Recent changes in Canada in the areas of trusts and estates law

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Abstract

This article discusses various types of trust planning currently and historically used by practitioners in Canada for their Canadian resident clients. Additionally, it explores the recent legislative changes to the Canadian trust and taxation laws that impact those types of planning, and the benefits previously associated with those structures. These changes include elimination of preferential tax treatment of testamentary as well as immigration trusts. Considerations of how to deal with these changes are also explored. Finally, an analysis of tax amnesty in Canada, known as the Voluntary Disclosure Program, is discussed.

Executive Summary

Canadian practitioners frequently use trusts to execute tax, personal succession, and business succession planning strategies for their clients. While the laws applicable to the tax and other benefits derived from trust planning at any given point in time will continue to be subject to change based on the government’s interest in controlling or curtailing such benefits, trusts continue to have an important and robust role in Canada.

There are a variety of planning strategies, both inter vivos and testamentary in nature, that are used widely. Over the last couple of years, however, there have been changes to the Canadian Income Tax Act (the ‘ITA’),1 and developing case law that alters the effectiveness of the use of trusts in certain circumstances.

The two types of trusts, inter vivos and testamentary, are currently subject to different tax regimes in Canada. Until the imposition of the proposed amendments of 2014 Federal Budget to the ITA, testamentary trusts are subject to graduated tax rates, whereas inter vivos trusts are subject to tax at the highest marginal rate. A great deal of testamentary trust planning revolved around the establishment of multiple testamentary trusts created under a Will so that these graduated rates could be enhanced over multiple beneficiaries. The tax-related benefits to this type of planning have been eliminated.

The Canadian rules applying to the taxation of offshore trusts went through multiple iterations starting with the earlier draft revisions in 1999 and becoming law, in 2013 with retroactive effect (subject to limited grandfathering) to taxation years beginning in 2007. These rules continued to allow for certain tax benefits for new immigrants when properly establishing trusts that were commonly referred to as ‘immigration trusts’. The 2014 Federal Budget will also eliminate the tax benefits to this type of planning. There are other types of offshore planning that are still available with the right fact pattern that can allow Canadian resident beneficiaries of offshore trusts to enjoy the benefit of trusts that accumulate income offshore tax free, with the tax-paid capital being available for the Canadian resident beneficiaries.

Tax amnesty, referred to in Canada as our Voluntary Disclosure Program (VDP), continues to

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1 R.S.O. 1985, c 1 (5th Supp).

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be very important for Canadian practitioners to understand and to use in appropriate circumstances for their clients. The manner in which the VDP is applied and the concessions made by the government with respect to interest and penalties arising from making disclosures are important to consider along with the consequences of such disclosures. The VDP is another example of Canada’s legislative attitude towards finding a balance between fair taxation and providing for tax benefits and breaks in certain circumstances.

In summary, this article will discuss the various types of trust planning currently being used by practitioners for their clients resident in Canada and also the planning with offshore trusts for the benefit of Canadians. It will also review the recent legislative changes that have an impact on the tax or other benefits previously associated with that type of planning. Finally, an analysis of the Canadian VDP will be reviewed.

I. How Robust is Trust Planning in the Region?

(a) Trusts—Generally

All across Canada, both inter vivos and testamentary trusts are widely used for many purposes. They provide an effective vehicle to reduce income tax and also provincial probate fees on death. In Ontario, with the recent changes to the provinces Estate Administration Tax Act, 1998 footnote and its more significant and onerous reporting obligations, we foresee the use of inter vivos trusts as Will substitutes increasing in importance.

There are also changes to the taxation of testamentary trusts and estates which will impact the use of multiple testamentary trusts for the purposes of income splitting.

This section of the article will discuss the various types of trusts employed throughout Canada, the use of these trusts in estate and tax planning, and the recent changes to the taxation of trusts relevant to an international audience.

(b) Alter-Ego Trusts and Joint Spousal or Common Law Trusts

(i) Generally

These types of trusts are becoming increasingly popular as an estate planning tool, as they allow taxpayers to transfer property into a trust on a tax-deferred ‘rollover’ basis, while allowing the taxpayer to retain an interest in the property. These types of trusts also provide planning opportunities with respect to addressing incapacity, reducing or eliminating probate, protecting against claims under dependants’ relief legislation, confidentiality, and continuity of management.

(ii) Conditions to be Met

For both alter ego and joint spousal trusts, the transferor of the property to the trust must be at least 65 years old at the time of the trust’s creation. The transferor, in the case of the alter ego trust, or the transferor and/or his or her spouse or common law partner, in the case of the joint spousal trust, must be entitled to receive all of the trust’s income while alive. No person, with the exception of the transferor or his or her spouse or partner, as the case may be, can receive or otherwise obtain the use of any of the income or capital of the trust before the transferor’s death or, in the case of the joint spousal trust, the transferor’s spouse’s death. It has been questioned whether these conditions must only be met at the time the trust is established or if such conditions must be maintained throughout the trust’s existence.
Moreover, it is not clear whether two spouses or partners can contribute to the same joint spousal trust. On the death of the transferor or his or her spouse, as the case may be, any person can benefit from the trust. It could be required that the trust be wound up and the trust assets distributed as per the terms of the trust deed. Alternatively, the trust deed could provide that the trust is to continue after the death of the transferor or his or her spouse, as the case may be. Since it is not a testamentary trust however, any trusts for the remainder beneficiaries will not be entitled to graduated rates of taxation, otherwise applicable, but as will be discussed below, the change to the taxation of testamentary trust status will likely bolster the efficacy and popularity of these trusts.

(iii) Exception to the 21-Year Rule
The ITA provides that most personal trusts are deemed to dispose of their capital assets on the trust’s 21st anniversary and every 21 years thereafter bringing all accrued capital gains into income. Income tax must then be paid. Without an actual disposition, this is often a problem as the trust may lack sufficient liquid assets to pay any tax owing. Often, to defer the application of tax, the assets of the trust are rolled out to the capital beneficiaries prior to the 21st anniversary of the trust.

