



**REGISTERED RETIREMENT SAVINGS PLANS (RRSPs)
AND BANKRUPTCY**

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REGISTERED RETIREMENT SAVINGS PLANS (RRSPs) AND BANKRUPTCY

INTRODUCTION

Registered Pension Plans (RPPs) and Registered Retirement Savings Plans (RRSPs) are two of the most important financial vehicles available to Canadians to save for their retirement. Many Canadians participate in Registered Pension Plans through their employment and many also contribute to personal RRSPs. Although each type of plan is a means to achieve the same end, i.e., retirement savings, they are not treated identically in a bankruptcy.

Money accumulated in a Registered Pension Plan (RPP) is exempt from creditors' claims in a bankruptcy and continues to be the property of the bankrupt individual. RRSPs, however, do not have the same level of protection. In general, money invested in an RRSP becomes the property of the bankruptcy trustee and available for distribution among creditors when the plan owner becomes bankrupt. But this is not the case for all RRSPs. Although RRSPs held by banks, brokerage firms, mutual fund companies or in self-directed funds become the property of the trustee in a bankruptcy, other types of RRSPs – insurance-product RRSPs and certain locked-in RRSPs – are out of creditors' reach.

The inconsistent treatment of RRSPs in bankruptcy has been a topic of discussion for some time. Parliamentary committees, bankruptcy experts and other stakeholders have weighed in with views and recommendations.

This paper presents an overview of the treatment of RRSPs in a bankruptcy as well as recent views and proposals pertinent to the issue.

CURRENT STATUS OF RRSPs IN A BANKRUPTCY

Subsection 91(22) of the *Constitution Act, 1867*, provides that “bankruptcy and insolvency” is a matter of federal jurisdiction. This jurisdiction allows Parliament to establish

the rules relating to bankruptcy and insolvency in Canada including the assets that are included as part of a bankrupt person's estate and divided among creditors as well as those that are exempt and therefore unavailable to creditors.

The *Bankruptcy and Insolvency Act* (BIA)⁽¹⁾ governs the distribution of assets when a person becomes bankrupt. The general rule is that all assets belonging to a bankrupt person become the property of the bankruptcy trustee and available to satisfy creditors' claims. This rule is subject to certain exceptions, which are set out in section 67 of the BIA. Among other things, subsection 67(1) provides:

67. (1) The property of a bankrupt divisible among his creditors shall not comprise
- (a) property held by the bankrupt in trust for any other person,
 - (b) any property that as against the bankrupt is exempt from execution or seizure under any laws applicable in the province within which the property is situated and within which the bankrupt resides, or
 - (b.1) such goods and services tax credit payments and prescribed payments relating to the essential needs of an individual as are made in prescribed circumstances and are not property referred to in paragraph (a) or (b)...

Because paragraph 67(1)(b) of the BIA exempts, from creditors' claims, property that is exempt from execution or seizure under federal or provincial laws, it is necessary to look to other provincial and federal statutes to determine which assets continue to belong to a bankrupt person during a bankruptcy.

Various provincial laws exempt assets from execution and seizure. These laws – which differ from province to province – generally allow individuals to retain essential items such as clothing, tools and household items of a specified maximum value, and equity in a home to a certain dollar limit.

Pension laws and insurance laws also exempt certain assets from seizure and execution. Money contributed to a Registered Pension Plan (RPP), for example, is exempt from seizure on bankruptcy as are certain insurance products. The rationale for these exemptions is straightforward. Insurance products are usually purchased for the benefit of others (spouse, children, etc.), not the policyholder, and it would be unfair to deprive those individuals of that

(1) R.S.C. 1985, C. B-3, as amended. <http://laws.justice.gc.ca/en/B-3/index.html>.

protection. As for Registered Pension Plans, by making money accumulated in these plans exempt from seizure, the savings are preserved for retirement, thereby reducing the potential for future dependence on publicly funded old age security programs.

For the most part, Registered Retirement Savings Plans do not have the same level of protection as an RPP in a bankruptcy. In fact, when it comes to the availability of plan assets to creditors, there are essentially three different categories of RRSPs:

- RRSPs held by banks, brokerage firms, mutual fund companies or in self-directed funds vest in the bankruptcy trustee on the bankruptcy of a plan owner – the money held in the RRSP becomes available for distribution to creditors.
- RRSPs in the form of a contract with an insurance company and where a spouse, child, parent, grandparent, or grandchild of the plan owner is named as a beneficiary are exempt from seizure on bankruptcy under laws governing insurance.
- Locked-in RRSPs holding money that was transferred from a pension plan on termination of employment after pension rights have vested are exempt from seizure on bankruptcy under pension legislation.

