

# *Probate Minimization Strategies: Tips and Traps*

November 2014  
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## **Probate minimization strategies: tips and traps**

Many taxpayers have shown increasing interest in probate minimization strategies. Arranging one's affairs to minimize probate fees<sup>1</sup> can certainly have merit, but there may be times when these arrangements aren't in a client's best interest. This article provides an overview of some of the more popular probate planning strategies, along with tips and traps to consider. Clients should always be encouraged to seek the advice of a lawyer experienced in estate matters.

### **Getting the facts**

Assets passing directly to a named beneficiary by operation of law (e.g. joint tenancy with right of survivorship<sup>2</sup>) or by certain beneficiary designations (e.g. life insurance) aren't usually subject to probate, as they bypass the estate and go directly to the other party. However, it's also true that if probate is required to deal with even one asset, then in most situations probate fees must be paid on the value of all assets that pass through the estate. The probate court application requires confirmation under oath of the total value of the estate, and fees are calculated on those values.

In addition to the actual fees paid to the court for the grant of probate (which are highest in Nova Scotia and Ontario, at roughly 1.5 per cent), there are frequently executor fees (typically between 2.5 and 5 per cent, depending on provincial guidelines and the complexity of the estate) and legal costs. These costs weigh heavily in the taxpayer's mind, and may provide additional motivation for probate minimization strategies.

In contrast to the facts, some taxpayers believe that probate fees are substantially higher, potentially reaching 10 per cent or more. If taxpayers are doing their planning based on such erroneous numbers, they are missing crucial information and may be implementing strategies where the cost of doing so far outweighs the benefit.

### **Probate minimization**

Probate minimization can be a deceptively simple and appealing concept. Frequent articles in the press, and helpful advice from friends and family, tends to reinforce the general view that probate must be avoided. On large estates, probate fees can certainly seem like a lot of money — but they pale in comparison to marginal rate taxation on income and capital gains. The following chart illustrates how the calculation of probate fees for a \$1 million estate varies from province to province.<sup>3</sup>

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<sup>1</sup> In Ontario, taxpayers no longer pay probate fees but instead are subject to the Estates Administration Tax Act, 1998 (EATA), introduced in response to the Supreme Court of Canada ruling in *Re Eurig Estate*, (1998) 2 S.C.R. 565, which held the former provincial probate fees constituted an invalidly introduced tax. This statute retroactively imposed a valid tax precisely equal to probate fees that had been collected since 1950. Despite the small variations in terminology across the provinces, the terms probate and probate fees will still be used in this article.

<sup>2</sup> Joint tenancy with right of survivorship means that on the death of one owner, property is transferred directly to the surviving owner. Co-owned life insurance does not automatically provide a right of survivorship, and co-owners will be treated as tenants in common. Where survivorship rights are desired, contingent owners should be appointed. Joint tenancy with right of survivorship isn't applicable under Quebec civil law.

<sup>3</sup> Additional administration/filing fees may apply in some provinces. Rates believed to be current as of November, 2013, but subject to change. Readers should consult applicable legislation for verification.

Province	Rates	Fee on Assets of \$1 million
Ontario	\$5 per \$1,000 for first \$50,000; plus \$15 per \$1,000 thereafter.	\$14,500
British Columbia	No fee for estates up to \$25,000; \$6 per \$1,000 for estates between \$25,000 & \$50,000, plus \$14 per \$1000 thereafter.	\$13,450
Alberta	\$25 for estates up to \$10,000; \$100 for estates of \$10,000 to \$25,000; \$200 for estates of \$25,000 to \$125,000; \$300 for estates of \$125,000 to \$250,000; \$400 for estates over \$250,000.	\$400
Saskatchewan	\$7 per \$1,000.	\$7,000
Manitoba	\$70 for estates up to \$10,000, plus \$7 per \$1,000 thereafter.	\$7,000
Quebec	Quebec does not levy probate fees based on the value of the estate. Instead, they charge a flat fee depending on whether the application is from a natural or a legal person. Notarial wills don't require probate in Quebec.	\$102/\$114
New Brunswick	\$25 for estates up to \$5,000; \$50 for estates of \$5,000 to \$10,000; \$75 for estates of \$10,000 to \$15,000; \$100 for estates of \$15,000 to \$20,000, plus \$5 per \$1,000 thereafter.	\$5,000
Newfoundland	\$60 for first \$1,000; \$0.50 per \$100 thereafter.	\$5,055
Nova Scotia	\$83.10 for estates up to \$10,000; \$208.95 for estates of \$10,000 to \$25,000; \$347.70 for estates of \$25,000 to \$50,000; \$973.45 for estates of \$50,000 to \$100,000, plus \$16.45 per \$1,000 thereafter.	\$15,778
Prince Edward Island	\$50 for estates up to \$10,000; \$100 for estates of \$10,000 to \$25,000; \$200 for estates of \$25,000 to \$50,000; \$400 for estates of \$50,001 to \$100,000, plus \$4 per \$1,000 thereafter.	\$4,000