The 21-year rule does not apply to alter ego and joint spousal trusts. A deemed disposition of the trust’s assets will, however, occur on the death of the transferor, in the case of an alter ego trust, and on the death of the last to die of the transferor and his or her spouse or partner, in the case of a joint spousal trust. Should the trust continue beyond either of these two triggering events, there will be a deemed disposition of the trust’s assets every 21 years thereafter.

An election can be made by an alter ego trust to have the 21-year rule apply to the trust. If such an election is made, regardless of when the transferor dies, the trust will be deemed to dispose of its assets for their then fair market value on its 21st anniversary. If this election is made, assets cannot be transferred to the trust on a tax-deferred basis.

(iv) Selected Benefits
There are a number of benefits to using an alter ego or joint spousal trust, including: (i) minimization of professional fees as a probate application may no longer be required on death; (ii) minimization of estate litigation; (iii) possible asset protection; and (iv) less chance of assets being lost or forgotten about on death as they will have been transferred to the trust during the taxpayer’s lifetime. While these are all important reasons to set up an alter ego or joint spousal trust, the most common reasons for the establishment of such trusts include: (i) the minimization of estate administration tax payable on death; (ii) confidentiality of the distribution of assets on death and the value of wealth on death; (iii) prompt distribution of assets on death; (iv) efficient and effective method to deal with international

6. ibid 3. The authors suggest that, pursuant to a strict reading of the ITA, this is not permissible. It should be noted that others have stated that such contributions are allowed.

7. The continuation of the trust may be desirable from an income tax perspective. The rule respecting the 1-year carry back of capital losses of the deceased at death (pursuant to subsection 164(6) of the ITA) does not apply to deal with post-mortem capital losses of a trust. Instead, the loss triggered by the death of the transferor is realized by the trust and, therefore, a 3-year carry back of the loss is allowed (para 11 1(1)(b) of the ITA). The trust needs to continue after the death of the transferor to permit the use of this longer carry back period:

8. Sub-s 104(4)(a) of the ITA.

9. Note that where the income attribution rule found in sub-s 75(2) of the ITA applies or has ever applied to a trust the trust is denied the opportunity to utilize this tax-deferred roll out. See ss 107(4.1) of the ITA.

10. Para 104(4)(b) of the ITA.

11. ibid ss 104(4).

12. But not a joint spousal trust.

13. Subpara 104(4)(a)(ii.1) of the ITA.

14. ibid ss 73(1).
assets; (v) effective management of assets during a subsequent mental incapacity; and (vi) opportunities for interprovincial tax planning. The tax planning benefits associated with these types of trusts will be discussed further below.

(v) Inter-Provincial Trust Planning within Canada

Subsections 104(13.1) and 104(13.2) of the ITA allow an election to have the income of an alter ego or joint spousal trust taxed in the trust and not in the hands of its beneficiaries. In this regard, the tax rates of a low tax province can be applied.15

For inter-provincial tax planning to succeed, subsection 75(2) of the ITA cannot apply to the alter ego or joint spousal trust at any time. Subsection 75(2) of the ITA is an income attribution rule. It applies whenever a person transfers property to a trust on the condition that (i) the property may revert to the person; (ii) the person may determine who can receive the property; or (iii) the property cannot be dealt with without the person’s consent or must be dealt with only on the instructions of the person. If the rule applies, all income, gains, and losses of the trust will be attributed to the transferor. The rule ceases to apply upon the death of the taxpayer or if the taxpayer ceases to be a resident of Canada for income tax purposes.

Not surprisingly, subsection 75(2) will apply to most alter ego and joint spousal trusts: the settler will be a capital beneficiary and/or will have the power to control the trust property. As a consequence, all of the income and gains will be attributed to the transferor.

Avoiding the application of subsection 75(2) requires that the transferor not be a capital beneficiary. The transferor also ought not to be the sole trustee or a trustee with veto power over the trustee decisions. Finally, the transferor cannot have the power to revoke the trust.

It is also possible to avoid the application of the rule by making a loan of assets to the trust on an interest-free basis.18

To ensure that the residency of the trust is in a low-tax province, a trustee in the low-tax province would have to be appointed and the mind and management of the trust would have to be maintained in the low-tax province. As such, the transferor would need to appreciate the control he or she would have to relinquish to the trustee. Typically, the use of a trustee in a low-tax province will lead to additional costs.

Case law suggests that there is nothing inherently abusive about shifting income amongst the provinces or ‘rate shopping’.21

(c) Testamentary Trusts

(i) Generally

A testamentary trust is a trust that arises on and as a consequence of the death of an individual. Currently, an estate and other testamentary trusts are taxed at graduated rates in the same way as an individual. This has, historically, provided testators with the ability to plan for income splitting upon their death between the estate and its beneficiaries. This was a popular and widely used estate planning tool, until recently when the Canada Revenue Agency (CRA) proposed to eliminate the favourable tax treatment of testamentary trusts.

(ii) Budget Proposal Change

On 21 March 2013, the federal government tabled its 2013 budget. The government announced that it

15. Sub-s 104(13.1) of the ITA.
16. It should be noted that some provinces (eg Quebec) have provincial laws in place to prevent such tax planning.
17. Does not include reversion of property by operation of law. See CRA doc. 2002-0116535.
19. See n 18.
22. S 108(1) of the ITA ‘testamentary trust’.
would consult on eliminating the tax benefit currently enjoyed by testamentary trusts and estates. The federal government released its consultation paper to solicit public comment on possible measures to deal with a perceived unfairness in taxing testamentary trusts and estates in a different manner than inter vivos trusts on 3 June 2013.23 The government was concerned that the use of testamentary trusts or the delay in administering estates were provoked by a wish to reduce income tax payable. Consequently, the government suggested that testamentary trusts be taxed at the same top tax rate as inter vivos trusts. In addition, the government proposed to tax estates at the highest graduated tax rate applicable to individuals as of the 36th month anniversary of the date of death.

