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INDIGENOUS LAW ISSUES

First Nation Taxation

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cpd Continuing Professional Development

First Nation Taxation

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The topic of First Nation taxation is very relevant and timely as Indian owned businesses continue to expand and evolve. The term "Indian" will be used because of statutory references. This article will summarize (a) the qualified exemption from tax under the *Income Tax Act* (Canada) (the "ITA") for Indians and bands, (b) its general application to employment, property and business income, and (c) the use of taxable and tax exempt corporations, and partnerships by Indians and bands. Due to the breadth of the subject, this paper will not be exhaustive of the income tax considerations and case law, or deal with other federal taxes such as GST, or provincial taxes. It is also beyond the scope of this paper to discuss particular treaties, specific agreements between bands and the government, and Indian remission orders.

I. Exemption From Tax under the *Indian Act*

A. General

The ITA does not specifically mention Indians but paragraph 81(1)(a) of the ITA excludes from income any amount that is declared exempt from tax by any other enactment of Parliament. Section 87 of the *Indian Act* provides for an exemption and therefore this exemption is operative for purposes of the ITA. Section 87 is the basis of tax planning for Indians and has been extensively litigated.

The section states:

> *87(1) Notwithstanding any other Act of the Parliament of Canada or any Act of the legislature of a province, but subject to section 83, the following property is exempt from taxation, namely:*
>
> *(a) The interest of an Indian or a band in reserve or surrendered lands; and*

(b) The personal property of an Indian or band situated on a reserve.

87(2) No Indian or band is subject to taxation in respect of the ownership, occupation, possession or use of any property mentioned in paragraph (1)(a) or (1)(b) or is otherwise subject to taxation in respect of any such property.

Before discussing the application of the exemption to particular types of income, comments are warranted about its requirements. There are three requirements to be satisfied: (a) the exemption applies only to individual Indians or bands, (b) the property must be personal property, and (c) the property must be "situated on a reserve". Each requirement will be briefly considered in turn.

(A) Indian and Indian Bands

Canadian law defines an Indian as a "person who pursuant to [the *Indian Act*] is registered as an Indian or is entitled to be registered as an Indian".

A "band" is a group of Indians who share the use and benefit of reserve lands, or who share funds held by the Department of Indian and Northern Affairs Canada (INAC), or who have been declared to be a band by the Governor in Council.

People who are members of an Indian band when the band is originally recognized by the government are entitled to be registered as Indians. But only the original status is derived from band membership. After that, status is inherited; Indians pass their status to their children from one generation to the next. In summary, to be entitled to be registered as an Indian, one must have at least one parent who was entitled to be registered as an Indian. Corporations and trusts are not Indians regardless of their ownership or beneficiaries.

The *Indian Act* defines "band" means as follows:

"band" means a body of Indians

(a) *for whose use and benefit in common, lands, the legal title to which is vested in Her Majesty, have been set apart before, on or after September 4, 1951,*

(b) *for whose use and benefit in common, moneys are held by Her Majesty, or*

(c) *declared by the Governor in Council to be for the purpose of this Act*

(B) Personal Property

Legally, "personal property" is generally defined to include everything except real estate (land and buildings) or an interest in land. Almost everything else is personal property. For example, the courts have accepted that wages qualify as personal property.

It has been argued that income is not personal property and consequently is not exempt from tax under the *Indian Act*. However, in the *Nowegijick* case in 1983, the Supreme Court of Canada concluded that income is in fact property, and that income in respect of personal property, such as wages, is exempt from income tax if it meets the other two conditions of section 87 of the *Indian Act*.

On this basis, income, including wages, business income, interest, dividends, rent, scholarships and pensions, represents personal property and may be exempt from income tax as long as it is received by an Indian or band and situated on a reserve, as summarized below.

(C) Situated on a Reserve

For purposes of the tax exemption under the *Indian Act*, it is the property, not the Indian, that must be situated on the reserve. In some cases, the residence of the Indian may influence where the property is situated. The legal term for where a property is situated is "*situs*", and the determination of *situs* is not always straightforward or clear in any particular situation.

The *Indian Act* provides limited guidance from next page with respect to where income is situated.

Section 90(1) provides the for purpose of section 87 and 89, personal property that was

(a) *purchased by Her Majesty with Indian money or moneys appropriated by Parliament for the use and benefit of Indians or Boards, or*

(b) *given to Indians or to a board under a treaty or agreement between a board and Her Majesty,*

shall be deemed always be situated on a reserve.

The *Indian Act* defines "reserve" as a tract of Crown land set apart by the Crown for the use and benefit of a band and other designated lands (subject to certain other provisions).

It was necessary for the courts to develop a test to determine the location of income for purposes of the exemption.

Situs of capital assets

Capital assets are usually physical assets such as equipment, land and buildings. Determining the *situs* of land and buildings is easy—their *situs* is where they are physically located. Land, buildings and immovable equipment such as manufacturing machinery that are located on reserve land obviously have on-reserve *situs*.

In the cases of trucks and other movable equipment, a clear connection with a reserve address is needed for such equipment to have a reserve *situs*. Factors to consider in determining *situs* include where the equipment is physically used, where it is stored when not in use, where repairs are made and where spare parts are kept.

Situs of income and other intangible property

Many forms of property, such as salary, business income and interest, have no obvious *situs* because of their intangible nature. An intangible right, like a contract debt such as a salary, rent, interest, dividend or pension, is called a "chose in action."