Clearly, the extent to which a client should consider implementing various probate planning strategies will vary greatly by province. In analyzing the pros and cons of any particular plan, advisors should consider the separate aspects or elements of any asset along with the way in which each of these elements interact to best meet that particular client's need. This may offer the taxpayer a different perspective on planning and the opportunity for more sophisticated solutions.

The advisor's role is to help the taxpayer understand their options so they make informed choices and not, of course, to make the choice for them. However, it's especially important to document advice about the risks and rewards of various probate planning strategies that have been discussed with clients. Remember it won't be the taxpayer client who will be second-guessing the advice. The results, and the reasons for it, will ultimately be reviewed by the beneficiaries — happy or disappointed.

## **Designating a beneficiary: life insurance**

One of the features of designating a named beneficiary on a life insurance policy (other than the estate) is that it passes proceeds directly to that beneficiary, avoiding probate fees on the funds. With that being said, advisors must keep in mind that there may be times when flowing funds into the estate may be part of other estate planning goals. This could include the establishment of testamentary trusts for a spouse or minors. There may also be times when the life insurance has been obtained to provide a source of immediate liquidity to the estate for covering certain debts, helping to avoid a forced sale of assets to make the payment.

## **Designating a beneficiary: registered plans**

Unless a tax-free rollover provision applies such as those for spouses or common law partners, designating a named beneficiary on a RRIF or RRSP has the effect of taking registered funds out of the control of the estate while still leaving the tax bill for the estate to pay. On the plan owner's death, the plan proceeds will be paid directly to the named beneficiary, without any holdback or deduction. Taxpayers are often unaware that a tax slip will then be issued to the deceased plan owner's estate, with the possible result being that the beneficiaries of the estate will pay the income tax due on funds that were actually received by some other party.

Designating their spouse as beneficiary, while avoiding probate, can also destroy any opportunity for income splitting after death. For example, suppose Taxpayer C dies on January 1 in any given year. Also assume C has a simple will leaving everything to their spouse. Taxpayer C will have virtually no taxable income for that calendar year.

If C had designated their estate as beneficiary for all or a portion of the registered plan, probate fees would be payable on the portion of the plan proceeds so designated. However, C's assorted personal credits, marginal rate taxation, loss carry forwards and a host of other factors may have resulted in tax-free or lightly taxed funds being generated in the estate. The residue would then be given to the spouse as after-tax capital. (This is especially so if Taxpayer C makes substantial charitable gifts by their will.) Accepting and paying probate fees, in this situation, could produce far cheaper after-tax dollars than most other forms of planning.

On the other hand, the taxpayer might happen to die late in the year, or with significant income from other sources. If so, the flexibility of the estate designation plan comes into play. A joint election between the estate trustee (usually the same spouse) and the spouse (in their personal capacity) could result in some or even all the proceeds going to the spouse, into their own registered plan, and not being taxed in the estate. Depending on the provincial probate fee structure, this flexibility could be worth the price.

## **Outright gifts**

Taxpayers are aware that, generally speaking, if you don't own something at your death, you don't pay probate on it. It follows that one simple way to reduce probate is to give up ownership. The simplest way to do so is to gift the property to a beneficiary while the donor is still alive. This is often done when a taxpayer believes they are likely to die soon, and indeed there's certainly nothing wrong with a terminally ill taxpayer distributing their own estate.

