

# **Personal Bankruptcy and Income Tax**

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*Bankruptcy*

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Most bankruptcies involve taxes to some extent. Even when the Canada Revenue Agency (“CRA”) is not a creditor in a personal bankruptcy, there are often filing and remittance obligations that need to be completed during the course of the bankruptcy. Both the bankrupt and the trustee have roles to play in meeting these obligations.

CRA is often a creditor in a bankrupt’s estate. The courts have consistently commented on “tax driven” bankruptcies at the time of discharge, noting that tax debts are not like other debts. In 2009, Parliament brought into force section 172.1 of the *Bankruptcy and Insolvency Act* (“BIA”), which applies to certain bankruptcies in which the majority of the unsecured debt is unpaid personal income tax. Section 172.1 in many ways restates what the courts have been saying for years, but also imposes certain parameters governing the discharge of bankrupts who fall within its scope.

This presentation will provide a general overview of tax obligations within a personal bankruptcy. It will also examine situations where tax debt forms a significant part of the bankrupt’s debt and how courts have treated the bankrupt’s application for discharge. Finally, it will examine the impact of section 172.1 of the BIA, including the factors that the bankruptcy court must consider when dealing with a discharge application under this section.

## **I. Income Tax Obligations Triggered in a Personal Bankruptcy.**

### Tax Returns – Who Prepares and Files Them.

The tax year of individuals is the calendar year (January 1 to December 31). Because a bankruptcy captures all debts that are provable up to the date of bankruptcy, an assignment into bankruptcy triggers a deemed year-end for the bankrupt and splits the calendar year in two, requiring a return to be filed for the “pre-bankruptcy period” being January 1<sup>st</sup> to the date of bankruptcy, and a second return for the period commencing on the date of the bankruptcy to the end of the calendar year.<sup>1</sup>

For example, if a person makes an assignment on March 15<sup>th</sup>, the pre-bankruptcy return would cover the period from January 1 of that year to March 14<sup>th</sup>. The post-assignment return would cover the period from March 15 to December 31<sup>st</sup>.

The trustee is obliged to prepare and file the pre-bankruptcy tax return. Section 128 of the ITA makes specific provision for bankruptcies, including deeming the trustee of a bankrupt estate to be the bankrupt’s agent for all purposes of the ITA. Section 128 also imposes upon the trustee the duty to file a return for the portion of the calendar year to the date of bankruptcy, i.e, January 1 to the day of bankruptcy. It remains the bankrupt’s responsibility to file the post-assignment return for the balance of the calendar year to report any income not included in the pre-bankruptcy return (ss. 128(2)(f)), and to file income tax returns for any years subsequent to the year of the bankruptcy.

If the bankrupt has not filed a tax return for the year immediately preceding the year of the bankruptcy, it also falls to the trustee to file that return as well. Section 22 of the BIA provides that “the trustee is not liable to make any return that the bankrupt was required to make more than one year prior to the commencement of the calendar, or the fiscal year of the bankrupt where that is different from the calendar year, in which he became bankrupt.”

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<sup>1</sup> *Income Tax Act*, R.S.C. 1985 (5<sup>th</sup> Suppl.) ss. 128(2).

If tax returns have not been filed for several years before the immediately preceding year, the bankrupt can (and should) prepare returns for those years. If the Minister has issued an assessment for a year in which the bankrupt did not file his or her tax returns<sup>2</sup>, the bankrupt could still file a return for that year, and seek to have that return assessed, such that a reassessment would issue. It will depend on circumstances whether the Minister will or can process the returns.

If the bankrupt is a GST registrant, similar provisions exist in the *Excise Tax Act* (ETA)<sup>3</sup>, that deem the trustee to be the agent of the bankrupt. It is the trustee's responsibility to file all outstanding GST returns that relate to the fiscal year during which the bankruptcy occurred and for the reporting period that ends on the date of bankruptcy (not the day before as with the ITA), and a second period begins immediately after that date.

### Tax Refunds

Income tax refunds for years prior to the year of the bankruptcy are property of the bankrupt available for distribution to creditors and vest with the trustee pursuant to section 71 of the BIA.

A refund for the pre-bankruptcy portion of the calendar year of the bankruptcy vests in the trustee in the same manner as prior-year refunds, again pursuant to section 71. Post-assignment refunds do not automatically vest with the trustee, and are specifically excluded from the property of the bankrupt divisible among the creditors, pursuant to section 67(1)(c) BIA.

A trustee who wishes to have a post-assignment refund sent to the estate directly will have to get an order pursuant to section 68 of the BIA (the surplus income provision), as the refund is properly characterized as income. While property of the bankrupt vests with the trustee as a consequence of the bankruptcy, and property under the BIA includes any property that is acquired or may devolve the bankrupt prior to his or her discharge, this does not include income earned after the assignment. For a trustee to obtain a post-assignment refund, an application pursuant to s. 68 is required<sup>4</sup>.

CRA can and does set off refunds against amounts owing by the bankrupt, and can do so as against different types of debt, pursuant to the set off provisions of the BIA (ss. 97(3)) and also the *Financial Administration Act*, which allows for the set-off of Crown liabilities against Crown debts for the same person.<sup>5</sup>

### Objections and Appeals of Tax Assessments

A bankruptcy proceeding is not the place to challenge the validity of a tax assessment. The ITA and the ETA are complete codes in respect of the process to object to or appeal an assessment. The Tax Court of Canada has the original and exclusive jurisdiction to determine the validity of a tax

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<sup>2</sup> Pursuant to ITA ss. 152(7) and ETA ss. 299(1), the Minister may issue an assessment even if the taxpayer has not filed a return for that year.

<sup>3</sup> *Excise Tax Act*, R.S.C. 1985, c. E-15, ss. 265(1)

<sup>4</sup> *Marzetti v. Marzetti*, [1994] 2 S.C.R. 765.

<sup>5</sup> *Financial Administration Act*, RSC 1985, c F-11 ss. 155(1).