person would do to be duly diligent, and partly subjective, in that the circumstances of each case must also be considered;

(b) A passive director is not required to exhibit the same degree of care, diligence and skill as an active director. However, until judicial interpretation provides further clarification, a passive director would be prudent to take some positive steps to ensure that tax is deducted, withheld and remitted as required by the Act;

(c) 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 CCRA 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;

(d) 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;

(e) 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 CCRA when due;

(f) 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;

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

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

(i) 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 RELATING TO DUE DILIGENCE DEFENCE

### 1. Soper v. The Queen, 1997 D.T.C. 5407

The taxpayer, who was an experienced businessman, became a director of RBI Inc. in October, 1987 and resigned as a director effective February 10, 1988. At the time he joined the Board of Directors, he knew that the corporation was experiencing financial difficulties. At the November, 1987 Board meeting, the taxpayer was given a copy of the balance sheet of RBI Inc. which revealed the corporation's serious financial problems. While RBI Inc.'s failure to remit source deductions was never raised at any Board meeting, the taxpayer did not at any time inquire as to whether the corporation was complying with its remittance obligations under the Act. As a result, the Minister

assessed the taxpayer personally for RBI Inc.'s unremitted source deductions for the period from October, 1987 to January, 1988. The Tax Court of Canada dismissed the taxpayer's appeal when it rejected the taxpayer's due diligence defence, stating that he knew of the corporation's financial difficulties when he accepted the directorship, and citing his failure to take steps to ensure remittance of source deductions. The taxpayer appealed to the Federal Court of Appeal.

In dismissing the taxpayer's appeal, the Federal Court of Appeal analyzed in detail the standard of care, diligence and skill to be exercised by a corporate director in the performance of his or her duties. As a starting point, the Court referred to the judgment in **Re City Equitable Fire Insurance Co. Ltd.**, a 1925 Court of Appeal decision which summarized a director's duties. In particular, this case held that, at common law, a director must act honestly, but with some degree of skill and diligence. However, he does not need to exercise a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. Furthermore he is not required to give continuous attention to the corporation's affairs and, in the absence of grounds for suspicion, he may trust the corporation's officials to perform their duties honestly.

The Federal Court of Appeal then analyzed the legislated duties of care imposed upon directors in the Ontario Business Corporations Act, the Canada Business Corporations Act and subsection 227.1(3) of the Act. Mr. Justice Robertson concluded that the common law standard of care outlined in the **City Equitable** case, while altered slightly, has not been significantly "upgraded" by statute. Furthermore, the standard of care laid down in subsection 227.1(3) of the Act is "inherently flexible". Specifically, instead of treating directors as a homogeneous group of professionals whose conduct is governed by a single, unchanging standard, that provision of the Act also contains a subjective element which takes into account the personal knowledge and background of the director as well as his or her corporate circumstances in connection with the company's organization, resources, customs and conduct. Therefore, the Court concluded that individuals with superior qualifications such as experienced business persons would be held to a higher standard of care under subsection 227.1(3) of the Act. Describing the standard as "objective-subjective", the Court warned that honesty and doing one's best are not enough to establish due diligence, although the standard is not a professional one nor is it one governed by the law of negligence.

The Federal Court of Appeal then reviewed the case law regarding section 227.1 of the Act by distinguishing between cases involving inside directors, meaning those involved in the day-to-day management of the company and who influence the conduct of its affairs, and outside directors, meaning those not involved in the day-to-day

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

running of the company. The Court concluded that inside directors will have the most difficulty in establishing the due diligence defence. For outside directors, the positive duty to act arises where a director obtains information or becomes aware of facts, which might lead one to conclude that there is, or could reasonably be a potential problem with remittances. In other words, it is incumbent upon an outside director to take positive steps if he or she knew, or ought to have known, that the corporation could be experiencing a remittance problem.