In the 2014 Federal Budget, the government further announced that it would go ahead with the transition discussed above and eliminate the graduated rates afforded to testamentary trusts. There was one exception provided for trusts established for the benefit of disabled beneficiaries. Therefore, it is possible that the use of inter vivos trusts may increase, since the tax benefits currently afforded to testamentary trusts are not always the main motivation for their creation. As a result, individuals may soon consider establishing such trusts during their lifetime as opposed to waiting until their death if the tax treatment is the same or comparable. The confidentiality offered by trusts is appealing to many individuals. The distribution of assets from a trust can generally occur more quickly than if an estate requires probate before its assets can be distributed to the beneficiaries. Further, an inter vivos trust can provide the same non-tax benefits enjoyed by testamentary trusts such as protecting children from a previous relationship in the situation of a blended family24 and safeguarding beneficiaries who are not financially sophisticated or have substance abuse problems. In addition, in Ontario, such trusts would have the additional benefit of moving the assets out of the individual’s estate and, consequently, reducing the amount of probate fees payable.

(d) Estate Freezing25

An estate freeze is a reorganization in which the value of an investment, such as the common shares of a corporation, is frozen at their fair market value at the date of the freeze. An estate freeze can be done with corporations, partnerships, or different forms of ownership, such as an investment portfolio. Typically, the freezeor exchanges common growth shares for fixed value preferred shares of equal value, with the next generation acquiring new common growth shares. The idea is to freeze the value of the current generation’s assets and shift the future growth in value elsewhere.

Estate freezes are particularly effective when the value of the assets are expected to increase significantly before the individual’s death, and when the children are expected to hold the shares after the death of the freezeor. There are many factors to consider when determining whether to implement an estate freeze and what approach to take: the age, lifestyle and health of the owner, the nature and size of the business, the future growth prospects of the business, current and future market conditions, interests of other family members or third parties, cash flow, sufficiency of assets and standard of living, other assets and income available to the owner, amount of accrued income tax liability and exposure to creditors.

Estate freezing is a useful tool to accomplish a variety of estate planning objectives. Trusts are also an integral part of effecting an estate freeze in a manner that is conducive to the tax planning as well as familial and other objectives.

24. A trust could be established for the benefit of children from a previous relationship so that on the death of the parent, while some of their assets will pass to their new spouse or partner, some of their assets will be kept separate and reserved for the benefit of their children from the previous relationship. Trusts, inter vivos, and testamentary are very popular for the blended family situation.
25. For a more in-depth discussion, see William Fowlis, Bryant Frydberg and Regan O’Neil, “Trusts and their Taxation” Miller Thomson on Estate Planning (Thomson Reuters 2012).
(i) Benefits of Estate Freezes
Generally speaking, any accrued capital gains are taxable at death.26 An estate freeze does not defer capital gains that have accrued up until the point of the freeze; however, it does reduce the value of the freezee’s capital property that will be subject to the deemed disposition. Therefore, the amount to be taxed at death will be limited to the freeze value and any subsequent increase in value of the frozen assets will accrue to the next generation. Further, estate freezes allow for shifting value in a corporation (for example) while still maintaining control and involvement in the business.

An estate freeze also assists in calculating and fixing the tax liability to be incurred when the freezer dies. This provides certainty for tax planning in the determination of the tax liability and the planning involved in satisfying such liability.

Estate freezes provide the opportunity, where applicable, to apply and multiply the capital gains deduction. At present, individuals are permitted a capital gains deduction27 of $750,000 realized on qualified small business corporation shares or qualified farm properties. The manner in which this deduction can be multiplied will depend on the structures involved.

Income splitting is another important benefit of an estate freeze. The opportunity to split income among family members is accomplished primarily through the distribution of dividends among family members with more favourable marginal rates, or those living in provinces with lower rates, in general.

(e) Non-Resident Trusts and Foreign Investment Entities28
(i) Changes to Method of Taxing an Non-Resident Trust and Resident Contributors
Prior to 2009, a trust was regarded as being a resident of the jurisdiction in which the majority of the trustees are resident.29 However, in Garron Family Trust v The Queen (‘Garron’),30 the Tax Court of Canada, per Woods, J. (also confirmed by the Supreme Court of Canada), applied a test similar to the common law residency test for corporations and held that a trust is resident where its central management and control actually abides. As a result, ensuring that a trust is non-resident under the common law is no longer as simple as it once was. A determination of the trust’s central management and control must be made before considering the Non-Resident Trust (NRT) rules since a trust settled in a foreign jurisdiction may be resident in Canada pursuant to Canadian common law.

Canada has complex rules dealing with preventing the avoidance or deferral of tax by Canadian residents through the use of planning techniques involving offshore trusts. After well over a decade of debate, consultation, and consideration, on 26 June 2013, Bill C-48 received royal assent. Bill C-48 is an omnibus tax bill that includes, among other measures, revised rules for the taxation of NRT in Canada (collectively, the ‘NRT Rules’). Retroactive to 1 January 2007, the NRT Rules amend section 94 of the ITA and established measures aimed at restricting the use of offshore or NRTs as a means of limiting or deferring the payment of income taxes in Canada. Under these rules, there continued to be an exception for trusts where the Canadian resident contributor to the trust had been a resident of Canada for less than 60 months in the aggregate in their lifetime. This 60-month tax holiday was commonly referred to as the ‘immigration trust’ exception. It will be discussed further after reviewing the application of the rules in a more general fashion but in general, the definitions regarding the taxation of NRT’s in the 2014 Federal Budget amend the definitions of ‘connected contributor’ and ‘resident contributor’ in order to eliminate the use of immigration trusts.

26. See s 70(5)-(10) of the ITA.
27. See s 110.6 of the ITA.
28. For a more in-depth discussion, see John Campbell and James Fraser, “Estate Freezing” Miller Thomson on Estate Planning (Thomson Reuters 2012).
Generally, where a trust is not resident in Canada, in accordance with the Garron principles, newly adopted section 94 of the ITA sets out certain conditions in which an otherwise NRT would be subject to Canadian income tax. In contrast to the replaced section 94 of the ITA, there are two different tests that can result in the NRT being deemed to be resident in Canada for Canadian income tax purposes:

- where there is a Canadian resident contributor; or
- where there is a Canadian resident beneficiary.

