Docket: 2008-2992(GST)I

BETWEEN:

RICHARD ALEXANDER ARSIC,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on June 7, 2010, at Hamilton, Ontario

Before: The Honourable Justice Diane Campbell

Appearances:

Counsel for the Appellant:	Clarke L. Melville Shannon Cole
Counsel for the Respondent:	Rita Araujo

JUDGMENT

The appeal from the assessment made under Part IX of the *Excise Tax Act*, dated July 23, 2007 and numbered A114368, is allowed, with costs, and the assessment is vacated in accordance with the attached Reasons for Judgment.

Signed at Charlottetown, Prince Edward Island, this 11th day of August 2010.

"Diane Campbell"

Campbell J.

Citation: 2010 TCC 423
Date: August 11, 2010
Docket: 2008-2992(GST)I

BETWEEN:

RICHARD ALEXANDER ARSIC,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Campbell J.

[1] The Appellant was a director of Industrial Electrical Group Inc. ("IEG"), which was assessed on May 10, 2000 for a failure to remit net tax in respect to the periods ending August 31, 1998, November 30, 1998 and February 28, 1999. On July 23, 2007, the Appellant was assessed pursuant to section 323 of the *Excise Tax Act* (the "*Act*") for net tax, penalties and interest. Subsection 323(1) imposes liability upon a director, such as the Appellant, for a corporate failure to remit net tax as required by subsection 228(2) of the *Act*. Subsection 323(1), as it related to these periods, provided:

> **323. (1) Liability of directors** – Where a corporation fails to remit an amount of net tax as required under subsection 228(2) or (2.3), the directors of the corporation at the time the corporation was required to remit the amount are jointly and severally liable, together with the corporation, to pay that amount and any interest thereon or penalties relating thereto.

[2] The primary issue is whether the Appellant exercised the degree of care, diligence and skill to prevent IEG's failure to remit its net tax that a reasonably prudent person would have exercised in comparable circumstances. This is

commonly referred to as the due diligence defence and if the Appellant can show he exercised the required diligence then he can avail himself of the defence provided in subsection 323(3). It states:

> **323 … (3) Diligence** – 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.

[3] The Appellant also raised the following *Charter* issues in the Notice of Appeal: whether the Appellant's rights to security of person under section 7 of the *Canadian Charter of Rights and Freedom*s ("*Charter*") and the right to be free of unreasonable search and seizure under section 8 of the *Charter* have been violated. These *Charter* issues need only be addressed if I conclude that the Appellant cannot avail himself of the due diligence defence under subsection 323(3) of the *Act*.

[4] The Appellant graduated from St. Clair College in 1982 with an electronic technician's diploma. Following this he took a four year electrician program. For many years the Appellant worked for different companies in the automation control industry. In 1990, he started his own business designing electrical control systems for automated processing machinery, such as beverage bottling equipment. In 1992, he incorporated Sevran Automation Group Inc. ("Sevran") for which he was the sole director and shareholder. Sevran never carried on business as it was formed to conduct work for a specific client but the contract never materialized. He testified that, when he operated his own business, he understood his obligations as a director to collect and remit goods and services tax ("GST") but as he had no bookkeeping background or experience, he always relied on others and, in particular, his accountant, Peter Williams, to complete all of the financial and accounting aspects of his business, including remitting GST.

[5] In late 1996 or early 1997, the Appellant met Edward Galick, who operated a company called EDJ Packaging and Conveyors Inc. ("EDJ"). EDJ purchased, refurbished and resold used packaging equipment. Since both individuals had complimentary strengths in manufacturing, automation and supply of automated packaging equipment, they began a joint business venture. Under this arrangement, EDJ continued its business of refurbishing used packaging equipment for sale and the Appellant worked in the field installing and wiring related electrical controls. They used the Appellant's dormant company, Sevran, for this business venture, changing the name to IEG on August 28, 1997.