However, for some taxpayers this strategy is implemented far too early in life. Taxpayers may make their gifts when ill or depressed but then surprise themselves (and others) by recovering. They may experience severe difficulty in unwinding earlier transactions – especially if the early inheritance has already been spent.

The most tangible trap with this gifting plan is that it may leave the donor in poverty. Some taxpayers actually set out to achieve this, assuming they'll become entitled to a larger share of provincial benefits based on income. Their plan is based upon the expectation of adequate future care from either the recipients of the gift or the province. This isn't something that should be accommodated without a very long and well-documented discussion. The taxpayer is giving up title and control of the asset. The least they might wish to do is to consider an agreement with the new owners, stipulating the benefits they will continue to enjoy during their lifetime.

## Unexpected life events

One often-overlooked trap is the risk that the recipient of the gift, often a child, may predecease the donor. With taxpayers routinely living into their nineties, the children themselves are often senior citizens by the time they inherit. A death out of expected order may be compounded by the terms of the recipient's will, or an intestate distribution. By dying without making provision to return or share the benefits of the gifted property, even a well-meaning child could cast a parent or grandparent into actual poverty. The gifted assets may be uncontrollably distributed to more distant or even hostile beneficiaries. In many cases, the recipient of the gift should be requested or required to amend their will, perhaps putting in a return of the gift, or at least a trust provision to provide an ongoing means of support for the original donor.

Taxpayers live in a culture where one-third to one-half of marriages end in divorce, and where roughly three-quarters of those divorced acquire new partners. Many advisors have seen a marriage end to the surprise of one party or a situation where blood relatives financially abused power or assets. Any grant of power over one's affairs should ideally be preceded by a consultation with a qualified legal practitioner. Advisors need to be aware that direct, outright gifts may simply be shipping wealth off into the sunset. This is particularly true with outright donation arrangements (including gifts by will) to the second spouse, effectively disinheriting the taxpayer's children from a previous marriage.

## Beware of marginal tax rates

Gifts to the next generation can have another tangible cost. Many seniors have a low income tax liability, some of which may be due to heavy medical expenses. In many cases, the recipient of the gift will invest it and be in a higher tax bracket than the original taxpayer was, with the result that there is less after-tax investment income to use for the senior's benefit. It makes little sense to avoid a 1.5% one-time probate fee only to incur higher marginal rate taxation on income generated by the assets on an annual basis. If the objective is simply to give control over the taxpayer's assets, this can easily be done without giving the asset away. For example, clients may consider adding authorized signatories to an account, or giving limited or general powers of attorney for property.

## Joint ownership

A more common variation on this gifting theme is transferring assets into joint ownership with right of survivorship.<sup>4</sup> Any asset capable of registered title can be owned by multiple owners. Between spouses, this is probably the most common form of estate planning. It's also extremely common between parent and child in an effort to avoid probate. With this plan, the taxpayer is sharing both legal title and legal control. There may be an assumption of shared benefits from the property in the absence of an agreement to the contrary.

This plan at least covers off the risk of the new co-owner predeceasing the donor, in which case title to the asset should revert to the original owner. If there are more than two joint owners, the survivors will usually share equally in the acquired ownership of the new portion.

The biggest trap in this plan likely relates to the loss of control by the donor. By giving up sole ownership of an asset, taxpayers are giving legal rights to another party. For example, joint bank accounts usually provide the new co-owner the right to withdraw any or all of the funds. The arrangement cannot be unilaterally unwound by the taxpayer without the consent of the new co-owner, regardless of the original source of funds.

Putting real estate into joint names with an adult child raises other major risks. Consider the exemption for capital gains on a principal residence. If the child already has their own principal residence and they now acquire part ownership of a parent's house, that parent has effectively turned their own 100% tax-free asset into a partially taxable real estate holding. There is a serious risk that future taxable growth in the value of the house will outstrip any probate savings. The child may also jeopardize their eligibility as a first-time home buyer under the Home Buyers' Plan.

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<sup>4</sup> See note 3. Not applicable in Quebec.

In addition, taxpayers often need to be alerted to the risk that the gifted asset will now be exposed to the new co-owner's creditors. Such assets aren't protected from seizure by business creditors. Of more practical significance may be the creditor who is or was the spouse.