In the event that there is either a resident contributor to the NRT, OR, a resident beneficiary, the NRT will be deemed to be resident in Canada and liable to tax under subsection 94(3) of the ITA.

In particular, when caught by the deeming provisions, an NRT is deemed to be resident in Canada throughout the particular taxation year for the purposes of computing its income for the particular taxation year, determining its liability for tax under Part I of the ITA and for determining the liability of a non-resident person for tax under Part XIII of the ITA.31

In addition, each person who is at any time in the particular taxation year a resident contributor to the NRT or a resident beneficiary under the NRT is jointly and severally liable with the NRT for the NRT’s Canadian tax.32

(ii) Resident Contributor

A resident contributor to an NRT at any time is defined as being a person who is, at that time, both resident in Canada and a contributor to the NRT. In addition, prior to the 2014 Federal Budget, it did not include an individual (other than a trust) who had not, at that time, been resident in Canada for more than 60 months during such person’s lifetime.33 This exception is being removed.

In analysing the resident contributor definition, one must look to the meaning of the word contributor since this is also a defined term. A contributor to an NRT at any time means a person who at, or before that time, has made a contribution to the NRT. Note that the definition of resident contributor requires that the person be both resident in Canada and a contributor to the NRT at a particular time, but the definition of contributor means a person who at or before that time has made a contribution. Therefore, if a person makes a contribution while a non-resident, and subsequently becomes resident, he or she will at that later time become a resident contributor.

A contributor also includes a person who has ceased to exist. The CRA agrees, however, that a person who is deceased cannot be a resident contributor, but only a contributor. The definition of contributor also contains a defined term being the word contribution. This is one of the most difficult and also fundamental aspects of the legislation. A contribution at any time to an NRT by a particular person or partnership means a transfer or loan, at that time, of property to the NRT by the particular person or partnership (other than by an arm’s length transfer).34

It should be noted that under the special provisions of subsection 94(2) of the ITA, there are at least 12 further rules which may deem a person to have transferred property in certain circumstances. The clear intent of the legislation is to address every conceivable situation under which property can be transferred from a Canadian resident person to an NRT. However, it is important to note that a loan made by a specified financial institution (ie a bank) to an NRT will not cause said institution to become a resident contributor where the loan is made on

31. Para 94(3)(a) of the Act
32. In order to be subject to the NRT Rules, the foreign entity must constitute a trust for Canadian tax purposes. Generally, if the foreign entity constitutes a trust within the meaning of the laws of that foreign jurisdiction, the foreign entity will be considered to be a trust for Canadian tax purposes. For a review of foreign entities as trusts for the purposes of the NRT Rules, see Guy Fortin, ‘Strangers in Strange Lands: The Hidden Traps of Offshore Trusts’, Report of Proceedings of Fifty-First Tax Conference, 1999 Tax Conference (Toronto: Canadian Tax Foundation, 2000) 40:1–68.
33. Sub-s 94(1) of the Act ‘resident contributor’, ‘contributor’, ‘contribution’.
34. Sub-s 94(1) of the Act ‘contribution’.
commercial terms and in the ordinary course of the institution's business.  

(iii) Resident Beneficiary

An NRT will also be liable to Canadian tax under subsection 94(3) of the ITA if, at the end of the year of the NRT, there is a resident beneficiary. The choice of the term resident beneficiary is an unfortunate one since it is a misnomer in that it means more than simply a beneficiary of the NRT who happens to be resident in Canada.

To determine whether there is a resident beneficiary at any time under a particular NRT includes a two-pronged test in that there must be both a connected contributor and a beneficiary resident in Canada (other than an exempt person or successor beneficiary in respect of a trust). The word beneficiary as used in this test is also a defined term in proposed subsection 94(1) of the ITA and it extends the meaning of beneficiary to include a person beneficially interested and a person who may receive income or capital of the NRT indirectly through other entities. For example, a shareholder of a corporate beneficiary can be considered a beneficiary of an NRT.

A connected contributor to an NRT means a contributor to the NRT, but excludes a person whose contribution to the NRT is made at what is called a 'non-resident time'. Previously, the definition also excluded an individual (other than a trust) who was before the particular time not resident in Canada for a total of 60 months during that person's lifetime. The reference to a person who has not resided in Canada for more than 60 months is being eliminated. As a result, in cases where there is a beneficiary resident in Canada, an otherwise NRT will be deemed to be resident in Canada where there has been a contribution by a person to the NRT otherwise than at a non-resident time of that person.

The 'non-resident time' of a person in respect of a contribution to an NRT means a time (the 'Contribution Time') at which the person made a contribution to an NRT, that is before the particular time (ie the taxation year end of the NRT) and at which the person was non-resident (or not in existence). However, such a time will qualify as a non-resident time only if the person was non-resident (or not in existence) throughout a specific period. This specific period refers, in particular, to the period that begins 60 months before the Contribution Time and ends at the earlier of 60 months after the Contribution Time and the particular time.

Subsection 94(10) of the ITA provides that a contributor will, for the purposes of the definition of connected contributor, be considered to have made the contribution at a time other than a non-resident time if the contributor becomes resident in Canada within the 60-month period after the Contribution Time.

In such a case, at the end of each of taxation year of the NRT following the contribution, there would be a connected contributor to the NRT and, where there is a resident beneficiary under the NRT, subsection 94(3) of the ITA would also apply in respect of those years to deem the NRT to be a resident of Canada.

Moreover, a successor beneficiary who is resident in Canada is not considered to be a beneficiary for the purposes of the definition of resident beneficiary. In order to fall within the definition of successor

35. Para 94(2)(c) of the Act.
36. In short, an 'exempt person' includes persons who are exempt from tax under Part I of the Act, such as registered charities and Crown corporations.
37. Sub-s 94(1) of the Act 'resident beneficiary'.
38. Sub-s 248 (25) of the Act 'beneficially interested' and sub-s 94(1) of the Act 'beneficiary'.
beneficiary, the beneficiary’s interest must arise only after the death of an individual who is alive and a contributor to the NRT or on the death of a person related to the contributor (including an uncle, aunt, niece, or nephew of the contributor).39

To summarize, an NRT will be deemed to be a resident of Canada under proposed subsection 94(3) of the ITA if there is either a resident contributor to the NRT (described earlier) or a resident beneficiary under the NRT. In order to have a resident beneficiary under an NRT, there must be both a Canadian resident beneficiary under the NRT and a connected contributor. Any person who has transferred property to the NRT, including a person who has ceased to exist, will be a connected contributor to the NRT unless exempted by certain rules, including, for our purposes, because they have made the contribution during a non-resident time. There will no longer be an exemption for those individuals who have not been resident in Canada for an aggregate of 60 months.

