Citation: 2008TCC199
Date: 20080410
Docket: 2005-2544(IT)G

BETWEEN:

GREGORY SCOTT MOHOS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Jorré, J.

Introduction

[1] This is an appeal from an assessment of the Appellant pursuant to section 227.1 of the *Income Tax Act* (the "*Act*") for unpaid source deductions, interest and penalties payable by Engine Tech Inc. ("Engine Tech"). The amount of federal tax not remitted was $5,231.24 in 1996 and $16,038.95 in 1997. With other source deductions and interest, the total amount of the assessment is $86,989.07.

[2] The Appellant appeals on two grounds. Firstly, he takes the position that he was not a director. Secondly, he argues, in the alternative, that if he was a director then he exercised due diligence bringing him within the defence set out in subsection 227.1(3) of the *Act*.

The Facts

[3] The Appellant has a grade 12 education and has worked as a mechanic for 15 years.

[4] Prior to his involvement with Engine Tech, he worked at McDonald Douglas.

[5] The Appellant became involved with Engine Tech in 1993 when Ray Crosato, who was the majority owner, hired him as an employee. At that time, Engine Tech was a partnership.

[6] His girlfriend, Heather McLeod, worked at Engine Tech prior to the Appellant's involvement with Engine Tech. The Appellant and Heather were already living together when the Appellant started to work at Engine Tech.

[7] After three months, Ray Crosato invited the Appellant to become his partner and replace Ray's previous partner. The Appellant bought the 49% share of business of the previous partner for $40,000. He borrowed the $40,000 to purchase the interest. Ray had a 51% interest.

[8] Engine Tech repaired and rebuilt engines. It outsourced some of the work. The Appellant would take out engines, prepare them for machining and then reassemble them.

[9] The Appellant was in charge of the shop, the technical side.

[10] Ray was in charge of everything else: administration, hiring employees, dealing with customers, obtaining customers, dealing and paying supplies although the Appellant sometimes dealt with suppliers in ordering parts.

[11] The Appellant worked at least five days a week, sometimes six or seven.

[12] Ray was mostly at the front counter and would only occasionally work in the shop.

[13] Heather did the office work. The office was located upstairs above the reception.

[14] Both the Appellant and Ray earned $500 a week and Engine Tech also made payments of $325 a month on the Appellant's truck. He received no management fees and, as far as he knows, Ray did not.

[15] Engine Tech had about six or seven employees, not including Ray and the Appellant; the number varied over time.

[16] In late 1995, Engine Tech was incorporated. The Appellant testified that Ray had the incorporation done for some legal or accounting reason. He does not know why. He also said he still understood this to be a partnership.

[17] Ray was the one who gave instructions to the lawyer. The lawyer prepared the necessary documents and arranged for Ray and the Appellant to become directors[1]. Ray was the initial incorporator in the Articles of Incorporation that took effect on November 23, 1995 (Exhibit A-1-18).

[18] On November 23, 1995, the Appellant signed, as Secretary of the company, a true copy of a special resolution of the company establishing that the company would have two directors (Exhibit A-1-24). This was the same day as the share certificates were issued.

[19] He received 49 shares and Ray received 51 shares. The Share certificates were signed by Ray as President and the Appellant as Secretary.

[20] Ray signed an Initial Notice under the Ontario *Corporations Information Act* (Exhibit A-1-23) that indicated both Ray and the Appellant were directors. The form was filed on November 30, 1995.

[21] The Appellant testified that, while he knew that he had the title of director he did not know what that meant. His understanding was that the partnership continued. No one explained to him what a director was.

[22] The Appellant only went to the lawyer's office once or twice. He was always with Ray. When he went to the lawyer, the meeting was not long. He did not know how long it lasted but it might perhaps have been half an hour. He recalled the lawyer saying there would be two directors.

[23] There was no evidence that Ray instructed the lawyer to do anything to which the Appellant objected. The Appellant could have asked the lawyer more questions but did not.

[24] The Appellant was unsure if he had signing authority for company cheques, but if he had the authority, he never exercised it and he never signed any payroll cheques.

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1 Reporting letter dated November 24, 1995 from the lawyer (Exhibit A-1-21, page 2).

[25] Bill Fallwell was the accountant for Engine Tech. He did the books at the end of the month as well as the tax returns. The Appellant did not normally deal with him.

[26] The Appellant had no prior experience in business and no specialized business training.