[6] IEG operated out of the EDJ business premises and by agreement used EDJ's bookkeeper, Trudy McClaskin. The Appellant testified that he directed Ms. McClaskin to change and file the corporate documents of IEG to reflect that both the Appellant and Mr. Galick were equal shareholders and directors, but only the company name was changed and the Appellant remained as the sole shareholder and director of IEG. When he later discovered that Mr. Galick had not been added as a director, both he and Mr. Galick instructed Ms. McClaskin to file the appropriate documentation. The Appellant never followed up again on Ms. McClaskin's actions as he thought she would comply with these instructions. He found out that he was the sole director on the corporate records in June of 2000 after he became aware of the remittance problems. According to his testimony, he believes that Mr. Galick instructed the bookkeeper not to change the directors of IEG.

[7] The Appellant testified that he and Mr. Galick were each to have a fifty per cent interest in IEG, that Mr. Galick would be President with the Appellant as Vice-President, that Mr. Galick would oversee the day-to-day operations of IEG from the EDJ premises and manage the employees, including the bookkeeper, that the Appellant would work in the field and that both signatures would be required on all cheques. The accountant, Mr. Williams, confirmed that he attended a meeting with the Appellant and Mr. Galick on February 25, 1998 where discussions occurred in his presence confirming the aforesaid arrangements. In essence, Mr. Galick agreed to oversee IEG's day-to-day activities at the EDJ premises including providing business leads and the Appellant agreed to provide the electrical expertise at the work sites.

[8] In addition to the testimony of the Appellant and the corroborating evidence of Mr. Williams, the banking documents of IEG suggest that Mr. Galick was a director in law if not on the corporate records. Although the banking resolution listed Mr. Galick as Vice-President and not President, the documents as a whole support that the intent was that Mr. Galick would be an officer and President of IEG and would have signing authority.

[9] The source deduction and GST remittance forms for IEG were completed by Ms. McClaskin, the bookkeeper for both IEG and EDJ. She testified that she prepared the financial reports for IEG and that Mr. Galick reviewed them but she did not recall if she ever showed them to the Appellant. Although the Appellant attended at the IEG premises on most occasions to sign cheques, Ms. McClaskin sometimes went to the work sites to have the Appellant sign the cheques. According to the Appellant, he attended at the premises between two to four times per month to review a folder of payables prepared by Ms. McClaskin and sign the cheques accompanying

the invoices and remittance statements. Ms. McClaskin's evidence confirmed this arrangement.

[10] The Appellant stated that he never gave instructions to the bookkeeper except to instruct her to remit GST. Ms. McClaskin testified that it was Mr. Galick who directed her on a day-to-day basis and that he would instruct her on whether or not to send invoices and bills. He also directed her to move money between the IEG and EDJ accounts. She also stated that Mr. Galick would sometimes instruct her not to forward cheques that the Appellant had already signed.

[11] Mr. Williams, who began working for the Appellant in 1993, testified that he always did all of the accounting aspects of the Appellant's business activities. He assisted Ms. McClaskin with bookkeeping at EDJ beginning in late 1997 and, under the direction of Mr. Galick, he also assisted her with IEG's books. He prepared IEG's corporate returns and helped Ms. McClaskin occasionally with the GST reports. He prepared IEG's corporate return for 1999 after it ceased operations, as well as the GST forms for that year.

[12] By the end of 1998 or January 1999, IEG had ceased operations. The Appellant thought IEG was doing well because he was busy doing work for customers and money was coming in. However, IEG was being cash starved over its short life span, because funds were being diverted from IEG to EDJ. The Appellant later determined that Mr. Galick had engaged in actions which had serious impact upon the company's finances. The Appellant also alleged that, without his knowledge, Mr. Galick diverted funds, including GST remittance funds, from IEG to himself or his company, EDJ. Invoices sent to IEG's clients were also being reversed and replaced by invoices from EDJ, although the actual work had been completed by the Appellant. When the invoice was reversed, it stopped any potential payment to IEG and redirected those funds to EDJ.