Applying the law to the facts of the **Soper** case, the Federal Court of Appeal found that the taxpayer was under a positive duty to act which arose, at the latest, in November of 1987 when he received the balance sheet of RBI Inc. revealing that the company was experiencing extremely serious financial problems. Given the taxpayer's experience in the field of business, this balance sheet should have alerted him to the existence of a possible problem with remittances. The fact that the taxpayer then took no positive steps to ensure remittance of employee withholdings, despite the fact that he should have been alerted to a potential problem in this regard, led the Court to conclude that the taxpayer did not exercise the degree of care, skill and diligence required by the Act. As a result, the taxpayer's appeal was dismissed.

## 2. Blanchard v. The Queen, 2000 DTC 2255

The Minister assessed two taxpayers personally as directors of a corporation for its unremitted source deductions in respect of wages and imposed penalties. The Tax Court of Canada dismissed the taxpayers' appeals. The Tax Court found: (i) the taxpayers both knew that they were directors of the corporation; (ii) both taxpayers were actively involved in its daily operations; (iii) the corporation was undercapitalized almost from the beginning and suffered ongoing cash flow problems; (iv) the corporation had a history of non-remittances of payroll deductions with respect to which discussions with the CCRA had taken place; and (v) both taxpayers viewed their duty as directors to collect and remit source deductions as a very substantial duty which could entail their own personal liability.

Therefore, both taxpayers were "inside directors", with a high standard of care. Notwithstanding that they continued to pay other suppliers and the corporation's employees, in order to facilitate the finishing of a certain job. They did not take the positive steps contemplated by the **Soper** case regarding the payment of source deductions. It was not enough for the taxpayers to claim that they believed that everything would be satisfactory if they continued on as they had done, allowing the source deduction arrears to accumulate in the hope of finding new investors, and in the meantime using whatever cash they themselves had available. The taxpayers

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

deserved sympathy for having spent considerable sums of their own personal funds to keep the corporation in business. However, they did not act as reasonable directors would have acted under the circumstances. The defence of due diligence, therefore, was denied, and they were personally liable as assessed.

**3. <u>Cireillo v. The Queen, 2001 GTC 249</u>**

Both taxpayers, a husband and wife, were directors of a corporation, which failed to remit GST for the periods from May 1, 1991 to October 31, 1991 and from February 1, 1992 to April 30, 1994. On June 25, 1994, the corporation made an assignment in bankruptcy and the Minister proved his claim for GST in the bankruptcy. The taxpayers were vicariously assessed as directors of the corporation for unremitted GST.

The taxpayers appeals to the Tax Court of Canada were allowed in part. The wife lacked the skill and experience to recognize any default by the corporation in remitting its GST. Any individual with her level of skill, experience and qualifications, or lack of them, would have acted in the same way that she did. The Court allowed her appeal.

Although, the husband, like his wife, had only a public school education, he had gained experience by managing the corporation's business. Prior to 1991, the corporation had remitted source deductions and the husband was aware that, with the coming into force of the GST in 1991, the corporation had to remit GST as well. The husband was also aware that the corporation was in financial difficulty, but he appeared not to have done much to solve the GST remission problem. The husband was absorbed in trying to satisfy the corporation's creditors and he failed to show the requisite degree of due diligence. The Tax Court disallowed the husband's claim that he had ceased to be a director as soon as the corporation had made an assignment in bankruptcy on June 25, 1994. The Tax Court held that a corporation continues to exist when it makes an assignment in bankruptcy or is petitioned into bankruptcy. The directors may no longer be operating the bankrupt corporation, but they still remain directors.

Therefore, the husband was personally liable as assessed. However, the Minister was still ordered to re-examine the assessment in order to determine if the corporation's trustee in bankruptcy had made any GST payments on its behalf, in which case, the amount of the husband's assessment was to be reduced accordingly.

**4. Dirienzo v. The Queen, 2000 DTC 2230**

The taxpayer's uncle was the beneficial owner of the shares of a corporation. The uncle was also a de facto director of the corporation. The Minister assessed the taxpayer personally, in his capacity as a director of the corporation, for its unremitted source deductions.