[27] Engine Tech was a small company and the Appellant testified that he expected that he would be told if there were financial difficulties. He also testified that he was unaware that they had financial problems until early 1997[2].

[28] Once he became aware of the financial problems, he borrowed money from time to time and put in significant amounts of cash in order to put money into the business and keep the company going. He either put funds into the company bank account or paid suppliers. He first put funds in at the end of February or the beginning of March 2007[3].

[29] The funds injected were used for a variety of purposes. There is no evidence that the Appellant made any efforts to ensure that source deductions were remitted[4].

[30] The evidence leads to the conclusion that the Appellant and Ray hoped to be able to turn things around and run the company profitably.

[31] The company continued to have difficulties. In July 1997 Revenue Canada issued a requirement to pay to the Canadian Imperial Bank of Commerce for the withholding tax liability of Engine Tech. This had the effect of freezing the company's bank account. As a result, Ray and the Appellant went to the offices of Revenue Canada and met with Mr. Henry Borgs on July 11, 1997. At the meeting the Appellant signed a document (Exhibit R-1-9) prepared by Revenue Canada which includes the passage: "I am or have been a director of Engine Tech…". The document stated the amount of the liability of Engine Tech at the time as well as the fact that directors may be held liable for unremitted source deductions.

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[2] Although he owned 49% of the company, the Appellant does not appear to have followed the finances of the company very much prior to then.

[3] The $3,000 cash advance shown in Exhibit A-1-40 was put into the business.

[4] The Appellant testified that Ray or Heather controlled the use of the money he put in. There was no testimony as to why he could not influence its use or that he tried to have it used to pay source deductions.

[32] On the same day arrangements were made for the bank to pay two months worth of source deductions and, as a result, Revenue Canada wrote to the CIBC on July 11, 1997 and advised the bank that the requirement to pay was withdrawn thereby unfreezing Engine Tech's bank account.

[33] The company shut down during the Christmas break at the end of 1997 due to the financial problems.

[34] Neither Ray nor the lawyer who incorporated Engine Tech were called as a witness.

Was the Appellant a Director?

[35] The Appellant's position is that he never consented to being a director and that he was not a director.

[36] While there is no document signed by the Appellant that says he agreed to become a director, the Appellant testified that he knew he was called a director. He also signed the Special Resolution of Engine Tech dated November 23, 1995 stating that there would be two directors and, on July 11, 1997, he also signed the document prepared by Revenue Canada where he acknowledges being a director.

[37] Other documents signed by Ray indicate that the Appellant was a director.

[38] The Appellant's and Ray's arrangement was that the Appellant would run the mechanical and technical part of Engine Tech and Ray would run the rest including the administrative and commercial part.

[39] Clearly, the Appellant trusted Ray and when Ray said they should incorporate, he was prepared to go along with it. He was content to go along with Ray's recommendation, do what was asked without making inquiries, go to the lawyer's office when requested, sign documents when asked to and concentrate his energies on the technical side of the business without concerning himself with the consequences of incorporation or of becoming a director.

[40] I do not accept that the Appellant did not consent to being a director. Such a conclusion is inconsistent with the rest of the evidence, particularly his knowledge of being called a director or his having signed the document dated July 11, 1997 that acknowledged being a director.

[41] I find that the Appellant consented to becoming a director and was a director[5].

Is a defence made out under subsection 227.1(3)?

[42] The second argument of the Appellant is that the defence set out in subsection 227.1(3) is applicable. Subsection 227.1(3) states:

> A director is not liable for a failure under subsection 227.1(1) 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.

[43] In *Soper v. R.*, [1997] 3 C.T.C. 242 the Federal Court of Appeal reviewed subsection 227.1(3) at length. In paragraphs 29 and 30[6], Robertson J.A. set out the legal test for the defence:

> 29 This is a convenient place to summarize my findings in respect of subsection 227.1(3) of the *Income Tax Act*. The standard of care laid down in subsection 227.1(3) of the Act is inherently flexible. Rather than treating directors as a homogeneous group of professionals whose conduct is governed by a single, unchanging standard, that provision embraces a subjective element which takes into account the personal knowledge and background of the director, as well as his or her corporate circumstances in the form of, *inter alia*, the company's organization, resources, customs and conduct. Thus, for example, more is expected of individuals with superior qualifications (*e.g.* experienced business-persons).
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> 30 The standard of care set out in subsection 227.1(3) of the Act is, therefore, not purely objective. Nor is it purely subjective. It is not enough for a director to say he or she did his or her best, for that is an invocation of the purely subjective standard. Equally clear is that honesty is not enough. However, the standard is not a professional one. Nor is it the negligence law standard that governs these cases. Rather, the Act contains both objective elements — embodied in the reasonable person language — and subjective elements — inherent in individual considerations like “skill” and the idea of “comparable circumstances”. Accordingly, the standard can be properly described as “objective subjective”.

