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## **LIMITATIONS ON DIRECTOR'S DUE DILIGENCE DEFENCE UNDER ITA & ETA**

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*By Terrance S. Carter\**

In the recent decision of *Buckingham v. Canada*,<sup>1</sup> a director of a corporation was found personally liable for failure to remit source deductions and taxes for the corporation and its various subsidiaries notwithstanding that considerable business measures had been taken to address the financial difficulties being faced by the corporation, including working on a proposed equity issue, attempting to secure a line of credit, reducing expenditures, and attempting to merge with another company.

*Buckingham* concerns section 227.1(1) of the *Income Tax Act*<sup>2</sup> ("ITA") and section 323(1) of the *Excise Tax Act*<sup>3</sup> ("ETA"), which impose personal liability on directors, either jointly and severally or solidarily, together with the corporation, to pay amounts and any interest or penalties relating to unremitted employee source deductions and GST/HST amounts. In this case, the issue raised was the appropriate standard of care, diligence and skill required of a director in using this defence of due diligence under subsection 227.1(3) of the *Income Tax Act* ("ITA") and subsection 323(3) of the *Excise Tax Act* ("ETA"), which both read that a director is not liable for failure under these sections "where the director exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances."

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\* Terrance S. Carter, B.A., LL.B., Trade-Mark Agent, is managing partner of Carters Professional Corporation, and counsel to Fasken Martineau DuMoulin LLP on charitable matters. The author would like to thank Kristen D. van Arnhem, B.A. (Hons.), J.D., Student-at-Law, for assisting in the preparation of this bulletin.

<sup>1</sup> *Buckingham v. Canada*, 2011 FCA 142, [2011] F.C.J. No. 616, [2011] A.C.F. no 616 (F.C.A.) ("*Buckingham*").

<sup>2</sup> *Income Tax Act*, R.S.C. 1985, c. 1 (5<sup>th</sup> Supp.) as amended ("ITA").

<sup>3</sup> *Excise Tax Act*, R.S.C. 1985, c. E-15 ("ETA").

The Federal Court of Appeal held that the trial judge erred in using the common law standard of the reasonable business decision test as set out in *Peoples Department Stores*<sup>4</sup> rather than using the statutory standard as set out in the ITA and ETA requiring “that the director’s duty of care, diligence and skill be exercised to prevent failures to remit.”<sup>5</sup> Furthermore, notwithstanding the director’s considerable efforts to keep the company operational, his duty was to prevent the failure to remit in the first place rather than a duty to cure the failures to remit after efforts to keep the company operational had failed. Therefore, the director was not able to use the due diligence defence where his efforts were focused on liquidating assets in order to remedy failures to remit source deductions and taxes after they became due. As such, the decision suggests that the director may have been better able to avoid personal liability if he had done nothing to keep the company operating during its financial difficulties and thereby avoid the ongoing liability of maintaining staff and the corresponding exposure for source deductions and applicable taxes.

The application of this case to charitable and not-for-profit organizations means that directors may be put in a difficult position. When a charity or not-for-profit organization is faced with financial difficulties, does the board continue to run the organization in the hope that better days are ahead, but risk personal liability for unpaid source deductions or applicable taxes? Of course, each case is different and must be looked at separately. However, generally the board will want to carefully consider whether to operate a charity or not-for-profit organization beyond the point when it can no longer continue to meet all of its financial obligations, including salaries, source deductions, and applicable taxes. Operating beyond that point will leave directors exposed to liability for source deductions and applicable taxes notwithstanding subsequent best efforts to pay those obligations.

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<sup>4</sup> *Peoples Department Stores Inc. (Trustee of) v. Wise*, 2004 SCC 68, [2004] 3 S.C.R. 461 (S.C.C.) (“*Peoples Department Stores*”).

<sup>5</sup> *Buckingham*, *supra* note 1 at para 40.