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FEDERAL EXEMPTIONS IN BANKRUPTCY

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FEDERAL EXEMPTIONS IN BANKRUPTCY

INTRODUCTION

When an individual becomes bankrupt, a bankruptcy trustee takes possession of the bankrupt person's property, which is then used to satisfy the individual's outstanding debts. The trustee and therefore creditors, however, are not entitled to any property that is considered exempt under bankruptcy law. Exempt property continues to belong to the debtor.

Section 67 of the *Bankruptcy and Insolvency Act* (BIA)[(1)] establishes three general categories of exempt property:

- property held by the bankrupt in trust for other persons;
- property of the bankrupt that is exempt from seizure under the applicable provincial law where the property is situated and where the bankrupt resides; and
- GST credit payments and prescribed payments relating to the essential needs of individuals.

The second category of exemptions – those set by the provinces and territories and incorporated into federal law under section 67 of the BIA – raises a number of concerns.

Critics of the current regime maintain that relying on the provinces and territories to establish bankruptcy exemptions discourages uniformity, creates inequities in the treatment of debtors and may even encourage forum shopping, especially if significant differences exist across provincial exemptions.

Proponents, on the other hand, point out that the present system allows regional variations in the cost of living and property use to be taken into account.

(1) R.S. 1985, c. B-3, as amended.

In April 2002, Industry Canada's Corporate and Insolvency Law Policy Directorate released a paper, *Consumer Insolvency Issues: A Discussion Paper*,[(2)] in which it examined several consumer-related insolvency issues.

This paper addresses one of those issues: whether a uniform federal exemption standard should be adopted under the BIA.

PROVINCIAL/TERRITORIAL EXEMPTIONS

The policy reasons for ensuring that bankrupt individuals can retain certain property are basic: a person requires essentials such as clothing, household goods and property necessary to earn a living. Laws may also exempt certain forms of retirement savings in order to encourage people to save for their post-employment years. Indeed, it would not serve any useful purpose to strip bankrupt individuals of all their assets.

An examination of provincial and territorial exemptions reveals a range of differences. These variations are further compounded by the fact that some exemption laws are outdated and have not kept pace with inflation or social changes. The following examples illustrate this point.

In British Columbia, for instance, a bankrupt person can retain:

- equity in a home in Greater Vancouver and Victoria equal to $12,000; in the rest of the province, home equity to a maximum of $9,000;
- household furniture and appliances up to a value of $4,000;
- a motor vehicle to a value of not more than $5,000 (the vehicle exemption is reduced to $2,000 if the debtor has not made child maintenance payments);
- tools and other personal property required to earn an income to a maximum value of $10,000;
- clothing and medical aids of unlimited value.

(2) Industry Canada, Corporate and Insolvency Law Policy Directorate, *Consumer Insolvency Issues: A Discussion Paper*, 23 April 2002, accessible on-line at: http://strategis.ic.gc.ca/SSG/cl00593e.html.

Alberta exempts:

- food for a 12-month period;
- clothing up to a value of $4,000;
- household furniture and appliances up to a value of $4,000;
- a motor vehicle to a value of not more than $5,000;
- equity in a principal residence up to $40,000;
- where the debtor is a bona fide farmer whose principal source of income is from farming, 160 acres of land if the debtor's principal residence is located on the 160 acres and that tract of land is part of the debtor's farm;
- personal property required to earn an income to a maximum value of $10,000.

In Ontario, a bankrupt individual can keep:

- necessary and ordinary clothing of the debtor and his or her family not exceeding a prescribed amount or $5,000 (if no amount is prescribed);
- household furniture, utensils, equipment, food and fuel contained in and forming part of the debtor's permanent home up to a prescribed amount or $10,000 (if no amount is prescribed);
- business tools, instruments and other chattels not exceeding a prescribed amount or $10,000 (if no amount is prescribed);
- if the debtor is a farmer, livestock, fowl, bees, books, tools and implements and other chattels not exceeding a prescribed amount or $25,000 (if no amount is prescribed);
- a motor vehicle up to a prescribed maximum value or $5,000 (if no amount is prescribed).

Ontario, however, does not provide an exemption for equity in real estate; nor do Nova Scotia, New Brunswick, Quebec and Prince Edward Island.