A chose in action has no *situs*. In the absence of anything in a contract or elsewhere to indicate the contrary, the *situs* of a simple contract debt has been held to be the residence or location of the debtor, since that is presumably where the assets to satisfy debt would be located. The residence or location of the debtor by itself is not sufficient to establish the *situs* of property for purposes of the *Indian Act*.

Nowegijick —"Situs of the debtor" test

Much of the debate over issues of *situs* has arisen from jurisprudence involving employment income. Until 1983, the Canada Revenue Agency (as it is now called) (“CRA”) took the position that salaries and wages were considered to be earned in the location where the services were performed. Simply, the CRA generally held that salaries and wages were tax-exempt only to the extent the related duties were performed physically on reserve land. The CRA also found it appropriate to allocate employment income between exempt and taxable income if duties were performed both on and off reserve.

This interpretation was challenged by the Supreme Court of Canada in the 1983 case of Nowegijick. Gene Nowegijick was a Status Indian employed as a logger by a corporation that had its head office and administrative offices on reserve. Mr. Nowegijick performed all his duties off reserve and was paid by cheque at the head office of the employer.

The Supreme Court held that salaries paid to a Status Indian are exempt from tax as long as the employer is resident on the reserve. The court defined "property" in this case as a debt created by a salary and held that its situs was the place where the employee could enforce payment of the debt, namely, the employer's residence. Contrary to the CRA's longstanding administrative position, the Supreme Court held that this was the major test that should be met: it is the employer/debtor that must be situated on the reserve; the location of the Indian, the money, and the work did not matter.

The rule established in *Nowegijick* has become known as the "*situs* of the debtor" test, and prior to the *Williams* case discussed below, its validity has been confirmed in other court rulings.

In the Mitchell case the Supreme Court of Canada stated that the purpose is to preserve entitlements of Indians to their reserve lands and to ensure that the use of their property on their reserve lands is not eroded by the ability of governments to tax, or creditors to seize. The purpose of the sections was not to confer a general economic benefit on Indians. The Court in *Mitchell* held that section 90 does not apply to a commercial arrangement.

The 1992 decision in *Williams* has had broad implications regarding the taxability of the income of Indians and Indian bands in Canada.

Glenn Williams was a Status Indian residing on reserve who received unemployment insurance benefits. The benefits arose from premiums from employment duties performed on reserve. Mr. Williams' former employer was located on reserve and paid Mr. Williams on reserve. The CRA assessed these benefits as taxable and Mr. Williams appealed this assessment all the way to the Supreme Court of Canada.

In ruling in Williams' favour, the Supreme Court looked to the employment income that gave rise to the unemployment insurance premiums that entitled Mr. Williams to benefits. In the court's view, because enough factors were present to connect the related employment income to a reserve, the *situs* of the unemployment insurance benefits was also on reserve.

The Supreme Court commented that, as well as the *situs* of debtor test set out in *Nowegijick*, a number of other "connecting factors" should be weighed when determining the *situs* of income for purposes of the tax exemption set out in the *Indian Act.* The Supreme Court suggested that these connecting factors may include:

- where the employer resides
- where the physical work is performed

- where employers' and employees' bank accounts are located whether the Status Indian resides on or off reserve.

The Supreme Court also introduced an "object and spirit test" by posing the question of whether an exemption from tax in any particular case meets the objectives of the *Indian Act*, or if it is merely a tax-avoidance scheme.

The *Williams* case did not reverse the principles established in *Nowegijick*. In fact, the Supreme Court commented that the *situs* of debtor test may still be valid and in certain cases may be the prevailing factor. However, the court said that the test should not necessarily be the sole factor in determining whether employment income has a *situs* on reserve.

The Supreme Court also noted that the connecting factors to be used may be different for various types of income and property.

After Williams there were many cases considering the location of different categories of income.

In *Greyeyes*, the court held that this rule deemed an educational scholarship received by an Indian under an agreement between a band and Ottawa and under certain treaty obligations of the federal government to be "personal property" of an Indian situated on a reserve. The scholarship was thus not subject to income tax.

In *Violet Pachanos*, the taxpayer appealed a reassessment of her employment income as taxable. One of her arguments was that the funds used by a corporation to pay her salary were funds loaned by the federal and provincial governments, and thus represented personal property given to Indians or to a band under a treaty or agreement between a band and the Crown.

The court dismissed this argument because:

- There was no agreement in place.

- The loans were to a corporation and not to Indians.
- The loans were drafted as genuine loans and not as donations in disguise.
- A loan is not a gift,

The last point was key: because a loan generally is not a gift, it could not fall within the rules in 90(1)(6) of the *Indian Act*.

In the 1991 case of Kirkness, the taxpayers worked at a nursing station located just outside reserve boundaries and funded by Health and Welfare Canada. The nursing station was created to provide services to both Indians and non-Indians. The CRA assessed the taxpayers' employment income as taxable.

The taxpayers argued that the funds used by the Department of Health and Welfare represented personal property that was both purchased by the Crown for the use and benefit of Indians or given to Indians or to a band under a treaty or agreement.

In rejecting this argument, the court made the following key points:

- The funding for the nursing station was out of general funds that were not specifically earmarked for this purpose.
- Because the funds were out of general funds, they were from funds set aside for all Canadians and not solely for the use and benefit of Indians or bands, a fact further supported by the availability of the nursing station's services to anyone.
- The services rendered to the band were not provided pursuant to any treaty or agreement between a band and the Crown.

The decision in Kakfwi has narrowed the interpretation of the deemed situs provision of the *Indian Act*. Everett Kakfwi was a Status Indian and chief of an Indian band that had no reserves. Kakfwi argued that his salary should be exempt from income tax because it came from band

support funding paid under an agreement between a band and the Crown and thus should be deemed to be situated on reserve.

