

Docket: 2009-3300(GST)G

BETWEEN:

HAROLD DAVID BABAKAIFF,

appellant,

and

HER MAJESTY THE QUEEN,

respondent.

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Appeal heard on October 20, 2011, at Vancouver, British Columbia.

Before: The Honourable Justice Robert J. Hogan

Appearances:

Counsel for the appellant: Dale Barrett

Counsel for the respondent: Selena Sit

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**JUDGMENT**

The appeal from the assessment made pursuant to subsection 323(1) of the *Excise Tax Act*, the notice of which is dated October 23, 2008 and bears number 695750, is dismissed with costs.

Signed at Ottawa, Canada, this 18th day of January 2012.

“Robert J. Hogan”

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Hogan J.

Citation: 2012 TCC 22  
Date: 20120118  
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BETWEEN:

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respondent.

## **REASONS FOR JUDGMENT**

### **Hogan J.**

#### I. CONTEXT

[1] Section 323 of the *Excise Tax Act* (the “ETA”) provides that a director may be found liable for a corporation’s failure to remit goods and services tax (“GST”) unless the director can show that he or she exercised due diligence to prevent the failure. The appellant, Harold David Babakaiff, is appealing a director’s liability assessment issued against him on October 23, 2008 for a corporation’s unremitted GST in the amount of \$400,323.12.

#### II. FACTUAL BACKGROUND

[2] The appellant is the sole director of New Street Developments Inc. (“New Street Developments”), which formerly operated under the name Excite Homes Inc. The corporation was in the business of building and selling residential properties, although it later tried to shift its business to land development.

[3] As a GST registrant, the corporation was responsible for collecting GST on all taxable supplies. The GST in question consisted mainly of GST collected on the sale of new homes. Like all GST registrants, the corporation was also able to claim input tax credits for GST paid or payable on goods and services acquired for use,

consumption, or supply in its commercial activities. In the course of its business of selling new homes, the corporation was also at times assigned a purchaser's right to the GST new housing rebate, thereby reducing the amount of GST the corporation had to remit.

[4] New Street Developments was late in filing its monthly GST returns for the following periods:

- May 1-31, 2006, due June 30, 2006, filed on February 16, 2007;
- June 1-30, 2006, due on July 31, 2006, filed on March 1, 2007;
- July 1-31, 2006, due on August 31, 2006, filed September 7, 2007;
- September 1-30, 2006, due October 31, 2006, filed on September 7, 2007;
- October 1-31, 2006, due on November 30, 2006, filed on September 7, 2007; and
- March 1-31 2007, due on April 30, 2007, filed on May 21, 2008.

[5] When New Street Developments did file its GST returns, the corporation reported its total GST collectible for those periods as being \$463,592.62 and claimed total input tax credits of \$98,895.41, for a net total of \$364,697.21 owed. Of that amount, the corporation only remitted \$22,800.00, which left an outstanding balance of \$341,897.21. The total amount of \$400,323.12 assessed against the company and, subsequently, its sole director, namely, the appellant, Harold David Babakaiff, includes related penalties and interest.

### III. ISSUES

[6] Is the appellant liable for the corporation's unremitted GST, or did he satisfy the requirements of the due diligence defence under subsection 323(3) of the ETA?

### IV. APPELLANT'S POSITION

[7] The appellant invokes the due diligence defence under subsection 323(3) of the ETA submitting that, as the sole director of New Street Developments, he exercised the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances to prevent the failure of the corporation to remit the GST owed.

[8] The appellant alleges that the corporation's failure to remit GST was directly caused by the negligent actions of two lawyers hired to take care of closing the corporation's sales of residential properties. According to the appellant, the corporation's lawyers neglected to complete the closing documentation for the residential real estate sales in a timely fashion.