Under the *Family Law Act* in Ontario, the capital value of gifts or inheritances received from third parties during a marriage is excluded from the financial division calculation on marriage breakdown. This calculation is known as the equalization payment. If the gift was kept intact and segregated in the recipient's name, or can be traced to replacement property, it's excluded from the calculation. The income that such a gift or inheritance generates can also be protected, if the donor makes that stipulation. But this doesn't mean that the former spouse won't target the assets as part of the litigation process. Inherited wealth enhances a spouse's ability to pay support, either ongoing or lump sum. Ex-spouses may acquire indirectly what they aren't entitled to directly.

If assets pass directly to one beneficiary by joint ownership, then the assets will be out of the control of the estate, potentially creating an inequitable distribution of the total estate (at least in the minds of the beneficiaries). This inequity may be compounded if the death of the joint owner creates a taxable disposition, or recapture of depreciation, which will be taxable in the estate even though the joint owner actually acquires the property.

Even if parents are comfortable with the issues raised above regarding joint ownership, the strategy may not be effective for joint bank accounts unless there's a clear intention of a gift. Two Supreme Court of Canada cases have shown that, absent this clear intention, the surviving child may be presumed to be holding the assets in a resulting trust for their parent's estate.<sup>5</sup>

## Gifts to *inter vivos* trusts

Trusts are often used to distance or relieve the beneficiary from the control of the trust property. They are frequently used for asset management during later life or incapacity. *Inter vivos* trusts, which are trusts created while one is still living, can be made revocable at the option of the person creating the trust, referred to as the settlor. Other parties can be given the power to terminate the trust. Unlike a will, which becomes public after probate, *inter vivos* trusts aren't probated and enjoy a high degree of confidentiality.

The settlor may reserve the income for life and stipulate new beneficiaries after their death. If not revoked, the trust relationship will continue past the death of the taxpayer and the new beneficiaries will step into a position of entitlement. In this fashion, an *inter vivos* trust may fill the role of a will substitute. Once assets have been gifted to a trustee, they are no longer owned by the taxpayer and this is where probate savings can be achieved.

By using a trust relationship, a taxpayer is selecting one of the oldest and most rigorously enforced relationships known to English common law. While co-owners of a bank account may have murky, if any, duties to each other, the relationship between trustee and beneficiary is very well spelled out and can be predetermined by the taxpayer choosing to create the relationship. By putting only the assets they choose into trust, the taxpayer can provide different destinations for different assets. The taxpayer can control the terms of continuing enjoyment of the assets. By carefully selecting the trustee(s) or by being one of the trustees themselves, they can determine who controls the administration of the assets. By making themselves the sole beneficiary, or one of the beneficiaries, they can continue to use and benefit from the assets even though they no longer own them. As such, using trusts as surrogate owners offers an array of advantages over other plans.

## Insurance trusts<sup>6</sup>

Advisors will sometimes recommend that life insurance proceeds be made payable to a trustee appointed in the context of the provincial Insurance Act (although designating an insurance trustee is no substitute for having a well-crafted will). The most common use is in situations involving minors as beneficiaries. The problem in many cases is that the terms of the insurance trust aren't spelled out. There may be no express power to invest, to pay or accumulate income, or anything else. In these instances, only the investment powers set forth in

<sup>5</sup> See *Pecore v. Pecore*, 2007 SCC 17 and *Madsen Estate v. Saylor*, 2007 SCC 18.

<sup>6</sup> Planning with insurance trusts may not be a valid option in Quebec.

provincial legislation will be available to the trustees, which can be somewhat restrictive. Care should be taken to ensure that proper powers are spelled out in the trust instrument.

In jurisdictions which still have an old rule of trust interpretation called the Rule in *Saunders v. Vautier*<sup>7</sup>, the failure to include contingent beneficiaries in the trust means the primary beneficiary can call for the proceeds upon attaining the age of majority. This is seldom what taxpayers want – typically varied distribution dates are preferred, for example, 50% at age 25 and 50% at age 30. This can only be achieved with careful planning and advice from a qualified legal practitioner.