Though the taxpayer was successful at the Tax Court of Canada (TCC), the FCA held that the band support funding agreement was not the kind of agreement contemplated by deemed sites provision of the *Indian Act* and overturned the lower court's decision. The FCA cited the landmark decision of the Supreme Court in Mitchell, in which the Supreme Court held that the agreements contemplated by the provision were limited to supplementary agreements in the nature of a treaty or attached to a treaty (that is, ancillary agreements that are often needed to flesh out the details of treaty promises). The agreements should be intertwined and "take colour from one another." The band support funding program did not constitute such an agreement.

The potential result of *Kakfwi* is that, if there is no treaty in place with respect to a particular Indian or band, then, arguably, the second part of the deemed sites provision of the *Indian Act* may not apply (i.e., property given to an Indian or a band under a treaty or agreement between a band and the Crown).

The question arises whether the exemption from tax under the *Indian Act* applies only to the reserves of the Indian or band, or does it apply to any reserve? For example, if an Indian works full-time on a reserve that does not belong to his or her particular band, is the income from this work exempt from income tax?

In the past, the CRA has generally accepted that access to the tax exemption is not restricted to the reserves of an Indian or band. However, the 2001 FCA decision in *Shilling* has raised doubt as to whether the reserve in question could be any reserve.

In *Shilling*, the court cited the more restrictive view taken by the British Columbia Court of Appeal in Leonard v. British Columbia In that case, the court restricted the tax exemption on the personal property of an Indian "to the place where the holder of such property is expected

to have it, namely on the lands which an Indian occupies as an Indian, *the reserve*" (emphasis added).

On the basis of informal discussions with the CRA, it appears that the CRA has not yet taken any lead from these comments. Whether these comments will be given greater consideration by the CRA in the future is not known. Anyone wishing to access the exemption from tax under the *Indian Act* would be prudent to try to ensure that there are connections to their own reserve. (For a more detailed discussion of *Shilling*, see 3.5.1.)

The *Williams* case introduced a purpose test for determining whether intangible property constitutes property situated on reserve. In Williams, the Supreme Court effectively looked beyond the letter of the law and asked whether the purpose of section 87 of the *Indian Act* is to exempt from tax all income from property (wherever it is located) or rather to prevent erosion of an Indian's assets and resources as they relate to a reserve.

In defining the issues and overriding purpose, the Supreme Court concurred with the judgment in *Mitchell v. Peguis Indian Band*, commenting that the tax exemption set out in the *Indian Act* is "to preserve the entitlements of Indians to their reserve lands and to ensure that the use of their property on their reserve lands was not eroded by the ability of governments to tax, or creditors to seize." The purpose is not to "confer a general economic benefit upon the Indians."

The court held that the *Indian Act* grants Indians a choice regarding their personal property:

> *The Indian may situate his property on the reserve, in which case it is within the protected area and free from seizure and taxation, or the Indian may situate his property off the reserve, in which case it is outside the protected area, and more fully available for ordinary commercial purposes in society. Whether the Indian wishes to remain within the protected reserve system or integrate more fully into the larger commercial world is a choice left to the Indian.*

II. Application of the Exemption to Employment income

A. Employment Income

The CRA's current assessing practices for determining whether employment income of an Indian is taxable are primarily based on the principles established in *Williams* and several tax court judgments rendered afterward. The post-*Williams* judgments summarized below have had the greatest influence on the development of the CRA's policies in this area, especially regarding the connecting factors test as set out in *Williams*.

McNab—Off-reserve duties ancillary to on-reserve work

Brenda McNab was an Indian employed by the Saskatchewan Treaty Indian Women's Council. Though her legal residence was on reserve, she spent about five days of each week in Regina and other Saskatchewan locations. More often than not, Ms. McNab worked off reserve. However, she was paid at the Council's reserve address about 75 per cent of the time.

The Council received its funding from both the Government of Canada and the Government of Saskatchewan. Its registered office was on reserve. However, the Council carried on its business in Regina at all material times. Noting that the guiding mind of the Council (Isobel McNab) resided on reserve, the court found that the off-reserve operations were ancillary to on-reserve work and that the Council itself was located on reserve. Thus the court found sufficient connecting factors to cause Ms. McNab's salary to be property situated on reserve. Most notably, the court noted that all of Ms. McNab's work *"was with Indians and all of her work was on the instructions of an employer whose sole purpose was to benefit Indians on reserves."*

Clarke—Duties performed 50 per cent on reserve

This case consisted of several cases tried at the same time, all of which involved members of the Norway House Indian Band. The first member was William Clarke, a Manitoba provincial government employee who worked at the Norway House, Manitoba airport. The airport was

situated off reserve on surrendered lands. Mr. Clarke was an Indian who resided on reserve. Mr. Clarke's paycheques were paid to a bank in Winnipeg and his employer, the Government of Manitoba, resided off reserve. Mr. Clarke and the CRA agreed that he spent half of his time working on reserve.

In 1992, the court ruled that because Mr. Clarke spent 50 per cent of his time working on reserve, he had chosen to "remain within the protective confines of the reserve." The court ruled that this choice should be the dominant factor in determining that the *situs* of his employment income was on the reserve.

Poker—Off-reserve duties closely connected to a reserve

One of the cases heard at the same time as Clarke involved Elizabeth Ann Poker, an Indian who resided on reserve and who was a teacher at a school that was adjacent to a reserve. The school received substantial funding from the government of Canada as financial assistance for the education of Indians. The school administration, the offices of which were on reserve, received a significant portion of its funding from Indian bands.