(iv) Resident and Non-Resident Portion

Where subsection 94(3) of the ITA applies to an NRT, the NRT is deemed to be a resident of Canada for the purposes of computing its worldwide income that is not otherwise distributed to its beneficiaries or attributed to an electing contributor (further explained below).

The NRT Rules propose that an NRT’s property be divided into two portions: (i) a taxable portion defined as the resident portion and (ii) a non-taxable portion defined as the non-resident portion.40

Generally speaking, the resident portion includes all property (and any property substituted for such property) acquired by the NRT by way of contribution from a connected contributor or a resident contributor. In short, contributions of property to the NRT will form part of the resident portion to the extent that they were made by current or former residents of Canada. It is also important to note that due to the application of subsection 94(10) of the ITA, if a non-resident person makes a contribution at a time which is within 60 months of becoming a resident of Canada, the property contributed will form part of the resident portion as of the contribution date.

Moreover, where the NRT acquires property, which would not form part of the resident portion (e.g. because a resident did not contribute said property), but in acquiring the property the NRT incurred indebtedness (e.g. by way of a loan, or the unpaid portion of the purchase price) to fund its acquisition, the NRT Rules apply a formula to allocate a part of the fair market value of said property to the resident portion of the NRT.

In short, the formula will allocate a part of the property to the resident portion of the NRT to the extent of the greater of:

- the fair market value of the property multiplied by the proportion that the total fair market value of all property held in the resident portion of the NRT at the beginning of the NRT’s taxation year in which the NRT acquired the property is of the total fair market value of all property held by the NRT at the beginning of the NRT’s taxation year in which the NRT acquired the property; and
- the fair market value of the property multiplied by the proportion that the total fair market value of all property held in the resident portion of the NRT at the end of the NRT’s taxation year in which the NRT acquired the property is of the total fair market value of all property held by the NRT at the end of the NRT’s taxation year in which the NRT acquired the property. Moreover, this amount must be determined as if the property in question was not held by the NRT at the end of that taxation year.41

In addition, when income of the NRT is not distributed to its beneficiaries, the amount of the

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39. Sub-s 94(1) of the Act ‘successor beneficiary’.
40. Para 94(3)(f) of the Act and sub-s 94(1) of the Act ‘resident portion’ and ‘non-resident portion’.
41. Sub-s 94(1) of the Act ‘resident portion’.
accumulated income for the relevant taxation year will form part of the NRT’s resident portion and thus, will be subject to taxation in Canada.\(^{42}\)

The non-resident portion includes all property held by the NRT that is not part of the resident portion.\(^{43}\) As mentioned above, the income derived from property forming part of the non-resident portion is not subject to taxation in Canada, except to the extent that the amount represents income from sources in Canada on which the NRT would normally pay tax if it were a non-resident of Canada throughout the taxation year in question.

In contrast, the prior enacted NRT Rules required a deemed resident trust to pay Canadian income tax on all of its income, regardless of who contributed the property on which the income was earned. As a result, the NRT Rules protected resident contributors since they were no longer liable for Canadian income tax, through the mechanism of joint and several liability, on income earned from property that has no link to the specific property contributed by them.

Also, in computing the NRT’s income, the NRT could have deducted certain amounts paid or payable to beneficiaries pursuant to subsection 104(6) of the ITA.\(^ {44}\) The NRT is still also able to deduct amounts included in the income of an electing contributor (further explained below).

\(\text{(v) Taxation of Resident Contributors}\)

The NRT Rules render each resident contributor and resident beneficiary under the NRT, jointly and severally liable with the NRT for the tax payable by the NRT. This effectively attributes the NRT’s income, arising from the property forming part of the resident portion, to said persons.\(^ {45}\)

Section 94 of the ITA provides, however, that a resident contributor may elect to have this income attribution limited to the NRT’s income for the year multiplied by the fair market value of his or her contributions to the NRT in proportion to the fair market value of all contributions made by all resident contributors and connected contributors.\(^ {46}\) Thus, subsection 94(16) of the ITA has the effect of attributing to a resident contributor his or her proportionate share of the income of the NRT.

In computing the income inclusion, the NRT’s income is determined after taking into consideration deductions permissible under subsection 104(4) of the ITA, such as amounts paid or payable to beneficiaries. The amount attributed to the electing contributor may also be reduced by losses incurred by the NRT in previous years and claimed by the NRT in the current year.\(^ {47}\) However, the income of the NRT that is attributable must be calculated before considering amounts deducted by the NRT and attributed to an electing contributor. As is the case for resident trusts, losses of an NRT cannot be attributed to an electing contributor.

In order for an election to be valid, it must be filed with the Minister of National Revenue on or before the resident contributor’s filing due date for the first taxation year of the resident contributor for which the election was to take effect and the election must include both the NRT’s account number assigned by the Minister of National Revenue (ie the number located at box 14 of the T3 information slip) and evidence that the resident contributor notified the NRT, no later than 30 days after the end of the NRT’s taxation year that ends in the initial year, that the election would be made.

Finally, it is important to note that said election is not available to a resident beneficiary and thus,
a resident beneficiary remains subject to the attribution rules mentioned above.

(vi) FIE Rules

Practitioners dealing with NRTs should also still consider the potential application of section 94.1 of the ITA to any planning. Section 94.1 provides rules for the Canadian tax treatment of investments in offshore investment fund property (the ‘FIE Rules’). The FIE Rules are, in general, engaged when a taxpayer holds or has an interest in or a right to acquire an interest in property that is a share in the capital stock of, an interest in or a debt of a ‘non-resident entity’.