[9] In the spring of 2006, the appellant claims, the company's first lawyer, Shaun Langin, became negligent in his handling of real estate sales closings and in delivering the closing documents to the corporation. Without the closing documents specifying the amount of GST paid or payable and indicating whether the buyer had assigned the GST new housing rebate, the corporation could not properly complete its GST returns and calculate the GST to be remitted. The appellant asserts that he made multiple efforts to obtain the closing documents from Mr. Langin, but, faced with the lawyer's continued negligence, ceased using his services at the end of the summer of 2006. The appellant submitted evidence that the Law Society of Alberta sanctioned Mr. Langin on October 12, 2006 for failing on numerous occasions to fulfil his commitments to his clients.

[10] After ceasing to use Mr. Langin's services, in September 2006 the corporation found another lawyer, Doug Welder, who, according to the appellant, also became negligent in providing closing documents and completing his work. The appellant also provided evidence that Mr. Welder was suspended for three months after being found guilty of professional misconduct by the Law Society of British Columbia for failing to remit GST and employee source deductions.

[11] The appellant submits that he sought and obtained professional accounting assistance, as he had done in his other business ventures, to guide him in the financial management of the corporation. He hired Tracy Welch, an experienced certified general accountant, and they met regularly to discuss the company's finances. When the problems arose with the lawyers, the appellant and Ms. Welch carefully considered how to proceed each month and decided, as each return became due, that they could not complete the returns and swear to the truth of their content, considering the missing information.

[12] According to the appellant, he had reasonable grounds to believe that the New Street Developments corporation was in a net GST refund position until the information needed to complete the late GST returns became available over the period from February 2, 2007 to May 21, 2008. Up until the time that the late returns were completed and filed, the corporation had been mainly in a GST refund position because its input tax credits exceeded the amount of GST that it was required to

collect and remit. The appellant alleges he did not know that the corporation was in financial trouble until the late summer of 2006. He assumed that once the late GST returns were filed he would owe very little GST for the reasons outlined above.

[13] The appellant believed he could meet the GST liability, if any, of the corporation by causing it to sell a large property it owned in Nanaimo, British Columbia. These efforts failed because of the abrupt and serious downturn in the Canadian real estate market that occurred in the middle of 2006. The holder of the mortgage on the Nanaimo property sold that property under an order for conduct of sale and as a result there was nothing left over to pay the corporation's GST liability.

## V. RESPONDENT'S POSITION

[14] The respondent argues that the appellant knew his corporation was in trouble as of March 2006, as evidenced by his lawyer's response, provided with respect to an undertaking given at discovery, that New Street Developments stopped making payments on the Nanaimo property as of March 1, 2006. The respondent submits that this date is an indication that the corporation was in financial trouble almost six months before the appellant claims he became aware of the corporation's financial difficulties, in the late summer of 2006, and that the appellant should therefore have taken significant steps much earlier to avoid the failures to remit.

[15] The respondent contends that, once the appellant realized he did not have the information required to complete the GST returns, he could have taken the necessary action to obtain this information and prevent future failures to remit. The corporation could have obtained such information from a simple statement of disbursements or adjustments prepared at the time of sale.

[16] The respondent argues that the appellant provided no evidence to support his claim that the corporation received very little in the way of proceeds which it could use to remit the GST because the mortgage creditors sold the property under an order for conduct of sale. Instead, at discovery, the appellant provided responses indicating that the corporation used the proceeds from sales to pay off builders' liens and judgments registered on properties. The onus is on the appellant to prove that these sales occurred under duress, and here, the respondent asserts that the appellant failed to meet his burden in this regard.

[17] The respondent also notes that the appellant, as a director and officer of the corporation, did not take any steps to cause the corporation to segregate the GST funds from its general account. The respondent argues that the appellant knew the

corporation was in financial trouble, and that his lack of due diligence is demonstrated by his failure to instruct his lawyers to segregate funds and ensure that any incoming funds would be used to pay the GST owed rather than paying other creditors.

[18] According to the respondent, the appellant gambled on the GST position of his corporation, hoping that the Nanaimo property would act as “insurance” to cover any debt. The respondent argues that such a gamble does not demonstrate appropriate care taken to ensure the fulfilment of the company’s GST obligations.