In 1992, the court found that Ms. Poker's income was situated on reserve because the funding arrangement under which her salary was paid caused her employment income to be deemed to be property situated on reserve.

This decision was affirmed by the FCTD in a 1994 appeal. In confirming the lower court's decision, the FCTD found that, even though the place of employment was not physically on reserve, the nature of Ms. Poker's employment was closely connected to the reserve based on the following factors:

- The school in question and the schools on the reserve were seen as one system by the Frontier School Division and the Norway House Indian Band.
- Ms. Poker's work was performed off reserve on instructions from her on-reserve employer. Most students attending the school were Indians.

- The government of Canada provided substantial operating funds to the school as part of its program to fund services for Indians.

Interestingly, the court found that the on-reserve location of Ms. Poker's employer, the Frontier School Division, was an important connecting factor.

Folster—Off-reserve duties not part of commercial mainstream

Marianne Folster was an Indian who resided on reserve and who worked for a hospital adjacent to, but not on, the reserve. The hospital was established and funded to meet a federal obligation to provide hospital services to Indians. Again, the court decided that the employment income was deemed to be situated on the reserve because the funding arrangement under which her salary was paid caused her employment income to be deemed to be property situated on reserve.

This decision was appealed by the CRA at the same time as Poker. The FCTD overturned the lower court's decision and ruled against Ms. Folster. However, this decision was appealed to the FCA, which held that Ms. Folster was not taxable based on the commercial mainstream doctrine.

Some unique facts influenced the court's conclusion. The existing hospital was built to replace a hospital that had been located on reserve but that had burnt down. The land on which the existing hospital was located was in the process of being converted to reserve. The court also considered the source and purpose of funding, namely for health care services for Indians who were on reserve.

Clarke, Wilson, Paupanekis, Albert—Factors pointing to off-reserve situs

In each of these cases, the employment income was held to be situated off reserve. Some of the more important factors pointing to off-reserve *situs* were as follows:

- No evidence indicated that employment duties were performed on reserve

- In two of the cases, the employers' head offices were located off reserve
- The primary place of employment was off reserve
- Employment earnings were paid off reserve

In all four cases, it was held that the individuals' residence on reserve was insufficient by itself to cause the employment income to be situated on reserve. Thus, an Indian's residence appears to have little weight when it is the sole connecting factor.

This set of cases raises several other interesting points. For example, the *situs* of debtor test still seems to be a factor and the type of employer seems to bear influence. Catherine Clarke worked at an off-reserve Hudson's Bay Company store that was completely surrounded by reserve land. However, the court felt it was relevant that her employer was a non-government private company (a finding that hints at the commercial mainstream doctrine).

Though none of these points is conclusive, they all warrant consideration and demonstrate that a much wider range of connecting factors must be weighed in each circumstance.

The courts have continued to consider the income tax treatment of Indians. As discussed above, in *Kakfwi*, the court took a more restrictive review of the application of the deemed on-reserve *situs* rules as they apply to employment income. In addition, as noted in *Shilling*, the courts appear to have reiterated the principle that the *situs* of debtor test remains a connecting factor, though it should not be given inordinate weight.

The courts have also considered the commercial mainstream doctrine within the context of employment income. As noted above, the courts applied this doctrine in *Shilling* and *Monias* and found that the taxpayers should be taxable. The Walkus and *Amos* cases elaborated on this principle. These cases, which focus on the true substance of the circumstances surrounding the taxpayers and not just the form, shed additional light on the treatment of employment income.

Amos—Off-reserve employment based on entitlement to reserve

This case involved two Indians who lived on reserve and worked at a pulp mill that operated predominantly on land owned by the operator of the mill. The mill also maintained storage on leased land that had been surrendered by a band. However, the employer was not resident on reserve and it was difficult to argue that the employees worked the majority of time on reserve.

In finding in favour of the taxpayers, the court noted that the leasing of reserve land was integral to the mill's operation and that the lease was entered into by the band to allow for employment of its members. The court found that benefits accrued to the reserve and that the employment income arising as a consequence of the lease was essentially a realization of their entitlement to their reserves.

Walkus—Off-reserve activities part of commercial mainstream

In *Walkus*, Indians who were employed as commercial fishermen argued their income was integrally connected to the reserve because their employer was on reserve and because they were involved in the band's ceremonial fishery and food fishery.

The court found that, while the Indians' activities contributed a degree of benefit to the reserve, they were not integral to the life of the reserve. Rather, the activities were within the commercial mainstream.

Further, the court determined that the employer was not resident on reserve because the on-reserve office had only minimal use and decision-making occurred in places other than at that office. In substance, the court appeared to consider the location of the employer's mind and management.

Monias—Off-reserve services and offices for benefit of Indians on reserve

This case involved Indian employees who were employed by a non-profit organization that was controlled by certain bands and provided child welfare services to members of those bands.

Owing to the isolated locations of some of the reserves, the directors' meetings were held off reserve and the main offices of the organization were off reserve. Nevertheless, the main purpose of the organization was to provide services to Indians who resided on reserve.

The court weighed the various connecting factors and ultimately decided against the taxpayers. Though the services benefited Indians on reserve, the court held that this by itself was insufficient to exempt the income and gave it little weight. One of the key factors the court considered was whether or not the salaries themselves benefited the reserve as they did in *Amos*, because the employees worked much of the time off reserve and because the organization had its offices off reserve, the court held that the salaries did not benefit the reserve. The locations of the employer's and employees' bank accounts were afforded little or no weight.

