Deakin v The Queen, 2012 TCC 270

"Due Diligence Defence" Against Directors' Personal Liability for Unremitted Source Deductions and GST NOT Available Where Directors consciously Use These Funds to Keep Business Afloat.

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At issue was the applicability of the due diligence defence for directors of a corporation in relation to unremitted source deductions under the ITA and unremitted GST under the ETA giving rise to director liability pursuant to ITA s 227.1(1) and ETA s 323(1).

The Court held that the due diligence defence is not available where directors consciously use unremitted funds to keep the business afloat in hopes of receiving payments that will allow them to remit the amounts due at some later point, and emphasised that ”[g]iven the specific wording of the subsections and the Federal Court of Appeal’s comments in Buckingham, it appears somewhat difficult to imagine circumstances in which an informed and active owner-manager and director of a corporation will not be liable for unremitted employee source deductions and unremitted GST amounts". Where director's chose to use unremitted funds for business purposes they are making all Canadian taxpayer's unwilling investors in their business, and the provisions that provide for Directors' personal liability for these unremitted amounts are akin to personal guarantees by the directors to the Canadian public.

FACTS

The taxpayers were directors and shareholders of the subject corporation. The corporation was encountering cash flow issues and awaiting a large cash payment. In order to be able to continue operations, the corporation used the source deductions to fund operations. The corporation eventually declared bankruptcy with significant amounts owing under the ITA and ETA.

ANALYSIS

The Court reviewed the employers obligation to withhold and remit source deductions on behalf of employees, and the obligation on a business to collect and remit net GST. Subsection.

Though directors are not generally liable to a corporation's own income tax liability, pursuant to .1 of the ITA and subsection 323 of the ETA provide that the directors of a corporation will be personally liable for a corporation’s failure to remit employee withholdings and GST as required by law. This reflects the degree of control directors have over a corporation's management and affairs. Directors are not personally liable under the preceding sections if they exercised a degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.

The Court referred to the FCA decision in Her Majesty the Queen v. Buckingham, 2011 FCA

142, were the due diligence defence was considered in relation to unremitted source deductions. The FCA recognised that the provisions in question aim at the prevention of failures to remit and stated:

> In order to rely on these defences, a director must thus establish that he turned his attention to the required remittances and that he exercised his duty of care, diligence and skill with a view to preventing a failure by the corporation to remit the concerned amounts.
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> […]
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> The traditional approach has been that a director's duty is to prevent the failure to remit, not to condone it in the hope that matters can be rectified subsequently: Canada v. Corsano, [1999] 3 F.C. 173 (C.A.) at para. 35, *Ruffo v. Canada*, 2000 D.T.C. 6317, [2000] 4 C.T.C. 39 (F.C.A.).
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> […]
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> In circumstances where a corporation is facing financial difficulties, it may be tempting to divert these Crown remittances in order to pay other creditors and thus ensure the continuation of the operations of the corporation. It is precisely such a situation which both section 227.1 of the Income Tax Act and section 323 of the Excise Tax Act seek to avoid. The defence under subsection 227.1(3) of the Income Tax Act and under subsection 323(3) of the Excise Tax Act should not be used to encourage such failures by allowing a due diligence defence for directors who finance the activities of their corporation with Crown monies on the expectation that the failures to remit could eventually be cured.
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> […]
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> A director of a corporation cannot justify a defence under the terms of subsection 227.1(3) of the Income Tax Act where he condones the continued operation of the corporation by diverting employee source deductions to other purposes. The entire scheme of section 227.1 of the Income Tax Act, read as a whole, is precisely designed to avoid such situations. In this case, though the respondent had a reasonable (but erroneous) expectation that the sale of the online course development division could result in a large payment which could be used to satisfy creditors, he consciously transferred part of the risks associated with this transaction to the Crown by continuing operations knowing that employee source deductions would not be remitted. This is precisely the mischief which subsection 227.1 of the Income Tax Act seeks to avoid.
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> [emphasis original]

The Court also referred to the FCA comments in *Buckingham* regarding the decision in *HMQ v. McKinnon*, [2001] 2 F.C. 203 CA, subnom Worrell v. Canada where the FCA wrote:

> 69. It will normally not be sufficient for the directors simply to have carried on the business, knowing that a failure to remit was likely but hoping that the company's fortunes would revive with an upturn in the economy or in their market position. In such circumstances directors will generally be held to have assumed the risk that the company will subsequently be able to make its remittances. Taxpayers are not required involuntarily to underwrite this risk, no matter how reasonable it may have been from a business perspective for the directors to have continued the business without doing anything to prevent future failures to remit.

The Court stated that the relevant considerations of the due diligence defence in the *Worell* circumstances will have to be developed by the courts, but in this case the earnest efforts by the directors to try to remedy the failure to remit after it had occurred could also not support the due diligence defence on the facts. There was no interfering person that exercised power over payments, and there was no evidence on which the court could determine the reasonableness of the anticipation of the funds expected.

The Court concluded by stating:

> Source deductions and GST remittances are required by law to be made by a business corporation. These are not the corporation's own funds. The corporation has collected them from its employees and customers. Those employees and customers are given credit for these amounts once withheld and collected, even when not remitted. When owner-managers and directors decide to use these funds to keep their business afloat and support their investments, they are making all Canadian taxpayers invest involuntarily in a business and investment in which they have no upside. In doing so, shareholders and corporate decision-makers are investing or gambling with other people's money. Directors should be aware of that when they cause or permit this to happen. The directors' liability provisions of the legislation should be regarded by business persons as somewhat similar to a form of personal guarantee by the directors that can expose them to comparable liability for the amount involved. It is they who are deciding to invest the funds in their own business, for their own gain, not the government or people of Canada. They are doing so contrary to clear law and it appears appropriate as a policy matter that Parliament has legislated clearly that they will generally be responsible for such decisions and the loss resulting from them. In essence, if a corporation and its directors choose to unilaterally "borrow" from Canadian taxpayers and the public purse, Canadians get the benefit of security akin to personal guarantees of the directors.

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