## VI. ANALYSIS

[19] Subsection 323(1) of the ETA outlines the liability of directors where a corporation fails to remit net tax owed:

### *Liability of directors*

323. (1) If a corporation fails to remit an amount of net tax as required under subsection 228(2) or (2.3) or to pay an amount as required under section 230.1 that was paid to, or was applied to the liability of, the corporation as a net tax refund, the directors of the corporation at the time the corporation was required to remit or pay, as the case may be, the amount are jointly and severally, or solidarily, liable, together with the corporation, to pay the amount and any interest on, or penalties relating to, the amount.

[20] The appellant invokes the due diligence defence that is available under subsection 323(3) of the ETA to a director who has been assessed on the basis of liability for a corporation’s unremitted tax. Subsection 323(3) states the following:

### *Diligence*

323. (3) A director of a corporation is not liable for a failure under subsection (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.

[21] In *Buckingham v. Canada*,<sup>1</sup> the Federal Court of Appeal confirmed that an objective standard must be applied in considering a director’s due diligence defence under both subsection 323(3) of the ETA and subsection 227.1(3) of the *Income Tax Act*<sup>2</sup> (the “ITA”). Before *Buckingham*, the leading authority on the applicable test

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<sup>1</sup> 2011 FCA 142.

<sup>2</sup> R.S.C. 1985, c. 1 (5th Supp.). See paras. 30-40 of *Buckingham*.

was *Soper v. Canada*,<sup>3</sup> a case in which the Federal Court of Appeal determined that the objective-subjective standard was the appropriate test.

[22] In *Buckingham*, the Federal Court of Appeal outlined how to apply the objective standard and set out the underlying rationale given by the Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v. Wise*<sup>4</sup> for imposing such a standard:

38 This objective standard has set aside the common law principle that a director's management of a corporation is to be judged according to his own personal skills, knowledge, abilities and capacities: *Peoples Department Stores* at paras. 59 to 62. To say that the standard is objective makes it clear that the factual aspects of the circumstances surrounding the actions of the director are important as opposed to the subjective motivations of the directors: *Peoples Department Stores* at para. 63. The emergence of stricter standards puts pressure on corporations to improve the quality of board decisions through the establishment of good corporate governance rules: *Peoples Department Stores* at para. 64. Stricter standards also discourage the appointment of inactive directors chosen for show or who fail to discharge their duties as director by leaving decisions to the active directors. Consequently, a person who is appointed as a director must carry out the duties of that function on an active basis and will not be allowed to defend a claim for malfeasance in the discharge of his or her duties by relying on his or her own inaction: Kevin P. McGuinness, *Canadian Business Corporations Law*, 2<sup>nd</sup> ed. (Markham, Ontario: LexisNexis Canada, 2007) at 11.9.

[23] This evaluation should not be undertaken, however, without considering the particular circumstances facing the corporation and the appellant. The Federal Court of Appeal, in *Buckingham*, asserted that contextual factors are part of an objective analysis:

39 An objective standard does not however entail that the particular circumstances of a director are to be ignored. These circumstances must be taken into account, but must be considered against an objective "reasonably prudent person" standard. As noted in *Peoples Department Stores* at paragraph 62:

The statutory duty of care in s. 122(1)(b) of the CBCA emulates but does not replicate the language proposed by the Dickerson Report. The main difference is that the enacted version includes the words "in comparable circumstances", which modifies the statutory standard by requiring the context in which a given decision was made to be taken into account. This is not the

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<sup>3</sup> [1998] 1 F.C. 124.

<sup>4</sup> 2004 SCC 68, [2004] 3 S.C.R. 461.

introduction of a subjective element relating to the competence of the director, but rather the introduction of a contextual element into the statutory standard of care. It is clear that s. 122(1)(b) requires more of directors and officers than the traditional common law duty of care outlined in, for example, *Re City Equitable Fire Insurance, supra* [[1925] 1 Ch. 407].