This case is a bit disturbing because it may cast some doubt on the principle, established in *McNab*, regarding off-reserve activities that benefit Indians on-reserve.

The CRA's Guidelines on the Treatment of Employment Income of Indians

In response to several of the post-Williams court cases discussed above, the CRA released guidelines in June 1994, that apply to all employment arrangements now in place.

Bear in mind that these guidelines are administrative in nature and do not have the force of law. The CRA follows these guidelines in most cases, but they are not binding on the CRA. If there is any uncertainty as to how the guidelines may apply in a particular case, an advance income tax ruling may be worth pursuing.

In summary, the CRA's guidelines are as follows:

- If duties are performed on reserve, the employment income that relates to those duties is tax-exempt. Incidental ditties performed off reserve will not usually violate this test.

- Where substantially all (90 per cent or more) of the duties are performed on reserve, all of the employment income will be tax-exempt.

- Employment income for duties performed completely "off reserve" will normally be tax-exempt if both the employer and the Indian reside on reserve.

- Where primarily all (more than 50 per cent) of the duties are performed on reserve and either the employer or employee resides on reserve, then all employment income will be tax-exempt.

- Duties performed off reserve will be considered tax-exempt if all of the following factors are present:

    - The employer is an Indian band (which has a reserve), a tribal council representing one or more Indian bands (which have reserves), or an Indian organization controlled by one or more such bands or tribal councils and dedicated exclusively to the social, cultural or economic development of Indians who mostly live on reserves. Social, cultural or economic development includes the provision of social services such as education, health care or counselling.

    - The employment duties are part of the non-commercial activities of the band, council or organization.

    - The band, council or organization is resident on a reserve.

(Given the decision in Monias, it is advisable to take care when relying on this guideline.)

- In all other cases, the employment income should be prorated between on- and off-reserve duties. The tax exemption will apply to the portion of the income relating to on-reserve duties.

- Where one of the main reasons for the existence of an employment relationship is to establish a connecting factor, then the income may be considered not to be tax-exempt.

This anti-avoidance test appears to be designed to catch employee leasing arrangements under which an Indian who would normally be employed by a non-native-owned business that operates off a reserve attempts to exempt his or her income by having his or her services provided indirectly through an employer that is resident on reserve.

- Employment insurance benefits, retiring allowances, Canada and Quebec Pension Plan payments, registered pension plan benefits, and wage-loss replacement plan benefits are normally exempt from income tax if the employment income that gave rise to those benefits was exempt.

- An employer is resident on reserve if the reserve is the place where the central management and control over the business is actually located. The central management and control of an organization is usually considered to be exercised by the group that performs the function of a board of directors of the organization. However, this rule of thumb does not apply if management and control is exercised at the principal place of business at a location other than the employer's principal administrative office. For example, if a corporation's business is an off-reserve store, even though administrative functions and directors' meetings are conducted on reserve, it may be argued that the corporation resides off reserve. When determining where an employer resides, all facts must be carefully considered.

- Indians will be considered to live on reserve if they live on a reserve in a domestic establishment that is their principal place of residence and that is the centre of their daily routine.

Even though the CRA has introduced an anti-avoidance test in its guidelines, whether the test is enforceable remains to be seen. That taxpayers have the right to structure their affairs in the most tax-advantageous way possible is a firmly entrenched canon of Canadian common law. Nevertheless, before an employment arrangement is established, all parties should carefully consider the CRA's views.

Factors to Consider for all Employment Arrangements with Indians

There have been many developments since the release of the CRA's 1994 guidelines. In particular, the *Amos*, *Walkus*, *Shilling* and *Monias* cases have raised additional issues. We understand that the guidelines will generally continue to be observed. However, for greater comfort, all matters pertaining to any employment relationship should be considered. For example:

- Director and management committee meetings should occur on reserve.
- The directors must be able to clearly demonstrate that they are the mind and management (i.e., the directors must not exist merely to bless the actions of management).
- Minutes of all meetings must clearly document the location of the meeting, the business conducted, and the decisions reached.
- The reserve location preferably should be the reserve belonging to the Indians and bands in question.
- A physical presence should be established on reserve, including offices that are not merely offices of convenience.

Again, these are some examples of additional steps that might be taken. The need for professional advice in each and every situation cannot be overstated. In some cases, advance income tax rulings should be considered.

B. Investment income

In determining whether the income earned by an Indian is situated on-reserve, thus exempt from taxation, the approach taken by the Supreme Court of Canada in the 1992 case of *Glenn Williams v. Her Majesty the Queen* (92 DTC 6320) is followed. This approach requires the examination of all factors to determine if the income is located on the reserve and, therefore,

exempt from income tax. The Supreme Court also indicates that the ultimate question is, to what extent is each connecting factor relevant in determining whether taxing the particular kind of property in a particular manner would erode the entitlement of an Indian to personal property situated on a reserve? One general direction provided in the Williams case was that an overly rigid test that identified one or two factors as having controlling force "would be open to manipulation and abuse." The Supreme Court rejected the previously adopted test that situs of the debtor was the sole test for determining whether the personal property of an Indian or band was situated on a reserve.

As a result of the Williams case, the CRA views that the location of a savings account on a reserve would not in itself be sufficient to exempt the interest income earned thereon. If a bank account is considered to be situated at a location on-reserve, this factor is weighed in determining whether interest earned on deposits in that account is exempt from taxation. There could also be other factors that would connect the income to a location off-reserve, such as, if an Indian lives off-reserve, earns only taxable income, and uses an automated teller machine located off-reserve to deposit funds into a bank account located on-reserve. In this example, it is the CRA's view that the interest income would be taxable, notwithstanding that the head office of the financial institution may be located on-reserve.