The taxpayer's appeal to the Tax Court of Canada was allowed. The taxpayer was a puppet in the hands of his uncle. The taxpayer was a mere nominal director of the corporation with no powers, responsibilities, or control in which it was being operated. The taxpayer had ingenuous blind faith in his uncle, who was the family patriarch. The Minister, therefore, would have been entitled to assess the uncle as a de facto director of the corporation. However, the Court's duty in this case was to decide the facts in a "highly imperfect world where malleable young family members are bullied by domineering patriarchs". In this context, the taxpayer was powerless to do anything since his uncle dominated the family and all aspects of the business.

**5. Hevenor v. The Queen, 99 GTC 3070**

The taxpayer was a farmer with a grade 10 education and with no knowledge of accounting and business practices. The taxpayer was the sole shareholder and director of the corporation, which was incorporated by his son (an individual with a grade 11 education), to finance the acquisition of a restaurant business. The Minister assessed the taxpayer for the corporation's unremitted GST.

The Tax Court of Canada allowed the taxpayer's appeal. Although the son admitted that the corporation had never paid GST, the father had no involvement with the corporation's business, having left all the decision-making to his son. The father had tried to assist his son by funding the business, but the father had not been kept informed on an ongoing basis by the son of the corporation's shaky financial position. The father has been put in a situation for which he had no experience of skill.

**6. Stein v. The Queen, 99 GTC 3186**

The Minister assessed the taxpayer as a director of a corporation for its unremitted GST. The taxpayer, claiming that she was not a director of the corporation and that she had shown due diligence, appealed to the Tax Court of Canada, which dismissed her appeal.

The Tax Court found the taxpayer was an experienced business person serving on various corporate boards and that she was not merely a "housewife" as she had claimed. The taxpayer had lent the corporation $50,000 and had guaranteed its $75,000 line of credit. The taxpayer was the only shareholder of the corporation authorized to sign its cheques. As a result the taxpayer was an "inside" director within the meaning of that term as set out by the Federal Court of Appeal in **Soper v. The Queen**.

In addition, the taxpayer must have known of the corporation's financial difficulties. Therefore, the allegations that the taxpayer lacked business experience, and that she was not a director of the corporation were lacking in credibility.

**7. Wallace v. The Queen, 2000 DTC 2537**

The Minister assessed two taxpayers personally, as directors of a corporation for unremitted source deductions. The taxpayers appeals to the Tax Court of Canada were dismissed. The Tax Court found that the first taxpayer had made no enquiries whatsoever with regard to the corporation's accounts payable, source deductions, or anything regarding its financial position. He had no idea how the corporation was being run, and had made no attempt to find out. He had set up a software system that would tell the corporation the amounts of the source deductions, and how it could draw money. But there was nothing to prevent the corporation from deliberately or accidentally defaulting in the payment of its source deductions.

The second taxpayer, as the managing partner of the corporation, had a duty to ensure that the corporation's employees were in fact performing their assigned tasks (including the remission of source deductions). She totally abdicated her responsibility in this connection to another of the corporation's employees. She would meet with this other employee approximately one hour a week and would spend the rest of her time on sales. Therefore, neither taxpayer demonstrated due diligence and they were personally liable as assessed.

**8. Bains v. The Queen, 99 GTC 3210**

The taxpayer was personally assessed in his capacity as a director for a corporation's unremitted GST for the period from December 1, 1994 to August 31, 1996. The taxpayer's appeal to the Tax Court of Canada was allowed in part. For the period ending February 28, 1995, the taxpayer had given another shareholder and director of the corporation $10,000 for payment by the corporation of its GST for that period. Therefore, the taxpayer was not personally liable for the corporation's GST for that

period of time. With respect to the corporation's remaining GST outstanding, the Tax Court found that the taxpayer had failed to show due diligence by having failed to take steps to insure that appropriate information about the corporation's affairs had been provided to him on a timely basis. The Minister was thus ordered to reassess the taxpayer's personal liability only by the amount of the corporation's GST for the period ending February 28, 1995.

## D. 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 (the "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; 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 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) is of unsound mind and has been so found 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.