[44] In *Peoples Department Stores Inc. (Trustees of) v. Wise*, 2004 SCC 68, the Supreme Court of Canada analyzed the language in paragraph 122(1)(*b*) of the

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5 On this point, the Appellant relied on *Lau v. Canada*, [2002] T.C.J. No. 615 and *Lambert v. Canada*, [2003] T.C.J. No. 486. Both cases are different on their facts.

6 The paragraph numbering is quite different in other reports of this case.

Canada Business Corporations Act that is virtually identical to the language of subsection 227.1(3). In *Higgins v. The Queen*, 2007 TCC 469, Webb J. concluded that the Supreme Court had modified the test in *Soper*:

> 8 The Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v. Wise*, 2004 SCC 68, [2004] 3 S.C.R. 461, made the following comments in relation to the objective subjective test as set out by the Federal Court of Appeal in *Soper*:
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>> 63 The standard of care embodied in s. 122(1)(*b*) of the CBCA was described by Robertson J.A. of the Federal Court of Appeal in *Soper v. R.* (1997), [1998] 1 F.C. 124 (Fed. C.A.), at para. 41, as being "objective subjective". Although that case concerned the interpretation of a provision of the *Income Tax Act*, it is relevant here because the language of the provision establishing the standard of care was identical to that of s. 122(1)(*b*) of the CBCA. With respect, we feel that Robertson J.A.'s characterization of the standard as an "objective subjective" one could lead to confusion. We prefer to describe it as an objective standard. To say that the standard is objective makes it clear that the factual aspects of the circumstances surrounding the actions of the director or officer are important in the case of the s. 122(1)(*b*) duty of care, as opposed to the subjective motivation of the director or officer, which is the central focus of the statutory fiduciary duty of s. 122(1)(*a*) of the CBCA.
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> 9 The Supreme Court of Canada again noted that because the language in paragraph 122(1)(*b*) of the *CBCA* is identical to that found in subsection 227.1(3) of the *Income Tax Act* (which is also identical to the language set out in subsection 323(3) of the *Act*) the provisions are to be interpreted in the same manner. Therefore, in my opinion, the conclusion is that the Supreme Court of Canada has modified the objective subjective test as set out by the Federal Court of Appeal in *Soper* and instead has adopted an objective standard that now should be used not only for the purposes of paragraph 122(1)(*b*) of the *CBCA* but also for the purposes of section 227.1(3) of the *Income Tax Act* and subsection 323(3) of the *Act*.
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> 10 The Supreme Court of Canada in *Peoples Department Stores Inc.* also made the following comments in relation to this duty:
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>> 67 Directors and officers will not be held to be in breach of the duty of care under s. 122(1)(*b*) of the CBCA if they act prudently and on a reasonably informed basis. The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known. In determining whether directors have acted in a manner that

> breached the duty of care, it is worth repeating that perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.

> 11 Therefore the issue in this case is whether the Appellants have acted prudently on a reasonably informed basis and have met the objective standard imposed upon them of exercising the duty of care, diligence and skill *to prevent the failure to remit* the HST that a reasonable prudent person would have exercised in comparable circumstances.

The Federal Court of Appeal in *Hartrell v. Canada*, 2008 FCA 59, did not have to decide whether *Peoples* modified the test in *Soper*. Ryer J.A. commented:

> 12 The appellant argued that the decision of the Supreme Court of Canada in *Peoples Department Stores Inc. (Trustees of) v. Wise*, 2004 SCC 68 changed the test with respect to the due diligence defence from the "objective subjective" test, in *Soper*, to simply an "objective" test. Whether *Peoples Department Stores* can be said to have eliminated the subjective aspects of the due diligence defence in subsection 227.1(3) of the ITA is not entirely clear since that the decision dealt with a provision of the *Canada Business Corporation Act* R.S.C. 1985, c. B-3. In that regard, the Supreme Court of Canada, in paragraph 63 of the decision, stated that:
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> > With respect, we feel that Robertson J.A.'s characterization of the standard as an "objective subjective" one could lead to confusion. We prefer to describe it as an objective standard. To say that the standard is objective makes it clear that the factual aspects of the circumstances surrounding the actions of the director or of the officer are important in the case of the s.122(1)(*b*) duty of care, as opposed to the subjective motivation of the director or officer, which is the central focus of the statutory fiduciary duty of s.122(1)(*a*) of the CBCA.
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> If *Peoples Department Stores* did change the test to be applied under subsection 227.1(3) of the ITA to one that requires due diligence to be demonstrated on a purely objective standard, such a new test would be more difficult to meet than a test that contains some elements of subjectivity. As such, we are unable to see how the potential application of *Peoples Department Stores* could be helpful to the appellant.