SHOULD ALL RRSPs ENJOY CONSISTENT TREATMENT IN A BANKRUPTCY?

The current treatment of RRSPs in a bankruptcy raises a number of concerns.

One of the most troubling issues is the inconsistent treatment of employees who accumulate retirement savings in Registered Pension Plans and the self-employed and employees without pension plans who rely on RRSPs to accumulate retirement savings. On a bankruptcy, the former retain their pension funds, but the latter lose their retirement savings.

Another concern is the inconsistent treatment of insurance and non-insurance RRSPs. Insurance-product RRSPs (such as segregated funds) enjoy creditor-proof status while most other types of RRSPs do not. This difference could favour sophisticated debtors and those to whom expert financial advice is available. And even though a bankruptcy trustee can challenge a transfer of funds from a non-exempt RRSP to a creditor-proof RRSP in anticipation of bankruptcy, the trustee must meet a difficult test under provincial fraudulent conveyance legislation to overturn the transfer.⁽²⁾

(2) *Ramgotra (Trustee of) v. North American Life Assurance Co.*, [1996] S.C.R. 325. See also Jeffrey C. Carhart, *The Creditor Proof Status of Life Insurance Products in Ontario* (1997), available at <http://servlets.mendlowitz.com/servlet/com.e400.maa.servlets.Articles>.

In 1997, the Standing Senate Committee on Banking, Trade and Commerce expressed its support for exempting all RRSPs from seizure in a bankruptcy, subject to the creation of appropriate anti-abuse measures. Uniform treatment, the Committee reasoned, would make the “exemption rules more equitable and certain and provide consistent protection for RRSPs regardless of type.”⁽³⁾ The Committee urged the federal government to address the inequities between insurance-product and other RRSPs.⁽⁴⁾

PROPOSALS FOR ESTABLISHING CONSISTENT TREATMENT OF RRSPs IN A BANKRUPTCY

To establish uniform treatment of RRSPs in bankruptcy, governments have the option of two main approaches:

- set out specific exemptions in the BIA itself and perhaps amend other federal statutes, if required;
- incorporate within the BIA exemptions that are found in other laws pursuant to paragraph 67(1)(b) of the BIA.

The first approach requires action on the part of the federal government, while the second involves provincial action to adopt uniform legislation to exempt RRSPs from seizure and execution. Preliminary work is underway in relation to both approaches.

Concerned about the lack of uniform treatment of RRSPs in relation to debt enforcement, the Uniform Law Conference of Canada⁽⁵⁾ made a proposal in 1999. It proposed The Uniform Registered Plan (Retirement Income) Exemption Act⁽⁶⁾ – a proposed uniform provincial law that would exempt a plan holder’s interest and property in an RRSP, Deferred Profit Sharing Plan or Registered Retirement Income Fund (that is, the contents of the plan), but

(3) Twelfth Report of the Standing Senate Committee on Banking, Trade and Commerce, Bill C-5, An Act to amend the Bankruptcy and Insolvency Act, the Companies’ Creditors Arrangement Act and the Income Tax Act, February 1997, p. 25.

(4) *Ibid.*, p. 26.

(5) The Uniform Law Conference of Canada brings together government policy lawyers and analysts, private lawyers and law reformers to consider areas in which provincial and territorial laws would benefit from harmonization.

(6) This draft act is available at <http://www.ulcc.ca/en/poam2/index.cfm?sec=1999&sub=1999ha>.

not individual withdrawals or payments out of such plans, from attachment, seizure, execution, garnishment or other legal process for the enforcement of a debt. To date, however, the provinces have not adopted this proposal.

At the federal level, the Personal Insolvency Task Force (PITF) – created by the Office of the Superintendent of Bankruptcy in 2000 to review the provisions of the BIA relating to personal bankruptcy – has developed options with respect to an RRSP exemption.

