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“FIRST NATIONS’ TAX EXEMPTIONS”

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First Nations' Tax Exemptions

Most often, a First Nation doing business will wish to have protection from liability for business losses.

The most common way to obtain such protection is to use an incorporated company. An incorporated company is a separate legal entity and its losses, in general, are not the personal responsibility of the owner of the business.

As a corporation is a separate legal entity, it is not usually eligible for the tax exemptions available to Indian bands under the *Indian Act*, even if the company is wholly owned by the band.

This memo sets out some of the ways First Nations can access valuable tax exemptions AND limit commercial liability.

1. Tax Exemption #1 – The *Indian Act*

Section 87 of the *Indian Act* creates four tax exemptions:

- i. a property exemption from taxation of the real property interests of an Indian or a band on-reserve or on surrendered lands in s. (1)(a);
- ii. a property exemption from taxation of the on-reserve personal property of an Indian or a band in s. (1)(b);
- iii. a property exemption from succession duties on such property in s. (3); and
- iv. a personal exemption from taxation of Indians and bands themselves.¹

How to Take Advantage of Tax Exemption #1

An incorporated company, even if owned by a band, is not able to take advantage of s.87 because it is a separate legal entity. Only an Indian or an unincorporated band-empowered entity may claim the s.87 exemption from tax. In order to provide some protection from liability while using s.87, a limited partnership (“LP”) may be appropriate.

The LP structure has two partners: one a general partner who carries on the management of the business, and a limited partner, who is a passive participant. In the First Nations context, it is the First Nation/band that would be the limited partner. A shell corporation with limited liability is usually the general partner. Although the First Nation would not have the advantage of full limited liability protection, its exposure would be limited to its capital investment.

As it is questionable whether a ‘band’ has the capacity to enter into a limited partnership, a trust is often used as the limited partner. Where a trust is used, the profits of the trust as limited partner in the LP will be paid out to the band as income.

In order to maintain the s.87 exemption for trust income, the income must be earned on reserve. In determining whether the income paid out of a trust is taxable, courts would look for the connecting factors that would connect the income to the reserve. Important factors to consider when structuring the trust would include:

- Situating the trust on reserve;

¹ *Nowegijick v. R.*, [1983] 1 S.C.R. 29, (1982), 144 D.L.R. (3d) 193 at 200.

- Making sure that the income of the trust is earned on reserve;
- Making sure that all records and meetings of the trustees are on reserve;
- Making sure that all bank accounts for the trust are kept at a branch of a financial institution on reserve;
- Making sure that band members are appointed as trustees; and,
- Making sure that the trustees pay the net income of the trust each year to the First Nation so that the trust has no residual income on which income tax would be payable.

One of the limitations of an LP is that the limited partner cannot take part in the management of business, or contribute services, or the limited liability shield could be lost. This would mean that neither the trustee nor other band council members could serve on the Board of the general partner which manages the business.

Another limitation to an LP is that allocation of income between the partners must be reasonable to ensure that it does not trigger the anti-avoidance rules in Section 103 of the *Income Tax Act*.

2. Tax Exemption #2 - Non-Profit Organization

Section 149(1)(l) of the *Income Tax Act* provides an income tax exemption to non-profit organizations. This may include Indian-owned corporations, where these have been incorporated for social and welfare purposes.² This exemption does not apply to for-profit corporations owned by a First Nation.³

How to Take Advantage of Exemption #2⁴

In order to take advantage of this section, the First Nation could incorporate a society as a non-profit organization (NPO), either provincially under the *Society Act*, or federally under the *Canada Corporations Act, Part II*.

In general terms, paragraph 149(1)(l) provides that the taxable income of an NPO is exempt from tax under Part I of the Act for a period throughout which the NPO complies with all of the following conditions:

- (a) it is not a charity;
- (b) it is organized exclusively for social welfare, civic improvement, pleasure, recreation or any other purpose except profit;
- (c) it is in fact operated exclusively for the same purpose for which it was organized or for any of the other purposes mentioned in (b); and
- (d) it does not distribute or otherwise make available for the personal benefit of a member any of its income.

When determining the purpose for which an association was organized, the instruments creating the association will normally be reviewed. These instruments would include articles of incorporation, memoranda of agreement, by-laws, and so on.

The terms "social welfare", "civic improvement", and "pleasure or recreation" are not defined in the Act.

In general terms, **social welfare** means that which provides assistance for disadvantaged groups or for the common good and general welfare of the people of the community.

² *Gull Bay Development Corporation v. R.*, [1984] 1 C.N.L.R. 74 (F.C. T.D.).

³ *Otineka Development Corp. v. R.*, [1994] 1 C.T.C. 2424 (T.C.C.).

⁴ Much of this information is taken directly and without modification from CRA Bulletin "IT-496R Non-Profit Organizations August 2, 2001", available online at: http://www.cra-arc.gc.ca/E/pub/tp/it496r/it496r-e.html#P74_6444.

Civic improvement includes the enhancement in value or quality of community or civic life. An example would be an association that works for the advancement of a community by encouraging the establishment of new industries, parks, museums, etc. Under the categories of social welfare and civic improvement, care must be taken to ensure that the purposes of the association are not those of a charity.

Pleasure or recreation means that which provides a state of gratification or a means of refreshment or diversion. Examples include social clubs, golf clubs, curling clubs, badminton clubs and so on that are organized and operated to provide recreational facilities for the enjoyment of members and their families.