[45] In this case, the Appellant took the position, *inter alia*, that he was in a situation akin to that of an outside director and that, as a result, the defence of subsection 227.1(3) applied. The Appellant also argued that he did take steps by providing funding to the company.

[46] Whatever the impact of *Peoples*, the difficulty with this argument is that, even if the Appellant was akin to an outside director, the Appellant did nothing to prevent the failure to remit in spite of the financial difficulties. While the Appellant did put significant funds into the company after February 27, 1997, this was directed at keeping the company going in the hope that the financial situation would improve. This did not constitute an effort to prevent a failure to remit[7].

[47] Consequently, the subsection 227.1(3) defence does not apply.

<u>What about prior to February 1997?</u>

[48] However, there remains a more limited question regarding subsection 227.1(3). The Appellant fails to meet the due diligence test once he is aware of the financial difficulties. On the evidence, that awareness occurred on or before February 28, 1997 when he first borrowed money to put into the company. What about the period prior to February 1997?

[49] In that prior period is it enough that the Appellant simply relied on Ray?

[50] The evidence of the Appellant was to the effect that he and Ray divided up the work. He was responsible for the operational/technical part of the operation; Ray was responsible for the business part of the operation. He relied on Ray for the business end and expected to be told if there were financial difficulties.

[51] It is important to note that the evidence does not show much of an effort by the Appellant to follow the general financial situation of Engine Tech prior to February 1997.

[52] In *Soper*[8], Robertson J.A., with respect to outside directors, commented:

> 40 Likewise, some commentators have advised directors that, if they wish to be able to rely successfully on the due diligence defence, it would be wise for

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7 See the discussion in paragraphs 14 to 19 of the decision of Webb J. in *Higgins v. The Queen*, 2007 TCC 469. See also paragraphs 52 and 53 below.

8 [1997] 3 C.T.C. 242.

them to consider undertaking a number of "positive steps" including, in certain circumstances, the establishment and monitoring of a trust account from which both employee wages and remittances owing to Her Majesty would be paid: see *e.g.* Moskowitz, *supra* at 566-68.

41 While such precautionary measures may be regarded as persuasive evidence of due diligence on the part of a director, in my view, those steps are not necessary conditions precedent to the establishment of that defence. This is particularly true with respect to the establishment of a separate trust account for source deductions to be remitted to the Receiver General. It is difficult to hold otherwise given the fact that Parliament abolished that express requirement for the purpose of achieving other legislative goals. Above all, a clear dividing line must be maintained between the standard of care required of a director and that of a trustee. Accordingly, an outside director cannot be required to go to the lengths outlined above. As an illustration, I would not expect an outside director, upon appointment to the board of one of Canada's leading companies, to go directly to the comptroller's office to inquire about withholdings and remittances. Obviously, if I would not expect such steps to be taken by the most sophisticated of business-persons, then I would certainly not expect such measures to be adopted by those with limited business acumen. This is not to suggest that a director can adopt an entirely passive approach but only that, unless there is reason for suspicion, it is permissible to rely on the day-to-day corporate managers to be responsible for the payment of debt obligations such as those owing to Her Majesty. This falls within the fourth proposition in the *City Equitable* case: see discussion *supra* at page 15. The question remains, however, as to when a positive duty to act arises.

42 In my view, 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. Put differently, it is indeed 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. The typical situation in which a director is, or ought to have been, apprised of the possibility of such a problem is where the company is having financial difficulties. For example, in *Byrt v. Minister of National Revenue*, (1991), 91 D.T.C. 923 (T.C.C.), an outside director signed financial statements revealing a corporate deficit and thus he knew, or ought to have known, that the company was in financial trouble. The same director also knew that the business integrity of one of his co-directors, who was the president of the corporation too, was questionable. In these circumstances, having made no efforts to ensure that remittances to the Crown were made, the outside director was held personally liable for amounts owing by the corporation to Revenue Canada. According to the Tax Court Judge the outside director had, in contravention of the statutory standard of care, failed to "heed what is transpiring within the corporation and his experience with the people who are responsible for the day-to-day affairs of the corporation" (*supra* at 930, per Rip J.T.C.C.).