Recalma

In the case of *Argol Recalma v. Her Majesty the Queen*, the Federal Court of Appeal upheld the Tax Court of Canada's decision concerning the taxability of income earned by an Indian living on a reserve, from investments purchased from an on-reserve branch of a bank. The Supreme Court of Canada has dismissed the application for leave to appeal. In *Recalma*, the following were considered in determining the *situs* of the investment income:

1) The residence of the taxpayer;

2) The origin or location of the capital used to buy the securities;

3) The location of the bank branch where the securities were bought;

4) The location where the investment income is used;

5) The location of the investment instruments;

6) The location where the investment income payment is made; and

7) The nature of the securities, in particular:

   (i) The residence of the issuer;

   (ii) The location of the issuer's income-generating activity from which the investment is made; and

   (iii) The location of the issuer's property in the event of a default that could be subject to potential seizure.

In any given situation, a few of these factors might support an argument for exemption. However, the court placed considerable weight on the location of the income-generating activity of the bank. In the *Recalma* case, the income in question was interest from banker's acceptances and income from mutual fund units. The court concluded that income from these investments started with companies off the reserve and were passed through a bank on-reserve to the taxpayers. It was held that the investment income of the taxpayer was not personal property situated on a reserve and, in making these investments, the taxpayer chose to invest in the economic mainstream of normal business conducted off the reserve.

Since the bank can use the funds received to make loans to Indians off the reserve, to non-Indians, or to invest in off-reserve activities, it may not be possible to trace the interest earned on these funds directly to the reserve. As a result, unless the investment income can be identified as being generated exclusively on the reserve, it is the CRA's position that the income is not exempt from tax.

Interest from guaranteed investment certificates and other interest bearing certificates, such as treasury bills and bonds, is not generally considered to be earned on a reserve. Although the financial instrument may have been purchased through a bank or trust company located on the reserve, the CRA considers the interest to be earned and paid from the taxpayer's principal place of business (which is often the issuer's head office). For example, in the case of a government bond, regardless of where purchased, the interest will be considered earned in, and paid from, Ottawa.

With regards to dividend income, dividends on shares from a company whose head office, principal business activity and share register are located on a reserve will generally be exempt. If the investment gives rise to a capital gain, it will be exempt from tax if the income that the investment generated was itself exempt from tax.

Following the decision in the *Recalma* case, the CRA issued an interpretation on July 16, 1999 (Tax Windows, Document # 9911687) dealing with the taxation of investment income from on-reserve financial institutions that were based on the Court's decision in the Recalma case. In summary, the following comments were made:

> *"In a situation where an on-reserve financial institution has less than 90 percent of its loans and investments on-reserve, in our view, any investment income earned by an Indian from investments in that financial institution would be taxable. For the Department to consider an Indian's investment income to be tax exempt, as a minimum requirement, the Indian's investment income would have to be from an on-reserve financial institution that generates its income exclusively from investment and loans to Indians on a reserve and it has to be established that the loans and investments are used by Indians for development on the reserve. In addition to the above-mentioned test for the financial institution, in our view, other connecting factors would still have to be present such as the Indian has to live and work on a reserve and the capital with which the Indian made the investments has to be from an exempt source.*

We are of the view that proration of an Indian's investment income based on the ratio of an on-reserve financial institution's income generating activity on-reserve to its off-reserve income generating activities is not a viable or feasible alternative given the Court's comments on exclusivity. In conclusion, since we would expect that in the vast majority of situations, it would be extremely difficult for all of the above-mentioned connecting factors to be present, generally, the investment income of an Indian would be taxable. In particular, in the case of an Indian living and working off-reserve who has investment income from an on-reserve financial institution, in our view, there would likely not be sufficient connecting factors present because the Indian would be viewed, based on the Court's comments, as having chosen to enter the main economic mainstream of normal business conducted off a reserve and consequently, such investment income would be taxable."

Therefore, based on the CRA's above stated position, it would appear that, unless the on-reserve financial institution's income-generating activity is from loans and investments to Indians on a reserve, and that such loans and investments are intimately connected to a reserve, the Indian investment income would be taxable. It appears they would be prepared to accept that this requirement may be met if an "all or substantially all" (i.e., 90 percent or more) test is used in this determination. However, it would also be necessary to ensure that the on-reserve financial institution's investments are actually "intimately connected" to the reserve – that is, the investments and loans from the on-reserve financial institution are actually used by Indians for development on a reserve and not, for example, loaned back to off-reserve Indians or non-Indian organizations, or invested in securities off the reserve.

This appears to be the court's view as well, as decided in Dube. In this case, the court put considerable weight on the way income had been generated, such that the emphasis had to be based on the *situs* of the source of the income. That *situs* was where the instruments were located and where their capital had been invested to earn the income and capital in question.

In other words, the connecting factors respecting the income and capital derived by the taxpayer placed it off-reserve and in the general mainstream of the economy. Further, it would appear that the courts are examining a second test: whether the income is derived from activities that are to benefit the "traditional way of life" on a reserve.

In *Sero and Frazer*, the Federal Court of Appeal dismissed the taxpayers' appeals with respect to interest income being exempt. The taxpayers were Indians as defined in the *Indian Act*. They earned interest on money invested at a Royal Bank branch situated on an Indian reserve, and the Minister assessed the taxpayers for tax on that interest income. The Federal Court of Appeal found that the Royal Bank operates in the commercial mainstream and, therefore, the interest income earned by the taxpayers was in that commercial mainstream and not on a reserve. Applying the connecting factors test, the taxpayers' investment income was not situated on a reserve for purposes of section 87 of the *Indian Act* and was, therefore, taxable.

