Bankruptcy and the Taxman

It is a sad but inescapable reality that the number of personal bankruptcies taking place in Canada has risen dramatically over the past year or so, and current economic news gives every indication that that trend will continue. A Statistics Canada report issued in December 2008 showed that for that month, the number of consumer (as opposed to business) bankruptcies rose by just over 50% on a year-over-year basis. The increase was particularly dramatic in the province of Alberta, where the number of individuals declaring personal bankruptcy more than doubled on a year-over-year basis. The only province where the number of consumer bankruptcies actually went down during the same period was Newfoundland and Labrador.

A declaration of personal bankruptcy, and the events leading to that declaration, affect the life of the person involved (and, in many cases, that person's family) in any number of ways, which could include the loss of a home, the loss of retirement savings, and, in many cases, a negative impact on one's future ability to access credit. And as with almost every other significant financial event in one's life, there are tax consequences to declaring bankruptcy. What follows is a general outline of how one's tax and tax-filing obligations are affected by a declaration of personal bankruptcy.

Most Canadians, fortunately, have never had reason to become familiar with what happens when bankruptcy is declared. In very general terms, control of the bankrupt person's assets are turned over to a trustee in bankruptcy, who oversees the distribution of those assets to the various creditors who come forward to make a claim on them. When that distribution of assets is complete, a process that generally takes no more than a year, the bankrupt individual is discharged from bankruptcy and has a fresh start.

Generally, where a bankruptcy occurs, the taxpayer's income or loss for the year of bankruptcy is divided into three portions, which must be reported on three separate tax returns. The trustee is responsible for the filing of one of those returns, while others remain the responsibility of the bankrupt taxpayer.

Take, for example, a taxpayer who declares bankruptcy on June 1, 2009, and is then discharged from bankruptcy on December 31, 2009. The filing obligations for such a taxpayer for the 2009 tax year will be as follows.

First, when bankruptcy is declared, the taxpayer is deemed to have a year end that occurred the day before the declaration of bankruptcy. So, in this case, the taxpayer will be deemed to have had a year end on May 31 and must file a tax return for the period of January 1, 2009, to May 31, 2009. That return will be due on or before April 30, 2010. In completing the return for the January-to-May period, the taxpayer can claim pension income credits, CPP/EI premium contribution credits, medical expense credits, tuition and education credits, and student loan interest credits which related to income received or expenditures made during that period. So, where student loan interest was paid or medical expenses incurred in any of those months, the taxpayer is entitled to claim credit for those costs on the return filed for the period. The tax credit for charitable donations made during the pre-bankruptcy period is also claimed on this return. Slightly different rules apply, however, when it comes to claiming "status" credits, such as the basic personal amount, the age amount, or the disability credit. Such credit amounts must be prorated, based on the proportion that the number of days in the tax year which fell before the date of bankruptcy is of the total number of days in the year.

The trustee in bankruptcy must also file a return, which accounts for the trustee's dealings with the bankrupt individual's property during the period of bankruptcy, and that return must be filed by the end of March in the following year.

Finally, the bankrupt individual must also file a return for the period from the date of bankruptcy to the end of the tax year. In the example outlined above, that would cover the period from June 1 to December 31, 2009. That return must, in effect, report any income for the period that was not reported on the trustee's return; for example, employment income earned during the period following the declaration of bankruptcy.

The requirement for multiple returns that must be filed where a taxpayer declares bankruptcy, and the rules that govern whether and to what extent certain credits or deductions can be claimed on each of those returns, can be complex and confusing. However, a taxpayer who has declared bankruptcy will already be working with a trustee and, in all likelihood, a lawyer, both of whom should be familiar with the rules governing such filings. Relying on their expertise should allow the taxpayer to comply fully with all such requirements and to emerge from bankruptcy with all obligations satisfied and ready to make a new start.