[24] Here, the context includes the economic conditions in the housing market that ultimately led to the corporation's demise, and the corporation's unfortunate experiences with two negligent lawyers. When evaluating what a reasonably prudent person would have done in similar circumstances, the Court cannot ignore the particular challenges facing the appellant's corporation.

[25] The Federal Court of Appeal in *Buckingham* specifically notes that, in applying the test under subsections 227.1(3) of the ITA and 323(3) of the ETA, one must consider a director's actions undertaken to prevent a failure to remit. The Court states:

40 The focus of the inquiry under subsections 227.1(3) of the *Income Tax Act* and 323(3) of the *Excise Tax Act* will however be different than that under 122(1)(b) of the CBCA, since the former require that the director's duty of care, diligence and skill be exercised to prevent failures to remit. 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.

[26] It is not sufficient to take actions to remedy failures to remit net tax. The concern in a due diligence defence is what actions were taken to prevent failures to remit in the first place. A director cannot, as the appellant does in this case, claim due diligence on the basis of having another asset on hand that could serve as insurance to pay off debts to the Crown. A corporation cannot gamble with money it holds for the Crown. Unlike others, the Crown is an involuntary creditor that is unable to decrease its exposure to risk according to a corporation's evolving financial state. As stated in *Buckingham*:

49 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.). Contrary to the suppliers of a corporation who may limit their financial exposure by requiring cash-in-advance payments, the Crown is an involuntary creditor. The level of the Crown's exposure to the corporation can thus increase if the corporation continues



its operations by paying the net salaries of the employees without effecting employee source deductions remittances, or if the corporation decides to collect GST/HST from customers without reporting and remitting these amounts in a timely fashion. 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.

...

56 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.

57 Once the trial judge found as a matter of fact that the respondent's efforts after February 2003 were no longer directed towards the avoidance of failures to remit, no successful defence under either subsection 227.1(3) of the *Income Tax Act* or subsection 323(3) of the *Excise Tax Act* could be sustained.

[27] The appellant contends that he should not be required to bear the corporation's GST liability because the corporation's failure to remit the GST occurred without his knowledge and was due to circumstances beyond his control. When he discovered the failure, it was too late for him to do anything about it.

[28] According to the appellant, the corporation's GST liability of \$364,697.21 arose during the period from May 31, 2006 to April 30, 2007. The appellant claims that during that period he could not complete the corporation's monthly GST returns because the corporation's lawyers were negligent in providing him the closing documents and the information necessary to complete the returns. He discovered for the first time that the corporation was behind in remitting GST only when he was

able to complete the GST return for the May 1-31, 2006 reporting period, that is, in February 2007. The extent of the problem only became fully apparent when all of the late GST returns were finally filed.

[29] In my opinion, it is wrong to lay the blame for the appellant's lack of knowledge of the corporation's GST liability on the alleged negligent actions of the corporation's lawyers. Indeed, the evidence reveals that a statement of disbursements was prepared prior to the sale of each property. This statement showed the sale price, the GST (to the extent that GST was not included in the price), the GST rebate, the assignment of the GST rebate to the seller, and all other disbursements relating to the closing. The purchase price could not be disbursed by the lawyers without this information. Exhibit R-3 is a good example of the type of statement that the corporation's officers could have relied on in order to prepare the corporation's monthly GST returns.

[30] The statement of disbursements contained all of the information necessary for the corporation to complete its monthly GST returns. Nothing prevented the appellant from returning to the office after each closing with that statement in hand. Had the appellant requested the statement he would have known the extent of the corporation's GST liability soon after each month-end.

[31] The appellant also claims that the corporation stopped filing its GST returns on time on the advice of Ms. Welch, the corporation's internal accountant. According to the appellant, Ms. Welch tried but failed to obtain the information necessary to complete the GST returns and then instructed the appellant not to file them until they could be properly completed. The appellant offered no explanation why Ms. Welch was not called as a witness to substantiate this allegation. I draw a negative inference from Ms. Welch's absence at trial.