[13] The Appellant testified that he believed GST remittances and source deductions were being made consistently because he was reviewing the remittance forms and signing the cheques. All of the business and accounting records of IEG always remained in the possession of Mr. Galick at the EDJ premises. When IEG ceased operating, the Appellant requested the books and records from Mr. Galick on numerous occasions but was told the documents plus a computer containing IEG's records were missing after an alleged break-in. He sought the assistance of Mr. Williams who was able to complete final GST remittance forms from back-up documents he had retained in an off-site computer. On March 18, 1999, the Canada Revenue Agency ("CRA") sent a Reminder Notice for overdue GST returns to the

IEG offices. The Appellant testified that he never saw this letter until a later date and that he first became aware of the remittance problems when he received correspondence from the CRA at his home later in 1999. On cross-examination, he testified that the first official letter he received from the CRA regarding GST was on February 25, 2000 but he had discussions prior to this date, presumably with Bill Haire from the CRA.

[14] The Appellant and Mr. Galick met with Mr. Haire on July 30, 1999 to discuss IEG remittance failures and both agreed to pay the past due amount by post-dated cheques. After the first cheque was cashed, the Appellant became aware that there were insufficient funds in the account so he contacted Mr. Haire and requested that he not cash the remaining cheques. He then pursued further discussions with Mr. Galick and they each agreed to send cheques to the CRA, splitting the amount owed equally between them. The Appellant followed through on his part of this arrangement but it appears that Mr. Galick did not pay his share.

[15] The Appellant testified that since the CRA never communicated with him between October 22, 2002 and October 2006 he never thought that he was personally liable for the remaining outstanding remittance amounts and he thought that the CRA was pursuing EDJ and Mr. Galick. The Appellant discovered, during a meeting with the CRA in 2007, that Mr. Galick had gone bankrupt in 2006.

[16] The Federal Court of Appeal in *Soper v. The Queen*, [1997] F.C.J. No. 881, 97 D.T.C. 5407, reviewed the standard of care to be employed for determining whether a director has been duly diligent in order to escape liability when the corporation fails to remit tax. Although the Court in *Soper* was considering the ambit of subsection 227.1(3) of the *Income Tax Act*, the wording in that provision is almost identical to the analogous subsection 323(3) of the *Act*. In describing the standard of care as objective/subjective, at paragraphs 40 and 41, Robertson J. made the following comments:

> [40] For example, in some instances the relevant issue will be whether an individual was in fact or in law a director at the relevant time for purposes of imposing personal liability or whether that individual ceased to hold office by operation of a valid resignation. In other cases, such as those involving bankruptcy and receivership, the central issue will be *de jure* control. Yet another cluster of cases, including situations in which a dominant director is able to limit others' influence over corporate affairs, will deal with *de facto* control. I intend to focus on the category of cases respecting the distinction between inside and outside directors since that line of authority is the most pertinent to this appeal.

> [41] 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.

As noted by Bowie J. in *Stafford v. The Queen*, 2009 TCC 247, [2009] T.C.J. No. 180, at paragraph 14:

> [14] **…** That decision [*Soper*] has since been reaffirmed by the Federal Court of Appeal in *Canada v. McKinnon* and again in *Hartrell v. The Queen*. Directors are not held to the standard of trustees. Mr. Stafford, of course, is an inside director, but even as such he is not an insurer. The appropriate standard of care was described by Robertson J.A. at paragraph 22 of *Soper* as that "... expected from a person of his or her knowledge and experience." …

[17] The Federal Court of Appeal again reviewed the standard of care imposed upon directors pursuant to subsection 323(1) in *Smith v. The Queen* [2001] F.C.J. No. 448, 2001 D.T.C. 5226. At paragraphs 12 to 14, Sharlow J. discussed the implications of being an “inside director” as opposed to an “outside director”:

> [12] The inherent flexibility of the due diligence defence may result in a situation where a higher standard of care is imposed on some directors of a corporation than on others. For example, it may be appropriate to impose a higher standard on an "inside director" (for example, a director with a practice of hands-on management) than an "outside director" (such as a director who has only superficial knowledge of and involvement in the affairs of the corporation).
>
> [13] That is particularly so if it is established that the outside director reasonably relied on assurances from the inside directors that the corporation's tax remittance obligations were being met. See, for example, *Cadrin v. Canada* (1998), 240 N.R. 354, [1999] 3 C.T.C. 366, 99 DTC 5079 (F.C.A.).
>
> [14] In certain circumstances, the fact that a corporation is in financial difficulty, and thus may be subject to a greater risk of default in tax remittances than other corporations, may be a factor that raises the standard of care. For

> example, a director who is aware of the corporation's financial difficulty and who deliberately decides to finance the corporation's operations with unremitted source deductions may be unable to rely on the due diligence defence (*Ruffo v. Canada*, 2000 DTC 6317 (F.C.A.)). In every case, however, it is important to bear in mind that the standard is reasonableness, not perfection.

These comments are particularly pertinent to the present appeal.

[18] Contrary to the Respondent's submissions, I do not believe that the Appellant was an inside director. He had no involvement in the day-to-day management of IEG. He was working out in the field and attended at the IEG premises only when cheques needed to be signed. He relied on the expertise of Mr. Galick and his bookkeeper, Ms. McClaskin, to oversee the proper administration and management of IEG. Although the Appellant was an officer and director of IEG and listed as the only director on the corporate records, the evidence of all witnesses supports the Appellant's evidence that the intention was that Mr. Galick would also be a fifty per cent owner and director of IEG. In fact, the almost absolute control which Mr. Galick had over IEG's activities is clearly supported by the testimony of Ms. McClaskin. She took direction from Mr. Galick, not the Appellant, and followed his instructions to redirect invoices and funds to Mr. Galick's own corporation, EDJ. Under Mr. Galick's direction, she did not forward cheques that the Appellant had signed and which he assumed had been mailed or delivered. The Appellant's evidence was that Ms. McClaskin would not respond to any of his directives unless Mr. Galick first approved of these.

[19] Since the Appellant was an outside director of IEG, the standard to be applied is a less stringent one in these circumstances. The Appellant knew his limitations respecting his lack of knowledge, education and experience with the financial and administrative aspects of business activities. He had a history of relying on the expertise of others to complete these aspects while he focussed on the technical side of the electrical automation trade. His competence was in that aspect of the business. He recognized that certain financial obligations had to be met, such as remittances, and he always depended on Mr. Williams prior to engaging in the business venture with Mr. Galick. After IEG began operating, he then properly relied, as he was entitled to do, in making an informed and prudent business decision, upon Mr. Galick, Ms. McClaskin and Mr. Williams. This was confirmed by the testimony of both Ms. McClaskin and Mr. Williams. It is clear from all of the evidence that Mr. Galick was the directing mind of IEG. He was a daily presence at the business premises, made all the decisions, provided direction to the bookkeeper and other employees and maintained the books and records. Mr. Galick controlled all of the

finances of IEG with the exception of the requirement of the Appellant's signature on cheques.