With respect to NRTs, together with the NRT Rules, the definition of ‘non-resident entity’ in subsection 94.1(2) of the ITA has been amended such that a ‘non-resident entity’ includes an ‘exempt foreign trust’, other than a trust falling within paragraphs (a) to (g) of the definition of an ‘exempt foreign trust’ in subsection 94(1) of the ITA. This addresses matters regarding the potential application of the FIE rules to beneficiaries of discretionary or certain non-resident family trusts to which the NRT Rules did not apply. Paragraphs (a) to (g) of the definition of an ‘exempt foreign trust’ include, inter alia, trusts established for charitable purposes, trusts settled solely for the maintenance of infirm dependants, trusts settled as a result of a marriage breakdown and/or trusts established for pension or employee benefits. As such, legitimate NRT arrangements that are not subject to the NRT Rules are likely to also fall outside the purview of the FIE Rules.

Section 94.2 deems certain NRT funds to be controlled by foreign affiliates for the purposes of the ITA, and accordingly subject to the ITA’s rules regarding foreign accrual property income. Section 94.2 will generally apply to taxpayers and persons not dealing at arm’s length with the taxpayer with fixed interests of 10 per cent or more in commercial offshore trust funds. Section 94.2 may also apply to taxpayers who transfer ‘restricted property’ to an NRT fund. ‘Restricted property’ is defined in subsection 94(1) of the ITA to include, inter alia, shares in a closely held corporation that are issued as a result of an estate freeze or similar reorganization-like transaction. Section 94.2 is also being amended to reflect the elimination of the immigration trust exemption. These rules will now apply to any beneficiary under a non-resident commercial trust or a particular person of which any such beneficiary is a controlled foreign affiliate with no long having an exclusion for a person who has been resident in Canada for less than an aggregate of 60 months in their lifetime.

2. Tax planning used to be core to our business—do your regions regard this as legitimate activity?

Estate and tax planning is and remains to be a legitimate and necessary activity for lawyers in Canada, especially with respect to the many legislative changes that have occurred and continue to occur.

As discussed in Part 1: How Robust is Trust Planning in the Region? of this article, inter vivos trusts, testamentary trusts, and NRTs are all utilized for planning purposes but regulated to reduce and control the associated benefits. The most recent changes affecting the testamentary trust tax rate and the elimination of immigration trusts are quite a substantial change as well as a clear demonstration of Canada’s balance with respect to permitting and regulating tax planning endeavours.

(a) Use of Inter Vivos Trusts in Estate Planning

(i) Alter Ego and Joint Partner Trusts

Alter Ego and Joint Partner Trusts are important mechanisms for tax planning. Firstly, they are increasingly popular will substitutes and they provide a tax deferral for assets transferred to the trust.

As will substitutes these trusts can be particularly useful. Since the residual beneficiaries become entitled to the income and capital of the trust upon the life tenant’s death (either the settlor for an Alter Ego trust and...
the spouse for a Joint Partner trust), these trusts operate similarly to wills. However, they also provide benefits that dispositions of property by Will do not, for example asset protection from creditors or dependents and avoidance of probate taxes on the assets held in trust.

Another tax planning advantage of these trusts is the tax-free rollover available to the settlor for the transfer of assets into the trust and that the 21-year deemed disposition does not apply to these trusts. Rather, the deemed disposition will occur, in the case of an Alter Ego Trust, upon the death of the settlor and in the case of a Joint Partner Trust, upon the death of the spouse of the settlor.

(ii) Estate Freezing
An estate freeze is a popular estate planning tool used in Canada that typically involves the use of at least one trust. Generally, an estate freeze involves a person with common shares of a private corporation with a significant accrued capital gain (the ‘freezor’) exchanging his or her common shares for fixed value preference shares of the corporation on a rollover basis. Those preference shares will have a value that is equal to the fair market value of the corporation at the time of the freeze. Upon the exchange, a trust for the benefit of the freezor’s family members (for example) would subscribe to new common shares. All of the future growth of the corporation would accrue to those new common shares held in the family trust.

The trusts that hold these shares are useful for similar reasons as mentioned above, specifically in the sense that the freezor is typically one of several trustees and likely maintains control over the common shares without the corresponding tax implications. The tax rules known as the ‘attribution rules’, discussed above, are important to consider in this type of estate or tax planning, especially where the freezor intends to maintain some level of control over the new common shares.

(b) Insurance Trusts
Insurance trusts are inter vivos trusts that are established to hold policies of life insurance during the life of the insured. The insurance trust has the double benefit of ensuring that policies of life insurance are kept outside of an individual’s estate (for probate/estate administration tax purposes) and for ensuring that they remain outside the reach of an individual’s creditors.

When the death benefit is paid into the trust after the individual’s death, the trustees may distribute funds to the deceased’s estate, or may distribute the funds to other beneficiaries of the insurance trust, depending on the terms of the Insurance Trust.

Prior to the proposed amendments of the taxation of testamentary trusts, insurance trusts established under testators’ wills were also subject to testamentary trust status. While the graduated rate taxation is no longer available for this type of testamentary trust, insurance trusts are useful in avoiding probate and claims from creditors for life insurance proceeds.

(c) Testamentary Trust Planning
Pursuant to the proposed amendments to the ITA concerning the change in the manner of taxation of testamentary trusts and estates, the historically popular use of testamentary trusts as a mechanism for income splitting is no longer available.

Testamentary trusts are still necessary and useful in circumstances where beneficiaries under a testator’s will can or should not receive their respective interests outright. Practically speaking, there could be a tax advantage to this in that income in a testamentary trust can be deemed to be earned in the hands of the beneficiary of such trust and taxed at that individual’s graduated rates under subsection 104(13) of the ITA. However, this is not as significant a tax planning strategy as it was prior to the Budget’s proposed amendments since the trust itself is no longer treated

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49. Sub-s 73(1) and (1.01) of the ITA.
50. Sub-s 104(4) of the Act.
as an individual taxpayer subject to the graduated rates of tax.