An insurance trust may be established through a separate trust instrument, or through a clause in the taxpayer's will. If the will is properly drafted, insurance proceeds flow into an insurance trust created in the will and should not form part of the taxpayer's estate, avoiding probate.<sup>8</sup>

## Testamentary trusts in probate planning

In addition to other benefits, testamentary trusts (which are trusts created as a consequence of death) can also be used as a method of probate minimization. Suppose spousal taxpayers A and B each have \$1 million in assets that are subject to probate. Taxpayer A dies and leaves these assets outright to his spouse B, paying probate on the \$1 million. When B dies, there will now be \$2 million in assets subject to probate, meaning that probate will be paid a second time on the \$1 million originally transferred.

This situation of multiple probate on the same assets can be avoided by putting A's assets into a testamentary trust for B. On the death of the survivor B, the assets in the trust may go to beneficiary C. (Alternatively, the assets may be held in trust for C's lifetime, and go to yet another beneficiary on his or her death.) The assets that had originally belonged to A never form part of the estate of B, and aren't probated a second time on B's death. By remaining in trust after the death of B, savings may be achieved.

If A and B are spouses (as defined by the Income Tax Act), and if the terms of the trust are properly designed, the death of A can still result in a capital gains rollover to the qualifying spousal trust for B. This will defer the triggering of capital gains, maintain the trust property at its pre-tax size, and enable the trustees to defer paying the capital gains tax until B dies, or until the assets are actually disposed of.

From B's perspective, especially if B is the trustee, or one of the trustees, there is remarkably little difference between being the trust beneficiary and owning the assets outright. B has the full enjoyment of the income and capital of A's assets. B has control, or at least some control. The only thing that B is lacking is legal ownership of the assets, and one might question the value of that in light of the other elements. It is even possible for A to give B the right to decide who will inherit the assets in the trust, through the exercise of a power of appointment. For all practical purposes, this brings outright owner status and trust beneficiary status very close together.

## Drawbacks of using trusts

The taxation of trusts, especially *inter vivos* trusts, can be complex and is beyond the scope of this article. However, several common traps do apply, especially when trusts are being considered to avoid probate.

When a taxpayer settles assets to a trust, there is a change in legal title. If the taxpayer is using a bare trust, and remains the only beneficiary, we say there has been no change in "beneficial" ownership; that is, the taxpayer remains entitled to the benefits and indirect control of the property. In past years, CRA attempted to address the issue of senior taxpayers increasingly using bare trusts and revocable *inter vivos* trusts for asset management, especially during incapacity. As a result, several new and potentially confusing terms for trusts with various stipulations such as *joint spousal* and *alter ego* trusts were introduced. Some of these terms are intended to designate trusts which won't involve a disposition upon being settled; however, property in one of

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<sup>7</sup> The English case referred to was decided in 1841. Simplified, the modern (expanded) rule states that if the owners of all income and capital interests in the trust are legally capable, they may agree to vary or even terminate the trust. In practice, this means that in selecting trust beneficiaries, settlors usually include minor, contingent or unascertained beneficiaries who cannot consent to early termination. This ensures that the trust will remain in force regardless of the wishes of any beneficiary.

<sup>8</sup> See the Supreme Court of Canada's decision in *Re MacInnes*, (1934) D.L.R. 302, which confirmed that a separate insurance trust can be created within the will and not form part of the estate. This and additional court decisions regarding wording and trustee/beneficiary designation requirements should be carefully reviewed by the client's legal advisor.

these trusts may also return to the settlor's testamentary estate upon death, and be disposed of according to the testator's will. As such, they won't all function as probate avoidance vehicles. Competent tax and legal advice is certainly needed before taxpayers set up any *inter vivos* trust.

## Watch for dispositions

Taxpayers may encounter a trap in settling an *inter vivos* trust. If there has been a change in beneficial ownership of the trust assets, this will constitute an actual disposition for tax purposes, and will trigger capital gains.

The outright gift plan first mentioned is also an actual disposition; a gift is an intentional change in beneficial ownership for no consideration. The transfer of assets into joint tenancy is also a disposition. Although only a half-interest or less is being transferred in this case, there is a new beneficial owner. As mentioned, death of a joint owner will also create another disposition.

Plans involving spouses may entitle the taxpayer to a tax-free spousal rollover, but the attribution rules always need to be kept in mind. Setting up a testamentary trust avoids attribution rules, but requires dying first, which of course is the most significant disposition a taxpayer can make.