[53] If an outside director must make some efforts in examining and considering information then an inside director must do at least as much and somewhat more.

[54] The Appellant worked on a daily basis at the company and would have seen his co-director on a daily basis as well. He had the benefit of seeing from day to day what was going on in the company. Even with the division of labour between the Appellant and Ray, the Appellant's situation is more that of an inside director[9].

[55] An inside director does face a higher burden in establishing that he exercised the requisite case, as explained in *Soper*:

> 33 At the outset, I wish to emphasize that in adopting this analytical approach I am not suggesting that liability is dependent simply upon whether a person is classified as an inside as opposed to an outside director. Rather, that characterization is simply the starting point of my analysis. At the same time, however, it is difficult to deny that inside directors, meaning those involved in the day-to-day management of the company and who influence the conduct of its business affairs, will have the most difficulty in establishing the due diligence defence. For such individuals, it will be a challenge to argue convincingly that, despite their daily role in corporate management, they lacked business acumen to the extent that that factor should overtake the assumption that they did know, or ought to have known, of both remittance requirements and any problem in this regard. In short, inside directors will face a significant hurdle when arguing that the subjective element of the standard of care should predominate over its objective aspect.

[56] To an extent, it is reasonable for one director to place reliance on another director in a small company with two directors. However, even if some tasks are effectively delegated to one director, the other director cannot completely abdicate responsibility and must at some point exercise his role as a director. One would expect, for example, periodic inquiries into the general financial state of the company, inquiries that might lead the director to become aware of issues with

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[9] See *Smith v. Canada*, 2001 FCA 84, Sharlow J.A. speaking for the court states at paragraph 24:

> 24 … Generally, for purposes of the due diligence defence, "inside directors" are those who are "involved in the day-to-day management of the company and who influence the conduct of its business affairs" (*Soper*, *supra*, paragraph 43). Those words simply do not describe the role of Mr. Smith when he first became a director. *The facts that are relevant to the determination of whether a person is an "inside director" relate to the tasks that the person undertakes as a director and the degree of the person's involvement in the business of the corporation.*
>
> [Emphasis added.]

respect to the remittance of source deductions. Of course in a situation like this with a small company and two inside directors, this may well occur informally without board meetings.

[57] Here there is an almost complete absence of efforts to exercise the role of director and make financial inquiries. Consequently, there was no possibility that the Appellant might have discovered problems at an earlier date[10]. Such inaction does not give rise to a defence prior to the Appellant's actual knowledge[11].

Conclusion

[58] I very much regret the situation the Appellant finds himself in. He invested a good deal of borrowed money to buy his interest in the business; later he put in more funds and he only took out a modest salary from the business. This liability further increases his losses.

[59] However, Parliament legislated a system designed to protect employees whereby employees get credit for withholdings made from their salary whether or not those withholdings are ever received by the government. Indeed, the Appellant would himself have received the benefit of this system insofar as he received full credit for the withholdings made from this own salary even though some of those withholdings no doubt form part of the unremitted amounts. When withholdings are not remitted, the state — and, as a consequence, all taxpayers — becomes an involuntary lender to the business. As a result, while Parliament did not legislate an absolute liability on directors it did impose a duty of care.

[60] That standard of care was not met and I must dismiss the appeal.

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[10] The duty of care requires at least this effort. It is a separate question whether or not the director would reasonably have been able to recognize problems.

[11] Whatever the effect of *Peoples* on the *Soper* decision, it does not affect the outcome here. I also note that there may be circumstances where there is an initial period where — in the absence of problems becoming readily apparent to the particular individual — it would be reasonable for a director to simply rely on others. For example, a new director to an existing corporation would not in most circumstances be expected to seek financial information prior to his or her first board meeting. Here given the division of roles there would be an initial period before one would expect the Appellant to make any inquiries. In this case, we are beyond such an initial period.

[61] With respect to costs, I will ask the Court Registry to arrange a conference call in the next few days so that the parties may make submissions on costs. I will issue the Judgment after I will have heard those submissions.

Signed at Ottawa, Canada, this 10th day of April 2008.

"Gaston Jorré"

Jorré, J.

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