First, the PITF examined the differences between pensions and RRSPs and concluded that the presence of significant differences makes it inappropriate to treat the two identically in a bankruptcy situation. The Task Force mentioned the following differences:

- Participating in a pension plan is often a condition of employment, and contributions come from employees and employers. RRSPs are voluntary and typically funded from plan owner contributions.
- Pension plan contributions are usually made on a regular basis over a defined period and are of a specified amount; RRSP contributions have no such limitations.
- Pensions are typically locked in until retirement; RRSP funds can be accessed at any time.
- Pensions are retirement savings vehicles; RRSPs can serve more than one purpose. They are a way to save for retirement, but can also be an important means to reduce income tax.⁽⁷⁾

However, the PITF goes on to state that if a goal of the BIA is to encourage retirement planning, then it ought to exempt “RRSP savings that have accumulated through prudent retirement savings practices before insolvency,” but, at the same time, not encourage abuse by those who would make tactical use of an RRSP exemption to shelter assets from creditors.⁽⁸⁾ Thus, the goal of any uniform RRSP exemption is twofold:

1. to shelter legitimate retirement savings; and
2. to preserve the integrity of the bankruptcy system by ensuring that a bankrupt individual cannot gain access to sheltered RRSP assets during or after a bankruptcy.⁽⁹⁾

(7) Personal Insolvency Task Force, *Discussion Paper on RRSP Exemption*, p. 2.

(8) *Ibid.*

(9) *Ibid.*, p. 3.

The PITF proposes that RRSPs be exempt from seizure in a bankruptcy with the following provisions:

- the exemption would be available only by converting the RRSP, shortly after the date of bankruptcy, into a “locked-in” RRSP or annuity that would be accessible at retirement age;
- the contents of an RRSP would be exempt from seizure in a bankruptcy except for contributions by the debtor (including contributions to a spousal RRSP), made within three years prior to the date of the “initial bankruptcy event,” which would become the property of the trustee in bankruptcy and divisible among creditors;
- the exemption would be capped at an amount equal to the maximum RRSP contribution limit in the year of bankruptcy times the number of years that the bankrupt’s age exceeds 21, to a limit of age 65;
- the exemption would require the filing with the applicable financial institution of an Election to Convert by the debtor, completion of a Certificate of Conversion by the financial institution, and receipt of these documents by the trustee. The conversion would have to be done prior to, or within 90 days of the date of bankruptcy, subject to a court-ordered extension of the time period in situations where there was an inadvertent good faith failure to convert;
- the insurance-product RRSP exemptions contained in the insurance legislation of the provinces would no longer apply in a bankruptcy and would be replaced by the federal RRSP exemption;
- a transition period (two or three years) would apply before the exemption came into force.⁽¹⁰⁾

COMMENTARY

Proposals have been put forward to deal with the inconsistent treatment of RRSPs in a bankruptcy. The Uniform Law Conference of Canada has proposed a Uniform Registered Plan (Retirement Income) Exemption Act and the PITF has recommended that, subject to certain rules, RRSP savings should be out of reach of creditors on a bankruptcy.

(10) Personal Insolvency Task Force Recommendation, RRSP Exemption, Draft #10, 10 February 2002, p. 7.

The PITF proposal contains a number of unique and possibly controversial provisions such as the three-year clawback rule and the cap on the dollar value of the exemption. The clawback would make RRSP contributions made during the three years prior to bankruptcy available to creditors. This anti-abuse provision is intended to combat attempts to shelter money in an RRSP in anticipation of bankruptcy. The PITF reasoned:

This formulation serves the purpose of preserving, for the debtor, retirement funds which were saved and accumulated long before bankruptcy. It appropriates for the creditors only those retirement funds which were accumulated in a period when one can reasonably infer – not with precision, but as a generality – that such contributions could otherwise have gone toward debt repayment. Under this formulation, a debtor who has been contributing for many years will preserve all but a fraction of the RRSP, whereas a debtor who started contributing only shortly before bankruptcy – perhaps in anticipation of the bankruptcy – has little justification to preserve these recent contributions from creditors. If the period were shorter, we would be inviting debtors (for example, strategic tax debtors) to make a significant RRSP contribution (perhaps by utilizing unused RRSP eligibility limits) and then to hold creditors off for the requisite short period in order to bullet-proof the RRSP.⁽¹¹⁾

The proposed cap on the dollar value of the exemption may also be contentious. Some may question the need for a cap; others may have concerns about the formula devised to establish the cap.

The PITF recommendation would also place insurance-product RRSPs on the same footing as other RRSPs. Consequently, the former – which are currently exempt from seizure in a bankruptcy – would no longer enjoy a bankruptcy advantage over other RRSPs. The insurance industry will likely be opposed to any attempt to alter the exempt status of their RRSP products.

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