## E. CASE LAW RELATING TO RESIGNATION BY A DIRECTOR

### 1. Zwierschke v. M.N.R., 1992 DTC 1003

In a Tax Court of Canada decision, a receiver was appointed to manage the affairs of a corporation. Subsequently, the taxpayer delivered a written notice to the

corporation of his resignation as president of the corporation. It was held that this resignation was ineffective since the individual was a first director of the corporation and there was no evidence that any other person was elected or appointed as a director of the corporation as successor to the individual to comply with requirements of Section 119(2) of the OBCA. Therefore, the Minister was successful in assessing the taxpayer personally in his capacity as the sole director of the corporation for unremitted source deductions. The appointment of the receiver did not terminate the taxpayer's directorship and at all material times the taxpayer remained as a director and could not mount a defence based on the two-year limitation period contained in the Act.

**2. <u>The Queen v. Kalef, 1996 DTC 6132</u>**

In a Federal Court of Appeal decision (for which leave to appeal to the Supreme Court of Canada was refused), the taxpayer was a director of a corporation which became bankrupt. The Minister assessed the taxpayer for the corporation's unremitted payroll deductions and the taxpayer who was not one of the first directors of the corporation argued that these assessments were made by the Minister more then 2 years after the individual had ceased to be a director. The individual contended that he had ceased to be a director of the company when the trustee in bankruptcy assumed control of the bankrupt corporation, since this was the moment at which the taxpayer lost actual control over the corporation. However, under the provisions of the OBCA, the taxpayer remained a director of the corporation, notwithstanding the appointment of the trustee in bankruptcy. Therefore, the Minister's assessment against the director was not statute-barred and was upheld by the Court. The Court found that the individual did not resign, although he could have done so, and he was neither removed nor disqualified from being a director.

**3. <u>Brakop v. Canada, (1996) 63 A.C.W.S. (3d) 181</u>**

In a Tax Court of Canada decision, a bank appointed a receiver to manage the affairs of a corporation which was in financial difficulty. Subsequently, the receiver was appointed the trustee in bankruptcy for the corporation. The directors claimed they had ceased to be directors by virtue of a letter of resignation as well as through a loss of control of the corporation as a result of the actions of the bank. However, the Court found that the directors did not effectively resign from their positions with the corporation since the letter of resignation was not delivered to the corporation's registered office and could not be found in the business and corporation records in the trustee in bankruptcy's possession. Provincial corporate registries did not reflect the resignations either. The directors were held to have never lost control of the corporation and the financial difficulty of the corporation did not mean that the individuals ceased to be

directors. Therefore the Court upheld an assessment by the CCRA against the directors in respect of unremitted employee deductions.

**4. Alfano v. The Queen, 2000 DTC 1962**

The Minister assessed the taxpayer as a director of the corporation for the latter's unremitted source deductions on October 28, 1996. The taxpayer appealed to the Tax Court of Canada, claiming that he had resigned as a director of the corporation on February 3, 1993, or within 30 days thereafter. The taxpayer alleged that the Minister's assessment was statute-barred, having been made beyond the two-year period contemplated in Subsection 227.1(4) of the Act.

The Tax Court of Canada allowed the taxpayer's appeal. Based on the credibility of the testimony offered by the taxpayer's witnesses, the Tax Court held that the taxpayer's resignation as a director of the corporation took effect in February, 1993, or very shortly thereafter. The solicitor for the corporation testified that the taxpayer was the incorporator and sole director of the corporation, which was incorporated on February 3, 1993. The taxpayer had never intended to remain as a director of the corporation, but became the incorporator out of a favour to his father and brothers, who were experiencing personal financial difficulties at the time.

The taxpayer resigned as a director in writing on February 3, 1993. The solicitor for the corporation prepared and sent to the corporation for filing with the Ontario Ministry of Consumer and Commercial Relations a notice of change in February 1993, showing the resignation and that his father had become the new director of the corporation. However, due to inadvertence this notice was not filed until May, 1995. After February 3, 1993 the taxpayer believed that he was no longer a director of the corporation. Alternatively, even if the resignation did not take effect the taxpayer actually believed that he was not a director of the corporation from and after 1993. Therefore the taxpayer could rely on the decisions in **Cybulski v. M.N.R. 39 B.L.R. and Sheremeta v. M.N.R., 91 DTC 867**. These decisions appear to stand for the proposition that if a person actually believes he is not a director, he escapes liability under section 227.1 of the Act. Therefore, the Minister's assessment was statute-barred, and was vacated by the Tax Court of Canada.