(d) Offshore Trust Planning

(i) Immigration Trusts

Until this year, the Canadian government continued to maintain a special exception to the NRT rules for high-net worth immigrants to Canada in an attempt to entice them to relocate to Canada rather than some other jurisdiction. While, like all other residents of Canada, immigrants must pay tax on their worldwide income or capital gains earned, Canada permitted high-net worth immigrants to use a qualified NRT—frequently referred to as an ‘immigration trust’—to protect, legitimately, the income earned in such a qualified trust from Canadian taxes for up to 60 months. Subject to the 2014 Federal Budget, the Immigration trust and its corresponding tax incentives have been eliminated.

Previously, the manner in which the immigration trust operates was as follows. The immigrant could be the settlor of the trust. Without this special exemption for immigration trusts, the existence of a Canadian resident settlor would deem the NRT to be resident of Canada and, therefore, income earned in the trust would be taxable as a part of the immigrant’s worldwide income. The beneficiaries of the trust were typically the immigrant and his or her family.

The trust would most often be resident in a low or no income and/or capital gains taxing jurisdiction. In this respect, the immigrant could take full advantage of the tax savings. There were other important factors to consider when deciding on the appropriate jurisdiction. Such factors include language barriers, asset protection legislation, banking and financial infrastructure, political stability, time zone differences and the reputation of the service providers.

Under the 2014 Federal Budget, the NRT rules will have the 60-month exemption removed for taxation years ending after 10 February 2014. As a result, an immigration trust will be deemed resident in Canada and subject to taxation on its worldwide income. Limited relief is available for immigration trusts that were established and funded before 11 February 2014.

In those cases, if there are no contributions made to the trust after 10 February 2014, the trust can continue to benefit from the exemption until 31 December 2014. Starting from 1 January 2015, the trust will become subject to worldwide income taxation.

It is, therefore, important that prior to 1 January 2015, all outstanding immigration trusts be reviewed in order to be considered any tax planning opportunities or different wind up strategies. Some options to be considered prior to 31 December 2014 include:

1. winding up the holding company beneath the trust (if one was included) before the end of the year in order to get a step up in the cost base in the underlying investments rather than in the shares of the offshore holding company;
2. the settlor may decide to emigrate from Canada and therefore the trust could continue to be in existence but not be liable to Canadian tax (if the trust structure is to stay in place you would need to consider the tax implications of the settlor’s jurisdiction to which they would be taken up residence after departing Canada);
3. the trust could be dissolved prior to 31 December 2014, and on dissolution the Canadian resident beneficiaries would be deemed to dispose of the capital interests in the trust on a rollover basis and to acquire the trust assets at their fair market value cost base (no rollover would apply to non-resident beneficiaries of the trust, if any); and
4. the trust could be migrated to Canada with a step up in the adjusted cost base of the assets on migration to Canada other than taxable Canadian property and certain other property not deemed disposed of under paragraph 128.1(1)(b) of the ITA. In considering this strategy, it is worthwhile to consider migrating the trust to the Province of Alberta because it has the lowest top marginal rate of tax in the Country. However, in order for that planning to work, it would be important to ensure that the central management and control of the trust actually were in Alberta given the Garron decision and its central management and control test for residency of a trust.
In addition, if the decision is to allow the trust to take no action and the trust simply becomes a deemed resident of Canada on 1 January 1015, it is worthwhile for the client to consider that absent the tax benefits, the trust may still be a practical and useful tool for asset protection and overall succession planning.

(ii) NRTs established by former residents of Canada
Where an NRT is established by a former resident of Canada who has been a non-resident of Canada for a minimum of 60 consecutive months prior to the time of contribution of assets to the NRT, AND the settlor continues to be a non-resident of Canada for a minimum of 60 months after the time of contribution to the Trust, the NRT would not be considered to be a deemed resident of Canada under the NRT rules since the only contributions made by the settlor were made at a non-resident time. Recall that the test is whether there is either a resident contributor, or a resident beneficiary. There would not be a resident contributor since the individual at the particular time would be a non-resident of Canada, and there would not be a resident beneficiary because even if Canadians were discretionary beneficiaries of the NRT, there would not be a connected contributor to the NRT as all contributions were made at a non-resident time. One thing to also keep in mind is that in the event that a former Canadian resident leaves Canada for a minimum of 5 years, settles an NRT for the discretionary benefit of Canadian resident individuals, and then the settlor remains a non-resident of Canada a minimum of 5 years past the time of contribution to the NRT but, then, for example, after having been a non-resident of Canada for 7 years after the time of contribution to the NRT, he/she decides to return to Canada as a resident—the result would be that the NRT would become a deemed resident of Canada only while the settlor is either alive or continues to be resident in Canada; however, should no changes be made to the offshore nature of the Trust and the Trustees who have control and management remains offshore and should the settlor and any other resident Canadian not make any further contributions to the NRT, then at such time, as the settlor either dies or becomes a non-resident of Canada, the NRT will depart Canada for Canadian income tax purposes and be able to continue as an NRT that is not taxable in Canada.

(iii) Granny/Inheritance Trusts
Many families with international connections have parents or grandparents of Canadian residents who themselves have never been resident in Canada. If a grandparent or parent of Canadian resident individuals sets up either an inter vivos or testamentary NRT for the benefit of their Canadian resident issue, if drafted and established properly, this type of trust which is commonly referred to as a Granny Trust or an Inheritance Trust, will not be caught by the deeming provisions of the Canadian NRT Rules and will be able to accumulate and earn income tax-free offshore, for the benefit of the Canadian resident beneficiaries. In short, this type of trust would be settled by a non-resident of Canada who had never been a resident of Canada for the benefit of Canadian resident beneficiaries. These are NRTs that do not engage the NRT rules, since there is no Resident Contributor or Connected Contributors, and therefore no ‘Resident Beneficiary’ as the rules define them. Therefore, these types of trusts will only be taxable on the income attributable to property acquired by the trust from Canadian residents and Canadian source income. Inheritance Trusts are a useful planning tool for international families, especially in light of the elimination of Immigration Trusts as an effective tax planning structure in Canada.