[32] The evidence also reveals that the corporation stopped paying the mortgage on the Nanaimo property in March 2006. This should have put the appellant on notice that the corporation had entered a period of financial turmoil. It was at that point in time that the appellant should have taken steps to ensure that the GST collected in trust from the buyers of the corporation's homes was segregated from the corporation's other funds.

[33] While there is no doubt that there was some negligence on the part of the lawyers with regard to completing the formalities of each closing in a timely fashion, that does not explain the appellant's failure to take decisive action to ensure that the corporation continued to remit GST. In fact, evidence was presented which showed

that, instead, the appellant used funds received to pay off debts to other creditors, giving those debts priority without taking sufficient action to determine the GST owed to the Crown and ensure that it was remitted.

[34] Nor does the context of the failing housing market offer the appellant any relief. As noted above, there is evidence pointing to the fact that the appellant had knowledge of the corporation's financial difficulties by the spring of 2006 when it defaulted on its payments on the Nanaimo property. It was at that moment that a reasonably prudent person would have taken concrete steps to ensure that the GST was remitted.

[35] The appellant's knowledge and background add nothing to his due diligence defence. As an experienced business person with a lot of knowledge of the housing industry, the appellant knew or ought to have known by the spring of 2006 that the corporation was no longer building at the same rate as in prior years, which resulted in a significant decrease in its input tax credits. I find it hard to believe that the appellant did not appreciate that the corporation would soon find itself in a net GST remittance position as it liquidated its inventory after having stopped building due to a lack of new funding. Considering all of the evidence, I suspect that it is not entirely coincidental that the corporation stopped filing its GST returns after it defaulted on its payment obligations with respect to the Nanaimo property. What appears to have been happening is that the corporation was selling its residential real estate at a price less than the corporation's costs. GST collected in trust for the Crown was diverted to pay mortgage creditors and other stakeholders, with the hope that the sale of the Nanaimo property would allow the corporation to settle its GST liability.

[36] The appellant claims that upwards of 30% of the corporation's properties were sold under duress by the corporation's mortgage creditors pursuant to court orders authorizing them to conduct the sales on behalf of the corporation without the intervention of its directors or officers. According to the appellant, the proceeds of these sales were disbursed without his knowledge and intervention. Except with regard to the Nanaimo property, no documentary evidence was provided to support this claim, although the appellant asserted on cross-examination that the corporation was in possession of documents that could prove the claim. The appellant did not identify the properties subject to the conduct of sale procedure, nor, for that matter, did he quantify the amount of GST that may have been diverted by the corporation's creditors. The onus is on the appellant to prove his claim in this regard. I find that he has failed to do so.

[37] A successful due diligence defence requires evidence of a director taking concrete actions to prevent failures to remit. The main evidence presented here was a number of emails in which the appellant expressed his frustration with the lawyers' ability, and none of these emails even specifically address GST concerns. When the negligence of his lawyers and the corporation's financial difficulties became evident, the appellant could have ensured the segregation of GST funds. He could also have insisted on receiving more information sooner, for each sale, as to the GST collected or collectible or as to the GST rebate assigned. Such are the actions a reasonably prudent person might take to avoid failures to remit. None of these measures were carried out by the appellant. Applying the objective standard enunciated in *Buckingham*, I conclude that the appellant did not exercise the care, diligence and skill a reasonably prudent person would have exercised to prevent the failures to remit.

[38] For all these reasons, the appeal is dismissed.

Signed at Ottawa, Canada, this 18th day of January 2012.

“Robert J. Hogan”

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Hogan J.

CITATION: 2012 TCC 22

COURT FILE NO.: 2009-3300(GST)G

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REASONS FOR JUDGMENT BY: The Honourable Justice Robert J. Hogan

DATE OF JUDGMENT: January 18, 2012

APPEARANCES:

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