## The 21-year deemed disposition

Another potential drawback to establishing trusts is that they're subject to a deemed disposition of capital properties every 21 years (except qualifying spousal and alter ego trusts). This deemed disposition can create problems with illiquid trust assets such as private company shares. However, this aspect of trust taxation may not necessarily be a problem. Many trust portfolios turn over gradually, and the capital gains/losses are taken out over time. Many taxpayers setting up trusts don't have significant capital assets, and the settling of GICs or cash into a trust does not create any substantial capital gain problem.

## More exotic probate minimization plans

For some taxpayers (especially those with private companies), there are a few more possible options to consider.

Some advisors are familiar with the application of so-called *situs* wills. Some taxpayers have separate wills, with different executors and different beneficiaries, in different countries. Each will can be expressed to govern only assets in that country. Some countries have no probate taxes at all, while others have enforced regimes of mandatory inheritances regardless of what the will says.

The same strategy can be applied to Canadian provinces. Determined taxpayers may opt to move assets into a province with a lower probate or tax regime, and control them with a local will. This multiple will strategy has been carried a step further in Ontario with the advent of two Ontario wills.

## Ontario dual will strategy: the Granovsky case

In retrospect, the dual will strategy seems quite straightforward. The former Ontario probate fee legislation, and the regulation which levied the fees<sup>9</sup>, made reference to persons seeking what is called a limited grant of probate. Such applicants are usually foreign executors seeking to deal with assets in Ontario, and only wishing a grant limiting their authority to the specific assets to be administered. The former statute section only required them to pay probate on those specific assets.

This concept was extended by a few lawyers to Ontario residents. They considered the situation of a taxpayer with valuable private company shares. Since the officers, directors and shareholders are almost invariably all members of the family, such persons have little need of the assurance of probate to transfer the shares of a deceased family member to the survivors (unlike a bank, property registry system or investment company which may require proof of probate prior to proceeding with the transfer). Accordingly, the plan

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<sup>9</sup> See the former Ontario Regulation 293/92, made pursuant to the *Estates Act*, R.S.O. 1990, c.E.21.



became to draft two (Ontario) wills for the taxpayer. The primary will dealt with every asset other than the private company shares. The secondary will dealt only with the private company shares. Probate would only be sought for the primary will.

Phillip Granovsky died in Ontario on Dec. 24, 1995 with this dual-will plan in place. Probate fees were calculated and submitted on his primary will alone, which covered about \$3 million in assets. Full disclosure was made about the secondary will and the value of the estate. In October 1996, the Court issued a limited grant on the condition that a full hearing be conducted on the law around the issue. In November 1997, his executor's application for an order confirming the arrangement was opposed by the lawyers for the province. In 1998, Justice Susan Greer of the Ontario Court (General Division)<sup>10</sup> concluded the plan was valid and that there was no obligation to probate both wills, nor was there any obligation to pay probate fees on all the assets. Mr. Granovsky's family saved probate fees on about \$25 million worth of private company shares. The province of Ontario appealed. In the meantime, however, the Supreme Court of Canada ruled in October 1998 in the case of *Re Eurig*.<sup>11</sup>

The province seems to have formed the view that the EATA, passed in response to the *Eurig* decision, put a stop to the dual-will plan. It therefore abandoned the appeal of the *Granovsky* decision. However, according to lawyers involved in the case, when the EATA was introduced, there was no change to the actual wording of the statute section dealing with limited grants. Accordingly, for the moment, there would seem to be no down-side to using the dual-will strategy in Ontario. The only cost of implementing the plan is really the cost of a second will. If a future test case or change in the law result in full Ontario probate tax being payable, the taxpayer is really no worse off than they would have been with a single will originally.

## Summary

Taxpayers often misunderstand a variety of estate planning issues. Probate planning is an important consideration. However, in their efforts to avoid probate fees, taxpayers may fall into traps which are far more expensive than the probate fees they wish to minimize. Advisors can help clients understand the options by taking the time to talk through the unique needs of each client.

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First published February 2000

Last revised November 2014

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<sup>10</sup> *Granovsky vs Ontario*, (1998) 156 D.L.R. (4th) 557, (1998) 21 E.T.R. (2d) 25.

<sup>11</sup> See footnote 1.