Brief Your CEO: Personal Liability of Directors for Company's Failure to Remit



THE SITUATION

An experienced business professional agrees to join the board of directors of a financially troubled talent agency. During his very first board meeting, he's handed a balance statement showing the company has a net operating loss of $132,000 through 3 quarters. What the other directors don't tell him is that the company hasn't been remitting employee source deductions to the CRA as required by the *Income Tax Act*. The director resigns 3 months later without ever asking or finding out about the remittances. When the government tries to personally assess him for the unpaid remittance, he claims he showed due diligence. The court disagrees and upholds the $13,000 assessment [*Soper v. Canada*].

THE PROBLEM

A corporate director can be held personally liable for a corporation's failure to deduct and remit taxes from employees. Directors can defend themselves against liability by showing that they exercised "due diligence" to prevent the company from committing the violation. But, as the *Soper* case shows, due diligence is a high standard for a director to meet. Even though *Soper* was decided in 1997, tax courts still look to it as the standard for determining a director liability for a corporation's failure to remit.

THE DUE DILIGENCE RULE

In the 1980s, the government was having a hard time collecting remittances from financially strapped companies. To prevent companies from using the money they were supposed to remit to pay off creditors, the government added section 227.1(1) to the *Income Tax Act* in 1982 to make corporate directors personally responsible for amounts their companies fail to remit. The new tax laws also included certain defences directors could use to avoid liability. One of them, Sec. 227(3), provides that a director isn't liable "where he exercised the degree of care, diligence and skill to prevent the [failure to remit] that a reasonably prudent person would have exercised in comparable circumstances." This is referred to as the "due diligence" defence.

THE QUESTION

What does due diligence mean? And what are corporate directors actually expected to *do* to meet the standard?

THE ANSWER

The *Soper* case goes a long way toward answering this question. Due diligence, the federal tax court said, is not a one-size-fits-all standard. It's a combination of objective and subjective factors. The objective part is the "reasonableness" standard; but in determining what's "reasonable" for a director to do, it's necessary to consider the director's circumstances, including:

The Director's Experience

The more extensive a director's experience and knowledge in financial matters, the higher the standard. Thus, the director in *Soper* was found liable because he was an experienced businessman. By contrast, in a case decided one year earlier, a director *wasn't* liable for his company's failure to remit because he "had no management experience" [*Sanford v. M.N.R.*].

The Director's Influence

The more influence a director has over the company's day-to-day business operations, the higher the standard of due diligence. Thus, more is generally expected of inside than outside directors (even though the director found liable in *Soper* was an outside director.)

The Warning Signs

Directors are expected to be on the lookout for and respond to red flags. The director in *Soper* claimed, accurately, that none of the directors told him that the company wasn't remitting. However, the tax court said that the balance sheet should have tipped the director off and caused him to make inquiries about whether the company was meeting its remittance obligations.

TAKEAWAY: THE 6 QUESTIONS DIRECTORS SHOULD ASK TO EXERCISE DUE DILIGENCE
Due diligence isn't just a one-time or sporadic activity; it's something a director must exercise on a regular, ongoing basis. The director also has to proactively attempt to head off problems with remittances, not simply respond to them when they arise. How can directors tell if they're doing enough? There's no precise formula. But, based on a recent CRA Circular, here are six questions they should ask:
Are there accounts for withholdings from employees and remittances of source deductions (as well as for GST/HST, ATSCA net amounts and Excise duty)?
Do financial officers provide regular reports on the status of each account?
Is regular confirmation being provided that all remittances have been made?
Is delegation proper? Directors may, in the words of the Soper case, "rely on company officials to perform honestly duties that have been properly delegated to them." But they must be on the lookout for and immediately respond to any grounds for suspicion.
Are directors aware of their legal obligations?
Are directors documenting their efforts so they can prove they were duly diligent in case they're charged for their company's failure to remit? As the lawyers say, if it isn't documented, it didn't happen.