C. Application of the Exemption to Business Income

The significant factor that courts now use to connect business income to a location on-reserve or off-reserve is the location in which the activities of the business are carried out. For example, if the main aspect of a logging business consists of the felling of trees, the location of the land being cleared would be a connecting factor of major importance with respect to income from such a business. Another significant connecting factor would be the location of the customers of the business.

Southwind

Southwind is the leading case dealing with the business income of an Indian. The case concerns income earned from logging, where a Status Indian lived on-reserve. However, all income earning activities were carried out off-reserve and his sole customer was off-reserve. The Tax Court decided that his income from this logging activity was taxable and the taxpayer appealed this decision. The Federal Court of Appeal confirmed the Tax Court's decision. In reaching its

decision, the court used two main connecting factors: namely, the location of the sole customer of the Indian and the location where the service is performed. Linden J.A. stated:

> *"Although Morrell Logging is not the appellant's employer, the significance of its off-reserve location lies in that Morrell Logging was the appellant's only customer and the debtor in the taxation year. The nature of the appellant's business income must be determined, in part, by reference to the source from which that business income is received. In this respect, the appellant's situation is distinguishable from Nowegijick, where the debtor employer was located on a reserve. Moreover, all of the services performed by the appellant were done off the Reserve, a very significant feature of this case."*

The fact that the taxpayer sometimes resided on-reserve, and that the books and records of the business are kept on-reserve are factors to be given less weight than the others. These factors are not sufficient to connect the business income to a location on-reserve.

It appears that the courts continue to apply the factors set out in *Southwind* as illustrated recently in *Pelletier*. In this case, a logging business was carried on and off-reserve. However, the logging physically occurred on crown land and the customers were located off-reserve. These were the two most important factors used by the judge to determine that Mr. Pelletier was conducting business in the commercial mainstream, and section 87 of the *Indian Act* did not apply to exempt the business income from income tax. Therefore, in a situation where it can be said that the business is not integral to the life of the reserve, and the business is in the commercial mainstream competing with others, the business income will be taxable.

In the *Gilles Cleary and Danny Cleary v. Her Majesty the Queen* case, a business partnership was determined not to be conducted on a reserve. Taking into account the factors in *Southwind*, it was difficult to conclude that the taxpayers' business income was situated on the reserve since they were living and conducting the business off the reserve, thus were subject to the same business conditions as other taxpayers.

In *Mitchell v. Peguis Indian Band*, the Supreme Court of Canada described the purpose of the *Indian Act* as being the preservation of the entitlements of Indians to their reserve lands and the prevention of

III. Use of Taxable and Tax Exempt Corporations, and Partnerships by Indians

A. General

A corporation is a legal entity having an existence separate and distinct from that of its owners. A corporation is, for legal purposes, an artificial person having many of the rights and responsibilities of a real person.

As a separate legal entity, a corporation may own property, enter into contracts, be responsible for its own debts, and pay income taxes on its profits.

Since a corporation is an entity separate from its owners (called shareholders), it can provide protection from both creditors and lawsuits, which is called "limited liability". Creditors of a corporation make a claim against the assets of the corporation, not against the personal property of the shareholders. The liability of the shareholders is limited to the amount they have invested in the corporation, provided they have not given the corporation's creditors a personal guarantee.

All corporations other than those exempt from tax are taxed on their profits as separate entities. The tax rate will depend on the type, amount and location of the income.

As noted above, section 87 of the *Indian Act* provides a tax exemption only for Indians and Indian bands. As noted above a corporation cannot rely on this exemption even if all of its shareholders are Indians and the corporation is located on a reserve. The courts have determined that the separate legal existence of a corporation cannot be disregarded. However, the situs of a corporation is important in determining the status of payments made by the corporation to Indians, as discussed above. When an individual Indian is a shareholder, there are compelling arguments, based on the Bastien and Dube cases that the dividends are exempt

of the corporation's registered and records office and its business office are located on a reserve.

Corporations with Indians and taxable non-Indians as shareholders will generally be disadvantageous because it will not be tax exempt even if the Indian shareholder is exempt. If a corporation is required for commercial reasons such as "bankability", consideration should be used in optimizing corporate deductions such as interest on any loans provided by shareholders. Consideration must always be given to whether income from the corporation will be exempt. If the business activities are both on reserve and off reserve, multiple corporations could be used. Salary and bonuses paid by a corporation to an individual for whom these amounts are tax exempt will only be deductible to the extent it is reasonable in the circumstances. This test may prevent shifting all corporate income to shareholders by way of fees or bonuses.

The potential exemptions that some Indians and bands have attempted to use under the ITA are:

- a public body performing a function of the government in Canada, under paragraph 149(1)(c) of the ITA;
- corporations owned 90 percent or more by a Canadian municipality or a "public body performing a function of government of Canada", under paragraph 149(1)(d.5) of the ITA; and
- a not for profit organization under a subsidiary of a municipality, under paragraph 149(1)(1) of the ITA.

The Public Body Exemption

The first and very most important exemption is found in paragraph 149(1)(c) of the ITA:

> *149(1) No tax is payable under this Part on the taxable income of a person for a period when that person was:*

(c) *a municipality in Canada, or a municipal or public body performing a function of government in Canada;*

The primary benefit to this exemption, over section 87 of the *Indian Act*, is that the income need not be situated on a reserve. Accordingly, this exemption is much more flexible and useful for an Indian band for structuring business ventures.