**5. Whybrow v. The Queen, 2000 DTC 3611**

From inception of the corporation, the taxpayer was a 25% shareholder and a director. The Minister assessed the taxpayer personally for the corporation's unremitted source deductions, and imposed penalties. The taxpayer appealed to the Tax Court of

Canada claiming that he had resigned as a director more than two years before the assessment, and alternatively that, he had demonstrated due diligence .

The Tax Court of Canada dismissed the taxpayer's appeal, holding: (i) that there was no corroborating evidence of the authenticity of the taxpayer's resignation as a director, since it was unsigned and no original had been produced; (ii) that there was no confirmation that it was ever sent or acted upon; (iii) that, as the Minister had alleged, the resignation was not authentic and a fabrication; and (iv) that the taxpayer failed to demonstrate due diligence as an inside director, knowing of the corporation's financial difficulties and of its source deduction arrears, but having failed to take meaningful steps to insure the remission thereof until too late.

## F. "DE FACTO" DIRECTOR

### 1. The Queen v. Corsano, 99 DTC 5658

**The Queen v. Corsano**, was an appeal to the Federal Court of Appeal from a decision of the Tax Court of Canada which previously allowed an appeal from an assessment pursuant to subsection 227.1(1) of the Act for unremitted federal income tax withheld from the wages paid to employees of Louisbourg Harbourfront Part Ltd. (the "Corporation"). In this case, the individual Respondents did not hold shares in the non-profit Corporation and therefore, according to the Corporation's Articles of Association, were not legally directors of the Corporation. The Tax Court of Canada therefore found that the Respondents could not be held liable for failure to remit source deductions. The Tax Court of Canada also found that there was a lower standard of care for directors of a non-profit corporation and that these individuals had exercised due diligence in the performance of their duties.

The Federal Court of Appeal disagreed with the Tax Court of Canada on all of the above matters and therefore allowed the appeal. Specifically, while the Federal Court of Appeal agreed that the nine individual Respondents lacked the requisite qualifications to be directors pursuant to the Corporation's Articles and the relevant incorporating provincial legislation, they did carry out the duties of directors and thus became "de facto" directors of the Corporation. As a result, these individuals could not rely on their lack of qualification as a defence to escape the liability attaching to a director for a failure to remit source deductions. The Federal Court of Appeal stated that subsection 227.1(1) of the Act should not be given an unduly restrictive interpretation regarding the meaning of the word "director", since "a failure to recognize

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

the responsibility and liability of persons acting as de facto directors amounts to condoning and inviting the performance of acts and omissions by such persons".

As a result, the Federal Court of Appeal held that individuals acting as directors are responsible for the failure to remit source deductions, regardless of whether or not they are qualified to have the status of director.

In the **Corsano** decision, the Federal Court of Appeal also held that the Tax Court of Canada had erred in concluding that the standard of care provided for in subsection 227.1(3) of the Act was less rigorous for directors of non-profit corporations. Furthermore, in applying the standard of care to the facts in this case, the Federal Court of Appeal held that the Tax Court of Canada judge erred in finding that the Respondents had demonstrated due diligence. In particular, the Federal Court of Appeal found that the Respondents had not exercised the degree of care and diligence expected to prevent a failure to withhold and remit source deductions since no positive steps were taken to prevent such failure for over a year after the Respondents became aware of the financial difficulties of the Corporation. Thus, the appeal of the Crown was allowed and the decision of the Tax Court of Canada was set aside.

## 2. The Attorney General of Canada v. McKinnon, 2000 DTC 6593

The Minister assessed the taxpayers as directors of a corporation for the corporation's unremitted source deductions and unremitted GST for periods following October 18, 1993. The taxpayer's appeals to the Tax Court of Canada were allowed (98 DTC 1783).