(e) General Anti-Avoidance Rule
There is, also, a general anti-avoidance rule\textsuperscript{52} that serves as an additional barrier to tax planning:

\textsuperscript{52} S 245 of the ITA.
strategies within Canada. This rule applies to ‘abusive’ income tax avoidance transactions and other arrangements. The rule permits the CRA to ignore certain ‘avoidance transactions’ which are deemed to be offensive. The provision allows for a tax benefit associated with a transaction to be set aside or denied where it is reasonable in the circumstances to do so. Once this determination is made, in some circumstances, the CRA may then recalculate income tax consequences of such transactions.

3. Tax Amnesties and their Growing Use: What is Happening in your Region?

(a) VDP

Tax evasion is illegal in Canada. It is a federal offence. Historically, where taxpayers held assets in other jurisdictions without reporting such holdings, the enforceability of consequences with respect to the lack of tax paid on these holdings was limited. This was due to the lack of information sharing between such jurisdictions and Canada. Currently, fewer jurisdictions remain closed with respect to information sharing. The transition of these jurisdictions from closed to open in relation to information sharing has thus created pressure among taxpayers to report and disclose these holdings, otherwise the CRA are likely to discover these assets and impose significant interest and penalties, in addition to the taxes owing.

The Canadian VDP promotes compliance with Canada’s tax laws by encouraging taxpayers to voluntarily come forward and correct previous omissions in their dealings with the CRA. Taxpayers who make a valid disclosure will have to pay the taxes or charges plus interest on their previously undisclosed holdings, but the CRA will waive penalty and prosecution that would otherwise apply to the taxpayer. Under certain circumstances, if a valid disclosure is made, the CRA may waive a portion of the interest applicable to the taxpayer in respect of assessments for years or reporting periods in the preceding 10 years prior to the application for relief.54

It is important to note that currently the Minister of Finance is not obligated to grant relief under the VDP. Each request will be reviewed and decided on its own merit. If relief is denied or partly granted, the CRA will provide the taxpayer with an explanation of the reasons and factors for the decision.

There are two methods of initiating a voluntary disclosure, either ‘named’ or ‘no-name’. A ‘named’ disclosure is a disclosure in which the identification of the taxpayer is stated on the initial disclosure submission. The CRA provides applicants under a named disclosure 90 days from the date the application is made to provide further materials and submissions, without the limitation clock continuing to run. Generally, if more time is required in order to prepare the full submission and to put together draft tax returns to correct the previous errors and omissions being dealt with for prior tax years, the VDP officer will normally give reasonable extensions for the time required to complete the filing.

A ‘no-named’ disclosure is more popular as an initial starting point because you give certain details regarding the tax errors or omissions without giving the name of the taxpayer. The benefit to this is that you have protection at that stage, even though no name has been released, that if an audit is initiated against that taxpayer, it will not impact the requirement that the voluntary disclosure was in fact voluntary. Over approximately 8 years ago, another benefit to the no-names was that in certain VDP offices in certain provinces and cities, it was often possible to discuss and actually come to an agreement on the tax liability without releasing the name of the taxpayer. Around 8 years ago, the CRA determined that there were abuses resulting from the inconsistent application of the program from city to city and office to office and they made it clear that no-name disclosures on a go forward basis would be consistently applied and that no deals would be made on the taxes owing or the

53. For more information, see CRA Income Tax Information Circular IC00-1R3.
54. See sub-s 230(3.1) of the ITA and R. v Bozzer 2011 FCA 186.
years of exposure that would be considered until the
taxpayer came forward by disclosing their name. So
today with a no-names disclosure, you have 90 days
to release the name of the taxpayer and get a further
extension to submit all materials but in advance of
releasing the taxpayers name, you will only be pro-
vided the opportunity to generally discuss the facts
and tax issues in a non-binding way.

A voluntary disclosure must meet the following four
conditions in order to qualify as a valid disclosure:

First, the disclosure must be voluntary. If the tax-
payer has knowledge of an audit, investigation
or other ‘enforcement action’\textsuperscript{55} prior to the disclos-
ure, the disclosure will not be considered voluntary.

Second, the disclosure must be complete. The tax-
payer must provide full and accurate facts and
documentation for all taxation years or reporting
periods where there was previously inaccurate, in-
complete or unreported information relating to any
and all tax accounts with which the taxpayer is
associated.

Third, a disclosure must involve the application or
potential application of a penalty. There are a range
of applicable penalties, and corresponding penalty
amounts.

Last, the disclosure must include information
that is at least 1 year past due or less than 1
year past due where the disclosure is to correct
a previously filed return or where the disclosure
contains information that is more than 1 year
past due.

The VDP in Canada provides taxpayers with an
opportunity to correct past tax deficiencies in a
manner that assists in avoiding criminal prosecution,
penalties, and also getting limited interest relief in
certain circumstances. It is also extremely helpful
when the taxpayer coming forward is not the taxpayer
who was non-compliant but rather in situations in
which a taxpayer who evaded taxes is now deceased
and the estate must deal with the deceased’s tax ob-
ligations. For example, where a deceased individual
was not compliant, the estate will have to become
compliant before any distributions can be made in
order to avoid liability for the executors. Further, in
the matrimonial context, upon marriage breakdown
and equalization, where undisclosed assets are
included in the calculation, consideration should be
given to ensure that those assets have become tax
compliant before they can be repatriated or trans-
ferred among spouses.

**Conclusion**

Canada is a jurisdiction where minimizing your over-
all tax obligation through planning is considered le-
gitimate activity which is controlled through the
application of legislation in order to regulate the
benefits associated with such planning. The VDP
Program creates an avenue for taxpayers who have
previously made errors or omissions on their tax fil-
ings that would otherwise be considered to be tax
evasion if discovered on an audit, to bring forward
the information under the umbrella of a VDP in order
to avoid criminal sanctions, penalties, and possibly
reduce the amount of interest that would otherwise
be applied to the taxes owing.

Trust planning is and will continue to be con-
sidered to be a key element to any practical and ef-
efective personal, estate, or business succession
planning undertaken on behalf of Canadian clients
and their assets.

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\textsuperscript{55} ibid para 33.
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