[20] The Appellant knew the corporate responsibilities concerning source deductions and remittances. To ensure those obligations were being met and while acknowledging his limitations in this area, he placed reliance on the practice he had of reviewing the cheques together with the accompanying invoices and remittance statements provided to him by IEG's bookkeeper. He also knew that Mr. Williams assisted the bookkeeper from time to time. He spent his time in the field and trusted Mr. Galick with overseeing the day-to-day operations of IEG. He had no reason to follow up to ensure that cheques were in fact being mailed after he signed them because he trusted his partner, Mr. Galick, and he had no reason to question the bookkeeper's actions. It is not clear from the evidence that the Appellant had access to the financial records but the lack of scrutiny of these records by the Appellant was reasonable because the business was thriving, money was coming in and the Appellant was busy in the field. Even if he had looked at the records periodically, without any expertise or training in the financial aspects, he may not have been able to detect possible suspicious entries and problems. There is sufficient case law to support that the Appellant will not be in breach of the standard of care imposed upon him as an outside director of IEG, where he has permitted delegation of corporate remittance obligations to apparently competent and experienced company officials and where no suspicions of remittance problems exist. There is no imprudent behaviour on the Appellant's part in relying not only on his business partner, whom he trusted and who had expertise in the managerial side of the business, but also on a bookkeeper and an outside accountant. He also had prior dealings with Mr. Williams in corporate operations in which he was involved. There were no suspicious circumstances that would have caused the Appellant to question the GST remittances. The business appeared to be busy and turning a profit, there was a dual signing requirement on all cheques and other individuals, whom he trusted, were available and giving the appearance of attending to the financial aspects of IEG, where the Appellant had little or no skills. In these circumstances, and without any indication of possible remittance problems, I do not believe that the Appellant was required to confirm that the cheques were being cashed by the Receiver General for Canada as the Respondent suggests.

[21] Based on the evidence before me, I conclude that, even after the Appellant became aware of Mr. Galick's mismanagement of corporate funds and his manipulation of IEG's invoices, he still had no reason to suspect that remittances were not current. It was reasonable for him to expect that the cheques for GST remittances that he had signed had been mailed after he signed them. Notice of the

failure to remit apparently first occurred on March 18, 1999 when the CRA sent a reminder notice respecting overdue GST returns. The Appellant testified that he never saw this letter probably because it went to the IEG premises where Mr. Galick controlled the records. The evidence suggests that the Appellant first became aware of the potential remittance problems several weeks prior to his meeting with Bill Haire on July 30, 1999. Consequently, the Appellant's knowledge of the remittance problems occurred subsequent to the actual failure to remit by IEG. The actions he took as an outside director, throughout the life of IEG's activities to ensure that GST remittances remained current, were in line with that of a person with his level of knowledge and skill in financial and accounting aspects. Because the evidence suggests that the Appellant became aware of the remittance problems only when he was contacted by Mr. Haire, there is no expectation of a positive duty to act on the Appellant's part because there would be little, if any, opportunity for him to be proactive in these circumstances. In the end, I must attempt the difficult task of determining what a reasonably prudent person should have done or would have done in circumstances comparable to those in this appeal. It remains a question of fact tempered with a good dose of even-handed common sense. It is always easy to criticize the choices of a taxpayer when armed with the benefit of hindsight. However, I believe that the Appellant's course of action, which he relied upon to ensure IEG's remittances were paid, was reasonable in the circumstances and a course which other reasonably prudent people might be expected to choose if placed in a similar situation.

[22] There is no doubt that the Appellant acted honourably throughout. He cooperated with the CRA after the failure, supplying post-dated cheques for his half share of the net tax owing, as well as informing the CRA of incoming payments to IEG which the CRA could access. However, these actions were taken to remedy past defaults and were not actions taken to prevent the failure to remit by IEG. Consequently, I have not given consideration to those actions in determining that he can avail himself of the due diligence defence pursuant to subsection 323(3) of the *Act*. In addition, because the Appellant has been successful, there is no need for me to address the *Charter* issues which were raised.

[23] The appeal is allowed with costs and the assessment is vacated on the basis that the Appellant is not liable pursuant to subsection 323(1) for payments that IEG was required to remit on account of net tax as he has satisfied the due diligence provision contained in subsection 323(3).

Signed at Charlottetown, Prince Edward Island, this 11th day of August 2010.

"Diane Campbell"

Campbell J.

CITATION:	2010 TCC 423
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PLACE OF HEARING:	Hamilton, Ontario
DATE OF HEARING:	June 7, 2010
REASONS FOR JUDGMENT BY:	The Honourable Justice Diane Campbell
DATE OF JUDGMENT:	August 11, 2010

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