There are several requirements:

(a) there must be a "person"; and

(b) that person must be a public body; and

(c) that public body must be performing the function of government in Canada.

Each of these requirements are subject to numerous legal complexities and discussions are beyond the scope of this paper.

Indian's band status as a municipality

Municipal corporation

Pursuant to paragraph 149(1)(d.5) of the ITA, subject to the limitations discussed below, a corporation may qualify for exemption from Part I tax only where at least 90 percent of the shares of the corporation are owned by one or more entities each of which is a municipality in Canada, or a municipal or public body performing a function of government in Canada.

If a particular self-governing First Nation meets the definition of "a public body performing a function of government in Canada", the relevant geographic boundary would delineate the area where the self government agreement, or the statute enacting self-government powers, provides the First Nation authority to impose direct taxes. If a particular Indian Band meets the definition of "a public body performing a function of government in Canada", the geographic boundary of the Indian Band be the band's reserves as defined in the *Indian Act*. There is a rule

which will deem income of a corporation from activities outside the geographic boundary to not include income from activities carried on under certain agreements between the corporation, her Majesty in Right of Canada, a province or a municipality or other specified persons. CRA has interpreted this deeming rule restrictively.

Paragraph 149(1)(d.5) will not apply if the votes or de facto control is held by non-qualified persons. For example, there are shareholders owning more than 10% of the shares giving them more than 10% of the votes that can be cast at a shareholders meeting other than the federal and provincial government, a municipality, a municipal or public body performing a function of government in Canada, or certain other entities.

In some instances a Nation may not be viewed as a "person". CRA has ruled where hereditary chiefs addressed the lack of separate legal personality by incorporating a society. The society provided an extensive list of social services and conducted treaty negotiations. CRA ruled that the society was a public body performing the function of government in Canada.

Non-profit organizations

In many situations, a corporation is organized for purposes other than to earn a profit. These non-profit organizations are exempt from taxation under paragraph 149(1)(l) of the ITA, provided the following requirements are met:

- The organization must be operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit
- No part of the income can be payable to, or otherwise available for, the personal benefit of any proprietor, member, or shareholder
- The organization cannot have the power to pay dividends
- The organization cannot distribute assets to a member or shareholder on amalgamation or wind-up

- The organization cannot be a charity

Non-profit organizations are useful vehicles for Indian-owned operations that have no profit motive. An example would be economic development corporations, such as the Gull Bay Development Corporation, which successfully confirmed its status as a non-profit organization in 1984. The Letters Patent of the company provided that the objectives of the company include:

> *"To promote the economic and social welfare of persons of native origin who are members of the Gull Bay Indian Reserve (No. 55) and to provide support for the recognized benevolent and charitable enterprises, federations, agencies and societies engaged in assisting the development, both economic and social, of native people who are members of the Gull Bay Indian Reserve (No. 55)."*

They further provide that the company may hire employees, maintain offices, and incur reasonable expenses in connection with its objectives that the company shall be carried on without purpose of gain for members, and that any profits or other accretions to the company will be used in promoting its objectives. It is further provided that the directors shall serve without remuneration and that no director shall directly or indirectly receive any profit from his position, provided only that he/she may be paid reasonable expenses incurred by him/her in the performance of his/her duties. In the event of dissolution of the company, all remaining property is to be distributed or disposed of to incorporated Native Peoples Organizations in Ontario.

The corporation employed a number of band members, several of whom worked in the areas of civic improvement, and social and charitable activities. Other employees carried on logging operations, a profitable activity for the corporation. The CRA's position was that the logging operations disqualified the corporation as a non-profit organization. However, the court held that the logging operations were incidental to the real objectives of the corporation, were to

provide training and employment to Indians on the reserve, and were to raise funds for the social and charitable activities of the corporation.

The CRA takes the position that the Gull Bay case was fact specific. Therefore, special care must be taken to ensure that any commercial activity is incidental to the corporation's other objectives. It is also important to emphasize that profits cannot be accumulated, nor can profits be distributed to the band. The profits must be spent within the corporation. However, where a non-profit occasionally has an excess of income over expenditures, it will not automatically lose its status as a non-profit organization. The non-profit must ensure that it does not accumulate an amount in excess of what would be reasonably required to conduct its non-profit activities. It is also not possible for the band to carry out benevolent activities on the corporation's behalf and still have the corporation retain non-profit status.

The CRA further states that an Indian-owned corporation that competes with other non-Indian-owned businesses, whether on- or off-reserve, will risk its status as a non-profit organization.

Partnerships

Partnerships can be a very effective vehicle for carrying on business. In general partnerships, creditors can sue anyone or all of the partners personally to collect amount owing by the partnership if there are deficient assets. A limited partnership consists of one or more limited partners. The general partner, which generally has nominal capitalization, has unlimited liability. A limited partner enjoys limited liability provided it is not involved in the day-to-day operations of the partnership.

A partnership is not a taxable entity. Income (or loss) is computed at the partnership level and allocated to the partners. Capital cost allowance and other deductions are claimed at the partnership level which will reduce income allocated to partners. A tax exempt person has no benefit from these deductions or start-up losses. A partnership provides an opportunity in appropriate circumstances to allocate start-up losses to the non-First Nation partners or for taxable partners to directly claim certain deductions such as capital cost allowance in respect of

the venture. For instance, a taxable partner might acquire depreciable property, claim capital cost allowance and rent it to the partnership on a rent free basis.

CRA has ruled favourably that the public body exemption applies to exempt business income earned by an Indian band from its limited partnership interest.

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