Newfoundland and Labrador exempts:

- food required by the debtor and his or her dependants during the next 12 months;
- necessary clothing of the debtor and his or her dependants to a maximum value prescribed by regulation ($4,000);
- household furnishings, utensils, equipment and appliances to a maximum value prescribed by regulation ($4,000);
- one motor vehicle to a maximum value prescribed by regulation ($2,000);
- medical and dental aids required by the debtor and his or her dependants;
- items of sentimental value to the debtor valued at not more than a prescribed amount ($500);
- domesticated animals (pets) not used for a business purpose;
- the debtor's principal residence to a maximum value prescribed by regulation ($10,000);
- either
  - (i) personal property used to earn income from an occupation, trade, business or calling to a maximum prescribed value ($10,000); or
  - (ii) where the debtor's primary occupation is farming, fishing or aquaculture, personal property ordinarily used by and necessary for the debtor to earn income from those occupations to a maximum prescribed value ($10,000);
- a pension plan, unless otherwise provided;
- property as prescribed by regulation;
- net income to a maximum prescribed amount.

EXEMPTIONS IN OTHER JURISDICTIONS

A. Australia

Australia's exemption regime applies throughout the country. It includes a list of exemptions, some of which can be adjusted by the courts or creditors.

The principal exemptions include:

- property held by the bankrupt in trust for another person;
- the bankrupt's household property; property is limited to what is reasonably necessary for domestic use in light of current social standards or that is exempted under regulations or by agreement of the creditors;
- property used by the bankrupt in earning income by personal exertion up to approximately A$2,600 (Australian dollars), or as increased by creditors or the court;
- property used by the bankrupt primarily for transportation up to a maximum of approximately A$5,000, or such greater amount as approved by creditors;
- prescribed interests in life or endowment assurance and in regulated superannuation funds or approved deposit funds;
- compensation for personal injuries and property purchased with such protected money; and
- amounts paid to the bankrupt as loan assistance for rehabilitation, household or re-establishment support under various state and federal rural support statutes.(3)

One of the most notable features of the Australian exemption regime is its flexibility. For example, the household property exemption is not an amount fixed by statute but rather is based on a determination of what is reasonably necessary in light of social standards, or as exempted by regulations or by agreement with creditors. Similarly, creditors or the court can increase the fixed value of exempt property used to earn income, and the established value of exempt property used for transportation can be increased by creditor agreement.

In its examination of the Australian exemption scheme, Industry Canada's Consumer Insolvency Issues Discussion Paper noted that there were no exemptions for equity in a bankrupt's home or farmland. It also queried whether the advantages associated with resorting to the courts or creditors to increase certain exemptions outweighed the disadvantages related to the time and financial resources involved in seeking such increases.(4)

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(3) *Ibid.*, pp. 11-12.

(4) *Ibid.*, p. 12.

B. England and Wales

England has two broad categories of exemptions, one relating to property required to earn a living and the other relating to household possessions necessary to meet basic needs.

These are:

- tools, books, vehicles and other items of equipment necessary for the bankrupt's personal use in his or her employment, business or vocation, and

- clothing, bedding, furniture, household equipment and provisions necessary for satisfying the basic domestic needs of the bankrupt and his or her family.[5]

This regime, which contains no limits on the value of exempt property, is highly flexible. The trustee in bankruptcy establishes the value of the bankrupt's exempt property based on individual and family situations.[6]

C. United States

In the United States, a list of federal exemptions is set out in the federal *Bankruptcy Code*.[7] Individual states, however, can "opt out" and preclude their residents from using the federal exemptions. Bankrupt individuals can elect to apply either state or federal exemptions if their state of residence has not opted out of the federal regime.

Federal exemptions include:

- a homestead exemption consisting of real property, including a co-op or mobile home, to a maximum value of $17,450 (any unused portion of the homestead exemption to a value of $8,725 may be applied to any property);

- alimony, child support payments;

- pensions and retirement benefits;

- household goods and furnishings to a maximum of $9,300;

- health aids;

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(5) *Ibid.*

(6) *Ibid.*

(7) United States Code, Title 11, Chapter 5, Section 522.

- jewelry not exceeding $1,150;
- lost earnings payments;
- a motor vehicle to a maximum of $2,775;
- personal injury compensation payments to a maximum of $17,425;
- wrongful death payments;
- crime victims' compensation payments;
- public assistance;
- social security;
- unemployment compensation;
- veterans' benefits;
- trade tools – books and equipment to a maximum value of $1,750;
- $925 of any property (if the debtor does not use all of the homestead exemption this can increase to $9,650); and
- various other exemptions relating to insurance policies.(8)

Each state has its own exemptions, some of which are more generous than those of others or the federal exemptions. Six states,(9) notably Florida and Texas, have an unlimited homestead exemption that allows bankrupt debtors to shelter the total value of their homes from creditors.