The phrase **any other purpose except profit** is interpreted as a catch-all for other associations that are organized and operated for other than commercial or financial reasons.

An association may be considered to be organized and operated for any other purpose except profit if its aims and activities are directed toward the general improvement of conditions within one or more areas of business. An example of this would be where an association was organized to advance the educational standards within a particular industry or profession, to publicize, improve and promote the association's objectives in a general way and to encourage the exchange of relevant technical information. If the activities of such an organization were consistent with these aims, then it would qualify for exemption provided all other conditions of paragraph 149(1)(f) were complied with in the year.

An association will probably not qualify as a tax-exempt NPO if it is **primarily involved**, for example, in an activity that is directly connected with the sales of members' goods or services and for such services receives a fee or commission computed in relation to sales promoted. Such an association is normally considered to be an extension of the members' sales organizations and will be considered to be carrying on a normal commercial operation.

Although a non-profit organization must also be operated exclusively for non-profit purposes, it may carry on some commercial activities provided the activities are only **ancillary** to its purposes. In *Gull Bay Development Corporation v. The Queen*⁵ the court upheld the exempt status of a non-profit corporation even though part of the corporation's activities included the establishment of a viable commercial logging operation to provide employment for members of the reserve.

⁵ [1984] C.T.C. 159 (F.C.T.D.).

The Court noted that the corporation itself was actively engaged in improving the social conditions on the reserve, and its employees spent more than 50 per cent of their time on these activities, and the profits from logging were used to improve the social conditions on the reserve.

3. Tax Exemption #3- A Public Body Performing a Function of Government in Canada

Income earned by a First Nation qualifying as a public body performing a function of government in Canada is tax exempt under s. 149(1)(c) of the *Income Tax Act*. Income is exempt whether it is earned on or off Reserve.

Canada Revenue Agency's (CRA) position is that if a band has passed significant bylaws under ss. 81 and 83 of the *Indian Act* it will be considered a public body performing the function of government.

The CRA has also accepted the characterization where a band demonstrates that it performs functions and provides services in a manner generally exhibited by a government. Examples of such activities would be if the band has been involved in negotiating land treaties or has negotiated a settlement agreement with Canada, or if the band provides community, health, safety, and education services to its members.

How to Take Advantage of Tax Exemption #3

The first step in taking advantage of this tax exemption is a legal review to determine whether the First Nation has reached an advanced stage of development as a public body performing a function of government.

If a legal review determines that it is likely that the First Nation has reached an advanced stage of development, the second step would be to apply to CRA for an advanced ruling on whether the First Nation qualifies for this exemption.

This is a significant and important tax exemption, especially when used with the LP structure described above. The LP provides liability protection and both on and off-Reserve income may be flowed through tax-exempt to the First Nation.

4. Tax Exemption #4 – Corporation Owned by a Public Body Performing a Function of Government

On February 27, 2004, the Minister of Finance released a revised package of draft technical amendments to the *Income Tax Act*, including an amendment to the exemption in s.149(1)(d.5) for income earned by municipal corporations.

The amendment extends the exemption to include any corporation, commission or association at least 90% of the capital of which was owned by one or more entities each of which is a municipal or public body performing a function of government in Canada, which is consistent with the bodies described in paragraph 149(1)(c) of the Act.

This is a significant exemption for bands which qualify under s.149(c), as a corporation owned by the band earning 90% or more of its income on reserve would be exempt from income tax even if operated for a profit.

It is expected that the draft technical amendments will come into force sometime in Spring of 2007. The amendments will be retroactive to May 8, 2000.

5. A Note about Tax Receipts for Gifts and Donations to Public Bodies Performing a Function of Government

Municipalities are eligible to issue tax receipts for gifts and donations under s. 110.1(1) and s. 118.1 of the *Income Tax Act*.

The February 2004 draft technical amendments to the *Income Tax Act* proposed to expand the list of “qualified donees” (found in 149.1(1)) for sections 110.1 and 118.1 to include municipal or public bodies performing a function of government in Canada.

Once these amendments are passed into law, the CRA will again formally recognize certain bands which are public bodies performing a function of government as qualified donees under the *Income Tax Act*. The proposed amendments will apply retroactively to gifts made after May 8, 2000.

Although the amendments are not yet in force, given the intent of the Department of Finance to make these amendments retroactive, it is the CRA’s administrative position that a band that would, under the proposed legislation, be considered to be a public body performing a function of government may **now** issue official donation receipts to donors for gifts that it receives.⁶

If a First Nation is deemed to be a public body performing the function of government by CRA, it will be able to issue official receipts to donors for gifts it receives, without being registered as a charity.

There are no restrictions in the *Income Tax Act* on the use of donations by qualifying First Nations. This exemption may be particularly useful for raising funds from the public and private sectors to protect sacred sites, cultural resources, or to encourage the donation of lands within traditional territories.

As well, it is important to note that CRA is now allowing registered charities to donate to qualifying First Nations.⁷ This may expand fund-raising opportunities for qualifying First Nations significantly.

⁶ CRA Registered Charities Newsletter No. 2005. Online: <http://www.cra-arc.gc.ca/E/pub/tg/charitiesnews-24/charitiesnews-24-e.html>

⁷ Ibid.