The Tax Court of Canada held: (i) that after October 18, 1993, the taxpayers, as directors, did not have de jure control of the corporation and did not have the necessary freedom of choice to enable them to act freely; (ii) that, following the advice of a financial consultant, they had not closed down the corporation, but had attempted to keep it running to save jobs for its 70 employees; (iii) that, until September 30, 1993, the corporation's bills had always been paid, and the taxpayers had made efforts to have its bank make payroll remittances, with the result that the employee portion thereof had always been remitted; and (iv) that, to have shut down the corporation, as the Minister suggested they should have, the taxpayers would not have been demonstrating due diligence. As a result, the Tax Court of Canada held that the taxpayers had exercised due diligence, and were, therefore, not to be held personally liable as assessed.

The Crown's appeal to the Federal Court of Appeal was dismissed. The Federal Court of Appeal held: (i) that nearly all of the corporation's debt to the CCRA for

unremitted payments (from which the taxpayers' personal liability had derived) had accrued after October 18, 1993, when the corporation's bank started to exercise control of the cheques that it issued; and (ii) that the outstanding employee portion of the amounts in issue was paid in full by the corporation's trustee in bankruptcy, so that the assessment against the taxpayers concerned only the employer portion.

The due diligence exemption in Subsection 227.1(3) of the Act will provide a defence to directors who have acted with propriety in attempting to prevent defaults by their corporation. In this case, the "due diligence" owned by the taxpayers was at the top of the range. They were "inside" directors who managed the corporation and had been associated with it from its early days. Hence, they were very experienced in, and knowledgeable about, the corporation's business.

The focus of the appeal, however, was on the taxpayers' conduct as directors after October 18, 1993, when the corporation's bank dishonoured the second remittance cheque (for which, admittedly, the taxpayers could not be held responsible). It was found that the taxpayers did exercise the required degree of care, diligence and skill. One of the corporation's employees continued to prepare remittance cheques even though without a realistic hope that the bank would honour them. Of more significance was that the taxpayers had engaged a consultant who continued to make efforts to find a new investor, given his belief that the corporation could then be quickly turned around. As a result, the taxpayers were not to be held personally liable.

**3. McDougall v. The Queen, 2001 DTC 1**

The Minister assessed the taxpayer as a director of the corporation for unremitted GST (for various reporting periods ending from January 1, 1995 to January 31, 1997), and for unremitted source deductions for various periods during 1996 and 1997. The taxpayer appealed to the Tax Court of Canada, alleging that he was neither a legal nor a de facto director of the corporation at the relevant times, and, alternatively, that if he was a director, he had demonstrated due diligence.

The Tax Court of Canada dismissed the appeal following the reasons in the **Corsano** decision. By using the word "directors" without qualifications in Subsection 227.1(1) of the Act, Parliament intended the word to cover all types of directors known to the law in company law, including de jure and de facto directors. In addition, the provisions of the Excise Tax Act (the "ETA") respecting directors' liability are similar to those in the Act under which the taxpayer in the **Corsano** decision was found vicariously liable as a corporate director.

In this case the company had registered under the ETA showing the taxpayer as a director. The taxpayer had completed the ETA forms as a director of the corporation and had signed corporate cheques. The taxpayer had also failed to withdraw the corporation's ETA filing of his name as a director, after first being notified on January 21, 1997 that he had been recorded as a director.

As a result, the taxpayer was a de facto director of the corporation. Regarding the due diligence issue the taxpayer knew that the corporation was experiencing financial problems from its beginning. The taxpayer also had well above average skill, experience and knowledge in corporate matters. He was aware, or ought to have been aware, of ever failed remittance by the corporation from the inception. The taxpayer only took one positive step to prevent the tax default. He produced a cheque dated January 29, 1997, but it was not soon enough. The corporation's debt to the CCRA was never discharged and the taxpayer never lost legal control over its affairs at any material time. Accordingly, the taxpayer failed to meet the criteria for directors' due diligence set out by the Federal Court of Appeal in **The Attorney General of Canada v. McKinnon**.

## G. 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 which 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 sections 227(4) and 227(5) of the Act, funds which 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 Act. A director who is required to pay an amount pursuant to Section 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 CCRA 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

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

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; (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 12 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; and (iv) willfully 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 or 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.