Other states have more limited homestead exemptions, although some are quite generous – indeed, for the most part, far more generous than the equity exemptions found in Canada.

The U.S. regime, which is a patchwork of exemptions that vary widely from state to state, has been criticized on a number of fronts. Debtors are subject to vastly different treatment depending on their state of residence. These wide variations increase opportunities for

(8) U.S. Federal Bankruptcy Exemptions, accessible on-line at: http://www.bankruptcyaction.com/fedexemptions.htm.

(9) Texas, Florida, Kansas, South Dakota, Iowa and Oklahoma.

forum shopping and pre-bankruptcy asset conversion; in the opinion of many, they challenge the integrity of the bankruptcy system. Consequently, there have been calls to eliminate the ability of states to opt out of the federal exemptions regime, thereby ensuring that debtors (and hence creditors) throughout the United States will be subject to the same treatment when a personal bankruptcy occurs.

RECOMMENDATIONS OF THE PERSONAL INSOLVENCY TASK FORCE

The Personal Insolvency Task Force (PITF)(10) was established in 2000 by the Office of the Superintendent of Bankruptcy to examine and make recommendations regarding consumer-related bankruptcy issues in Canada.

The PITF studied the present exemption regime and proposed a federal list of the following exemptions (periodically adjusted for inflation) that bankrupts could choose instead of the provincial or territorial exemptions:

- apparel and household furnishings to a maximum value of $7,500;
- medically prescribed aids and appliances and medication for use or consumption by the debtor or the debtor's family – unlimited value;
- one motor vehicle whether used for personal, trade or business purposes to a value of $3,000;
- tools of the trade and professional books, but not including motor vehicles used in trade or business, up to a maximum of $10,000;
- equity in a debtor's residence (in the case of a joint filing, each debtor will be entitled to the full exemption) to a maximum value of $5,000;
- real and personal property used by a debtor whose livelihood is derived from farming, fishing, forestry and other activities related to the natural resource sector to a value of not less than $10,000 and not more than $20,000 (as governed by provincial or territorial law).(11)

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(10) The PITF comprises stakeholders interested in bankruptcy such as creditors and/or creditor representatives, debtor representatives, members of the judiciary, lawyers, trustees, a member of the Canadian Insolvency Practitioners Association, and a number of scholars in the field of bankruptcy law.

(11) *Consumer Insolvency Issues: A Discussion Paper* (2002), p. 13.

Under the PITF's proposed model, a debtor could choose between the federal and applicable provincial exemptions when filing for bankruptcy. In joint bankruptcy situations, each person could claim his or her full exemption as if there were two separate bankruptcies. Both parties could choose between the federal and provincial exemption regime, but, in the event of an impasse, the federal regime would apply.(12)

OPTIONS FOR REFORM

Industry Canada's Consumer Insolvency Issues Discussion Paper examines whether a uniform federal standard should be adopted under the BIA. Four models are reviewed:

- existing provisions of the BIA, which rely on provincially set exemptions;
- the regime in Australia;
- the English model; and
- recommendations of the PITF.

The Discussion Paper points out that the existing Canadian regime raises issues in relation to fairness and concludes, "a federal list of exemptions under the *BIA* might provide more certainty and fairness."(13)

The Paper further suggests that a list of this nature would have to be flexible to accommodate individual situations and must be reviewed periodically to account for cost-of-living increases and to ensure its continued relevance and effectiveness.(14)

COMMENTARY

The issue of whether a uniform federal exemption standard should be adopted under the BIA will likely be the subject of considerable discussion during the forthcoming Parliamentary review of the *Bankruptcy and Insolvency Act*.

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(12) *Ibid.*

(13) *Ibid.*, p. 14.

(14) *Ibid.*

Some, no doubt, will argue that a federal list is both appropriate and necessary, simply because federally determined amounts should apply when one is seeking protection under federal law. Furthermore, a federal standard would promote uniformity and fair treatment of debtors and creditors.

Others may suggest that creating federal exemptions also provides policy makers with an opportunity to introduce a measure of flexibility into the exemptions regime that could allow for periodic adjustments for inflation, social changes and meeting a debtor's particular circumstances.

But adopting a list of federal exemptions may also have opponents. Some may argue that the present regime of provincially and territorially set exemptions works well because it accommodates regional variations in living costs, economies and property use. They are also likely to contend that the differences in the types and levels of exemptions across the various jurisdictions are not significant and do not jeopardize the integrity of the Canadian bankruptcy process.