## H. DIRECTORS' LIABILITY FOR TAX UNDER OTHER LEGISLATION

Under the Excise Tax Act which deals with the Goods and Services Tax ("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, 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.

Pursuant to Ontario's Retail Sales Tax Act, where a corporation has failed to collect or remit retail sales tax or has failed to pay any interest or penalty relating thereto, the directors of the corporation at the time the corporation was required to collect or remit the taxes or to pay the interest or penalty relating thereto, are jointly and severally liable together with the corporation to pay such amounts. This liability is again subject to a due diligence defence. There is a similar liability under Ontario's Employer Health Tax Act.

Similarly, Ontario's 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 tobacco, fuel or gasoline taxes payable under any of the above-noted Acts which has not been paid by the corporation.

## I. RECENT AMENDMENTS TO 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.

Amendments made on March 11, 1999 to 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. These amendments were a response to recent case law which held that enhanced garnishments were not effective in the collection of employer contributions under the above-noted legislation. These changes were made effective as of November 30, 1992, which corresponds to the date upon which most Crown priorities were removed under Section 86 of the Bankruptcy and Insolvency Act.

On March 11, 1999, amendments to the income tax regulations were 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

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

trust. Further technical restrictions are applicable after 1999 in determining what constitutes a "prescribed security interest".

While these enhanced collection powers of Revenue act to the detriment of creditors, they are beneficial to directors of a corporation. The more unpaid source deductions that the CCRA 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.

## J. CASE LAW REGARDING DUTY TO REMIT

### 1. Roll v. The Queen, 2000 DTC 1454

The taxpayer commenced employment as a bookkeeper for a corporation in 1995. By October or early November 1995, the corporation's financial position had deteriorated. Therefore, the taxpayer consented to use his own personal bank account which he maintained jointly with his wife to assist the corporation by depositing therein a cheque for its November net payroll (net of source deductions), and then drawing cheques for the corporation's employees on that account. For the next six and one-half months, the corporation's net payroll was processed in this manner by the taxpayer, using a separate bank account that he had opened by December 1995.

The Minister reassessed the taxpayer under Subsection 165(3) of the Act for the corporation's unremitted source deductions for the period from January 1 to July 15, 1996. The Minister's reassessment was based on the allegation that the taxpayer was "a person paying salary or wages or other remuneration" pursuant to subsection 153(1) of the Act. The Minister also claimed that the taxpayer was a "trustee" pursuant to the act.

The taxpayer's appeal to the Tax Court of Canada was allowed in part. The Tax Court held that the taxpayer had stepped outside his employment when he deposited the corporation's funds in a bank account in which only he had the signing authority, and then disbursed the funds according to instructions provided to him. The taxpayer was well aware of the obligation to withhold source deductions and of the fact that this was not being done. The Act imposes liability on an individual who makes payment in such circumstances, even though that individual is not the employer of the persons to whom the payments are made.

The Tax Court found that the taxpayer calculated the payroll and withholdings in his capacity as an employee of the corporation at its offices. The taxpayer was not a

1 St. Clair Ave. East, Suite 900 Toronto, Canada M4T 2V7 Tel: 416-923-0809 Fax: 416-923-1549 www.alpertlawfirm.ca

contractor providing services to the corporation. The taxpayer had not been provided with the amount of the gross payroll by the corporation and did not have any discretion as to the payment of the funds he received. The taxpayer was a bare trustee of those funds. Therefore, the taxpayer was not personally liable pursuant to the provisions of the Act. The taxpayer did not have any direct or indirect influence over the disbursements, property, business, or estate of the corporation and did not come within the scope of the personal liability provisions of Subsection 227(5) of the Act. Thus, the taxpayer was not jointly and severally liable for the full amount of the withholdings. However, he was found liable for the penalty that had been assessed under Subsection 227(9) 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.**

**If you require assistance with directors' liability for tax or need other tax, corporate and estate planning advice, please contact Howard Alpert directly at (416) 923-0809.**

**No part of this publication may be reproduced by any means without the prior written permission of Alpert Law Firm.**
**© 2004 Alpert Law Firm. All rights reserved.**